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Accounting Committee Meeting

Wednesday, March 30th
3pm – 4:30pm
Marriott Marquis, Washington DC

Moderator:
Chris Drula, VP-Financial Standards, NAREIT

Panelists:
Glenn Cohen, EVP-CFO & Treasurer, Kimco Realty Corp.
Keri Shea, SVP-Finance & Treasurer, AvalonBay Communities, Inc.
Stephen Theriot, CFO, Vornado Realty Trust

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REITS: BUILDING DIVIDENDS AND DIVERSIFICATION®

ACCOUNTING COMMITTEE MEETING
(Open to all REITWise® Registrants)
Marriott Marquis Washington, DC
Room TBD
Washington, D.C.
Wednesday, March 30, 2016
3:00 p.m. – 4:30 p.m.

Co-Chairs:

Glenn G. Cohen, EVP – CFO & Treasurer, Kimco Realty Corporation
Keri A. Shea, SVP, Finance & Treasurer, AvalonBay Communities, Inc.
Stephen W. Theriot, CFO, Vornado Realty Trust

NAREIT Staff Liaisons:

George Yungmann, SVP Financial Standards
Christopher T. Drula, VP Financial Standards

I. **Update on SASB Standard Setting**
Tom Riesenberg, Consultant to SASB

II. **State of Real Estate Non-GAAP Reporting**
- NAREIT Funds from Operations (FFO)
- Net Operating Income (NOI)

III. **FASB *Financial Performance Reporting* Research Project**
Kirk Rogers, Partner, Grant Thornton LLP

IV. **FASB *Financial Instruments – Recognition and Measurement* Standard**
Chris Merchant, Partner, PwC

V. **FASB *Financial Instruments – Credit Losses* Standard**
Daniel Goerlich, Director, PwC

Note: This meeting may qualify for 1.5 hours of continuing professional education credits, depending on the state. For CLE or CPE credit information, please contact Afia Nyarko at 202-739-9433 or anyarko@nareit.com.

Deloitte.

Accounting Journal Entry

Financial Instruments — FASB Makes Tentative Decisions About Purchased Credit-Impaired Assets

April 23, 2015 — At its meeting yesterday, the FASB discussed (1) the definition of a purchased credit-impaired (PCI) asset and (2) assets acquired in a business combination. Specifically, the Board tentatively decided to revise the definition of a PCI asset[1] such that an entity would be required to apply the gross-up approach[2] to an asset for which there has been a "more than insignificant" deterioration in credit quality since origination. In addition, the Board reaffirmed the proposed ASU's[3] requirement under which an entity would use the gross-up approach to account for PCI assets acquired in a business combination.

Editor's Note: The Board chose to revise the definition of a PCI asset partially in response to continued stakeholder feedback suggesting that if an entity were to recognize expected credit losses in its income statement upon purchase of any asset, regardless of the level of credit deterioration in the asset's credit quality since origination, the entity would be "double-counting" expected credit losses on that asset because those losses were already contemplated in the purchase price. Although the Board decided not to require an entity to apply the gross-up approach to all acquired assets, stakeholders are likely to support the change to the definition of a PCI asset because an entity is likely to apply the gross-up approach to more assets than it would have under the proposed ASU's requirements. The Board also indicated at the meeting that the final standard will include implementation guidance to help entities assess whether there has been a "more than insignificant" deterioration in a purchased asset's credit quality since origination.

The Board tentatively decided to require an entity to apply the gross-up approach to assets acquired in a business combination that are determined to be PCI assets because the Board believes that in the measurement of expected credit losses, there is no inherent difference between PCI assets acquired in a business combination and those acquired outside of one. Consequently, an entity would continue to account for non-PCI assets acquired in a business combination in accordance with existing U.S. GAAP. That is, for non-PCI assets acquired in a business combination, an entity would measure the assets at fair value upon acquisition and would be prohibited from recognizing a separate valuation allowance for those assets.

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1 The proposed ASU defines PCI assets as "[a]cquired individual assets (or acquired groups of financial assets with shared risk characteristics at the date of acquisition) that have experienced a significant deterioration in credit quality since origination."

2 Under the gross-up approach, an entity would recognize its initial expectation of credit losses on PCI assets as an allowance for expected credit losses with an adjustment that increases the cost basis of the asset. As a result of applying this approach, the entity avoids immediately recognizing expected credit losses in its income statement upon acquiring the asset. For more information about the gross-up approach, see Deloitte's March 13, 2015, *Heads Up*.

3 FASB Proposed Accounting Standards Update, *Financial Instruments — Credit Losses*.

Deloitte.

January 12, 2016
Volume 23, Issue 1

Heads Up

Targeted Therapy
FASB Amends Guidance on Classification and Measurement of Financial Instruments

by Jamie Davis and Shahid Shah, Deloitte & Touche LLP

Introduction

On January 5, 2016, the FASB issued ASU 2016-01,[1] which amends the guidance in U.S. GAAP on the classification and measurement of financial instruments. Although the ASU retains many current requirements, it significantly revises an entity's accounting related to (1) the classification and measurement of investments in equity securities and (2) the presentation of certain fair value changes for financial liabilities measured at fair value. The ASU also amends certain disclosure requirements associated with the fair value of financial instruments.

This *Heads Up* provides a comprehensive summary of the FASB's changes to its classification and measurement model for financial instruments. In addition, the appendix to this *Heads Up* compares the classification and measurement models under current U.S. GAAP, the ASU, and IFRS 9 (2014).[2]

Editor's Note: Although the FASB and IASB had been working to converge their respective classification and measurement models (see the FASB's February 2013 exposure draft), after performing stakeholder outreach and a cost-benefit analysis, the FASB ultimately decided to make only limited changes to existing U.S. GAAP. Consequently, the ASU's amendments do not achieve convergence with IFRSs. The IASB's final guidance on this topic was issued in July 2014 in the form of amendments to IFRS 9 (see Deloitte's August 8, 2014, *Heads Up* for more information about the amendments to IFRS 9 (2014)).

Summary of Changes to U.S. GAAP on Classification and Measurement

Key changes as a result of the ASU are discussed below.

Classification and Measurement of Equity Investments

The ASU requires entities to carry all investments in equity securities, including other ownership interests such as partnerships, unincorporated joint ventures, and limited liability companies, at fair value through net income (FVTNI). This requirement does not apply to investments that qualify for the equity method

[1] FASB Accounting Standards Update No. 2016-01, *Recognition and Measurement of Financial Assets and Financial Liabilities*.
[2] IFRS 9, *Financial Instruments* (revised 2014).

of accounting or to those that result in consolidation of the investee or for which the entity has elected the practicability exception to fair value measurement (as discussed below).

Editor's Note: Under current U.S. GAAP, marketable equity securities other than (1) equity method investments (those for which the investor has significant influence over the investee) or (2) those that result in consolidation of the investee are classified as either held for trading or available for sale (AFS). For AFS equity securities, any amounts in accumulated other comprehensive income (OCI) are recycled to net income upon sale or an other-than-temporary impairment. Investments in nonmarketable equity securities other than equity method investments or those that result in consolidation of the investee are measured at cost (less impairment) unless the fair value option has been elected. Because equity securities would no longer be accounted for as AFS securities or by using the cost method, entities that hold such equity investments could see significant volatility in earnings. For instance, this new requirement would significantly affect certain types of mutual funds (e.g., bond funds and fixed-income funds) that are currently accounted for as AFS securities. According to ASC 320-10-55-9,[3] a mutual fund is considered an equity security even if it invests only in U.S. government debt securities. Consequently, investments in bond funds and fixed-income mutual funds are considered equity securities and must be accounted for at FVTNI under the ASU.

For investments in equity securities without a readily determinable fair value that do not qualify for the net asset value (NAV) practical expedient in ASC 820-10-35-59, an entity is permitted to elect a practicability exception to fair value measurement, under which the investment will be measured at cost, less impairment, plus or minus observable price changes (in orderly transactions) of an identical or similar investment of the same issuer. The ASU clarifies that when identifying observable price changes, an entity should consider relevant transactions "that are known or can reasonably be known" and that an entity is not required to spend undue cost and effort to identify such transactions. The ASU also indicates that an entity should consider a security's rights and obligations, such as voting rights, distribution rights and preferences, and conversion features, when evaluating whether the security issued by the same issuer is similar to the equity security held by the entity.

The practicability exception is not available to (1) reporting entities that are investment companies, (2) broker-dealers in securities, or (3) postretirement benefit plans.

Editor's Note: Entities that elect the practicability exception would still need to assess the equity investment for impairment (see discussion below).

Furthermore, investments in Federal Home Loan Bank (FHLB) and Federal Reserve Bank (FRB) stock issued to member financial institutions are not subject to this guidance. Instead, FHLB and FRB stock would continue to be accounted for at cost less impairment under ASC 942-325-35-3. The ASU's impairment guidance on equity investments for which fair value is not readily determinable also does not apply to FHLB or FRB stock.

[3] For titles of *FASB Accounting Standards Codification* (ASC) references, see Deloitte's "Titles of Topics and Subtopics in the *FASB Accounting Standards Codification*."

Impairment Assessment of Equity Investments Without Readily Determinable Fair Values That Are Measured by Using the Practicability Exception

In an effort to simplify the impairment model for equity securities for which an entity has elected the practicability exception, the FASB eliminated the requirement in U.S. GAAP to assess whether an impairment of such an investment is other than temporary. Under the new guidance, as of each reporting period, an entity will qualitatively consider the following indicators (from ASC 321-10-35-3, which was added by the ASU) to determine whether the investment is impaired:

a. A significant deterioration in the earnings performance, credit rating, asset quality, or business prospects of the investee
b. A significant adverse change in the regulatory, economic, or technological environment of the investee
c. A significant adverse change in the general market condition of either the geographical area or the industry in which the investee operates
d. A bona fide offer to purchase, an offer by the investee to sell, or a completed auction process for the same or similar investment for an amount less than the carrying amount of that investment
e. Factors that raise significant concerns about the investee's ability to continue as a going concern, such as negative cash flows from operations, working capital deficiencies, or noncompliance with statutory capital requirements or debt covenants.

If it determines that the equity security is impaired on the basis of the qualitative assessment, the entity will recognize an impairment loss equal to the amount by which the security's carrying amount exceeds its fair value. By contrast, the current guidance in ASC 320-10-35-30 requires an entity to perform a two-step assessment under which it first determines whether an equity security is impaired and then evaluates whether any impairment is other than temporary.

Presentation of Fair Value Changes Attributable to Instrument-Specific Credit Risk for Fair Value Option Liabilities

The ASU establishes an incremental recognition and disclosure requirement related to the presentation of fair value changes of financial liabilities for which the fair value option has been elected. Under this guidance, an entity would be required to separately present in OCI the portion of the total fair value change attributable to instrument-specific credit risk as opposed to reflecting the entire amount in earnings. For derivative liabilities, however, any changes in fair value attributable to instrument-specific credit risk would continue to be presented in net income, which is consistent with current U.S. GAAP. This new requirement to separately present in OCI the portion of the total fair value change attributable to instrument-specific credit risk does not apply to financial liabilities of consolidated collateralized financing entities that are measured in accordance with ASC 810-10-30-10 through 30-15 and ASC 810-10-35-6 through 35-8.

An entity would measure the portion of the change in fair value attributable to instrument-specific credit risk as the excess of total change in fair value over the change in fair value that results from a change in a base market risk, such as a risk-free interest rate or a benchmark interest rate. Alternatively, an entity would be permitted to use another method that it considers to more faithfully represent the portion of the total change in fair value resulting from a change in instrument-specific credit risk. In either case, the entity would disclose the method it used to determine the gains and losses attributable to instrument-specific credit risk and would be required to apply the method consistently from period to period.

Any accumulated gains or losses reflected in OCI as a result of this provision would be recognized through earnings once the financial liability is derecognized.

Editor's Note: During the financial crisis of 2008, many stakeholders expressed concerns about the counterintuitive impact on earnings of recording changes in the fair value of financial liabilities when such changes are related to an entity's own debt for which the fair value option had been elected.

Under U.S. GAAP today, for financial liabilities measured at fair value, an entity would recognize a gain in earnings when there is an increase in instrument-specific credit risk or a loss when there is a decrease in instrument-specific credit risk. The new guidance aims to eliminate this counterintuitive result by requiring entities to present in OCI changes in fair value that result from changes in an entity's own credit risk.

As discussed in more detail below in the Effective Date and Early Adoption section, entities are permitted to early adopt this provision of the ASU for financial statements that have not yet been issued.

Valuation Allowance on a Deferred Tax Asset Related to an AFS Debt Security

The new guidance eliminates the diversity in practice related to the evaluation of the need for a valuation allowance for deferred tax assets (DTAs) related to debt securities that are classified as AFS. Under current U.S. GAAP, entities may perform this evaluation either separately from their other DTAs or in combination with them. The new guidance clarifies that an entity should "evaluate the need for a valuation allowance on a [DTA] related to [AFS] securities in combination with the entity's other [DTAs]."

Editor's Note: When a financial instrument is measured at fair value, the tax basis of that instrument is not usually affected. This causes a temporary difference between the tax basis and financial reporting basis of an investment, thereby creating a DTA or DTL pursuant to ASC 740. Historically, some entities have evaluated the need for a valuation allowance on DTAs associated with AFS debt securities separately from other DTAs. The revised guidance clarifies that such separate evaluation is not permitted.

Disclosure Requirements

Summarized below are some of the ASU's notable changes related to disclosures.

Amendments to Disclosures in ASC 825

For financial instruments not recognized at fair value in the statement of financial position, the ASU specifies that:

- Entities that do not meet the definition of a public business entity (PBE) are no longer required to provide the disclosures[4] in ASC 825-10-50 about fair value.
- PBEs are no longer required to disclose the information in ASC 825-10-50-10(b) and (c) related to (1) the methods and significant assumptions they used to estimate fair value or (2) a description of the changes in the methods and significant assumptions they used to estimate fair value.

[4] Before ASU 2016-01's amendments, ASC 825-10-50-10 states that "a reporting entity shall disclose all of the following:

a. Either in the body of the financial statements or in the accompanying notes, the fair value of financial instruments for which it is practicable to estimate that value
b. The method(s) and significant assumptions used to estimate the fair value of financial instruments consistent with the requirements of paragraph 820-10-50-2(bbb) except that a reporting entity is not required to provide the quantitative disclosures . . . by that paragraph
c. A description of the changes in the method(s) and significant assumptions used to estimate the fair value of financial instruments, if any, during the period
d. The level of the fair value hierarchy within which the fair value measurements are categorized in their entirety (Level 1, 2, or 3)."

However, the ASU retains the current requirements in U.S. GAAP for PBEs to provide fair value information about (1) financial instruments not recognized at fair value in the statement of financial position either in the body of the financial statement or in accompanying notes and (2) the level of the fair value measurement hierarchy in which financial instruments are classified (i.e., Level 1, Level 2, or Level 3).

Editor's Note: The option permitting entities to omit ASC 825-10-50 fair value disclosures if it is not "practicable to estimate fair value" has been eliminated.

The ASU also clarifies U.S. GAAP by eliminating the guidance in ASC 825 that had been interpreted to permit an "entry" price notion for estimating the fair value of loans for disclosure purposes. The amendments instead require a PBE to disclose the fair value, in accordance with the "exit" price notion in ASC 820, of financial assets and financial liabilities measured at amortized cost, except for (1) receivables and payables due within one year or less; (2) equity investments for which the practicability exception is applied; and (3) deposit liabilities with no defined or contractual maturities.

Editor's Note: Practitioners may have interpreted the current illustrative guidance in ASC 825-10-55-3 to allow entities to disclose the fair value of loans on the basis of an "entry" price notion. The ASU's requirement to disclose fair value on the basis of an "exit" price notion may represent a major shift for some entities that have continued to disclose the fair value of loans on the basis of entry price. The new guidance was intended to achieve greater consistency and comparability related to fair value measurements for financial statement users.

The ASU also requires all entities to disclose either on the balance sheet or in the notes to the financial statements all financial assets and financial liabilities grouped by (1) measurement category (i.e., amortized cost or fair value — net income or OCI) and (2) form of financial asset (i.e., securities and loans/receivables).

Equity Investments Without Readily Determinable Fair Values

The new guidance requires entities that have elected the practicability exception to fair value measurement (discussed above) to disclose (1) the carrying amount of investments without readily determinable fair values, (2) the amount of the adjustment (either upward or downward) made to the carrying amount due to observable price changes, (3) any impairment charge during the reporting period, and (4) additional information to help users understand the information the entity considered in determining the quantitative information disclosed in items (1) through (3).

Effective Date and Early Adoption

For PBEs, the new standard is effective for fiscal years and interim periods within those fiscal years beginning after December 15, 2017. For all other entities, including not-for-profit entities and employee benefit plans within the scope of ASC 960 through ASC 965 on plan accounting, the effective date is in line with the recommendation of the private-company decision-making framework — that is, the guidance is effective for fiscal years beginning one year after the effective date for PBEs (i.e., December 15, 2018) and interim reporting periods within fiscal years beginning two years after the PBE effective date (i.e., December 15, 2019).

Early adoption is permitted for all entities whose financial statements have not yet been issued or have not been made available for issuance with respect to the following changes made to ASC 825:

- For financial liabilities measured under the fair value option, fair value changes resulting from a change in instrument-specific credit risk would be presented separately in other comprehensive income.
- The fair value disclosure requirements for financial instruments not recognized at fair value would be eliminated for non-PBEs.

Early adoption of other provisions is not permitted for PBEs. Non-PBEs are permitted to early adopt the new standard when it becomes effective for PBEs (i.e., fiscal years beginning after December 15, 2017, including interim periods therein).

To adopt the amendments, entities will be required to make a cumulative-effect adjustment to beginning retained earnings as of the beginning of the fiscal year in which the guidance is effective, with the exception of the following:

- Guidance (including disclosure requirements) on equity securities without readily determinable fair values will be applied prospectively to all equity investments that exist as of the date of adoption.
- Guidance consistent with ASC 820 on using the exit price notion to measure the fair value of financial instruments for disclosure purposes will be applied prospectively. If information is no longer comparable as a result of adopting the guidance, entities will be required to disclose that fact.

Appendix — Comparison of Classification and Measurement Models

The table below compares the classification and measurement models under current U.S. GAAP, the ASU, and IFRS 9 (2014).

Subject	Current U.S. GAAP	ASU 2016-01	IFRS 9 (2014)
Classification and measurement categories for financial assets other than equity investments	Under ASC 320, three categories are used to classify and measure investments in securities: • Trading (FVTNI). • AFS (FVTOCI). • Held to maturity (amortized cost). Under ASC 310, two categories are used to classify and measure loans: • Held for investment (amortized cost). • Held for sale (lower of cost or fair value).	No changes.	Three categories are used: • Amortized cost. • Fair value through other comprehensive income (FVTOCI). • Fair value through profit or loss (FVTPL).
Classification and measurement categories for equity investments	Under ASC 320, marketable equity securities other than equity method investments (those for which the investor has significant influence over the investee) or those that result in consolidation of the investee are classified as either held for trading (FVTNI) or AFS (FVTOCI). For AFS equity securities, any amounts in accumulated OCI are recycled to net income upon sale or when the security becomes other than temporarily impaired. Investments in nonmarketable equity securities other than equity method investments are measured at cost (less impairment) unless the fair value option has been elected.	Under ASC 321, entities will carry all investments in equity securities that do not qualify for equity method accounting or result in consolidation of the investee at FVTNI. For equity investments that do not have a readily determinable fair value, entities are permitted to elect a practicability exception and measure the investment at cost less impairment plus or minus observable price changes (in orderly transactions). The exception would not be available to investment companies, broker-dealers, defined benefit plans, and investors in equity investments that apply the NAV practical expedient under ASC 820-10-35-59.	Equity investments other than equity method investments or those that result in consolidation of the investee are accounted for at FVTPL with an option to irrevocably designate equity investments that are not held for trading at FVTOCI at initial recognition. For FVTOCI equity investments, any amounts in accumulated OCI are not transferred to profit or loss, even if the investment is sold or impaired. In limited circumstances, "cost may be an appropriate estimate of fair value."
Classification and measurement categories for financial liabilities	Nonderivative financial liabilities (primarily an entity's own debt) are accounted for at amortized cost unless the fair value option is elected. Derivative financial liabilities and short-sale obligations are measured at fair value.	No changes, except for the presentation of certain fair value changes for fair value option liabilities (see below).	Financial liabilities are carried at amortized cost, except for derivative and trading liabilities and those designated under the fair value option (see below).
Method for classifying financial assets	For securities, the classification depends on whether the entity holds the security for trading or has the intent and ability to hold it to maturity. For loans, the classification depends on whether the entity intends to hold the loan to maturity or for the foreseeable future.	No changes.	The classification is based on both the entity's business model for managing the financial assets and the contractual cash flow characteristics of the financial asset.
Criteria for carrying financial assets at amortized cost	The following financial assets are carried at amortized cost: • Debt securities that the entity has the positive intent and ability to hold to maturity. • Loans that the entity has the intent and ability to hold to maturity or for the foreseeable future.	No changes.	Financial assets are carried at amortized cost if they satisfy both of the following criteria: • They meet the cash flow characteristics criterion (i.e., solely payments of principal and interest). • They are held in a business model whose objective is to hold assets for the collection of contractual cash.

Subject	Current U.S. GAAP	ASU 2016-01	IFRS 9 (2014)
Criteria for measuring financial assets other than equity investments at FVTOCI	The following financial assets other than equity investments are measured at FVTOCI: • Investments in debt securities that are not classified as either trading or held to maturity. • Loans not classified as held for trading if the investor is contractually at risk of not recovering substantially all of its initially recorded investment.	No changes.	Financial assets other than equity investments are measured at FVTOCI if they satisfy both of the following criteria: • They meet the cash flow characteristics criterion. • They are held in a business model in which assets are managed both to collect contractual cash flows and for sale.
Criteria for measuring financial assets other than equity investments at FVTNI (or FVTPL)	The following financial assets other than equity investments are measured at FVTNI: • Debt securities bought and held principally for trading. • Loans bought and held principally for trading if the investor is contractually at risk of not recovering substantially all of its initially recorded investment. • Financial assets elected under the fair value option (see below).	No changes.	The following financial assets other than equity investments are measured at FVTPL: • Financial assets that fail to qualify for either amortized cost or FVTOCI. • Financial assets designated under the fair value option (see below).
Criteria for measuring financial assets at the lower of cost or fair value	Loans held for sale.	No changes.	Not applicable.
Unrealized foreign currency gains and losses on financial assets accounted for at FVTOCI	For AFS debt securities, unrealized foreign currency gains and losses are deferred in OCI in a manner similar to how other unrealized gains and losses are deferred.	No changes.	Unrealized foreign currency gains and losses on nonequity investments accounted for at FVTOCI are recognized in profit or loss.
Hybrid financial assets	Embedded derivatives in hybrid financial assets are bifurcated and accounted for separately at FVTNI when certain conditions are met.	No changes.	Measured and classified in their entirety in accordance with their contractual cash flow characteristics and the business model under which they are managed. Bifurcation of embedded derivatives in hybrid financial assets is prohibited.
Fair value option — qualifying conditions	For financial instruments within the scope of the guidance, qualifying conditions need not be met before the fair value option may be elected.	No changes.	The fair value option may be elected only if qualifying conditions are met. For a financial asset, the option may be elected if exercising it would eliminate or significantly reduce an accounting mismatch. For a financial liability, the option may be elected if either of the following applies: • Exercising the option would eliminate or significantly reduce an accounting mismatch. • A "group of financial liabilities or [a group of] financial assets and financial liabilities is managed and its performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy, and information about the group is provided internally on that basis to the entity's key management personnel." In addition, the fair value option may be elected for a hybrid financial liability unless either of the following applies: • The embedded derivative or derivatives do not "significantly modify the cash flows that otherwise would be required by the contract." • "[I]t is clear with little or no analysis when a similar hybrid instrument is first considered that separation of the embedded derivative(s) is prohibited."

Subject	Current U.S. GAAP	ASU 2016-01	IFRS 9 (2014)
Presentation of fair value changes attributable to instrument-specific credit risk for financial liabilities designated under the fair value option	There are no similar requirements under current U.S. GAAP.	The portion of the total fair value change caused by a change in instrument-specific credit risk is recognized in OCI. Any accumulated amount remaining in OCI is reclassified to earnings when the liability is extinguished.	The portion of the total fair value change caused by a change in the liability's credit risk is recognized in OCI unless such treatment would create or enlarge an accounting mismatch in profit or loss. This amount is not subsequently transferred to profit or loss.
Reclassification of financial assets other than equity investments	Reclassification is permitted in certain circumstances. Transfers from the held-to-maturity category and transfers into or out of the trading category are expected to be rare.	No changes.	Reclassification is required if the business model changes and would be recorded as of the first day of the period after the period in which the business model changes.

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March 13, 2015
Volume 22, Issue 7

Heads Up

In This Issue:

We've Been Expecting You

FASB Finalizing Credit Impairment Guidance

by Abhinetri Velanand, Anthony Mosco, and Stephen McKinney, Deloitte & Touche LLP

The FASB is currently finalizing amendments to its guidance on the impairment of financial instruments. The proposed amendments would introduce a new impairment model[1] based on expected losses rather than incurred losses. Under this current expected credit loss (CECL) model, an entity would recognize as an allowance its estimate of the contractual cash flows not *expected* to be collected. The FASB believes that the CECL model will result in more timely recognition of credit losses and will reduce the complexity of U.S. GAAP by decreasing the number of credit impairment models used to account for debt instruments.[2]

This *Heads Up* provides a comprehensive summary of the FASB's proposed changes to the credit impairment guidance under current U.S. GAAP, which are reflected in the Board's December 2012 proposed ASU[3] and subsequent tentative decisions.[4] In addition, this newsletter contains several appendixes. Appendix A compares the impairment models under current U.S. GAAP, the FASB's tentative approach, and the IASB's recently amended IFRS 9, respectively. Appendix B gives an overview of the existing impairment models under U.S. GAAP for loans and debt securities. Appendix C and Appendix D provide illustrative examples of how an entity might apply the CECL model to purchased credit-impaired (PCI) assets and trade receivables, respectively.

Editor's Note: Although the FASB has completed nearly all significant redeliberations and its staff has begun drafting a final ASU, the Board has yet to discuss the effective date of its proposed amendments to the current guidance on accounting for credit losses. A final standard is likely to be issued in the second half of this year.

The CECL Model

Scope

The CECL model would apply to most[5] debt instruments (other than those measured at fair value through net income (FVTNI)), trade receivables, lease receivables, reinsurance receivables that result from

[1] Although impairment began as a joint FASB and IASB project, constituent feedback on the boards' "dual-measurement" approach led the FASB to develop its own impairment model. The IASB, however, continued to develop the dual-measurement approach and issued final impairment guidance based on it as part of the July 2014 amendments to IFRS 9. For more information about the IASB's impairment model, see Deloitte's August 8, 2014, *Heads Up*.

[2] Note that the proposed CECL model would replace or amend several existing U.S. GAAP impairment models. See Appendix B for a tabular summary of those models.

[3] FASB Proposed Accounting Standards Update, *Financial Instruments — Credit Losses*.

[4] Decisions are as of the FASB's March 11, 2015, meeting. Although the Board has nearly completed its deliberations in the project, the guidance in the final ASU may differ from that in the tentative decisions as a result of changes made during the finalization process.

[5] The CECL model would not apply to the following debt instruments:
- Loans made to participants by defined contribution employee benefit plans.
- Policy loan receivables of an insurance entity.
- Pledge receivables (promises to give) of a not-for-profit entity.
- Loans and receivables between entities under common control.

insurance transactions, financial guarantee contracts,[6] and loan commitments. However, available-for-sale (AFS) debt securities would be excluded from the model's scope and would continue to be assessed for impairment under ASC 320[7] (the FASB has proposed limited changes to the impairment model for AFS debt securities, as discussed below).

Recognition of Expected Credit Losses

Unlike the incurred loss models in existing U.S. GAAP, the CECL model does not specify a threshold for the recognition of an impairment allowance. Rather, an entity would recognize an impairment allowance equal to the current estimate of expected credit losses (i.e., all contractual cash flows that the entity does not expect to collect) for financial assets as of the end of the reporting period. Credit impairment would be recognized as an allowance — or contra-asset — rather than as a direct write-down of the amortized cost basis of a financial asset. However, the carrying amount of a financial asset that is deemed uncollectible would be written off in a manner consistent with existing U.S. GAAP.

Editor's Note: Because the CECL model does not have a minimum threshold for recognition of impairment losses, entities will need to measure expected credit losses on assets that have a low risk of loss (e.g., investment-grade held-to-maturity (HTM) debt securities). However, the FASB tentatively decided that an "entity would not be required to recognize a loss on a financial asset in which the risk of nonpayment is greater than zero [but] the amount of loss would be zero."[8] U.S. Treasury securities and certain highly rated debt securities may be assets the FASB contemplated when it tentatively decided to allow an entity to recognize zero credit losses on an asset, but the Board decided not to specify the exact types of assets. Nevertheless, the requirement to measure expected credit losses on financial assets whose risk of loss is low is likely to result in additional costs and complexity.

Measurement of Expected Credit Losses

Under the proposed amendments, an entity's estimate of expected credit losses represents all contractual cash flows that the entity does not expect to collect over the contractual life of the financial asset. When determining the contractual life of a financial asset, the entity would consider expected prepayments but would not be allowed to consider expected extensions unless it "reasonably expects that it will execute a troubled debt restructuring with the borrower."[9]

The entity would consider all available relevant information in making the estimate, including information about past events, current conditions, and reasonable and supportable forecasts and their implications for expected credit losses. That is, while the entity would be able to use historical charge-off rates as a starting point in determining expected credit losses, it would have to evaluate how conditions that existed during the historical charge-off period differ from its current expectations and accordingly revise its estimate of expected credit losses. However, the entity would not be required to forecast conditions over the contractual life of the asset. Rather, for the period beyond the period for which the entity can make reasonable and supportable forecasts, the entity would revert to an unadjusted historical credit loss experience.

Editor's Note: Measuring expected credit losses will most likely be a significant challenge for all entities, particularly financial institutions. As a result of moving to an expected loss model, entities could incur one-time and recurring costs when estimating expected credit losses, some of which may be related to system changes and data collection. While the costs associated with implementing the CECL model will vary by entity, nearly all entities will incur some costs when using forward-looking information to estimate expected credit losses over the contractual life of an asset.

[6] The CECL model would not apply to financial guarantee contracts that are accounted for as insurance or measured at FVTNI.

[7] For titles of *FASB Accounting Standards Codification* (ASC) references, see Deloitte's "Titles of Topics and Subtopics in the *FASB Accounting Standards Codification*."

[8] Quoted text is from the FASB's summary of tentative Board decisions reached at the joint meeting of the FASB and IASB on September 17, 2013.

[9] Quoted text is from the FASB's summary of tentative Board decisions reached at its September 3, 2014, meeting.

Unit of Account

The CECL model would not prescribe a unit of account (e.g., an individual asset or a group of financial assets) in the measurement of expected credit losses. However, an entity would be required to evaluate financial assets within the scope of the model on a collective (i.e., pool) basis when similar risk characteristics are shared. If a financial asset does not share similar risk characteristics with the entity's other financial assets, the entity would evaluate the financial asset individually. If the financial asset is individually evaluated for expected credit losses, the entity would not be allowed to ignore available external information such as credit ratings and other credit loss statistics.

Editor's Note: The FASB's tentative decisions would require an entity to collectively measure expected credit losses on financial assets that share similar risk characteristics (including HTM securities). While the concept of pooling and collective evaluation currently exists in U.S. GAAP for certain loans, the FASB has not specifically defined "similar risk characteristics." As a result, it remains to be seen whether the FASB expects an aggregation based on "similar risk characteristics" to be consistent with the existing practice of pooling PCI assets on the basis of "common risk characteristics." Entities may need to make changes to systems and processes to capture loss data at more granular levels depending on the expectations of market participants such as standard setters, regulators, and auditors.

Practical Expedients for Measuring Expected Credit Losses

The FASB tentatively decided to permit entities to use practical expedients when measuring expected credit losses for two types of financial assets:

- *Collateral-dependent financial assets* — In a manner consistent with existing U.S. GAAP, an entity would be allowed to measure its estimate of expected credit losses for collateral-dependent financial assets as the difference between the financial asset's amortized cost and the collateral's fair value (adjusted for selling costs, when applicable).
- *Financial assets for which the borrower must continually adjust the amount of securing collateral (e.g., certain repurchase agreements and securities lending arrangements)* — The estimate of expected credit losses would be measured consistently with how it is measured for other financial assets within the scope of the CECL model but would be limited to the difference between the amortized cost basis of the asset and the collateral's fair value (adjusted for selling costs, when applicable).

Write-Offs

Under the proposed ASU, an entity would write off a financial asset if it determines that it has no reasonable expectation of future recovery. However, in light of stakeholders' concerns that the proposed requirement could conflict with regulatory guidance and may result in entities' recognizing write-offs significantly later than under current practice, the FASB tentatively agreed to retain the write-off requirements in existing U.S. GAAP. That is, an entity would write off the carrying amount of a financial asset when the asset is deemed uncollectible. The Board also tentatively decided that this write-off guidance would apply to AFS debt securities.

AFS Debt Securities

Under the proposed ASU, the CECL model would have applied to AFS debt securities. However, during redeliberations, the FASB tentatively decided not to include AFS debt securities within the scope of the CECL model. Instead, the impairment of AFS debt securities would continue to be accounted for under ASC 320. However, the FASB tentatively decided to revise ASC 320 by:

- Requiring an entity to use an allowance approach (vs. permanently writing down the security's cost basis).
- Removing the requirement that an entity must consider the length of time fair value has been less than amortized cost when assessing whether a security is other-than-temporarily impaired.
- Removing the requirement that an entity must consider recoveries in fair value after the balance sheet date when assessing whether a credit loss exists.

Editor's Note: The Board did not revise (1) step 1 of the existing other-than-temporary impairment model (i.e., an "investment is impaired if the fair value of the investment is less than its cost") and (2) the requirement under ASC 320 that entities recognize the impairment amount only related to credit in net income and the noncredit impairment amount in other comprehensive income (OCI). However, the FASB did tentatively decide that entities would use an allowance approach when recognizing credit losses (as opposed to a permanent write-down of the AFS security's cost basis). As a result, in both of the following instances, an entity would reverse credit losses through current-period earnings on an AFS debt security:

- If the fair value of the debt security exceeds its amortized cost in a period after a credit loss had been recognized through earnings (because fair value was less than amortized cost), the entity would reverse the *entire* credit loss previously recognized and recognize a corresponding adjustment to its allowance for credit losses.
- If the fair value of the debt security does not exceed its amortized cost in a period after a credit loss had been recognized through earnings (because fair value was less than amortized cost) but the credit quality of the debt security improves in the current period, the entity would reverse the credit loss previously recognized only in an amount that would reflect the improved credit quality of the debt security.

The FASB's tentative decisions to revise the impairment model in ASC 320 could result in earlier recognition of impairment.

PCI Assets

For PCI assets as defined[10] in the proposed ASU, an entity would measure expected credit losses consistently with how it measures expected credit losses for originated and purchased non-credit-impaired assets. Upon acquiring a PCI asset, the entity would recognize as its allowance for expected credit losses the amount of *contractual* cash flows not expected to be collected as an adjustment that increases the cost basis of the asset (the "gross-up" approach). After initial recognition of the PCI asset and its related allowance, the entity would continue to apply the CECL model to the asset — that is, any changes in the entity's estimate of cash flows that it expects to collect (favorable or unfavorable) would be recognized immediately in the income statement. Consequently, any subsequent changes to the entity's estimate of expected credit losses — whether unfavorable or favorable — would be recorded as impairment expense (or reduction of expense) during the period of change. Interest income recognition would be based on the purchase price plus the initial allowance accreting to the contractual cash flows. See Appendix C for an illustrative example on how to apply the proposed guidance to PCI assets.

Editor's Note: Under the current accounting for PCI assets, an entity recognizes unfavorable changes in cash flows as an immediate credit impairment but treats favorable changes in cash flows that are in excess of the allowance as prospective yield adjustments. The CECL model's proposed approach to PCI assets eliminates this asymmetrical treatment in cash flow changes. However, in a manner consistent with current practice, the CECL model precludes an entity from recognizing as interest income the discount embedded in the purchase price that is attributable to expected credit losses as of the date of acquisition.

An acquired asset is currently considered credit-impaired when it is probable that the investor would be unable to collect all contractual cash flows as a result of deterioration in the asset's credit quality since origination. Under the FASB's tentative approach, a PCI asset is an acquired asset that has experienced significant deterioration in credit quality since origination. Consequently, entities will most likely need to use more judgment than they do under current U.S. GAAP in determining whether an acquired asset has experienced significant credit deterioration.

[10] The proposed ASU defines PCI assets as "[a]cquired individual assets (or acquired groups of financial assets with shared risk characteristics at the date of acquisition) that have experienced a significant deterioration in credit quality since origination."

Certain Beneficial Interests Within the Scope of ASC 325-40

The FASB tentatively decided that an impairment allowance for "purchased or retained beneficial interests for which there is a significant difference between contractual and expected cash flows" should be measured in the same manner as PCI assets under the CECL model. Therefore, at initial recognition, a beneficial interest holder would present an impairment allowance equal to the estimate of expected credit losses (i.e., the estimate of *contractual* cash flows not expected to be collected). In addition, the FASB indicated that "changes in expected cash flows due to factors other than credit should be accreted into interest income over the life of the asset (that is, the difference between contractual and expected cash flows attributable to credit would not be included in interest income)."[11]

Editor's Note: Under the CECL model, an entity would be required to determine the contractual cash flows of beneficial interests in securitized transactions. However, there may be certain structures in which the beneficial interests do not have contractual cash flows (e.g., when a beneficial interest holder receives only residual cash flows of a securitization structure). In these situations, an entity may need to use a proxy for the contractual cash flows of the beneficial interest (e.g., the gross contractual cash flows of the underlying debt instrument).

Modified Financial Assets

In a manner consistent with the proposed ASU, the FASB decided not to comprehensively reconsider the accounting for modifications during redeliberations (e.g., when a modification results in derecognition or what constitutes a troubled debt restructuring (TDR)). However, the Board affirmed its previous decision that the CECL model would apply to modified debt instruments.

For non-TDR modifications that do not result in derecognition, an entity would measure expected credit losses on the basis of the cash flows expected after the modification, discounted at the post-modification effective interest rate. However, as stated in the proposed ASU, when an entity executes a TDR, "the cost basis of the modified asset shall be adjusted . . . so that the effective interest rate on the modified asset continues to be the original effective rate, given the new series of contractual cash flows. The basis adjustment . . . would be determined as the amortized cost basis before modification less the present value of the new series of contractual cash flows (discounted at the original effective interest rate)." The basis adjustment that reflects a *decrease* in cash flows post-modification would be recognized as a credit loss with a corresponding reduction to the amortized cost basis of the instrument. The basis adjustment that reflects an *increase* in cash flows post-modification would be recognized as an increase to the instrument's amortized cost basis with a corresponding increase in the allowance for expected credit losses.

Loan Commitments

Off-balance-sheet arrangements such as commitments to extend credit, guarantees, and standby letters of credit that are not considered derivatives under the guidance in ASC 815 are subject to credit risk and are therefore within the scope of the CECL model. In a manner consistent with the proposed ASU, the FASB tentatively decided that the estimate of expected credit losses on the *funded* portion of a loan commitment should be determined similarly to how the estimate is determined for other loans. For an *unfunded* portion of a loan commitment, the Board tentatively decided to retain the guidance in the proposed ASU that would require an entity to "estimate [expected] credit losses over the full contractual period over which the entity is exposed to credit risk [under an unconditional] present legal obligation to extend credit." Such an estimate would take into account both the likelihood that funding will occur and the expected credit losses on commitments to be funded.

Editor's Note: An entity's estimate of expected credit losses on unfunded loan commitments (e.g., credit card receivables) will most likely depend on (1) whether the entity has the unconditional ability to cancel the commitment to extend credit and, if so, (2) the time it takes for the cancellation to become effective.

[11] Quoted text is from the FASB's summary of tentative Board decisions reached at its June 11, 2014, meeting.

Disclosures

Many of the disclosures that would be required under the proposed ASU are similar to those already required under U.S. GAAP as a result of ASU 2010-20.[12] Accordingly, entities would be required to disclose information related to:

- Credit quality.[13]
- Allowance for expected credit losses.
- Policy for determining write-offs.
- Past-due status.
- PCI assets.
- Collateralized financial assets.

In addition, the FASB affirmed the provision in the proposed ASU that would require an entity to provide a rollforward of its allowance for expected credit losses for assets measured at amortized cost and AFS debt securities. However, in a change from the proposed ASU, an entity would not be required to provide rollforward disclosures of the amortized cost balances of its debt instruments. Instead, an entity would be required to disclose credit-quality indicators for each asset class, disaggregated by vintage, for a period not to exceed five years (although upon transition, the entity would be required to provide this disclosure only for the current and prior-year amortized cost balances). The disclosure would be required for annual and interim periods and would not be required for an entity's revolving lines of credit.

Editor's Note: The FASB's decision not to require the amortized cost rollforward disclosure is in response to the concerns raised by financial statement preparers about the operational challenges in providing such information. The FASB believes that disclosing credit-quality information disaggregated by asset class and by vintage would be operationally easier for financial statement preparers and would provide financial statement users with information similar to that provided in a rollforward of the amortized cost balance. Because the FASB's tentative decision to require this new disclosure has not been exposed for public comment, the Board directed its staff to conduct significant outreach activities to obtain feedback from financial statement users, preparers, and other stakeholders on the proposed requirement.

Transition

Approach

For most debt instruments, the amendments would require entities to record a cumulative-effect adjustment to the statement of financial position as of the beginning of the first reporting period in which the guidance is effective (modified retrospective approach). However, the Board tentatively decided on the following instrument-specific transition provisions:

- *Other-than-temporarily impaired debt securities* — An entity would be required to apply (1) the CECL model prospectively to HTM debt securities and (2) the changes to ASC 320 prospectively to AFS debt securities. As a result, previous write-downs of a debt security's amortized cost basis would not be reversed; rather, only changes in the estimate of expected cash flows of the debt security occurring on or after the effective date of the guidance would be reflected as an allowance for credit losses. Upon adoption of the new guidance, any impairment previously recognized in OCI would be accounted for as a prospective adjustment to the accretable yield of the debt instrument.
- *PCI assets* — An entity would be required to apply the changes to PCI assets prospectively. That is, the change in the definition of a PCI asset would apply only to assets acquired on or after the effective date of the guidance. For debt instruments accounted for under ASC 310-30, an entity would apply the gross-up approach as of the transition date (i.e., establish an allowance for expected credit losses with a corresponding adjustment to the debt instrument's cost basis).

[12] FASB Accounting Standards Update No. 2010-20, *Disclosures About the Credit Quality of Financing Receivables and the Allowance for Credit Losses.*

[13] Short-term trade receivables resulting from revenue transactions within the scope of ASC 605 are excluded from these disclosure requirements.

In addition, any post-adoption changes in the entity's estimate of cash flows that it expects to collect (favorable or unfavorable) would be recognized immediately in the income statement as impairment expense (or reduction of expense). Accordingly, the yield on a PCI asset as of the date of adoption would be "locked" and would not be affected by subsequent changes in the entity's estimate of expected credit losses.

- *Certain beneficial interests within the scope of ASC 325-40* — Entities holding such interests would need to comply with the same transition requirements as those that apply to PCI assets.

Disclosures

The FASB tentatively decided to retain the following transition disclosure guidance in ASC 825-15-65-1(d) and 65-1(e) of the proposed ASU:

d. An entity shall provide the following disclosures in the period that the entity adopts [the new guidance]:

1. The nature of the change in accounting principle, including an explanation of the newly adopted accounting principle.
2. The method of applying the change.
3. The effect of the adoption on any line item in the statement of financial position, if material, as of the beginning of the first period for which the guidance is effective. Presentation of the effect on financial statement subtotals is not required.
4. The cumulative effect of the change on retained earnings or other components of equity in the statement of financial position as of the beginning of the first period for which the guidance is effective.

e. An entity that issues interim financial statements shall provide the disclosures in item (d) in each interim financial statement of the year of change and the annual financial statement of the period of the change.

Next Steps

An effective date for the final guidance has not yet been proposed but will be determined at a future FASB meeting. The FASB directed its staff to prepare a draft of the final ASU for distribution to stakeholders (including financial statement users, preparers, and auditors) to obtain feedback on the proposed amendments ("fatal flaw review").

Appendix A — Comparison of Impairment Models

The table below compares the impairment models under current U.S. GAAP, the FASB's tentative approach, and IFRS 9 (2014), respectively.

Subject	Current U.S. GAAP	FASB's Tentative Approach	IFRS 9 (2014)
Scope	Applicable to: • Large groups of smaller-balance, homogeneous loans that are collectively evaluated for impairment. • Loans identified for individual evaluation. • Loans acquired with deteriorated credit quality. • Debt securities (including beneficial interests in securitized financial assets).	Applicable to: • Most debt instruments (other than those measured at FVTNI). • Lease receivables. • Reinsurance receivables from insurance transactions. • Financial guarantee contracts. • Loan commitments. AFS debt securities are excluded.	Applicable to: • Financial assets measured at amortized cost. • Financial assets mandatorily measured at fair value through OCI. • Loan commitments when there is a present obligation to extend credit (except for those measured at fair value through profit or loss (FVTPL) under IFRS 9 (2014)). • Financial guarantee contracts to which IFRS 9 applies (except for those measured at FVTPL). • Lease receivables within the scope of IAS 17.[1] • Contract assets within the scope of IFRS 15.[2]
Recognition threshold	Depending on the nature of the financial asset, credit losses must be either probable or other-than-temporary before recognition.	None. Impairment is based on expected (rather than incurred) credit losses.	None. Impairment is based on expected (rather than incurred) credit losses.
Measurement	Varies depending on the nature of the financial asset and unit of account. Approaches used in practice include: • Fair value measurement. • Present value of expected cash flows. • Fair value of underlying collateral.	Single-measurement approach: current expected credit losses (i.e., all contractual cash flows that the entity does not expect to collect).	Dual-measurement approach: • For assets in the first category, 12-month expected credit losses. • For assets in the second category, lifetime expected credit losses.
Transfer criteria between measurement categories	Not applicable under existing U.S. GAAP models.	Not applicable under CECL model. Only one measurement category.	Transfer to lifetime expected credit losses when there has been significant deterioration in credit quality since initial recognition unless credit risk is low. Transfer back to 12-month expected credit losses when transfer criteria are no longer satisfied.
Trade receivables	No specific guidance or applicable simplified approach.	No specific guidance or applicable simplified approach.	For trade receivables with a significant financing component, the three-bucket impairment model or a simplified model with an allowance of lifetime expected losses could be used.
PCI assets	Credit impairment is recognized when, on the basis of current information and events, it is probable that an investor will be unable to collect (1) all cash flows expected at acquisition plus (2) additional cash flows expected to be collected that arise from changes in post-acquisition estimates. Significant increases in the estimate of expected cash flows expected to be collected at acquisition are recognized as prospective yield adjustments.	The allowance for PCI assets is the current expected credit losses. Interest income recognition is based on purchase price plus the initial allowance accreting to the contractual cash flows. The non-credit-related discount or premium that results from acquiring a pool of PCI assets is allocated to each individual financial asset.	The allowance for PCI assets is based on the cumulative change (from the original expectation at acquisition) in lifetime expected credit losses. Interest income recognition is based on applying the credit-adjusted effective interest rate to the amortized cost of the financial asset (rather than contractual cash flows).

[1] IAS 17, *Leases.*

[2] IFRS 15, *Revenue From Contracts With Customers.*

Subject	Current U.S. GAAP	FASB's Tentative Approach	IFRS 9 (2014)
Nonaccrual accounting	No applicable guidance.	No applicable guidance.	IFRSs do not permit nonaccrual of interest. However, for assets that have become credit-impaired, interest income is based on the net carrying amount of the credit-impaired financial asset.
Write-offs	An entity writes off a financial asset in the period in which the financial asset is deemed *uncollectible*.	Same as under current U.S. GAAP.	An entity writes off the carrying amount of a financial asset if it ultimately determines that it has no reasonable expectation of future recovery.

Appendix B — Impairment Models Under U.S. GAAP

The table below highlights several impairment models under current U.S. GAAP for loans and debt securities.

Impairment Models for Loans and Debt Securities		
Guidance	**Scope**	**Measurement Objective**
ASC 450-20	Large groups of smaller-balance, homogeneous loans that are collectively evaluated for impairment.	All probable and reasonably estimable losses.
ASC 310-10-35	Loans that are identified for individual evaluation.	If it is probable that all of the contractual cash flows will not be collected, the difference between the carrying amount and the present value of the expected future cash flows discounted at the original effective interest rate. Certain practical expedients exist.
ASC 310-30	Loans acquired with deteriorated credit quality.	See ASC 310-10-35 or ASC 450-20, as applicable (as discussed in ASC 310-30-35-10). Or, for a loan accounted for as a debt security, see ASC 320-10-35 (as discussed in ASC 310-30-35-8). Recoveries (i.e., reversals of impairments) are not permitted for a loan accounted for as a debt security.
ASC 320-10-35 ASC 325-40-15	Debt securities (including beneficial interests in securitized financial assets).	If the investor intends to sell a debt security or it is more likely than not the investor will be required to sell the security before recovery of its amortized cost basis, impairment is deemed to be other than temporary and the difference between the amortized cost and fair value of the security is recognized in earnings. However if (1) the investor does not intend to sell, (2) it is not more likely than not that the investor will be required to sell the security before recovery, and (3) the investor does not expect to recover the entire cost basis of the security, the security is other than temporarily impaired and only the credit-related component of the impairment loss is recognized in earnings, and the noncredit portion is recorded in OCI. Credit losses might be measured in accordance with ASC 310-10-35, ASC 325-40, or ASC 310-30 depending on the circumstances. Recoveries are not permitted for debt securities.

Appendix C — Application of the CECL Model to PCI Assets

The example below, which is reproduced from ASC 825-15-55-40 through 55-42 of the proposed ASU, illustrates the application of the proposed guidance to PCI assets.

> Entity E is a bank that records [PCI] assets in its existing systems by recognizing the amortized cost of the asset, at acquisition, as equal to the sum of the purchase price and the associated expected credit loss at the date of acquisition. The difference between amortized cost and the par amount of the debt is recognized as a noncredit discount or premium. By doing so, the asset is accreted from this amortized cost to the contractual cash flows without ever recognizing as interest income the purchase discount attributable to expected credit losses at acquisition.
>
> Assume that Entity E pays $750,000 for a debt instrument with a par amount of $1,000,000. The instrument is classified at amortized cost. At the time of purchase, the expected credit loss embedded in the purchase price is $175,000. At that date of acquisition, the statement of financial position would reflect a financial asset carrying value of $925,000 (that is, par less the non-credit-related discount) and an associated allowance for expected credit losses of $175,000. The acquisition-date journal entry is as follows.

Loan — par amount	$	1,000,000		
Loan — noncredit discount			$	75,000
Allowance for credit losses				175,000
Cash				750,000

> Subsequently, the $75,000 noncredit discount would be accreted into interest income over the life of the debt instrument . . . . The $175,000 allowance for expected credit losses would be updated in subsequent periods . . . , with changes in the allowance for expected credit losses reflected immediately in the statement of financial performance as a provision for credit losses.

Appendix D — Application of the CECL Model to Trade Receivables

The CECL model would apply to trade receivables that result from revenue transactions within the scope of ASC 605 (or ASC 606, if adopted). The example below, which is reproduced from ASC 825-15-55-37 and 55-38 of the proposed ASU, illustrates how an entity would apply the proposed guidance to trade receivables by using a provision matrix.

> Entity D manufactures and sells toys to a broad range of customers, primarily retail toy stores. Customers typically are provided payment terms of 90 days with a 2 percent discount if paid within 60 days. The entity has tracked historical loss experience for its trade receivables over the past five years and calculated the following historical loss experience:
>
> a. 0.3 percent for receivables that are current
>
> b. 8 percent for receivables that are 1–30 days past due
>
> c. 26 percent for receivables that are 31–60 days past due
>
> d. 58 percent for receivables that are 61–90 days past due
>
> e. 82 percent for receivables that are more than 90 days past due.
>
> Entity D believes that this historical loss experience is consistent with what will be experienced for financial assets held at the reporting date because the composition of the receivables at the reporting date is consistent with that used in developing the historical statistics (that is, the shared risk characteristics of its customers has not changed significantly over time) and the economic conditions in which the historical statistics were calculated generally are consistent with the economic conditions expected over the remaining lives of the receivables.
>
> At the reporting date, Entity D develops the following provision matrix to estimate current expected credit losses.

Past-Due Status	Carrying Value	Loss Rate	Expected Credit Loss Estimate
Current	$ 5,984,698	0.3%	$ 17,954
1–30 days past due	8,272	8%	662
31–60 days past due	2,882	26%	749
61–90 days past due	842	58%	488
More than 90 days past due	1,100	82%	902
	$ 5,997,794		$ 20,755

Editor's Note: The proposed ASU's example highlights that application of the CECL model to trade receivables through the use of a provision matrix may not differ significantly from an entity's current methods for determining the allowance for doubtful accounts. However, the example illustrates that moving to an expected loss model would require entities to consider the following when using a provision matrix to estimate credit losses on trade receivables:

- Under the CECL model, an entity would be required to consider whether expected credit losses should be recognized for trade receivables that are considered "current" (i.e., not past due). In the example above, a loss rate of 0.3 percent is applied to the trade receivables that are classified as current.
- When using historical loss rates in a provision matrix, an entity would be required to consider whether and, if so, how the historical loss rates differ from what is currently expected over the life of the trade receivables (on the basis of current conditions and reasonable and supportable forecasts about the future).

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No. 2016-01
7 January 2016

To the Point

FASB —final guidance

FASB makes targeted amendments to guidance on classifying and measuring financial instruments

Entities will have to measure many equity investments at fair value and recognize changes in fair value in net income unless they qualify for the new practicability exception.

What you need to know

- The FASB issued final guidance that will require entities to measure equity investments that do not result in consolidation and are not accounted for under the equity method at fair value and recognize any changes in fair value in net income unless the investments qualify for the new practicability exception.
- The standard doesn't change the guidance for classifying and measuring investments in debt securities and loans.
- Entities will have to record changes in instrument-specific credit risk for financial liabilities measured under the fair value option in other comprehensive income.
- Entities that are not public business entities (PBEs) will no longer have to disclose the fair value of financial instruments measured at amortized cost.
- The guidance is effective for calendar-year PBEs beginning in 2018. For all other calendar-year entities, it is effective for annual periods beginning in 2019 and interim periods beginning in 2020. Non-PBEs can adopt the standard at the same time as PBEs, and both PBEs and non-PBEs can early adopt certain provisions.

Overview

The Financial Accounting Standards Board (FASB) issued final guidance[1] that will change how entities measure certain equity investments and present changes in the fair value of financial liabilities measured under the fair value option (FVO) that are attributable to their own credit.

Building a better working world

The new guidance also changes certain disclosure requirements and other aspects of current US GAAP. It does not change the guidance for classifying and measuring investments in debt securities and loans.

Under the new guidance, entities will have to measure many equity investments at fair value and recognize any changes in fair value in net income unless the investments qualify for the new practicability exception. For financial liabilities measured using the FVO in Accounting Standards Codification (ASC) 825, *Financial Instruments*, entities will need to present any change in fair value caused by a change in instrument-specific credit risk (own credit risk) separately in other comprehensive income (OCI).

The new standard differs significantly from the model the FASB developed jointly with the International Accounting Standards Board (IASB) and from IFRS 9, *Financial Instruments*, which the IASB issued in July 2014. The FASB plans to issue a separate standard on credit losses later this quarter with requirements that will also differ from those in IFRS 9. Entities that invest in debt securities should monitor that project because the guidance will affect the measurement, presentation and disclosure of impairment related to these securities.

This publication summarizes the key provisions of the new guidance and includes a summary of changes in presentation and disclosure requirements in the appendix.

Summary of key amendments

Equity investments

The new guidance requires the fair value measurement of investments in equity securities and other ownership interests in an entity, including investments in partnerships, unincorporated joint ventures and limited liability companies (collectively, equity investments) that do not result in consolidation and are not accounted for under the equity method. Entities will have to measure these investments at the end of each reporting period and recognize changes in fair value in net income (FV-NI). Entities will no longer be able to recognize unrealized holding gains and losses on equity securities they classify today as available for sale (AFS) in OCI. They also will no longer be able to use the cost method of accounting for equity securities that do not have readily determinable fair values.

The guidance applies to all entities except those in certain industries that are required to account for substantially all of their investments at fair value with changes in fair value recognized in net income or in the change in net assets (e.g., broker-dealers in securities, investment companies, defined benefit pension and other postretirement plans). It also does not apply to (1) derivative instruments that are subject to the requirements of ASC 815, *Derivatives and Hedging*, (2) Federal Home Loan Bank and Federal Reserve Bank stock and (3) an exchange membership that has the characteristics of an ownership interest specified in ASC 940-340-25-1(b).

A practicability exception will be available for equity investments that do not have readily determinable fair values and do not qualify for the practical expedient to estimate fair value under ASC 820, *Fair Value Measurement* (i.e., the net asset value practical expedient). These investments may be measured at cost, less any impairment, plus or minus changes resulting from observable price changes in orderly transactions for an identical or similar investment of the same issuer. Entities will have to reassess at each reporting period whether an investment qualifies for this practicability exception.

To identify observable price changes, entities should consider relevant transactions that occurred on or before the balance sheet date that are known or can reasonably be known. To identify price changes that can be reasonably known, entities will be expected to make a reasonable effort (without expending undue cost and effort) to identify any observable transactions. However, they will not be required to perform exhaustive searches. In addition, when determining whether an equity instrument issued by the same issuer is similar to the equity investment it holds, an entity should consider the different rights and obligations associated with the instruments. Differences in rights and obligations could include characteristics such as voting rights, distribution rights and preferences, and conversion features. Entities should adjust the observable price of the similar instrument for the different rights and obligations to determine the amount that should be recorded as an adjustment in the carrying value of the instrument being measured.

How we see it

An entity will have to exercise judgment and consider its facts and circumstances to determine whether an equity instrument issued by the same issuer is similar to the equity investment it holds and to apply the concepts of "undue cost and effort," and "reasonably known" under the new practicability exception.

For each reporting period, an entity that uses the practicability exception to measure an equity investment will be required to make a qualitative assessment of whether the investment is impaired. If an impairment exists, the entity will have to estimate the investment's fair value in accordance with ASC 820 and recognize an impairment loss in net income equal to the difference between the investment's carrying value and its fair value. The entity will no longer be able to consider whether the decline is other than temporary, as is required under current US GAAP. This single-step model for assessing impairment is expected to accelerate the recognition of losses in investments without readily determinable fair values.

The guidance is expected to accelerate recognition of impairment losses in equity investments without readily determinable fair values.

Financial liabilities measured under the fair value option

For financial liabilities measured using the FVO in ASC 825, the change in fair value caused by a change in instrument-specific credit risk (own credit risk) will be presented separately in OCI. An entity may consider this amount to be the difference between the total change in fair value and the amount resulting from a change in a base market rate (e.g., a risk-free interest rate). This is a significant change from current US GAAP, which requires the instrument's entire change in fair value to be recognized through earnings. An entity may use another method that it believes results in a faithful measurement of the fair value change attributable to instrument-specific credit risk. However, it will have to apply the method consistently to each financial liability from period to period.

Upon derecognition of the financial liability, the accumulated gains and losses due to changes in the instrument-specific credit risk will be reclassified from OCI to net income.

How we see it

The only own-credit relief the guidance provides is for financial liabilities measured using the FVO. The effect of an entity's own credit risk for other financial liabilities measured at FV-NI, including derivatives, will continue to be reported in net income, resulting in continued earnings volatility due to changes in an entity's nonperformance risk.

Deferred tax assets

The remeasurement of a financial instrument at fair value generally creates a temporary difference between the reporting basis and the tax basis of the instrument under ASC 740, *Income Taxes*, because the tax basis generally remains unchanged. This difference requires recognition of deferred taxes. Unrealized losses can give rise to deferred tax assets (DTAs), which must be assessed for realizability. Under the new guidance, entities will have to assess the realizability of a DTA related to an AFS debt security in combination with the entity's other DTAs.

How we see it

The new guidance eliminates one method that is currently acceptable for assessing the realizability of DTAs related to AFS debt securities. That is, an entity will no longer be able to consider its intent and ability to hold debt securities with unrealized losses until recovery, which may not be until maturity, akin to a tax planning strategy. Under this method, a valuation allowance currently wouldn't be necessary for DTAs on unrealized losses, even when there is significant negative evidence (e.g., recent cumulative losses) related to the realizability of other DTAs because the specific DTAs are expected to reverse as time passes.

Presentation and disclosure

The new guidance requires entities to present financial assets and financial liabilities separately, grouped by measurement category and form of financial asset in the statement of financial position or in the accompanying notes to the financial statements. Entities that are not PBEs will no longer have to disclose the fair value of financial instruments measured at amortized cost. PBEs will no longer have to disclose the method(s) and significant assumptions they use to estimate the fair value of financial instruments measured at amortized cost. In addition, PBEs will have to use the exit price notion when measuring the fair value of financial instruments measured at amortized cost for disclosure purposes.

Non-PBEs can early adopt a provision that eliminates the fair value disclosures for financial instruments not recognized at fair value.

Transition and effective date

The guidance is effective for PBEs for annual periods beginning after 15 December 2017, and interim periods therein. For all other entities, it is effective for annual periods beginning after 15 December 2018, and interim periods within annual periods beginning after 15 December 2019. Non-PBEs can early adopt the standard as of the effective date for PBEs. All entities can early adopt a provision requiring them to recognize the fair value change from own credit in OCI for financial liabilities measured using the FVO in ASC 825. Non-PBEs can early adopt a provision that eliminates the fair value disclosures for financial instruments not recognized at fair value. Both of these provisions can be early adopted for financial statements of annual or interim periods that have not yet been issued or made available for issuance, including those for periods in 2015.

An entity will record a cumulative-effect adjustment to beginning retained earnings as of the beginning of the first reporting period in which the guidance is adopted, with two exceptions. The amendments related to equity investments without readily determinable fair values (including disclosure requirements) will be effective prospectively. The requirement to use the exit price notion to measure the fair value of financial instruments for disclosure purposes will also be applied prospectively.

Endnote:

[1] Accounting Standards Update 2016-01, *Financial Instruments — Overall — Recognition and Measurement of Financial Assets and Financial Liabilities.*

Appendix: Summary of key presentation and disclosure requirements

Instruments and features affected	Presentation and disclosure requirements
Financial assets and financial liabilities	Entities will separately present financial assets and financial liabilities by measurement category and form of financial asset (i.e., securities or loans and receivables) in the statement of financial position or in the notes to the financial statements.

Financial instruments, with certain exceptions (such as equity method investments, equity investments without readily determinable fair values, receivables and payables due in less than one year and demand deposit liabilities)	A PBE will be required to disclose, either in the body of the financial statements or in the accompanying notes, the fair value of financial instruments and the level of the fair value hierarchy within which the measurements are categorized in their entirety (i.e., Level 1, 2 or 3).
	▸ A PBE won't be required to disclose:
	  ▸ The methods and significant assumptions used to estimate the fair value of financial instruments consistent with the requirements of ASC 820-10-50-2(bbb).
	  ▸ A description of the changes in the methods and significant assumptions used to estimate the fair value of financial instruments, if any, during the period.
	Non-PBEs will no longer be required to disclose the fair value of financial instruments measured at amortized cost.

Fair value measurements only for disclosure purposes	The new guidance eliminates the exception in ASC 825 that allows entities to calculate fair values of certain financial instruments (e.g., loans) using an entry price notion rather than the exit price notion of ASC 820.
Equity investments without readily determinable fair values measured using the new practicability exception	An entity that applies the practicability exception for measuring equity investments without readily determinable fair values will disclose all of the following: ▸ The carrying amount of investments without readily determinable fair values ▸ The amount of impairments and downward adjustments, if any, both annual and cumulative ▸ The amount of upward adjustments, if any, both annual and cumulative ▸ As of the date of the most recent statement of financial position, additional information (in narrative form) that is sufficient to permit financial statement users to understand the quantitative disclosures and the information that the entity considered in reaching the carrying amounts and upward or downward adjustments resulting from observable price changes
Financial liabilities measured under the fair value option	Entities will disclose the following information about the effects of the instrument-specific credit risk and changes in it for financial liabilities measured under the FVO: ▸ The amount of change, during the period and cumulatively, of the fair value of the liability that is attributable to changes in the instrument-specific credit risk ▸ How the unrealized gains and losses attributable to changes in instrument-specific credit risk (and recorded in OCI) were determined ▸ If a liability is settled during the period, the amount, if any, recognized in OCI that was recognized in net income at settlement
Fair value option	In annual periods only, an entity will need to disclose the methods and significant assumptions used to estimate the fair value of items measured under the FVO, consistent with the requirements of ASC 820-10-50-2(bbb), except that an entity is not required to provide the quantitative disclosures about significant unobservable inputs used in measurements categorized in Level 3 of the fair value hierarchy.

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12 November 2015

To the Point

FASB — proposed guidance

Preparing for the new credit impairment standard

Now that the FASB has set effective dates for the new credit impairment standard, entities should start planning for implementation.

What you need to know

- The FASB set effective dates for the new credit impairment standard starting in the first quarter of 2019 for calendar-year entities.
- Because implementing the new credit impairment standard will likely require significant effort, entities should begin planning now. The standard would require them to estimate and recognize an allowance for lifetime expected credit losses for loans, trade receivables, held-to-maturity debt securities and certain other financial assets measured at amortized cost.
- Implementing the new credit impairment standard will likely require changes in processes, systems and controls for financial institutions and other entities. Public companies also will need to consider disclosures they would have to make about the new standard and its effects.
- If they haven't yet done so, entities should establish a governance structure for implementation.

Overview

With more than three years before the first effective date of the new credit impairment standard, entities may think they have ample time to implement the standard the Financial Accounting Standards Board (FASB or Board) plans to issue in the first quarter of 2016. But financial institutions and other entities should be taking steps now to prepare for the potentially significant changes they would need to make.

Building a better working world

The first steps for management are developing a governance structure for implementation and performing a preliminary assessment of how much work will be necessary. Implementing the standard will likely require significant adjustments to processes, systems and controls, especially for financial institutions.

Entities should also develop plans to communicate with investors and other stakeholders, including making disclosures about the effects of new standards discussed in Securities and Exchange Commission (SEC) Staff Accounting Bulletin (SAB) Topic 11.M.[1]

Background

The new impairment standard would supersede today's guidance and would apply to all entities that hold financial assets that are not measured at fair value through net income. The guidance would address the recognition and measurement of credit losses on debt securities, trade receivables, loans, net investments in leases, off-balance sheet credit exposures, reinsurance receivables and other financial assets that represent the contractual right to receive cash.

For available-for-sale (AFS) debt securities, the FASB has decided to modify today's other-than-temporary impairment (OTTI) model to no longer require entities to consider certain factors when determining whether a credit loss should be recognized. The FASB also has decided to require entities to recognize credit losses through an allowance for credit impairment (rather than a direct reduction of a security's cost basis), thereby allowing for the reversal of credit impairments in later periods.

Now is the time for preparers to begin developing a plan to implement the credit impairment standard.

For all other affected financial assets, the FASB has decided to replace today's "incurred loss model" with an "expected credit loss model." This change would require entities to make more estimates of future losses, which would require more judgment.

Key considerations

The FASB decided on the following effective dates for the credit impairment standard:

- For public business entities (PBEs) that meet the definition of an SEC filer, the standard would be effective for annual periods beginning after 15 December 2018, and interim periods therein. That means calendar-year SEC filers would begin applying it in the first quarter of 2019.
- For other PBEs, the standard would be effective for annual periods beginning after 15 December 2019, and interim periods therein. That means calendar-year PBEs that are not SEC filers would begin applying it in the first quarter of 2020.
- For all other entities, the standard would be effective for annual periods beginning after 15 December 2019, and interim periods within annual periods beginning after 15 December 2020. That means these entities that have calendar years would begin applying it in their annual financial statements for 2020 and in interim statements in 2021.

All entities would be allowed to adopt the guidance as of the effective date for PBEs that are SEC filers.

In making their decision on effective dates, the FASB discussed the difficulty of implementing several major new standards, including those involving classification and measurement of financial instruments, revenue recognition and accounting for leases, over the next several years.

While the effective dates of the impairment standard may seem distant, entities should take steps to prepare for implementation once it is issued. This graphic depicts the steps an entity might take to meet the first effective date.

Illustration 1: Implementation plan to meet the first effective date

2015	2016		2017 - 2018
Stage 1: Mobilize	**Stage 2: Design**	**Stage 3: Build**	**Stage 4: Test and deploy**
▸ Establish governance structure ▸ Assess current models and data availability ▸ Educate individuals from credit risk management, finance, information technology and the disclosure committee about the new standard	▸ Perform gap analysis and highlight changes required ▸ Design or modify models and allowance methodology ▸ Design or modify data flows, processes and controls ▸ Document proposed accounting policies or changes to existing policies	▸ Implement organizational changes ▸ Build, adjust and calibrate models ▸ Build or enhance data warehouse(s) ▸ Monitor and validate reporting changes	▸ Validate and deploy allowance models ▸ Validate and deploy data flows ▸ Monitor and validate process and control changes ▸ Run old and new systems at the same time and prepare to go live

A good place to start is putting in place a governance structure for implementation that brings together multiple disciplines. For example, a financial institution that expects to be significantly affected may consider a governance structure that includes individuals from accounting policy, credit risk management, information technology, treasury, finance, accounting controllership, investor relations, regulatory reporting, internal control and internal audit.

The next step is typically identifying key actions that need to be taken during the implementation phase. A preliminary assessment of the current state and future state required by the standard can be used to identify key actions that need to be taken to implement the new standard.

For example, entities will need to decide how to change their credit risk models to estimate lifetime expected credit losses. As a result, entities may need to:

- Compile additional historical loss data to transform today's historical loss estimate from an incurred loss to an estimate of lifetime losses
- Identify information (internal or external) that can be used to develop what the FASB is calling a "reasonable and supportable" forecast of the future
- Consider how to adjust their historical lifetime loss statistics for these reasonable and supportable forecasts, including developing the necessary processes and controls.

In addition, entities with trade receivables will need to think about changing their processes and documentation to meet the requirements of the standard, even though in many cases the standard won't significantly change their results.

Entities also will need to start planning for new disclosures because the standard is expected to require significantly more interim and annual disclosures than current US GAAP. Entities will need to assess whether they currently collect the information they will need to satisfy the new requirements or whether they will need to adjust their processes and controls or put new ones in place to gather the information and make sure it is accurate.

Implementing the standard also will be challenging because industry groups, regulators and implementation groups will be addressing questions that arise over time, and an entity's understanding of the new requirements will likely evolve. In addition to industry groups and banking regulators, we expect the staff of the SEC, the American Institute of Certified Public Accountants and the FASB's Transition Resource Group on Credit Impairment to all weigh in.

Questions to consider now

As entities develop their implementation plans, management should consider the following questions:

- What governance structure will be used to oversee and coordinate implementation? How will this effort be communicated and agreed to by the Board of Directors?
- What is the plan for a preliminary assessment of the standard's effect on the entity? When will it be complete?
- If the entity is an SEC registrant, what is the plan for making the disclosures under SAB Topic 11.M about the effect of a new accounting standard?
- What process has the entity put in place to monitor interpretations by the various organizations that are likely to interpret the standard?

Endnote:

[1] Refer to SEC Staff Accounting Bulletin Topic 11.M, *Disclosure Of The Impact That Recently Issued Accounting Standards Will Have On The Financial Statements Of The Registrant When Adopted In a Future Period.*

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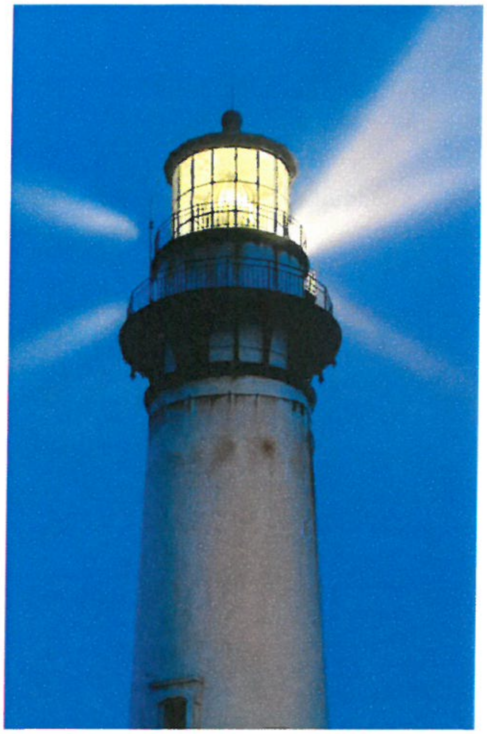

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FASB Makes Impairment Transition and Disclosure Decisions

At two recent meetings, the FASB reached decisions on transition methods and disclosures for the proposed standard on financial instruments impairment (proposed ASU).[1] The FASB directed its staff to draft the final standard, and plans to discuss the effective date at a later meeting.

Key Facts

- The FASB provided the transition method for purchased-credit impaired (PCI) financial assets and other-than-temporarily impaired (OTTI) debt securities at the adoption date.
- The disclosure requirements for debt securities classified as available-for-sale (AFS) will be retained and updated for the proposed ASU's general credit risk disclosure principles.[2]
- A period-to-period rollforward of the amortized cost for financial assets measured at amortized cost and at fair value through other comprehensive income (FVOCI) will not be required.
- Disclosures of credit quality indicators for financing receivables will be disaggregated by the year of the asset's origination.

Key Impacts

- Entities may need to evaluate the new disclosure requirements, particularly credit quality indicators disaggregated by vintage year, and assess their impact on systems, processes, and controls.
- The transition method for OTTI debt securities and PCI financial assets is likely to be less burdensome for entities to implement than the original proposal.

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[1] FASB Proposed Accounting Standards Update, Financial Instruments – Credit Losses, December 20, 2012, available at www.fasb.org.

[2] FASB ASC Subtopic 320-10, Investments – Debt and Equity Securities, available at www.fasb.org.

Impairment Project Timeline

- 2010 – Exposure Draft
- December 2012 – Revised Exposure Draft
- April 2013 – Comment Period Ended
- 2013 to Present – Redeliberations
- 2015 – Final Standard Expected

Purchased-Credit Impaired Financial Assets

The Board decided that an entity will account for PCI financial assets upon transition as follows:

- All loans and debt securities acquired with deteriorated credit quality for which an entity applies Subtopic 310-30 (including by analogy) will be classified as PCI financial assets at the date of adoption.[3]
- Entities will not be permitted to perform further assessments at the adoption date to determine whether other previously acquired assets meet the new definition of PCI assets.
- Entities will be required to gross up the allowance for lifetime expected credit losses at the date of adoption with a corresponding adjustment to the carrying value of the assets.
- Interest income will be recognized based on the yield as of the adoption date.

The Board also decided that subsequent increases and decreases in lifetime expected credit losses will be recorded through the allowance for expected credit losses with a corresponding adjustment to the current-period provision for credit losses.

Background. The current PCI definition in Subtopic 310-30 is not the same as the proposed definition. Also, some entities have applied Subtopic 310-30 by analogy to other purchased loans. Respondents questioned whether loans purchased before the effective date of the proposed ASU would need to be reevaluated under the new PCI definition, and if so, whether the determination would be made as of the date of adoption or the date the assets were acquired.

Currently for PCI financial assets, the excess of expected cash flows at acquisition over the acquirer's initial investment in the assets is recognized as interest income on a level-yield basis over the remaining life of the assets. If there is a subsequent significant increase in estimated future cash flows, that change is recognized prospectively by increasing the yield. The Board decided entities will continue to recognize interest income on these assets based on their yield as of the adoption date.

OTTI Debt Securities

The Board decided that entities will adopt the provisions of the ASU related to OTTI debt securities prospectively as of the adoption date.

- Amounts previously recognized in accumulated other comprehensive income (AOCI) as of the date of adoption that relate to significant improvements in cash flows will continue to be accreted to interest income over the remaining life of the debt security on a level-yield basis.
- Any improvements in cash flows due to improving credit after the adoption date will be recorded through the provision for credit losses in the income statement.

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[3] FASB ASC Subtopic 310-30, Receivables – Loans and Debt Securities Acquired with Deteriorated Credit Quality, available at www.fasb.org.

Background. At a previous meeting, the Board decided that debt securities classified as AFS would be excluded from the scope of the lifetime expected credit-loss model. Instead, the impairment amount would be recognized through an allowance account that would allow reversals of previously recognized credit losses. Under current U.S. GAAP, credit losses on debt securities are recognized in earnings through an adjustment to the amortized cost basis, and the amortized cost basis is not adjusted for improvements.

The proposed ASU would have required a cumulative-effect adjustment to the carrying amount of the debt securities at the adoption date with an offsetting adjustment to the opening balance of retained earnings or other appropriate components of equity. Respondents to the proposal requested additional guidance on transition for OTTI debt securities and specifically highlighted these two issues:

- Hindsight may be required to determine how much of the allowance initially recognized would have been written off.
- Accounting for a debt security that has had a significant improvement in cash flows following the initial impairment. Under current GAAP, subsequent improvements are recognized prospectively as an adjustment to yield.

Disclosures

An entity will be required to disclose a period-to-period rollforward of the allowance for expected credit losses for financial assets measured at amortized cost and at FVOCI. The Board decided not to require the amortized cost rollforward disclosures. However, entities will be required to disaggregate the credit quality indicators for all classes of financing receivables (excluding revolving lines of credit such as credit cards) that are disclosed under current GAAP by the year of the asset's origination (i.e., vintage year).[4] Some of the key requirements are:

- Disaggregation by vintage year will be for a specified minimum number of annual reporting periods, and any financing receivable originated prior to that will be disclosed in an aggregate column;
- Entities will apply current GAAP to determine if a loan refinancing or restructuring is a new loan or a loan modification;[5] and
- Revolving lines of credit will not be subject to the vintage year disclosure, but will still need to be disaggregated by credit quality indicators.

Background and Observations. The proposed ASU would have retained current U.S. GAAP requirements to disclose a rollforward of the allowance for credit losses and introduced an amortized cost rollforward of financial assets measured at amortized cost and FVOCI. Financial statement users generally supported this requirement while preparers believed implementation would be difficult.

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[4] A financing receivable is a defined as a financing arrangement that: (1) represents a contractual right to receive money either on demand or on fixed or determinable dates, and (2) is recognized as an asset in the entity's statement of financial position. Financing receivables include, but are not limited to, loans, trade accounts receivables, and notes receivable.

[5] ASC Paragraphs 310-20-35-9 through 35-12, available at www.fasb.org.

Transition Disclosures

The Board affirmed the transition disclosure requirements included in the proposed ASU, which are listed below:

(a) The nature of the change in accounting principles, including an explanation of the newly adopted accounting principles.

(b) The method of applying the change.

(c) The effect of the adoption on any line item in the statement of financial position, if material, as of the beginning of the first period for which the guidance is effective. Presentation of the effect on financial statement subtotals is not required.

(d) The cumulative effect of the change on retained earnings or other components of equity in the statement of financial position as of the beginning of the first period for which the guidance is effective.

(e) An entity that issues interim financial statements must provide the disclosures in item (d) in each interim financial statement of the year of change and the annual financial statements of the period of change.

Next Steps

The Board directed the staff to draft the final standard. During the drafting process, the staff will perform outreach with preparers and users on the disclosure requirement to disaggregate credit quality disclosure by vintage year, any remaining issues identified, and the effective date. The Board will meet with the staff to discuss any remaining issues, the cost-benefit and complexity of the decisions reached to date, and the effective date.

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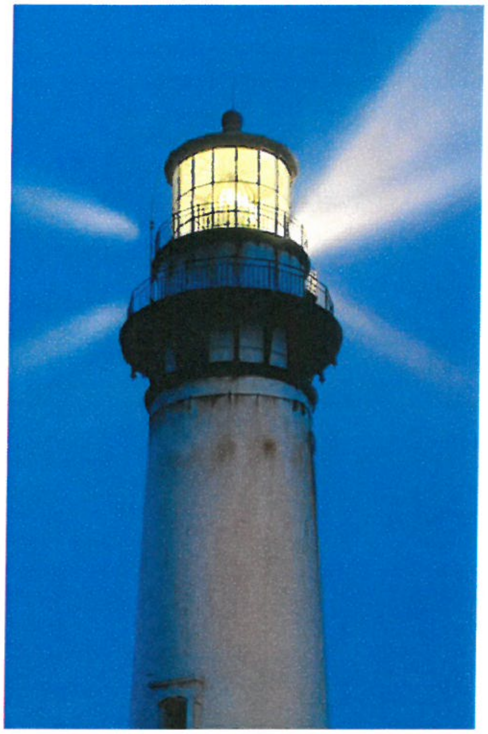

FASB Nears Completion of Financial Instruments Standards

The FASB recently reached decisions on the financial instruments standards related to the accounting for troubled debt restructurings (TDRs), impairment of available-for-sale (AFS) debt securities, and the effective dates for the impairment and classification and measurement standards.[1]

The Board will meet before year end to discuss the remaining impairment issues and cost-benefit considerations, and intends to issue a final impairment standard in the first quarter of 2016. The Board plans to issue a final classification and measurement standard in 2015.

Contents

Key Facts

- Credit losses for loans classified as TDRs would be measured under the current expected credit loss (CECL) model.
- Impairment of debt securities classified as AFS would be limited to the difference between their amortized cost and fair value.
- Public business entities that are SEC filers would apply the ***impairment*** standard for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years.[2]
- Public business entities would apply the ***classification and measurement*** standard for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years.

Key Impacts

- Entities that previously had to segregate TDRs for subsequent measurement may not need to continue this practice.
- The effective dates for the new impairment guidance under U.S. GAAP and IFRS would be different.

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[1] The FASB met on November 11, 2015. FASB Proposed Accounting Standards Updates, Financial Instruments – Credit Losses, December 20, 2012; and Financial Instruments Overall: Recognition and Measurement of Financial Assets and Liabilities, February 14, 2013, both available at www.fasb.org.

[2] An SEC filer is defined as an entity that is required to file or furnish its financial statements with either (a) the SEC, or (b) with respect to an entity subject to Section 12(i) of the Securities Exchange Act of 1934, the appropriate agency. Financial statements for other non-SEC filers whose financial statements are included with another filer's SEC submission are not included in this definition.

Impairment

External Review Draft

In August 2015, the FASB distributed an external review draft of the financial instruments impairment standard to a select group of stakeholders. The FASB staff received approximately 950 comments; the reviewers identified 147 comments as fatal flaws. The Board will discuss some of these issues in greater detail. For other comments, the staff said it would clarify the language in the final standard.

Effective Date

The Board decided that the impairment standard would be effective for:

- Public business entities that are SEC filers for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years;
- Public business entities that are *not* SEC filers for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years; and
- All other entities for fiscal years beginning after December 15, 2019, and interim periods within fiscal years beginning after December 15, 2020.[3]

Early adoption would be permitted for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years.

KPMG Observations

The 2019 and 2020 effective dates might seem a long way off but already many companies are analyzing the implications of the standards. Entities may need to develop or revise accounting processes and internal controls, which would require applying significant judgments and developing new estimates. IT systems also may need to be modified to capture additional data to support the accounting and disclosure requirements.

Considerations for IFRS Convergence. Both U.S. GAAP and IFRS would have new impairment requirements that, while not converged, generally would result in an increase in the allowance for credit losses when compared with amounts recorded under current guidance. However, the mandatory effective dates of the respective standards are not the same.

For U.S. GAAP, the standard would be applied no earlier than fiscal years beginning after December 15, 2018. In contrast, the impairment guidance in IFRS 9, *Financial Instruments,* is effective for fiscal periods beginning on or after January 1, 2018.

[3] All other entities include not-for-profit entities, and employee benefit plans within the scope of ASC Topics 960, Defined Benefit Pension Plans; 962, Defined Contribution Pension Plans; and 965, Health and Welfare Benefit Plans, all available at www.fasb.org.

Impairment Floor for AFS Debt Securities

The Board decided that the amount of impairment recognized for debt securities classified as AFS would be limited to a fair value floor. The impairment recognized would be the lesser of:

- The difference between the amortized cost basis and the fair value, and
- The credit loss amount.

Applying the Board's Decision on Recognizing Impairment on AFS Debt Securities			
Facts	**Scenario 1**	**Scenario 2**	**Scenario 3**
Amortized Cost	$100	$100	$100
Fair Value	98	92	107
Credit Loss Amount	5	5	5
Impairment Recognized Through Earnings	2	5	0

Background. The Board previously decided that debt securities classified as AFS would continue to use the current other-than-temporary impairment (OTTI) model. However, it decided to make targeted amendments to the model to address concerns about the timely recognition of credit losses.

As part of the external review process, the Board requested feedback from stakeholders about whether incorporating a fair value floor would further simplify the impairment model for AFS debt securities. Generally, stakeholders favored the fair value floor because the cost basis would not be lower than the price at which the entity could sell the debt securities.

KPMG Observations

Incorporating the fair value floor would not change the amount of impairment recognized for debt securities that entities intend to sell or are more likely than not to be required to sell before recovery of the amortized cost basis. In these cases, the impairment recognized in earnings would be equal to the difference between the fair value and the amortized cost basis.

Effect of Fair Value Floor. The Board's decision ensures that entities would not recognize an allowance for credit losses that reduces the carrying amount of a debt security below its fair value. Without the fair value floor, if the allowance for credit losses reduced the carrying amount below fair value, entities would record a simultaneous gain in other comprehensive income for the excess of the fair value over the net carrying amount.

Incorporating a fair value floor into the model for accounting for AFS debt securities would result in noncomparability with the allowance for credit losses recorded for financial instruments measured at amortized cost (e.g., held-to-maturity debt securities).

If the amount initially recognized as an allowance for credit losses was limited to the fair value floor, subsequent changes in fair value would require adjusting the allowance, even if those fair value changes were driven by non-credit factors, e.g., interest rates or liquidity.

Troubled Debt Restructurings

The Board decided that credit losses for loans classified as TDRs would be measured using the CECL model that would apply to all other financial assets measured at amortized cost. Therefore, entities would evaluate impairment of TDRs on a collective (pool) basis together with other loans that have similar risk characteristics. If TDRs do not share similar risk characteristics with other loans, impairment would be evaluated individually.

Consistent with current U.S. GAAP, credit losses would continue to be recognized through earnings using an allowance account that is updated each period.

Background. The Board had previously decided that the amortized cost basis of the asset would have been adjusted when impairment was recognized for TDRs. The new amortized cost basis would have been the present value of the post-modification contractual cash flows (discounted at the asset's original effective interest rate). Stakeholders raised concerns about the cost and complexity of the cost-basis adjustment, including determining the cumulative-effect transition adjustment required at the time of adoption for loans previously classified as TDRs.

KPMG Observations

Allowing TDRs to be measured using the CECL model gives entities more latitude to develop different methods to estimate and measure expected credit losses. The methods must be applied consistently and must reflect the key elements of the CECL model. This represents a change from current U.S. GAAP, which requires TDRs to be measured individually using a discounted cash-flow technique.

Because the same methods could be used to measure expected credit losses for TDRs and non-TDRs, entities that previously had to segregate TDRs for subsequent measurement may not need to continue to do so. However, for loan modifications that also are TDRs, consistent with current U.S. GAAP, creditors would continue to separately disclose both the impairment amounts related to TDRs and the recorded investment in the period in which the entity recognized impairment.[4]

The Board decided to provide more latitude to determine the methods that entities could use to measure impairment for TDRs. However, it is not clear whether the Board intended to permit measurement methods that would not recognize an impairment loss when the lender grants a concession through a reduction of the interest rate charged to the borrower.

Next Steps

The Board will meet again before year end to discuss cost-benefit considerations and an issue related to measuring expected credit losses for purchased assets with more-than-insignificant credit deterioration. The Board expects to issue the final impairment standard during the first quarter of 2016.

The Board decided not to align the effective date of the new classification and measurement standard with the effective date of the new impairment standard. Instead, the Board aligned the effective date of classification and measurement with the effective date of the revenue standard.

Classification and Measurement

External Review Draft

In August 2015, the FASB distributed an external review draft of the classification and measurement standard to a select group of stakeholders. The FASB received approximately 233 comments; the reviewers identified 36 comments as fatal flaws. The staff concluded there were no issues that the Board needed to discuss.

Effective Date

The Board decided the classification and measurement standard would be effective for:

- Public business entities for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years; and
- All other entities for fiscal years beginning after December 15, 2018, and interim periods within fiscal years beginning after December 15, 2019.[5]

Early adoption would be permitted for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. When the standard is issued, entities could early adopt at the beginning of a fiscal year to separately present in other comprehensive income the portion of the change in fair value of the financial liability (for which the fair value option had been elected) that results from a change in the instrument-specific credit risk.

[4] FASB ASC paragraph 310-40-50-4, available at www.fasb.org.

[5] All other entities includes not-for-profit entities, and employee benefit plans within the scope of ASC Topics 960, Defined Benefit Pension Plans; 962, Defined Contribution Pension Plans; and 965, Health and Welfare Benefit Plans, all available at www.fasb.org.

Next Steps

The Board concluded that the benefits of the new classification and measurement standard would outweigh the costs of application and directed the staff to draft a final standard for vote by written ballot. A final standard is expected to be issued by the end of 2015.

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NATIONAL ASSOCIATION OF
REAL ESTATE INVESTMENT TRUSTS®

May 31, 2013

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Technical Director
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Financial Accounting Standards Board
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Delivered Electronically

Re: File Reference No. 2012-260, *Financial Instruments – Credit Losses (Subtopic 825-15)*

Dear Ms. Cosper:

This letter is submitted by the National Association of Real Estate Investment Trusts® (NAREIT) in response to the Proposed Accounting Standards Update from the Financial Accounting Standards Board (FASB or the Board) on *Financial Instruments – Credit Losses (Subtopic 825-15)* (the Proposal).

NAREIT is the worldwide representative voice for real estate investment trusts (REITs) and publicly traded real estate companies with an interest in U.S. real estate and capital markets. NAREIT's members are REITs and other businesses throughout the world that own, operate, and finance income-producing real estate, as well as those firms and individuals who advise, study, and service those businesses.

REITs are generally deemed to operate as either Equity REITs or Mortgage REITs. Our members that operate as Equity REITs acquire, develop, lease, and operate income-producing real estate. Our members that operate as Mortgage REITs finance housing and commercial real estate by originating mortgages or by purchasing whole loans or mortgage backed securities in the secondary market.

A useful way to look at the REIT industry is to consider an index of stock exchange-listed companies like the FTSE NAREIT U.S. Real Estate Index, which covers both Equity REITs and Mortgage REITs. This Index contained 172 companies representing an equity market capitalization of $603.4 billion at 2012 year end. Of these companies, 139 were Equity REITs representing 90.2% of total U.S. listed

REIT equity market capitalization (amounting to $544.4 billion)[1]. The remainder, as of December 31, 2012, was 33 publicly traded Mortgage REITs with a combined equity market capitalization of $59 billion.

NAREIT's Recommendation

NAREIT concurs with the FASB's goal of developing a financial reporting model that more accurately reflects the timing and degree to which companies sustain credit losses on financial assets. However, with respect to the FASB's proposed current expected credit loss model (CECL), we believe that there are a number of areas that need improvement for the model to become operational for preparers and understandable for users, regulators, and auditors alike. Therefore, NAREIT proposes the following enhancements with regard to the CECL model:

- **Allow the credit loss allowance to be based on management's "best estimate" of expected credit losses – so, for example, an investor in an AA-rated bond or U.S. Treasury bond or Agency security would expect a best estimate of zero**

- **Clarify that the time horizon for the CECL model is based on the expected life (as opposed to the contractual life) of the financial asset**

- **Allow preparers to reverse previously recorded credit losses and require preparers to adjust the effective yield over the remaining life of the financial instrument to the extent that the expected cash flows exceeds the <u>originally</u> anticipated amount**

- **Exclude trade receivables and lease receivables from the scope of the Proposal**

- **Ensure that interim disclosures are not a mere repeat of the annual disclosures unless there is a material change**

Allow the credit loss allowance to be based on management's "best estimate" of expected credit losses – so, for example, an investor in an AA-rated bond or U.S. Treasury bond or Agency security would expect a best estimate of zero

NAREIT understands that the Proposal would require companies to book a credit loss upon execution of the transaction based on multiple possible outcomes. The estimate would be neither a worst-case scenario nor a best-case scenario, but rather would be based on an entity's assessment of current conditions and reasonable and supportable forecasts about the future. As such, the Proposal would expressly prohibit companies from utilizing a "best estimate" or "most likely outcome" approach that may result in recognizing zero credit losses.

NAREIT does not believe that the Proposal, as written, would faithfully present the underlying economics of certain transactions. NAREIT questions the Proposal's outcome when the model is applied to securities that are measured at fair value with changes in value recognized in other comprehensive income. For example, preparers would be required to record an allowance for credit losses immediately upon purchasing an AA-rated bond, a U.S. Treasury bond, or an Agency

[1] http://returns.reit.com/reitwatch/rw1301.pdf at page 20.

mortgage-backed security and thus "expect" credit losses of something other than zero. The vast majority of companies have never incurred a credit loss with respect to these particular investments. Therefore, NAREIT questions why the Board would require management to book an allowance for credit losses for these types of financial instruments, regardless of how small, when management's long-standing history indicates that there has never been a credit loss incurred historically. Further, the purchase price already inherently reflects what little credit risk exists.

The results of the CECL model become further perplexing when considering the fact that a company would record ***no allowance for credit losses*** at the date of purchase if these financial instruments are measured at fair value, with changes in value recognized in net income.

In NAREIT's view, the Board could easily address this accounting anomaly in the Proposal by permitting management to utilize a "best estimate" of expected credit losses. The concept of "best estimates" has conceptual merits in current U.S. GAAP. For example, FASB Concepts Statement No.7, *Using Cash Flow Information and Present Value in Accounting Measures*, defines the term *best estimate* as follows:

> The single most-likely amount in a range of possible estimated amounts; in statistics, the estimated mode. In the past, accounting pronouncements have used the term *best estimate* in a variety of contexts that range in meaning from "unbiased" to "most likely[2]."

NAREIT believes that providing management with the ability to use a "best estimate" approach within the CECL model would more accurately report management's view of the financial position of a company to users of financial statements.

Clarify that the time horizon for the CECL model is based on the expected life (as opposed to the contractual life) of the financial asset

A literal reading of the Proposal suggests that the allowance for credit losses estimate would be based on the cash flows that management does not expect to collect over the *contractual* life of the financial instrument. NAREIT questions whether it was the Board's intention for management to use the entire contractual life in all instances. For example, based on information obtained from the Federal Housing Finance Agency, the historical assumption for the average life of a 30-year residential mortgage loan is approximately 10 years[3]. The shorter life is due to prepayments that result when homeowners either sell their homes to move, decide to refinance due to decreasing interest rates, or default on the mortgage loan. NAREIT does not believe that an allowance for credit losses that is based on the entire 30-year life of the mortgage loan would be an accurate estimate.

NAREIT recommends that the Board discontinue use of the phrase "contractual cash flows" and utilize the term "expected cash flows" in its place. This would permit management to take

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[2] http://www.fasb.org/cs/BlobServer?blobkey=id&blobnocache=true&blobwhere=1175820900214&blobheader=application%2Fpdf&blobcol=urldata&blobtable=MungoBlobs at page CON7-5.

[3] http://www.fhfa.gov/webfiles/25006/MIRS_Feb_2013_final.pdf at page 2.

prepayments into consideration when estimating the expected life of a loan. NAREIT believes that making this change would dispel the confusion regarding whether the Board's intention was for preparers to estimate credit losses over the life-time contractual term of financial instruments that surfaced after the Proposal was issued. Subsequently, the Board attempted to address its intention in question 8 of the Proposed Accounting Standards Update, *Financial Instruments—Credit Losses (Subtopic 825-15)* Frequently Asked Questions document.

Allow preparers to reverse previously recorded credit losses and require preparers to adjust the effective yield over the remaining life of the financial instrument to the extent that the expected cash flows exceeds the originally anticipated amount

While we understand the impetus for the development of an expected credit loss model, we are concerned about any model that would only allow preparers to record downward adjustments and not reverse those credit losses in situations where the fair value of investments (*e.g.,* estimates of future cash flows) subsequently increases. With the benefit of hindsight, a preparer could observe whether market downturns later reverse. To the extent that market conditions stabilize, we believe that an accounting model that allows for reversals of previously recorded credit losses would more accurately reflect the financial position of a company. Thus, in that regard, we agree with the Proposal as an improvement over current practices for debt securities.

However, NAREIT believes that preparers should be able to adjust the effective yield over the remaining life of the financial instrument to the extent that the expected cash flows exceed the *originally* anticipated amount, unlike the Proposal that would record an immediate gain. In our view, the accounting model that we recommend would provide the best information to users of financial statements as well as address the uncertainty of estimates in a prudent manner.

Exclude trade receivables and lease receivables from the scope of the Proposal

NAREIT fails to see the benefit of including trade receivable and lease receivables within the scope of the Proposal. NAREIT observes that the Board is inconsistent when it comes to defining whether a lease is a financial asset. For example, lease receivables are excluded from the scope of the project that deals with financial assets (*e.g.,* the Proposed Accounting Standards Update on *Financial Instruments: Recognition and Measurement*), while in projects such as this, the FASB includes lease receivables as financial assets within the scope of the Proposal. Further, we note that trade receivables are generally short term and present few accounting issues under current U.S. GAAP.

To avoid confusion and complexity, NAREIT recommends that the Board exclude these assets from the scope of the Proposal. NAREIT believes that the accounting treatment for credit losses with respect to these asset types is best suited for the chapters in the codification that address these asset types. For example, credit losses for leases should be included within the codification section that is dedicated to leases. In order to ensure that convergence is achieved, the FASB and IASB should include the accounting for credit losses for leases within the scope of the *Leases* Project.

In the event that the Board does not decide to follow our recommendation, NAREIT requests that the Board clearly articulate the types of leases that would be in scope of the Proposal (*e.g.,* both operating and finance lease receivables?). Depending on the Board's anticipated timing for the effective date, this scoping decision should contemplate both leases under current U.S. GAAP and leases that would exist under the proposed *Leases* standard.

Ensure that interim disclosures are not a mere repeat of the annual disclosures unless there is a material change

As NAREIT indicated in its November 30, 2012 submission[4] on the FASB's *Disclosure Framework* discussion paper and in its May 15, 2013 submission[5] on the FASB's *Financial Instruments: Recognition and Measurement* Proposal, NAREIT has observed a growing trend in accounting pronouncements that requires companies to prepare the same types of disclosures at both interim and annual reporting dates. NAREIT questions whether detailed information can continue to be disclosed at interim periods given shorter quarterly SEC financial reporting deadlines (*i.e.*, 40 days for both large accelerated filers and accelerated filers, and 45 days for non-accelerated filers[6]) when compared with annual SEC financial reporting deadlines (*i.e.*, 60 days for large accelerated filers, 75 days for accelerated filers, and 90 days for non-accelerated filers[7]). According to APB 28: *Interim Financial Reporting* (Accounting Standards Codification Topic 270), each interim period is an integral part (as opposed to a discrete part) of the annual reporting period.

NAREIT suggests that the Board consider the approach that the SEC utilizes for changes in financial condition and quantitative and qualitative disclosures of market risks. The SEC requires these disclosures in annual reports. To the extent that there has been a material change since the date of the most recent annual report, the SEC requires disclosures in quarterly filings as well. By taking this approach, the SEC has effectively reduced unnecessary disclosure duplication. NAREIT believes that the FASB would achieve its objective by taking a similar approach.

We urge the FASB and the IASB to work toward a converged solution. As the Boards near the completion of the convergence projects, we implore the FASB and IASB to work together to reduce differences in their respective Financial Instruments models. This will benefit preparers, users, auditors, and regulators alike.

We thank the FASB for the opportunity to comment on the Proposal. If you would like to discuss our views in greater detail, please contact George Yungmann, NAREIT's Senior Vice President, Financial Standards, at gyungmann@nareit.com or 1-202-739-9432, or Christopher Drula, NAREIT's Vice President, Financial Standards, at cdrula@nareit.com or 1-202-739-9442.

Respectfully submitted,

[4] http://www.reit.com/~/media/Files/Policy/Letter-to-FASB-on-Disclosure-Framework-11-30-12.ashx

[5] http://www.reit.com/~/media/2013/NAREIT%20Comment%20Letter%20on%20FASB%20Recognition%20and%20Measurement%20Proposal.ashx

[6] http://www.sec.gov/answers/form10q.htm

[7] http://www.sec.gov/answers/form10k.htm

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NATIONAL ASSOCIATION OF
REAL ESTATE INVESTMENT TRUSTS®

May 15, 2013

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Technical Director
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Delivered Electronically

Re: File Reference No. 2013-220, Financial Instruments – Overall (Subtopic 825-10): *Recognition and Measurement of Financial Assets and Financial Liabilities*

Dear Ms. Cosper:

This letter is submitted by the National Association of Real Estate Investment Trusts® (NAREIT) in response to the Proposed Accounting Standards Update (Proposed ASU or the Proposal) from the Financial Accounting Standards Board (FASB or the Board) on Financial Instruments – Overall (Subtopic 825-10): *Recognition and Measurement of Financial Assets and Financial Liabilities*.

NAREIT is the worldwide representative voice for real estate investment trusts (REITs) and publicly traded real estate companies with an interest in U.S. real estate and capital markets. NAREIT's members are REITs and other businesses throughout the world that own, operate, and finance income-producing real estate, as well as those firms and individuals who advise, study, and service those businesses.

REITs are generally deemed to operate as either Equity REITs or Mortgage REITs. Our members that operate as Equity REITs acquire, develop, lease, and operate income-producing real estate. Our members that operate as Mortgage REITs finance housing and commercial real estate, by originating mortgages or by purchasing whole loans or mortgage backed securities in the secondary market.

A useful way to look at the REIT industry is to consider an index of stock exchange-listed companies like the FTSE NAREIT U.S. Real Estate Index, which covers both Equity REITs and Mortgage REITs. This Index contained 172 companies representing an equity market capitalization of $603.4 billion at 2012 year end. Of these companies, 139 were Equity REITs representing 90.2% of total U.S. listed

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REIT equity market capitalization (amounting to $544.4 billion)[1]. The remainder, as of December 31, 2012, was 33 publicly traded Mortgage REITs with a combined equity market capitalization of $59 billion.

NAREIT's Recommendation

NAREIT recommends that the FASB continue with its approach in the Proposal to provide companies with the ability to recognize and measure financial assets and financial liabilities based on a business model assessment. NAREIT commends the Board for working with the International Accounting Standards Board (IASB) (collectively, the Boards) in developing a mixed attribute model for the recognition and measurement of financial assets (*i.e.*, amortized cost, fair value through other comprehensive income, and fair value through net income) and financial liabilities (*i.e.*, amortized cost and fair value through net income). NAREIT has supported a mixed attribute model for financial instruments previously. For example, NAREIT recommended that the Board develop a mixed attribute model in its September 30, 2010 submission[2] regarding the FASB's Proposal on Financial Instruments (Topic 825) and Derivatives and Hedging (Topic 815): *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities.*

In NAREIT's view, a mixed attribute model would be consistent with the business models of companies that own and operate real estate, as well as companies that finance transactions involving real estate. These companies typically hold or issue financial assets and financial liabilities for collection or payment of contractual cash flows for principal and interest. We believe that the amortized cost method more accurately reflects this business strategy, rather than measuring these financial instruments at fair value implying that the intention is to trade financial instruments. In addition, for companies that hold mortgage backed securities for collection or payment of contractual cash flows for principal and interest or for sale, we believe that the fair value through other comprehensive income method appropriately reflects this business strategy. For financial instruments held for trading purposes, we agree with the Board that fair value through net income is a more appropriate method.

While NAREIT supports the FASB's mixed attribute model, we recommend the following enhancements to the Proposal:

- **Synchronize embedded derivatives guidance for financial assets with financial liabilities**

- **Eliminate the assessment for cash flows based solely on principal and interest**

- **Converge the Proposal's impairment guidance with the FASB and IASB respective Credit Impairment models in allowing for the reversal of previously recorded impairment charges**

[1] http://returns.reit.com/reitwatch/rw1301.pdf at page 20.
[2] http://www.reit.com/~/media/Files/Policy/NAREITFinancialInstrumentsLetter1810-100.ashx

- **Clearly articulate the threshold for sales and the consequence of selling financial assets that are classified in the amortized cost category**

- **Ensure that interim disclosures are not a mere repeat of the annual disclosures unless there is a material change**

Synchronize embedded derivatives guidance for financial assets with financial liabilities

NAREIT contends that the Proposal, as written, creates asymmetry between financial assets and financial liabilities. While financial liabilities would continue to be evaluated for bifurcation of embedded derivatives, the corresponding embedded derivative guidance for financial assets would no longer exist. As a result, the *mere existence* of an embedded derivative in a financial asset, even if of quite limited magnitude, would cause the entire financial instrument to be subject to the cash flow characteristics and business model assessment to determine its classification and measurement. In NAREIT's view, this could result in different accounting treatment for economically similar arrangements.

Common investments amongst NAREIT's membership are debt investments, which may have embedded derivatives designed to remove uncertainty about future cash flows. NAREIT believes that to the extent that an embedded derivative *exists* in debt instruments, these instruments would fail the proposed cash flow characteristics test. Consequently, these investments would be measured at fair value with changes in value recognized in net income. Thus, NAREIT believes that it is not the existence of the derivative, but the function of the derivative that should matter. An instrument with an embedded derivative that is economically similar to an instrument that qualifies for amortized cost should be accounted for at amortized cost (*i.e.*, a single instrument). If an embedded derivative is not clearly and closely related to the host contract, it should be bifurcated and accounted for separately.

NAREIT recommends that the FASB retain existing embedded derivatives guidance for financial assets, which would create symmetry with financial liabilities. NAREIT does not believe that the current embedded derivative guidance for financial assets is broken. Currently, an embedded derivative is bifurcated and accounted for separately if it is not clearly and closely related to the host contract. Preparers account for the host contract separately from the embedded derivative, which is measured at fair value with changes in value recognized in net income. In this manner, changes in fair value are isolated to the embedded derivative only, as opposed to the entire financial asset as required by the Proposal.

Eliminate the assessment for cash flows based solely on principal and interest

NAREIT believes that the criteria to classify financial instruments at amortized cost are too restrictive. For example, many financial instruments that currently are held for the collection of cash flows and are therefore measured at amortized cost would be precluded from such classification under the Proposal. Additionally, financial assets with early redemption features could fail the assessment of cash flows based solely on principal and interest when acquired at a premium or discount. Another example is an investment in subordinated tranches of a mortgage securitization. In NAREIT's view, current U.S. GAAP that requires an embedded derivatives assessment more faithfully presents the underlying economics of the transaction. Therefore, NAREIT recommends that the FASB eliminate the assessment for cash flows based solely on principal and interest from the Proposal, and maintain existing embedded derivatives guidance for financial assets.

NAREIT also notes that the proposed cash flow test would *add* to complexity because the embedded derivative bifurcation rules would still be needed for financial liabilities. And no doubt, the proposed new test would lead to more questions and interpretation.

Converge the Proposal's impairment guidance with the FASB and IASB respective Credit Impairment models that allow for the reversal of previously recorded impairment charges

NAREIT understands that the Proposal would eliminate current impairment guidance on other-than-temporary-impairments (OTTI) for equity investments not measured at fair value through net income. The new impairment model would be based on a qualitative assessment (*i.e.,* more likely than not) as to whether the carrying amount of the investment exceeds fair value.

While we welcome the simplified approach to recording impairment charges, we are concerned that the Proposal would only allow preparers to record downward adjustments and not reverse those losses in situations where the fair value of investments subsequently increases. With the benefit of hindsight, we could observe whether market downturns are sustained. To the extent that markets stabilize, we believe that an accounting model that allows for reversals of previously recorded impairment write-downs would more accurately reflect the financial position of a company. In our view, this symmetric accounting model would provide the best information to users of financial statements.

Further, NAREIT observes that the proposed impairment model is divergent from the models proposed by the FASB and the IASB in their respective Credit Impairment models. NAREIT notes that both the FASB and IASB Credit Impairment proposals allow for the reversal of previously recorded allowance for credit losses. In our view, providing companies with the ability to reverse previously recorded impairment write-downs would serve as an opportunity for the FASB to synthesize impairment guidance within U.S. GAAP with respect to financial instruments and achieve convergence with the IASB at the same time.

Clearly articulate the threshold for sales and the consequence of selling financial assets that are classified in the amortized cost category

NAREIT understands that the Proposal would eliminate the concept of "tainting" from U.S. GAAP that occurs when a company sells financial instruments that are classified as held to maturity. Under the Proposal, the FASB indicates that such sales should be rare and infrequent. However, the Proposal does not articulate how many times such sales could occur. Nor does the Proposal indicate what the consequences are of executing sales from the amortized cost category. In order to reduce the possibility for improper sales from the amortized cost category, and work towards reducing situations whereby some companies might try to "game the system," NAREIT recommends that the FASB clearly articulate a threshold for sales (and the consequence of selling beyond this threshold) of financial assets that are classified in the amortized cost category.

Ensure that interim disclosures are not a mere repeat of the annual disclosures unless there is a material change

As NAREIT indicated in its November 30, 2012 submission[3] on the FASB's *Disclosure Framework* discussion paper, NAREIT has observed a growing trend in accounting pronouncements that requires companies to prepare the same types of disclosures at both interim and annual reporting dates. NAREIT questions whether detailed information can continue to be disclosed at interim periods given shorter quarterly SEC financial reporting deadlines (*i.e.,* 40 days for both large accelerated filers and accelerated filers, and 45 days for non-accelerated filers[4]) when compared with annual SEC financial reporting deadlines (*i.e.,* 60 days for large accelerated filers, 75 days for accelerated filers, and 90 days for non-accelerated filers[5]). According to APB 28: *Interim Financial Reporting*, each interim period is an integral part (as opposed to a discrete part) of the annual reporting period. Therefore, NAREIT suggests that the Board consider the approach that the SEC utilizes for changes in financial condition and quantitative and qualitative disclosures of market risks. The SEC requires these disclosures in annual reports. To the extent that there has been a material change since the date of the most recent annual report, the SEC requires disclosures in quarterly filings as well. By taking this approach, the SEC has effectively reduced unnecessary disclosure duplication. NAREIT believes that the FASB would achieve its objective by taking a similar approach.

Other Comments

NAREIT notes that in the FASB's consequential amendments document, hedge accounting for interest rate risk is not permitted for debt securities measured at amortized cost, but apparently is permitted for loans measured at amortized cost. NAREIT found this difficult to understand given that the Proposal overall treats securities and loans in the same manner. NAREIT believes hedge accounting should be permitted for both loans and securities which would be consistent with good treasury risk management practices (*e.g.,* see paragraph 825-10-55-73 in the Proposal).

NAREIT observes that the proposed held-for-sale criteria for equity method investments may be interpreted very broadly. We are concerned that this may result in certain investments being inappropriately reported at fair value through net income, which may be contrary to the Board's intention. For example, investments reported under the equity method of accounting (*e.g.,* investments in joint ventures, partnerships and limited liability companies) might be considered held-for-sale investments simply because (1) the underlying arrangements may contain explicit or implied end/termination dates or (2) management often considers a wide range of exit plans depending on future developments over a long time horizon. NAREIT does not believe this result would represent the most useful financial reporting and questions whether or not the Board intended this result.

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[3] http://www.reit.com/~/media/Files/Policy/Letter-to-FASB-on-Disclosure-Framework-11-30-12.ashx

[4] http://www.sec.gov/answers/form10q.htm

[5] http://www.sec.gov/answers/form10k.htm

In summary, we urge the FASB and the IASB to remain committed on their convergence efforts. As the Boards near the completion of the convergence projects, we implore the FASB and IASB to work together to reduce differences in their respective Financial Instruments models. This will benefit preparers, users, auditors, and regulators alike.

We thank the FASB for the opportunity to comment on the Proposal. If you would like to discuss our views in greater detail, please contact George Yungmann, NAREIT's Senior Vice President, Financial Standards, at gyungmann@nareit.com or 1-202-739-9432, or Christopher Drula, NAREIT's Vice President, Financial Standards, at cdrula@nareit.com or 1-202-739-9442.

Respectfully submitted,

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Dataline
A look at current financial reporting issues

No. 2013-01
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What's inside:

Credit losses on financial assets
An overview of the FASB's current expected credit loss model

Overview

At a glance

- Impairment is a major component of the FASB and IASB's (the boards') joint project to revisit most aspects of financial instruments accounting. In the aftermath of the recent financial crisis, the current incurred loss approach has been criticized for delaying the recognition of credit losses. As a result, many constituents believe revisions to the current impairment model are necessary.

- The FASB has completed redeliberations on its proposed impairment model, referred to as the "current expected credit loss" (CECL) model. In December 2012, the FASB issued for public comment its proposed Accounting Standards Update (ASU), *Financial Instruments—Credit Losses (Subtopic 825-15)*. The ASU proposes recognition of the full expected credit loss on financial instruments that fall within its scope. The comment period ends on April 30, 2013.

- The IASB has completed redeliberations on its proposed model, previously referred to as the "three bucket" model and now known as the "credit deterioration" model. The IASB's model differs from the FASB's model in several key areas, which are highlighted throughout this Dataline. The IASB is expected to issue its exposure draft in the first quarter of 2013.

The main details

.1 The development of a revised standard on the impairment of financial assets is one part of the boards' joint priority project to address various aspects of financial instruments accounting. This Dataline focuses only on the developments in impairment accounting. Refer to Dataline 2012-21, *Financial instruments classification and measurement — An update on the FASB's tentative approach to be exposed in Q1 2013*, for information on the classification and measurement portion of the financial instruments project.

.2 Various constituents have expressed the need for the accounting standard setters to address the perceived flaws in the current impairment model. For example:

1) In an April 2009 report reflecting on the causes of the global financial crisis, the Group of 20, consisting of the finance ministers and central bank governors of the major economies, made several recommendations. Among other things, the report recommended that accounting principles related to loan loss provisioning be improved to permit consideration of a "broader range of credit information."

2) The Financial Crisis Advisory Group, formed to advise the FASB and IASB, said in its final July 2009 report that the financial crisis exposed weaknesses in financial reporting that included "the delayed recognition of losses associated with loans, structured credit products, and other financial instruments by banks, insurance companies and other financial institutions." They recommended that the boards explore an approach that uses more forward-looking information, such as an expected loss model or fair value model.

3) The Basel Committee on Banking Supervision stated in an August 2009 report that the IASB's new financial instruments standard should "reflect the need for earlier recognition of loan losses to ensure robust provisions."

.3 Both the FASB's CECL model and the IASB's credit deterioration model seek to improve the decision usefulness of the reporting of credit losses by removing the perceived constraints to timely recognition, and allowing entities to consider a broader information set. Both models move away from the incurred loss model that exists in practice today and consider expected losses when determining the amount of credit losses that should be recognized each reporting period.

PwC observation:

Extensive system and process changes may be needed to apply both models and may require a considerable amount of lead time in order to be designed and implemented. Specifically, entities will need to develop the infrastructure to estimate losses over a longer time horizon. If there are concerns about the operationality and system requirements to implement the proposed model, constituents are encouraged to communicate those concerns through the comment letter process.

.4 This Dataline is focused on the FASB's CECL model but draws comparisons to the credit deterioration model throughout the document. In addition, refer to Appendix I of this Dataline for a side-by-side comparison of the boards' respective impairment approaches.

.5 As both boards move away from an incurred loss model and instead look to expected losses, it is likely that levels of allowance for credit losses will change. This could potentially impact regulatory capital requirements and various key financial metrics.

.6 The FASB has not yet determined an effective date for the proposed model. The FASB will discuss an effective date after considering feedback it receives during the comment period. The FASB has indicated that it will consider multiple potential effective dates, and may consider different effective dates for public versus non-public companies and regulated versus non-regulated entities.

PwC observation:

Given the FASB released its proposed CECL model in December 2012, it is unlikely it will issue a final standard before the later part of 2013. Therefore, an effective date earlier than 2015 appears unlikely.

Key elements of the CECL model

Objective

.7 The objective of recording an allowance for credit losses is to reflect the estimate of the amount of contractual cash flows not expected to be collected. The CECL model provides guidance on how an entity should recognize and measure expected credit losses. The CECL model is intended to simplify current practice by eliminating today's multiple impairment models. It also allows entities to consider a broader information set to determine the amount of credit losses expected to occur.

.8 For debt instruments, there are several different impairment models used today under US GAAP, including the following:

- ASC 310-30, *Receivables — Loans and Securities Acquired with Deteriorated Credit Quality* (formerly SOP 03-3)
- ASC 310-40, *Receivables — Troubled Debt Restructurings by Creditors* (formerly FAS 114)
- ASC 320-10-35, *Investments — Debt and Equity Securities — Recognition of an Other-Than-Temporary Impairment* (formerly FSP FAS 115-2)
- ASC 325-40, *Investments — Beneficial Interests in Securitized Financial Assets* (formerly EITF 99-20)
- ASC 450, *Contingencies* (formerly FAS 5)

The CECL model aims to replace the various impairment models that exist today with a single approach for all debt instruments.

PwC observation:

With respect to interest income recognition, the CECL model only speaks to how to recognize interest income on purchased credit impaired assets, and when to stop accruing interest income altogether. The proposed ASU does not address how a creditor should recognize interest income on the remainder of the portfolio. However, the proposed ASU is intended to supersede ASC 310-30 and ASC 325-40, which currently provide guidance on interest income recognition for certain instruments. We anticipate questions to arise regarding how interest income should be recognized under the CECL model.

Scope

.9 Both the CECL model and the credit deterioration model will apply to financial assets that are subject to losses related to credit risk and are *not* measured at fair value with changes in fair value recognized in net income. Said differently, both models will apply to financial assets that are subject to losses related to credit risk that are carried at amortized cost or fair value with changes in fair value recorded in other comprehensive income (FV-OCI).

.10 The scope of both models includes loans, debt securities, trade receivables, lease receivables, and loan commitments. At this stage, the FASB has also included reinsurance receivables that result from insurance transactions in the scope of its impairment model. The IASB recently made a decision to subject reinsurance receivables to insurance accounting, which under IFRS, results in an expected value measurement. Therefore, the proposed measurement of credit loss associated with a reinsurance receivable will be the same under US GAAP and IFRS despite these arrangements being within the scope of two different areas of the accounting standards.

PwC observation:

Many have questioned whether or not financial guarantees are included in the scope of the FASB's proposed ASU. Many argue that financial guarantee contracts present many of the same credit considerations as loan commitments, which are included in the scope of the proposed guidance. However, others view financial guarantees as insurance contracts and believe they should be accounted for as such.

The FASB has made a tentative decision that the proposed insurance contracts standard should apply to financial guarantee contracts currently accounted for as insurance under existing US GAAP, such as mortgage insurance and financial guarantee contracts sold by insurance enterprises. The FASB has yet to decide whether guarantees issued by banks or other financial institutions will be included in the scope of the insurance standard. In its project on insurance contracts, the FASB has tentatively defined "insurance contracts" broadly. Therefore, absent a specific scope exclusion in the insurance contracts standard, financial guarantee contracts will likely meet the definition of an insurance contract.

The IASB has made a decision to include financial guarantee contracts in the scope of the impairment project. However, if an entity previously asserted explicitly that it regards financial guarantee contracts as insurance contracts and applied insurance accounting, the IASB will permit the entity to elect to continue applying insurance accounting.

Measurement

.11 The CECL model will require an entity to recognize an allowance for all expected credit losses on debt instruments. The FASB defines expected credit losses as "an estimate of all contractual cash flows not expected to be collected from a recognized financial asset (or group of financial assets) or commitment to extend credit." There will be no threshold to meet prior to recognizing a credit loss, and the allowance must reflect the time value of money. Refer to further discussion under "Information set to consider" below regarding consideration of the time value of money in applying the CECL model.

PwC observation:

The CECL model and the credit deterioration model both represent potentially significant changes from current practice, as both models move away from the incurred loss notion and instead focus on expected losses. While both models represent a change from current practice, there are several key differences between the two models.

Perhaps the most significant difference is that the CECL model does not contain a "trigger" to recognizing full expected credit losses, while the credit deterioration model only requires recognition of a full expected credit loss on those assets for which there has been a significant deterioration in credit or there is a probability of loss in the next twelve months.

.12 Both the CECL model and the credit deterioration model require that an entity's estimate of expected credit losses reflect, at a minimum, two possible outcomes: an outcome in which a credit loss results and an outcome in which no credit loss results. An entity will be prohibited from estimating expected credit losses on the basis of the most likely outcome for an individual financial asset.

PwC observation:

Both the CECL model and the credit deterioration model require consideration of more than one possible scenario in estimating the allowance for credit losses. Because one scenario must reflect the possibility that a credit loss results, there will be some amount of allowance for every financial asset.

The CECL model does not contain a threshold to meet prior to recognizing a full expected credit loss. As all loans have some risk of loss, the CECL model will require day one loss recognition for the credit risk associated with newly originated loans. While application of the IASB's credit deterioration model will also result in day one losses, such losses will likely be smaller than under the CECL model. This is due to the fact that the IASB model only contemplates the probability of loss in the next twelve months for newly originated loans that have not experienced significant credit deterioration.

.13 Both the CECL model and the credit deterioration model apply to financial assets measured at amortized cost and FV-OCI. However, the CECL model contains a practical expedient for financial assets measured at FV-OCI. The practical expedient allows entities not to recognize credit losses when both of the following conditions are present:

- The fair value of the individual financial asset is greater than (or equal to) the amortized cost basis of the financial asset; and

- The expected credit losses on the individual financial asset are insignificant, which may be determined by considering the general expectation of the range of expected credit losses given the credit-quality indicator(s) for the asset as of the reporting date.

PwC observation:

Debt securities are expected to be one of the more common types of financial assets carried at FV-OCI. In many cases, entities hold large portfolios of debt securities with high credit quality, including U.S. Treasury and other highly rated securities. Often, credit losses will not be significant on an individual asset basis; therefore, these securities will likely meet the second criterion to qualify for the practical expedient.

However, the fair value of such securities is impacted by a variety of factors, including liquidity, interest rates, and credit. As a result, movement in market interest rates that result in a decrease in fair value could lead to these securities no longer qualifying for the practical expedient. Therefore, recognition of expected credit losses will be required even though there was no change in the credit risk of the securities. Although these credit losses may not be significant on an individual asset basis, they could potentially be significant across an entire portfolio.

.14 Consistent with current practice, the CECL model provides a practical expedient when estimating credit losses on collateral-dependent financial assets. The practical expedient allows entities to compare the fair value of the collateral to the amortized cost basis to determine the allowance for credit losses. If an entity elects to apply the practical expedient and repayment or satisfaction of the asset depends on the sale of the collateral, the fair value of the collateral is required to be adjusted to consider estimated costs to sell. If the repayment or satisfaction of the asset depends on the operation of the collateral, but not the sale, the fair value is not adjusted.

PwC observation:

The FASB expanded the current definition of a collateral-dependent financial asset. Under today's guidance, collateral dependent only applies to loans and is defined as "a loan for which repayment is expected to be provided solely by the underlying collateral."

The new definition of collateral-dependent financial asset is revised to "a financial asset for which repayment is expected to be provided primarily or substantially through the operation (by the lender) or sale of the collateral, based on an entity's assessment as of the reporting date."

Today, there is diversity in how entities apply the definition of a collateral-dependent financial asset. While the FASB expanded the scope and definition to accommodate additional financial instruments, they did not provide a significant amount of additional application guidance on collateral-dependent financial assets. Therefore, we expect that there will continue to be diversity in how entities apply the definition in practice.

.15 For loan commitments not measured at fair value through net income, the CECL model requires entities to estimate credit losses over the full contractual period over which the entity is exposed to credit risk via an unconditional legal obligation to extend credit. The estimate of credit losses on loan commitments will consider the likelihood of funding and the extent of credit losses expected to occur on such funded amounts.

Subsequent measurement

.16 At each reporting period, entities will recognize, as a provision for credit loss, the amount of credit loss (or reversal), required to adjust the allowance to reflect the updated expectation of contractual cash flows not expected to be collected.

.17 An entity will be required to write-off a financial asset (or portion thereof) in the period in which a determination is made that the entity has no reasonable expectation of future recovery.

PwC observation:

The guidance in the proposed ASU on write-offs represents a significant change from current practice. With respect to securities, there will no longer be a "write-down" of the cost basis to reflect other-than-temporary impairment. Rather, entities will record an allowance for credit losses, which could decrease in subsequent periods.

With respect to loans, current practice varies as to when a loan is written-off. Although practice is mixed, a level of consistency has been achieved in certain industries where a common approach has been established by regulators or others. For example, banks typically write-off a loan when it becomes 180 days past due.

The CECL model establishes a single approach to recognizing write-offs. That approach requires write-off when there is no reasonable expectation of recovery. While the CECL model attempts to bring consistency, we anticipate that regulators will continue to express a point of view about how to interpret the guidance, as a "no reasonable expectation of recovery" principle leaves room for interpretation. Additionally, the FASB will require entities to disclose their write-off policy.

Information set to consider

.18 Both the CECL model and the credit deterioration model require estimates of expected credit losses to be based on internally and externally available information considered relevant in making the estimate. This includes information about past events, current conditions, and reasonable and supportable forecasts. Entities will be able to consider both qualitative and quantitative factors specific to borrowers and the economic environment in which the reporting entity operates.

PwC observation:

One of the goals of both the CECL and the credit deterioration models is to allow entities to consider a broader information set when estimating the allowance for credit losses. During the financial crisis of 2008, entities were restricted by the incurred loss model. Despite having information available that suggested further credit losses would eventually occur, entities could only record credit losses when those losses had been incurred. In establishing the information set to consider, both boards were focused on ensuring that entities could consider all relevant information, including forecasts about macroeconomic and borrower-specific conditions.

.19 The CECL model recognizes the inherent judgment involved in estimating credit losses and also recognizes that the most appropriate method to do so will vary depending on the asset and the information available that is relevant to the process. Therefore, the CECL model does not mandate specific approaches or policy elections to determine an expected credit loss. The proposed ASU includes examples of various methodologies that could be used to estimate expected credit losses under the CECL model.

PwC observation:

The FASB has given constituents latitude to determine the most appropriate method to satisfy the principles of estimating an expected credit loss. This will represent a change from today's guidance, which requires entities to use discounted cash flow calculations in certain situations. No such mandates will exist in the CECL model.

.20 Both the CECL and credit deterioration models require the allowance to consider time value of money. However, the CECL model allows for that consideration to be either implicit or explicit. The FASB believes that an example of a method that considers time value of money explicitly is a discounted cash flow calculation, and examples of methods that consider time value of money implicitly are historical loss ratios and probabilities of default.

PwC observation:

The FASB spent considerable time discussing the need for the CECL model to consider time value of money. Constituents had expressed concern about whether incorporating the time value of money effectively required entities to use discounted cash flow calculations. The FASB believes that many commonly used methods for estimating credit losses; including probability of default/loss given default (PD/LGD) and historical loss rates, inherently capture the time value of money.

The FASB's conclusions are based on the premise that the amortized cost recorded on the balance sheet at a point in time reflects the present value of all expected future cash flows, discounted at the effective interest rate. If an entity has historically measured losses against the amortized cost basis, such historical loss information inherently captures the time value of money. Therefore, historical loss rates and loss given default rates that incorporate this information would satisfy the objectives of the model.

.21 The CECL model allows entities to consider how credit enhancements mitigate expected credit losses on financial assets when estimating the allowance for credit losses, provided such credit enhancements are not separate freestanding instruments. As a result, the estimate of expected credit losses on a financial asset should not be offset by a legally detachable and separately exercisable contract that may mitigate expected credit losses on the financial asset.

PwC observation:

The proposed ASU cites a purchased credit default swap as an example of a freestanding contract that cannot be considered when establishing an estimate of expected credit losses. While a credit default swap is clearly a freestanding contract, it is not clear whether other common credit enhancements would be considered freestanding contracts.

For example, standard representations and warranties, while not a "separately exercisable" contract, do not necessarily travel with a loan upon subsequent sale. As a result, it is unclear whether standard representations and warranties will be considered freestanding. Based on the wording in the proposed ASU, we anticipate questions to arise regarding how various types of credit enhancements like representations and warranties should or should not be factored into an entity's estimate of credit losses.

Interest income

.22 The CECL model only addresses two areas related to interest income recognition: (1) interest income recognition on purchased credit-impaired (PCI) financial assets, and (2) when to cease the accrual of interest income on financial assets. Otherwise, the CECL model does not address how a creditor should recognize, measure, or display interest income on financial assets.

.23 The CECL model defines PCI assets as "acquired individual financial assets (or acquired groups of financial assets with shared risk characteristics at the date of acquisition) that have experienced a significant deterioration in credit quality since origination, based on the assessment of the acquirer."

PwC observation:

The definition of purchased credit-impaired financial assets represents a change from current practice. Under ASC 310-30, purchased assets are deemed to be impaired (and therefore in the scope of that section) if there is evidence of credit deterioration since origination and it is probable, at acquisition, that the investor will be unable to collect all contractually required payments receivable.

The definition used in the CECL model eliminates the second criterion in existing guidance. As a result, there may be a change in the scope of assets that qualify as PCI under the proposed model.

.24 For PCI assets, the CECL model requires buyers to assess the discount embedded in the purchase price that is attributable to expected credit losses at the date of acquisition. This amount is not recognized as interest income.

PwC observation:

Under the CECL model, PCI assets will continue to be subject to specific guidance on day one. Upon acquisition, an entity will be required to record an allowance to represent the amount of contractual cash flows not expected to be collected. Each component of the original purchase price will be "grossed up" to reflect the day one allowance.

For example, assume an entity purchases an asset with a par value of $100 for $85. At the acquisition date, the entity estimates it will not collect $10 of the contractual cash flows. The $85 cost basis of the asset will be “grossed up” to $95 to reflect the $10 embedded allowance. The remaining $5 of purchase discount attributed to factors other than credit is accreted in interest income over the remaining life of the asset.

The credit deterioration model differs from the CECL model with respect to PCI assets. Under the credit deterioration model, there is no concept of “grossing up” the basis of the loan to reflect the embedded allowance. The IASB’s model does not require an allowance to be recorded on day one, but instead limits the accrual of interest income to the expected cash flows as opposed to the contractual cash flows. This is consistent with current US GAAP treatment of PCI assets under ASC 310-30.

.25 On day two, the allowance for expected credit losses for PCI assets will follow the same approach as other debt instruments in the scope of the model. Changes in the allowance for expected credit losses will be recognized as an adjustment to the provision for credit losses in the current period.

PwC observation:

The CECL model attempts to address concerns raised about the complexity of today's accounting for purchased credit-impaired assets. Under today's guidance in ASC 310-30, deteriorations in expected cash flows on purchased credit impaired assets are reflected as additional provision expense, while improvements in cash flow expectations are generally reflected as prospective yield adjustments.

Under the CECL model, this "asymmetry" is eliminated. Any changes in expected cash flows, positive or negative, will be reflected through an adjustment of provision expense in the current period. As a result, if credit expectations significantly improve, gains could be recorded on assets for which the initial credit losses were never recorded in income due to the entity purchasing the asset at a discount.

.26 The CECL model requires entities to recognize contractual interest income unless it is not probable that the entity will collect all contractual cash flows. An entity will cease its accrual of interest income when it is not probable it will receive substantially all of the principal or substantially all of the interest.

.27 If it is not probable the entity will receive payment of substantially all of the principal, the entity will recognize all future cash receipts as a reduction in the carrying amount of the asset. When the carrying amount has been reduced to zero, additional payments are recognized as recoveries of amounts previously written off (that is, recorded as an adjustment to the allowance for expected credit losses) with any excess recognized as interest income.

.28 If it is probable the entity will receive payment of substantially all of the principal, but it is not probable the entity will receive substantially all of the interest, the entity will recognize interest income on the debt instrument when cash payments are received. Cash receipts that exceed the amount of interest income that would have been recognized had the asset not been placed on non-accrual status will be applied to reduce the carrying amount of the asset.

PwC observation:

Current practice varies in terms of when entities stop recognizing interest income, although in certain industries a consistent approach has evolved or has been established by regulators or others. For example, in the banking industry, interest is typically no longer recognized for loans that are more than 90 days past due. During its deliberations of this project, the FASB conducted outreach with various constituents, including the banking regulators. The FASB considered the banking regulators' feedback on current "non-accrual" practices in the banking industry when drafting the guidance in the proposed ASU. Therefore, constituents outside of the banking industry may see changes to their current practices.

Modifications

.29 For modifications that are not troubled debt restructurings (TDRs), there is no change to current guidance with respect to evaluating whether the modification results in a new loan or a continuation of the old loan. Creditors will be required to evaluate whether the modification is "more than minor" as outlined in ASC 310-20-35-9 (formerly EITF 01-7). If the modification is deemed more than minor, the loan is accounted for as a new loan and the effective interest rate is based on the terms of the new loan and current market conditions.

.30 The CECL model carries forward the definition of a TDR from current US GAAP. The FASB concluded that that the economic concession granted by the lender to the borrower in a TDR reflects the lender attempting to maximize its recovery of the original contractual cash flows. Therefore, a TDR will be viewed as a continuation of the original debt instrument and the effective interest rate will be the "pre-modification" effective interest rate.

.31 For TDRs, the CECL model will require an adjustment to the cost basis of the modified asset (with a corresponding adjustment to the allowance for expected credit losses) so that the effective interest rate on the modified asset continues to be the original effective interest rate, given the new series of cash flows. The basis adjustment will be calculated as the amortized cost basis before modification less the present value of the new series of contractual cash flows (discounted at the original effective interest rate).

Disclosures

.32 The ASU requires various disclosures. The proposed disclosures are summarized in Appendix II to this Dataline. The disclosures are intended to enable users of the financial statements to understand (1) the credit risk inherent in the portfolio and how management monitors the credit quality of the portfolio, (2) management's estimate of expected credit losses, and (3) changes in the estimate of expected credit losses that have taken place during the period. The ASU includes examples of the required disclosures.

.33 Several of the disclosures require entities to provide information either by portfolio segment or class of financial asset. Portfolio segment is defined in the ASU as "the level at which an entity develops and documents a systematic methodology to determine its allowance for expected credit losses." For example, this may be by type of receivable, industry, or risk. Class of financial asset is defined as "a group of financial assets determined on the basis of all of the following: (1) measurement attribute, (2) risk characteristics of the financial asset, and (3) an entity's method for monitoring and assessing credit risk." For example, this may be by measurement attribute, product, and risk rating.

.34 Entities will be required to determine, in light of their specific facts and circumstances, how much detail they must provide to meet the objectives of the disclosures outlined in the ASU. An entity must strike a balance between obscuring important information as a result of too much aggregation and providing excessive detail that may not be beneficial to financial statement users.

Transition

.35 The FASB has not yet determined an effective date for the new guidance. However, once an effective date is established, the guidance will be effective for fiscal years, and interim periods within those fiscal years, beginning on or after the effective date.

.36 Entities will apply the guidance by recording a cumulative-effect adjustment to the statement of financial position as of the beginning of the first reporting period in which the guidance is effective. For example, for calendar year-end companies with quarterly reporting requirements, if the effective date is determined to be January 1, 2015, a cumulative-effect adjustment will be recorded as of January 1, 2015, and the first reporting period that the guidance will be effective is the quarter ending March 31, 2015. Early adoption will not be permitted.

Questions

.37 PwC clients who have questions about this Dataline should contact their engagement partner. Engagement teams that have questions should contact a member of the Financial Instruments team in the National Professional Services Group (1-973-236-7803).

Appendix I — Comparison between the FASB's and IASB's models

Description	CECL model (FASB)	Credit deterioration model (IASB)
Scope	The CECL model will apply to loans, debt securities, loan commitments, trade receivables, reinsurance receivables, and lease receivables that are not measured at FV-NI.	Generally, the scope of the credit deterioration model is consistent with that of the CECL model. However, there are a few differences: • The credit deterioration model does not apply to reinsurance receivables. • Financial guarantee contracts are included in the scope of the credit deterioration model. If an entity has previously asserted explicitly that it regards financial guarantees contracts as insurance contracts and applied insurance accounting, it can elect to continue applying insurance accounting.
Information considered when estimating credit losses	The CECL model will require entities to consider all internally and externally available information relevant to the estimate. This includes information about past events, current conditions, and reasonable and supportable forecasts and their implications for expected credit losses.	Same
Definition of expected credit losses	The CECL model defines expected credit losses as an estimate of all contractual cash flows not expected to be collected from a recognized financial asset (or group of financial assets) or commitment to extend credit.	Same
Measurement objective for the allowance for credit losses	Under the CECL model, an entity recognizes an allowance for all expected credit losses for all debt instruments at each reporting date.	Under the credit deterioration model, recognition of full expected credit losses is required only when there has been a significant deterioration in credit or there is a probability of loss in the next twelve months.

Description	CECL model (FASB)	Credit deterioration model (IASB)
Recognition of changes in the allowance for credit losses	Under the CECL model, changes in the allowance for credit losses are recognized immediately in net income.	As a result of utilizing a dual measurement approach, the amount recognized through net income also includes (1) the effect of a change in the credit loss measurement objective from “12-months of expected losses” to “lifetime expected losses” for assets that have experienced significant credit deterioration and (2) the effect of a changes in the credit loss measurement objective from “lifetime expected losses” to “12-months of expected losses” for assets that have no longer experienced a significant deterioration in credit.
Purchased credit-impaired financial assets	Under the CECL model, purchased credit-impaired assets are subject to specific guidance on day one. The basis of the asset is "grossed up" to reflect the embedded allowance. The remaining portion of the original purchase discount not attributed to credit is accreted in interest income over the life of the asset.	The credit deterioration model does not have the concept of "grossing up" the basis of the loan to reflect the embedded allowance. Instead, the asset is recorded at its initial fair value and accreted to the level of cash flows expected to be collected.
Principles for measuring expected credit losses	Under the CECL model, the estimate of expected credit losses reflects the time value of money and, at a minimum, reflects both the possibility that a credit loss results and the possibility that no credit loss results. An entity is prohibited from estimating expected credit losses based solely on the most likely outcome.	Same
Principle for writing off financial assets	Under the CECL model, An entity will write-off a financial asset in the period in which it has no reasonable expectation of recovery.	Same

Appendix II – Disclosure requirements

	Required disclosure
Credit quality information	• Quantitative and qualitative information by class of financial asset about the credit quality, including (1) a description of the credit-quality indicator, (2) the amortized cost (by credit-quality indicator), and (3) for each credit-quality indicator, the date or range of dates in which the information was last updated • If an entity disclosures internal risk ratings, qualitative information on how those internal risk ratings relate to the likelihood of loss
Allowance for expected credit losses	• Information that enables financial statement users to understand (1) management's process for developing its allowance for expected credit losses, (2) the information that management has used in developing its current estimate of expected credit losses, and (3) the economic circumstances that caused changes to the allowance for expected credit losses • By portfolio segment, a description of the entity's accounting policies and methodology used to estimate the allowance for expected credit losses, including: (1) a description of how expected loss estimates are developed, (2) a description and discussion of the factors that influenced management's current estimate of expected credit losses, including past events, current conditions, and reasonable and supportable forecasts about the future, (3) a discussion of risk characteristics relevant to each portfolio segment, (4) a discussion of the changes in the factors that influenced management's current estimate of expected credit losses and the reasons for those changes (for example, changes in loss severity, change in portfolio composition, change in volume of assets whether purchased or originated, significant events or conditions that affect the current estimate but were not contemplated during the previous period), (5) identification of any changes to the entity's accounting policies or methodology from the prior period and the entity's rationale for the change, if applicable, (6) a discussion of any significant changes in estimation techniques used and reasons for the changes, if applicable, and (7) reasons for significant changes in the amount of write-offs, if applicable • For assets classified at amortized cost and FV-OCI, a roll forward of activity in the allowance for expected credit losses that includes: beginning balance in the allowance, current period provision for credit losses, write-offs charged against the allowance, recoveries of amounts previously written off, ending balance in the allowance • If an entity has utilized the practical expedient in paragraph 825-15-25-2 not to measure expected credit losses for certain financial assets classified at FV-OCI, the amortized cost balance of those assets at the portfolio segment level
Roll forward for certain debt instruments	• A roll forward, by portfolio segment, for a portfolio of debt instruments measured at FV-OCI or amortized cost that includes beginning amortized cost, originations, purchases, sales, repayments, write-offs, and ending amortized cost • The roll forward disclosures identified above do not apply to the following: (1) receivables that result from revenue transactions within the scope of Topic 605, (2) reinsurance receivables that result from insurance transactions within the scope of Topic 944, and (3) loan commitments that are not measured at fair value with changes in fair value recognized in net income.

	Required disclosure
Reconciliation between fair value and amortized cost for debt instruments classified at FV-OCI	• If not already presented on the balance sheet, a reconciliation of the difference between the fair value and amortized cost for assets measured at FV-OCI, including amortized cost, the allowance for expected credit losses, the accumulated amount needed to reconcile amortized cost less the allowance for expected credit losses to fair value, and fair value
Past due status	• An aging analysis of the amortized cost for debt instruments that are past due as of the reporting date disaggregated at the portfolio segment level, and disclosure of when the entity considers a debt instrument to be past due
Non-accrual status	Disaggregated at the portfolio segment level: • The amortized cost of debt instruments on non-accrual status as of the beginning of the reporting period and the end of the reporting period • The amount of interest income recognized during the period on nonaccrual debt instruments in accordance with paragraph 825-15-25-10 • The amortized cost of debt instruments that are 90 days or more past due, but not on nonaccrual status as of the reporting date • The amortized cost of debt instruments on nonaccrual status for which there are no related expected credit losses as of the reporting date because the debt instrument is a fully collateralized collateral-dependent financial asset
Purchased credit-impaired financial assets	• To the extent an entity purchased credit-impaired financial assets during the period, a reconciliation of the difference between the purchase price of the assets and the par value of the assets, including: (1) the purchase price, (2) discount attributable to expected credit losses based on the buyer's assessment, (3) the discount (or premium) attributable to other factors, and (4) the par value
Collateralized financial assets	• By class of financial asset, a description of the type of collateral and the extent to which collateral secures an entity's financial assets • By class of financial asset, an explanation of significant changes in the extent to which collateral secures an entity's financial assets, whether because of a general deterioration or some other reason
Transition	In the period an entity adopts the ASU: • The nature of the change in accounting principle, including an explanation of the newly adopted accounting principle • The method of applying the change • The effect of the adoption on any line item in the statement of financial position, if material, as of the beginning of the first period for which the guidance is effective. Presentation of the effect on financial statement subtotals is not required. • The cumulative effect of the change on retained earnings or other components of equity in the statement of financial position as of the beginning of the first period for which the guidance is effective An entity that issues interim financial statements will provide the disclosures above in each interim financial statement of the year of change and the annual financial statement of the period of the change.

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No. US2016-01
January 7, 2016

Classification and measurement – FASB issues final standard

What happened?

On January 5, 2016, the FASB issued Accounting Standards Update 2016-01, *Financial Instruments–Overall: Recognition and Measurement of Financial Assets and Financial Liabilities* (the ASU). Changes to the current GAAP model primarily affects the accounting for equity investments, financial liabilities under the fair value option, and the presentation and disclosure requirements for financial instruments. In addition, the FASB clarified guidance related to the valuation allowance assessment when recognizing deferred tax assets resulting from unrealized losses on available-for-sale debt securities. The accounting for other financial instruments, such as loans, investments in debt securities, and financial liabilities is largely unchanged. The more significant amendments are summarized below.

At a glance

The FASB has issued the classification and measurement standard. The standard principally affects accounting for equity investments and financial liabilities where the fair value option has been elected.

Equity investments

All equity investments in unconsolidated entities (other than those accounted for using the equity method of accounting) will generally be measured at fair value through earnings. There will no longer be an available-for-sale classification (changes in fair value reported in other comprehensive income) for equity securities with readily determinable fair values.

For equity investments without readily determinable fair values, the cost method is also eliminated. However, entities (other than those following "specialized" accounting models, such as investment companies and broker-dealers) will be able to elect to record equity investments without readily determinable fair values at cost, less impairment, and plus or minus subsequent adjustments for observable price changes. Changes in the basis of these equity investments will be reported in current earnings. This election only applies to equity investments that do not qualify for the NAV practical expedient.

The impairment model for equity investments subject to this election is a single-step model (unlike today's two-step approach). Under the single-step model, an entity is required to perform a qualitative assessment each reporting period to identify impairment. When a qualitative assessment indicates an impairment exists, the entity would estimate the fair value of the investment and recognize in current earnings an impairment loss equal to the difference between the fair value and the carrying amount of the equity investment.

Financial liabilities and the fair value option

When the fair value option has been elected for financial liabilities, changes in fair value due to instrument-specific credit risk will be recognized separately in other comprehensive income. The accumulated gains and losses due to these changes will be reclassified from accumulated other comprehensive income to earnings if the financial liability is settled before maturity.

The ASU will allow, but not require, preparers to measure the change in fair value due to instrument-specific credit risk based on the portion of the total change in fair value that does not result from a change in a base market risk, such as a risk-free rate or a benchmark interest rate.

Disclosure

Entities that are not public business entities will no longer be required to disclose the fair value of financial instruments carried at amortized cost. While public business entities will continue to be required to make this disclosure, the ASU eliminates the requirement to disclose the methods and significant assumptions used to estimate the fair value.

Public business entities will be required to use the exit price when measuring the fair value of financial instruments measured at amortized cost for disclosure purposes. In addition, the new guidance requires financial assets and financial liabilities to be presented separately in the notes to the financial statements, grouped by measurement category (e.g., fair value, amortized cost, lower of cost or market) and form of financial asset (e.g., loans, securities).

Why is this important?

Certain financial institutions, such as retail and commercial banks and insurance companies, are likely to be most affected by the new guidance. Companies with large equity investment portfolios that are not currently being measured at fair value through net income may also be significantly impacted.

What's next?

The classification and measurement guidance will be effective for public business entities in fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. All other entities, including certain not-for-profit entities and employee benefit plans, will have an additional year, or may early adopt coincident with the public business entity effective date.

All entities can early adopt the provision to record fair value changes for financial liabilities under the fair value option resulting from instrument-specific credit risk in other comprehensive income. Entities that are not public business entities can early adopt the provision permitting the omission of fair value disclosures for financial instruments at amortized cost. Early adoption of these provisions can be elected for all financial statements of fiscal years and interim periods that have not yet been issued (for public business entities) or that have not yet been made available for issuance.

The classification and measurement guidance is the first ASU issued under the FASB's financial instruments project. The ASU for the new impairment guidance is expected in the first quarter of 2016. An exposure draft of the new hedging guidance is expected in the first half of 2016.

Questions?

PwC clients who have questions about this *In brief* should contact their engagement partner. Engagement teams who have questions should contact the Financial Instruments team in the National Professional Services Group (1-973-236-7803).

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No. US2015-36
November 18, 2015

FASB finalizes effective date for the proposed impairment standard

What happened?

On November 11, the FASB discussed the effective date for the proposed new impairment standard. Expected to be issued early next year, the impairment standard will be effective for:

- Public business entities (PBEs) that meet the definition of an SEC filer in fiscal years beginning after December 15, 2018 including interim periods within those fiscal years;
- PBEs that do not meet the definition of an SEC filer in fiscal years beginning after December 15, 2019 including interim periods within those fiscal years; and
- Non-PBEs (including certain not-for-profit entities and employee benefit plans) in fiscal years beginning after December 15, 2019 and interim periods within fiscal years beginning after December 15, 2020.

Early application of the guidance will be permitted for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years.

At a glance

The FASB has determined the effective date for the new impairment standard and made decisions on two other aspects: troubled debt restructurings and the available-for-sale credit loss model.

Other provisions

At the same meeting, the FASB also discussed two issues: the accounting for Troubled Debt Restructuring (TDRs) by creditors and one aspect of the available-for-sale (AFS) securities credit loss model.

Troubled debt restructurings

The impairment standard will require use of the current expected credit loss (CECL) model for financial assets measured at amortized cost. The FASB decided that credit losses for TDRs should be measured using the same CECL model that will be applied to other financial assets measured at amortized cost. This would be a change from the current US GAAP model and the previous proposal, which, under certain circumstances, would require use of a discounted cashflow approach.

This represents a significant change from the proposed model and is responsive to feedback the FASB received during the external review process.

Available-for-sale securities

The Board deliberated and decided on the following:

- A fair value floor will be incorporated into the credit loss model for available-for-sale (AFS) debt securities. Specifically, credit losses on AFS debt securities will be limited to the difference between its amortized cost and fair value.
- Consistent with current guidance, an AFS debt security will be written down to fair value if it is more likely than not that an entity will be required to sell it prior to the fair value recovering to or above its amortized cost basis.
- The historical or implied volatility is not a required factor to consider when estimating whether a credit loss exists, however, an entity will not be prohibited from considering it.

Why is this important?

Companies with portfolios of financial assets subject to the scope of the proposed standard are likely to see an increase in credit reserves given the proposed standard's departure from the current US GAAP "incurred loss" concept. The proposed standard will likely require system and process changes to apply the new model and may require a considerable amount of time to implement. Specifically, entities will need to develop the infrastructure to estimate losses over a longer time horizon.

With the expected issuance of the standard in early 2016, companies that are SEC filers will have only three years before they begin reporting under the new guidance. With uncertainty as to the effective date now resolved, preparers can begin to develop a plan for an orderly and smooth transition.

What's next?

Another FASB meeting to discuss impairment is scheduled for November 23, 2015 and a final standard is expected to be issued in the first quarter of 2016.

Questions?

PwC clients who have questions about this *In brief* should contact their engagement partner. Engagement teams who have questions should contact the Financial Instruments team in the National Professional Services Group (973-236-7803).

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No. US2016-01
January 29, 2016

What's inside:

New guidance on recognition and measurement to impact financial instruments

At a glance

The FASB issued the new recognition and measurement guidance on January 5, 2016. The changes to the current US GAAP financial instruments model primarily affect the accounting for equity investments, financial liabilities under the fair value option, and the presentation and disclosure requirements for financial instruments.

No significant changes were made to the recognition and measurement guidance for investments in loans and debt securities.

The standard is effective for public business entities for annual periods (and interim periods within those annual periods) beginning after December 15, 2017. All other entities will need to apply the standard for annual periods beginning after December 15, 2018, and for interim periods beginning after December 15, 2019.

Background

.1 On January 5, 2016, the FASB issued Accounting Standards Update 2016-01, *Financial Instruments–Overall: Recognition and Measurement of Financial Assets and Financial Liabilities* (the "ASU"). Once effective, the ASU will apply to the recognition and measurement of certain financial instruments for all entities.

.2 The recognition and measurement project started as a joint project with the IASB, with an objective of improving the decision usefulness of financial statements by simplifying and harmonizing the accounting for financial instruments. The recognition and measurement guidance is the first ASU issued under the FASB's financial instruments project. The ASU for the new impairment guidance is expected in the upcoming months. An exposure draft of the new hedging guidance is expected in the first half of 2016.

.3 The most recent exposure draft for the recognition and measurement project (issued in February 2013) proposed significant changes to current US GAAP guidance, including an accounting model that linked the measurement of an entity's financial assets to its cash flow characteristics and the manner in which the entity expected to benefit from the related cash flows. The measurement of financial liabilities also would have taken into account whether the entity expected to pay the contractual cash flows or to settle the liability at its fair value.

.4 The FASB noted that while the current accounting for the subsequent measurement of financial instruments is complex, stakeholders have learned how to navigate that complexity to obtain the information they need. The FASB also noted that the 2013 proposed ASU (which was more consistent with IFRS 9) would simply have replaced the known complexities under current US GAAP with an unknown amount and type of complexity. As a result, the FASB discarded many of the proposals in the 2013 exposure draft and instead decided to make targeted improvements while retaining much of today's recognition and measurement model for financial instruments.

Key provisions

.5 The new guidance will impact the accounting for equity investments, financial liabilities under the fair value option, and the presentation and disclosure requirements for financial instruments. In addition, the FASB clarified the need for a valuation allowance on deferred tax assets resulting from unrealized losses on available-for-sale debt securities. The accounting for other financial instruments, such as loans, investments in debt securities, and financial liabilities not under the fair value option is largely unchanged.

Accounting for equity investments

.6 The ASU makes significant changes to the accounting for equity investments. The ASU's accounting model will apply to all types of equity investments, including equity instruments that meet the definition of a security (as provided under current US GAAP) and those that would not be considered securities (e.g., limited partnership interests). Equity investments included in the scope of the new guidance may include investments in the equity of investment companies that hold nothing but debt securities, as the ASU does not permit an investor to "look through" the investment to determine the appropriate recognition and measurement model.

.7 The guidance also applies to forwards and options to acquire and dispose of ownership interests that are not accounted for as derivative instruments under ASC 815, *Derivatives and Hedging*. For example, the ASU applies to a gross physically-settled forward contract to purchase equity shares that are not deemed to be readily convertible to cash.

Equity investments with readily determinable fair values

.8 All equity investments in unconsolidated entities (other than those accounted for using the equity method of accounting) will generally be measured at fair value through earnings. There will no longer be an available-for-sale classification (changes in fair value reported in other comprehensive income) for equity securities with readily determinable fair values.

.9 Equity securities have no maturity date, and therefore the primary way an entity realizes the value of their investment (aside from dividends) is through sale. As such, the FASB believes that "fair value through earnings" is the most appropriate measurement and recognition method for equity investments in unconsolidated entities not accounted for under the equity method.

PwC observation:

The FASB considered providing an exception to the fair value through earnings measurement model for equity securities deemed to be strategic investments, as entities may be able to realize the value from these types of investments by means other than sale or collecting dividends. Developing a definition of a strategic investment proved difficult, and the FASB concluded that providing an exception would add complexity to the accounting model that would not be worth the perceived benefits.

Equity investments without readily determinable fair values

.10 Under current US GAAP, an unconsolidated investment in an equity security without a readily determinable fair value that is not accounted for by the equity method is measured at cost, less any impairment determined to be other than temporary.

.11 The ASU generally eliminates the cost method for these investments. However, entities (other than those following "specialized" accounting models, such as investment companies and broker-dealers) will be able to elect to record equity investments without readily determinable fair values at cost, less impairment, adjusted for subsequent observable price changes. Entities that elect this measurement alternative will report changes in the carrying value of the equity investments in current earnings.

.12 If this measurement alternative is elected, changes in the carrying value of the equity investment will be required to be made whenever there are observable price changes in orderly transactions for the identical or similar investment of the same issuer. The implementation guidance notes that an entity should make a "reasonable effort" to identify price changes that are known or that can reasonably be known. The implementation guidance also indicates that in determining whether a security issued by the same issuer is similar, an entity should consider differences in the rights and obligations of the securities. Differences in rights and obligations may indicate that the security is not similar (and thus the observable price would not be used to adjust the carrying value of the equity investment held) or may indicate that the observable price should be adjusted to reflect such differences.

.13 The measurement alternative may be elected separately on an investment by investment basis for each equity investment without a readily determinable fair value. Once elected, it should be applied consistently as long as the investment meets the qualifying criteria. The standard requires that the entity reassess whether the investment continues to qualify for the measurement alternative each reporting period. If, for example, the investee subsequently undergoes an initial public offering such that there is now a readily determinable fair value, the measurement alternative would no longer be permitted, and the investment would be prospectively measured at fair value in accordance with ASC 820, *Fair Value Measurement*.

PwC observation:

The application of the measurement alternative will require new processes, controls, and procedures and will require the exercise of significant professional judgment. For example, entities will need to establish procedures to identify observable prices for the same or similar securities and to adopt policies for determining what types of securities would be considered similar for the purposes of determining whether an observable price of a different security should be utilized to adjust the basis of the security owned. Entities will also have to establish internal controls to ensure that each equity investment subject to the measurement alternative is evaluated each reporting period to ensure that it continues to meet the qualifying criteria (i.e., the equity security does not have a readily determinable fair value).

While there is no explicit requirement in the ASU for the preparation of contemporaneous documentation of the election of the measurement alternative, we believe entities should consider establishing procedures to evidence the election at the time an investment is made.

.14 If the election is not made, equity investments without readily determinable fair values should be reported at fair value in accordance with the provisions of ASC 820, with all subsequent changes in fair value recorded in earnings.

PwC observation:

Obtaining the necessary information to support a valuation prepared in accordance with ASC 820 for investments without readily determinable fair values can be time consuming and may require the assistance of third-party valuation professionals. Given the potential amount of time and expense involved with obtaining valuations for each equity investment for each reporting period, entities should carefully evaluate the costs and benefits associated with electing full fair value versus the measurement alternative.

Impairment model for equity investments without readily determinable fair values

.15 The ASU includes a new impairment model for equity investments without readily determinable fair values. The new model is a single-step, unlike today's two-step approach.

.16 Under the single-step model, an entity is required to perform a qualitative assessment each reporting period to identify impairment. When a qualitative assessment indicates that an impairment exists, the entity will need to estimate the fair value of the investment and recognize in current earnings an impairment loss equal to the difference between the fair value and the carrying amount of the equity investment.

.17 The single-step model is intended to reduce subjectivity, improve comparability, and increase representation faithfulness of the financial statements. In addition, the FASB looked to reduce the burden on preparers of financial statements by eliminating the need to forecast whether an equity investment will eventually recover value.

.18 The measurement alternative was established, in part, to provide entities with relief from having to get a valuation prepared each reporting period for equity investments without readily determinable fair values. The use of a qualitative impairment model is consistent with that objective. A quantitative impairment analysis does not need to be prepared, unless the qualitative assessment indicates that the fair value of the investment is less than its carrying value. The ASU provides a representative, but not all inclusive list of impairment indicators, which includes a "significant" deterioration or "significant" adverse change, or "significant" concerns about the investee's ability to continue as a going concern. The significance of these factors should be evaluated relative to the conditions that existed at the time of the investment's acquisition or last adjustment for either an impairment or an observable price. Considerable judgment will need to be applied in determining when an impairment indicator is significant enough to warrant preparation of a full quantitative valuation.

PwC observation:

The ASU does not include a threshold to be met in order for an equity investment to be evaluated for impairment (i.e., the model does not consider whether an impairment is "probable" or "more likely than not"). Rather, the qualitative assessment is used to identify the presence of significant impairment indicators. The presence of one or more indicators does not necessarily mean an equity investment is impaired. However, it does mean the entity is required to perform a valuation to determine whether an impairment exists (i.e., whether fair value is below the carrying value of the equity investment).

Financial liabilities and the fair value option

.19 The impact of changes in instrument-specific credit risk on liabilities for which the fair value option has been elected is reported in current earnings under current US GAAP. This resulted in gains when the entity's credit deteriorated and losses when it improved. While preparers and users understood the theory behind these counterintuitive outcomes, some questioned the value of this reporting given that such impacts may not be realizable. Many entities removed this amount from earnings in non-GAAP measures, because they believed the amount was not useful in analyzing an entity's financial performance.

.20 Under the ASU, when the fair value option has been elected for financial liabilities, changes in fair value due to instrument-specific credit risk will be recognized separately in other comprehensive income (OCI). This provision does not apply to financial liabilities required to be measured at fair value with changes in fair value recognized in current earnings. For example, this guidance would not apply to derivative instruments.

.21 The accumulated gains and losses due to changes in instrument-specific credit risk will be recycled from accumulated other comprehensive income and recognized in earnings if the financial liability is settled before maturity.

.22 In 2014, the FASB provided an alternative measurement for collateralized financing entities (CFEs) that eliminated the measurement difference that may exist when financial assets and financial liabilities of the CFE are measured independently at fair value. A requirement for CFEs to record changes in fair value due to instrument-specific credit risk in OCI would have generated a new measurement difference for these entities, as changes in credit risk related to financial assets would continue to impact earnings. As a result, the final ASU specifies that the guidance related to instrument-specific credit risk does not apply to financial liabilities of a CFE measured using the alternative measurement.

PwC observation:

During its deliberations, the Board also discussed other instances when preparers elected the fair value option on non-recourse liabilities to avoid a mismatch in recognition from the assets that support them. They noted that some entities do not disclose changes in instrument-specific credit risk for nonrecourse liabilities. The Board explains in the basis of conclusion that they did not intend to change how entities were identifying and measuring changes in instrument-specific credit risk from what is currently disclosed under US GAAP. While no guidance was formally included in the codification, we understand that the Board believes that entities can continue their current disclosure practices in this area both with respect to disclosure and what is included in OCI.

.23 The ASU allows, but does not require, preparers to measure the change in instrument-specific credit risk as the portion of the periodic change in fair value that is not due to changes in a base market rate, such as a risk-free interest rate. A reporting entity will be able to use an alternative method if it believes it to be a more faithful measurement of the change in credit risk for the entity. The selected methodology is a policy election and will need to be disclosed and consistently applied to each financial liability from period to period.

.24 No significant changes were made to the recognition and measurement of liabilities for which the fair value option has not been elected.

Loans and debt securities

.25 With the exception of those instruments for which the fair value option has been elected, the ASU does not make significant changes to the recognition and measurement guidance for investments in loans and debt securities.

PwC observation:

The FASB's project on credit losses will have a significant impact on how credit losses will be measured on loans and debt securities. That guidance is expected to be issued in the upcoming months.

Deferred tax assets

.26 Unrealized losses on available-for-sale debt securities are recognized in other comprehensive income and typically give rise to deferred tax assets. A valuation allowance is required to the extent it is more likely than not that a deferred tax asset is not realizable. Historically, entities applied one of two views. The need for a valuation allowance on a deferred tax asset related to available-for-sale securities was assessed either (1) in combination with the entity's other deferred tax assets, or (2) separately from other deferred tax assets and considered to be inherently recoverable so long as the related debt securities were expected to be held until they recovered in value (i.e., maturity, if necessary). The second view was supportable even if a valuation allowance was required on other deferred tax assets of a company.

.27 Although the latter approach was accepted by the SEC, the Board ultimately saw no conceptual basis for separately analyzing deferred tax assets for available-for-sale debt securities.

.28 The ASU requires that these deferred tax assets be evaluated for realizability in combination with other deferred tax assets of an entity. This approach is consistent with IFRS.

Presentation and disclosure

.29 The ASU makes targeted changes to the presentation requirements for financial instruments under current US GAAP. In addition to the change discussed above related to instrument-specific credit risk, the ASU requires separate presentation of financial assets and financial liabilities by measurement category and form of financial asset (e.g., securities or loans and receivables) on the balance sheet or in the accompanying notes to the financial statements.

.30 With regard to disclosure, the ASU eliminates the requirement for entities that are not public business entities (PBEs) to present fair value information for financial assets and liabilities measured at amortized cost. PBEs will continue to be required to present this information either parenthetically on the face of the balance sheet or in the notes to the financial statements. PBEs do not need to provide fair value information for receivables and payables due within one year and demand deposit liabilities. The board concluded that the benefit to financial statement users of disclosing such information did not justify the likely cost for non-PBEs.

.31 PBEs will be required to determine fair value for financial assets and liabilities based on the exit price notion in ASC 820, *Fair Value Measurement*. This may represent a change in practice for some entities that had previously provided fair value information for loans carried at amortized cost using an entry price based on their interpretation of the illustrative examples in ASC 825, *Financial Instruments*.

.32 All entities will be required to disclose financial assets and financial liabilities separately, grouped by measurement category (e.g., fair value, amortized cost, lower of cost or market) and form of financial asset (e.g., loans, securities).

.33 For equity investments without readily determinable fair values measured under the measurement alternative, the ASU requires disclosures of:

- the carrying value of such investments;
- the total amount of adjustments resulting from impairment; and
- the total amount of adjustments for observable prices.

Transition

.34 In general, the new guidance will require modified retrospective application to all outstanding instruments, with a cumulative effect adjustment recorded to opening retained earnings as of the beginning of the first period in which the guidance becomes effective. However, changes to the accounting for equity securities without a readily determinable fair value will be applied prospectively.

PwC observation:

The ASU requires that the changes to the accounting for equity securities without readily determinable fair values to be applied prospectively. The Board made this decision. principally to eliminate the need for preparers to retrospectively identify impairments using the new single-step model and observable price changes for the same or similar instruments that may have occurred in prior periods for entities that elect to apply the measurement alternative.

This means that any impact from the adoption of this ASU on equity securities without readily determinable fair values will not be reported as part of the transition adjustment. Instead, these impacts will be recorded after the transition date and will impact that period's current earnings.

What's next?

.35 The new guidance will be effective for PBEs in fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. All other entities, including certain not-for-profit entities and employee benefit plans, will have an additional year, or may early adopt coincident with the PBE effective date. For these entities, the guidance will be effective in fiscal years beginning after December 15, 2018 and interim periods within fiscal years beginning after December 15, 2019.

.36 All entities can early adopt the provision to record fair value changes for financial liabilities under the fair value option resulting from instrument-specific credit risk in other comprehensive income. Entities that are not PBEs can early adopt the provision permitting the omission of fair value disclosures for financial instruments reported at amortized cost. Early adoption of these provisions can be elected for all financial statements of fiscal years and interim periods that have not yet been issued or that have not yet been made available for issuance.

Questions?

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Government Relations Committee Meeting

Wednesday, March 30th
1:15pm – 3:30pm
Marriott Marquis, Washington DC

Co-Chairs:
Jeffrey Clark, SVP-Tax & JV Accounting, Host Hotels & Resorts, Inc.
Rohn Grazer, Managing Director-Tax, Prologis, Inc.
Brian Wood, SVP & CTO, Ventas, Inc.

Panelists:
Julanne Allen, Assistant to Branch Chief-FI&P, IRS
Paul Chambers, Partner-Tax, KPMG LLP
Jeffrey Clark, SVP-Tax & JV Accounting, Host Hotels & Resorts, Inc.
James Finnerty, SVP-Tax, Forest City Realty Trust, Inc.
Andrea Hoffenson, Branch Chief-FI&P, IRS
Joseph Howe, Partner, Arnold & Porter LLP
Richard Lipton, Partner, Baker & McKenzie, LLP
Jack Miller, VP-Tax Planning, Ventas, Inc.
Donald Susswein, Principal, Washington National Tax, RSM US LLP

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GOVERNMENT RELATIONS COMMITTEE MEETING
(Open to all REITWise® Registrants)
Marriott Marquis Washington, DC
Independence E-H
Washington, D.C.
Wednesday March 30, 2016
1:15 p.m. – 3:30 p.m.

Co-Chairs:

Jeffrey Clark, SVP-Tax & JV Accounting, Host Hotels & Resorts, Inc.
Rohn Grazer, Managing Director-Tax, Prologis, Inc.
Brian Wood, SVP & Chief Tax Officer, Ventas, Inc.

NAREIT Staff Liaisons:

Tony Edwards, EVP & General Counsel
Cathy Barre, SVP, Policy & Politics
Dara Bernstein, VP & Senior Tax Counsel

I. PATH Act Recap, Technical Corrections & Regulatory Issues
- FIRPTA
- U.S. REIT Act
- REIT Spin-offs/Built-in Gains

II. Partnership Tax Audits After the 2015 Budget Bill
Donald Susswein, Principal, Washington National Tax, RSM

III. Current Legislative Tax Issues
- Comprehensive Tax Reform
- International Tax Reform
- Mark-to-Market
- Like Kind Exchanges
- Cost Recovery
- Marketplace Fairness

IV. Treasury/IRS Project on Congregate Care Facilities
Joseph Howe, Partner, Arnold & Porter

V. ILM 201606027: "Bad Boy" Guarantees and Partnership Allocations
Richard Lipton, Partner, Baker & McKenzie

VI. IRS Perspectives
Julanne Allen, Assistant to the Branch Chief, FI&P, IRS (invited)
Andrea Hoffenson, Branch Chief, FI&P, IRS (invited)

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VII. Accounting for Income Taxes

- Valuation allowance
- Interim reporting
- Effective tax rate
- REIT and TRS interaction
- Purchase accounting
- Foreign entities and investments
- Uncertain tax positions
- Footnotes

Paul Chambers, Partner-Tax, KPMG
Jeffrey Clark, SVP-Tax & JV Accounting, Host Hotels & Resorts, Inc.
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Jack Miller, VP-Tax Planning, Ventas, Inc.

Note: This meeting may qualify for 2.5 hours of continuing professional education credits, depending on the state. For CLE or CPE credit information, please contact Afia Nyarko at 202-739-9433 or anyarko@nareit.com.

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March 30 - April 1

2016

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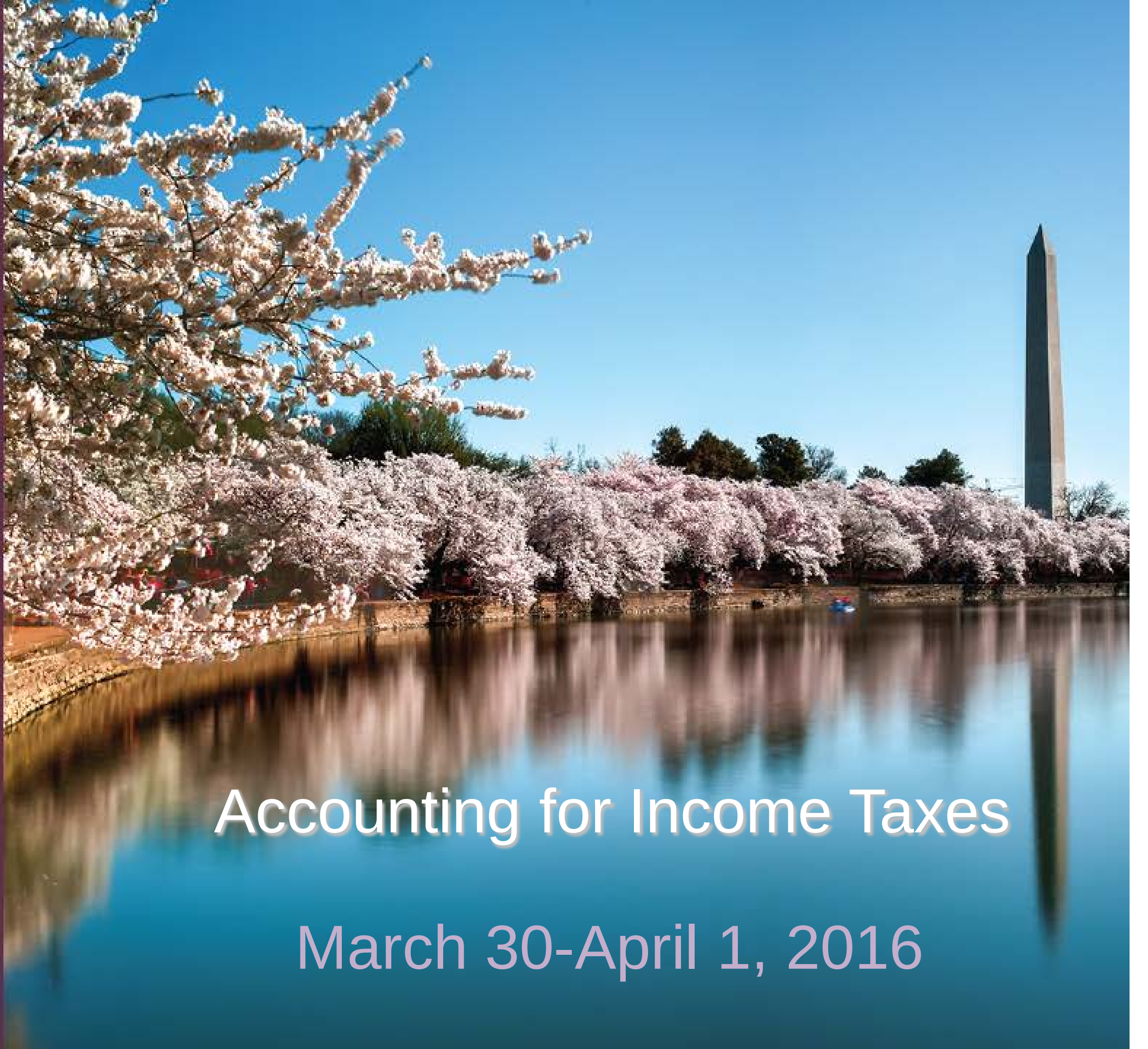

Accounting for Income Taxes

March 30-April 1, 2016

Speakers

- Paul Chambers, Partner-Tax, KPMG
- Jeffrey Clark, SVP-Tax & JV Accounting, Host Hotels & Resorts, Inc.
- James Finnerty, SVP-Tax, Forest City Realty Trust, Inc.
- Jack Miller, VP-Tax Planning, Ventas, Inc.

Agenda

- Overview
- Special issues
  - Valuation allowance
  - Interim reporting
  - Effective tax rate
  - REIT and TRS interaction
  - Purchase accounting
  - Foreign entities and investments
  - Uncertain tax positions
  - Footnotes

Scope of Income Taxes

- Federal income tax
- State and local income taxes (margin taxes)
- Foreign income tax
- Withholding taxes
- Special taxes
  - Section 857(b)(7)
  - Prohibited transaction
  - Foreclosure property
  - Section 1374

Separate Tax Calculations

- REIT
  - Treatment in calculation of Funds From Operations (“FFO”)
- Taxable subsidiaries
  - TRSs domestic and foreign
  - Foreign entities disregarded for US tax
  - Variable interest entities
  - Partnerships (with TRS or foreign entity as partner)
  - Noncontrolling interests

Basic Elements of Tax Expense or Benefit Calculation

- Annual reporting
  - Provision – Tax expense or benefit
    - Book income
    - Permanent items
    - Temporary differences
    - Valuation allowance adjustments
    - Discrete items
    - Uncertain tax position amounts
    - Tax rates
    - Foreign tax items
  - Balance sheet
    - Current income tax accrual or refund including liability for uncertain tax positions
    - Deferred tax assets (“DTA”) and liabilities (“DTL”) calculation
- Interim reporting
  - Effective tax rate calculation
  - Ordinary income or loss
  - Discrete items
- Auditor approach to documentation

Basic Approach

- Balance sheet or liability approach
- Current liability or refund
- Deferred tax on temporary differences between financial statement and tax basis
- Change in Net DTA or (DTL) for the Reporting Year = Deferred Income Tax Expense or Benefit +

  Change in Current Year Tax Accrual or Receivable (Before Payments and Refunds) =

  Current Year Income Tax Expense or Benefit
- Taxable difference = book over tax basis of asset or tax over book liability
- Deductible difference = tax over book basis of asset or book over tax liability

Primary Objectives related to Accounting for Income Taxes (ASC 740-10-10-1)

- To recognize the amount of taxes payable or refundable for the current year
- To recognize deferred tax liabilities and assets for the future tax consequences of events that have been recognized in an entity's financial statements or tax returns

Incremental Concept (ASC 740-10-10-3)

- A deferred tax liability or asset represents the increase or decrease in taxes payable or refundable in future years as a result of temporary differences and carryforwards at the end of the current year
- The difference between:
  - The amount of taxes that will be payable or refundable in the future years inclusive of reversing temporary differences and carryforwards
  - The amount of taxes that would be payable or refundable in future years exclusive of reversing temporary differences and carryforwards

Recognition (ASC 740-10-25-2)

- A tax liability or asset shall be recognized … for the estimated taxes payable or refundable on the tax returns for the current and prior years
- A deferred tax liability or asset shall be recognized for the estimated future tax effects attributable to temporary differences and carryforwards

Special Issues – Valuation Allowances

- Evaluating the need for a valuation allowance
  - Net operating losses
  - Deferred deductions
  - Other temporary differences
    - Book accruals
    - Reserves
    - Tax over book basis
  - Scheduling

Valuation Allowances - 4 Sources of Taxable Income

1. Future reversal of taxable temporary differences
   - Indefinite-lived assets and carryovers (Example 1)
   - Contingent liabilities and reserves
   - Indefinite-lived declining balance depreciable assets
2. Future taxable income exclusive of reversing temporary differences and carryforwards
   - Consistent with projections used for other purposes
3. Taxable income in carryback years
4. Tax planning strategies
   - Prudent & feasible
   - Would likely be implemented
   - Results in realization of DTA – not an increase in another DTA

Example 1 – Valuation Allowance

Tax Rate 40%	Tax Amount	Book Value
NOL	100	
Trademark (indefinite life)		100
Deferred tax asset (“DTA”)	40	
Deferred tax liability (“DTL”)		(40)

Since trademark has indefinite life and may never reverse, DTA may require a full valuation allowance, resulting in a net DTL.

Special Issues – Valuation Allowances (cont.)

- Negative evidence of need for valuation allowance – cumulative losses – current year and two proceeding years
- Impact on provision
  - Discrete item tax expense if related to deferred tax assets previously benefited
  - Increase in effective tax rate for current year impact or exclusion from calculation
- Release of valuation allowance
  - Period of positive income and gains
  - Current year reduction in effective rate or expense – future years impact discrete

Special Issues – Interim Reporting

- Multiple jurisdictions – consolidated ordinary income/loss and ETR
  - Exceptions
  - Multi-jurisdictional blended effective tax rate
- Exclusion of entities with full valuation allowance for the current year (exception for jurisdictions with tax benefit)
- Limitation on tax benefit in early quarters to full year benefit
- Valuation allowance in early quarters due to reversing taxable differences leaving net unrealizable DTA at year-end (Example 2)
- Use of cutoff or discrete method if ETR unreliable (e.g. unusual circumstances or significant permanent items) (Example 3)
- Unusual or extraordinary items exclusion that distort ETR (e.g. transaction costs)

Example 2 – Valuation Allowance

Tax Rate 40%	12/31/X1		Forecast 12/31/X2	
	Book/Tax Difference	DTA / (DTL)	Book/Tax Difference	DTA / (DTL)
NOL	250	100	250	100
Fixed asset	(250)	(100)	0	0

Fixed asset difference reverses in 12/X2. This may require a full valuation allowance and tax expense for the $100 NOL DTA in Q1 of 12/X2.

Example 3 – Effective Tax Rate

Forecast	Company 1	Company 2	Consolidated
Ordinary income	100	(110)	(10)
Permanent items		100	100
Book taxable income	100	(10)	90
Tax (40%)	40	(4)	36

Effective tax rate (ETR) =36/(10) = (360%)

Q1 ordinary income	50
ETR	(360)%
Q1 tax benefit	(180)

As the ETR is unreliable, discrete (or cut-off) method may be appropriate.

Special Issues – Effective Tax Rate

- Determination of effective tax rates – interim and annual
  - Federal tax rate
  - State tax rates
    - Apportionment and tax rates – prior tax returns
    - Changes due to merger or acquisition – discrete
    - Changes in rate or computation due to tax laws enacted - discrete impact
    - Deferred tax issues (Example 4)
  - Foreign tax rates – changes in law

Example 4 – State Deferred Tax

	Amount	DTA
Federal NOL	1000	400
State X NOL ($400 over Federal)	1400	2
State Y excess tax basis due to bonus disallowance	500	2
Total DTA		404

Federal and blended State rate	40%
State X rate times apportionment	10% * 5% = 0.5%
State Y rate times apportionment	4% * 10% = 0.4%

Special Issues – Effective Tax Rate (cont.)

- Special REIT / TRS Issues
  - Separate entity states
  - Unitary returns
    - Rate applicable to TRS
    - Allocation of NOL carryforwards and benefit
    - Utilization of unitary NOL by REIT
  - Combined TRS returns
    - Exception to overall valuation allowance for certain members of group (Example 5)
  - Tax sharing agreements amount REIT and TRSs

Example 5 – State Tax – Combined Return / Valuation Allowance

Current Year	
TRS A loss – State X	2,000
TRS B loss – State X	1,000
TRS C – deferred tax liability – State X	(50)

State rate * combined apportionment = 8% * 5% = 0.4%

TRS A and TRS B losses are otherwise subject to a full valuation allowance

TRS C has a DTL

Entry - TRS	DR(CR)
DTA (Note 1)	12
Tax benefit	(12)

Note 1: 3000 * 0.4%

Special Issues – REIT and TRS Interaction

- TRS sales or distributions of assets to REIT
  - Deferral of tax expense or benefit – prepaid or accrual (Example 6)
  - Release on ultimate sale to unconsolidated party
  - Valuation allowance issues
- Transfer of assets and liabilities to TRS by contribution to capital or sale
  - Book tax differences – impact on tax expense or benefit and DTAs and DTLs (Example 7)
  - Pursuant to a business combination
- Termination of TRS status by tax liquidation
  - Expense or benefit related to net deferred tax asset or liability (Example 8)
  - Built-in gains and NOL (Section 1374)

Example 6 – Sale by TRS to REIT

Tax Rate 40%	Tax Basis	Book Value	FMV
Asset	50	100	150

TRS sells asset to REIT at FMV

Entry-TRS	DR(CR)
DTL	20
Prepaid tax	20
Tax payable	(40)

Example 7 – Contribution by REIT to TRS / Sale by REIT to TRS

Tax Rate 40%	Tax Basis	Book Value	FMV
Depreciable Asset	50	100	200

REIT contributes asset to TRS as capital

Entry - TRS	DR(CR)
Fixed asset	100
Capital	(100)
DTL (40%)	(20)
Tax expense	20

REIT sells asset to TRS at FMV

Entry*	DR(CR)		
	TRS	REIT	Elim
Fixed asset	200	(100)	(100)
Cash	(200)	200	
Gain		(100)	100

* REIT Tax Rate deemed to be 0%

Example 8 – Voluntary Revocation of TRS Election to QRS

DTA/DTL Schedule (Tax) **Tax Rate 40%**	**Tax Basis**	**Book Value***	**DTA/ (DTL)**
Intangibles	0	100	(40)
Fixed assets	100	200	(40)
Land (to be sold within 5 years)	50	100	(20)
NOL	100	0	40
	250	400	(60)

- TRS terminates TRS status on 12/30/X1
- Deemed liquidation as QRS 100% owned by REIT
- Land DTL and equal amount of NOL DTA at REIT level

*Assume FMV exceeds book value

Entry - TRS	DR(CR)
DTL	80
DTA	(20)
Tax benefit	(60)

Special Issues – Purchase Accounting

- Business combinations involving REIT & TRS
- Impact on valuation allowances – benefit or expense
- Tax over book basis of indefinite-lived assets
- REIT conversions and mergers with non-REITS
  - Elimination of deferred tax assets and liabilities
  - Exceptions – Section 1374 and gains/income recognized within 5 years
  - UTP reserve for dispositions

Special Issues – Purchase Accounting (cont.)

- Goodwill – Tier 1 and Tier 2 deferred tax implications
  - Possible gain if substantial tax basis over book (Example 9)
  - Section 197 assets – Goodwill or other intangibles
- Single asset acquisitions - excess tax basis – simultaneous equation and adjustment to book value
- Noncontrolling interest in investees – book tax differences

Example 9 - Goodwill

	Section 197 Goodwill	Preliminary Book Goodwill	Difference
At acquisition	1000	100	900

GAAP only gain calculation (40% tax)

Initial calculation (40% / 1-40%) * 900 = 600
However, 600 exceeds 100 book value of goodwill

GAAP Gain Calculation
(40% / 1-40%) * X = 100 (Book goodwill)
(40% / 1-40%) * 150 = 100
(900-150) * 0.4 = 300 gain

Entry-TRS	DR/(CR)
DTA	400
Goodwill	(100)
Gain	(300)

Special Issues – Foreign Entities and Investments

- Tax rate changes and asset cost indexation
- APB 23 implications – US and Foreign taxes
  - TRS and REIT differences – foreign tax credit (Example 10)
- Foreign branches and Section 987 (foreign tax credit or deduction)
- Foreign operations with US$ functional currency
  - Historic cost for fixed assets and depreciation
  - Monetary assets and liabilities
- Foreign partnership outside basis differences
- Translation adjustment in OCI – deferred tax implications

Example 10 – APB 23

	Tax Amount	Book Value
Investment in Country X Sub	500	1000

Distribution in liquidation of excess book value is subject to 10% foreign country withholding tax. Subsidiary has history of distributing book earnings.

Entry – REIT	DR(CR)
DTL	(50)
Tax Expense	50

Special Issues – Uncertain Tax Positions

- Determination, recognition, measurement (REIT, TRSs and foreign entities)
- Subsequent adjustment and derecognition
- Tax indemnification agreements – on and after acquisition date
- Interest and penalties – tax expense or other expense
- Discrete items – not in ETR
- Current liability or offset to DTA
  - Utilization of NOL or other deductible differences
- Transfer pricing issues – Section 857
  - Recognition as deducted or reported

General Content of Footnote Disclosure

- Tax treatment of distribution
- Current and deferred income tax expense schedule
- Reconciliation of statutory rate to tax expense or benefit
- Deferred tax asset and liability schedule
- Roll forward of valuation allowances
- Tabular reconciliation of uncertain tax positions
- Other disclosures –
  - Year over year significant changes in accounts
  - Purchase accounting adjustments
  - Net operating loss carryforwards
  - Statute of limitations on examinations
  - Examination activity
  - Reason for tax expense or benefit

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Comparison of Proposed Solutions to Sales Tax Collection Disparity

	Online Sales Simplification Act (Goodlatte-Eshoo Draft Bill)[1]	S. 698, The Marketplace Fairness Act[2]	H.R. 2775, The Remote Transactions Parity Act[3]
Parity at Point of Purchase (Regardless of Channel)	No - Hybrid Origin Sourcing Model – sellers will apply origin-based sourcing rules for remote sale, but destination-based sourcing rules for nonremote interstate sales.	Yes – Destination Sourcing Model – uniform destination-based sourcing rules are applied to all transactions.	Yes – Destination Sourcing Model - uniform destination-based sourcing rules are applied to all transactions.
Small Seller Exemption	No small seller exemption.	A small seller exemption of $1 million in annual nationwide gross remote sales	A phased-out small seller exemption over three years. The first year is gross annual receipts under $10 million, the second year is gross annual receipts under $5 million and the third year is $1 million. After the third year, the exemption will be zero. Sales made via an online marketplace are not exempted.
Audit Procedures	Remote sellers may be audited by their home state taxing authority. A single audit is only allowed for a NOMAD[4] state if the NOMAD state is not part of the distribution agreement.	One audit per state with the potential for a maximum of 45 audits per year (i.e. 45 states have a sales and use tax system).	Audits are conducted through the certified service provider (CSP). Eliminates state audits and demand letters for remote sellers under $5 million in gross annual receipts unless intentional misrepresentation or fraud. [5]
Software Costs and Integration	No assistance is provided to remote sellers to comply with the additional collection and reporting requirements.	Provides software free of charge for remote sellers and potentially creates multiple state software systems. Integration costs are not included.	Allows remote seller to select its own software, the cost of which is paid for by the state. States' payment of set-up, installation, and maintenance costs is included. Software must work in all states qualified under the Act.
Liability	The remote seller is liable for the tax that is not properly collected.	Relieves remote sellers from liability to the state or locality for incorrect collection, remittance, or noncollection of sales and use taxes if the liability is a result of error or omission made by a certified software provider.	Ensures the certified software provider, not the remote seller, is held liable for all regulation and compliance burdens unless there is reasonable suspicion that the remote seller has engaged in intentional misrepresentation.
Economic Neutrality	Remote sellers would not collect the same tax rate or tax the same products as local sellers. The amount of tax collected from the consumer and taxability of products will differ based on where the seller is located.	All consumers would pay their home state's tax rate and on the same products, regardless of channel. All remote sellers would collect the same tax rate on a taxable item.	All consumers would pay their home state's tax rate and on the same products, regardless of channel. All remote sellers would collect the same tax rate on a taxable item.

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[1] House Judiciary Committee Chairman Bob Goodlatte (R-VA) and Rep. Anna Eshoo's (D-CA) Online Sales Simplification Act draft bill released January 12, 2015 and revised April 15, 2015.

[2] S. 698, The Marketplace Fairness Act, sponsored by Senators Michael B. Enzi (R-WY) and Dick Durbin (D-IL), was introduced on March 10, 2015.

[3] H.R. 2775, The Remote Transactions Parity Act, sponsored by Representatives Jason Chaffetz (R-UT) and John Conyers (D-MI), was introduced on June 15, 2015.

[4] NOMAD – Five states that do not collect sales and use tax, and they are known as "Nomad States." The list includes: New Hampshire, Oregon, Montana, Alaska and Delaware.

[5] All sellers can be audited where they have a physical presence consistent with existing law.

Economic Impact of Repealing IRC Section 1031
Synopsis of Ernst & Young Study

Background:

Section 1031 of the Internal Revenue Code permits deferral of capital gains and recapture tax on business or investment property that is exchanged for like-kind business or investment property rather than sold for cash. Like-kind exchanges are relied on extensively by small businesses and taxpayers in multiple industries, including real estate, transportation, equipment / vehicle rental and leasing, and construction.

These rules are based on the tax policy that it is unfair to tax a "paper" gain when there is continuity of investment in like-kind property; i.e. there has been no "cashing out" by the taxpayer. Section 1031 encourages transactional activity by making it more cost effective to relocate to larger or more appropriate sites and to exchange assets for those that better meet business needs.

Ernst & Young conducted an analysis of the macroeconomic impact on the U.S. economy of recent tax reform proposals to repeal §1031 like-kind exchanges and documented these findings in a March, 2015 report (revised November, 2015), titled *Economic Impact of Repealing Like-Kind Exchange Rules*.

Major Findings:

- Repeal of §1031 would subject businesses to a higher tax burden on their transactions, resulting in longer holding periods (the "lock-in" effect), greater reliance on debt financing and less-productive deployment of capital in the economy.
- The cost of capital would be increased, discouraging investment, entrepreneurship and risk-taking, and slowing the velocity of investment.
- Repealing like-kind exchange rules would slow economic growth, shrink investment, and ultimately reduce gross domestic product (GDP), even if the revenue savings were used to lower tax rates.
- This negative economic impact would be most concentrated in those industries that rely heavily on like-kind exchanges, such as: real estate, construction, truck transportation, equipment / vehicle rental and leasing.
- The effect of §1031 repeal on economic activity supported by the **ten most impacted industries** would be a **decline in annual GDP of $27.5 billion**. (Table 1 below).
- **The total impact on overall U.S. GDP would be a drop of $8.1 billion each year** (Table 2 below).

Repeal of Section 1031 Does Not Meet the Goals of Tax Reform:

The stated goals of tax reform are economic growth, fairness, efficiency, revenue neutrality, competitiveness, and investment, leading to job creation and a stronger economy. The study concludes that repeal of §1031 would be at cross-purposes with these goals. It would adversely impact the U.S. economy by discouraging investment, causing a reduction in GDP, a contraction in the economy, and would unfairly burden certain industries and taxpayers. Moreover, lower GDP results in lowered tax revenue, thus, repeal of §1031 would not be revenue neutral.

Important Comparison:

- Estimated tax revenue to Treasury over 10 years (repeal score for years 2014-2023 by Joint Committee on Taxation) $40.9 billion
- Estimated **reduction** of overall U.S. GDP over 10 years (EY Study) **($61 - $131 billion)**

Table 1. Long-run effect of repeal on GDP each year of the 10 sub-industries with large proportions of like-kind exchange property as a % of capital stock ($billions)

Industry	Like-kind exchange property as % of sub-industry capital stock	Annual Direct GDP impact	Annual Indirect GDP impact	Annual Induced GDP impact	Annual Total GDP impact
Non-residential real estate	27%	-$6.0	-$1.4	-$1.3	-$8.7
Specialty construction trade contractors	16%	-$2.3	-$2.6	-$2.8	-$7.7
Truck transportation	34%	-$1.5	-$1.5	-$1.7	-$4.7
Heavy and civil engineering construction	19%	-$0.9	-$1.1	-$1.1	-$3.1
Air transportation	14%	-$0.5	-$0.4	-$0.3	-$1.2
Residential real estate	3%	-$0.4	-$0.1	-$0.1	-$0.6
Oil and gas extraction	7%	-$0.4	-$0.1	-$0.2	-$0.6
Commercial and industrial machinery and equipment rental and leasing	14%	-$0.3	-$0.1	-$0.1	-$0.5
Automotive equipment rental and leasing	14%	-$0.2	-$0.1	-$0.1	-$0.3
Pipeline transportation of natural gas	26%	-$0.1	$0.0	-$0.1	-$0.2
Total, 10 selected industries		**-$12.5**	**-$7.3**	**-$7.7**	**-$27.5**

Note: The 10 sub-industries selected for this analysis include sub-industries with like-kind exchange property of at least 3.0% of sub-industry capital stock, and with at least a 0.5% share of economy-wide capital stock. These industries are listed, with their NAICS codes, in Appendix D. Long-run impacts are scaled to the 2013 US economy. Figures may not sum due to rounding. Source: EY analysis.

Table 2. Long-run effect of repeal on GDP each year under revenue-neutral reduction in the corporate income tax rate and alternative policy scenarios

Scenario	Annual GDP change ($billions)	Annual GDP change (%)
Increased revenue used to reduce corporate income tax rate	-$8.1	-0.04%
Increased revenue used to increase government spending	-$13.1	-0.07%
Increased revenue used to reduce business sector taxes	-$6.1	-0.03%

Note: Long-run dollar figures are scaled to the 2013 US economy. Source: EY analysis.

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Characteristics of Depreciation in Commercial and Multi-Family Property: An Investment Perspective

Sheharyar Bokhari, *MIT Center for Real Estate*,
David Geltner, *MIT Center for Real Estate*

Abstract:

This paper reports empirical evidence on the nature and magnitude of real depreciation in commercial and multi-family investment properties in the United States. The paper is based on a much larger and more comprehensive database than prior studies of depreciation, and it is based on actual transaction prices rather than appraisal estimates of property or building structure values. The paper puts forth an "investment perspective" on depreciation, which differs from the tax policy perspective that has dominated the previous literature in the U.S. From the perspective of the fundamentals of investment performance, depreciation is measured as a fraction of total property value, not just structure value, and it is oriented toward cash flow and market value metrics of investment performance such as IRR and HPR. Depreciation from this perspective includes all three age-related sources of long-term secular decline in real value: physical, functional, and economic obsolescence of the building structure. The analysis based on 107,805 transaction price observations finds an overall average depreciation rate of 1.5%/year, ranging from 1.82%/year for properties with new buildings to 1.12%/year for properties with 50-year-old buildings. Apartment properties depreciate slightly faster than non-residential commercial properties. Depreciation is caused almost entirely by decline in current real income, only secondarily by increase in the capitalization rate ("cap rate creep"). Depreciation rates vary considerably across metropolitan areas, with areas characterized by space market supply constraints exhibiting notably less depreciation. This is particularly true when the supply constraints are caused by physical land scarcity (as distinct from regulatory constraints). Commercial real estate asset market pricing, as indicated by transaction cap rates, is strongly related to depreciation differences across metro areas.

1 Introduction

This paper reports empirical evidence on the nature and magnitude of real depreciation in commercial and multi-family investment properties in the United States. By the term "real depreciation" (or simply, "depreciation") we are referring to the long-term or secular decline in property value, after netting out inflation, due to the aging and obsolescence of the building structure, apart from temporary cyclical downturns in market values, and even after routine capital maintenance. Such depreciation is measured empirically by an essentially cross-sectional comparison of the transaction prices of properties with building structures of different ages, controlling for other non-age-related differences among the properties and the transactions. In the U.S., most prior studies of depreciation in income-producing structures have been made from the perspective of income tax policy, given that asset value in accrual income accounting in the U.S. is based on historical cost and allows for depreciation to be deducted from taxable income. But considering basic economics, depreciation is important from an investment perspective apart from tax policy, as depreciation is ubiquitous and significantly affects the nature of property investment performance. Though tax policy considerations certainly are important (including from an after-tax investment perspective for taxable investors), we leave such considerations for another paper.

This investments perspective is the major focus of this paper, though we will also make some observations relevant to the tax policy perspective. From the investment perspective depreciation constrains how much capital growth the investor can expect over the long run, and from this perspective depreciation is measured with respect to total property value not just structure value, and is measured on a cash flow and current market value basis rather than a historical cost accrual accounting basis. In this paper we explore how such depreciation varies with several correlates including metropolitan location, building type, structure age, and market conditions. We also explore the role of income versus capitalization as the source of depreciation.

2 Literature Review

Most of the prior literature on structure depreciation has focused on owner-occupied housing, and as noted, most of the U.S. literature that has focused on depreciation in commercial real estate (income property) has done so from the perspective of taxation policy. An early and influential example is Taubman and Rasche (1969), which used limited data on building operating expenses to quantify a theoretical model of profit-maximizing behavior on the part of building owners to estimate the optimal lifetime of structures and the age and value profile of office buildings, assuming rental revenues decline with building age while operating costs remain constant. The result was a model in which the building structure (excluding land) becomes completely worthless (fit for redevelopment) after generally 65 to 85 years of life, with the rate of depreciation growing with the age of the structure.[1] The focus of the analysis was on what sort of depreciation allowances would be fair from an income tax policy perspective.

By the mid-1990s subsequent research led to a consensus that the balance of empirical evidence supported the view that commercial structures tend to decline in value in a somewhat geometric pattern (roughly constant rate over time), averaging about 3 percent per year (of remaining structure value), though there was some evidence for faster depreciation rates in the earlier years of structure life. (See most influentially Hulton & Wyckoff, 1981, 1996.) In the paper that most influenced subsequent tax policy, Hulton & Wyckoff (1981) estimated average depreciation rates of approximately 3 percent per year of remaining structure value. With the 1986 tax reform, income tax policy settled on straight-line depreciation methods (which imply an increasing rate of depreciation for older buildings), with the depreciation rate based on 27.5 years for apartments and 31 (subsequently increased to 39) years for non-residential commercial buildings. This has remained a relatively constant and non-controversial aspect of the income tax code since then.[2]

Gravelle (1999) reviewed the evidence on depreciation rates for the Congressional Research Service and found that rates allowed in current tax law are not too far off from economic reality, if one uses as the benchmark the present value of the allowed depre-

[1] This is where the depreciation rate is measured as a percent per year of the remaining value of the structure alone, excluding the land component of the property value. Of course, any model in which the structure becomes completely worthless at a finite age (such as straight-line depreciation) will necessarily tend to have increasing depreciation rates as the structure ages measured as a fraction of the structure value alone excluding land, at least after some point of age. (For example, in the last year of building life, the depreciation rate is by definition 100% of the remaining structure value.)

[2] Straight-line methods are easy to understand and administer, and can be designed in principle so that the present value of the depreciation is the same as that of an actual geometric profile of declining building value which might better represent the economic reality. By completely exhausting the book value of the structure at a finite point in time (and hence, exhausting the depreciation tax shields), straight-line methods may tend to stimulate sale of older buildings (so as to re-set the depreciable basis and begin generating tax shields again).

ciation (recognizing that the straight-line pattern is only a simplification). An industry white paper produced in 2000 by Deloitte-Touche studied 3144 acquisition prices of properties held by REITs for which data existed on the structure and land value components separately as of the time of acquisition. The Deloitte-Touche study found approximately constant depreciation rates for acquisition prices as a function of structure age, measured as a percent of remaining structure value, ranging from 2.1%/year for industrial buildings to 4.5%/year for retail buildings (with office at 3.5% and apartments at 4%). However, the study was limited to only buildings less than 20 years old. The Deloitte study also separately estimated depreciation rates for gross rental income, finding rates ranging from 1.7% for office to 2.5% for retail (with industrial at 1.9%, and apartments omitted). Note that, as fractions of pre-existing rent, these depreciation rates would be more comparable to rates based on total property value than just on structure value (Like property value, rents reflect land and location value as well as just structure value.). The working consensus apparently persists that, at least for tax policy considerations, commercial structures tend to depreciate in a roughly geometric pattern at typically a rate of 2 to 4 percent of the remaining structure value per year, with apartment structures depreciating slightly faster than commercial.[3]

More recent literature is sparse and primarily focused on new empirical data. Fisher et al (2005) used sales of some 1500 NCREIF apartment properties to examine depreciation in institutional quality multi-family property.[4] They conclude that a constant rate of 2.7% per year of property value including land, or 3.25% of structure value alone, well represents the depreciation profile for NCREIF apartments.[5]

There have also been a number of studies of commercial property depreciation in Europe, particularly in the U.K. Many of these studies focus on the investment perspective rather than the tax policy perspective, and they tend to be very applied, industry sponsored reports that use less sophisticated methodologies. In one of the more academic studies, Baum and McElhinney (1997) studied a sample of 128 office buildings in the City of London and estimated a capital value depreciation rate averaging 2.9%/year as a fraction of total property value (including land), with older buildings (over age 22 years) depreciating

[3]See United States Treasury (2000).

[4]NCREIF properties are owned by tax-exempt investors and tend to be at the upper end of the asset market. The average initial cost in the Fisher et al sample was $17 million.

[5]NCREIF records indicate that on average almost 20% of apartment property net operating income is plowed back into the properties as capital improvement expenditures. The depreciation occurs in spite of such upkeep.

less than new or middle-aged buildings. Their study was based on appraised values. More recently, a 2011 study by the Investment Property Forum (IPF), an industry group, examined 729 buildings in the UK that were held continuously over the period 1993-2009. Office buildings were found to experience the highest rate of rental depreciation at 0.8%/year followed by industrial at 0.5% and retail at 0.3%, all as a fraction of total property value. A comparable IPF (2010) article on office properties in select European cities, estimated depreciation rates that ranged up to almost 5%/year in Frankfurt to no depreciation at all in some cities (such as Stockholm). The IPF studies were based on comparing the rental growth (based on appraisal valuation estimates) of the held properties with that of a benchmark based on a new property held in the same location. However, problems with using valuations and in benchmark selection led Crosby, Devaney & Law (2011) to conclude that these findings are not a good indication of the rates of depreciation in Europe.

3 Investment Perspective on Depreciation

Although tax policy is clearly important, the previous literature's focus on it may have complicated or omitted some considerations that are more important from a before-tax investment perspective. What we are referring to as the investment perspective on depreciation is the perspective that reflects the fundamental economic performance of investments. This perspective is the basis on which capital allocation decisions derive their economic value and opportunity cost. In the investment industry profit or performance is measured by financial return metrics such as (most prominently) the internal rate of return and the total holding period return. These metrics are based on market value and cash flow, not on historical cost accrual accounting principles. From the investment perspective there is less rationale for contriving (inevitably somewhat arbitrarily) to separate structure value from land value in investments in real estate assets. At the most fundamental level, real economic depreciation directly and importantly affects investment returns before, and apart from, income tax effects.[6] Therefore, investors care (or should care) about the granular characteristics and determinants or correlates of property depreciation, in order to make better property investment and management decisions.

[6]It is worth noting, as well, that many major investment institutions are tax-exempt (such as pension and endowment funds). Furthermore, the U.S. is fairly unique in having financial accounting rules based on historical cost asset valuation. In most other countries the type of tax policy considerations that have dominated the U.S. literature on commercial property depreciation are not relevant.

Yet, in practice today it appears that many investors do not think carefully about depreciation in this sense. General inflation masks the existence of real depreciation, and the typical commercial property investment cash flow forecast used in industry (the so-called "pro-forma") almost automatically and complacently projects rent growth equal to a conventionally defined inflation rate (typically 3%). Unless this assumed general inflation rate is below the realistic inflation expectation in the economy (and usually it is not), then the implication is that investors are typically ignoring the existence of real depreciation, at least in their stated pro-formas. (We shall explore this question further in this paper.)

(a) A Conceptual Framework for Analyzing Depreciation

A careful and complete view of depreciation from the investment perspective must consider the causes and correlates of differences in depreciation rates across different types or locations of properties. Such an investment perspective on depreciation must strive in particular to recognize differences and patterns in the urban economic dynamics of locations of commercial properties. The fundamental economic framework from which to view depreciation from the investment perspective is presented in Figure 1.

Figure 1 depicts a single urban site or property parcel over time, with the horizontal axis representing a long period of time, and the vertical axis representing the money value of the property asset on the site.[7] The top (light) line connecting the U values reflects the evolution of the location value of the site as represented by the value of the "highest and best use" (HBU) development of the site whenever it is optimally developed or redeveloped (new structure built), an event that occurs at the points in time labeled R. This location value of the site fundamentally underpins the potential long-run appreciation of the property value and the capital return to the investor in the property asset. But the actual market value of the property over time is traced out by the heavy solid line labeled P, which represents the opportunity cost or price at which the property asset would sell at any given time. P declines relative to U due to the depreciation of the building structure on the site. Based on standard cash flow (opportunity cost) based investment return metrics such as IRR or total HPR, it is the combination of the change in location value (U) and the occurrence of structure depreciation which determines the price path of P and hence the capital return

[7] A very long span of time must be represented, because depreciation is, by definition, a long-term secular phenomenon, reflecting permanent decrease in building value, and buildings are long-lived, transcending medium-term or transient changes in the supply/demand balance in the real estate asset market.

possibility for the investor over the long run.[8]

From an investment perspective one can define the "land value" component of the property value in either of two alternative and mutually exclusive ways as indicated in Figure 1. The more traditional conception of land value is labeled L and may be referred to as the "legalistic" or "appraisal" value of the land. It reflects what the parcel would sell for if it were vacant, that is, with no pre-existing structure on it. The second, newer conception of land value comes from financial and urban economics and views the land (as distinct from the building on it) as consisting of nothing more (or less) than the call option right (without obligation) to develop or redevelop the site by constructing a new building on it.[9] This value, labeled C, generally differs from L. The redevelopment call option is nearly worthless just after a (re)development of the site, because the site now has a new structure on it built to its HBU. But at the time when it is optimal (value maximizing) to tear down the old structure and build a new one, the entire value of the property is just this call option value, the land value. Out-of-the-money call options are highly risky, meaning they have very high opportunity cost of capital (high required investment returns), and the investment returns of options must be achieved entirely by capital appreciation as options themselves pay no dividends. Thus, the call option value of the site tends to grow very rapidly over time between the R points, ultimately catching up with the legalistic or appraisal value of the land.

At the reconstruction points (R) all three measures and components of property value, P, L, and C are the same; the old building is no longer worthwhile to maintain (at least, given the redevelopment opportunity), so the property value entirely equals its land value.[10]

[8]Although it is the total investment return that matters most, including current income (cash flow) plus change in capital value, there is also interest in breaking out the total return into components, one of which is the current income return or yield rate (net cash flow as a fraction of current asset market value). In such breakout, current routine capital improvement expenditures which are financed internally as plow-back of property earnings are a cash outflow from the property owner, netted out of the income return (i.e., not taken out of the capital return component, from a cash flow perspective). Thus, the investment capital return indicated by the change in P between R points reflects the growth in total property value including (after) the effect of such routine capital improvement expenditures. In the figure 1 model, major externally financed capital improvement expenditures would be considered redevelopments associated with the R points on the horizontal axis.

[9]The exercise cost (or "strike price") of the call option consists not only of the construction cost of the new building plus any demolition costs of the old building, but also includes the opportunity cost of the foregone present value of the net income that the old building could still continue to earn (if any). Thus, for it to make sense to exercise the redevelopment option either the old building must be pretty completely obsolete or the new HBU of the site must be considerably greater than the old HBU to which the previous structure was built.

[10]It makes sense for functional and economic obsolescence to detract from the value of the structure, not

At that point new capital (cash infusion) in an amount of K is added to the site, as depicted in Figure 1, and this value of K (construction costs including demolition costs) adds to the site-acquisition cost (the pre-existing property value, Old P = L = C) to create the newly redeveloped property value (the new P value = Old P + K) upon completion of the development. The net present value (NPV) of the redevelopment project investment is: NPV = New P − Old P − K. In an efficient capital market super-normal profits will be competed away and this NPV will equal zero, providing just the opportunity cost of its invested capital as the expected return on the investment.[11]

The investor's capital return is represented by the change in the property value P between the reconstruction points in time. The change in P across a reconstruction point R includes new external capital investment (K), not purely return to pre-existing invested financial capital. By definition, property value, P, is the sum of land value plus building structure value. The path of P between reconstruction points therefore reflects the sum of the change in the building structure value plus the change in the land value. The latter reflects the underlying usage value of the location and site as represented by its HBU as if vacant, the U line at the top in Figure 1. Thus, the land value component does not tend to decline over time in real terms in most urban locations, although there certainly are exceptions to this rule. However, the building structure component of the property value will almost always tend to decline over the long run, at least in real terms (net of inflation), reflecting building depreciation. In any case, the extent to which the property value path falls below the location value of the site (U), causing a reduction in the investors capital return below the trend rate in U, is due largely and ubiquitously to building structure depreciation. This is the fundamental reason why, and manner in which, the investor cares about depreciation.

from the value of the land. "Functional obsolescence" refers to the structure becoming less suited to its intended use or relatively less desirable for its users/tenants compared to newer competing structures, for example due to technological developments or changes in preferences, such as need for fiber-optic instead of copper wiring or need for sustainable energy-efficient design. "Economic obsolescence" refers to the phenomenon of the HBU of the site evolving away from the intended use of the structure, the type and scale of the building becoming no longer the HBU for the site as if it were vacant, as for example if commercial use would be more profitable than the pre-existing residential, or high-rise residential would be more profitable than the pre-existing low-rise.

[11]Note that this zero NPV assumption is consistent with the classical "residual theory of land value", in which any windfall in location value accrues to the pre-existing landowner (thus adding to the "acquisition cost" of the redevelopment site, the value of C or L or Old P at the time of redevelopment). However, if the redevelopment is particularly entrepreneurial or innovative, perhaps there will be some Schumpeterian profits for the new developer.

Note that from this perspective the rate at which the building structure itself declines in value due to depreciation is fundamentally ambiguous. This is because building value equals the total property value minus the land value. But there are two very different yet fundamentally equally valid ways to define and measure land value, the legalistic or appraisal perspective (L) and the economic or functional call option perspective (C). The structure value component (labeled S in Figure 1), can be defined either as P − L or P − C. Thus, the rate of depreciation expressed as a fraction of building structure value is ambiguous from the investment perspective. However, depreciation measured as a fraction of total property value, P, is not ambiguous.[12] Therefore, from the investment perspective (as distinct from the tax policy or accrual accounting perspective), it is more appropriate to focus on depreciation relative to total property value including land value (P) rather than only relative to remaining structure value (S). We will adopt this approach for the remainder of this paper.

Finally, given that land generally does not depreciate, an implication of this framework is that we should expect newer properties to depreciate at a faster rate since land value is a smaller proportion of the total property value of a new building. This also suggests that depreciation rates may vary across metropolitan areas as different cities have different scarcity of land, and therefore, different land value proportions of total property value. We test both these hypotheses in our subsequent empirical analysis.

(b) Source of Depreciation: Income or Capitalization?

It is of interest from an investment perspective to delve deeper into the depreciation phenomenon and explore how much depreciation is due to changes in the current net cash flow the property can generate as it ages versus how much is due to the property asset market's reduction in the present value it is willing to pay for the same current cash flow as the building ages. This latter phenomenon is sometimes referred to as "cap rate creep". Such

[12]It is worth noting that, apart from the conceptual problem, measuring depreciation as a fraction of structure value (S) is also difficult to estimate empirically. This is because, compared to quantifying the total property value, P, it is usually relatively difficult to quantify either L or C for a given property at a given time. While appraisers or assessors sometimes estimate the value of L, such valuations are only estimates, and are often crude and formulaic. In built-up areas there is often little good empirical evidence about the actual transaction prices of comparable land parcels recently sold vacant. And land value estimates can be circular from the perspective of quantifying structure depreciation, as the land value may be backed out from property value minus an estimate of depreciated structure value, meaning that for purposes of empirically estimating structure depreciation we get an estimate of depreciation based on an estimate of depreciation!

an understanding could improve the accuracy of investment return forecasts, and possibly improve the management and operation of investment properties.[13]

By way of clarification and background, consider the fundamental present value model of an income property asset:

$$P_{i,t} = \sum_{s=t+1}^{\infty} \frac{E_t[CF_s]}{(1+r_{i,t})^{s-t}} \tag{3.1}$$

where $P_{i,t}$ is the price of property i at time t; $E_t[CF_s]$ is the expectation as of t of the net cash flow generated by the property in future period s; and $r_{i,t}$ is the property asset market opportunity cost of capital (OCC, the investor's required expected total return) for property i as of time t. With the simplifying assumption that the expected growth rate in the future cash flows is constant (at rate $g_{i,t}$) and the property resale price remains a constant multiple of the current cash flow, (3.1) simplifies to the classic "Gordon Growth Model" of asset value (GGM), which is a widely used valuation model in both the stock market and the property market:[14]

$$P_{i,t} = \frac{E_t[CF_s]}{r_{i,t} - g_{i,t}} \tag{3.2}$$

With the slight further simplification that the net operating income approximately equals the net cash flow ($NOI_{i,t} \approx E_t[CF_s]$),[15] this formula provides the so-called "direct capitalization" model of property value which is widely used in real estate investment:

$$P_{i,t} = \frac{NOI_{i,t}}{k_{i,t}} \tag{3.3}$$

[13]For example, there might be things the investor could do to mitigate the decline in net cash flow, whereas there might be less that can be done to influence caprates.

[14]Clearly the GGM is a simplification of the actual long-term cash flow stream as modeled in Figure 1. But the GGM is widely used and its simplification is relatively benign for our purpose, which is only to explicate the basic roles in property depreciation of the two factors, current net cash flow and asset market capitalization.

[15]The difference between NOI and CF is the routine capital improvement expenditures: $CF_t = NOI_t - CI_t$. Although this difference does not matter for our purpose in this paper, it is of interest to note that among properties in the NCREIF Property Index, the historical average capital expenditure (CI) is over 2% of property value (including land value) per year. Deloitte-Touche (2000) reports that U.S. Census data indicates overall post-construction capital improvement expenditures on buildings is approximately 40% of the cost of new construction. (If the average building is somewhat more than 20 years old, this would be roughly consistent with the NCREIF 2%/year rate.) The Deloitte-Touche study also conducted a survey which suggested that capital expenditures may often exceed 5% of structure value per year. (If structure value is on average halfway between 80% and 0% of total property value, then this too would be roughly consistent with the NCREIF data.) However, the D-T survey was very limited.

where $k_{i,t} = r_{i,t} - g_{i,t}$ is the capitalization rate ("cap rate" for short) for property i as of time t. The property value equals its net operating income divided by its cap rate.

Thus, if the property real value tends to decline over time with depreciation, due to the aging of the building, then such value decline may be (with slight simplification) attributed either to a decline over time in the real NOI that the property can generate, or to an increase over time in the cap rate that the property asset market applies to the property as it ages, or to a combination of these two sources of present value. To the extent depreciation results from an increase in the cap rate with building age ("cap rate creep"), this could result either from an increase in the OCC or from a decrease in the expected future growth rate, $g_{i,t}$, or a combination of those two. In the present paper we will not attempt to parse out this OCC versus growth expectations breakout. We content ourselves with exploring the question of how much of the depreciation in P is due to the NOI and how much is due to k. To answer this question, we will estimate the effects of depreciation on both property value and on cap rates. The difference between the total depreciation and effect of the cap rate creep will be attributable to NOI depreciation. We now turn to outlining our empirical model.

4 The Hedonic Price and Cap Rate Models

In this section, we outline our approach for estimating the effects of depreciation on both total property value and the property cap rate. Following in the tradition of depreciation estimation modeling, the approach known as "used asset price vintage year" analysis is applied to quantify real depreciation. This involves an essentially cross-sectional analysis of the prices at which properties of different ages (defined as the time since the building was constructed) are transacted, controlling for other variables that could affect price either cross-sectionally or longitudinally. This is estimated via the hedonic price model given in equation (4.1)

$$ln(p_{i,t}) = \sum_{h=1}^{H} \beta_A A_{h,i,t} + \sum_{j=1}^{J} \beta_X X_{j,i,t} + \sum_{m=1}^{M} \beta_M M_{m,i,t} + \sum_{s=1}^{T} \beta_T T_{s,i,t} + \epsilon_{i,t} \tag{4.1}$$

where,

- $p_{i,t}$ is the price of property sale transaction i occurring in year t.
- $A_{h,i,t}$ is a vector of H property and location characteristics attributes for property sale transaction i as of year t.
- $X_{j,i,t}$ is a vector of J transaction characteristics attributes for property sale transaction i as of year t.
- $M_{m,i,t}$ is a vector of fixed-effects dummy variables representing M metropolitan markets for property sale transaction i as of year t
- $T_{s,i,t}$ is a vector of s = 1,2,...,T time-dummy variables equaling one if $s = t$ and zero otherwise (for property sale transaction i as of year t).

The A_h property and location characteristics in the model include, most importantly, the property age in years since the building was constructed and age-squared, but also include the natural log of the property size in square feet, dummy variables for property usage type sector (office, industrial, retail, or apartment), and a dummy variable flagging whether the property is in the central business district (CBD) of its metro area. The X_j transaction characteristics include an indicator of seller type, a dummy variable to control whether the sale was in distress, a dummy variable to indicate if the buyer had a loan that was part of a CMBS pool, as well a flag to indicate whether the property had excess land available (was not fully built out).

(a) Censored Sample Bias and Correction

As pointed out by Hulton & Wyckoff (1981), any estimation of the depreciation rate would need to take into account the experience of torn-down buildings in order to avoid introducing a survivorship bias. Since buildings that have been demolished have already depreciated to a point that their structure has no value, omission of such data is likely going to result in an estimate that is smaller than it should be. Hulton & Wyckoff (1981) correct for this censored sample bias by noting that the average price of a building (of a given age) is the price of surviving buildings, multiplied by the survival probability (having survived until that age), plus the zero value of torn-down buildings (of that vintage) times the probability of being torn-down (having not survived by that age). Using this approach, we can re-write the left-hand side of equation (4.1) as

$$ln(P_i * p_{i,t}) = \sum_{h=1}^{H} \beta_A A_{h,i,t} + \sum_{j=1}^{J} \beta_X X_{j,i,t} + \sum_{m=1}^{M} \beta_M M_{m,i,t} + \sum_{s=1}^{T} \beta_T T_{s,i,t} + \epsilon_{i,t} \qquad (4.2)$$

where P_i is the probability of survival until the age of building i.

This expected price formulation of equation (4.2) will be the focal regression for the remainder of this study. In order to estimate a survival probability for our sample properties, we will employ data on demolished buildings (along with surviving buildings) and use the Kaplan-Meier estimator to calculate the survival probability at each building age.

(b) Cap Rate Model

We also estimate a hedonic model of the cap rate that can, similar to the analysis of property price, quantify how the cap rate is a function of the age of the property's building structure (holding other characteristics constant). This cap rate model can then be combined with the hedonic price model to derive how much of the overall depreciation in the property value is due to depreciation in the property net operating income and how much is due to change in the cap rate.

Our hedonic cap rate model is very similar to our hedonic model of property price in (4.1) except that we replace the dependent variable with a normalized construct of the property's cap rate at the time of sale instead of the property price. The normalized cap rate is the difference between the property's cap rate minus the average cap rate prevailing in the property's metropolitan market (for the type of property) during the year of the transaction. This normalization controls for systematic differences in cap rates across metropolitan areas, as well as for cyclical and market effects on the cap rate.[16] The normalized cap rate thus allows the individual property differences in cap rates that could be caused by the age of the buildings to be estimated in the model below:

$$CapRate_{i,t} = \sum_{h=1}^{H} \beta_A A_{h,i,t} + \sum_{j=1}^{J} \beta_X X_{j,i,t} + \sum_{m=1}^{M} \beta_M M_{m,i,t} + \sum_{s=1}^{T} \beta_T T_{s,i,t} + \epsilon_{i,t} \qquad (4.3)$$

[16] Alternatively, cap rates on the left hand side and interacted dummies between MSA and time would also capture the between market variation in cap rate over time. This alternative specification gives nearly identical results, not surprisingly.

5 Data

This study is based on the Real Capital Analytics Inc (RCA) database of commercial property transactions in the U.S.[17] RCA collects all property transactions greater than $2,500,000, and reports a capture rate in excess of 90 percent. Properties smaller than $2.5M are often owner-occupied or effectively out of the main professional real estate investment industry. We believe the data represent a much larger and more comprehensive set of investment property transactions than prior studies of depreciation. The present analysis is limited to the four major core property sectors of office, industrial, retail, and apartment. The study dataset consists of all such transactions in the RCA database from 2001 through the second quarter of 2014 and which pass the data quality control filters and for which there is sufficient hedonic information in the RCA database, 107,805 transactions in all.[18] This includes 80,431 non-residential commercial property sales and 27,374 apartment property sales. A subsample of 81,310 transactions are located in the top 25 metropolitan area markets which are studied separately.[19] 32,481 sales have, in addition to sufficient hedonic data, also reliable information about the cap rate (as defined in section 3). This cap rate subsample will be used in subsequent analysis of the cap rate creep. Table 1 presents the summary statistics for the overall dataset. The average age of the properties in our sample is 32 years and the median age is 25 years. The data are fairly equally distributed across the four core property types. The seller types are broadly categorized as Equity, Institutional, Public, Private, User and CMBS Financed, of which Private constitutes about 69% of the data. Figure 2 shows the number of observations in each of the top 25 RCA Metro Markets. The sample sizes range from 15,380 transactions in Metro Los Angeles down to only 288 in Pittsburgh.

[17] In general from here on, unless specified otherwise or it is clear from the context, we will use the term "commercial" property to refer to all income-producing property including multi-family apartments.

[18] We drop sales that were part of a portfolio sale to avoid an uncertain sale price for a property within the portfolio. We also drop properties for which the sale price was not classified as confirmed by RCA's standards and if they were older than 150 years.

[19] RCA has their own definition of metropolitan areas which differ slightly from the U.S. Census definitions and conform better to actual commercial property markets. We refer to these as "RCA metros" or "Metro Markets."

(a) Torn-Down Building Data, Multiple Imputation of Age-at-Demolition and Survival Probabilities

In addition to the above described data which will serve as the basis of our analysis, we have a stock of 12,903 buildings that were either demolished or acquired with the intention of demolition. Unfortunately, of these, only 2,109 observations have non-missing age information. In order to calculate survival probabilities at each building age, we first need to impute the missing age-at-demolition data. We choose a multiple imputation approach where each missing age is imputed 20 times. The method of imputation outlined by Royston (2007) is particularly suited for imputing censored variables. It's main feature is that the researcher can specify an interval of the normal distribution from which the imputed values will be simulated. In our case, we specified that interval to be between ages 10 and 150 years, the assumption being that buildings with age less than ten years are very unlikely to be demolished. An added advantage of this approach is that our imputed values are always going to be non-negative and within a sensible range. As recommended by the multiple imputation literature, the model for the conditional distribution of Age contains all co-variates, including price and a dummy variable for surviving properties. Upon obtaining 20 imputations of age-at-demolition, we construct 20 separate sets of survival probabilities using the Kaplan-Meier estimator. Figure 3 shows an example survival function using one such imputation. We find that the other 19 sets are very similar in shape. Finally, we construct a single set of survival probabilities (P_i in (4.2)) by taking an average over the 20 sets. The thus obtained survival probabilities are then multiplied by the price of the surviving buildings (107,805 transactions) to create the left-hand side (in logs) of the regression equation (4.2).

6 Empirical Analysis

(a) Depreciation Magnitude and Age Profile

The first set of results is based on the bias-corrected hedonic price model in (4.2), run on the entire 107,805 US transaction sample, and focuses on the overall rate of depreciation and its profile over time. Column (1) in Table 2 presents the regression results. The variables of interest, both Age and Age-squared, are highly significant, with the coefficient on Age being negative and that on Age-squared being positive; a convex quadratic function. Thus, the property value tends to decline in real terms with building age, but at a declining rate. Also shown in column (2) of Table 2 is the regression from equation (4.1), reflecting an estimate that does not correct for censored sample bias caused by torn-down buildings whose structures have already fully depreciated. There are two points worthy of note when comparing the Age and Age-squared coefficients between columns (1) and (2). First, the coefficients are less precise in the bias-corrected estimates of column (1). The standard errors are greater due to the uncertainty introduced by the multiple imputation (of age-at-demolition) step in the estimation of the survival probabilities. Nevertheless, the results are still statistically significant. Second, the biased estimates of column (2) do indeed underestimate the rate of depreciation. This is best seen in Figure 4, where the two quadratic specifications are compared in an implied Age-Price profile (constructed using both Age and Age-squared coefficients). It is clear that while the biased and un-biased profiles mostly agree up until the first 40 years of building age, the biased quadratic specification fails to capture the continued decay in property value much beyond that point. Also shown in Figure 4 is an alternate bias-corrected age dummy specification as a robustness check.[20] We also show a two standard error bound around this specification to depict the noise in these estimates in the range beyond 110 years, a point where the data starts to get thin. The age dummy specification suggests that the bias-corrected quadratic approach is a very good approximation to a more flexible but noisier alternative.

Using the quadratic specification as the more parsimonious model, we model the depreciation rate (using the Age and Age-squared coefficients) for all building ages from 1 to 50 years old. We then take, as our summary measure of average depreciation rate, the equally-weighted average rate across the 50 year horizon. (That is, each of the 50 years' rates counts equally. This average is normally very similar to the depreciation rate of a 25 year old building.[21]) Thus, in effect, this is a summary depreciation metric that holds the age of the building structure constant across comparisons, at the time-weighted average depreciation rate over a 50-year building life horizon.

For the national sample, this gives an average real depreciation rate of 1.5%/year of property value (including land). The depreciation rate declines from 1.82%/year for a property with a new building down to 1.12%/year for a property with a 50-year old building (see Figure 5). At first glance, these depreciation rates appear to be smaller than what was reported in earlier studies in the U.S., such as the Hulton-Wyckoff (1981) and Deloitte-

[20] In this specification, there is a dummy for each age up until age 129, while ages 130 to 150 are lumped together into one final dummy variable.

[21] As noted earlier, the mean building age in our sample is 32 years, with a median age of 25 years.

Touche (2000). But those studies were quoting rates as a fraction of remaining estimated structure value, not total property value which is our focus.

We have noted in Section 3 that from the investment perspective it is less important to attempt to quantify depreciation as a fraction of only structure value. Nevertheless, to compare our results with the previous U.S. depreciation literature, it may be of some interest to make some observations in that regard. Given our bias-corrected empirical model in column (1) of Table 2, we can estimate an implied average structure lifetime by finding the minimum point (over Age) at which there is no further property depreciation. The minimum point of the quadratic $Ln(p) = -0.0185 * Age + 0.00007 * Age^2$ is at age 128 years (see also Figure 4). When a building is no longer depreciating, it is worthless and hence it is time for redevelopment. At that point, the entire property value is land value. As a fraction of value of newly-built property value, this pure land value component can be found by plugging the building lifetime age (i.e., age when structure becomes worthless as indicated by no further depreciation) back into our hedonic price equation [$\exp(-0.0185 * 128 + 0.00007 * (128)^2 = 0.31)$]. Since land value fraction is 31% of newly-built property value, the corresponding structure value fraction would be 69%. Given this initial structure value fraction and our property value depreciation profile, we back out that the rate of structure depreciation (per annum) is 2.7% at the median building age of 25 years. This estimate would be roughly consistent with previous studies' findings.

In Table 3, we run separate regressions for the 4 core property types. We find (consistent with the national aggregate results) signs and significance for the Age and Age-squared variables across all property types. In the case of non-residential commercial real estate, office and retail properties depreciate the fastest at similar rates, while industrial depreciates the slowest (at least until buildings become very old). In Figure 6, we lump all the non-residential commercial property sectors together and break out the analysis separately for apartments and non-residential commercial properties. It is not clear a priori why apartment properties should depreciate at different rates than commercial property, but tax policy has long differentiated them (possibly for political reasons). In fact, we see that apartments do on average depreciate slightly faster than non-residential commercial properties, holding age constant. In our sample, the average apartment building is 10 years older than the average non-residential commercial property (median of 35 years vs 23 years old) and the depreciation rate of the median apartment property is 1.63% vs 1.5% per annum for commercial.

In summary, our aggregate-level findings suggest depreciation rates that average 1.5%

per annum as a fraction of total property value (including land). Compared to the previous literature, our estimates are based on actual transaction prices rather than building structure value estimates, and are based on a much larger and more comprehensive property sample. Given our model's implications for structure depreciation, the rates we find are consistent with the earlier findings. We find clear evidence that properties depreciate slower as buildings age. There is also clear evidence that apartment properties depreciate faster, but only slightly faster, than non-residential commercial properties.

(b) Estimation of Cap Rate and NOI Effects on Total Depreciation

In order to estimate how much property value depreciation would result purely from cap rate creep, and how much from NOI decline, we estimate the (bias-corrected) hedonic price and cap rate models (equations (4.2) and (4.3) respectively) on the same transaction subsample for which we have cap rate data available. These regressions are shown in columns (1) and (2), respectively, of Table 4. We first compute the total depreciation in property value from the age coefficients in the price model (column (1) of Table 4), much as described in the previous section. We next compute how much decline in property value with building age would result purely from the increase in the cap rate due to age as implied by the age coefficients in the cap rate model (column (2) of Table 4), holding the property net operating income constant. The difference between the total depreciation and the pure cap rate creep depreciation presumably is attributable to NOI depreciation.

The result of this analysis is shown in Figure 7. It can be seen that almost all of the property value real depreciation results from the decline in the real NOI and very little from cap rate creep. Using our previously defined average-age metric for the summary depreciation rate, the overall average depreciation rate in the subsample is 1.5%/year, while the average depreciation rate due solely to cap rate creep is only 0.17%/year. The implication is that the NOI source of depreciation accounts for 1.38%/year or 92% of all the depreciation. This implies that the conventional approach in current investment industry practice in commercial property pro-formas of forecasting rent and cash flow growth at a standard 3% rate (presumably equal to inflation but in reality if anything slightly greater than inflation in recent years) is substantially biased on the high side, especially for newer buildings.

Because discounted cash flow (DCF) analyses of such pro-forma cash flow forecasts must of necessity arrive at a present value for the property approximately equal to the current market value of the property, this implies that the discount rate employed in such analyses must be substantially greater than the actual opportunity cost of capital. In other words, the discount rate typically employed in micro-level real estate investment analysis in the industry today is substantially greater than the actual realistic expected total return on the investment.

The dominance of net income and the space market as the fundamental source of property value in real depreciation is interesting in view of the fact that changes in capitalization, in the asset market's opportunity cost of capital or future growth expectations, have been found to play a major and perhaps even dominant role in short to medium-term movements in property value.[22] But depreciation is a very long-term secular phenomenon, and it makes sense that it would largely reflect underlying fundamentals.

(c) Depreciation and Metropolitan Location

We noted previously that real depreciation is a phenomenon of decline in the value of the building structure on the property, as land generally does not depreciate (or not as much or as relentlessly). This probably largely accounts for why the rate of depreciation is greater in properties with newer buildings. This also strongly suggests that property depreciation rates may vary across metropolitan areas, as different cities have different scarcity of land and different land value proportions of total property value. To analyze this issue, we estimated the bias-corrected hedonic price model in (4.2) separately for the top 25 Metro Markets (see again Figure 2 for the sample sizes in each metro).[23]

Figure 8 shows the resulting estimated coefficients on the Age variable in (4.2), in terms of absolute value (higher value is faster depreciation). The Age coefficients are statistically significant in all 25 Metro Markets and Age-squared coefficients are statistically significant for all but 9 Metro Markets. The Figure ranks the metros from greatest (fastest) to lowest (slowest) depreciation (based on the Age coefficient) and shows the 2-standard-deviation confidence bounds around the Age coefficient estimate in each metro. However, recall that the Age coefficient by itself is not the complete story about depreciation, as the effect of the Age-squared coefficient must also be considered, which makes the property depreciation rate a function of building age. Table 5 therefore shows for each metro the implied depreciation rates as a function of building age, as well as the time-weighted

[22] See for example Geltner & Mei (1995), and Plazzi, Torous & Valkanov (2010).

[23] For this analysis, the imputation of the age-at-demolition data was computed separately for each market.

average summary metric for each metro (which effectively compares across metro holding building age constant). Finally, Figure 9 depicts some representative age/value profiles for three major metropolitan areas, providing a visual impression of how both the average depreciation rate and the age profile of the depreciation can vary across select metropolitan areas.[24]

The extent of variation across metropolitan areas is striking. For the age-constant summary metric, the average depreciation rate for all income-producing commercial property ranges from 2.95%/year in Dallas down to 0.42%/year in Los Angeles. The age profile (see Figure 9) also can vary greatly, with NY apparently exhausting the property depreciation just prior to 85 years of building age. This probably does not generally reflect an historic building or "vintage effect" as has been sometimes found for single-family houses.[25] And income-producing properties, essentially capital assets traded in the investments industry, are probably not very susceptible to architectural style vintage year preference effects like houses may be. Rather, the exhaustion of property depreciation probably suggests rapid economic obsolescence in a dynamic metropolitan area where the highest and best use (HBU) of locations has been rapidly changing over the past couple of generations.

On the other hand, metro areas that show little depreciation right from the start, even when buildings are new, may reflect systematically higher land value proportions of total property value, even when the buildings are new. This may reflect land scarcity. Figure 10 explores this issue by regressing the metro areas' depreciation rates onto the Saiz (2010) measure of metro area real estate supply elasticity.[26] The Saiz elasticity measure is based on both regulatory and physical land supply constraints on real estate development, which Saiz (2010) has shown are major determinants of overall real estate development supply elasticity. Thus, the Saiz elasticity measure should be highly correlated (negatively) with land value and the land value fraction of total development costs (and therefore, with the average land value fraction of total property value). Metro Markets with higher Saiz elasticity measures probably tend to have lower land values. Figure 10 indeed reveals a strong positive relationship between depreciation and the Saiz elasticity. Metro areas that tend to have more elastic supply of real estate by the Saiz measure (which probably have

[24] The Age-Price profile is noisy for several metro areas as that level of granularity introduces more noise in the imputation and survival probability estimations.

[25] See Clapp & Giacotto (1998), who document that home buyers may develop preferences for certain vintages of housing construction.

[26] Figures 10, 11, 12 and 13 show results for 24 instead of 25 metro areas because at present there is no elasticity estimate available for Sacramento MSA.

lower land costs resulting in building value being a larger share of total property value) are associated with faster depreciation, especially in the early years of building life.[27] We see the opposite in metros that have the lowest Saiz elasticities.[28]

In Figure 11, we regress MSA depreciation rates against the physical land constraint component of Saiz's elasticity measure. The physical land constraint measure is a sum of various geographical constraints within a 50km radius from the center of an MSA. These constraints include the share of land area that's at more than a 15% slope, or if it is under open water or wetlands, or generally not available for development. The figure shows that depreciation rates are lower in MSAs where there are greater (higher value) physical constraints to development. This again is consistent with the view that land value proportions of total property value would be higher in such MSAs and therefore, depreciation in the structure would be a smaller percentage of total property value.

In Figure 12, we regress MSA depreciation rates against the Wharton Land Regulation Index (WLRI, also a component of Saiz's elasticity measure). In the Figure, higher values reflect greater regulatory constraints and we see a negative relationship between average depreciation rates and the WLRI. However, the relationship between depreciation and regulatory constraints in Figure 12 is weaker than the relationship between depreciation and physical land constraints in Figure 11. Onerous regulations constrain development without adding to land value (they don't cause land scarcity per se but merely an increase in development costs), while physical land constraints should cause land scarcity and higher land costs. In a simple regression of average MSA depreciation rates onto the Saiz physical land constraints measure and the WLRI, we find that the physical land constraints measure has greater explanatory power than the WLRI measure. The physical land constraint measure has a bigger coefficient (-0.71) and higher statistical significance (at 1% level) than WRLI, which has a coefficient of -0.37 and is only statistically significant at the 10% level. Physical land constraints alone can explain over 40% of the variation in average depreciation rates across MSAs while adding WRLI only marginally increases the explained variation to 50%. Thus, low depreciation is more associated with physical land constraint than with regulatory constraints.

[27]As noted, lower depreciation as a fraction of property value in later years (older buildings) in metro areas with rapid initial depreciation rates could reflect exhaustion of building value due to widespread economic obsolescence of structures reflecting very dynamic metropolitan growth. Ex.s. include Dallas, Denver, Phoenix, Atlanta, etc.

[28]Most notably the West Coast metros (LA, SF, SD, Seattle, Portland) and major North Atlantic metros (NY, Bos, DC).

The analysis in Figures 10, 11 & 12 explores a major cause of the cross-section of metropolitan depreciation rates in commercial property. On the other hand, the analysis in Figure 13 explores a major effect of this variation in depreciation rates. Figure 13 regresses the average cap rates of property sale transactions onto the average depreciation rates across the Metro Markets. As noted in our derivation of the direct capitalization formula for property value in Formula (3.2) in Section 3, cap rates can be viewed as reflecting essentially or primarily the current opportunity cost of capital (the investors' expected total return, $r_{i,t}$) minus the long-term expected growth rate in property value (what we labeled $g_{i,t}$, which fundamentally and primarily reflects the long-term growth in property net income). Clearly the long-term growth rate strongly reflects the property depreciation rate that we have been estimating. Therefore, we should expect property transaction prices, as reflected in their cap rates, to be partially and importantly determined by depreciation expectations. Thus, the dispersion in cap rates should be correlated with the dispersion in depreciation rates across Metro Markets. Figure 13 shows that this is exactly what we find. The relationship is strongly positive and statistically significant.

However, the cap rate/depreciation relationship in Figure 13 is less than a one-to-one correspondence (slope is less than 1.00). If cap rates were completely determined by the $r_{i,t} - g_{i,t}$ relationship, and if $g_{i,t}$ were completely determined by depreciation (growth is the negative of depreciation), then we would expect the estimated slope line in Figure 13 to be closer to 1.00. Instead, the slope is just under 0.5. Apparently cap rates are a bit more complicated than $r_{i,t} - g_{i,t}$ and/or the growth that matters to investors is more complicated than just the long-term depreciation that characterizes the metro area.

Nevertheless, Figure 13 suggests that the type of depreciation we are measuring is important for investors, as it should be. This finding suggests some nuance on the point we made previously that in current industry practice the routine cash flow forecasts in individual property investment DCF valuations seem to ignore real depreciation and the differences in depreciation across metro areas. While this is true of the cash flow forecasts in the numerators of the DCF present value analyses, the discount rates applied in the denominators are more flexible and are used to bring those cash flow forecasts in the numerators to a present value that coincides with current asset market valuation which does, apparently, reflect sensitivity to differences in growth and depreciation across metro areas. In other words, the discount rates used by investors must tend to be smaller in metro areas with less depreciation, and larger in those with greater depreciation. An effect which actually, realistically exists in the numerators (cash flows) is instead applied in the denominators (discount rate). As the discount rate is, in principle, the investor's going-in expected return, this suggests a lack of realism in these expected returns, both on average in general, and relatively speaking cross-sectionally, particularly in high depreciation Metro Markets such as many in the South and interior Sun Belt.[29]

7 Conclusion

In this paper we have analyzed the wealth of empirical data about U.S. commercial investment property contained in the RCA transaction price database in order to characterize the nature and magnitude of real depreciation. We introduce and explicate what we call the investment perspective for this analysis, which differs from that of the income tax policy oriented studies that have dominated most of the past literature in the U.S. The investment perspective is based on before-tax cash flow and market value metrics such as the IRR and the holding period total return that are prominent in the financial economics field, instead of on the historical cost accrual accounting perspective that underlies IRS tax policy in the U.S. Given our investment perspective, we focus on depreciation as a fraction of property total value (including land value), although we make some observations about building value fractions in order to place our empirical findings in comparison to results reported in earlier literature.

To briefly summarize our empirical findings about depreciation in income property viewed from the investment perspective, we see first that depreciation is significant. With average rates well over 100 basis-points per year, often over 200 bps in newer properties, depreciation has an important impact on realistic expected returns and property investment values. Furthermore, depreciation varies in interesting ways. It tends to be greater in younger properties (those with more recently constructed buildings). This probably largely reflects the relative share of land value and building structure value in overall property value, as land does not tend to depreciate. Holding building age constant, depreciation tends to be slightly greater in apartment properties than in non-residential commercial properties. Depreciation varies importantly across metropolitan areas. We see that metros

[29]This lack of a realistic correspondence between the implied expected returns and the realistic expected returns does not necessarily imply that asset mispricing exists. Asset prices reflect supply and demand for investment assets, and could rationally reflect risk and return preferences and perceptions. For example, Dallas properties may realistically provide less expected return than is suggested by the discount rates employed in their DCF analyses, but they also may present less risk than would warrant expected returns as high as the discount rates.

with lower development supply elasticity, especially places with physical land constraints such as the large East and West Coast metropolises, have lower depreciation rates. Places with plenty of land and less development constraints (higher supply elasticity) have higher average depreciation (holding building age constant). We also confirm that investment property asset prices do significantly reflect the differences in depreciation rates across metropolitan areas (as they should with rational asset pricing), though depreciation can only explain about half of the cross-sectional differences in cap rates.

Finally, we have seen that real depreciation is largely caused by (or reflects) real depreciation in the net operating income (NOI) that the property can generate, rather than by "cap rate creep" (increasing property cap rate with building age). Depreciation is a long-term secular phenomenon, so it makes sense that it would largely reflect property value fundamentals. This finding, combined with the magnitude of real depreciation that we find, strongly undercuts the realism in the typical prevailing industry practice of automatically forecasting a rental growth rate of 3%/year in most cash flow pro-formas and DCF present value analyses of individual property investments.

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The component of total property value (P) attributed to the building structure equals the component not attributed to land value. There are two ways to conceptually define land value: “L” is the legal/appraisal definition (value of comparable vacant lot); “C” is the economic definition (value of the redevelopment call option). In the graph below, S = P-C. But most practical applications use the legal definition of land value, and S = P-L. Depreciation results from any/all of three forms of obsolescence: (i) Physical (wearing out, more expensive maintenance), (ii) Functional (components & design no longer optimal for the intended use), & (iii) Economic (intended use no longer optimal for the site).

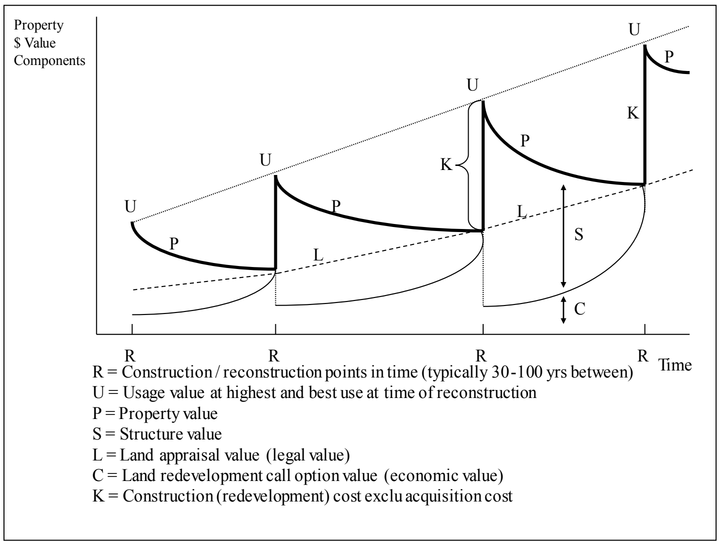

Figure 1: A Framework for Analyzing Depreciation

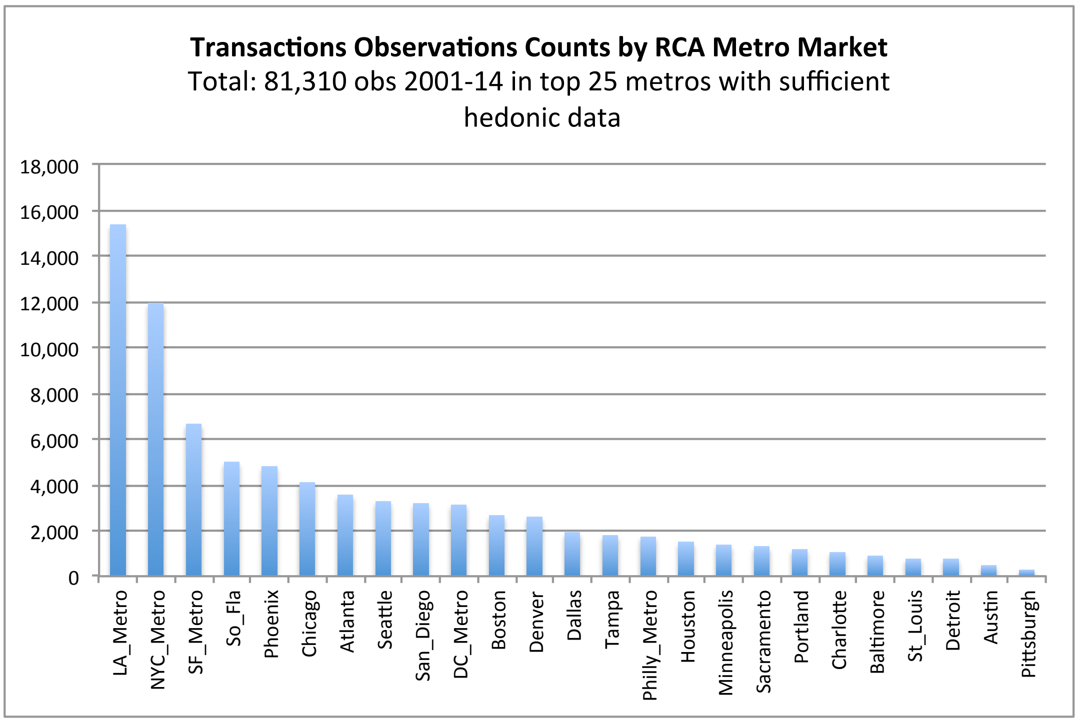

Figure 2: Transactions by RCA Metro Area

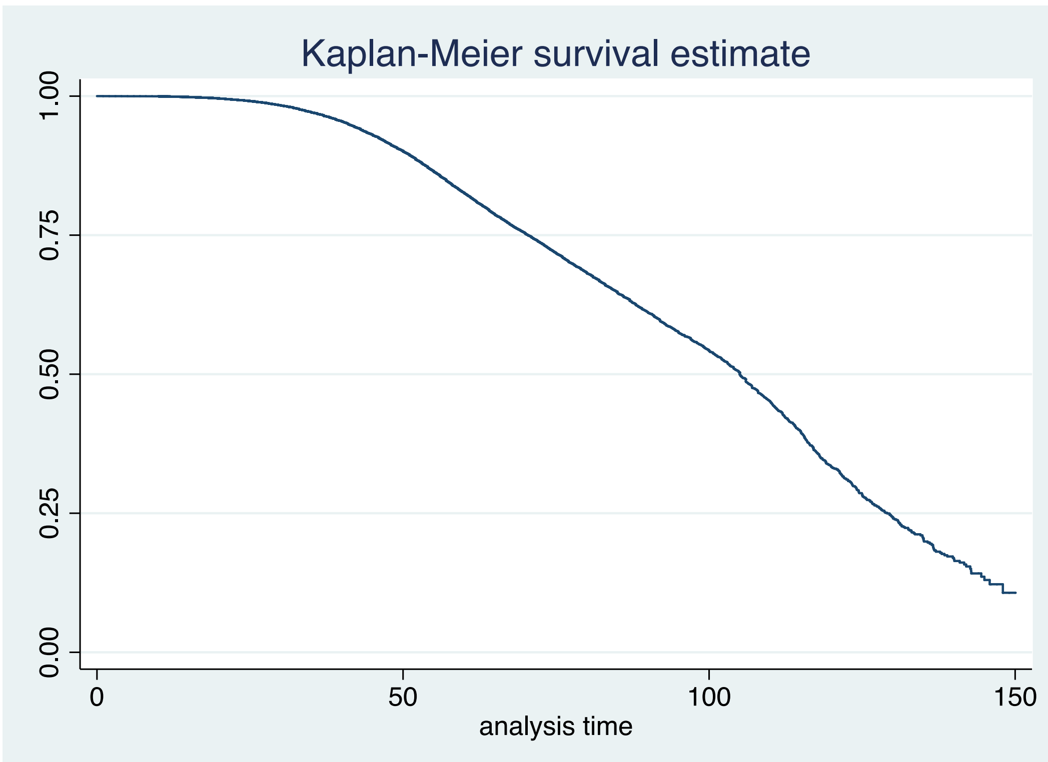

Figure 3: Kaplan-Meier Survival Function (based on one set of imputations)

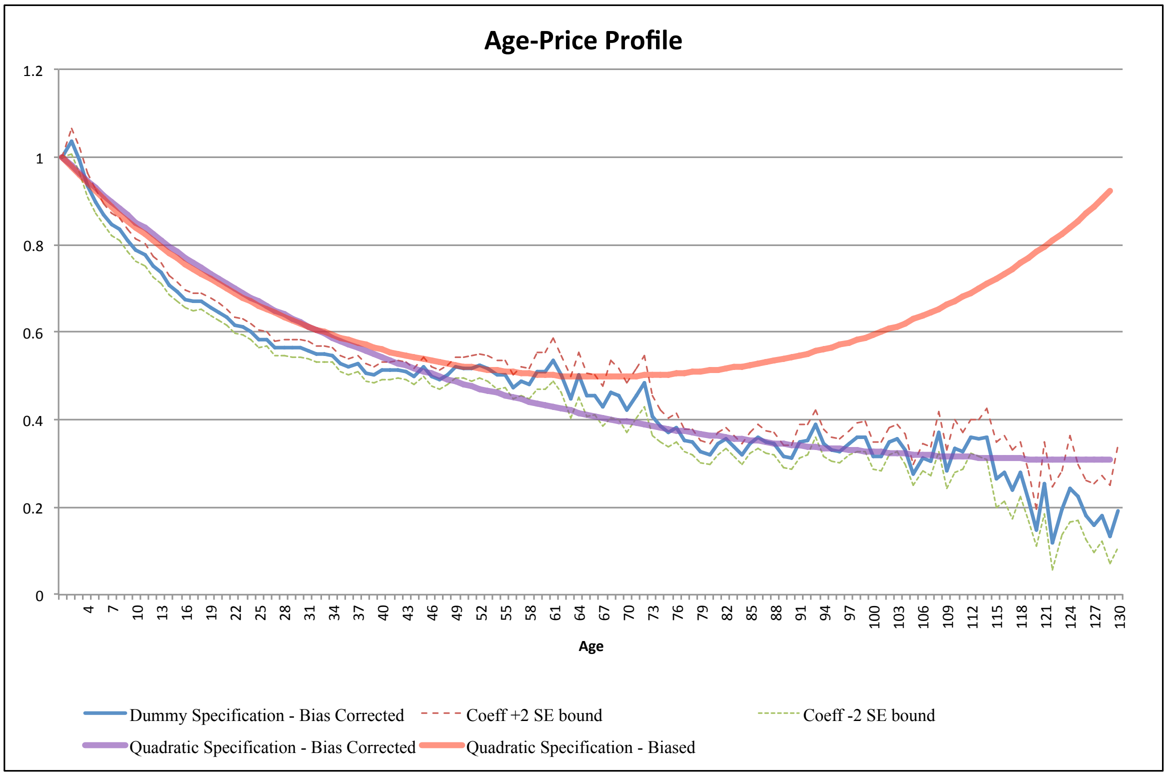

Figure 4: Implied Age-Price Profiles - Alternate Specifications

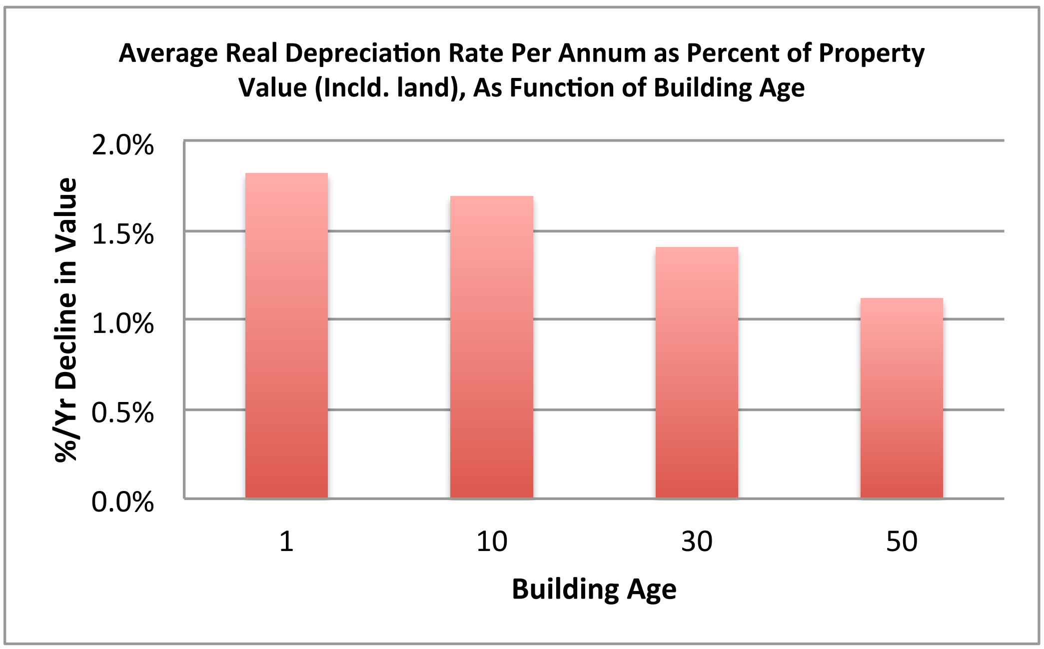

Figure 5: Real Depreciation (per annum) by Building Age

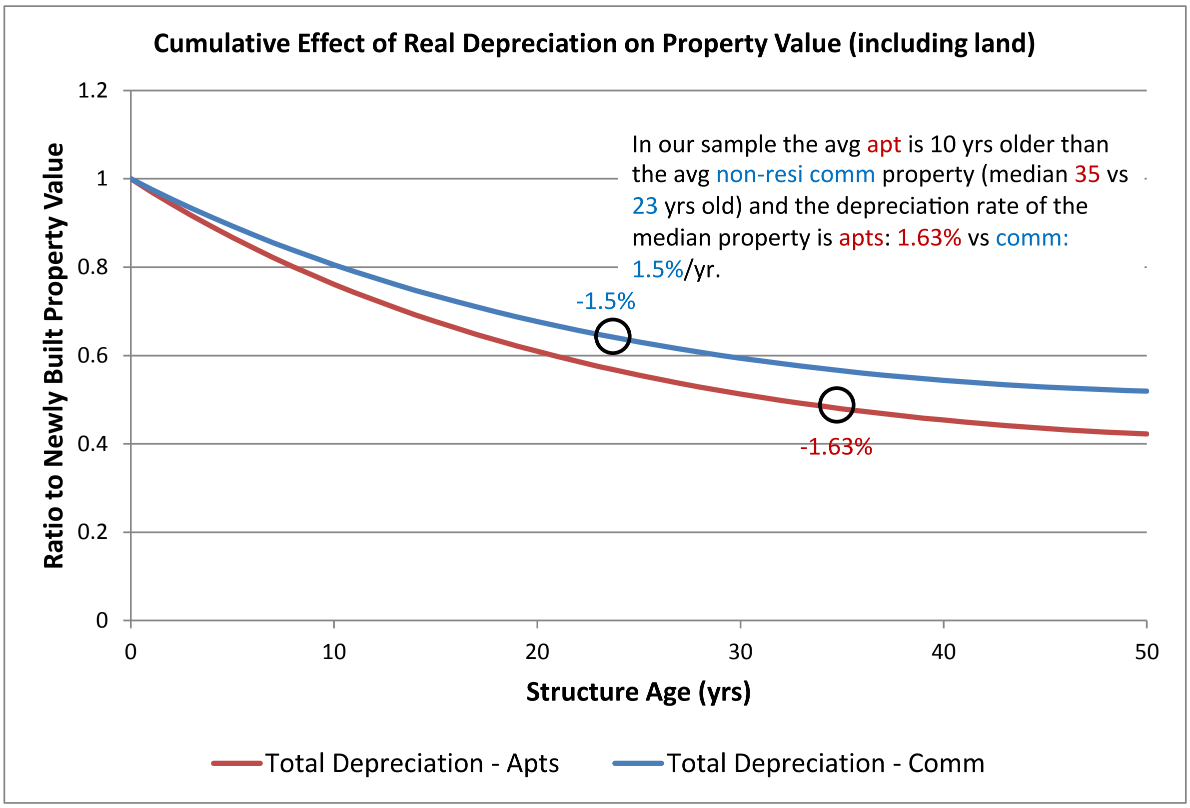

Figure 6: Real Depreciation: Apartments vs Non-Residential

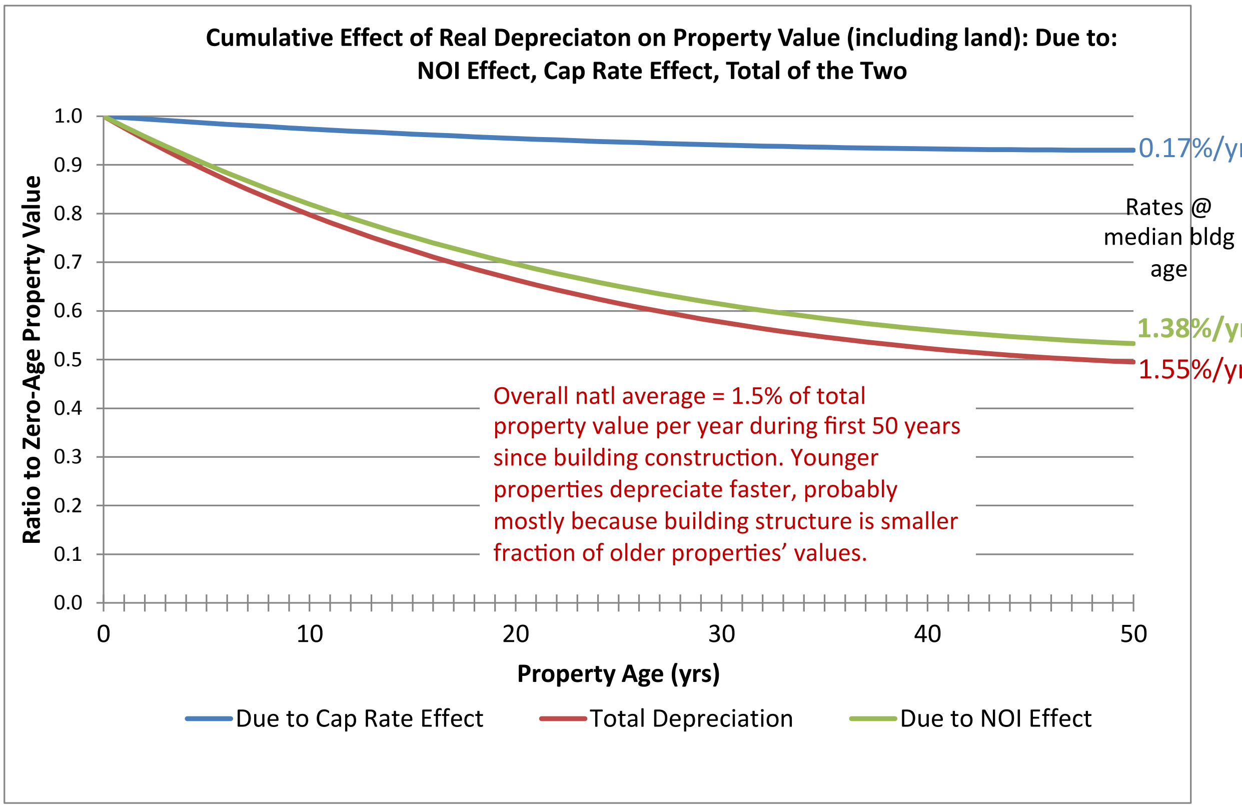

Figure 7: Real Depreciation due to Cap Rate Effect vs NOI Effect

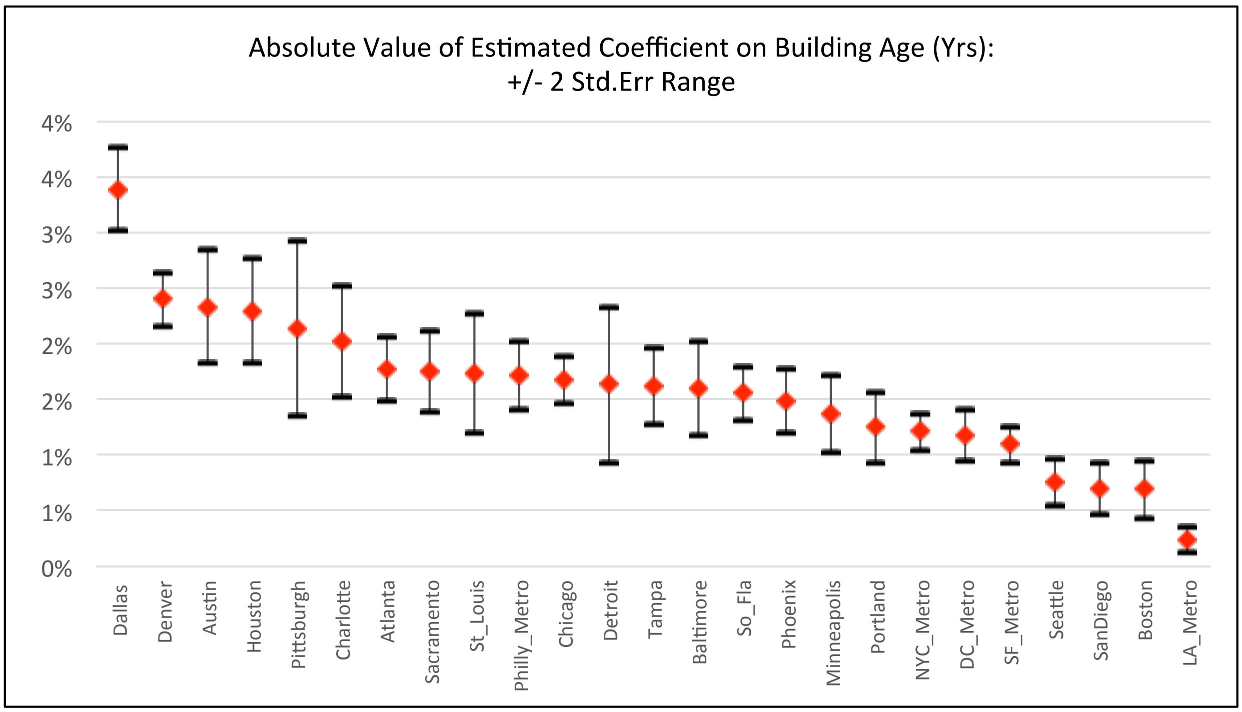

Figure 8: MSA Age Coefficients and Standard Errors

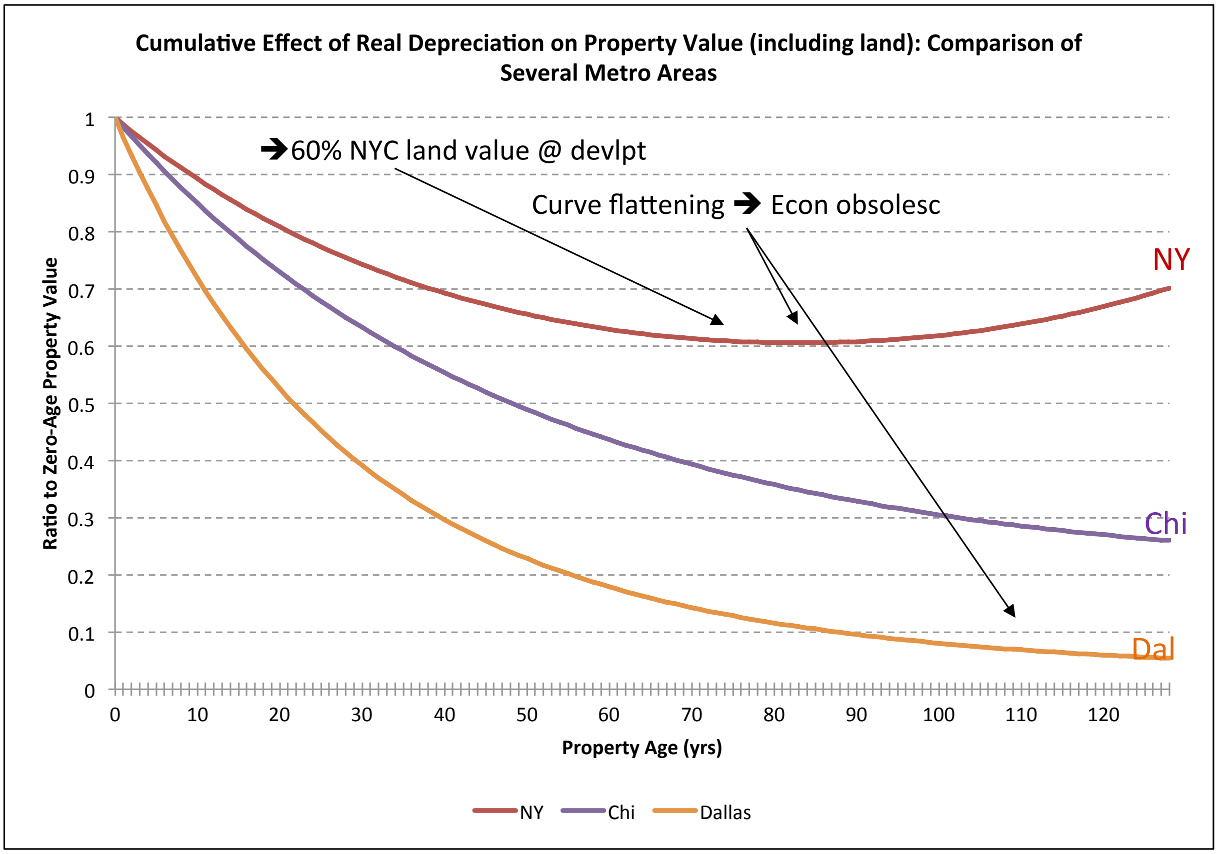

Figure 9: Depreciation Rates and Age Profiles Across MSAs

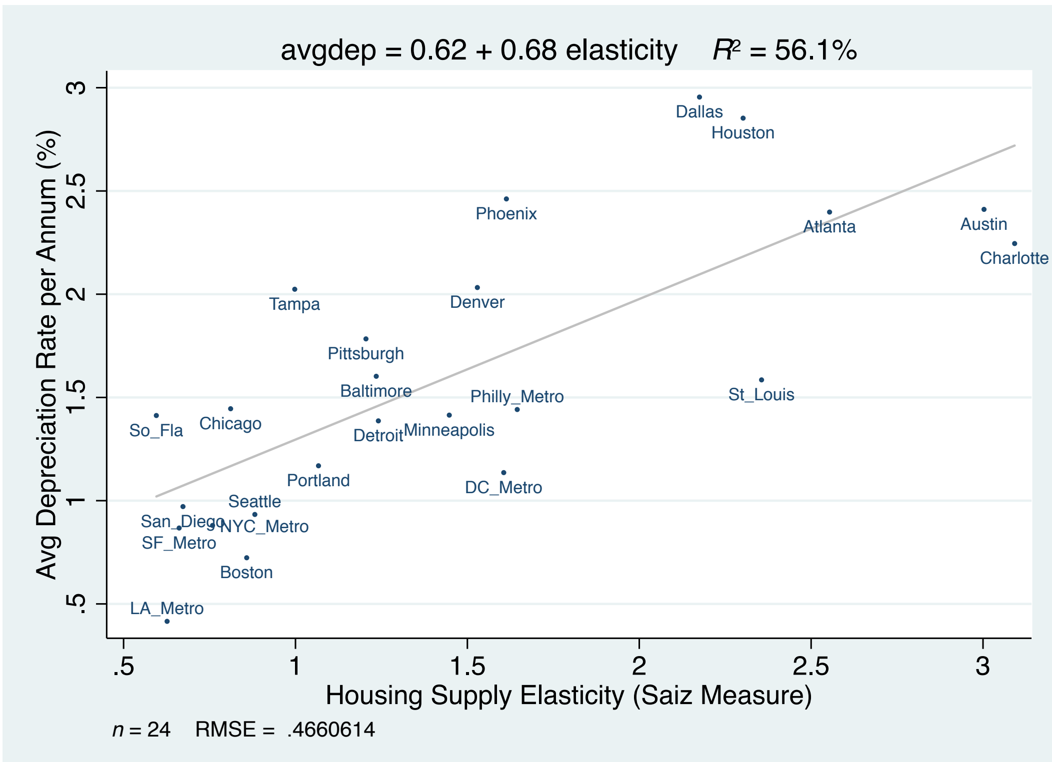

Figure 10: Depreciation and Housing Supply

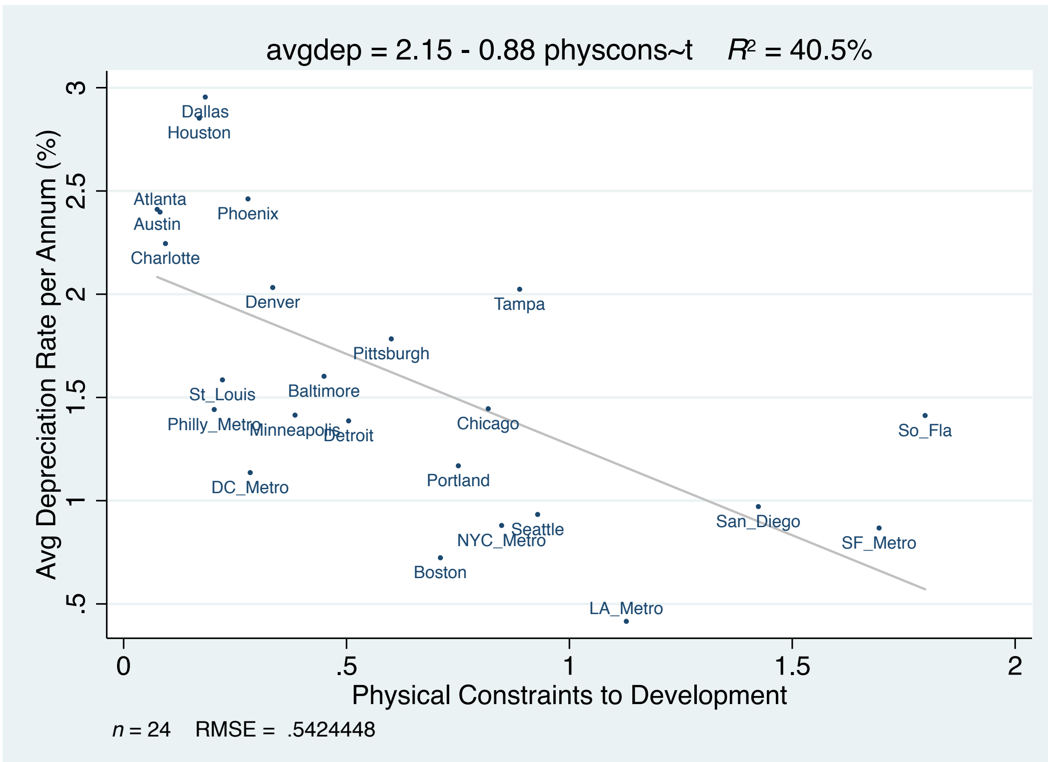

Figure 11: Depreciation and Physical Constraints to Development

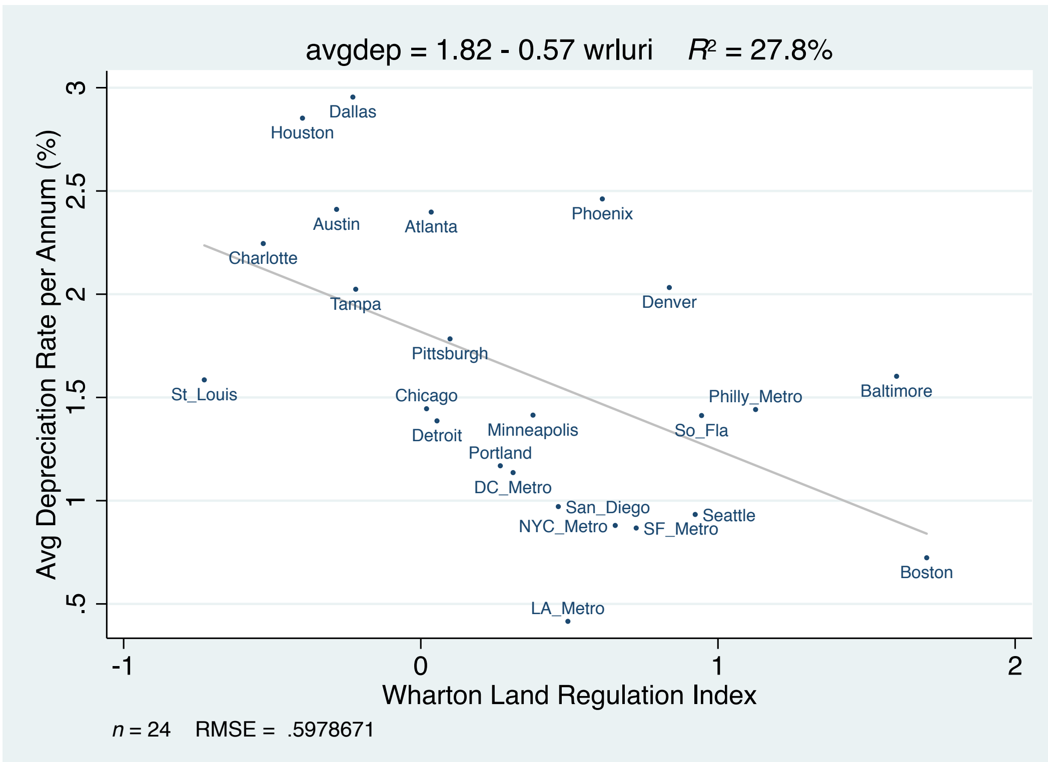

Figure 12: Depreciation and the Wharton Land Regulation Index

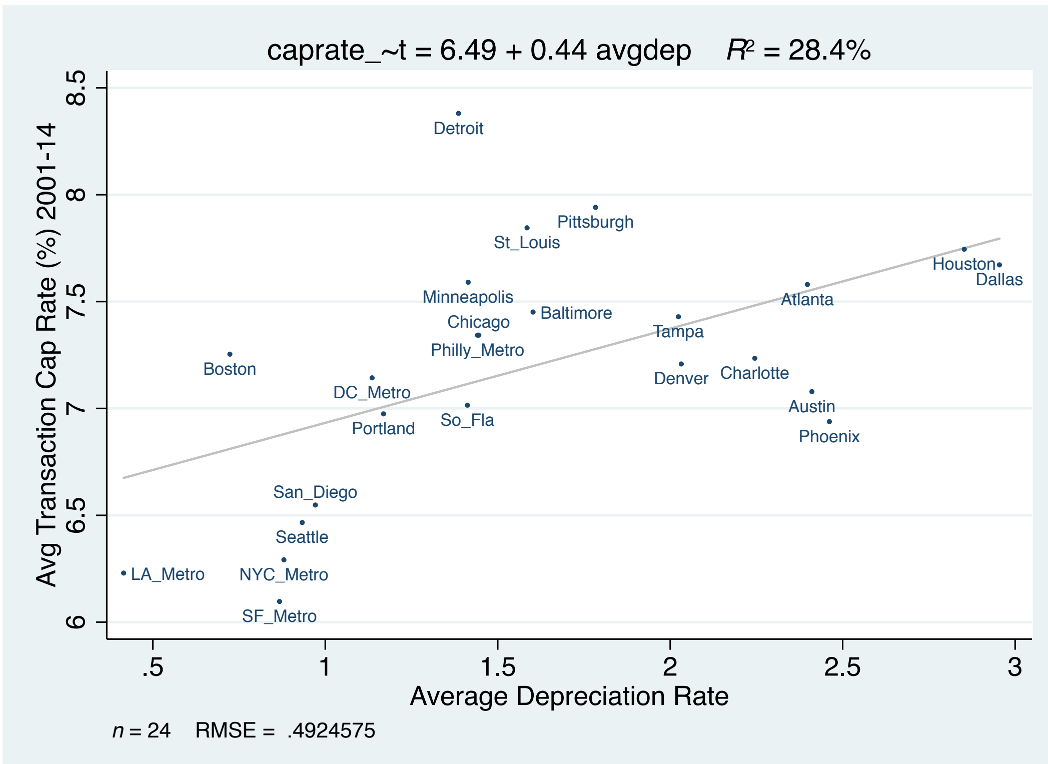

Figure 13: Depreciation and Cap Rates

Variable	Mean	Std. Dev.	N
Age	32	26	107,805
Age Squared	1706	2726	107,805
Price	$15,176,605	$47,556,544	107,805
Square Feet	116,694	178,773	107,805
Cap Rate	0.07	0.017	32,481
Normalized Cap Rate	0	0.013	32,481
CBD	0.153	0.36	107,805
Distress Flag	0.067	0.25	107,805
CMBS Financed	0.109	0.311	107,805
Excess Land Potential Flag	0.023	0.151	107,805
Apartments	0.254	0.435	107,805
Industrial	0.259	0.438	107,805
Office	0.234	0.423	107,805
Retail	0.253	0.435	107,805
Seller Type - User/Other	0.037	0.189	107,805
Seller Type - CMBS Financed	0.003	0.05	107,805
Seller Type - Equity Fund	0.032	0.175	107,805
Seller Type - Institutional	0.105	0.307	107,805
Seller Type - Private	0.689	0.463	107,805
Seller Type - Public	0.048	0.215	107,805

Table 1: Summary Statistics

Table 2: Effect of Depreciation on Property Value

	(1) Log Expected Price	(2) Log Price
Age	-0.01845	-0.02110
	(75.12)**	(88.27)**
Age Squared	0.00007	0.00016
	(26.52)**	(62.37)**
Ln Sqft	0.69647	0.69709
	(318.60)**	(319.45)**
CBD	0.41110	0.40685
	(52.55)**	(52.33)**
Industrial	-0.34602	-0.34429
	(73.75)**	(73.49)**
Office	0.26328	0.26551
	(50.46)**	(51.00)**
Retail	0.29279	0.29383
	(52.99)**	(53.26)**
Distress Flag	-0.58159	-0.58180
	(60.84)**	(60.91)**
CMBS Financed	0.25262	0.25220
	(47.89)**	(47.89)**
Excess Land Potential Flag	0.20432	0.20389
	(15.67)**	(15.66)**
Seller Type - CMBS Financed	0.00262	0.00355
	(0.08)	(0.10)
Seller Type - Equity Fund	0.35121	0.35172
	(27.66)**	(27.73)**
Seller Type - Institutional	0.23632	0.23696
	(28.44)**	(28.54)**
Seller Type - Private	0.09390	0.09358
	(16.85)**	(16.82)**
Seller Type - Public	0.19405	0.19503

Table 2: Effect of Depreciation on Property Value

	(1) Log Expected Price	(2) Log Price
	(19.37)**	(19.49)**
Constant	7.64135	7.64808
	(108.58)**	(108.94)**
R^2	0.72	0.70
N	107,805	107,805

* $p < 0.05$; ** $p < 0.01$

MSA and Year dummies not shown

Log Expected Price	Apartments	Industrial	Office	Retail
Age	-0.02699	-0.01133	-0.01759	-0.01739
	(56.08)**	(23.03)**	(33.25)**	(34.21)**
Age Squared	0.00015	0.00001	0.00006	0.00009
	(29.83)**	(1.37)	(11.16)**	(14.95)**
Ln Sqft	0.80033	0.59403	0.83244	0.59855
	(167.64)**	(144.12)**	(194.53)**	(129.36)**
CBD	0.27821	0.38906	0.42497	0.34850
	(17.46)**	(22.04)**	(36.66)**	(17.82)**
Distress Flag	-0.46068	-0.44758	-0.67668	-0.61466
	(28.00)**	(24.21)**	(36.12)**	(29.05)**
CMBS Financed	0.13760	0.34349	0.22706	0.29982
	(14.20)**	(23.53)**	(23.71)**	(33.39)**
Excess Land Potential Flag	0.31029	0.16883	0.17500	0.18751
	(7.81)**	(7.98)**	(8.34)**	(6.74)**
Seller Type - CMBS Financed	0.08695	0.11973	0.08416	0.01474
	(1.20)	(1.95)	(1.44)	(0.25)
Seller Type - Equity Fund	0.14889	0.33638	0.31126	0.37409
	(6.21)**	(14.22)**	(15.96)**	(10.44)**
Seller Type - Institutional	0.20924	0.17049	0.18319	0.25393
	(11.71)**	(12.25)**	(12.08)**	(12.36)**
Seller Type - Private	0.10168	0.06406	0.06786	0.15205
	(7.29)**	(8.15)**	(5.62)**	(12.37)**
Seller Type - Public	0.30655	0.19398	0.13518	0.14470
	(16.17)**	(12.24)**	(6.63)**	(6.72)**
Constant	6.32318	8.77162	6.12840	9.11602
	(51.93)**	(57.60)**	(51.50)**	(67.83)**
R^2	0.79	0.63	0.80	0.62
N	27,374	27,959	25,231	27,241

* $p < 0.05$; ** $p < 0.01$

MSA and Year dummies not shown

Table 3: Effect of Depreciation on Expected Property Value, by Property Type

	(1) Log Expected Price	(2) Normalized Cap Rate
Age	-0.02296	0.00021
	(62.01)**	(23.49)**
Age Squared	0.00018	-0.00000
	(42.13)**	(19.04)**
Ln Sqft	0.78572	0.00011
	(236.86)**	(1.46)
CBD	0.45527	-0.00632
	(35.91)**	(19.78)**
Industrial	-0.22395	0.01270
	(25.07)**	(53.55)**
Office	0.41326	0.01079
	(53.56)**	(50.37)**
Retail	0.40223	0.00854
	(50.30)**	(43.31)**
Distress Flag	-0.48032	0.00527
	(24.65)**	(9.57)**
CMBS Financed	0.09227	-0.00204
	(14.91)**	(12.70)**
Excess Land Potential Flag	0.14649	-0.00169
	(7.25)**	(3.37)**
Seller Type - CMBS Financed	-0.28012	-0.00596
	(3.16)**	(1.85)
Seller Type - Equity Fund	0.23578	-0.00343
	(13.09)**	(7.68)**
Seller Type - Institutional	0.16904	-0.00307
	(12.42)**	(8.63)**
Seller Type - Private	0.03202	-0.00107
	(3.10)**	(3.95)**
Seller Type - Public	0.08835	-0.00115
	(5.90)**	(3.06)**
Constant	6.84101	-0.01142
	(46.02)**	(3.98)**
R^2	0.82	0.14
N	32,481	32,481

* $p < 0.05$; ** $p < 0.01$
MSA and Year dummies not shown

Table 4: Effect of Depreciation on Cap Rate

Metro Market	1 Yr	10 Yrs	30 Yrs	50 Yrs	Average
Dallas	3.32%	3.17%	2.83%	2.50%	2.95%
Houston	2.29%	2.52%	3.04%	3.56%	2.85%
Phoenix	1.50%	1.90%	2.78%	3.66%	2.46%
Austin	2.31%	2.35%	2.45%	2.54%	2.41%
Atlanta	1.77%	2.03%	2.61%	3.18%	2.40%
Charlotte	2.00%	2.10%	2.33%	2.55%	2.25%
Denver	2.36%	2.22%	1.92%	1.62%	2.03%
Tampa	1.62%	1.79%	2.16%	2.53%	2.02%
Pittsburgh	2.10%	1.97%	1.68%	1.39%	1.78%
Sacramento	1.74%	1.76%	1.80%	1.83%	1.78%
Baltimore	1.59%	1.59%	1.61%	1.62%	1.60%
St Louis	1.71%	1.66%	1.54%	1.43%	1.59%
Chicago	1.65%	1.57%	1.38%	1.19%	1.45%
Philly Metro	1.69%	1.59%	1.36%	1.13%	1.44%
Minneapolis	1.36%	1.38%	1.43%	1.48%	1.41%
So Fla	1.54%	1.49%	1.37%	1.25%	1.41%
Detroit	1.61%	1.52%	1.31%	1.11%	1.39%
Portland	1.24%	1.21%	1.15%	1.08%	1.17%
DC Metro	1.17%	1.16%	1.12%	1.09%	1.14%
SanDiego	0.70%	0.81%	1.06%	1.31%	0.97%
Seattle	0.76%	0.83%	0.99%	1.15%	0.93%
NYC Metro	1.19%	1.06%	0.78%	0.49%	0.88%
SF Metro	1.09%	1.00%	0.79%	0.59%	0.87%
Boston	0.69%	0.70%	0.73%	0.76%	0.72%
LA Metro	0.25%	0.32%	0.47%	0.63%	0.42%
Average	**1.57%**	**1.59%**	**1.63%**	**1.67%**	**1.61%**

All estimated rates are statistically significant

Table 5: Real Depreciation Rates (per annum) by Building Age

NAREIT Alert (December 18, 2015)

NAREIT Alert Important Industry Updates from NAREIT

Dec. 18, 2015

Late on Dec. 15, Congressional leaders announced they had reached agreement on a $650 billion year-end "tax extenders" package named the Protecting Americans from Tax Hikes Act of 2015 (the PATH Act) that they believe lays the groundwork for Congress and the next President to consider comprehensive tax reform. On Dec. 17, the House of Representatives voted 318-109 to approve the measure, the Senate voted 65 to 33 on Dec. 18 to approve it, and President Obama signed the bill into law the same day. The leaders released the PATH Act's statutory language, a section-by-section summary, a detailed summary by the Joint Committee on Taxation and a revenue estimate of all provisions in the bill. Important elements of both FIRPTA and REIT reform are included in the PATH Act, and NAREIT commends the leadership for incorporating both the FIRPTA and the Update and Streamline REIT Act (U.S. REIT Act) changes that were discussed in the Dec. 8 NAREIT Alert.

FIRPTA Reform

Foreign investors of any type will be able to double (5 percent to 10 percent) their investment in publicly traded U.S. REITs and certain other entities held by qualified shareholders that are exempt from the FIRPTA exit tax on gains from sale of stock and from capital gain distributions. The PATH Act also contains a useful presumption for listed REITs that will make it easier for them to be considered domestically controlled so as to be exempt from

FIRPTA, effective on the PATH Act's date of enactment.

Foreign pension and retirement fund investments in U.S. REITs and real estate will no longer be subject to the FIRPTA exit tax on gains from sale of the property or REIT stock and from capital gain distributions. The PATH Act reflects some technical changes made from the Dec. 7 proposal released by Ways & Means Chairman Kevin Brady (R-TX) that clarifies the original intent to exempt foreign pension plans from FIRPTA for both sales of REIT stock as well as REIT capital gains distributions, whether or not that ownership is direct or through a partnership.

Both changes will apply to any disposition on and after the package's date of enactment and for any distribution by a REIT on or after the enactment date for which the REIT receives a dividends paid deduction for its taxable year ending after such date. The PATH Act also includes three revenue raising FIRPTA proposals that were included in the Senate Finance Committee's passage of S. 915 on Feb. 11, 2015 that are described in detail in a Senate Finance Committee Report.

U.S. REIT Act

As described in more detail in the Dec. 8 NAREIT Alert, the PATH Act would include almost all of the provisions in the U.S. REIT Act that was introduced by Representatives Pat Tiberi (R-OH) and Richard Neal (D-MA) in 2012.

These provisions will improve safe harbors from the dealer sales rules; repeal the preferential dividend rules for both listed and public non-listed REITs and provide the IRS with the authority to provide relief to private REITs from these antiquated rules (effective for distributions in taxable years beginning after Dec. 31, 2014); enhance the ability of taxable REIT subsidiaries (TRSs) to provide certain services; eliminate potential double taxation of earnings and profits; enhance the ability of REITs to hold certain debt assets of listed and public non-listed REITs; enhance the ability of REITs to hold certain ancillary personal property; and improve certain REIT hedging abilities. One important change from the Dec. 7 proposal is that another one of the U.S. REIT Act proposals to expand certain services that a timberland REIT TRS can provide was included in the PATH Act.

Other than the preferential dividend changes as described above, the U.S. REIT Act changes will apply to post-2015 taxable years.

REIT Spin-offs

Under the PATH Act, C corporations will no longer be able to spin off REITs in a tax-free transaction, but REITs will be able to spin off REITs and their TRSs held for at least three years on a tax-free basis. The PATH Act includes a technical change that clarifies that a TRS can be spun off on a tax-free basis even if the REIT holds the TRS through a partnership which it controls or if the TRS creates a new TRS to effectuate the spin transaction.

The PATH Act also includes a transition rule permitting a tax-free spin-off for companies which had filed prior to Dec. 7 with the IRS for a private letter ruling related to such a spin-off plan so long as the request has not been withdrawn, issued or denied as of that date.

In addition, beginning in post-2017 taxable years, the permissible size of TRSs will be reduced from 25 percent to 20 percent.

The proposal contained in the Dec. 7 proposal to limit contingent rents discussed in the Dec. 8 NAREIT Alert is not included in the PATH Act.

Other Real Estate Provisions

Finally, the PATH Act: 1) makes permanent: a) the 15-year depreciation period for leasehold improvements for property placed in service after Dec. 31, 2014; and, b) the 5-year (rather than 10-year) holding period for built-in gain tied to the conversion of a C corporation to an S corporation (and by extension to a REIT), effective in taxable years beginning after

Dec. 31, 2014; and, 2) extends for two years the section 179D deduction for energy efficient commercial buildings while updating that section's ASHRAE standards, retroactively for 2015, and then for 2016.

Contact

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March 18, 2015

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Dear Laurie and Viva:

The National Association of Real Estate Investment Trusts (NAREIT)[1] welcomes the opportunity to provide comments on H.R. 1, *The Tax Reform Act of 2014* (based on the discussion draft proposal, released on February 26, 2014) with respect to provisions to reform the taxation of financial products (the 2014 TRA).[2] NAREIT previously submitted comments on April 25, 2013 (the Initial Comments) regarding the initial financial products discussion draft released by former Ways and Means Committee Chair Dave Camp on January 23, 2013 (the Initial Discussion Draft). [3] A copy of the Initial Comments is attached.

Many of the concerns NAREIT expressed regarding the Initial Discussion Draft were addressed in the 2014 TRA. However, NAREIT continues to believe that aspects of the proposal to require mark-to-market accounting for derivatives and current inclusion of income on market discount bonds, if enacted, would unintentionally present problems for REITs and other investors in real estate and mortgage-related securities.

NAREIT looks forward to working with Congress on these issues.

EXECUTIVE SUMMARY

NAREIT believes that the 2014 TRA's proposal to mark-to-market "derivatives" continues to be too broad and would apply mark-to-market accounting to many common commercial transactions.[4] Accordingly, NAREIT

[1] NAREIT®, the National Association of Real Estate Investment Trusts®, is the worldwide representative voice for real estate investment trusts (REITs) and publicly traded real estate companies with an interest in U.S. real estate and capital markets. NAREIT's members are REITs and other businesses throughout the world that own, operate, and finance income-producing real estate, as well as those firms and individuals who advise, study, and service those businesses
[2] http://tax.house.gov/.
[3] http://waysandmeans.house.gov/uploadedfiles/leg_text_fin.pdf and http://waysandmeans.house.gov/uploadedfiles/final_financial_products_discussion_dated_tomorrow.pdf.
[4] President Obama's fiscal year 2016 budget contains a similar proposal to mark certain derivatives to market. Depending upon the specific details of the President's proposal, NAREIT would have similar concerns with that proposal.

believes the 2014 TRA should be amended to:

1) for purposes of the exception from mark-to-market accounting for derivatives with respect to real property, clarify that the definition of "real property" is the same for both investors and dealers (*e.g.*, the definition for investors is not limited to undeveloped land);

2) expand the exception from mark-to-market accounting for derivatives with respect to hedging transactions, which would: a) ensure that the market for "to be announced" (TBA) forward contracts to acquire mortgage-backed securities (MBS) guaranteed by Fannie Mae, Freddie Mac and Ginnie Mae (collectively, the Agencies) would not be disrupted in a way that could increase the interest rates borrowers pay on residential mortgage loans and possibly jeopardize the ability to offer 30-year, fixed rate mortgages to the public; b) allow REITs to continue to use derivatives with respect to Government securities to hedge fluctuations in the value of their investments in MBS and mortgage loans; and, c) clarify that a borrower's "rate-lock" is not a derivative that needs to be marked-to-market, which could affect mortgage lending activity around year-end; and,

3) allow REITs the ability to elect not to include accrued market discount in income currently, which would eliminate the possibility that REITs could have liquidity issues (potentially resulting in the need to incur additional debt or sell assets they otherwise would hold for the long term) as a result of having to distribute or pay corporate income tax on phantom market discount income.

DISCUSSION

A. Background

1. REIT Distribution Requirement

Background on REITs and the various requirements for qualification as a REIT are described in more detail in the Initial Comments. NAREIT concerns with the 2014 TRA generally relate to the distribution requirement required for REIT qualification. [5] A REIT must distribute to its shareholders at least 90% of its REIT taxable income (excluding net capital gain) each year (the 90% Distribution Requirement).[6] Like a mutual fund (called a regulated investment company in the Internal Revenue Code of 1986, as amended (the Code))[7] on which it is patterned, a REIT is allowed a dividends paid deduction in computing its taxable income because the taxable income so distributed is no longer available to the REIT.[8] Thus, if a REIT distributes 100% of its taxable income, it will not pay corporate income tax.

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[5] I.R.C. § 857(a)(1).
[6] *Id.*
[7] References to "section" in this letter are to sections of the Code. References to "Proposed Section" are to the Code as it would be amended by the TRA 2014.
[8] I.R.C. § 857(b)(2)(B).

A limited exception from the 90% Distribution Requirement is available for certain types of "phantom" or "noncash" income recognized by a REIT.[9] A REIT is not required to distribute "excess noncash income," which is certain noncash income in excess of 5% of the REIT's taxable income (excluding net capital gains).[10] However, a REIT *is* required to distribute noncash income that does not exceed 5% of the REIT's taxable income (the 5% Basket). The potential sources of "excess noncash income" under section 857(e) include, *inter alia*, original issue discount (OID) and cancellation of indebtedness (COD) income.[11] A REIT is required to pay corporate income tax on any "excess noncash income" that it does not distribute to its shareholders.

When a REIT has phantom income that must be distributed to its shareholders, either because the phantom income is included in the 5% Basket or is phantom income that is not subject to the excess noncash income rules, the REIT may incur debt or sell assets it otherwise would hold long-term in order to satisfy the 90% Distribution Requirement. Similarly, a REIT with a corporate tax liability on excess noncash income may also have to incur debt or sell assets to pay the corporate income tax on the phantom income. Neither incurring debt nor selling assets that would otherwise be held long term is typically in the best economic interests of the REIT's shareholders. Incurring debt to satisfy the 90% Distribution Requirement or pay tax on excess noncash income would necessarily increase the REIT's leverage beyond what it otherwise would have been, and that increased leverage may make it more difficult for the REIT to survive an economic downturn.[12]

2. <u>TBA Market</u>

Approximately 90% of residential mortgage loans are currently guaranteed by the Agencies.[13] Agencies guarantee mortgage loans by guaranteeing the payment of principal and interest on,

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[9] I.R.C. § 857(a)(1)(B).
[10] I.R.C. § 857(e)(1).
[11] I.R.C. § 857(e)(2). Excess noncash income also includes: 1) "excess inclusion income," a type of phantom income recognized by a holder of a residual interest in a real estate mortgage investment conduit (REMIC) or a taxable mortgage pool; 2) gain from certain failed section 1031 "like-kind" exchanges; and, 3) rental income accelerated under section 467 (requiring accrual of rental income on level basis on certain leases with back loaded rent). I.R.C. § 857(e)(2)(A), (B), and (C). In the case of OID, excess inclusion income, and section 467 income, the "excess noncash income" is the amount in excess of the cash actually received on the related investment.
[12] Unlike other real estate owners that use high levels of debt, average debt levels for public equity REITs are around 40%, leading to less volatility in the real estate market and fewer bankruptcies and workouts. Additionally, academics have noted the positive impact REITs have due to the transparency of information about commercial real estate that becomes available to investors, financial institutions, regulators, and private real estate investors. *See, e.g.*, Frank Packer, Timothy Riddiough, and Jimmy Shek, *Securitization and the Supply Cycle: Evidence from the REIT Market*, 39 J. PORTFOLIO MANAGEMENT 134, 135 (2013).
[13] Written Statement of Thomas Hamilton, Managing Director, Barclays Capital, on behalf of The Securities Industry and Financial Markets Association, Hearing before the U.S. Senate Committee on Banking, Housing and Urban Affairs, Subcommittee on Securities, Insurance and Investment, at 2 (Aug. 3, 2011) [hereinafter *SIFMA Testimony*].

which are referred to as Agency MBS, in return for a guarantee fee paid by the borrower. A vital risk management component of the market for Agency MBS, and thus the market for residential mortgage loans, is the TBA market.

Today, most "conforming" mortgage loans are securitized through Agency MBS. A loan originator originates a pool of mortgage loans and then sells the mortgages to the Agencies in return for "pass-through" MBS,[14] which are collateralized by the transferred mortgage loans and carry an Agency guarantee. The loan originator then typically sells the Agency MBS through a forward commitment to market makers and uses the proceeds from the sale of the Agency MBS to originate new mortgage loans. The forward commitment guarantees the price at which the market maker will purchase the MBS, thereby allowing the loan originator to "lock in" mortgage rates for a fixed period of time for homebuyers.

Market makers often dispose of the Agency MBS acquired from loan originators through the TBA market. Under a TBA contract, one party agrees to purchase, and one party agrees to sell, a certain dollar amount of Agency "pass-through" MBS at a fixed price on a fixed settlement date in the future. When the TBA contract is entered into, the specific Agency MBS to be delivered at settlement is not stipulated. Instead, only six parameters are agreed to: issuer, coupon, maturity, price, par amount and settlement date.[15] Only Agency-guaranteed, residential, single-class MBS are eligible to be traded in the TBA market. Settlement dates for TBA transactions are standardized and occur on four specified days each month, with different dates set for different types of MBS.[16] Most TBA trades are executed for settlement within one to three months. However, some trades may extend further forward from time to time. The unique structure of TBAs has created a standardized and liquid market for the forward trading of Agency MBS and the timely and efficient financing of homeownership.

Investors, such as mortgage REITs, may enter into TBAs to lock in prices of Agency MBS. However, rather than taking physical delivery at settlement, an investor may elect to "dollar roll" a TBA. A dollar roll is the combination of one TBA trade with a simultaneous offsetting TBA trade settling on a different (future) date. The ability to dollar roll TBAs allows investors and market makers flexibility in adjusting their positions for economic or operational reasons. For example, an investor who purchased a TBA but faces operational concerns with taking physical delivery on the scheduled settlement date could sell an offsetting TBA on that date and simultaneously buy another TBA due one month later, effectively avoiding the operational issue but retaining much of the economic exposure.[17]

The TBA market is what connects the residential mortgage borrower to the ultimate funders of

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[14] In a "pass-through" structure, the underlying mortgage principal and interest payments are forwarded to security-holders on a pro rata basis, with no "tranching" or structuring of cash flows.
[15] Federal Reserve Bank of New York, Staff Report No. 468, *TBA Trading and Liquidity in the Agency MBS Market*, at 7 (2010) [hereinafter *Federal Reserve Report*].
[16] *SIFMA Testimony* at 12.
[17] *Federal Reserve Report* at 13.

residential mortgages, the secondary mortgage market. As investors enter into TBA purchase contracts to acquire Agency MBS in the future, loan originators enter into TBA sale contracts to sell loans (through the market makers) to investors. This enables a residential mortgage borrower to "lock in" a mortgage interest rate up to 30, 60 or 90 days in advance. By entering into a TBA sale contract, a loan originator can hedge the risk of its loan origination pipeline and "lock in" a price for the mortgage loans they are currently originating, which, in turn, allows borrowers the ability "lock in" interest rates on their mortgage loans up to 90 days in advance of closing on their home purchase. Although there are other means available, TBAs are a simple and low-cost way for originators to hedge loan production. Indeed, as a recent report from the Federal Reserve Bank of New York concluded, "[w]ithout TBAs, originators would have to engage in sophisticated trading strategies using a variety of derivatives to replicate the effect of a TBA."[18] The report further noted that, without TBAs, it would be more difficult for smaller loan originators to securitize loans through the Agencies.

The TBA market is the mechanism through which the vast majority of Agency MBS trading occurs,[19] and only the market for trading in Treasury securities is larger than the Agency MBS market.[20] According to the Securities Industry and Financial Markets Association, the TBA market is the most liquid and most important secondary market for mortgage loans.[21] Moreover, TBAs are the means through which many newly issued Agency MBS are distributed to investors.

The liquidity of the TBA market reduces risk management costs, thereby raising MBS prices and improving market functioning, which ultimately lowers the interest rates paid by borrowers for residential mortgage loans and enhances the availability and reliability of mortgage credit.[22] This liquidity helps mortgage originators manage risk, as it allows them to "lock in" mortgage rates in the TBA market before originating a mortgage loan.[23] This ability to sell mortgages forward through the TBA market allows loan originators the ability to offer borrowers fixed-rate loan terms well in advance of an actual mortgage closing, and is an important feature of labor market mobility in the United States. This, in turn, greatly facilitates the final negotiations of home purchases and the overall viability of the fixed-rate, 30-year residential mortgage loan.

B. <u>Proposed Sections 485 & 486: Marking-to-Market Derivatives</u>

NAREIT believes that certain provisions of Proposed Sections 485 and 486 would subject common commercial transactions to mark-to-market accounting, which would have significant unintended consequences on the markets for real estate and MBS. In addition, we anticipate that

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[18] *Id.* at 14.
[19] *Federal Reserve Report* at 2.
[20] *SIFMA Testimony* at 14.
[21] *Id.* at *13*.
[22] *Federal Reserve Report* at 1; *SIFMA Testimony* at 2.
[23] *Federal Reserve Report* at 1; Securities Industry and Financial Markets Association, *TBA Market Fact Sheet* at 1 (2011).

Proposed Sections 485 and 486 could impair the ability of some REITs to satisfy the 90% Distribution Requirement and could create liquidity problems for REITs.

Proposed Section 485 would require taxpayers to mark to market for federal income tax purposes any "derivative" held at the close of a taxable year.[24] All items of income, loss, and deduction from any "derivative" would be treated as ordinary income.[25]

The 2014 TRA, unlike the Initial Discussion Draft, would treat mark-to-market income recognized under Proposed Section 485 as a potential source of excess noncash income.[26] Although treating mark-to-market income as "excess noncash income" is a significant improvement over the Initial Discussion Draft, there may be situations in which a REIT would have to recognize income under Proposed Section 485 and would not have cash from the transaction to satisfy the 90% Distribution Requirement. As noted above, a REIT is excused from distributing only the noncash income that exceeds the 5% Basket. A REIT may have difficulty distributing the mark-to-market income included in the 5% Basket. In addition, a REIT would have to pay corporate income tax on any excess noncash income that it did not distribute, and the 90% Distribution Requirement may leave a REIT with insufficient cash to pay the corporate tax on the mark-to-market income that is treated as excess noncash income. Because of the liquidity issues that Proposed Sections 485 and 486 would create for REITs and the other reasons noted below, NAREIT recommends the following improvements to Proposed Section 485 and 486.

1. <u>The Real Property Exception to the Definition of "Derivative" Should Be Clarified</u>

NAREIT believes that the current exemption in the 2014 TRA from the definition of "derivative" for real property merits clarification. The 2014 TRA did not substantively change the real property exception included in the Initial Discussion Draft. NAREIT believes that common commercial transactions entered into by investors in real estate could be subject to mark-to-market accounting, which could cause some REITs to have difficulty satisfying the 90% Distribution Requirement with respect to noncash income in the 5% Basket and would require REITs to be subject to corporate tax on any undistributed phantom income treated as excess noncash income.

The current exception for real property in Proposed Section 486(b) applies only to: 1) a "tract of real property" as defined in section 1237(c); or, 2) real property that would be property described in section 1221(a)(1) (*i.e.*, property held by a "dealer") if held directly by the taxpayer.[27] The exception for "dealer" property will not apply to REITs and other long-term investors in real

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[24] Proposed Section 485(a)(1).
[25] Proposed Section 485(b)(1).
[26] TRA 2014, § 3401(f)(3).
[27] Proposed Section 486(b)(1)(A). Proposed Section 486(b)(1)(B) grants the Secretary the authority to prescribe regulations or other guidance to treat multiple tracts of real property as a single tract.

estate. Indeed, REITs are subject to a 100% prohibited transaction tax on the gain from the sale of "dealer" property. Moreover, the meaning of "tract of real property" as used in Proposed Section 486(b)(1)(A)(i) is not entirely clear. The phrase "tract of real property" is borrowed from section 1237, which generally provides that a taxpayer other than a C corporation will not be treated as a dealer with respect to a "tract of real property" solely because the taxpayer subdivided the tract.[28] One of the requirements of section 1237 is that no improvement that substantially enhances the value of the tract is made by the taxpayer on the tract while held by the taxpayer or is made pursuant to a contract of sale entered into between the taxpayer and the buyer.[29] NAREIT has found no authorities that address solely the definition of "tract of real property" in section 1237(c), and the limited authorities under section 1237 generally address undeveloped land.[30]

Proposed Section 486(b)(1)(A)(i) specifically references only section 1237(c) (which itself does not limit the definition of a "tract of real property" to undeveloped land). Accordingly, NAREIT assumes that the definition of "real property" for purposes of Proposed Section 486(b)(1)(A)(i) and the dealer exception in Proposed Section 486(b)(1)(A)(ii) are the same (*e.g.*, Proposed Section 486(b)(1)(A)(i) is not limited to undeveloped land and would apply to single tracts of land with improvements on them). However, given the importance of this exception, this should be further clarified.

2. The Hedging Exception to the Definition of "Derivative" Should Be Expanded to Cover Common Interest Rate Financial Hedges

NAREIT believes that the exception from mark-to-market accounting in the 2014 TRA for derivatives that are used in hedging transactions is too narrow to cover certain common commercial transactions that mitigate the risk of interest rate fluctuations. Specifically, Proposed Section 485(b) requires ordinary treatment on all items of income or loss with respect to a "derivative." Proposed Section 486(b)(2) excludes from mark-to-market accounting under Proposed Section 485 any "hedging transaction," as defined in Proposed Section 1221(b).[31] The definition of "hedging transaction" under Proposed Section 1221(b) is generally consistent with the current definition of "hedging transaction" in section 1221(b)(2), except Proposed Section

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[28] I.R.C. § 1237(a).
[29] I.R.C. § 1237(a)(2).
[30] There are some rulings addressing the sale of fee interests in lots in which development occurred on the lots via lease development agreements, pursuant to which a developer leases a tract under long-term leases, develops homes on the tract, and assigns leases to the ultimate tenants of the developed property. *E.g.*, Rev. Rul. 77-338, 1977-2 C.B. 312 (involving sales of fee interest in land to ultimate tenants of houses constructed under lease development agreements; leases allowed the tenants the option of removing the constructed homes at the end of the lease term); P.L.R. 8630712 (June 2, 1986) (same); P.L.R. 8038196 (June 30, 1980) (prior ruling related to P.L.R. 8630712).
[31] The TRA 14 also would repeal several current law Code sections that are applied to determine the character of income and losses from derivatives, on the grounds that these sections would be obsolete for derivatives that are marked to market when the gains and losses are treated as ordinary income and losses. For hedging transactions that are excluded from mark-to-market treatment, these sections remain relevant in determining the character of income and losses from these derivatives, and the Committee should consider retaining these sections for this purpose.

1221(b) includes some helpful changes to the hedge identification requirement and is expanded to include hedges of debt assets held by insurance companies. Under Proposed Section 1221(b)(2) (and section 1221(b)(2)), a hedging transaction includes only transactions entered into in the ordinary course of the taxpayer's trade or business primarily to manage: 1) risk of price changes or currency fluctuations with respect to *ordinary* property which is held or to be held by the taxpayer; or, 2) risk of interest rate or price changes or currency fluctuations with respect to borrowings made or to be made, or ordinary obligations incurred or to be incurred by the taxpayer. A transaction that hedges a capital asset of a taxpayer could not be a "hedging transaction" under Proposed Section 1221(b)(2) (and section 1221(b)(2)), with the exception of debt assets held by insurance companies (under Proposed Section 1221(b)(2)). Accordingly, a hedge of a capital asset generally would be subject to mark-to-market accounting under Proposed Sections 485 and 486.

For hedges that are not treated as "hedging transactions" under Proposed Section 1221(b)(2), the 2014 TRA would require both the hedge (if it is a derivative) and the hedged asset (or other item) to be marked to market, with any built-in gain (but not loss) on the hedged asset being recognized at the time the hedge is acquired.

a. TBA Market and Interest Rate Locks

NAREIT believes that the effect of Proposed Sections 485 and 486 on the TBA market is unwarranted. The definition of "derivatives" would include TBAs, as that phrase includes a "forward contract."[32] As discussed above, the TBA market is vital to the efficiency of the residential mortgage market. Because of the TBA market, loan originators can allow borrowers to lock-in interest rates on a cost-effective basis. The TBA market also provides a means for loan originators to sell new Agency MBS to market makers and for market makers, in turn, to distribute those Agency MBS to investors.

NAREIT believes that requiring mark-to-market accounting of TBAs could disrupt the TBA market. Investors in new Agency MBS may avoid acquiring TBAs near the end of their taxable year so they do not have to recognize ordinary mark-to-market income. Any disruption to the TBA market would ripple through the markets for Agency MBS and residential mortgage loans, likely increasing the interest rate paid by borrowers under standard fixed-rate, 30-year residential mortgage loans. Not only would the avoidance of TBAs have the effect of reducing the availability of mortgage credit over year-end, but it may also force market participants to reduce their prudent interest rate risk management by reducing their TBA hedging activity.

Marking to market TBAs may make it difficult for some mortgage REITs to satisfy the 90% Distribution Requirement. Under current law, a REIT seeking to acquire a new Agency MBS through a TBA would not have an income event as a result of entering into a TBA and taking delivery of the TBA. Under the 2014 TRA, the same REIT would have ordinary income if the

[32] Proposed Section 486(a).

TBA was "in the money" at the end of its taxable year. Although the REIT would have no income from the TBA (indeed, the REIT would have to pay for the Agency MBS subject to the TBA), the REIT would have an increased distribution requirement as a result of having to distribute any mark-to-market income that is included in the 5% Basket. In addition, the REIT could have a significant corporate tax liability on any mark-to-market income treated as excess noncash income. REITs would either have to reduce their participation in the TBA market, which could contribute to difficulties in arranging for home financings, or potentially face difficult issues satisfying the 90% Distribution Requirement and paying the corporate income tax on any excess noncash income.

Finally, NAREIT believes there is a risk that borrowers who have "locked in" a mortgage interest rate prior to closing could be treated as having an "option" to acquire a mortgage loan at a specified interest rate. If interest rates increase after the borrower "locks in" the interest rate and the lock extends over the end of the borrower's taxable year, the borrower would have phantom ordinary income. Clearly, a rate lock is not a speculation on the part of the borrower since an unrealized gain in the value of the rate lock could not be realized by selling or trading it. Nevertheless, borrowers could avoid "locking in" interest rates on residential mortgage loans if they knew they could potentially pay a derivatives tax as the 2014 TRA contemplates in its current form.

NAREIT believes the 2014 TRA should include an expanded exception for hedging transactions that would address the issues discussed above with TBAs and interest rate locks, which are standard commercial real estate transactions and not speculative in nature. Specifically, to ensure that TBAs are not subject to mark-to-market accounting, NAREIT suggests treating Government securities as ordinary property solely for the purpose of determining whether the exception for hedging transactions applies to a derivative that hedges these securities.[33] By treating Government securities as ordinary property, TBAs would satisfy the definition of a "hedging transaction" under Proposed Section 1221(b) for this purpose, and they would not be subject to mark-to-market accounting. A "Government security" would be defined as "any security issued or guaranteed as to principal or interest by the United States, or by a person controlled or supervised by and acting as an instrumentality of the Government of the United States pursuant to any authority granted by the Congress of the United States, or any certificate of deposit for any of the foregoing." This is the same definition of "Government securities" that is used for purposes of the Investment Company Act of 1940, [34] and that is incorporated into the rules for REITs and regulated investment companies.[35] NAREIT believes

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[33] Alternatively, the Committee should consider addressing this specific issue through a broader reform to the current law section 1221(b)(2) definition of a hedging transaction that generally would permit hedges of capital assets to be treated as hedging transactions for tax purposes. Gains and losses from hedges of capital assets already typically result in capital gains and losses, and concerns regarding the "harvesting" of tax losses presumably would be addressed by the application of regulation section 1.446-4.

[34] Investment Company Act of 1940, 15 U.S.C. § 80a-2(a)(16) (2012).

[35] I.R.C. §§ 851(c)(6) (using the definitions of terms in the Investment Company Act of 1940 for purposes of the rules for regulated investment companies), 856(c)(5)(F) (using the definitions of terms in the Investment Company Act of 1940 for purposes of the REIT rules); G.C.M. 39700 (Mar. 7, 1988) (applying the definition of "Government

treating Government securities as ordinary property for this purpose would ensure that the TBA market is not disrupted by strategies to avoid mark-to-market accounting. In addition, mortgage REITs would be able to use derivatives on Government securities as asset hedging transactions without i) endangering their ability to satisfy the 90% Distribution Requirement (as a result of having to distribute any mark-to-market income that is included in the 5% Basket), and, ii) causing liquidity issues as a result of having a significant corporate tax liability on any mark-to-market income treated as excess noncash income.

With regard to interest rate locks, these transactions already satisfy the "hedging transaction" definition and, therefore, are eligible for the exception for hedging transactions in the 2014 TRA. However, individual borrowers are likely unaware of the identification requirement for securing hedging transaction treatment of their residential mortgage loan interest rate locks. The consequences under current law of failing to satisfy the identification requirement are unlikely to be significant for these borrowers, but could be significant if their interest rate locks were marked to market under the 2014 TRA. Therefore, NAREIT recommends that the identification requirement not apply solely for the purpose of determining whether an interest rate lock on a residential mortgage loan satisfies the definition of a "hedging transaction" under Proposed Section 1221(b) and, in turn, the exception from mark-to-market accounting for hedging transactions.

b. Hedges of Outstanding MBS and Mortgage Loans

NAREIT notes that the 2014 TRA may harm mortgage REITs that use "derivatives" with respect to Government securities to hedge fluctuations in the value of their MBS and mortgage loans caused by interest rate changes. In particular, under the 2014 TRA, both the derivative and the hedged MBS or mortgage loan would be marked to market, and any built-in gain (but not loss) on the hedged MBS or mortgage loan would be recognized upon acquisition of the derivative because the MBS or mortgage loan in the hands of the mortgage REIT is a capital asset and, therefore, does not satisfy the definition of a "hedging transaction" under Proposed Section 1221(b).

In general, mortgage REITs invest primarily in MBS and mortgage loans. In accordance with the requirements for REIT qualification, mortgage REITs typically hold those assets as investors, and their assets, accordingly, are treated as capital assets. The value of MBS and mortgage loans is sensitive to changes in interest rates. In an environment of rising interest rates or widening of the "spread" between interest rates on Treasury debt and other debt instruments, certain MBS and mortgage loans may decrease in value.

Mortgage REITs may enter into hedging transactions using Treasury bonds, Treasury bond futures or TBAs to reduce exposure to the effect of rising interest rates on their investment portfolio. Such transactions may also be used to hedge the interest rate risk on the mortgage

securities" from the Investment Company Act of 1940 for purposes of the rules for regulated investment companies).

REIT's short-term, floating rate borrowing. If the mortgage REIT designates those transactions as "hedging transactions" with respect to its short-term, floating rate borrowing, they are treated as qualified liability hedges, and the income from those transactions is ignored for purposes of the REIT gross income tests.[36]

Some mortgage REITs, however, do not designate all of those types of transactions as "hedging transactions" or may not have sufficient borrowings to be able to designate all of those transactions as "hedging transactions" under the definition of section 1221(b)(2). In those cases, the transactions economically hedge fluctuations in the value of the REIT's assets. We will refer to transactions that hedge asset values as "asset hedging transactions." An asset hedging transaction would not be treated as a "qualified liability hedge," the income from which is ignored for purposes of the REIT gross income tests.[37] However, asset hedging transactions may produce qualifying income for the 95% gross income test applicable to REITs when they give rise to gain from the sale of "securities."[38]

Under current law, the failure of an asset hedging transaction to be treated as a "hedging transaction" under section 1221(b)(2) does not generally affect the ability of a mortgage REIT to satisfy the 90% Distribution Requirement or cause the REIT to incur corporate income taxes. The gain or loss on an asset hedging transaction is capital, as is the gain or loss on the hedged MBS and mortgage loans. Thus, the gains and losses from the asset hedging transaction and the hedged items can offset each other, subject to the limitations on offsetting short-term and long-term gains and losses.

Under Proposed Section 485, however, both the asset hedging transaction and the hedged MBS or mortgage loan would be marked to market (with gains and losses be treated as ordinary), and any built-in gain on the MBS or mortgage loan would be recognized upon acquisition of the asset hedging transaction. While the gains and losses on the asset hedging transaction and the hedged MBS or mortgage loan would be expected to largely offset each other, they will not entirely offset each other in all cases. Any residual gains, as well as the recognition of any built-in gains on the hedged MBS or mortgage loan, may increase a mortgage REIT's distribution requirement, impair its ability to satisfy the 90% Distribution Requirement, and require the REIT to pay the corporate income tax liability on excess noncash income.

NAREIT believes the 2014 TRA should include an additional expansion to the exception for hedging transactions that would address the issues discussed above with hedges of outstanding MBS and mortgage loans which—like TBAs and interest rate locks—are standard commercial real estate transactions and not speculative in nature. Specifically, to ensure that these asset hedging transactions s are not subject to mark-to-market accounting, NAREIT suggests treating MBS and mortgage loans as ordinary property solely for the purpose of determining

[36] I.R.C. § 856(c)(5)(G).
[37] I.R.C. § 856(c)(5)(G).
[38] I.R.C. § 856(c)(2)(D) (treating gain from the sale of "securities" as qualifying income for the 95% gross income test applicable to REITs).

whether the exception for hedging transactions applies to a derivative that hedges these assets.[39] By treating MBS and mortgage loans as ordinary property, the asset hedging transactions would satisfy the definition of a "hedging transaction" under Proposed Section 1221(b) for this purpose, and they would not be subject to mark-to-market accounting.

C. Proposed Section 1278: Current Inclusion of Deemed Interest Component of Market Discount – NAREIT Recommends That Flexibility under Current Law Regarding Recognition of Market Discount Be Retained for REITs

Although it supports generally the Committee's effort to reform the market discount rules, NAREIT notes that the requirement to include market discount in income currently could make it difficult for some REITs to satisfy the 90% Distribution Requirement (as a result of having to distribute any market discount income that is included in the 5% Basket) and could cause some REITs to have liquidity issues as a result of the corporate tax liability on any market discount treated as excess noncash income.

Under the 2014 TRA, REITs would be required to include a portion of the accrued market discount in income even if no cash payment was received in respect of the debt instrument.[40] The 2014 TRA, unlike the Initial Discussion Draft, would treat market discount income as a potential source excess noncash income.[41] Although treating market discount income as excess noncash income is a significant improvement over the Initial Discussion Draft, there may be situations in which a REIT would have to recognize significant market discount income and would not have cash from the transaction to satisfy the 90% Distribution Requirement. As noted above, a REIT is excused from distributing noncash income only to the extent it exceeds the 5% Basket. A REIT may have difficulty distributing the market discount income included in that 5% Basket. Moreover, a REIT may not have sufficient liquidity to pay the corporate income tax on any market discount income treated as excess noncash income.

The proposed treatment of market discount could present problems for mortgage REITs that invest in loans that do not require the borrower to make significant principal payments prior to maturity. For example, commercial mortgage loans typically require a single "bullet" principal payment at maturity. REITs that invest in commercial mortgage loans would be required by the 2014 TRA to include in income market discount, even though they would not receive any cash that could be used to i) satisfy the distribution requirement with respect to the market discount income included in the 5% Basket, or, ii) pay corporate tax on the noncash income that exceeds the 5% Basket.

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[39] As noted above with regard to TBAs and interest rate locks, the Committee alternatively should consider addressing this specific issue through a broader reform to the current law section 1221(b)(2) definition of a hedging transaction that generally would permit hedges of capital assets to be treated as hedging transactions for tax purposes. Gains and losses from hedges of capital assets already typically result in capital gains and losses, and concerns regarding the "harvesting" of tax losses presumably would be addressed by the application of regulation section 1.446-4.

[40] Proposed Section 1278(a).

[41] 2014 Discussion Draft, § 3401(f)(3).

NAREIT believes this issue could be solved by allowing REITs the ability to elect to: 1) include market discount in income under Proposed Section 1278; or, 2) be subject to the current rules for the recognition of market discount in section 1276. Under current law, unless a taxpayer elects under section 1278(b) to include market discount into income as it accrues, market discount is included in income under section 1276 only if the taxpayer has received a principal payment or disposes of the debt instrument. In those cases, the taxpayer generally has cash from the debt instrument in an amount equal to or in excess of the market discount included in income.[42] As a result, the recognition rules in section 1276 do not generally make it difficult for a REIT to comply with the 90% Distribution Requirement.

NAREIT believes that the flexibility under current law regarding recognition of market discount should be retained for REITs. Otherwise, REITs may be reluctant to acquire debt instruments with market discount, because acquiring those instruments may make it difficult for the REIT to satisfy the 90% Distribution Requirement and pay corporate tax on any market discount income treated as excess noncash income.[43]

If you would like to discuss these issues in greater detail, feel free to contact me at (202) 739-9408 or tedwards@nareit.com or Dara Bernstein, NAREIT's Senior Tax Counsel, at (202) 739-9446 or dbernstein@nareit.com.

Respectfully submitted,

Tony M. Edwards
Executive Vice President & General Counsel
Attachment

[42] I.R.C. § 1276(a).
[43] The government's response to the 2007-2009 credit crisis evidenced the policy goals of: 1) encouraging lenders to modify mortgage loans to avoid foreclosure; and, 2) injecting liquidity into the market for distressed debt, mortgage loans, and mortgage-backed securities. Failure to retain for the flexibility under current law regarding recognition of market discount for REITs would impede the ability of REITs to advance those goals in the event of a similar future crisis.

NATIONAL ASSOCIATION OF REAL ESTATE INVESTMENT TRUSTS®

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REITs: BUILDING DIVIDENDS AND DIVERSIFICATION®

March 23, 2016

The Honorable Jacob J. Lew
Secretary of the Treasury
U. S. Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

The Honorable John A. Koskinen
Commissioner
Internal Revenue Service
1111 Constitution Avenue N.W.
Washington, DC 20224

Re: Definition of "Congregate Care" for Purposes of Definition of "REIT Health Care Facility"/Notice 2016-26

Dear Secretary Lew and Commissioner Koskinen:

NAREIT appreciates the opportunity to submit these comments in connection with inclusion of a guidance item defining "congregate care facility" for purposes of the definition of a "health care facility" under sections 856(e)(6)(D)(ii) and (l)(4)(B) of the Internal Revenue Code of 1986, as amended (the Code)[1], on the Treasury Department and IRS' 2015-2016 Priority Guidance Plan, [2] as well as in response to Notice 2016-26's request for comments on recommendations for the 2016-17 Priority Guidance Plan.

NAREIT® is the worldwide representative voice for REITs and publicly traded real estate companies with an interest in U.S. real estate and capital markets. NAREIT's members are REITs and other businesses throughout the world that own, operate, and finance income-producing real estate, as well as those firms and individuals who advise, study, and service those businesses.

EXECUTIVE SUMMARY

NAREIT commends the IRS and the Treasury Department for its efforts and success in issuing private letter rulings (PLRs) over the past few years in the REIT area that effectuate Congressional intent and are consistent with current market practices in the health care industry. As a result, and, as further discussed below, we do not believe that additional guidance is needed or merits priority attention. Based on the ruling practices of the IRS in several private letter rulings dealing specifically with such facilities, health care REITs have developed a good working understanding that the IRS and the Treasury

[1] Unless otherwise provided, all "section" references herein shall be to a section of the Code.
[2] *See* 2015-16 Priority Guidance Plan, 2d Quarter Update (Feb. 5, 2016)

Department currently interpret the definition of a "congregate care facility" as an age-restricted community, where, in addition to providing communal dining and living quarters, services are provided to advance the health and physical well-being of its residents. These rulings have provided sufficient guidance for health care REITs and advisors to determine whether a facility meets the definition or which additional health and wellness-related services should be provided to bring a facility within the definition.

If the IRS and the Treasury Department issue guidance of general application under this project, NAREIT requests that: 1) the IRS and Treasury be mindful not to expand (or otherwise change) the definition of a "congregate care facility" in a manner that would up-end the market by inadvertently including age-restricted or non-age-restricted apartments, student housing, typical children's summer camps, or other properties generally not considered health care facilities in the definition, 2) the guidance continues to treat independent living facilities similar to those described in PLRs 201147015, 201429017, and 201509019 as "health care facilities," and, 3) the guidance have a prospective effective date so that the new rule would apply only to properties contracted to be acquired after the date the change is effective.

DISCUSSION

I. Background: Health Care REIT Industry

Health care REITs are REITs that own and manage a variety of health care-related properties and collect rent from tenants. Health care REITs' property types include senior living communities, hospitals, life science buildings, medical office buildings and skilled nursing facilities. As of December 31, 2015, there were 17 health care REITs in the FTSE NAREIT All REITs Index,[3] with a combined market capitalization of $90.7 billion.

These REITs owned over 7,000 properties with an estimated value of nearly $90 billion. The number of properties increased 11% over the past year, and has risen 108% and 212% over the past five and 10 years, respectively. Net property investment increased 19% over 2015, and has risen 167% and 565% over the past five and 10 years, respectively.

Total Funds From Operations (FFO) of health care REITs was $4.9 billion in 2015. Net Operating Income (NOI) was $8.5 billion, and total dividends paid were $5.3 billion.

[3] NAREIT® REITWatch® (January 2016) (available at: https://www.reit.com/sites/default/files/reitwatch/RW1601.pdf). For additional background regarding the history of legislation applicable to Health Care REITs, *see* "Toward a Workable Definition of a REIT Healthcare Facility," by Paul W. Decker, Ameek Ashok Ponda, and Jonathan Stein, *Tax Notes*, December 5, 2011, at p. 1231, available at: http://www.sandw.com/assets/htmldocuments/B1362833.PDF.

II. Definition of Congregate Care Facility for Health Care REITs

The term "health care facility" was added to the Code as part of the REIT Modernization Act of 1999 (RMA)[4] (effective 2001). As further described below, the term was applicable at the time in two specific contexts. First, it was relevant as an expansion of the "foreclosure property" rule to terminations of health care property leases absent a formal default or imminent default. In addition, the RMA referenced the definition of "health care facility" in the context of taxable REIT subsidiaries (TRSs), entities which Congress created to provide non-customary services to REIT tenants, and are able to lease lodging properties directly from an affiliated REIT in exchange for qualifying rental income, but are prohibited from operating health care properties. In 2008, Congress enacted the REIT Investment Diversification and Empowerment Act of 2007 (RIDEA),[5] extending the TRS rule regarding the leasing of lodging facilities to the leasing of health care properties by TRSs.

A. Health Care Facilities and Foreclosure Property Rule

By way of background, qualifying REIT income for purposes of sections 856(c)(2) and (3) is either passive income or specific real estate-related income, including "rents from real property." The term "rents from real property" is a defined term and generally does not include tenant-specific or "non-customary" services. While the above is the general rule, there are cases in which a REIT must foreclose on a lease or a loan, and, as a result, the REIT will come into possession of property that generates otherwise non-qualifying income. In such a case, the Code permits the REIT to operate the property and earn qualifying REIT income for a specified period of time. Such property is termed "foreclosure property."

Income and gain from "foreclosure property" as defined in section 856(e) which would otherwise be nonqualifying REIT income (under sections 856(c)(2) and (3)) is qualifying REIT income under those sections if the REIT makes a foreclosure property election under section 856(e)(5). Section 856(e)(1) generally defines "foreclosure property" as:

> any real property (including interests in real property), and any personal property incident to such real property, acquired by the real estate investment trust as the result of such trust having bid in such property at foreclosure, or having otherwise reduced such property to ownership or possession by agreement or process of law, after there was default (or default was imminent) on a lease of such property or on an indebtedness which such property secured.

While the general definition of foreclosure property requires a default or imminent default, the RMA added section 856(e)(6)(A) to expand the term 'foreclosure property' to include any qualified health care property acquired by a real estate investment trust as the result of the termination of a lease of such property (other than a termination by reason of a default, or the

[4] Sections 541-71 of Pub. L. No. 106-170, the Ticket to Work and Work Incentives Improvement Act of 1999.
[5] P.L. 110-289, §§3031-3071.

imminence of a default, on the lease).” Thus, for example, in the “health care facility” context, the RMA expanded the “foreclosure property” rules to cover normal lease expirations or other non-default situations.

Section 856(e)(6)(D)(i) defines “qualified health care property” as a “health care facility” or property necessary or incidental to the use of a “health care facility.” The term “health care facility” is defined in section 856(e)(6)(D)(ii) as:

> a hospital, nursing facility, assisted living facility, **congregate care facility**, qualified continuing care facility(as defined in section 7872(g)(4)), or other licensed facility which extends medical or nursing or ancillary services to patients, and which was operated by a provider of such services that is eligible for participation in the Medicare program under Title XVII of the Social Security Act [subchapter XVIII of chapter 7 of Title 42 (42 U.S.C.A. § 1395 et seq.)] with respect to the facility.(Emphasis added).

The RMA’s extension of the foreclosure property rules to non-defaulting terminations of health care facility leases was explained in the relevant Senate Finance Committee report:

> The Committee believes that allowing operation of health care facilities directly by a REIT for a limited period of time is appropriate to assure continuous provision of **health care services** where the facilities are acquired by the REIT upon termination of a lease (as upon foreclosure) where there may not be enough time to obtain a new independent provider of such health care services.(Emphasis added).[6]

Thus, in the case of non-health care properties, a REIT can make a foreclosure property election only with respect to property acquired on foreclosure or after imminent default. Congress recognized that requiring such dire circumstances for the tenant or borrower in the context of health care properties could hurt the residents of these facilities. As a result, Congress authorized

[6] S. Rep. No. 201, 106th Cong, 1st Sess. 58 (1999). Available at: https://www.congress.gov/106/crpt/srpt201/CRPT-106srpt201.pdf. A similar provision extending the foreclosure property rule to termination of leases of health care facilities originally was part of H.R. 1150, the Real Estate Investment Trust Simplification Act of 1997 (REITSA). Notably, however, the definition of “health care facility” in H.R. 1150 **did not include a congregate care facility**. Almost all of the REITSA provisions were included in the Taxpayer Relief Act of 1997, signed by then President Clinton on August 5, 1997. However, the extension of foreclosure property rules to lease terminations of health care properties was not included apparently for procedural reasons. In his introductory remarks concerning REITSA, Congressman E. Clay Shaw, Jr. noted the concern with the REIT’s “likely inability to simply close the facility due to **the nature of the facility's inhabitants**.” 143 Cong. Rec. E559, 561 (Daily Ed. March 21, 1997) (remarks of the Honorable E. Clay Shaw, Jr.). (Emphasis added). Thus, it appears that the original concern with respect to this provision in 1997 was a general concern for “the nature of the facility’s inhabitants,” while the concern expressed with respect to this provision in 1999 was to the more specific “to assure continuous provision of **health care services.**”

a REIT to acquire a health care property by terminating a lease with a troubled operator even if not terminating due to default or imminent default.[7]

B. "Congregate Care" Facilities and TRSs: General Background

As noted above, "rents from real properties" under section 856(d) is a defined term and generally does not include tenant-specific or "non-customary" services. In fact, more than a *de minimis* amount of tenant-specific or non-customary services at a particular REIT-owned property will disqualify all of the otherwise qualifying rental income from that property from constituting "rents from real property." Because of the significant amount of services generally provided at health care properties (and similarly, at lodging facilities), income attributable to a REIT's direct ownership and operation of these facilities cannot constitute "rents from a real property."[8] Furthermore, absent a special statutory rule otherwise, REIT could not net lease to a related tenant who operated the property because the term "rents from real property" generally excludes rents from a related party.[9]

While a REIT historically could own and net lease (to an operator or a third party tenant that hired an operator) a lodging or health care facility, this arrangement creates complexity, inefficiencies and potential conflicts of interest. As a result, in 1999 Congress enacted the RMA, which, in addition to the modification of the foreclosure property rules described above, authorized lodging REITs to own and earn qualifying rental income from leases of lodging facilities to TRSs.

Specifically, the RMA exempts from the related party rent exclusion under section 856(d)(2)(B) rents from a TRS for the lease of a lodging facility so long as, among other things, the lodging facility is operated by an independent contractor that actively operates such facilities for unrelated third parties. Further, the RMA specifically excluded from the definition of TRS an entity that operates or manages a health care facility.[10]

The RMA's related party rent exemption that allowed hotel REITs to lease properties to their TRSs was not extended to health care REITs at the time of RMA enactment. However, over time, heath care REITs became more interested in the RMA's TRS structure because, as was the case in the lodging industry, health care property operators preferred not to bear the risks of a lease, and instead preferred to operate properties. In 2008, Congress enacted RIDEA, which, among other things, exempted from the related party tenant rules rent earned for the lease of

[7] For additional background, *see* "Toward a Workable Definition of a REIT Healthcare Facility," *supra* note 3 at 1231, available at: http://www.sandw.com/assets/htmldocuments/B1362833.PDF.
[8] *See* Section 856(d)(7); Rev. Rul. 98-60, 1998-2 C.B. 751.
[9] A related party tenant is a corporation in which the REIT owns shares comprising 10% or more of the total voting power or value of such corporation or an entity other than a corporation in which a REIT owns 10% of the interests or net profits. Section 856(d)(2)(B).
[10] Section 856(l)(3)(A).

"qualified health care property (as defined in section 856](e)(6)(D)(i))," provided that the property is operated by an eligible independent contractor.[11]

Since the time of RMA's enactment and as cross-referenced in RIDEA, section 856(e)(6)(D)(i) has defined qualified health care property to include any real property which is a health care facility. Furthermore, as noted above, one type of a facility specifically included in the "health care facility" as defined in section 856(e)(6)(D)(ii) is a congregate care facility.

C. "Congregate Care Facility" in Section 856(e)(D)(ii) Should Be Read in Context along with the Surrounding Words

"Congregate care facility" as used in the definition of "health care facility" in section 856(e)(6)(D)(ii) is not defined in the Code or the Treasury regulations promulgated thereunder or in the Investment Company Act of 1940, nor does any court decision or revenue ruling provide such a definition. However, as further described below, reading it as part of section 856(e)(6)(D)(ii) in its general historical context, in the context of the IRS ruling parameters, and interpreting the term under general rules of statutory construction, has yielded a manageable definition for the health care REIT industry.

1. Historical Context

At the time of the enactment of section 856(e)(6)(D)(ii) in 1999, the senior housing industry generally defined a congregate care facility as an age-restricted housing facility that provides residents with separate living quarters, but provides central dining facilities (congregate meals), housekeeping, transportation, and social and recreational activities. Subsequently, in 2004 the senior housing industry changed the name of congregate care facilities to independent living facilities.[12] The industry differentiated congregate care facilities from "senior apartments" in defining the latter as age-restricted multifamily residential rental properties that do not have central kitchen facilities and generally do not provide meals to residents, but may offer

[11] Section 856(d)(8)(B). RIDEA was intended to allow REITs to continue to participate in the ownership of congregate care facilities in a changing business environment. "Operators that now lease such facilities would rather have a REIT (through its TRS) assume any leasing risk and instead be hired purely to operate the facilities. Accordingly, this provision would extend the exception made in 1999 for lodging facilities to health care facilities. This change should make it easier for health care facilities to be provided to senior citizens and others in need of such services." 153 *Cong. Rec.* S10931 (introductory remarks by Senator Orrin G. Hatch). For additional background regarding RIDEA, *see* "REITs Empowered," by Tony M. Edwards and Dara F. Bernstein, *Tax Management Real Estate Journal*, at 1, Vol. 24, No. 11, 11/05/2008, available at: https://www.reit.com/sites/default/files/media/Portals/0/PDF/REITSEMPOWERED.pdf.

[12] In 2004, the senior housing industry, in a push for standardized data reporting and improved marketability of the congregate care industry segment, standardized the names and definitions of different senior housing facility types, and "[a]mong the most significant changes in specialized terms [was] the renaming of the property type "congregate care" to "independent living". "NIC and ASHA Announce Standardized Classifications For Seniors Housing Property Types," National Investment Center for the Seniors Housing and Care Industry (Press Release, April 2004).

community rooms, social activities, and other amenities.[13] Many facilities marketed as "independent living facilities" now provide some level of health care-related and wellness services as the health care/senior living industry has evolved. Also, it should be noted that the leading senior housing trade associations work with the health care industry not only in providing services and assistance in marketing independent living facilities, but also assisted living facilities. Indeed, a significant number of REITs' senior housing facilities are combined independent living/assisted living facilities.

The industry and tax practitioners believe that the existing ruling practice has created clarity that is working reasonably well and has addressed a significant number of fact patterns distinguishing between what is and is not a congregate care facility. While the ruling practice does not establish a fixed rule applicable to all fact patterns in a changing and constantly evolving industry, it has allowed the industry and its advisors to structure investments with considerable confidence. Any effort to provide more formal guidance, such as a list of required wellness programs or health care-related services, may create more uncertainty and may result in the need for more PLR requests to clarify different factual situations depending upon the nature of the guidance due to the nature of this evolving sector.

The health care business also is a highly regulated one, and rearranging existing leases, ownership, "business configurations" and contracts as a result of any new guidance may be not only expensive, but extremely disruptive and difficult to do, particularly with complex and various multiple state regulatory agency oversight, in the wake that any new Service guidance may require. Any new guidance therefore should include liberal transition rules due to the numerous potential unintended consequences that might ensue.

2. IRS Ruling Practice

a. *Pre-RIDEA*

Prior to RIDEA's enactment, the IRS ruled in PLR 200813005 that age-restricted residential "independent living facilities" with congregate dining and possible other services such as "exercise and wellness programs, medical alert systems, security services, and daily status checks," but at which the taxpayer expressly represented that there would be "no medical or nursing services, or skilled nursing licensed beds," was *not* a "qualified health care facility" within the meaning of section 856(e)(6)(D)(ii).

b. *"Mixed-Use Facilities"*

More recently, the IRS has issued a series of private letter rulings (PLRs 201104033, 201104023, 201125013 and 201250019) dealing with "mixed use" properties

[13] In the last few years, the REIT industry and its professionals have accepted and embraced the industry definition of congregate care facilities, now known as" independent living" facilities.

that included both "independent living" facilities, as well as "assisted living facilities." In all those cases, the IRS appropriately ruled that the facilities were "health care facilities."

In short, the IRS private letter rulings have, without exception, concluded that a mixed use facility (*i.e.*, one that combines independent living with assisted living) is a health care facility.

c. *Age-Restricted Residential Communities*

Furthermore, there have been several private letter rulings in the last four years that have provided that age-restricted independent living facilities are health care facilities. Specifically, in PLRs 201147015, 201429017, and 201509019, the IRS concluded that age-restricted, unlicensed facilities that provided "congregate care services," wellness-related services, and, in some cases, health care-related services, not commonly offered by a typical multi-family rental property, but limited true medical care *per se*, were "health care facilities."

The facts in those rulings encompassed age-restricted facilities with a) congregate dining facilities; b) "wellness" or similar preventive health care programs; and, c) health care-related services, such as the provision of emergency call assistance and advice and referral services regarding medical care of the residents. Although such "independent living" facilities vary somewhat in the degree to which such services and amenities are provided and by whom provided, the congregate services and amenities provided to tenants are invariably well beyond those provided to tenants in general multi-family housing. The extent to which significant congregate services and amenities are provided to tenants demonstrates that the provision of services to promote the **health and well-being** of the residents of such **age-restricted** facilities clearly distinguishes these facilities from the typical multi-family rental property.

3. **Statutory Construction: "Congregate Care" Should Be Interpreted Consistently with Surrounding Words**

The IRS also ruled in both PLRs 201317001 and 201320007 that correctional and detention facilities are not congregate care facilities because those facilities are not related to a health care facility and the medical care provided by such facilities is not part of the "primary function" of the facilities. In these rulings, the IRS noted that the term "congregate care facility" is not defined in the Code or regulations and that commonly used definitions of congregate care include "the sharing of living space, dining space, transportation, and group activities." However, the IRS stated that the meaning "congregate care facility" must be interpreted in the context of the definition of "health care facility," which describes various facilities that provide health care, not as an auxiliary function, but as part of the primary function (such as a hospital) or in connection with a facility that has the primary function of providing health care (such as assisted living facilities). The "primary focus" requirement is important. Without it, one could, patently contrary to legislative intent, argue that a correctional or detention facility is a "qualified health care facility," a fact that the IRS has rightly recognized in both PLRs 201320007 and 201317001.

The analysis in PLRs 201317001 and 201320007 follows a well-established maxim of statutory interpretation, *noscitur a sociis*, which provides that a word is known by the company it keeps.[14] NAREIT recognizes that the term "congregate care" has been used in non-REIT contexts, and its interpretation in those contexts may differ from its meaning in section 856(e)(6)(D)(ii). For example, the term has been used to describe group homes for foster children.[15] With that said, we believe that the term "congregate care facility" in section 856(e)(6)(D)(ii) should be read in context of the surrounding words in the statutory definition.

As noted above, Congress included the term in the definition of health care facility as part of the foreclosure property rules to ensure the continuous provision of **health care services** to residents in the event that a REIT terminated the lease of a property with respect to which such services were provided. Further, the surrounding words in section 856(e)(6)(D)(ii), hospital, nursing facility, assisted living facility, qualified continuing care facility(as defined in section 7872(g)(4)), or other facility operated by a Medicare-eligible provider, all relate to facilities which also provides for the wellness and/or health of their residents. Thus, it appears that some minimum level of health and wellness programming, beyond that which might be available at typical multi-family properties, was contemplated by Congress in connection with the definition of "health care facility," which includes a congregate care facility.[16]

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[14] *See Jarecki v. G.D. Searle & Co.*, 367 U.S. 303, 305–07 (1961) *(*"The maxim *noscitur a sociis*, that a word is known by the company it keeps, while not an inescapable rule, is often wisely applied where a word is capable of many meanings in order to avoid the giving of unintended breadth to the Acts of Congress") (which led to interpreting the word "discovery" in the list of items "resulting from exploration, discovery, or prospecting,'" as meaning only discovery of mineral resources, and not including the "development and manufacture of drugs and cameras" at issue in the case).

[15] Section 1103 of the Social Security Act (For purposes of [the relevant statutory provision], the child welfare program improvement policies described in this paragraph are the following: ….(E) The development and implementation of a plan that ensures **congregate care** is used appropriately and reduces the placement of children and youth in such care.")(Emphasis added). *See also* "A National Look at the Use of Congregate Care in Child Welfare," U.S. Department of Health and Human Services, Administration for Children and Families, and the Children's Bureau (March 30, 2015) ("For this analysis, **congregate care** is defined as a placement setting of group home (a licensed or approved home providing 24-hour care in a small group setting of 7-12 children) or institution (a licensed or approved child care facility operated by a public or private agency and providing 24-hour care and/or treatment typically for 1 or more children who require separation from their own homes or a group living experience). These settings may include child care institutions, residential treatment facilities, or maternity homes. Through …. research interviews with states, we found that although all states submit placement data gathered in accordance with Adoption and Foster Care Analysis and Reporting System (AFCARS) definitions, many have developed **their own levels of care within those categories**.") (Emphasis added).

[16] Note that the phrase in section 856(e)(6)(D)(ii) ", or other licensed facility which extends medical or nursing or ancillary services to patients, and which was operated by a provider of such services that is eligible for participation in the Medicare program under Title XVII of the Social Security Act [subchapter XVIII of chapter 7 of Title 42 (42 U.S.C.A. § 1395 et seq.)] with respect to the facility", when read in context and in connection with the punctuation of in section 856(e)(6)(D)(ii), is properly interpreted as applying Medicare participation eligibility only to "other licensed facilities" not otherwise a hospital, nursing facility, assisted living facility, congregate care facility, qualified continuing care facility(as defined in section 7872(g)(4)), for example, a private hospital.

4. Market Practice: Health Care REIT Industry

The development of the IRS ruling policy over the last several years has led industry and tax professionals at health care REITs and their advisors to a consensus view that age-restricted facilities with congregate dining (and possibly also housekeeping, transportation and a services to enhance the health and physical well-being of their residents) are “congregate care facilities” even though the provision of direct medical services at such facilities may be minimal and even though the facility may not be licensed in its state.[17]

Accordingly, the typical health care REIT structure today for a congregate care facility of the type under consideration in PLRs 201147015, 201429017 and 201509019 involves ownership of a specific age-restricted, residential facility by the REIT at which services are offered generally “targeted to monitor and help improve the health and well-being of the senior citizen residents,”[18] the lease of that facility from the REIT to a TRS, and the operation of the facility by an eligible independent contractor.

The current IRS ruling practice with respect to such facilities is a fair summary of how the industry and advisors generally interpret the current rules. Therefore, NAREIT does not believe that additional guidance is needed. However, if codified as regulations or other precedential guidance, these standards should be described in a general (and prospective) manner in order to avoid generating numerous questions regarding their precise meaning and application in a wide variety of highly factual circumstances in an industry which is constantly evolving.[19]

Further while the private letter rulings to date have been limited to age-restricted independent living communities, if the IRS is inclined to provide guidance that such facilities may include other types of residents or populations, we suggest that such guidance be crafted to ensure non-applicability to other communal living arrangements such as student housing or typical (age-restricted or non-age restricted) apartment properties in order to avoid interpretative issues like those which necessitated the requests to confirm that correctional and detention facilities are not congregate care facilities.[20]

Imagine the case, for example, of a REIT-owned university dormitory with a variety of dining facility options and a nurse on campus. Under current IRS ruling practice, most industry professionals would not consider this property a “congregate care facility” (and therefore a

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[17] While we think that state licensing should clearly mean that a facility is a qualified health care facility, we do not believe that such state licensing is a *sine qua non* given that the Code does not expressly establish such a requirement.
[18] PLR 201429017.
[19] In lieu of regulatory guidance defining a “congregate care facility,” an alternative may be a revenue procedure that summarizes the circumstances under which the IRS will not object to a property’s classification as a “congregate care facility” or “health care facility” if a REIT owns the facility and leases it to a TRS; the TRS retains an eligible independent contractor to manage the facility; and the REIT consistently treats the facility as a health care facility.
[20] *See also supra* note 16 (noting that states have varied definitions of the requisite services for property to be considered “congregate care” in the foster care context).

health care facility) notwithstanding that there are living facilities, some form of explicit or implicit age restriction, communal dining and some "health care" provided. As a result, the REIT owner may use a TRS to provide amenities and services at this property without affecting the TRS' status as a TRS. However, if the ruling practice or guidelines were to be changed, and this property were considered a "congregate care facility", the TRS would be disqualified as such for providing such services and amenities at, with the result that the REIT might own more than 10% of a non-TRS corporation, and/or the result may cause the REIT to fail its 95% gross income test, thereby destroying its REIT status.

On the other hand, a REIT failure could occur if a REIT were to take the incorrect view that this property was in fact a congregate care facility. Thus, the REIT erroneously leases the property to a TRS which then hires an eligible independent contractor to operate the property, all of the rental income from the TRS would be "related party rent," potentially destroying the REIT's tax status.

Finally, if the IRS and the Treasury Department issue precedential guidance under this Priority Guidance Plan item, NAREIT respectfully reiterates that the guidance have a prospective effective date so that the new rule would apply only to properties contracted to be acquired after the date the change is effective. We would be pleased to further discuss these comments if you believe it would be helpful. Please feel free to please contact me at (202) 739-9408, or tedwards@nareit.com, Cathy Barré, NAREIT's Senior Vice President, Policy & Politics, at (202) 739-9422, or cbarre@nareit.com; or Dara Bernstein, NAREIT's Vice President and Senior Tax Counsel, at (202) 739-9446 or dbernstein@nareit.com.

Respectfully submitted,

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April 15, 2015

The Honorable Orrin G. Hatch
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The Honorable Ron Wyden
Ranking Member
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Filed at International@finance.senate.gov

Re: Comments to the Senate Committee on Finance International Tax Reform Working Group

Dear Chairman Hatch and Ranking Member Wyden:

The National Association of Real Estate Investment Trusts[1] (NAREIT) welcomes the opportunity to provide comments to the Senate Committee on Finance International Tax Reform Working Group (the Working Group). We look forward to working with the Senators and staff who are participating in the Working Group on ways to modernize our outdated international tax system.

EXECUTIVE SUMMARY

NAREIT supports the goals of modifying the U.S. tax system to make U.S. companies more competitive and to encourage job creation and investment in the U.S. while simultaneously limiting inappropriate opportunities for base erosion. As further described below, NAREIT suggests that the Working Group consider the unique nature of the REIT rules in designing any new international tax system because: 1) REITs generally invest overseas for the purpose of generating more current income to distribute to shareholders as they are statutorily mandated to do (contrary to the more prevalent practice of deferring U.S. taxation of retained foreign earnings overseas under our current worldwide international tax system); and, 2) international tax reform could create inadvertent, yet adverse, consequences to REITs if certain design features of a new international tax system were to be enacted.[2]

[1] NAREIT, the National Association of Real Estate Investment Trusts, is the worldwide representative voice for real estate investment trusts (REITs) and publicly traded real estate companies with an interest in U.S. real estate and capital markets. NAREIT's members are REITs and other businesses throughout the world that own, operate, and finance income-producing real estate, as well as those firms and individuals who advise, study, and service those businesses.

[2] NAREIT has previously discussed some of these issues in its letter dated May 31, 2013 to the Committee on Ways and Means commenting on the international tax reform discussion draft released on October 26, 2011 by former Chairman Dave Camp (2011 Discussion Draft).

In the event that the Working Group considers a dividend exemption system to replace our current international tax system, similar to the proposal that was included in [H.R. 1, *The Tax Reform Act of 2014*] (or the 2014 TRA, released on February 26, 2014 by former Ways and Means Committee Chair Dave Camp), NAREIT recommends that REITs be treated similarly to pass-through entities so that REITs would continue to apply current law rather than a dividend exemption system.

However, if it is determined that REITs should be included in a dividend exemption system, NAREIT believes that such a system should provide for the following: 1) REITs should be excluded from any "deemed incorporation" of foreign branches, as well as any tax on accumulated foreign earnings requiring immediate inclusion of such earnings; and, 2) the concept of allowing a shareholder to exclude previously taxed subpart F income (PTI) should be retained.

Further, because a number of the potentially adverse tax consequences for REITs under a dividend exemption system would be due to the treatment of a U.S. REIT's foreign rental income earned through subsidiaries as subpart F income, we recommend that the Working Group consider a modification to the definition of foreign personal holding company income so that employees of a related company could be considered as employees of the lessor company. Specifically, the subpart F rules treat rents as passive rents if direct employees of the landlord are not involved in the management and operation of the rental property (disregarding the active role of the employees of any related property manager in such operations). Due to local employment laws and practices, often the individuals who provide property management services are employed by a separate property manager affiliate in the group rather than the real estate holding entity.

Accordingly, NAREIT recommends a modification to the subpart F rules so that the services provided by an affiliate could be allowed to be taken into account for subpart F testing as to whether the rents are active, particularly considering that many businesses outside the U.S. are compelled by local rules to house such employees abroad in an affiliate management company.

DISCUSSION

A. Background

1. REITs Generally

Authorized by Congress over 50 years ago, and modeled after mutual funds, REITs represent the easiest way through which investors can invest in professionally managed portfolios of real estate assets. Stock in stock exchange-traded REITs typically is held by retail investors, either directly or indirectly through mutual funds or exchange traded funds. Investing in a diverse, professionally managed portfolio of real estate assets provides all Americans access to, and the benefits of investing in, large scale income-producing real estate, without the risks and transaction costs associated with investing in individual properties.

Like a mutual fund, a REIT is not subject to entity-level federal income tax on taxable income that it distributes to its shareholders as dividends each year. REIT dividends are taxed at the highest rate applicable to ordinary income. However, to achieve this tax treatment, sections 856 through 860 require a REIT to satisfy several tests related to the nature of the REIT's assets, the sources of its income, its mandatory distributions to its shareholders, and the ownership of its stock.[3] Although REIT income in general is not subject to a corporate-level tax like partnerships and other types of fiscally transparent entities, the REIT income and asset tests, coupled with the mandatory distribution rules, and the fact that REITs may not pass through losses and credits to investors, distinguish REITs from pass-through entities.

2. <u>REIT Gross Income and Asset Tests and the 90% Distribution Requirement</u>

a. <u>Gross Income Tests</u>

To ensure that a REIT derives substantially all of its income from real estate related sources, a REIT is required to derive at least 75% of its gross income each year from, *inter alia*: 1) rents from real property; 2) interest on obligations secured by mortgages on real property or on interests in real property; and, 3) gain from the sale or other disposition of real property, including interests in real property and interest in mortgages on real property, that is not "dealer property" (*i.e.*, property held primarily for sale to customers in the ordinary course of business).[4] (75% Gross Income Test). A REIT also is required to satisfy the 95% gross income test. That test requires that a REIT derive at least 95% of its gross income each year from passive sources, including, *inter alia*, any income that is qualifying for the 75% Gross Income Test, interest, dividends, and gains from the sale or other disposition of stock, securities and real estate that is not "dealer property."[5] (95% Gross Income Test).

b. <u>Asset Tests</u>

Among other things, on a quarterly basis, 1) at least 75% of the value of a REIT's total assets must be from "real estate" sources (including foreign real estate[6]) (75% Asset Test)[7]; 2) a REIT

[3] For further detail regarding the positive effects of REITs on the economy and investors, please see NAREIT's submission to the Ways & Means Committee Real Estate, Energy, International, Pensions/Retirement, Debt, Equity and Capital, Education and Family Benefits, Charitable/Exempt Organizations, Financial Services and Small Business Tax Reform Working Groups dated April 15, 2013, available at http://waysandmeans.house.gov/uploadedfiles/nareit_wg_comments.pdf.

[4] I.R.C. § 856(c)(3).

[5] I.R.C. § 856(c)(2).

[6] Rev. Rul 74-191, 1974-1 C.B. 170.

cannot own more than 10% of the vote or value in a corporation other than another REIT, a "taxable REIT subsidiary" (TRS) or a wholly owned "qualified REIT subsidiary" (QRS)[8] (10% Asset Test); and 3) the value of securities of all TRSs cannot exceed 25% of a REIT's assets (TRS Asset Test). A TRS is a fully taxable corporate subsidiary of a REIT. A REIT and affiliated TRSs must elect jointly for the TRS or TRSs to be treated as TRSs.

c. Distribution Test

A REIT must distribute 90% of its "REIT taxable income" (excluding net capital gain) each year (the 90% Distribution Requirement).[9] Like a mutual fund (called a regulated investment company in the Code), a REIT is allowed a dividends paid deduction in computing its taxable income.[10] Thus, a REIT does not pay an entity-level tax on its distributed taxable income, and most REITs distribute 100% of their taxable income. As with mutual funds, the tax burden from a REIT's activities is borne by the REIT's shareholders. SEC-registered REITs paid out over $47 billion in dividends in 2014, most of which were taxed at the ordinary income rate, not the lower rate applicable to qualified dividends. At the end of February 2015, 223 REITs that are listed on stock exchanges had an equity market capitalization of $953 billion.

A limited exception from the 90% Distribution Requirement is available for certain types of "phantom" or "noncash" income recognized by a REIT.[11] A REIT is not required to distribute "excess noncash income," which is certain noncash income in excess of 5% of the REIT's taxable income (excluding net capital gains).[12] The potential sources of "excess noncash income" under section 857(e) include, *inter alia*, original issue discount (OID) and cancellation of indebtedness (COD) income.[13] A REIT, however, is required to pay corporate income tax on any "excess noncash income" that it does not distribute to its shareholders.

Notwithstanding the limited exception for excess noncash income, REITs generally are required by market forces to distribute all of their taxable income, and, as a result, also their phantom income. In order to raise the cash necessary to distribute phantom income as required by the 90%

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[7] I.R.C. § 856(c)(4).

[8] Under section 856(i), a QRS is treated as a disregarded entity of its parent REIT.

[9] I.R.C. § 857(a)(1)(A).

[10] I.R.C. § 857(b)(2)(B).

[11] I.R.C. § 857(a)(1)(B).

[12] I.R.C. § 857(e)(1).

[13] I.R.C. § 857(e)(2). Excess noncash income also includes: 1) "excess inclusion income," a type of phantom income recognized by a holder of a residual interest in a real estate mortgage investment conduit (REMIC) or a taxable mortgage pool; 2) gain from certain failed section 1031 "like-kind" exchanges; and, 3) rental income accelerated under section 467 (requiring accrual of rental income on a level basis on certain leases with backloaded rent). I.R.C. § 857(e)(2)(A), (B), and (C). In the case of OID, excess inclusion income, and section 467 income, the "excess noncash income" comprises income in excess of the cash actually received on the related investment.

Distribution Requirement, a REIT may incur debt or sell assets it otherwise would hold on a long-term basis. Neither of these alternatives typically is in the best economic interests of the REIT's shareholders. Incurring debt to satisfy the 90% Distribution Requirement will necessarily increase the REIT's leverage beyond what it otherwise would have been, and that increased leverage may make it more difficult for the REIT to survive an economic downturn.

Ultimately, if the recognition of and the failure to distribute phantom income causes a failure of the 90% Distribution Requirement, the REIT will lose its REIT status. This would cause the REIT to be treated as a C corporation that is subject to regular corporate income tax for the year of the failure and for the following four years**,** unless the REIT obtains the consent of the IRS to maintain its REIT status.[14] The corporate income tax resulting from a failure to satisfy the 90% Distribution Requirement would greatly reduce the distributions the REIT could pay to its shareholders and likely would significantly reduce the value of the REIT's stock. In sum, phantom income can cause significant negative consequences for a REIT and its shareholders.

B. REIT Investment Outside of the U.S.

1. Generally

In Revenue Ruling 74-191, 1974-1 C.B. 170, the IRS concluded that otherwise-qualifying assets do not fail to satisfy section 856(c)(4) merely because the assets are located outside the United States. Several REITs invest in part outside of the U.S. as a way of servicing their tenants, which are global enterprises, teaming with foreign real estate experts and diversifying their asset base.

Of particular concern to REITs when investing outside of the U.S. are the following factors: 1) maximizing the generation of cash for distribution to shareholders, while complying with the 75% Gross Income Test and the 75% Asset Test; 2) complying with the TRS Asset Test; 3) satisfying the 90% Distribution Requirement/shareholder demand for cash, while avoiding phantom income; and, 4) minimizing foreign tax liability, as REITs generally cannot use foreign tax credits.

REITs may invest outside of the U.S. through fiscally transparent entities, including disregarded entities (either limited liability companies or QRSs, partnerships, or foreign entities that "check the box" to be treated as a disregarded entity or as a partnership) or through U.S. or foreign corporate entities.

2. REIT Use of Fiscally Transparent Entities

Specifically, REITs may invest in foreign real estate through a U.S. partnership, limited liability company or disregarded entity or a foreign limited liability entity that "checks the box" to be

[14] I.R.C. § 856(g)(3) (prohibiting an entity that has failed to qualify as a REIT from electing REIT status for the next four taxable years).

treated as a disregarded entity or as a partnership for U.S. tax purposes. (These entities may be regarded, or corporate, entities for foreign income tax purposes.) By doing so, the REIT achieves immediate and ongoing flow-through of foreign income that maximizes distributions to shareholders and complies with the REIT income and asset tests similar to its investments in U.S. real estate.[15]

In many cases, once a top-tier entity is established, regional investments (*e.g.*, investments in the European Union or throughout Asia) are made through subsidiary disregarded entities in order to achieve operational efficiencies, minimize liabilities, and reduce foreign taxes. Reduction of foreign taxes allows for a greater amount of income to flow through to REIT shareholders. As REITs generally do not claim foreign tax credits and cannot pass such credits through to their shareholders, a reduction in foreign taxes results in REITs being able to distribute more income currently to their shareholders. Thus, the REIT's investments are structured using fiscally transparent entities in order to maximize current income and distributions to shareholders, *not to defer U.S. taxes*.

3. REIT Use of Corporate Entities

Although a REIT may prefer to invest overseas through fiscally transparent entities, a REIT may face a number of issues by investing outside of the U.S. through flow-through entities. First, if the foreign entity or the REIT's foreign partner in the foreign entity inadvertently invests in non-qualifying REIT assets or generates non-qualifying REIT income, the REIT's tax status could be jeopardized.

Second, many countries limit the actual cash distributions that can be made to foreign shareholders. Often, this limit will be based on book income (distributable reserves); thus, companies that claim depreciation (that is, non-cash) expense may have book income that is less than its distributable cash flow. Due to typical acquisition structures, book depreciation often exceeds tax depreciation. Although Treasury Regulation § 1.856-3(g) requires a REIT to include its proportionate share of the flow-through entity's income in its taxable income, and the 90% Distribution Test requires the REIT to distribute 90% of such income, the REIT may not have access to the flow-through entity's cash. As a result, the REIT may consider making its overseas investments through entities that are treated as corporations for U.S. tax purposes. Further, some countries require foreign companies like U.S. REITs to invest in real estate located in their countries through entities that are treated as corporations for U.S. tax purposes.

Finally, for those REITs in the hospitality and healthcare industries that lease their real estate to a TRS,[16] the ownership of such real estate by a fiscally transparent entity is somewhat impractical

[15] Under Treas. Reg. § 1.856-3(g), a REIT is deemed to own its proportionate share of the assets and income of a partnership in which it owns an interest.

[16] *See* I.R.C. § 856(d)(8)(B).

as it doubles up on audit, tax and other local country fee-heavy requirements. Thus, these REITs often invest overseas through TRSs, subject to compliance with the TRS Asset Test.

Because a REIT only may own up to 10% of a corporation other than another REIT, a QRS, or a TRS, if a REIT invests in a foreign corporate entity, typically the REIT and the foreign corporate entity will elect for the foreign entity to be a TRS. By investing through a TRS, rather than a flow-through entity, the REIT avoids the risk that a foreign flow-through entity inadvertently may invest in non-qualifying REIT assets or generate non-qualifying REIT income that could jeopardize the REIT's tax status. Additionally, the REIT avoids the issue of foreign entities being legally prevented from distributing all of its available cash to the REIT, when the REIT is required to distribute at least 90% of such taxable income.

Even if a REIT does invest outside of the U.S. through foreign TRSs, the REIT is limited by the TRS Asset Test to the value of securities it can own in TRSs. As noted above, the value of the securities in all of its TRSs cannot exceed 25% of the REIT's total assets. Thus, to the extent the REIT may approach that limit, it would be required to make further investments through flow through entities.

REITs typically do not invest in foreign countries in order to defer the recognition of taxable income. First, in certain cases, rental income earned by the TRSs may be considered subpart F income (if the company earning the rental income is not the same company whose employees are managing the property).[17] Thus, if the REIT is a "U.S. shareholder" of CFCs, the REIT is required by section 951(a)(1)(A)(i) to include in its gross income its pro rata share of the subpart F income, as defined in section 952(a), of any such CFCs. Additionally, as a result of being a U.S. shareholder of CFCs, the REIT is required by section 951(a)(1)(B) to include in its gross income its share of the amount determined under section 956 with respect to each CFC for the relevant tax year (but only to the extent not excluded from gross income under section 959(a)(2)).

If the REIT is not a U.S. shareholder of the CFC, the entity will be considered a passive foreign investment company (PFIC) if it generates sufficient FPHCI. If so, the REIT's tax treatment will

[17] Foreign personal holding company income (FPHCI), one type of subpart F income, is defined to include "…rents, … other than…rents and royalties derived in the active conduct of a trade or business and which are received from a person that is not a related person." Section 954(c)(2)(A); Treas. Reg. § 1.954-2(b)(6).

Further, Treas. Reg. § 1.954-2(c) provides "[e]xcluded rents-(1) Active conduct of a trade or business. Rents will be considered for purposes of paragraph (b)(6) of this section to be derived in the active conduct of a trade or business if such rents are derived by the [CFC] (the lessor) from leasing . . . (ii) Real property with respect to which the lessor, through its own officers or staff or employees, regularly performs active and substantial management and operational functions while the property is leased . . . ."

Notably, the IRS has held in Rev. Rul. 2001-29, 2001-1 C.B. 1348 that, in the context of the section 355 active trade or business requirement: "A REIT can be engaged in the active conduct of a trade or business within the meaning of § 355(b) solely by virtue of functions with respect to rental activity that produces income qualifying as rents from real property.

vary based on whether it has made a qualified electing fund (QEF) election for that PFIC. As a result of being a shareholder in PFICs for which it has made QEF elections, the REIT is required under section 1293(a) to include in its gross income its pro rata share of the ordinary earnings and net capital gain of each such QEF. As a result of being a shareholder in PFICs for which it has not made any QEF elections, a REIT is required to include amounts in income (as ordinary income) pursuant to section 1291.

In either case, the subpart F income will not qualify as 75% Gross Income. However, the IRS has appropriately issued a number of private letter rulings holding that subpart F income inclusions and/or PFIC inclusions qualify as 95% Gross Income.[18]

C. 2014 TRA: International Tax Proposals

As relevant to REITs, the 2014 TRA would have modified current law by generally proposing the following: 1) a dividend exemption system that would exclude 95% of foreign-source dividends from a U.S. parent corporation's taxable income; and, 2) immediate U.S. taxation (with the related tax liability to be paid over eight years if desired) of post 1986-accumulated earnings of foreign subsidiaries.

Unlike the 2011 Discussion Draft, the 2014 TRA did not propose a deemed incorporation rule for foreign branches (the Deemed Incorporation Rule). The Deemed Incorporation Rule would have treated any foreign branch as a separate corporation which is a CFC, and the U.S. corporate shareholder as a "U.S. shareholder" under the CFC rules. A "foreign branch" was defined as "any trade or business of [a] domestic corporation in a foreign country." Although the Deemed Incorporation Rule was eliminated in the 2014 TRA so that branches would continue to be treated as branches, the international tax reforms included in President Obama's fiscal year 2016 budget proposal would treat branches as CFCs. The Deemed Incorporation Rule, along with the proposed dividend exemption system and the tax on accumulated foreign earnings, are discussed below.

D. NAREIT's International Tax Reform Recommendations to the Working Group

1. Current Law, Rather Than a Dividend Exemption System, Should Continue to Apply to REITs

As described above, REITs generally structure their foreign operations in a manner that results in current U.S. taxation of foreign income - either through foreign branches or disregarded entities for U.S. tax purposes, or through subsidiary corporations that qualify as TRSs that often generate subpart F rental income. Even to the extent foreign subsidiaries do not generate subpart F rental income recognized as taxable income currently, the 90% Distribution Requirement and market expectations, as a practical matter, pressure REITs to receive and distribute current income

[18] *See, e.g.*, PLRs 201226004 http://www.irs.gov/pub/irs-wd/1226004.pdf and 201246013 http://www.irs.gov/pub/irs-wd/1246013.pdf .

earned by lower-tier entities located in the U.S. and overseas. Accordingly, REITs do not raise the issues which are intended to be addressed by a territorial taxation regime such as a dividend exemption system, as they generally do not defer U.S. taxation on foreign operations or retain funds from operations in the foreign branches.

Because of the uniqueness of the REIT rules, proposals to adopt a dividend exemption international tax system such as that included in the 2014 TRA, without careful modification to address the interplay with the REIT tax rules or appropriate carve outs, could inadvertently affect in an adverse way REITs with foreign operations. Furthermore, some of these proposals could alter substantially a REIT's compliance with the gross income and asset tests. As a result, we suggest that any dividend exemption proposal considered by the Working Group (including that proposed in the 2014 TRA) not apply to REITs even though REITs would not be entitled to the benefits of an exemption of CFC dividends from U.S. Federal income tax.

The dividend exemption proposal that was included in the 2014 TRA is limited to owners of CFCs that are C corporations and would not apply to partnerships and other pass-through owners of CFCs. While REITs generally are formed as C corporations, their tax treatment is comparable to that of a pass-through entity (in that tax liability is borne by the entity's owners). Therefore, considering the special challenges discussed above that a dividend exemption system poses for REITs, NAREIT recommends that REITs be excluded from any proposed dividend exemption system and continue to be subject to current law.

However, if it is determined that REITs should be included in any dividend exemption system that the Working Group considers, we make the recommendations described below to mitigate the potentially adverse consequences of applying a dividend exemption system to REITs.

2. <u>Any Tax on Accumulated Foreign Earnings Should Not Apply to REITs</u>

Both the 2014 TRA and President Obama's fiscal year 2016 budget proposals include a mandatory tax on accumulated foreign earnings (often referred to as a "transition rule" or "deemed repatriation"). Under this mandatory tax, there would be immediate inclusion in a domestic parent's taxable income of accumulated foreign earnings of CFCs at a specified effective tax rate. Under the 2014 TRA, the rate would be 8.75% on foreign earnings to the extent of the CFC's unrepatriated cash and cash equivalents, while the rate would be 3.5% on the CFC's remaining foreign earnings. Under President Obama's budget, the rate would be 14% on all of the CFC's foreign earnings. At least in the case of the 2014 TRA, previously taxed (subpart F) income and "effectively connected" U.S. source income would be excluded from this income inclusion.

With regard to the 2014 TRA, the split-rate of 8.75% and 3.5% is the result of including accumulated foreign earnings of CFCs in gross income, but allowing a 75% deduction and a 90% deduction, respectively (against the 35% corporate tax rate). President Obama's budget proposal lacks sufficient detail to indicate whether a similar mechanism would be employed to apply the proposal's 14% effective tax rate to accumulated foreign earnings of CFCs.

For those REITs operating outside of the U.S. and generating qualifying 75% Gross Income that is not considered subpart F income, the immediate inclusion in taxable income of previously deferred foreign earnings would subject these earnings to the requirement that the REIT distribute at least 90% of these earnings. To the extent that the REIT retained (or reinvested) up to 10% of these earnings, it would be required to pay corporate income tax on the earnings.[19] Failing to distribute the remaining 90% of these earnings could result in a loss of REIT status. Consequently, many REITs would be forced to sell assets or borrow money to satisfy this distribution requirement, neither of which necessarily would be in the long term best interests of its shareholders. Furthermore, REIT shareholders generally do not pay tax on the distributions of these earnings at the lower tax rate applicable to qualified dividends.

Thus, because of the interplay of the REIT rules with the mandatory tax on accumulated foreign earnings, the mandatory tax inadvertently would create adverse consequences for REITs. Accordingly, NAREIT recommends that any mandatory tax on accumulated foreign earnings not apply to REITs. Alternatively, NAREIT recommends that REITs be treated, for purposes of any mandatory tax, similarly to S corporations in the 2014 TRA, which generally deferred the imposition of the tax as long as the S corporation maintained its status as an S corporation (in recognition of the fact that S corporations are excluded from the dividend exemption system in the 2014 TRA).

3. <u>Any Partial Dividend Exemption System Should Exclude Previously Taxed Income</u>

The 2014 TRA proposed to retain a modified version of the subpart F rules and to create a dividend exemption system that would allow a domestic corporation that is a U. S. shareholder[20] to deduct 95% of its dividends received from a CFC (a dividends received deduction or DRD). In its release of the 2014 TRA, the Ways and Means Committee indicated that a partial dividend exemption system was included in lieu of a full dividend exemption system accompanied by rules requiring the allocation of U.S. expenses to exempt foreign income.

As we understand it, the interaction of the subpart F rules and a partial dividend exemption system would mean that, if a U.S. shareholder, like a REIT, were required to include $100 of subpart F income from a CFC in taxable income in year 1, and the CFC distributed a $100 dividend to the U.S. shareholder in year 2, the U.S. shareholder would have $5 of taxable income in year 2 ($100-(95%)*($100)). The U.S. shareholder also would recognize $100 of taxable

[19] As noted above, I.R.C. § 857(e)(2) allows a REIT to retain a type of phantom income called "excess noncash income." While this type of income is not subject to the 90% Distribution Requirement, the REIT must pay tax thereon. Thus, if a mandatory tax on accumulated foreign earnings did not exclude REITs, at the very least, the foreign earnings that are subject to the tax should be considered excess noncash income.
[20] The 2014 TRA would define a "U.S. shareholder" according to current section 951(b).

income in year 1. The October 26, 2011 discussion draft released by the Ways and Means Committee proposed to repeal current law's exclusion of a CFC's "previously taxed income" (PTI) from taxable income. As discussed below, repealing the exclusion for PTI raises two significant issues for REITs.

First, a partial dividend exemption raises the potential for double taxation for REIT shareholders with CFCs that generate subpart F income.[21] For example, under current law, assume REIT owns 100% of TRS which owns UK property and earns subpart F rental income of $100 in year 1. TRS distributes $100 of cash in Year 2. In year 1, REIT includes $100 in taxable income, distributes $100 and has no corporate income tax liability. In year 2, REIT has no consequences from TRS' distribution of the $100 of previously taxed income under current subpart F rules which exclude PTI from taxable income. REIT shareholders would have $100 of taxable income in year 1.

Applying a 95% partial dividend exemption to the same facts, in year 1, REIT includes $100 in taxable income, distributes $100 and has no corporate income tax liability. REIT shareholders have $100 of income in year 1. In year 2, the REIT would have a $100 dividend, but because of the repeal of the PTI rules, it only could exclude 95% of the foreign source dividend amount. The foreign-source portion of the dividend is determined based on the ratio of the CFC's undistributed foreign earnings to total undistributed earnings. Undistributed earnings are defined as the earnings and profits of the CFC computed under sections 964(a) and 986. Undistributed earnings include earnings previously included by the US shareholder under subpart F. This would result in these earnings being taxed currently and again upon repatriation, subject to the 95% DRD. A non-REIT U.S. shareholder would be subject to an additional tax on subpart F income of 1.25% (assuming a corporate tax rate of 25%).

The REIT could exclude $95 of the $100 dividend, leaving it with $5 of taxable income. If it distributes the $5, it would have no corporate income tax liability, but its shareholders have another $5 of income, $5 more than under current law. Also, unlike non-REIT C corporations, REIT shareholders would not benefit from a lower income tax rate – their top ordinary income tax rate is 39.6% (plus a potential 3.8% surtax on dividend income).

Additionally, if the partial dividend exemption is available only to domestic C corporations, then dividends received by U.S. partnerships would be subject to U.S. tax at the partner level and not eligible for the exemption. Many REITs, particularly listed REITs, own no assets directly other than an interest in an operating partnership that owns and operates all of their assets (these REITs are known as UPREITs). It appears that the potential for double taxation would be even more extreme in this structure.

[21] Some have queried whether REITs would be allowed to claim the DRD. Under current section 243, which provides for a DRD in certain cases, a dividend from a REIT is not considered a "dividend." Presumably, a full or partial dividend exemption would apply to dividends received by a REIT.

Double taxation would result through the combination of repealing the PTI rules and excluding from gross income only 95% (or some other percentage less than 100%) of the CFC's distributions. Accordingly, in order to avoid this double taxation, we recommend that the PTI rules be retained, at least for REITs, in any dividend exemption system that may be considered by the Working Group.

The second issue for REITs with regard to eliminating the PTI rules is that a (full or partial) dividend exemption in the form of a deduction (rather than an exemption) may raise compliance issues for REITs with respect to the 95% Gross Income Test. Thus, income under current law that is excluded from gross income (*e.g.*, PTI) now would be included in income (and may be considered 95% Gross Income), which could skew the REIT's gross income test results, thereby potentially affecting REIT status.

4. Any Dividend Exemption System Should Not Include The Deemed Incorporation Rule

Although the 2014 TRA did not include the Deemed Incorporation Rule, because it was included in the 2011 Discussion Draft, it is possible that this Rule may be considered as part of a Dividend Exemption System. NAREIT urges the Working Group not to include the Deemed Incorporation Rule in any dividend exemption system (or, at the very least, not to apply it to REITs).

While the Deemed Incorporation Rule should have no effect on a REIT's foreign investments currently structured as corporations, it raises a number of issues for REITs that invest in foreign countries through branches and other fiscally transparent arrangements.

First, the Deemed Incorporation Rule may result in a "deemed sale" under section 367(a) with respect to which phantom gain would require to be recognized and distributed.[22] While section 367(a)(3) would exempt from deemed sale treatment those deemed transfers of assets that are used by such a foreign corporation "in the active conduct of a trade or business outside the United States," as noted above, it is likely that, in many cases, the assets of entities currently treated as branches of a REIT would not be considered active for purposes of this rule. Of course, since the entities currently are fiscally transparent, this issue is not relevant under current law.

[22] It is unclear whether section 367 would apply to the deemed incorporation of a branch, and it would be helpful if the Deemed Incorporation Rule (if proposed) would clarify that section 367 treatment would not apply. Specifically, it would be helpful to clarify that the deemed incorporation of a REIT's wholly-owned branch would continue to be treated as a QRS, and section 367 deemed sale treatment did not apply. (Note that this issue is generally not applicable in the umbrella partnership REIT context, when a REIT owns the majority interests in an operating partnership, and the operating partnership owns and operates all of the "REIT's" properties.) For purposes of this discussion, however, this letter describes the presumably inadvertent, but adverse, consequences if section 367 deemed sale treatment did apply.

Second, the Deemed Incorporation Rule could cause the REIT to fail the 10% Asset Test because the REIT would be treated as owning more than 10% of the securities of another corporation.[23] While the REIT could make a TRS election for these entities to be treated as TRSs, the TRS Asset Test may limit the REIT's ability to do so.

Third, the Deemed Incorporation Rule would cause income that currently qualifies for the 75% Gross Income Test to be converted into, at best, income qualifying for the 95% Gross Income Test. As noted above, income of fiscally transparent REIT investments likely consists mostly of rental income that qualifies as 75% Gross Income. If the fiscally transparent entity were a corporation, its rental income may be viewed as subpart F income, and the REIT would have to include in income either its subpart F inclusions or its PFIC inclusions.

Additionally, because the former fiscally transparent entity's income and assets no longer would be flowing through to the REIT for federal tax purposes based on Treasury Regulation § 1.856-3(g), the REIT would have less gross income, which could affect the calculation of both the 75% and 95% Gross Income Tests. Similarly, the disregarded entities' assets that currently are viewed as qualifying assets for purposes of the 75% Asset Test would be converted into non-qualifying assets for such test.

Fourth, currently disregarded loans to foreign disregarded entities would become "regarded" loans that, if unsecured, could result in additional 95% Gross Income to the REIT, again potentially affecting its REIT qualification.[24]

In sum, REITs that invest outside of the U.S. through fiscally transparent entities are doing so in order to maximize current distributions to shareholders and not for the purposes of income deferral. Because of the various issues raised by the Deemed Incorporation Rule, we recommend that any dividend exemption system that the Working Group considers follow the 2014 TRA by continuing to treat foreign branches as branches or, if the Deemed Incorporation Rule is included, excluding REITs from its application.

[23] If the fiscally transparent entity is currently 100% owned by the REIT, presumably the entity would be converted into a QRS, which would not raise an asset test issue for the REIT. If the fiscally transparent entity currently is not 100% owned by the REIT, the REIT and the entity could elect for the entity to be a TRS, but no more than 25% of the REIT's total assets can consist of TRS securities without being disqualified as a REIT.

[24] Another potential issue is whether all of a REIT's foreign branches would be viewed as engaged in a "trade or business" in a foreign country, and, if not, how the Deemed Incorporation Rule would apply. As noted above, not all of a REIT's foreign branches will have employees and/or significant activities on their own, and, therefore, may not be considered engaged in a trade or business. Presumably, such entities would continue to be treated as fiscally transparent entities. It would be helpful to have this issue clarified if the Deemed Incorporation Rule is included in a dividend exemption system.

Thank you for the opportunity to provide these comments. Please contact me at (202) 739-9408 or tedwards@nareit.com or Dara Bernstein, NAREIT's Senior Tax Counsel, at (202) 739-9446 or dbernstein@nareit.com if you would like to discussion this letter in greater detail.

Respectfully submitted,

Tony M. Edwards
Executive Vice President & General Counsel

Office of Chief Counsel
Internal Revenue Service
Memorandum

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date: October 23, 2015

to: William D. Richard
Attorney (Seattle, Group 1)
(Small Business/Self-Employed)

from: James A. Quinn
Senior Counsel, Branch 3
(Passthroughs & Special Industries)

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subject: Guarantee of Qualified Non-Recourse Financing

This memorandum responds to your request for assistance dated August 13, 2015. This advice may not be used or cited as precedent.

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ISSUES

1. If one partner guarantees a partnership's obligation to satisfy a promissory note in the event of, among other events, the partnership admitting in writing that it is insolvent or unable to pay its debts when due, or its voluntary bankruptcy or acquiescence in an involuntary bankruptcy, does this guarantee preclude the promissory note from qualifying as a nonrecourse obligation of the partnership under § 752 of the Internal Revenue Code ("Code") and regulations promulgated thereunder?
2. If the partnership's sole business activity involves acquiring existing hotels, renovating them, installing personal property appropriate to improve the properties' utility as hotels, and holding and maintaining the premises, but does not include the hotels' day-to-day operations, does this business activity qualify as an "activity of holding real property" within the meaning of § 465(b)(6)(A)?
3. If a partner guarantees partnership debt that otherwise had met the requirements of qualified nonrecourse financing within the meaning of § 465(b)(6), are the other non-guarantor partners entitled to treat the obligation as qualified nonrecourse financing within the meaning of § 465(b)(6) and regulations promulgated thereunder or otherwise at risk with respect to the guaranteed obligation?
4. If the partnership operating agreement provides that, in the event that the guaranteeing partner makes a payment under a guarantee, the guaranteeing partner has the right to call for the non-guaranteeing partners to make capital contributions and, if they fail to do so, treat ratable portions of the payment as loans to those partners, adjust their fractional interests in the partnership, or enter into a subsequent allocation agreement under which the risk of the guarantee would be shared among the partners, is this provision sufficient to make the non-guaranteeing partners personally liable with respect to the guaranteed obligation for the purposes of §§ 752 and 465?

CONCLUSIONS

1. If a partner guarantees an obligation of the partnership and the guarantee is sufficient to cause the guaranteeing partner to bear the economic risk of loss for that obligation within the meaning of § 1.752-2(b)(1) of the Income Tax Regulations, the guaranteed debt is properly treated as recourse financing for purposes of applying the basis allocation rules of § 752. For this purpose, certain contingencies such as the partnership admitting in writing that it is insolvent or unable to pay its debts when due, its voluntary bankruptcy, or its acquiescence in an involuntary bankruptcy, after taking into account all the facts and circumstances, are not so remote a possibility that it is unlikely the obligation will ever be discharged within the meaning § 1.752-2(b)(4) that would cause the obligation to be disregarded under § 1.752-2(b)(3).
2. Where the partnership's sole business activity includes acquiring existing hotels, renovating them, installing personal property appropriate to improve the properties' utility as hotels, and holding and maintaining the premises, but does not include the hotels' day-to-day operations, the partnership is engaged in an "activity of holding real property" within the meaning of § 465(b)(6)(A).
3. When an individual partner guarantees a partnership obligation, the amount of the guaranteed debt no longer meets the definition of "qualified nonrecourse financing" under § 465(b)(6)(B), and the amount of the guaranteed debt will no longer be includible in the at-risk amount of the other non-guaranteeing partners, if the guarantee is bona fide and enforceable by creditors of the partnership under local law.
4. To the extent the guaranteeing partner has the right under the partnership operating agreement to call for the non-guaranteeing partners to make capital contributions and, if they fail to do so, treat ratable portions of the payment as loans to those partners, adjust their fractional interests in the partnership, or enter into a subsequent allocation agreement under which the risk of the guarantee would be shared among the partners, this right generally will not be sufficient to make the non-guaranteeing partners personally liable with respect to the guaranteed obligation for the purposes of §§ 752 and 465.

FACTS

X is a limited liability company electing to be taxed as a partnership. Its members are A, an individual who owns n1% of the profits and equity interest in X; B, an individual who owns n2% of X; and C, an individual who owns the remaining n3% of X. A, B and C each owns more than 10% of the profits and equity of X. X directly or indirectly owns a number of corporate subsidiaries (hereinafter "the subsidiaries").

Section 7.5 of the Amended and Restated Operating Agreement of X ("Operating Agreement") contains a number of provisions with respect to additional capital contributions to X.

Section 7.5(a) of the Operating Agreement states that, except as otherwise provided for therein or mutually agreed upon by the Members, no Member shall be obligated to make capital contributions to X.

Section 7.5(b) of the Operating Agreement states that in the event additional capital is needed for X's business, C, or an affiliate (the "Lender") may elect to loan funds to X for its business purposes ("C loans"). Such C loans shall be made on commercially reasonable terms and conditions, and the Members agree that such loans shall bear interest at a rate equal to n4% per annum, compounded annually. Such loans shall be an obligation of X and, at the option of the Lender, may be repaid prior to any distributions to the Members. C or its affiliates shall have no obligation to make C loans to X. If C elects to make C loans to X, A and B shall be given the opportunity to make similar loans in accordance with their respective ownership percentage interests in X. If C makes any C loans to X, C may at any time convert such C loans into additional capital.

Section 7.5(c) of the Operating Agreement states that in the event that C determines in his sole discretion that additional capital is needed for X's operations in addition to the initial capital contributions (as set forth in Section 7.2 of the Operating Agreement) and C loans under section 7.5(b) above, if any, C may elect to make additional capital contributions to X. If C elects to contribute additional capital, A and B shall be given the opportunity to make similar additional capital contributions in accordance with their respective ownership percentages in X. C's additional capital shall not exceed an amount which would cause C's adjusted contribution amount at any point to exceed $n5.

Section 7.5(d) of the Operating Agreement states that in the event C's adjusted contribution amount exceeds $n5 and C determines in his sole discretion that additional capital is needed for X's business in addition to the initial capital contributions, any C loans under section 7.5(b), and C's additional capital contributions under section 7.5(c) (but excluding guarantee contributions, which are subject to section 7.5(e)), the Members shall contribute their ownership percentage interest of the required capital to X within 20 days of receiving notice from C of the amount of required additional capital (the "Demand Notice"). If a Member fails to contribute an amount required pursuant to this section 7.5(d) (a "Defaulting Member") within 20 days of receipt of a Demand Notice from C, then C may elect one or more of the following remedies:

(i) C may elect to loan to X the amount that a Defaulting Member failed to contribute which loan shall be treated as a loan to the Defaulting Member and which shall bear interest at the rate of n6% per annum compounded annually from the date of the advance until the date the loans are paid in full, and shall be payable out of any distributions to the Defaulting Member (which payments will be applied first to accrued interest on the loans and then to the outstanding principal balance of such loans). If C elects to make such a loan, the other non-defaulting members shall be given a similar opportunity to make similar loans in accordance with their respective ownership percentage interests in X; or

(ii) C may elect to adjust the ownership percentage interest of each Defaulting Member by n7% for each $n8 a Defaulting Member failed to contribute, and the ownership percentage interest of the Members who contributed their proportionate share in response to the Demand Notice (the "Contributing Members") shall increase n7% by each $n8 the Defaulting Member failed to contribute, which increase in the ownership percentage interest of the Contributing Members shall be allocated among the Contributing Members based on the existing ownership percentage interests held by the Contributing Members. However, a Defaulting Member shall have the right to negate an adjustment of ownership percentage interests under this section 7.5(d)(ii) pursuant to the provisions of section 7.5(g).

Section 7.5(e) states that in the event any Member makes a Guaranty Contribution, the other Members shall contribute their ownership percentage interest of the Guaranty Contribution to X (and X shall return a portion of the Guaranty Contribution to the Member making such Guaranty Contribution) within 20 days of receiving written notice from the Member making the Guaranty Contribution of the amount of the Guaranty Contribution and the amount due from such Members (the "Guaranty Contribution Demand Notice"). If a Member fails to contribute the amount required pursuant to this section 7.5(e) (a "Guaranty Contribution Defaulting Member") within 20 days of receipt of the Guaranty Contribution Demand Notice, then the Member making the Guaranty Contribution may elect one of the following remedies:

(i) The Member making the Guaranty Contribution may elect to loan to X the amount of the Guaranty Contribution Defaulting Member failed to contribute, which loan shall be treated as a loan to the Guaranty Contribution Defaulting Member and which shall bear interest at the rate of n9% per annum, compounded annually from the date of the Guaranty Contribution until the date the loan is repaid in full, and shall be payable out of any distributions to the Guaranty Contribution Defaulting Member (which payments shall be applied first to accrued interest on the loans, and then to the outstanding principal balance of the loans). If the Member making the Guaranty Contribution elects to make such a loan, the other non-defaulting Members shall be given a similar opportunity to make similar loans in accordance with their ownership percentage interest; or

(ii) The Member making the Guaranty Contribution may elect to adjust the ownership percentage interest of the Guaranty Contribution Defaulting Member by n7% by each $n10 a Guaranty Contribution Defaulting Member failed to contribute, and the ownership percentage interests of the Members who contributed their proportionate share in response to a Guaranty Contribution Demand Notice (the "Guaranty Contribution Contributing Members") shall increase n7% by each $n10 the Guaranty

> Contribution Defaulting Member failed to contribute, which increase in the ownership percentage interest of the Guaranty Contribution Contributing Members shall be allocated among the Guaranty Contribution Contributing Members. However, a Guaranty Contributing Defaulting Member shall have the right to negate an adjustment of ownership percentage interests under this section 7.5(e)(ii) pursuant to the provisions of section 7.5(g).

Section 7.5(f) of the Operating Agreement states that at any time when A or B has an adjusted contribution amount in relation to the combined amount of all Members' adjusted contribution amounts which is less than the ownership percentage interest of A or B, either A or B may make voluntary capital contributions to X, which capital contributions will be used to repay the capital contributions of the Members who have adjusted capital amounts in relation to the combined amount of all Members' adjusted contribution amounts which are greater than such Member's ownership percentage interest. Similarly, at any time C has made a C loan under section 7.5(b) or a default loan under section 7.5(d)(i), the creditor under such loan may repay such loan (with interest) at any time and thus discontinue the interest accrual thereunder. Finally, if the Members receive commissions or other fees generated in connection with the facilitation of a transaction in which X has an interest, and if C has an adjusted contribution amount which is greater than n11% of the combined amount of all Members' adjusted contribution amounts, C can require all Members to contribute the net after-tax proceeds from such commissions and fees to the capital of X (with such net after-tax amount calculated based on all foreign, national, state and local taxes associated with such commissions and fees).

Section 7.5(g) of the Operating Agreement states that a Member may negate the dilution of its ownership percentage interest under section 7.5(d)(ii) or section 7.5(e)(ii) if, within 12 months of the date of the Demand Notice or the Guaranty Contribution Demand Notice, as applicable, the defaulting Member or Guaranty Contribution Defaulting Member contributed to X the amount which would be due under section 7.5(d)(ii) or section 7.5(e)(ii) if the failure of such Member to make a contribution was treated as a loan under such sections. Under such circumstances, the dilution shall be negated, the prior contributions shall be treated as loans in accordance with section 7.5(d)(i) or section 7.5(d)(ii) [sic], as applicable, and such loans shall be repaid from the amounts contributed by the Defaulting Member or Guaranty Contribution Defaulting Member.

Section 7.7 of the Operating Agreement states that in the event any Member shall fail to contribute any cash or property when due hereunder, such Member shall remain liable therefor to X, which may institute proceedings in any court of competent jurisdiction in connection with which such Member shall pay the costs of such collection, including reasonable attorneys' fees. Any compromise or settlement with a Member failing to contribute cash or property due hereunder may be approved by the Manager.

Section 7.9 of the Operating Agreement states that in the event X's financing or other X undertakings whereby any Member of X elects or is required to become personally obligated (including execution of guarantees of indebtedness, non-recourse carve-out guarantees, environmental indemnities, etc.), the Members agree to enter into a contribution agreement pursuant to which all Members agree to allocate the risks of such personal obligations in accordance with their ownership percentage interests in X.[1]

A senior promissory note was executed in Year1 by some (but not all) of the subsidiaries of X as co-borrowers ("the senior promissory note"). The purpose of the funds borrowed under the senior promissory note (and the "mezzanine financing" discussed below) included acquiring and renovating real property used in the activity of Z and financing its operation. The senior promissory note is secured by a security trust agreement under the laws of Country; the security covers property constituting the activity of Z. The activity of Z includes the acquisition and renovation of two hotel properties in Country; the installation of furniture, fixtures, and equipment appropriate to improve the properties' use as hotels; and holding the hotel properties. Another entity (also owned by A, B, and C) is responsible for managing the hotel properties; it hired a hotel management company to conduct the day-to-day operation of the hotels comprising Z. Starting in Year1 and continuing through Year3, X owned the hotel properties used in the activity of Z.

The senior promissory note provides that Y will provide $n12 as of the date of closing, and will provide up to $n13 between the date the loan transaction closes and the date that the obligations under the senior promissory note mature.

C executed three personal guarantees of the senior promissory note, each subject to different terms. The first guarantee, entitled "Guaranty of Recourse Obligations," executed on Date, provides that C "hereby unconditionally, absolutely and irrevocably, as a primary obligor and not merely as a surety, guarantees to Lenders the punctual and complete payment of the entire amount of the Guaranteed Obligations upon demand by [Y, as agent for the Lenders]" (the "First Guarantee"). Section 1(b) of the First Guarantee provides that the term "Guaranteed Obligations" means, among other things, the entire outstanding principal amount of the Loan, together with all interest thereon and all other amounts due and payable under the Loan Documents in the event that:

(1) the co-borrowers fail to obtain the lender's consent before obtaining subordinate financing or transfer of the secured property,

(2) any co-borrower files a voluntary bankruptcy petition,

(3) any person in control of any co-borrower files an involuntary bankruptcy petition against a co-borrower,

[1] The taxpayer has not provided the examining agent with a separate contribution agreement and, for purposes of this analysis, we are assuming that no separate contribution agreement has been entered into pursuant to section 7.9 of X's Operating Agreement.

(4) any person in control of any co-borrower solicits other creditors to file an involuntary bankruptcy petition against a co-borrower,

(5) any co-borrower consents to or otherwise acquiesces or joins in an involuntary bankruptcy or insolvency proceeding,

(6) any person in control of any co-borrower consents to the appointment of a receiver or custodian of assets, or

(7) any co-borrower makes an assignment for the benefit of creditors, or admits in writing or in any legal proceeding that it is insolvent or unable to pay its debts as they come due.

The second guarantee, entitled "Required Amortization Guaranty," provides that C, "as a primary obligor and not merely as a surety," guarantees the punctual and complete payment of all required amortization payments under the promissory note, but in an amount not to exceed $n14. The required amortization payments represent amounts required to be paid as necessary to maintain minimum yields on the underlying obligation.

The third guarantee, a completion guarantee, provides that C will guarantee part of the $n13 "as a primary obligor and not merely as a surety." In addition, the third guarantee provides that C will personally guarantee repayment of any amounts expended to complete the renovation of Z. C's liability under the third guarantee will not be subject to, or limited by, any non-recourse provisions contained in the promissory note.

Also in Year1, some (but not all) of the subsidiaries of X executed two other promissory notes ("the Z mezzanine notes") in addition to the senior promissory note described above. The co-borrowers on the Z mezzanine notes are the same co-borrowers on the senior promissory note. The Z mezzanine notes are secured by security trust agreements under the laws of Country; the security covers property constituting the activity of Z. The Z mezzanine notes provide that Y will provide $n15 and $n16 for the first and second Z mezzanine notes, respectively. Both of the Z mezzanine notes are subject to guarantees ("Guaranty of Recourse Obligations" and "Required Amortization Guaranty") substantially similar to the first and second guarantees of the senior promissory note described above.

In Year2, the parties to the senior promissory note and the Z mezzanine notes amended the terms of the notes, deleting and releasing some co-borrowers from the notes. The loan modification agreements explicitly recites that all of the guarantees in effect with respect to the notes remain in effect. As of the end of Year3, none of the members of X have been called upon to make an additional capital contribution or a Guaranty Contribution to X in accordance with X's Operating Agreement, although C made a loan to X that remains outstanding.

In Year3, A claimed a pass-through loss for the current year as well as a pass-through net operating loss (NOL) deduction from X. A claims that he is entitled to the net operating loss deduction without limitation, because the business activity that generated the loss was funded with "Qualified Non-Recourse Financing" within the meaning of § 465(b)(6), and that C's First Guarantee for this debt should be disregarded for this purpose under § 1.752-2(b)(4) and § 1.465-27(b)(4)(i) because the First Guarantee is a "contingent" liability. There are no other amounts for which A could be considered at-risk with respect to the business activity of X within the meaning of § 465(b). Your request for advice asks whether A's deduction is allowable in Year3 in light of the basis limitations of § 704(d) and the at-risk limitations of § 465.

LAW AND ANALYSIS

Section 752 Basis

Section 704(d) provides that a partner's distributive share of partnership loss (including capital loss) shall be allowed only to the extent of the adjusted basis of such partner's interest in the partnership at the end of the partnership year in which such loss occurred. Any excess of such loss over such basis shall be allowed as a deduction at the end of the partnership year in which such excess is repaid to the partnership.

Section 722 provides that the basis of an interest in a partnership acquired by a contribution of property, including money, to the partnership shall be the amount of such money and the adjusted basis of such property to the contributing partner at the time of the contribution increased by the amount (if any) of gain recognized under § 721(b) to the contributing partner at such time.

Section 752(a) provides that any increase in a partner's share of the liabilities of a partnership, or any increase in a partner's individual liabilities by reason of the assumption by such partner of partnership liabilities, shall be considered as a contribution of money by such partner to the partnership.

Section 1.752-2(a) provides that a partner's share of a recourse partnership liability equals the portion of that liability, if any, for which the partner or related person bears the economic risk of loss. The determination of the extent to which a partner bears the economic risk of loss for a partnership liability is made under the rules in §§ 1.752-2(b) through (k).

Section 1.752-2(b)(1) provides generally that, except as otherwise provided, a partner bears the economic risk of loss for a partnership liability to the extent that, if the partnership constructively liquidated, the partner or related person would be obligated to make a payment to any person (or a contribution to the partnership) because that liability becomes due and payable and the partner or related person would not be entitled to reimbursement from another partner or person that is a related person to another partner. Upon a constructive liquidation, all of the following events are deemed to occur simultaneously --

(i) All of the partnership's liabilities become payable in full;
(ii) With the exception of property contributed to secure a partnership liability (see § 1.752-2(h)(2)), all of the partnership's assets, including cash, have a value of zero;
(iii) The partnership disposes of all of its property in a fully taxable transaction for no consideration (except relief from liabilities for which the creditor's right to repayment is limited solely to one or more assets of the partnership);
(iv) All items of income, gain, loss, or deduction are allocated among the partners; and
(v) The partnership liquidates.

Section 1.752-2(b)(3) provides that the determination of the extent to which a partner or related person has an obligation to make a payment under § 1.752-2(b)(1) is based on the facts and circumstances at the time of the determination. All statutory and contractual obligations relating to the partnership liability are taken into account for these purposes, including (i) contractual obligations outside the partnership agreement such as guarantees, indemnifications, reimbursement agreements, and other obligations running directly to creditors or other partners, or to the partnership; (ii) obligations to the partnership that are imposed by the partnership agreement, including the obligation to make a capital contribution and to restore a deficit capital account upon liquidation of the partnership, and (iii) payment obligations (whether in the form of direct remittances to another partner or a contribution to the partnership) imposed by state law, including the governing state partnership statute. To the extent that the obligation of a partner to make a payment with respect to a partnership liability is not recognized under § 1.752-2(b)(3), § 1.752-2(b) is applied as if the obligation does not exist.

Section 1.752-2(b)(4) provides that a payment obligation is disregarded if, taking into account all the facts and circumstances, the obligation is subject to contingencies that make it unlikely that the obligations will ever be discharged. If a payment obligation would arise at a future time after the occurrence of an event that is not determinable with reasonable certainty, the obligation is ignored until the event occurs.

As a threshold matter, a bona fide guarantee that is enforceable by the lender under local law generally will be sufficient to cause the guaranteeing partner to be treated as bearing the economic risk of loss for the guaranteed partnership liability for purposes of § 1.752-2(a). For purposes of § 1.752-2, we believe it is reasonable to assume that a third-party lender will take all permissible affirmative steps to enforce its rights under a guarantee if the primary obligor defaults or threatens to default on its obligations. In this case, we view the "conditions" listed in section 1(b) of the First Guarantee as circumstances under which the lender may enforce the guarantee to collect the entire outstanding balance on the loan, beyond an actual default by X on its obligations. As such, we do not believe these "conditions" are properly viewed as conditions precedent that must occur before Y is entitled to seek repayment from C under the guarantee.[2] In addition, we believe it is reasonable to assume that one or more of these conditions, more likely than not, would be met upon a constructive liquidation of X under § 1.752-2(b)(1). Accordingly, we believe that these "conditions" do not fall within the definition of "contingencies" as intended by § 1.752-2(b)(4).

For these reasons, we conclude that, for the purposes of §§ 704(d) and 752, and § 1.752-2(a), the promissory notes described above are recourse partnership liabilities allocable to the guaranteeing partner (C), and not to either A or B.

Section 465 At-Risk Amount

Section 465(a)(1) (by reference to § 465(c)(3)(A)) allows losses incurred by an individual engaged in a trade or business activity or an activity for the production of income only to the extent of the amount by which the individual is at risk (within the meaning of § 465(b)) for such activity at the close of the taxable year.

Section 465(b)(1) includes in a taxpayer's amount at risk for an activity (A) the amount of money and the adjusted basis of other property contributed by the taxpayer to the activity, and (B) amounts borrowed with respect to such activity (as determined under § 465(b)(2)).

Section 465(b)(2) includes amounts borrowed for use in an activity in a taxpayer's at-risk amount to the extent that he (A) is personally liable for the repayment of such amounts, or (B) has pledged property, other than property used in such activity, as security for such borrowed amount (to the extent of the net fair market value of the taxpayer's interest in such property). No property shall be taken into account as security if such property is directly or indirectly financed by indebtedness which is secured by property described in § 465(b)(1).

Section 465(b)(4) provides that, notwithstanding any other provision of § 465, a taxpayer shall not be considered at risk with respect to amounts protected against loss through nonrecourse financing, guarantees, stop loss agreements, or other similar arrangements.

Section 465(b)(6)(A) includes in a taxpayer's amount at risk the taxpayer's share of any qualified nonrecourse financing which is secured by real property used in such

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[2] According to the submission, it appears the taxpayer may assert that the various events listed in section 1(b) of the First Guarantee, upon the occurrence of which the First Guarantee will become immediately due and payable for the entire outstanding balance of the loan, are the only events under which the First Guarantee will become due and payable. It appears to us that a failure of X to repay the loan, by itself, likely would be sufficient to trigger the First Guarantee, as evidenced by the first sentence of section 1 of the First Guarantee. Assuming, arguendo, that the taxpayer's assertion is correct, we nevertheless believe that the likelihood that X or any other co-borrower will ever meet any one of these conditions, in the aggregate, is not so remote a possibility that would cause the obligation to be considered "likely to never be discharged" within the meaning of § 1.752-2(b)(4).

activity. Section 465(b)(6)(B) defines qualified nonrecourse financing as any financing (i) which is borrowed by the taxpayer with respect to the activity of holding real property, (ii) which is borrowed by the taxpayer from a qualified person or represents a loan from any Federal, State, or local government or instrumentality thereof, or is guaranteed by any Federal, State, or local government, (iii) except to the extent provided in regulations, with respect to which no person is personally liable for repayment, and (iv) which is not convertible debt.

Section 465(b)(6)(C) requires, in the case of a partnership, a partner to determine its share of partnership qualified nonrecourse financing on the basis of that partner's share of partnership liabilities incurred in connection with such financing (within the meaning of § 752).

Section 465(e)(1) requires taxpayers to include in gross income the amount by which zero exceeds a taxpayer's amount at risk in any activity at the close of any taxable year. An amount equal to the amount so included in gross income shall be treated as a deduction allocable to such activity for the first succeeding taxable year.

Section 1.465-27(b)(1) defines qualified nonrecourse financing, for purposes of § 465(b)(6), as financing (i) which is borrowed by the taxpayer with respect to the activity of holding real property; (ii) which is borrowed by the taxpayer from a qualified person or represents a loan from any federal, state, or local government or instrumentality thereof, or is guaranteed by any federal, state, or local government; (iii) for which no person is personally liable for repayment, taking into account § 1.465-27(b)(3), (4), and (5); and (iv) which is not convertible debt.

Section 1.465-27(b)(2)(i) provides that, for a taxpayer to be considered at risk under § 465(b)(6), qualified nonrecourse financing must be secured only by real property used in the activity of holding real property. For this purpose, however, property that is incidental to the activity of holding real property will be disregarded. In addition, for this purpose, property that is neither real property used in the activity of holding real property nor incidental property will be disregarded if the aggregate gross fair market value of such property is less than 10 percent of the aggregate gross fair market value of all the property securing the financing.

Section 1.465-27(b)(3) provides that if one or more persons are personally liable for repayment of a portion of a financing, the portion of the financing for which no person is personally liable may qualify as qualified nonrecourse financing.

Section 1.465-27(b)(4) provides that for purposes of § 465(b)(6), the personal liability of any partnership for repayment of a financing is disregarded and, provided the requirements contained in § 1.465-27(b)(1)(i), (ii), and (iv) are satisfied, the financing will be treated as qualified nonrecourse financing secured by real property if (i) the only persons personally liable to repay the financing are partnerships; (ii) each partnership with personal liability holds only property described in § 1.465-27(b)(2)(i) (applying the principles of § 1.465-27(b)(2)(ii) in determining the property held by each partnership); and (iii) in exercising its remedies to collect on the financing in a default or default-like situation, the lender may proceed only against property that is described in § 1.465-27(b)(2)(i) that is held by the partnership or partnerships (applying the principles of § 1.465-27(b)(2)(ii) in determining the property held by the partnership or partnerships).

Generally, a limited partner, in a limited partnership organized under state law, who guarantees partnership debt is not at risk with respect to the guaranteed debt, because the limited partner has a right to seek reimbursement from the partnership and the general partner for any amounts that the limited partner is called upon to pay under the guarantee. The limited partner is "protected against loss" within the meaning of § 465(b)(4) unless or until the limited partner has no remaining rights against the partnership or general partner for reimbursement of any amounts paid by the limited partner. To the extent that a general partner does not have a right of contribution or reimbursement under local law against any other partner for the debts of the partnership, the general partner is at risk for such debts under § 465(b)(2). The general partner's right to subrogation, reimbursement, or indemnification from the partnership's assets (and only the partnership's assets) does not protect the general partner against loss within the meaning of § 465(b)(4).

In the case of an LLC, all members have limited liability with respect to LLC debt. In the absence of any co-guarantors or other similar arrangement, an LLC member who guarantees LLC debt becomes personally liable for the guaranteed debt and more closely resembles a general partner with respect to the guaranteed debt. If called upon to pay under the guarantee, the guaranteeing member may seek recourse only against the LLC's assets, if any. As in the case of a general partner, a right to subrogation, reimbursement, or indemnification from the LLC (and only the LLC) does not protect the guaranteeing LLC member against loss within the meaning of § 465(b)(4). Therefore, in the case of an LLC treated as a partnership or disregarded entity for federal tax purposes, we conclude that an LLC member is at risk with respect to LLC debt guaranteed by such member, but only to the extent that

(1) the guaranteeing member has no right of contribution or reimbursement from other guarantors,

(2) the guaranteeing member is not otherwise protected against loss within the meaning of § 465(b)(4) with respect to the guaranteed amounts, and

(3) the guarantee is bona fide and enforceable by creditors of the LLC under local law.

As a general rule, LLC members may not include liabilities of the LLC in their at-risk amounts unless the members are personally liable for the debt as provided by

§ 465(b)(2)(A). Further, under § 465(b)(4), taxpayers are not at risk with respect to amounts protected against loss through nonrecourse financing. Section 465(b)(6)(A) creates an exception to these rules when a liability meets the definition of qualified nonrecourse financing. Under § 465(b)(6)(B)(iii), a liability is qualified nonrecourse financing only if no person is personally liable for repayment. When a member of an LLC treated as a partnership for federal tax purposes guarantees LLC qualified nonrecourse financing, the member becomes personally liable for that debt because the lender may seek to recover the amount of the debt from the personal assets of the guarantor. Because the guarantor is personally liable for the debt, the debt is no longer qualified nonrecourse financing as defined in § 465(b)(6)(B) and § 1.465-27(b)(1). Further, because the creditor may proceed against the property of the LLC securing the debt, or against any other property of the guarantor member, the debt also fails to satisfy the requirement in § 1.465-27(b)(2)(i) that qualified nonrecourse financing must be secured only by real property used in the activity of holding real property.

It should be noted that this conclusion generally will not be affected by a determination that the guarantee is a “contingent” liability within the meaning of § 1.752-2(b)(4). Instead, the question is simply whether the guarantee is sufficient to cause the guarantor to be considered personally liable for repayment of the debt, based on all the facts and circumstances, within the meaning of § 465(b)(6)(B)(iii). In this case, we believe the First Guarantee is sufficient for this purpose.

When the debt is no longer qualified nonrecourse financing due to a guarantee of that debt, the non-guaranteeing members of the LLC who previously included a portion of the qualified nonrecourse financing in their amount at risk and who have not guaranteed any portion of the debt may no longer include any amount of the debt in determining their amount at risk. Any reduction that causes an LLC member’s at-risk amount to fall below zero will trigger recapture of losses under § 465(e). The at-risk amount of the LLC member that guarantees LLC debt is increased, but only to the extent such debt was not previously taken into account by that member, the guaranteeing member has no right of contribution or reimbursement from other guarantors, the guaranteeing member is not otherwise protected against loss within the meaning of § 465(b)(4) with respect to the guaranteed amounts, and the guarantee is bona fide and enforceable by creditors of the LLC under local law.

In this case, we conclude that, for the purposes of § 465(b)(6)(B)(iii) and § 1.465-27(b)(1)(iii), the First Guarantee described above is sufficient to cause the guaranteeing partner, C, to be considered personally liable for the guaranteed debt obligations of X. Accordingly, the guaranteed debt obligations of X will no longer qualify as “Qualified Non-Recourse Financing” within the meaning of § 465(b)(6)(B) and § 1.465-27. A and B, as non-guaranteeing members of X, will not be considered at-risk with respect to any such amounts as a consequence of the First Guarantee.

Guarantor’s Remedies Under Section 7.5(e) of the Operating Agreement

The taxpayer has presented an alternative argument that, even if the First Guarantee is respected as a full and bona fide guarantee that will cause C to be treated as personally liable for the guaranteed debt of X for purposes of § 1.752-2(a) and § 465(b)(6)(B)(iii), section 7.5(e) of X's Operating Agreement nevertheless operates to cause A and B to be treated as personally liable (i.e., to bear the ultimate economic risk of loss for purposes of § 752, and to be payors of last resort in a worst case scenario for purposes of § 465) with respect to their proportionate share of the guaranteed debt, because A and B are obligated under that provision to reimburse C in proportionate amounts for any payments that C makes under the guarantees. For the reasons discussed below, we disagree with this contention.

Section 1.752-2(b)(4) provides that a payment obligation is disregarded if, taking into account all the facts and circumstances, the obligation is subject to contingencies that make it unlikely that the obligations will ever be discharged. If a payment obligation would arise at a future time after the occurrence of an event that is not determinable with reasonable certainty, the obligation is ignored until the event occurs.

Section 1.752-2(b)(5) provides that a partner's or related person's obligation to make a payment with respect to a partnership liability is reduced to the extent that the partner or related person is entitled to reimbursement from another partner or a person who is a related person to a partner.

Section 1.752-2(b)(6) provides that for purposes of determining the extent to which a partner or related person has a payment obligation and the economic risk of loss, it is assumed that all partners and related persons who have obligations to make payments actually perform those obligations, irrespective of their actual net worth, unless the facts and circumstances indicate a plan to circumvent or avoid the obligation.

Section 1.752-2(j)(1) provides that an obligation of a partner or related person to make a payment may be disregarded or treated as an obligation of another person for purposes of § 1.752-2 if facts and circumstances indicate that a principal purpose of the arrangement between the parties is to eliminate the partner's economic risk of loss with respect to that obligation or create the appearance of the partner or related person bearing the economic risk of loss when, in fact, the substance of the arrangement is otherwise. Circumstances with respect to which a payment obligation may be disregarded include, but are not limited to, the situations described in §§ 1.752-2(j)(2) and (j)(3).

Section 1.752-2(j)(3) provides that an obligation of a partner to make a payment is not recognized if the facts and circumstances evidence a plan to circumvent or avoid the obligation.

Section 465(b)(3)(A) provides that, except as otherwise provided in regulations, for purposes of § 465(b)(1), amounts borrowed shall not be considered at risk with respect to an activity if such amounts are borrowed from any person who has an interest in such an activity or from a related person to a person (other than the taxpayer) having such an interest.

Section 465(b)(4) provides that, notwithstanding any other provision of § 465, a taxpayer shall not be considered at risk with respect to amounts protected against loss through nonrecourse financing, guarantees, stop loss agreements, or other similar arrangements.

With respect to § 465, no temporary or final regulations exist that provide rules for determining when taxpayers will be considered personally liable with respect to partnership debt subject to guarantees, including guarantees that may contain certain reimbursement rights. Nevertheless, the following case law provides helpful guidance in applying § 465.

In Pritchett v. Comm'r, 85. T.C. 581 (1985), rev'd and remanded, 827 F.2d 644 (9th Cir. 1987), the taxpayers were limited partners in an oil and gas drilling operation, and they claimed deductions for losses in excess of their cash contributions to the partnership. The taxpayers argued that under the partnership agreement, they were "at risk" for partnership liabilities held by a drilling company that was responsible for developing the oil and gas fields. Under the contract the creditor would receive a portion of profits from the drilling operation. While general partners were the only parties personally liable, under the partnership agreement the general partners were given the right to call on the limited partners to make a capital contribution if the notes issued by the partnership remained unpaid upon their maturity date. The Service argued that the liability was contingent and that the taxpayers were only at risk once general partners called upon them to make a contribution. The Tax Court agreed with this analysis. Upon appeal, the Ninth Circuit held that the contractual obligations of the limited partners under the partnership agreement made them ultimately responsible for the debt. While the Commissioner argued that the liability was contingent simply because the general partners could elect to not make the cash calls, the Ninth Circuit did not agree. The Ninth Circuit determined that the cash calls were mandatory under the partnership agreements and that "economic reality" dictated that the general partners would make the calls.

In Melvin v. Comm'r, 88 T.C. 63 (1987), aff'd, 894 F.2d 1072 (9th Cir. 1990), the general partnership in which the taxpayer was a partner invested in a limited partnership. In payment for its limited partnership interest, the general partnership paid $35,000 cash and agreed to make additional capital contributions of $70,000. The obligation to make the additional capital contributions was evidenced by a $70,000 recourse promissory note. The taxpayer's share of the note was $50,000. The limited partnership obtained a $3,500,000 recourse loan from a bank and pledged partnership assets to the bank, including the $70,000 note along with other limited partner notes, as security. These notes were subsequently physically transferred to the bank. The court concluded that the taxpayer was at risk on the $3,500,000 loan to the extent of his pro rata share thereof. In reaching it conclusion the court reasoned that "a partner will be regarded as personally liable within the meaning of § 465(b)(2)(A) if he has the ultimate liability to repay the debt obligation of the partnership in the event funds from the partnership's assets are not available for that purpose. The relevant question is who, if anyone, will ultimately be obligated to pay the partnership's recourse obligations if the partnership is unable to do so. It is not relevant that the partnership MAY be able to do so. The scenario that controls is the worst-case scenario, not the best case." Melvin, 88 T.C. at 75 (citations omitted).

We believe that Pritchett and Melvin stand for the proposition that the relevant inquiries when dealing with guarantees of partnership debt, for purposes of § 465, are whether the guarantee causes the guaranteeing partner to become the "payor of last resort in a worst case scenario" for the partnership debt, given the "economic realities" of the particular situation, and whether the guarantor possesses any "mandatory" rights to contribution, reimbursement, or subordination with respect to any other parties, as a result or consequence of paying on the guarantee, that would cause these other parties to be considered the "payors of last resort in a worst case scenario" with respect to that debt.

We do not agree with the taxpayer's interpretation of X's Operating Agreement. We do not believe section 7.5(e) of the Operating Agreement imposes a mandatory payment obligation on A and B to make additional contributions to X if C is called upon to pay on C's personal guarantees. Rather, section 7.5(e) permits C to call for additional capital from A and B, but if A and/or B chooses not to contribute additional capital, C's remedies are limited to the remedies identified in paragraphs (i) and (ii) of that section. As a result, we do not believe the Operating Agreement gives C the right to bring an action against A and B to require them to contribute additional capital to X if they choose not to. Further, because we believe C's remedies are limited to paragraphs (i) and (ii) of section 7.5(e) if C calls for additional capital contributions from A and B if C is required to pay on C's personal guarantee, we believe section 7.7 of the Operating Agreement is not applicable. In addition, because a separate contribution agreement was not entered into by the parties, section 7.9 is also inapplicable. Accordingly, because neither remedy available to C under section 7.5(e) requires A or B to make additional contributions to X if C is called upon to pay on C's personal guarantees, we conclude that A and B do not bear the ultimate economic risk of loss for the guaranteed debt of X for purposes of § 752.

Moreover, for purposes of § 465, we believe the facts of this case are distinguishable from those in Pritchett. Since X's Operating Agreement does not require A and B to make additional capital contributions to X, it does not appear that "economic reality" would dictate that X or C *must* require A and B to make additional contributions to X if C is required to pay on C's personal guarantees. Accordingly, we conclude that A and B are not "payors of last resort in a worst case scenario," as discussed in Pritchett and Melvin, and A and B are not currently at risk with respect to the guaranteed debt of X for purposes of § 465.

It appears that the taxpayer interprets X's Operating Agreement as giving C an enforceable right to require A and B to make additional contributions to X, in addition to the specific remedies provided in paragraphs (i) and (ii) of section 7.5(e) of the Operating Agreement. As noted above, we do not agree with this interpretation of the Operating Agreement. Nevertheless, even if the taxpayer's interpretation of the Operating Agreement is ultimately determined to be correct, we still conclude that the taxpayer is not allocated basis under § 752 and is not at risk under § 465 with respect to the guaranteed debt.

We reach this conclusion because we view the requirement for A and B to make additional capital contributions to X as a contingent liability within the meaning of § 1.752-2(b)(4). Because C may choose alternate remedies that would not cause A or B to be viewed as bearing the ultimate economic risk of loss for the guaranteed debt of X, we believe these alternate remedies are properly viewed as contingencies that make it unlikely that any payment obligations of A or B would ever be discharged. In addition, we believe these remedies may also be viewed as future events that cause the payment obligations of A and B to be "not determinable with reasonable certainty" and cause the obligations to be ignored until A and B are actually required to make payments to X, for purposes of § 1.752-2(b)(4).[3]

In addition, for purposes of § 465, even if we view C as having an enforceable right to require A and B to make additional contributions to X in addition to the other remedies available in section 7.5(e) of X's Operating Agreement, we believe that the facts of this case would continue to be distinguishable from those in Pritchett. In this case, C has been provided with alternate remedies under section 7.5(e) of X's Operating Agreement if A and B choose not to make additional contributions to X under this provision. As a result, it appears that the requirement for A and B to make additional contributions under this provision is not a "mandatory" requirement, since C may elect to use these alternate remedies rather than have X enforce the Operating Agreement under the default provision of section 7.7. Therefore, it does not appear that "economic reality" would dictate that X or C *must* enforce the Operating Agreement under section 7.7 in a court proceeding against A and B in such circumstances. Accordingly, we conclude that A and B are not "payors of last resort in a worst case scenario", as discussed in Pritchett and Melvin, and therefore A and B are not currently at risk with respect to the guaranteed debt of X for purposes of § 465.

We would further note that, to the extent that C may elect to use the remedy described in section 7.5(e)(i) of X's Operating Agreement, in which C may treat the

[3] We believe that one or more arguments may also be made under §1.752-2(j) in this case, depending on further factual development. [redacted]

amount of a Guaranty Contribution that a defaulting member failed to contribute as a loan to the defaulting member, such "loan" would appear to be subject to the related-party rule of § 465(b)(3)(A). Under the remedy of section 7.5(e)(i), A and B would be viewed as borrowing money from C with respect to the activity of X, at a time when C also possesses an ownership interest in the activity. Accordingly, A and B would not be considered at risk with respect to such amounts pursuant to § 465(b)(3)(A) under this scenario.

Of course, if a payment obligation does arise in the future which requires A and B to make a payment to X, A and B would properly be viewed as making contributions to X at that time, for purposes of §§ 722, 704(d) and 465(b)(1)(A).

In conclusion, because A and B do not have a mandatory obligation to make additional capital contributions to the X, regardless of which interpretation of X's Operating Agreement is ultimately determined to be correct, A and B do not bear the ultimate economic risk of loss for purposes of § 752, and A and B are not the payors of last resort in a worst case scenario for purposes of § 465.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

[redacted]

[redacted]

[redacted]

Please call (202) 317-6852 if you have any further questions.

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Significant Private Letter Rulings for Government Relations Committee Meeting Discussion

1. PLRs 201527012 and 201527013 (counteracting hedges will not constitute gross income for REIT gross income tests)

2. PLR 201530014 (section 857(d)(3) applies to a liquidating distribution by a REIT to its shareholders)(

3. PLR 201609004 (sale of REIT's assets pursuant to a plan of liquidation will not constitute prohibited transactions)

[JOINT COMMITTEE PRINT]

GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN 2015

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

MARCH 2016

JCS–1–16

pitalization. Accordingly, the collection period expires 10 years after assessment, plus the actual time spent in a combat zone, regardless of the length of the postponement period available for hospitalized taxpayers to comply with their tax obligations.

Effective Date

The provision applies to taxes assessed before, on, or after the date of the enactment (December 18, 2015).

B. Real Estate Investment Trusts

Overview

In general

A real estate investment trust ("REIT") is an entity that otherwise would be taxed as a U.S. corporation but elects to be taxed under a special REIT tax regime. To qualify as a REIT, an entity must meet a number of requirements. At least 90 percent of REIT income (other than net capital gain) must be distributed annually;[848] the REIT must derive most of its income from passive, generally real estate-related, investments; and REIT assets must be primarily real estate-related. In addition, a REIT must have transferable interests and at least 100 shareholders, and no more than 50 percent of the REIT interests may be owned by five or fewer individual shareholders (as determined using specified attribution rules). Other requirements also apply.[849]

If an electing entity meets the requirements for REIT status, the portion of its income that is distributed to its shareholders as a dividend or qualifying liquidating distribution each year is deductible by the REIT (whereas a regular subchapter C corporation cannot deduct such distributions).[850] As a result, the distributed income of the REIT is not taxed at the entity level; instead, it is taxed only at the investor level. Although a REIT is not required to distribute more than the 90 percent of its income described above to retain REIT status, it is taxed at ordinary corporate rates on amounts not distributed or treated as distributed.[851]

A REIT may designate a capital gain distribution to its shareholders, who treat the designated amount as long-term capital gain when distributed. A REIT also may retain net capital gain and pay corporate income tax on the amount retained, while the shareholders include the undistributed capital gain in income, obtain a credit for the corporate tax paid, and step up the basis of their

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[848] Even if a REIT meets the 90-percent income distribution requirement for REIT qualification, more stringent distribution requirements must be met in order to avoid an excise tax under section 4981.

[849] Secs. 856 and 857.

[850] Liquidating distributions are covered to the extent of earnings and profits, and are defined to include redemptions of stock that are treated by shareholders as a sale of stock under section 302. Secs. 857(b)(2)(B), 561, and 562(b).

[851] An additional four-percent excise tax is imposed to the extent a REIT does not distribute at least 85 percent of REIT ordinary income and 95 percent of REIT capital gain net income within a calendar year period. In addition, to the extent a REIT distributes less than 100 percent of its ordinary income and capital gain net income in a year, the difference between the amount actually distributed and 100 percent is added to the distribution otherwise required in a subsequent year to avoid the excise tax. Sec. 4981.

REIT stock for the amount included in income.[852] In this manner, capital gain also is taxed only once, whether or not distributed, rather than at both the entity and investor levels.

Income tests

A REIT is restricted to earning certain types of generally passive income. Among other requirements, at least 75 percent of the gross income of a REIT in each taxable year must consist of real estate-related income. Such income includes: rents from real property; gain from the sale or other disposition of real property (including interests in real property) that is not stock in trade of the taxpayer, inventory, or other property held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business; interest on mortgages secured by real property or interests in real property; and certain income from foreclosure property (the "75-percent income test").[853] Qualifying rents from real property include rents from interests in real property and charges for services customarily furnished or rendered in connection with the rental of real property,[854] but do not include impermissible tenant service income.[855] Impermissible tenant service income includes amounts for services furnished by the REIT to tenants or for managing or operating the property, other than amounts attributable to services that are provided by an independent contractor or taxable REIT subsidiary, or services that certain tax exempt organizations could perform under the section 512(b)(3) rental exception from unrelated business taxable income.[856] Qualifying rents from real property include rent attributable to personal property which is leased under, or in connection with, a lease of real property, but only if the rent attributable to such personal property for the taxable year does not exceed 15 percent of the total rent for the taxable year attributable to both the real and personal property leased under, or in connection with, the lease.[857]

In addition, rents received from any entity in which the REIT owns more than 10 percent of the vote or value generally are not qualifying income.[858] However, there is an exception for certain rents received from taxable REIT subsidiaries (described further below), in which a REIT may own more than 10 percent of the vote or value.

In addition, 95 percent of the gross income of a REIT for each taxable year must be from the 75-percent income sources and a sec-

[852] Sec. 857(b)(3).

[853] Secs. 856(c)(3) and 1221(a)(1). Income from sales that are not prohibited transactions solely by virtue of section 857(b)(6) also is qualified REIT income.

[854] Sec. 856(d)(1)(A) and (B).

[855] Sec. 856(d)(2)(C).

[856] Sec. 856(d)(7)(A) and (C). If impermissible tenant service income with respect to any real or personal property is more than one percent of all amounts received or accrued during the taxable year directly or indirectly with respect to such property, then the impermissible tenant service income with respect to such property includes all such amounts. Sec. 856(d)(7)(B). The amount treated as received for any service (or management or operation) shall not be less than 150 percent of the direct cost of the trust in furnishing or rendering the service (or providing the management or operation). Sec. 856(d)(7)(D). For purposes of the 75-percent and 95-percent income tests, impermissible tenant service income is included in gross income of the REIT. Sec. 856(d)(7)(E).

[857] Sec. 856(d)(1)(C).

[858] Sec. 856(d)(2)(B).

ond permitted category of other, generally passive sources such as dividends and interest (the "95-percent income test").[859]

A REIT must be a U.S. domestic entity, but it is permitted to hold foreign real estate or other foreign assets, provided the 75-percent and 95-percent income tests and the other requirements for REIT qualification are met.[860]

Asset tests

At least 75 percent of the value of a REIT's assets must be real estate assets, cash and cash items (including receivables), and Government securities[861] (the "75-percent asset test").[862] Real estate assets are real property (including interests in real property and interests in mortgages on real property) and shares (or transferable certificates of beneficial interest) in other REITs.[863] No more than 25 percent of a REIT's assets may be securities other than such real estate assets.[864]

Except with respect to securities of a taxable REIT subsidiary, not more than five percent of the value of a REIT's assets may be securities of any one issuer, and the REIT may not possess securities representing more than 10 percent of the outstanding value or voting power of any one issuer.[865] In addition, not more than 25 percent of the value of a REIT's assets may be securities of one or more taxable REIT subsidiaries.[866]

The asset tests must be met as of the close of each quarter of a REIT's taxable year. However, a REIT that has met the asset tests as of the close of any quarter does not lose its REIT status solely because of a discrepancy during a subsequent quarter between the value of the REIT's investments and such requirements, unless such discrepancy exists immediately after the acquisition of any security or other property and is wholly or partly the result of such acquisition.[867]

Taxable REIT subsidiaries

A REIT generally cannot own more than 10 percent of the vote or value of a single entity. However, there is an exception for ownership of a taxable REIT subsidiary ("TRS") that is taxed as a corporation, provided that securities of one or more TRSs do not represent more than 25 percent of the value of REIT assets.

A TRS generally can engage in any kind of business activity except that it is not permitted directly or indirectly to operate either a lodging facility or a health care facility, or to provide to any other person (under a franchise, license, or otherwise) rights to any

[859] Sec. 856(c)(2).

[860] See Rev. Rul. 74–191, 1974–1 C.B. 170.

[861] Government securities are defined for this purpose under section 856(c)(5)(F), by reference to the Investment Company Act of 1940. The term includes securities issued or guaranteed by the United States or persons controlled or supervised by and acting as an instrumentality thereof, but does not include securities issued or guaranteed by a foreign, state, or local government entity or instrumentality.

[862] Sec. 856(c)(4)(A).

[863] Temporary investments in certain stock or debt instruments also can qualify if they are temporary investments of new capital, but only for the one-year period beginning on the date the REIT receives such capital. Sec. 856(c)(5)(B).

[864] Sec. 856(c)(4)(B)(i).

[865] Sec. 856(c)(4)(B)(iii).

[866] Sec. 856(c)(4)(B)(ii).

[867] Sec. 856(c)(4). In the case of such an acquisition, the REIT also has a grace period of 30 days after the close of the quarter to eliminate the discrepancy.

brand name under which any lodging facility or health care facility is operated.[868]

However, a TRS may rent a lodging facility or health care facility from its parent REIT and is permitted to hire an independent contractor[869] to operate such facility. Rent paid to the parent REIT by the TRS with respect to hotel, motel, or other transient lodging facility operated by an independent contractor is qualified rent for purposes of the REIT's 75-percent and 95-percent income tests.[870] This lodging facility rental rule is an exception to the general rule that rent paid to a REIT by any corporation (including a TRS) in which the REIT owns 10 percent or more of the vote or value is not qualified rental income for purposes of the 75-percent or 95-percent REIT income tests.[871] There is also an exception to the general rule in the case of a TRS that rents space in a building owned by its parent REIT if at least 90 percent of the space in the building is rented to unrelated parties and the rent paid by the TRS to the REIT is comparable to the rent paid by the unrelated parties.[872]

REITs are subject to a tax equal to 100 percent of redetermined rents, redetermined deductions, and excess interest. These are defined generally as the amounts of specified REIT transactions with a TRS of the REIT, to the extent such amounts differ from an arm's length amount.[873]

Prohibited transactions tax

REITs are subject to a prohibited transaction tax ("PTT") of 100 percent of the net income derived from prohibited transactions. For this purpose, a prohibited transaction is a sale or other disposition of property by the REIT that is "stock in trade of a taxpayer or other property which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held for sale to customers by the taxpayer in the ordinary course of his trade or business"[874] and is not foreclosure property. The PTT for a REIT does not apply to a sale if the REIT satisfies certain safe harbor requirements in section 857(b)(6)(C) or (D), including an asset holding period of at least two years.[875] If the conditions are met, a REIT may either (1) make no more than seven sales within a taxable year (other than sales of foreclosure property or involuntary conversions under section 1033), or (2) sell either no more than 10 percent of the aggregate bases, or no more than 10

[868] The latter restriction does not apply to rights provided to an independent contractor to operate or manage a lodging or health care facility if such rights are held by the corporation as a franchisee, licensee, or in similar capacity and such lodging facility or health care facility is either owned by such corporation or is leased by such corporation from the REIT. Sec. 856(l)(3).

[869] An independent contractor will not fail to be treated as such for this purpose because the TRS bears the expenses of operation of the facility under the contract, or because the TRS receives the revenues from the operation of the facility, net of expenses for such operation and fees payable to the operator pursuant to the contract, or both. Sec. 856(d)(9)(B).

[870] Sec. 856(d)(8)(B).

[871] Sec. 856(d)(2)(B).

[872] Sec. 856(d)(8)(A).

[873] Sec. 857(b)(7).

[874] This definition is the same as the definition of certain property the sale or other disposition of which would produce ordinary income rather than capital gain under section 1221(a)(1).

[875] Additional requirements for the safe harbor limit the amount of expenditures the REIT can make during the two-year period prior to the sale that are includible in the adjusted basis of the property, require marketing to be done by an independent contractor, and forbid a sales price that is based on the income or profits of any person.

percent of the aggregate fair market value, of all its assets as of the beginning of the taxable year (computed without regard to sales of foreclosure property or involuntary conversions under section 1033), without being subject to the PTT tax.[876]

REIT shareholder tax treatment

Although a REIT typically does not pay corporate level tax due to the deductible distribution of its income, and thus is sometimes compared to a partnership or S corporation, REIT equity holders are not treated as being engaged in the underlying activities of the REIT as are partners or S corporation shareholders, and the activities at the REIT level that characterize its income do not generally flow through to equity owners to characterize the tax treatment of REIT distributions to them. A distribution to REIT shareholders out of REIT earnings and profits is generally treated as an ordinary income REIT dividend and is treated as ordinary income taxed at the shareholder's normal rates on such income.[877] However, a REIT is permitted to designate a "capital gain dividend" to the extent a distribution is made out of its net capital gain.[878] Such a dividend is treated as long-term capital gain to the shareholders.[879]

REIT shareholders are not taxed on REIT income unless the income is distributed to them (except in the case of REIT net capital gain retained by the REIT and designated for inclusion in the shareholder's income as explained in the preceding footnote). However, since a REIT must distribute 90 percent of its ordinary income annually, and typically will distribute or designate its income as capital gain dividends to avoid a tax at the REIT level, REIT income generally is taxed in full at the shareholder level annually.

REIT shareholders are not entitled to any share of REIT losses to offset against other shareholder income. However, if the REIT itself has income, its losses offset its income in determining how much it is required to distribute to meet the distribution requirements. Also, REIT losses that reduce earnings and profits can cause a distribution that exceeds the REIT's earnings and profits to be treated as a nontaxable return of capital to its shareholders.

Tax exempt shareholders

A tax exempt shareholder is exempt from tax on REIT dividends, and is not treated as engaging in any of the activities of the REIT. As one example, if the REIT borrowed money and its income at the REIT level were debt-financed, a tax exempt shareholder would not

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[876] Sec. 857(b)(6).

[877] Because a REIT dividend is generally paid out of income that was not taxed to the distributing entity, the dividend is not eligible for the dividends received deductions to a corporate shareholder. Sec. 243(d)(3). A REIT dividend is not eligible for the 20 percent qualified dividend rate to an individual shareholder, except to the extent such dividend is attributable to REIT income from nondeductible C corporation dividends, or to certain income of the REIT that was subject to corporate level tax. Sec. 857(c).

[878] Sec. 857(b)(3)(C). Net capital gain is the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for the taxable year. Sec. 1222.

[879] A REIT may also retain its net capital gain without distribution, while designating a capital gain dividend for inclusion in shareholder income. In this case, the REIT pays corporate-level tax on the capital gain, but the shareholder includes the undistributed capital gain in income, receives a credit for the corporate level tax paid, and steps up the basis of the REIT stock for the amount included in income, with the result that the net tax paid is the shareholder-level capital gain tax. Sec. 857(b)(3)(D).

have debt-financed unrelated business income from the REIT dividend.

Foreign shareholders

Except as provided by the Foreign Investment in Real Property Tax Act of 1980 ("FIRPTA"),[880] a REIT shareholder that is a foreign corporation or a nonresident alien individual normally treats its dividends as fixed and determinable annual and periodic income that is subject to withholding under section 1441 but not treated as active business income that is effectively connected with the conduct of a U.S. trade or business, regardless of the level of real estate activity of the REIT in the United States.[881] A number of treaties permit a lower rate of withholding on REIT dividends than the Code would otherwise require.

Although FIRPTA applies in many cases to foreign investment in U.S. real property through a REIT, REITs offer foreign investors some ability to invest in U.S real property interests without subjecting gain on the sale of REIT stock to FIRPTA (for example, if the REIT is domestically controlled).[882] In general, if any class of stock of a corporation is regularly traded on an established securities market, stock of such class is subject to FIRPTA only in the case of a person who, at some time during the testing period, held more than 5 percent of such class of stock.[883] Also, if the REIT stock is publicly traded and the foreign investor does not own more than five percent of such stock, the investor can receive distributions from the sale by the REIT of U.S. real property interests without such distributions being subject to FIRPTA.[884]

1. Restriction on tax-free spinoffs involving REITs (sec. 311 of the Act and secs. 355 and 856 of the Code)

Present Law

A corporation generally is required to recognize gain on the distribution of property (including stock of a subsidiary) to its shareholders as if the corporation had sold such property for its fair market value.[885] In addition, the shareholders receiving the distributed property are ordinarily treated as receiving a dividend equal to the value of the distribution (to the extent of the distributing corporation's earnings and profits),[886] or capital gain in the case of an acquisition of its stock that significantly reduces the shareholder's interest in the parent corporation.[887]

An exception to these rules applies if the distribution of the stock of a controlled corporation satisfies the requirements of section 355.

[880] Pub. L. No. 96–499. FIRPTA treats income of a foreign investor from the sale or disposition of U.S. real property interests as effectively connected with the operation of a trade or business in the United States. Such income is taxed at regular U.S. rates and withholding obligations are imposed on payors of the income. Secs. 897 and 1445.

[881] As noted above, REITs are not permitted to receive income from property that is inventory or that is held for sale to customers in the ordinary course of the REIT's business. However, REITs may engage in certain activities, including acquisition, development, lease, and sale of real property, and may provide "customary services" to tenants.

[882] Sec. 897(h)(2).

[883] Sec. 897(c)(3).

[884] Sec. 897(h)(1).

[885] Sec. 311(b).

[886] Sec. 301(b)(1) and (c)(1).

[887] Sec. 302(a) and (b)(2).

If all the requirements are satisfied, there is no tax to the distributing corporation or to the shareholders on the distribution.

One requirement to qualify for tax-free treatment under section 355 is that both the distributing corporation and the controlled corporation must be engaged immediately after the distribution in the active conduct of a trade or business that has been conducted for at least five years and was not acquired in a taxable transaction during that period (the "active business test").[888]

For this purpose, the active business test is satisfied only if (1) immediately after the distribution, the corporation is engaged in the active conduct of a trade or business, or (2) immediately before the distribution, the corporation had no assets other than stock or securities in the controlled corporations and each of the controlled corporations is engaged immediately after the distribution in the active conduct of a trade or business.[889] For this purpose, the active business test is applied by reference to the relevant affiliated group rather than on a single corporation basis. For the parent distributing corporation, the relevant affiliated group consists of the distributing corporation as the common parent and all corporations affiliated with the distributing corporation through stock ownership described in section 1504(a)(1) (regardless of whether the corporations are otherwise includible corporations under section 1504(b)),[890] immediately after the distribution. The relevant affiliated group for a controlled distributed subsidiary corporation is determined in a similar manner (with the controlled corporation as the common parent).

In determining whether a corporation is directly engaged in an active trade or business that satisfies the requirement, IRS ruling practice formerly required that the value of the gross assets of the trade or business being relied on must ordinarily constitute at least five percent of the total fair market value of the gross assets of the corporation directly conducting the trade or business.[891] The IRS suspended this specific rule in connection with its general administrative practice of moving IRS resources away from advance rulings on factual aspects of section 355 transactions in general.[892]

Section 355 does not apply to an otherwise qualifying distribution if, immediately after the distribution, either the distributing or the controlled corporation is a disqualified investment corporation and any person owns a 50 percent interest in such corporation and did not own such an interest before the distribution. A disqualified investment corporation is a corporation of which two-thirds or more

[888] Sec. 355(b).

[889] Sec. 355(b)(1).

[890] Sec. 355(b)(3).

[891] Rev. Proc. 2003–3, sec. 4.01(30), 2003–1 I.R.B. 113.

[892] Rev. Proc. 2003–48, 2003–29 I.R.B. 86. Since then, the IRS discontinued private rulings on whether a transaction generally qualifies for nonrecognition treatment under section 355. Nonetheless, the IRS may still rule on certain significant issues. See Rev. Proc. 2016–1, 2016–1 I.R.B. 1; Rev. Proc. 2016–3, 2016–1 I.R.B. 126. Recently, the IRS announced that it will not rule in certain situations in which property owned by any distributing or controlled corporation becomes the property of a RIC or a REIT; however, the IRS stated that the policy did not extend to situations in which, immediately after the date of the distribution, both the distributing and controlled corporation will be RICs, or both of such corporations will be REITs, and there is no plan or intention on the date of the distribution for either the distributing or the controlled corporation to cease to be a RIC or a REIT. See Rev. Proc. 2015–43, 2015–40 I.R.B. 467.

of its asset value is comprised of certain passive investment assets. Real estate is not included as such an asset.[893]

The IRS has ruled that a REIT may satisfy the active business requirement through its rental activities.[894] More recently, the IRS has issued a private ruling indicating that a REIT that has a TRS can satisfy the active business requirement by virtue of the active business of its TRS.[895] Thus, a C corporation that owns REIT-qualified assets may create a REIT to hold such assets and spin off that REIT without tax consequences to it or its shareholders (if the newly-formed REIT satisfies the active business requirement through its rental activities or the activities of a TRS). Following the spin-off, income from the assets held in the REIT is no longer subject to corporate level tax (unless there is a disposition of such assets that incurs tax under the built in gain rules).

Explanation of Provision

The provision makes a REIT generally ineligible to participate in a tax-free spin-off as either a distributing or controlled corporation under section 355. There are two exceptions, however. First, the general rule does not apply if, immediately after the distribution, both the distributing and the controlled corporations are REITs.[896] Second, a REIT may spin off a TRS if (1) the distributing corporation has been a REIT at all times during the 3-year period ending on the date of the distribution, (2) the controlled corporation has been a TRS of the REIT at all times during such period, and (3) the REIT has had control (as defined in section 368(c)[897] applied by taking into account stock owned directly or indirectly, including through one or more partnerships, by the REIT) of the TRS at all times during such period. For this purpose, control of a partnership means ownership of at least 80 percent of the profits interest and at least 80 percent of the capital interests.

A controlled corporation will be treated as meeting the control requirements if the stock of such corporation was distributed by a TRS in a transaction to which section 355 (or so much of section 356 as relates to section 355) applies and the assets of such corporation consist solely of the stock or assets held by one or more TRSs of the distributing corporation meeting the control requirements noted above.

If a corporation that is not a REIT was a distributing or controlled corporation with respect to any distribution to which section 355 applied, such corporation (and any successor corporation) shall not be eligible to make a REIT election for any taxable year beginning before the end of the 10-year period beginning on the date of such distribution.

[893] Sec. 355(g).
[894] Rev. Rul. 2001–29, 2001–1 C.B. 1348.
[895] Priv. Ltr. Rul. 201337007. A private ruling may be relied upon only by the taxpayer to which it is issued. However, private rulings provide some indication of administrative practice.
[896] As long as a REIT election for each corporation is effective immediately after the distribution, the elections may be made after that time.
[897] Under section 368(c), the term "control" means the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation.

Effective Date

The provision generally applies to distributions on or after December 7, 2015,[898] but does not apply to any distribution pursuant to a transaction described in a ruling request initially submitted to the Internal Revenue Service on or before such date, which request has not been withdrawn and with respect to which a ruling has not been issued or denied in its entirety as of such date.

2. Reduction in percentage limitation on assets of REIT which may be taxable REIT subsidiaries (sec. 312 of the Act and sec. 856 of the Code)

Present Law

A REIT generally is not permitted to own securities representing more than 10 percent of the vote or value of any entity, nor is it permitted to own securities of a single issuer comprising more than 5 percent of REIT value.[899] In addition, rents received by a REIT from a corporation of which the REIT directly or indirectly owns more than 10 percent of the vote or value generally are not qualified rents for purposes of the 75-percent and 95-percent income tests.[900]

There is an exception from these rules in the case of a TRS.[901] No more than 25 percent of the value of total REIT assets may consist of securities of one or more TRSs.[902]

Explanation of Provision

The provision reduces to 20 percent the permitted percentage of total REIT assets that may be securities of one or more TRSs.

Effective Date

The provision applies to taxable years beginning after December 31, 2017.

3. Prohibited transaction safe harbors (sec. 313 of the Act and sec. 857 of the Code)

Present Law

REITs are subject to a prohibited transaction tax ("PTT") of 100 percent of the net income derived from prohibited transactions. For this purpose, a prohibited transaction is a sale or other disposition of property by the REIT that is "stock in trade of a taxpayer or other property which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held for sale to customers by the taxpayer in the ordinary

[898] The provision does not apply to distributions by a corporation pursuant to a plan under which stock constituting control (within the meaning of section 368(c)) of the controlled corporation was distributed before December 7, 2015.
[899] Sec. 856(c)(4)(B)(iii).
[900] Sec. 856(d)(2)(B).
[901] Sec. 856(d)(8).
[902] Sec. 856(c)(4)(B)(ii).

course of his trade or business"[903] and is not foreclosure property. The PTT for a REIT does not apply to a sale if the REIT satisfies certain safe harbor requirements in section 857(b)(6)(C) or (D), including an asset holding period of at least two years.[904] If the conditions are met, a REIT may either (1) make no more than seven sales within a taxable year (other than sales of foreclosure property or involuntary conversions under section 1033), or (2) sell either no more than 10 percent of the aggregate bases, or no more than 10 percent of the aggregate fair market value, of all its assets as of the beginning of the taxable year (computed without regard to sales of foreclosure property or involuntary conversions under section 1033), without being subject to the PTT tax.[905]

The additional requirements for the safe harbor limit the amount of expenditures the REIT or a partner of the REIT can make during the two-year period prior to the sale that are includible in the adjusted basis of the property. Also, if more than seven sales are made during the taxable year, substantially all marketing and development expenditures with respect to the property must have been made through an independent contractor from whom the REIT itself does not derive or receive any income.

Explanation of Provision

The provision expands the amount of property that a REIT may sell in a taxable year within the safe harbor provisions, from 10 percent of the aggregate basis or fair market value, to 20 percent of the aggregate basis or fair market value. However, in any taxable year, the aggregate adjusted bases and the fair market value of property (other than sales of foreclosure property or sales to which section 1033 applies) sold during the three taxable year period ending with such taxable year may not exceed 10 percent of the sum of the aggregate adjusted bases or the sum of the fair market value of all of the assets of the REIT as of the beginning of each of the 3 taxable years that are part of the period.

The provision clarifies that the determination of whether property is described in section 1221(a)(1) is made without regard to whether or not such property qualifies for the safe harbor from the prohibited transactions rules.

Effective Date

The provision generally applies to taxable years beginning after the date of enactment (December 18, 2015). However, the provision clarifying the determination of whether property is described in section 1221(a)(1) has retroactive effect, but does not apply to any sale of property to which section 857(b)(6)(G) applies.

[903] This definition is the same as the definition of certain property the sale or other disposition of which would produce ordinary income rather than capital gain under section 1221(a)(1).

[904] Additional requirements for the safe harbor limit the amount of expenditures the REIT can make during the two-year period prior to the sale that are includible in the adjusted basis of the property, require marketing to be done by an independent contractor, and forbid a sales price that is based on the income or profits of any person.

[905] Sec. 857(b)(6).

4. Repeal of preferential dividend rule for publicly offered REITs; authority for alternative remedies to address certain REIT distribution failures (secs. 314 and 315 of the Act and sec. 562 of the Code)

Present Law

A REIT is allowed a deduction for dividends paid to its shareholders.[906] In order to qualify for the deduction, a dividend must not be a "preferential dividend."[907] For this purpose, a dividend is preferential unless it is distributed pro rata to shareholders, with no preference to any share of stock compared with other shares of the same class, and with no preference to one class as compared with another except to the extent the class is entitled to a preference.

Similar rules apply to regulated investment companies ("RICs").[908] However, the preferential dividend rule does not apply to a publicly offered RIC (as defined in section 67(c)(2)(B)).[909]

Explanation of Provision

The provision repeals the preferential dividend rule for publicly offered REITs. For this purpose, a REIT is publicly offered if it is required to file annual and periodic reports with the Securities and Exchange Commission under the Securities Exchange Act of 1934.

For other REITs, the provision provides the Secretary of the Treasury with authority to provide an appropriate remedy to cure the failure of the REIT to comply with the preferential dividend requirements in lieu of not considering the distribution to be a dividend for purposes of computing the dividends-paid deduction where the Secretary determines the failure to comply is inadvertent or is due to reasonable cause and not due to willful neglect, or the failure is a type of failure identified by the Secretary as being so described.

Effective Date

The provision to repeal the preferential dividend rule for publicly offered REITs applies to distributions in taxable years beginning after December 31, 2014.

The provision granting authority to the Secretary of the Treasury to provide alternative remedies addressing certain REIT distribution failures applies to distributions in taxable years beginning after December 31, 2015.

5. Limitations on designation of dividends by REITs (sec. 316 of the Act and sec. 857 of the Code)

Present Law

A REIT that has a net capital gain for a taxable year may designate dividends that it pays or is treated as paying during the

[906] Sec. 857(b)(2)(B).
[907] Sec. 562(c).
[908] Sec. 852(b)(2)(D).
[909] Sec. 562(c).

year as capital gain dividends.[910] A capital gain dividend is treated by the shareholder as gain from the sale or exchange of a capital asset held more than one year.[911] The amount that may be designated as capital gain dividends for any taxable year may not exceed the REIT's net capital gain for the year.

A REIT may designate dividends that it pays or is treated as paying during the year as qualified dividend income.[912] Qualified dividend income is taxed to individuals at the same tax rate as net capital gain, under rules enacted by the Taxpayer Relief Act of 1997.[913] The amount that may be designated as qualified dividend income for any taxable year is limited to qualified dividend income received by the REIT plus some amounts subject to corporate taxation at the REIT level.

The IRS has ruled that a RIC may designate the maximum amount permitted under each of the provisions allowing a RIC to designate dividends even if the aggregate of all the designated amounts exceeds the total amount of the RIC's dividends distributions.[914]

The IRS also has ruled that if a RIC has two or more classes of stock and it designates the dividends that it pays on one class as consisting of more than that class's proportionate share of a particular type of income, the designations are not effective for federal tax purposes to the extent that they exceed the class's proportionate share of that type of income.[915] The Internal Revenue Service announced that it would provide guidance that RICs and REITs must use in applying the capital gain provision enacted by the Taxpayer Relief Act of 1997.[916] The announcement referred to the designation limitations of Revenue Ruling 89–91.

Explanation of Provision

The provision limits the aggregate amount of dividends designated by a REIT for a taxable year under all of the designation provisions to the amount of dividends paid with respect to the taxable year (including dividends described in section 858 that are paid after the end of the REIT taxable year but treated as paid by the REIT with respect to the taxable year).

The provision provides the Secretary of the Treasury authority to prescribe regulations or other guidance requiring the proportionality of the designation for particular types of dividends (for example, capital gain dividends) among shares or beneficial interests in a REIT.

Effective Date

The provision applies to distributions in taxable years beginning after December 31, 2015.

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[910] Sec. 857(b)(3)(C).

[911] Sec. 857(b)(3)(B).

[912] Sec. 857(c)(2).

[913] Sec. 1(h)(11) enacted in Pub. L. No. 105–34.

[914] Rev. Rul. 2005–31, 2005–1 C.B.1084.

[915] Rev. Rul. 89–81, 1989–1 C.B. 226.

[916] Notice 97–64, 1997–2 C.B. 323. Recently, the IRS modified Notice 97–64 and provided certain new rules for RICs; the designation limitations in Revenue Ruling 89–81, however, continue to apply. Notice 2015–41, 2015–24 I.R.B. 1058.

6. Debt instruments of publicly offered REITs and mortgages treated as real estate assets (sec. 317 of the Act and sec. 856 of the Code)

Present Law

At least 75 percent of the value of a REIT's assets must be real estate assets, cash and cash items (including receivables), and Government securities (the "75-percent asset test").[917] Real estate assets are real property (including interests in real property and mortgages on real property) and shares (or transferable certificates of beneficial interest) in other REITs.[918] No more than 25 percent of a REIT's assets may be securities other than such real estate assets.[919]

Except with respect to a TRS, not more than five percent of the value of a REIT's assets may be securities of any one issuer, and the REIT may not possess securities representing more than 10 percent of the outstanding value or voting power of any one issuer.[920] No more than 25 percent of the value of a REIT's assets may be securities of one or more TRSs.[921]

The asset tests must be met as of the close of each quarter of a REIT's taxable year.[922]

At least 75 percent of a REIT's gross income must be from certain real estate related and other items. In addition, at least 95 percent of a REIT's gross income must be from specified sources that include the 75 percent items and also include interest, dividends, and gain from the sale or other disposition of securities (whether or not real estate-related).

Explanation of Provision

Under the provision, debt instruments issued by publicly offered REITs are treated as real estate assets, as are interests in mortgages on interests in real property (for example, an interest in a mortgage on a leasehold interest in real property). Such assets therefore are qualified assets for purposes of meeting the 75-percent asset test, but are subject to special limitations described below.

As under present law, income from debt instruments issued by publicly offered REITs that is interest income or gain from the sale or other disposition of a security is treated as qualified income for purposes of the 95-percent gross income test. Income from debt instruments issued by publicly offered REITs that would not have been treated as real estate assets but for the new provision, however, is not qualified income for purposes of the 75-percent income

[917] Sec. 856(c)(4)(A).

[918] Such term also includes any property (not otherwise a real estate asset) attributable to the temporary investment of new capital, but only if such property is stock or a debt instrument, and only for the one-year period beginning on the date the REIT receives such capital. Sec. 856(c)(5)(B).

[919] Sec. 856(c)(4)(B)(i).

[920] Sec. 856(c)(4)(B)(iii).

[921] Sec. 856(c)(4)(B)(ii).

[922] Sec. 856(c)(4). However, a REIT that has met the asset tests as of the close of any quarter does not lose its REIT status solely because of a discrepancy during a subsequent quarter between the value of the REIT's investments and such requirements, unless such discrepancy exists immediately after the acquisition of any security or other property and is wholly or partly the result of such acquisition. Sec. 856(c)(4).

test, and not more than 25 percent of the value of a REIT's total assets is permitted to be represented by such debt instruments.

Effective Date

The provision is effective for taxable years beginning after December 31, 2015.

7. Asset and income test clarification regarding ancillary personal property (sec. 318 of the Act and sec. 856 of the Code)

Present Law

75-percent income test

Among other requirements, at least 75 percent of the gross income of a REIT in each taxable year must consist of real estate-related income. Such income includes: rents from real property; income from the sale or exchange of real property (including interests in real property) that is not stock in trade, inventory, or held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business; interest on mortgages secured by real property or interests in real property; and certain income from foreclosure property (the "75-percent income test"). Amounts attributable to most types of services provided to tenants (other than certain "customary services"), or to more than specified amounts of personal property, are not qualifying rents.

The Code definition of rents from real property includes rent attributable to personal property which is leased under, or in connection with, a lease of real property, but only if the rent attributable to such property for the taxable year does not exceed 15 percent of the total rent for the taxable year attributable to both the real and personal property leased under, or in connection with, such lease.[923]

For purposes of determining whether interest income is from a mortgage secured by real property, Treasury regulations provide that where a mortgage covers both real property and other property, an apportionment of the interest must be made. If the loan value of the real property is equal to or exceeds the amount of the loan, then the entire interest income is apportioned to the real property. However, if the amount of the loan exceeds the loan value of the real property, then the interest income apportioned to the real property is an amount equal to the interest income multiplied by a fraction, the numerator of which is the loan value of the real property and the denominator of which is the amount of the loan.[924] The remainder of the interest income is apportioned to the other property.

The loan value of real property is defined as the fair market value of the property determined as of the date on which the commitment by the REIT to make the loan becomes binding on the REIT. In the case of a loan purchased by a REIT, the loan value

[923] Sec. 856(d)(1)(C).

[924] Treas. Reg. sec. 1.856–5(c)(1). The amount of the loan for this purpose is defined as the hightest principal amount of the loan outstanding during the taxable year. Treas. Reg. sec. 1.856–5(c)(3).

of the real property is the fair market value of the real property determined as of the date on which the commitment of the REIT to purchase the loan becomes binding.[925]

75-percent asset test

At the close of each quarter of the taxable year, at least 75 percent of the value of a REIT's total assets must be represented by real estate assets, cash and cash items, and Government securities.

Real estate assets generally mean real property (including interests in real property and interests in mortgages on real property) and shares (or transferable certificates of beneficial interest) in other REITs.

Neither the Code nor regulations address the allocation of value in cases where real property and personal property may both be present.

Explanation of Provision

The provision allows certain ancillary personal property leased with real property to be treated as real property for purposes of the 75-percent asset test, applying the same threshold that applies under present law for purposes of determining rents from real property under section 856(d)(l)(C) for purposes of the 75-percent income test.

The provision also modifies the present-law rules for determining when an obligation secured by a mortgage is considered secured by a mortgage on real property if the security includes personal property as well. Under the provision, in the case of an obligation secured by a mortgage on both real property and personal property, if the fair market value of such personal property does not exceed 15 percent of the total fair market value of all such property, such personal property is treated as real property for purposes of the 75-percent income and 75-percent asset test computations.[926] In making this determination, the fair market value of all property (both personal and real) is determined at the same time and in the same manner as the fair market value of real property is determined for purposes of apportioning interest income between real property and personal property under the rules for determining whether interest income is from a mortgage secured by real property.

Effective Date

The provision is effective for taxable years beginning after December 31, 2015.

8. Hedging provisions (sec. 319 of the Act and sec. 857 of the Code)

Present Law

Except as provided by Treasury regulations, income from certain REIT hedging transactions that are clearly identified, including gain from the sale or disposition of such a transaction, is not included as gross income under either the 95-percent income or 75-

[925] Special rules apply to construction loans. Treas. Reg. sec. 1.856–5(c)(2).
[926] Sec. 856(c)(3)(B) and (4)(A).

percent income test. Transactions eligible for this exclusion include transactions that hedge indebtedness incurred or to be incurred by the REIT to acquire or carry real estate assets and transactions entered primarily to manage risk of currency fluctuations with respect to items of income or gain described in section 856(c)(2) or (3).[927]

Explanation of Provision

The provision expands the scope of the present-law exception of certain hedging income from gross income for purposes of the income tests, under section 856(c)(5)(G). Under the provision, if (1) a REIT enters into one or more positions described in clause (i) of section 856(c)(5)(G) with respect to indebtedness described therein or one or more positions described in clause (ii) of section 856(c)(5)(G) with respect to property that generates income or gain described in section 856(c)(2) or (3); (2) any portion of such indebtedness is extinguished or any portion of such property is disposed of; and (3) in connection with such extinguishment or disposition, such REIT enters into one or more transactions which would be hedging transactions described in subparagraph (B) or (C) of section 1221(b)(2) with respect to any position referred to in (1) above, if such position were ordinary property,[928] then any income of such REIT from any position referred to in (1) and from any transaction referred to in (3) (including gain from the termination of any such position or transaction) shall not constitute gross income for purposes of the 75-percent or 95-percent gross income tests, to the extent that such transaction hedges such position.

The provision is intended to extend the current treatment of income from certain REIT hedging transactions as income that is disregarded for purposes of the 75-percent and 95-percent income tests to income from positions that primarily manage risk with respect to a prior hedge that a REIT enters in connection with the extinguishment or disposal (in whole or in part) of the liability or asset (respectively) related to such prior hedge, to the extent the new position qualifies as a section 1221 hedge or would so qualify if the hedged position were ordinary property.

The provision also clarifies that the identification requirement that applies to all hedges under the hedge gross income rules is the requirement described in section 1221(a)(7), determined after taking account of any curative provisions provided under the regulations referred to therein.

Effective Date

The provision is effective for taxable years beginning after December 31, 2015.

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[927] Sec. 856(c)(5)(G).

[928] Such definition of a hedging transaction is applied for purposes of this provision without regard to whether or not the position referred to is ordinary property.

9. Modification of REIT earnings and profits calculation to avoid duplicate taxation (sec. 320 of the Act and secs. 562 and 857 of the Code)

Present Law

For purposes of computing earnings and profits of a corporation, the alternative depreciation system, which generally is less accelerated than the system used in determining taxable income, is used in the case of the depreciation of tangible property. Also, certain amounts treated as currently deductible for purposes of computing taxable income are allowed as a deduction ratably over a period of five years for computing earnings and profits. Finally, the installment method is not allowed in computing earnings and profits from the installment sale of property.[929]

In the case of a REIT, the current earnings and profits of a REIT are not reduced by any amount which is not allowable as a deduction in computing its taxable income for the taxable year.[930] In addition, for purposes of computing the deduction for dividends paid by a REIT for a taxable year, earnings and profits are increased by the total amount of gain on the sale or exchange of real property by the trust during the year.[931]

These rules can by illustrated by the following example:

Example.—Assume that a REIT had $100 of taxable income and earnings and profits in each of five consecutive taxable years (determined without regard to any energy efficient commercial building deduction[932] and without regard to any deduction for dividends paid). Assume that in the first of the five years, the REIT had an energy efficient commercial building deduction in computing its taxable income of $10, reducing its pre-dividend taxable income to $90. Assume further that the deduction is allowable at a rate of $2 per year over the five-year period beginning with the first year in computing its earnings and profits.

Under present law, the REIT's earnings and profits in the first year are $98 ($100 less $2). In each of the next four years, the REIT's current earnings and profits are $100 ($98 as computed for the first year plus an additional $2 under section 857(d)(1) for the $2 not deductible in computing taxable income for the year).

Assume the REIT distributes $100 to its shareholders at the close of each of the five years. Under present law, the shareholders have $98 dividend income in the first year and a $2 return of capital and $100 dividend income in each of the following four years, for a total of $498 dividend income, notwithstanding that the REIT had only $490 pre-dividend taxable income over the period. The dividends paid by the REIT reduce its taxable income to zero in each of the taxable years.

Explanation of Provision

Under the provision, the current earnings and profits of a REIT for a taxable year are not reduced by any amount that (1) is not

[929] Sec. 312(k)(3) and (n)(5).

[930] Sec. 857(d)(1). This provision applies to a REIT without regard to whether it meets the requirements of section 857(a) for the taxable year.

[931] Sec. 562(e).

[932] Sec. 179D.

allowable as a deduction in computing its taxable income for the current taxable year and (2) was not so allowable for any prior taxable year. Thus, under the provision, if an amount is allowable as a deduction in computing taxable income in year one and is allowable in computing earnings and profits in year two (determined without regard to present-law section 857(d)(1)), section 857(d)(1) no longer applies and the deduction in computing the year two earnings and profits of the REIT is allowable. Thus, a lesser maximum amount will be a dividend to shareholders in that year. This provision does not change the present-law determination of current earnings and profits for purposes of computing a REIT's deduction for dividends paid.

In addition, the provision provides that the current earnings and profits of a REIT for a taxable year for purposes of computing the deduction for dividends paid are increased by any amount of gain on the sale or exchange of real property taken into account in determining the taxable income of the REIT for the taxable year (to the extent the gain is not otherwise so taken into account). Thus, in the case of an installment sale of real property, current earnings and profits for purposes of the REIT's deduction for dividends paid for a taxable year are increased by the amount of gain taken into account in computing its taxable income for the year and not otherwise taken into account in computing the current earnings and profits.

The following illustrates the application of the provision:

Example.—Assume the same facts as in the above example. Under the provision, as under present law, in the first taxable year, the earnings and profits of the REIT were $98 and the shareholders take into account $98 dividend income and $2 is a return of capital. Under the provision, in each of the next four years, the earnings and profits are $98 (i.e., section 857(d)(1) does not apply) so that the shareholders take into account $98 of dividend income in each year and $2 is a return of capital each year.

For purposes of the REIT's deduction for dividends paid, present law remains unchanged so that the REIT's taxable income will be reduced to zero in each of the taxable years.

Effective Date

The provision is effective for taxable years beginning after December 31, 2015.

10. Treatment of certain services provided by taxable REIT subsidiaries (sec. 321 of the Act and sec. 857 of the Code)

Present Law

Taxable REIT subsidiaries

A TRS generally can engage in any kind of business activity except that it is not permitted directly or indirectly to operate either a lodging facility or a health care facility, or to provide to any other person (under a franchise, license, or otherwise) rights to any brand name under which any lodging facility or health care facility is operated.

REITs are subject to a tax equal to 100 percent of redetermined rents, redetermined deductions, and excess interest. These are defined generally as the amounts of specified REIT transactions with a TRS of the REIT, to the extent such amounts differ from an arm's length amount.

Prohibited transactions tax

REITs are subject to a prohibited transaction tax ("PTT") of 100 percent of the net income derived from prohibited transactions.[933] For this purpose, a prohibited transaction is a sale or other disposition of property by the REIT that is stock in trade of a taxpayer or other property that would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held for sale to customers by the taxpayer in the ordinary course of his trade or business and is not foreclosure property. The PTT for a REIT does not apply to a sale of property which is a real estate asset if the REIT satisfies certain criteria in section 857(b)(6)(C) or (D).

Section 857(b)(6)(C) provides that a prohibited transaction does not include a sale of property which is a real estate asset (as defined in section 856(c)(5)(B)) and which is described in section 1221(a)(1) if (1) the REIT has held the property for not less than two years; (2) aggregate expenditures made by the REIT, or any partner of the REIT, during the two year period preceding the date of sale which are includible in the basis of the property do not exceed 30 percent of the net selling price of the property; (3) either: (A) the REIT does not make more than seven sales of property[934] during the taxable year, or (B) the aggregate adjusted bases (as determined for purposes of computing earnings and profits) of property[935] sold during the taxable year does not exceed 10 percent of the aggregate bases (as so determined) of all of the assets of the REIT as of the beginning of the taxable year, or (C) the fair market value of property[936] sold during the taxable year does not exceed 10 percent of the aggregate fair market value of all the assets of the REIT as of the beginning of the taxable year; (4) in the case of land or improvements, not acquired through foreclosure (or deed in lieu of foreclosure), or lease termination, the REIT has held the property for not less than two years for production of rental income; and (5) if the requirement of (3)(A) above is not satisfied, substantially all of the marketing and development expenditures with respect to the property were made through an independent contractor (as defined in section 856(d)(3)) from whom the REIT does not derive or receive any income.

Section 857(b)(6)(D) provides that a prohibited transaction does not include a sale of property which is a real estate asset (as defined in section 856(c)(5)(B)) and which is described in section 1221(a)(1) if (1) the REIT has held the property for not less than two years in connection with the trade or business of producing timber; (2) the aggregate expenditures made by the REIT, or any partner of the REIT, during the two year period preceding the date

[933] Sec. 857(b)(6).
[934] Sales of foreclosure property or sales to which section 1033 applies are excluded.
[935] Sales of foreclosure property or sales to which section 1033 applies are excluded.
[936] Sales of foreclosure property or sales to which section 1033 applies are excluded.

of sale which (A) are includible in the basis of the property (other than timberland acquisition expenditures), and (B) are directly related to operation of the property for the production of timber or for the preservation of the property for use as a timberland, do not exceed 30 percent of the net selling price of the property; (3) the aggregate expenditures made by the REIT, or a partner of the REIT, during the two year period preceding the date of sale which (A) are includible in the basis of the property (other than timberland acquisition expenditures), and (B) are not directly related to operation of the property for the production of timber or for the preservation of the property for use as a timberland, do not exceed five percent of the net selling price of the property; (4) either: (A) the REIT does not make more than seven sales of property[937] during the taxable year, or (B) the aggregate adjusted bases (as determined for purposes of computing earnings and profits) of property[938] sold during the taxable year does not exceed 10 percent of the aggregate bases (as so determined) of all of the assets of the REIT as of the beginning of the taxable year, or (C) the fair market value of property[939] sold during the taxable year does not exceed 10 percent of the aggregate fair market value of all the assets of the REIT as of the beginning of the taxable year; (5) if the requirement of (4)(A) above is not satisfied, substantially all of the marketing expenditures with respect to the property were made through an independent contractor (as defined in section 856(d)(3)) from whom the REIT does not derive or receive any income, or, in the case of a sale on or before the termination date, a TRS; and (6) the sales price of the property sold by the trust is not based in whole or in part on income or profits derived from the sale or operation of such property.

Foreclosure property

Under current law, certain income and gain derived from foreclosure property satisfies the 95-percent and 75-percent REIT income tests.[940] Property will cease to be foreclosure property, however, if used in a trade or business conducted by the REIT, other than through an independent contractor from which the REIT itself does not derive or receive any income, more than 90 days after the day on which the REIT acquired such property.[941]

Explanation of Provision

For purposes of the exclusion from the prohibited transactions excise tax, the provision modifies the requirement of section 857(b)(6)(C)(v), that substantially all of the development expenditures with respect to the property were made through an independent contractor from whom the REIT itself does not derive or receive any income, to allow a TRS to have developed the property.[942]

[937] Sales of foreclosure property or sales to which section 1033 applies are excluded.
[938] Sales of foreclosure property or sales to which section 1033 applies are excluded.
[939] Sales of foreclosure property or sales to which section 1033 applies are excluded.
[940] Sec. 856(c)(2)(F) and (3)(F).
[941] Sec. 856(e)(4)(C).
[942] The requirement limiting the amount of expenditures added to basis that the REIT, or a partner of the REIT, may make within two years prior to the sale, as well as other requirements for the exclusion, are retained.

The provision also allows a TRS to make marketing expenditures with respect to property under section 857(b)(6)(C)(v) or 857(b)(6)(D)(v) without causing property that is otherwise eligible for the prohibited transaction exclusion to lose such qualification.

The provision allows a TRS to operate foreclosure property without causing loss of foreclosure property status, under section 856(e)(4)(C).

The items subject to the 100-percent excise tax on certain non-arm's-length transactions between a TRS and a REIT are expanded to include "redetermined TRS service income." Such income is defined as gross income of a TRS of a REIT attributable to services provided to, or on behalf of, such REIT (less the deductions properly allocable thereto) to the extent the amount of such income (less such deductions) would be increased on distribution, apportionment, or allocation under section 482 (but for the exception from section 482 if the 100-percent excise tax applies). The term does not include gross income attributable to services furnished or rendered to a tenant of the REIT (or deductions properly attributable thereto), since that income is already subject to a separate provision of the 100-percent excise tax rules.

Effective Date

The provision is effective for taxable years beginning after December 31, 2015.

11. Exception from FIRPTA for certain stock of REITs; exception for interests held by foreign retirement and pension funds (secs. 322 and 323 of the Act and secs. 897 and 1445 of the Code)[943]

Present Law

General rules relating to FIRPTA

A foreign person that is not engaged in the conduct of a trade or business in the United States generally is not subject to any U.S. tax on capital gain from U.S. sources, including capital gain from the sale of stock or other capital assets.[944]

However, the Foreign Investment in Real Property Tax Act of 1980 ("FIRPTA")[945] generally treats a foreign person's gain or loss from the disposition of a U.S. real property interest ("USRPI") as income that is effectively connected with the conduct of a U.S. trade or business, and thus taxable at the income tax rates applica-

[943] The Senate Committee on Finance reported S.915 on April 14, 2015 (S. Rep. No. 114–25). Section 2 of that bill contained a provision similar to section 322 of the Protecting Americans from Tax Hikes Act of 2015 (Division Q of Pub. L. No. 114–113).

[944] Secs. 871(b) and 882(a). Property is treated as held by a person for use in connection with the conduct of a trade or business in the United States, even if not so held at the time of sale, if it was so held within 10 years prior to the sale. Sec. 864(c)(7). Also, all gain from an installment sale is treated as from the sale of property held in connection with the conduct of such a trade or business if the property was so held during the year in which the installment sale was made, even if the recipient of the payments is no longer engaged in the conduct of such trade or business when the payments are received. Sec. 864(c)(6).

[945] Pub. L. No. 96–499. The rules governing the imposition and collection of tax under FIRPTA are contained in a series of provisions enacted in 1980 and subsequently amended. See secs. 897, 1445, 6039C, and 6652(f).

ble to U.S. persons, including the rates for net capital gain.[946] With certain exceptions, if a foreign corporation distributes a USRPI, gain is recognized on the distribution (including a distribution in redemption or liquidation) of a USRPI, in an amount equal to the excess of the fair market value of the USRPI (as of the time of distribution) over its adjusted basis.[947] A foreign person subject to tax on FIRPTA gain is required to file a U.S. tax return under the normal rules relating to receipt of income effectively connected with a U.S. trade or business.[948]

The payor of amounts that FIRPTA treats as effectively connected with a U.S. trade or business ("FIRPTA income") to a foreign person generally is required to withhold U.S. tax from the payment.[949] Withholding generally is 10 percent of the sales price, in the case of a direct sale by the foreign person of a USRPI (but withholding is not required in certain cases, including on any sale of stock that is regularly traded on an established securities market[950]), and 10 percent of the amount realized by the foreign shareholder in the case of certain distributions by a corporation that is or has been a U.S. real property holding corporation ("USRPHC") during the applicable testing period.[951] The withholding is generally 35 percent of the amount of a distribution to a foreign person of net proceeds attributable to the sale of a USRPI from an entity such as a partnership, REIT, or RIC.[952] The foreign person can request a refund with its U.S. tax return, if appropriate, based on that person's total U.S. effectively connected income and deductions (if any) for the taxable year.

USRPHCs and five-percent public shareholder exception

USRPIs include not only interests in real property located in the United States or the U.S. Virgin Islands, but also stock of a USRPHC, generally defined as any domestic corporation, unless the taxpayer establishes that the fair market value of the corporation's USRPIs was less than 50 percent of the combined fair market value of all its real property interests (U.S. and worldwide) and all its assets used or held for use in a trade or business, at all times during a "testing period," which is the shorter of the duration of the taxpayer's ownership of the stock after June 18, 1980, or the five-year period ending on the date of disposition of the stock.[953]

Under an exception, even if a corporation is a USRPHC, a shareholder's shares of a class of stock that is regularly traded on an established securities market are not treated as USRPIs if the shareholder holds (applying attribution rules) no more than five percent

[946] Sec. 897(a).
[947] Sec. 897(d). In addition, such gain may also be subject to the branch profits tax at a 30-percent rate (or lower treaty rate).
[948] In addition, section 6039C authorizes regulations that would require a return reporting foreign direct investments in U.S. real property interests. No such regulations have been issued, however.
[949] Sec. 1445(a).
[950] Sec. 1445(b)(6).
[951] Sec. 1445(e)(3). Withholding at 10 percent of a gross amount may also apply in certain other circumstances under regulations. See sec. 1445(e)(4) and (5).
[952] Sec. 1445(e)(6) and Treasury regulations thereunder. The Treasury Department is authorized to issue regulations that would reduce the 35 percent withholding on distributions to 20 percent during the time that the maximum income tax rate on dividends and capital gains of U.S. persons is 20 percent.
[953] Sec. 897(c)(1) and (2).

of that class of stock at any time during the testing period.[954] Among other things, the relevant attribution rules require attribution between a corporation and a shareholder that owns five percent or more in value of the stock of such corporation.[955] The attribution rules also attribute stock ownership between spouses and between children, grandchildren, parents, and grandparents.

FIRPTA rules for foreign investment through REITs and RICs

Special FIRPTA rules apply to foreign investment through a "qualified investment entity," which includes any REIT and certain RICs that invest largely in USRPIs (including stock of one or more REITs).[956]

Stock of domestically controlled qualified investment entities not a USRPI

If a qualified investment entity is "domestically controlled" (defined to mean that less than 50 percent in value of the qualified investment entity has been owned (directly or indirectly) by foreign persons during the relevant testing period[957]), stock of such entity is not a USRPI and a foreign shareholder can sell the stock of such entity without being subject to tax under FIRPTA, even if the stock would otherwise be stock of a USRPHC. Treasury regulations provide that for purposes of determining whether a REIT is domestically controlled, the actual owner of REIT shares is the "person who is required to include in his return the dividends received on the stock."[958] The IRS has issued a private letter ruling concluding that the term "directly or indirectly" for this purpose does not require looking through corporate entities that, in the facts of the ruling, were represented to be fully taxable domestic corporations for U.S. federal income tax purposes "and not otherwise a REIT, RIC, hybrid entity, conduit, disregarded entity, or other flow-through or look-through entity."[959]

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[954] Sec. 897(c)(3). The constructive ownership attribution rules are specified in section 897(c)(6)(C).

[955] If a person owns, directly or indirectly, five percent or more in value of the stock in a corporation, such person is considered as owning the stock owned directly or indirectly by or for such corporation, in that proportion which the value of the stock such person so owns bears to the value of all the stock in such corporation. Sec. 318(c)(2)(C) as modified by section 897(c)(6)(C). Also, if five percent or more in value of the stock in a corporation is owned directly or indirectly, by or for any person, such corporation shall be considered as owning the stock owned, directly or indirectly, by or for such person. Sec. 318(c)(3)(C) as modified by section 897(c)(6)(C).

[956] Sec. 897(h)(4)(A)(i). The provision including certain RICs in the definition of qualified investment entity previously expired December 31, 2014. Section 133 of the Protecting Americans from Tax Hikes Act of 2015 (Division Q of Pub. L. No. 114–113) reinstated the provision and made it permanent as of January 1, 2015, as described above in item 22 of Title I.A.

[957] The testing period for this purpose if the shorter of (i) the period beginning on June 19, 1980, and ending on the date of disposition or distribution, as the case may be, (ii) the five-year period ending on the date of the disposition or distribution, as the case may be, or (iii) the period during which the qualified investment entity was in existence. Sec. 897(h)(4)(D).

[958] Treas. Reg. sec. 1.897–1(c)(2)(i) and –8(b).

[959] PLR 200923001. A private letter ruling may be relied upon only by the taxpayer to which it is issued. However, private letter rulings provide some indication of administrative practice.

FIRPTA applies to qualified investment entity (REIT and certain RIC) distributions attributable to gain from sale or exchange of USRPIs, except for distributions to certain five-percent or smaller shareholders

A distribution by a REIT or other qualified investment entity, to the extent attributable to gain from the entity's sale or exchange of USRPIs, is treated as FIRPTA income.[960] The FIRPTA character is retained if the distribution occurs from one qualified investment entity to another, through a tier of REITs or RICs.[961] An IRS notice (Notice 2007–55) states that this rule retaining the FIRPTA income character of distributions attributable to the sale of USRPIs applies to any distributions under sections 301, 302, 331, and 332 (i.e., to dividend distributions, distributions treated as sales or exchanges of stock by the investor, and both nonliquidating and liquidating distributions) and that the IRS will issue regulations to that effect.[962]

There is an exception to this rule in the case of distributions to certain public shareholders. If an investor has owned no more than five percent of a class of stock of a REIT or other qualified investment entity that is regularly traded on an established securities market located in the United States during the one-year period ending on the date of the distribution, then amounts attributable to gain from entity sales or exchanges of USRPIs can be distributed to such a shareholder without being subject to FIRPTA tax.[963] Such distributions that are dividends are treated as dividends from the qualified investment entity,[964] and thus generally would be subject to U.S. dividend withholding tax (as reduced under any applicable treaty), but are not treated as income effectively connected with the conduct of a U.S. trade or business. An IRS Chief Counsel advice memorandum concludes that such distributions which are made in complete liquidation of a REIT are not treated as dividends from the qualified investment entity and thus generally would not be subject to U.S. dividend withholding tax (in addition to not being treated as income effectively connected with the conduct of a U.S. trade or business).[965]

Explanation of Provision

Exception from FIRPTA for certain REIT stock

In the case of REIT stock only, the provision increases from five percent to 10 percent the maximum stock ownership a shareholder may have held, during the testing period, of a class of stock that is publicly traded, to avoid having that stock be treated as a USRPI on disposition.

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[960] Sec. 897(h)(1).

[961] In 2006, the Tax Increase Prevention and Reconciliation Act of 2005 ("TIPRA"), Pub. L. No. 109–222, sec. 505, specified the retention of this FIRPTA character on a distribution to an upper-tier qualified investment entity, and added statutory withholding requirements.

[962] Notice 2007–55, 2007–2 C.B.13. The Notice also states that in the case of a foreign government investor, because FIRPTA income is treated as effectively connected with the conduct of a U.S. trade or business, proceeds distributed by a qualified investment entity from the sale of USRPIs are not exempt from tax under section 892. The Notice cites and compares existing temporary regulations and indicates that Treasury will apply those regulations as well to certain distributions. See Temp. Treas. Reg. secs. 1.892–3T, 1.897–9T(e), and 1.1445–10T(b).

[963] Sec. 897(h)(1), second sentence.

[964] Secs. 852(b)(3)(E) and 857(b)(3)(F).

[965] AM 2008–003, February 15, 2008.

The provision likewise increases from five percent to 10 percent the percentage ownership threshold that, if not exceeded, results in treating a distribution to holders of publicly traded REIT stock, attributable to gain from sales of exchanges of USRPIs, as a dividend, rather than as FIRPTA gain.

The attribution rules of section 897(c)(6)(C) retain the present-law rule that requires attribution between a shareholder and a corporation if the shareholder owns more than five percent of a class of stock of the corporation. The attribution rules now apply, however, to the determination of whether a person holds more than 10 percent of a class of publicly traded REIT stock.

The provision also provides that REIT stock held by a qualified shareholder, including stock held indirectly through one or more partnerships, is not a U.S real property interest in the hands of such qualified shareholder, except to the extent that an investor in the qualified shareholder (other than an investor that is a qualified shareholder) holds more than 10 percent of that class of stock of the REIT (determined by application of the constructive ownership rules of section 897(c)(6)(C)). Thus, so long as the "more than 10 percent" rule is not exceeded, a qualified shareholder may own and dispose of any amount of stock of a REIT (including stock of a privately-held, non-domestically controlled REIT that is owned by such qualified shareholder) without the application of FIRPTA.

If an investor in the qualified shareholder (other than an investor that is a qualified shareholder) directly, indirectly, or constructively holds more than 10 percent of such class of REIT stock (an "applicable investor"), then a percentage of the REIT stock held by the qualified shareholder equal to the applicable investor's percentage ownership of the qualified shareholder is treated as a USRPI in the hands of the qualified shareholder and is subject to FIRPTA. In that case, an amount equal to such percentage multiplied by the disposition proceeds and REIT distribution proceeds attributable to underlying USRPI gain is treated as FIRPTA gain in the hands of the qualified shareholder.

The provision is intended to override in certain cases one of the conclusions reached in AM 2008–003. Specifically, the provision contains special rules with respect to certain distributions that are treated as a sale or exchange of REIT stock under section 301(c)(3), 302, or 331 with respect to a qualified shareholder. Any such amounts attributable to an applicable investor are ineligible for the FIRPTA exception for qualified shareholders, and thus are subject to FIRPTA. Any such amounts attributable to other investors are treated as a dividend received from a REIT for purposes of U.S. dividend withholding tax and the application of income tax treaties, notwithstanding their general treatment under the Code.

A qualified shareholder is defined as a foreign person that (i) either is eligible for the benefits of a comprehensive income tax treaty which includes an exchange of information program and whose principal class of interests is listed and regularly traded on one or more recognized stock exchanges (as defined in such comprehensive income tax treaty), or is a foreign partnership that is created or organized under foreign law as a limited partnership in a jurisdiction that has an agreement for the exchange of information with respect to taxes with the United States and has a class of limited partnership units representing greater than 50 percent of the value of all the partnership units that is regularly traded on the NYSE or NASDAQ markets, (ii) is a qualified collective investment vehicle (as defined below), and (iii) maintains records on the identity of each person who, at any time during the foreign person's taxable year, is the direct owner of 5 percent or more of the class of interests or units (as applicable) described in (i), above.

A qualified collective investment vehicle is defined as a foreign person that (i) would be eligible for a reduced rate of withholding under the comprehensive income tax treaty described above, even if such entity holds more than 10 percent of the stock of such REIT,[966] (ii) is publicly traded, is treated as a partnership under the Code, is a withholding foreign partnership, and would be treated as a USRPHC if it were a domestic corporation, or (iii) is designated as such by the Secretary of the Treasury and is either (a) fiscally transparent within the meaning of section 894, or (b) required to include dividends in its gross income, but is entitled to a deduction for distributions to its investors.

The provision also contains rules with respect to partnership allocations of USRPI gains to applicable investors. If an applicable investor's proportionate share of USRPI gain for the taxable year exceeds such partner's distributive share of USRPI gain for the taxable year then such partner's distributive share of non-USRPI income or gain is recharacterized as USRPI gain for the taxable year in the amount that the distributive share of USRPI gain exceeds the proportionate share of USRPI gain. For purposes of these partnership allocation rules, USRPI gain is defined to comprise the net of gain recognized on disposition of a USRPI, distributions from a REIT that are treated as USRPI gain, and loss from the disposition of USRPIs. An investor's proportionate share of USRPI gain is determined based on the applicable investor's largest proportionate share of income or gain for the taxable year, and if such proportionate amount may vary during the existence of the partnership, such share is the highest share the applicable investor may receive.

Domestically controlled qualified investment entity

The provision redefines the term "domestically controlled qualified investment entity" to provide a number of new rules and presumptions relating to whether a qualified investment entity is domestically controlled. First, a qualified investment entity shall be permitted to presume that holders of less than five percent of a class of stock regularly traded on an established securities market in the United States are U.S. persons throughout the testing period, except to the extent that the qualified investment entity has actual knowledge that such persons are not U.S. persons. Second, any stock in the qualified investment entity held by another qualified investment entity (I) which has issued any class of stock that is regularly traded on an established stock exchange, or (II) which is a RIC that issues redeemable securities (within the meaning of section 2 of the Investment Company Act of 1940) shall be treated

[966] The qualified collective investment vehicle must be eligible for a reduced rate of withholding under a provision in the dividends article of the relevant treaty dealing specifically with dividends paid by REITs. For example, the U.S. income tax treaties with Australia and the Netherlands provide such a reduced rate of withholding under certain circumstances.

as held by a foreign person unless such other qualified investment entity is domestically controlled (as determined under the new rules) in which case such stock shall be treated as held by a U.S. person. Finally, any stock in a qualified investment entity held by any other qualified investment entity not described in (I) or (II) of the preceding sentence shall only be treated as held by a U.S. person to the extent that the stock of such other qualified investment entity is (or is treated under the new provision as) held by a U.S. person.

Exception for interests held by foreign retirement and pension funds

The provision exempts from the rules of section 897 any USRPI held directly (or indirectly through one or more partnerships) by, or to any distribution received from a real estate investment trust by, a qualified foreign pension fund or by a foreign entity wholly-owned by a qualified foreign pension fund. A qualified foreign pension fund means any trust, corporation, or other organization or arrangement [967] (A) which is created or organized under the law of a country other than the United States, (B) which is established to provide retirement or pension benefits to participants or beneficiaries that are current or former employees (or persons designated by such employees) of one or more employers in consideration for services rendered,[968] (C) which does not have a single participant or beneficiary with a right to more than five percent of its assets or income, (D) which is subject to government regulation and provides annual information reporting about its beneficiaries to the relevant tax authorities in the country in which it is established or operates, and (E) with respect to which, under the laws of the country in which it is established or operates, (i) contributions to such organization or arrangement that would otherwise be subject to tax under such laws are deductible or excluded from the gross income of such entity or taxed at a reduced rate, or (ii) taxation of any investment income of such organization or arrangement is deferred or such income is taxed at a reduced rate.

The provision also makes conforming changes to section 1445 to eliminate withholding on sales by qualified foreign pension funds (and their wholly-owned foreign subsidiaries) of USRPIs.

The Secretary of the Treasury may provide such regulations as are necessary to carry out the purposes of the provision.

Effective Date

The provision to extend exceptions from FIRPTA for certain REIT stock applies to dispositions and distributions on or after the date of enactment (December 18, 2015).

The provision to modify the definition of a domestically controlled qualified investment entity is effective on the date of enactment (December 18, 2015).

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[967] Foreign pension funds may be structured in a variety of ways, and may comprise one or more separate entities. The word “arrangement” encompasses such alternative structures.

[968] Multi-employer and government-sponsored public pension funds that provide pension and pension-related benefits may satisfy this prong of the definition. For example, such pension funds may be established for one or more companies or professions, or for the general working public of a foreign country.

The exception for interests held by foreign retirement and pension funds generally applies to dispositions and distributions after the date of enactment (December 18, 2015).

12. Increase in rate of withholding of tax on dispositions of United States real property interests (sec. 324 of the Act and sec. 1445 of the Code)[969]

Present Law

A purchaser of a USRPI from any person is obligated to withhold 10 percent of gross purchase price unless certain exceptions apply.[970] The obligation does not apply if the transferor furnishes an affidavit that the transferor is not a foreign person. Even absent such an affidavit, the obligation does not apply to the purchase of publicly traded stock.[971] Also, the obligation does not apply to the purchase of stock of a nonpublicly traded domestic corporation, if the corporation furnishes the transferee with an affidavit stating the corporation is not and has not been a USRPHC during the applicable period (unless the transferee has actual knowledge or receives a notification that the affidavit is false).[972]

Treasury regulations[973] generally provide that a domestic corporation must, within a reasonable period after receipt of a request from a foreign person holding an interest in it, inform that person whether the interest constitutes a USRPI.[974] No particular form is required. The statement must be dated and signed by a responsible corporate officer who must verify under penalties of perjury that the statement is correct to his knowledge and belief. If a foreign investor requests such a statement, then the corporation must provide a notice to the IRS that includes the name and taxpayer identification number of the corporation as well as the investor, and indicates whether the interest in question is a USRPI. However, these requirements do not apply to a domestically controlled REIT or to a corporation that has issued any class of stock which is regularly traded on an established securities market at any time during the calendar year. In such cases a corporation may voluntarily choose to comply with the notice requirements that would otherwise have applied.[975]

In addition to these exceptions that might be determined at the entity level, even if a corporation is a USRPHC, its stock is not a USRPI in the hands of the seller if the stock is of a class that is publicly traded and the foreign shareholder disposing of the stock has not owned (applying attribution rules) more than five percent of such class of stock during the relevant period.

[969] The Senate Committee on Finance reported S.915 on April 14, 2015 (S. Rep. No. 114–25). Section 3 of that bill contained an identical provision.

[970] Sec. 1445.

[971] Sec. 1445(b)(6).

[972] Sec. 1445(b)(3). Other exceptions also apply. Sec. 1445(b).

[973] Treas. Reg. Sec. 1.897–2(h).

[974] As described previously, stock of a U.S. corporation is not generally a USRPI unless it is stock of a USRPHC. However, all U.S. corporate stock is deemed to be such stock, unless it is shown that the corporation's U.S. real property interests do not amount to the relevant 50 percent or more of the corporation's relevant assets. Also, even if a REIT is a USRPHC, if it is domestically controlled its stock is not a USRPI.

[975] Treas. Reg. sec. 1.897–2(h)(3).

Explanation of Provision

The provision generally increases the rate of withholding of tax on dispositions and certain distributions of URSPIs, from 10 percent to 15 percent. There is an exception to this higher rate of withholding (retaining the 10 percent withholding tax rate under present law) for sales of residences intended for personal use by the acquirer, with respect to which the purchase price does not exceed $1,000,000. Thus, if the present law exception for personal residences (where the purchase price does not exceed $300,000) does not apply, the 10 percent withholding rate is retained so long as the purchase price does not exceed $1,000,000.

Effective Date

The provision applies to dispositions after the date which is 60 days after the date of enactment (December 18, 2015).

13. Interests in RICs and REITs not excluded from definition of United States real property interests (sec. 325 of the Act and sec. 897 of the Code)[976]

Present Law

An interest in a corporation is not a USRPI if (1) as of the date of disposition of such interest, such corporation did not hold any USRPIs and (2) all of the USRPIs held by such corporation during the shorter of (i) the period of time after June 18, 1980, during which the taxpayer held such interest, or (ii) the five-year period ending on the date of disposition of such interest, were either disposed of in transactions in which the full amount of the gain (if any) was recognized, or ceased to be USRPIs by reason of the application of this rule to one or more other corporations (the so-called "cleansing rule").[977]

Explanation of Provision

Under the provision, the cleansing rule applies to stock of a corporation only if neither such corporation nor any predecessor of such corporation was a RIC or a REIT at any time during the shorter of the period after June 18, 1980 during which the taxpayer held such stock, or the five-year period ending on the date of the disposition of such stock.

Effective Date

The provision applies to dispositions on or after the date of enactment (December 18, 2015).

[976] The Senate Committee on Finance reported S.915 on April 14, 2015 (S. Rep. No. 114–25). Section 6 of that bill contained an identical provision.
[977] Sec. 897(c)(1)(B).

14. Dividends derived from RICs and REITs ineligible for deduction for United States source portion of dividends from certain foreign corporations (sec. 326 of the Act and sec. 245 of the Code)[978]

Present Law

A corporation is generally allowed to deduct a portion of the dividends it receives from another corporation. The deductible amount is a percentage of the dividends received. The percentage depends on the level of ownership that the corporate shareholder has in the corporation paying the dividend. The dividends-received deduction is 70 percent of the dividend if the recipient owns less than 20 percent of the stock of the payor corporation, 80 percent if the recipient owns at least 20 percent but less than 80 percent of the stock of the payor corporation, and 100 percent if the recipient owns 80 percent or more of the stock of the payor corporation.[979]

Dividends from REITs are not eligible for the corporate dividends received deduction.[980] Dividends from a RIC are eligible only to the extent attributable to dividends received by the RIC from certain other corporations, and are treated as dividends from a corporation that is not 20-percent owned.[981]

Dividends received from a foreign corporation are not generally eligible for the dividends-received deduction. However, section 245 provides that if a U.S. corporation is a 10-percent shareholder of a foreign corporation, the U.S. corporation is generally entitled to a dividends-received deduction for the portion of dividends received that are attributable to the post-1986 undistributed U.S. earnings of the foreign corporation. The post-1986 undistributed U.S. earnings are measured by reference to earnings of the foreign corporation effectively connected with the conduct of a trade or business within the United States, or received by the foreign corporation from an 80-percent-owned U.S. corporation.[982] A 2013 IRS chief counsel advice memorandum advised that dividends received by a 10-percent U.S. corporate shareholder from a foreign corporation controlled by the shareholder are not eligible for the dividends-received deduction if the dividends were attributable to interest income of an 80-percent owned RIC.[983] Treasury regulations section 1.246–1 states that the deductions provided in sections "243 . . . 244 . . . and 245 (relating to dividends received from certain foreign corporations)" are not allowable with respect to any dividend received from certain entities, one of which is a REIT.

[978] The Senate Committee on Finance reported S.915 on April 14, 2015 (S. Rep. No. 114–25). Section 7 of that bill contained an identical provision.

[979] Sec. 243.

[980] Secs. 243(d)(3) and 857(c)(1).

[981] Secs. 243(d)(2) and 854(b)(1)(A) and (C).

[982] Sec. 245

[983] IRS CCA 201320014. The situation addressed in the memorandum involved a controlled foreign corporation that had terminated its "CFC" status before year end, through a transfer of stock to a partnership. The advice was internal IRS advice to the Large Business and International Division. Such advice is not to be relied upon or cited as precedent by taxpayers, but may offer some indication of administrative practice.

Explanation of Provision

Under the provision, for purposes of determining whether dividends from a foreign corporation (attributable to dividends from an 80-percent owned domestic corporation) are eligible for a dividends-received deduction under section 245, dividends from RICs and REITs are not treated as dividends from domestic corporations.

Effective Date

The provision applies to dividends received from RICs and REITs on or after the date of enactment (December 18, 2015). No inference is intended with respect to the proper treatment under section 245 of dividends received from RICs or REITs before such date.

C. Additional Provisions

1. Provide special rules concerning charitable contributions to, and public charity status of, agricultural research organizations (sec. 331 of the Act and secs. 170(b) and 501(h) of the Code)[984]

Present Law

Public charities and private foundations

An organization qualifying for tax-exempt status under section 501(c)(3) of the Internal Revenue Code of 1986, as amended (the "Code") is further classified as either a public charity or a private foundation. An organization may qualify as a public charity in several ways.[985] Certain organizations are classified as public charities per se, regardless of their sources of support. These include churches, certain schools, hospitals and other medical organizations (including medical research organizations), certain organizations providing assistance to colleges and universities, and governmental units.[986] Other organizations qualify as public charities because they are broadly publicly supported or support specific public charities. First, a charity may qualify as publicly supported if at least one-third of its total support is from gifts, grants or other contributions from governmental units or the general public.[987] Alternatively, it may qualify as publicly supported if it receives more than one-third of its total support from a combination of gifts, grants, and contributions from governmental units and the public plus revenue arising from activities related to its exempt purposes (*e.g.*, fee for service income). In addition, this category of public charity must not rely excessively on endowment income as a source of support.[988] A supporting organization, i.e., an organization that

[984] The Senate Committee on Finance reported S. 906 on April 14, 2015 (S. Rep. No. 114–19).

[985] The Code does not expressly define the term "public charity," but rather provides exceptions to those entities that are treated as private foundations.

[986] Sec. 509(a)(1) (referring to sections 170(b)(1)(A)(i) through (iv) for a description of these organizations).

[987] Treas. Reg. sec. 1.170A–9(f)(2). Failing this mechanical test, the organization may qualify as a public charity if it passes a "facts and circumstances" test. Treas. Reg. sec. 1.170A–9(f)(3).

[988] To meet this requirement, the organization must normally receive more than one-third of its support from a combination of (1) gifts, grants, contributions, or membership fees and (2) certain gross receipts from admissions, sales of merchandise, performance of services, and fur-

Continued

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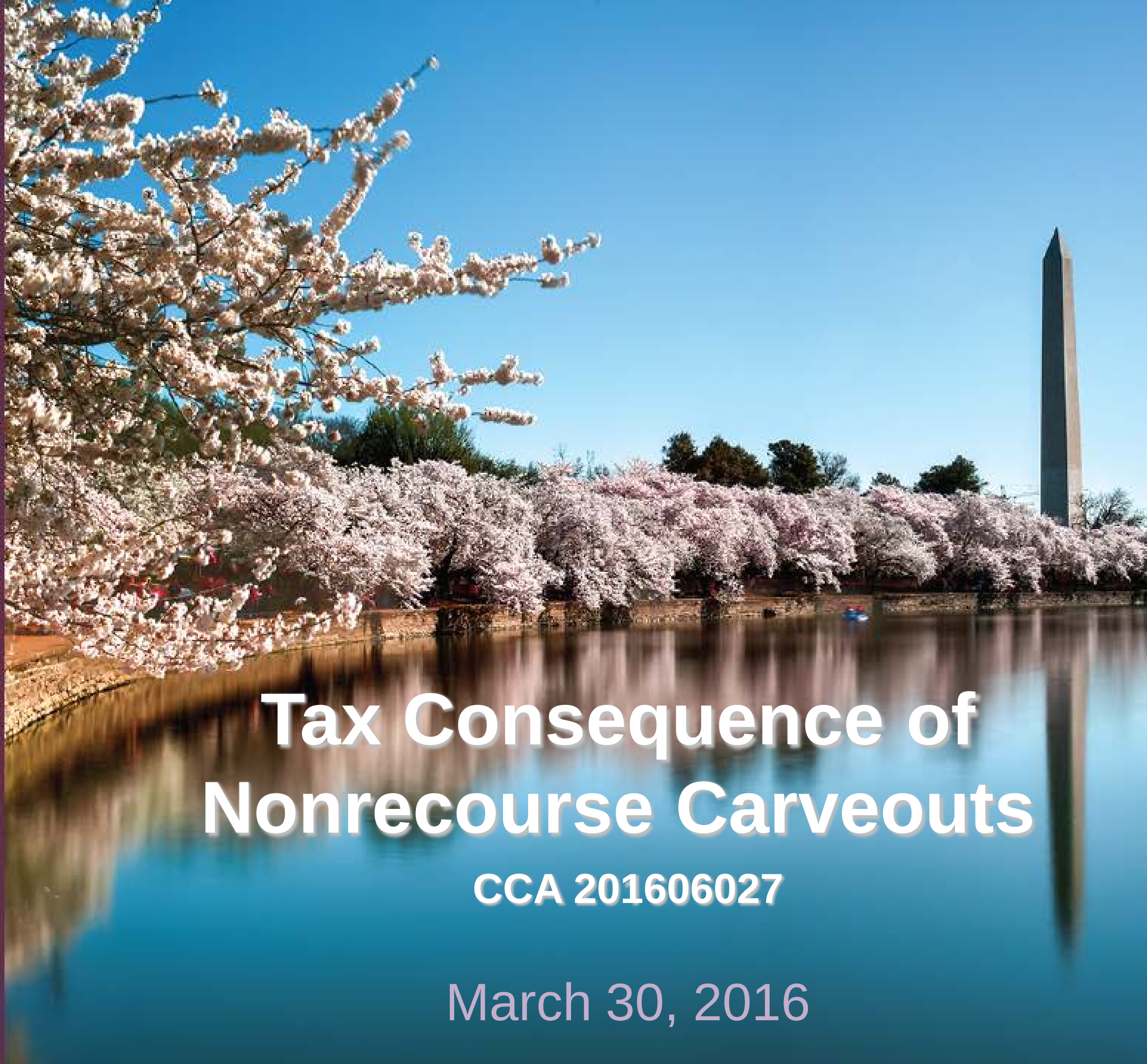


Tax Consequence of Nonrecourse Carveouts

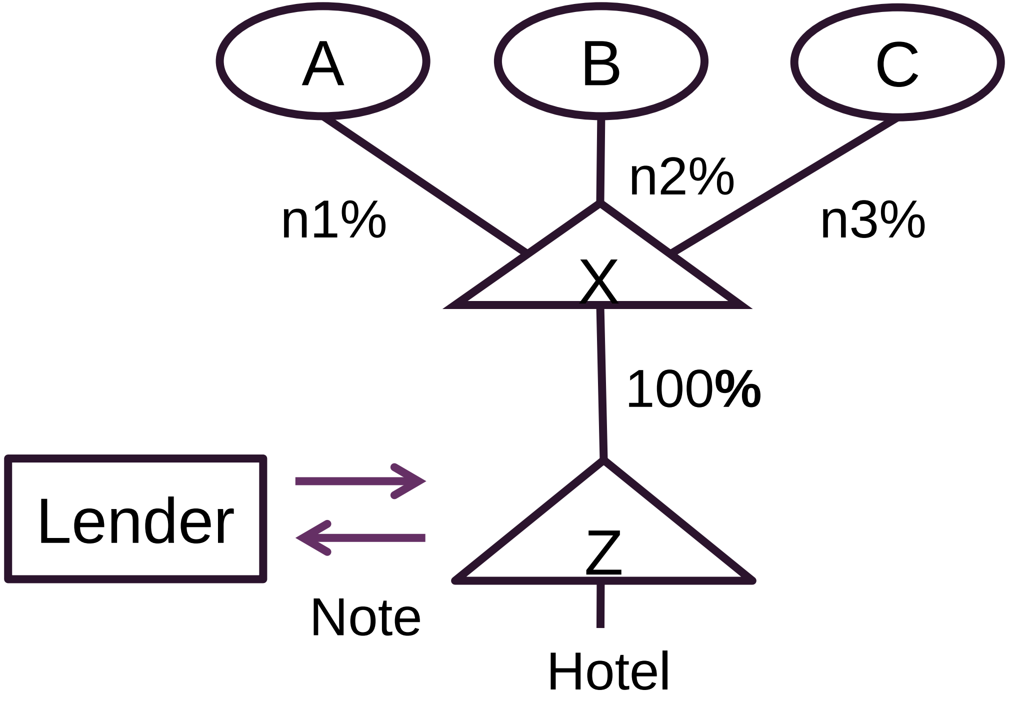
CCA 201606027

March 30, 2016

Presenter:

Richard M. Lipton
Baker & McKenzie, LLP (Chicago)

The Structure



- Note secured by hotel.
- C executed 3 personal guarantees.

The Nonrecourse Carveout

- The entire amount due under the note due and payable if:
  1. the co-borrowers fail to obtain the lender's consent before obtaining subordinate financing or transfer of the secured property,
  2. any co-borrower files a voluntary bankruptcy petition,
  3. any person in control of any co-borrower files an involuntary bankruptcy petition against a co-borrower,
  4. any person in control of any co-borrower solicits other creditors to file an involuntary bankruptcy petition against a co-borrower,

The Nonrecourse Carveout

5. any co-borrower consents to or otherwise acquiesces or joins in an involuntary bankruptcy or insolvency proceeding,
6. any person in control of any co-borrower consents to the appointment of a receiver or custodian of assets, or
7. any co-borrower makes an assignment for the benefit of creditors, or admits in writing or in any legal proceeding that it is insolvent or unable to pay its debts as they come due.

The Regulations

- Treas. Reg. § 1.752-2(b)(4)

Contingent obligations. A payment obligation is disregarded if, taking into account all the facts and circumstances, the obligation is subject to **contingencies** that make it unlikely that the obligation will ever be discharged. If a payment obligation would arise at a future time after the occurrence of an event that is not **determinable with reasonable certainty**, the obligation is ignored until the event occurs.

Conclusions

- IRS concludes that the nonrecourse carveouts cause the note to be recourse to C.
  - “We believe it is reasonable to assume that one or more of these conditions, more likely than not, would be met upon a constructive liquidation of X under § 1.752-2(b)(1). Accordingly, we believe that these ‘conditions’ do not fall within the definition of ‘contingencies’ as intended by § 1.752-2(b)(4).”

Conclusions

- "We nevertheless believe that the likelihood that X or any other co-borrower will ever meet any one of these conditions, in the aggregate, is not so remote a possibility that would cause the obligation to be considered 'likely to never be discharged' within the meaning of § 1.752-2(b)(4)."

Conclusions

- Real world borrowers understand that they do not have recourse liability on a loan with a nonrecourse carveout unless they engage in a voluntary or intentional “bad act.”
- Borrowers would not sign if they thought liability was “more likely than not”.
- If correct, liability (and deductions) would shift to NRCO signatory.
- Tax Returns?

The Economic Impact of Repealing or Limiting Section 1031 Like-Kind Exchanges in Real Estate

David C. Ling and Milena Petrova

July 2015

Presentation Outline

1. Overview of Study Results
2. Evidence on Use of Real Estate (RE) Like-Kind Exchanges
3. Estimated Magnitude of Exchange Tax Benefits
4. Effects of Elimination of Like-Kind Exchanges in RE on Property Values and Required Rents
5. Economic Benefits of 1031 Exchanges – Empirical Evidence
6. Like-Kind Exchanges and Taxes
7. Consequences of Removal of LKEs Based on the Established Micro-economic Effects

The Impact of Repealing Like-Kind Exchanges in Real Estate

1. Overview of Study Results

Overview of Study Results

1. Widespread use of RE like-kind exchanges:
   - 6% (5%) of all commercial RE sales based on $ volume (# of transactions)
   - Use of exchanges in high-tax states varies between 10% & 18% of all sales in their respective market
   - These %s are likely **understated**

2. We estimate the static present value of lost tax revenue to be, on average, $2-$4 billion per year, assuming taxpayers would not delay transactions
   - But…taxpayers would delay transactions, driving revenue gains toward zero
   - Note: JCT's estimated revenue loss, that does factor in investor behavior, **is only 9%** of its corresponding tax expenditure estimate

Overview of Study Results (2)

3. But…elimination would produce many negative consequences
   - Liquidity would be reduced (holding periods would increase)
     - Less efficient allocation of scarce resources
     - Less ability, especially for small investors, to reposition portfolios
   - Prices in most markets would decrease in the short-run; especially in markets where marginal investor expects to use exchanges to dispose of property:
     - Short-run CRE price declines of 8%-17% in markets with moderate taxes; 22%-27% declines in high tax states/markets
     - These declines would
       - reduce the wealth of a large cross-section of households
       - slow or stop construction in many local markets
   - Longer-run rent increases of 8%-20% in moderately taxed markets; 28%-38% required increases in high tax states/markets
     - Such increases would reduce affordability of CRE space for both large & small tenants

Overview of Study Results (3)

4. RE exchanges are associated with increased investment, reduced leverage & shorter holding periods (more liquidity)
   - Replacement like-kind exchanges are associated with an investment that is approximately $305,000 greater (33 percent of value) than “regular” acquisitions by the same investor following a sale of a property.
   - Capital expenditures (specifically building improvements) in replacement exchange properties tend to be higher by about $0.27/sf-$0.40/sf ($0.18/sf-$0.24/sf for building improvements).
   - Investors in like-kind exchanges use less leverage compared to ordinary acquisitions.
   - Holding periods for properties disposed through 1031 exchanges are, on average, shorter.

Overview of Study Results (4)

5. Most exchange replacement properties are subsequently sold in fully taxable sales
   - In 88% of our sample, investors disposed of properties acquired in a 1031 exchange through a fully taxable sale.
   - The estimated taxes paid in an exchange followed by a taxable sale vs. ordinary sale followed by an ordinary sale are on average 19% higher.

But…Elimination Would Produce Many Negative Consequences, cont.

- Less reinvestment in commercial and residential real estate
- Greater use of leverage (with it attendant costs)
- Downward pressure on employment, especially in related sectors
- Decreased tax benefits for local governments

The Impact of Repealing Like-Kind Exchanges in Real Estate

2. Evidence on the Use of Real Estate Like-Kind Exchanges

Evidence from Transaction Data

- CoStar COMPS database includes historical information on CRE transactions in over 878 CBSAs dating back to 1989
- CoStar agents physically inspect the property & record/verify a variety of property characteristics & transaction details
- COMPS database includes 1,609,711 confirmed CRE transactions from 1997 through 2014
  - Total transaction volume = $4.8 trillion (unadjusted for inflation)
- Sales in which CoStar determined that buyer and/or seller were engaged in a like-kind exchange = 81,104
  - 5% of all transactions
  - 6% by sales volume

Table 3: % of CoStar Sales Involving an Exchange by Property Type

	Full sample: 1997-2014		1997-2007		2008-2014	
Property type	Based on number of sales	Based on $ transaction volume	Based on number of sales	Based on $ transaction volume	Based on number of sales	Based on $ transaction volume
Multifamily (≥ 10 units)	12%	8%	16%	11%	5%	5%
Multifamily (< 10 units)	10%	11%	14%	15%	4%	7%
Flex	6%	7%	9%	8%	3%	4%
Total	5%	6%	8%	7%	2%	4%
Office	5%	5%	8%	6%	2%	3%
Industrial	5%	5%	7%	8%	2%	3%
General retail	4%	7%	7%	10%	2%	5%
Hospitality	3%	3%	5%	3%	2%	2%
Speciality	2%	3%	4%	4%	1%	2%
Land	2%	3%	3%	3%	1%	2%
Health care	2%	1%	3%	1%	1%	1%
Sports & Entertainment	2%	1%	3%	3%	0%	0%
Mixed-Use	1%	1%	2%	2%	1%	1%

Table 5: % of 81,104 Exchanges by State: 1997-2014

	Based on:			
	Number of sales		$ Transaction volume	
State	Percentage	Cumulative	Percentage	Cumulative
California	46.5%	46.5%	39.7%	39.7%
Washington	9.1%	55.6%	7.3%	46.9%
Colorado	6.4%	62.0%	4.6%	51.5%
Oregon	5.1%	67.1%	3.4%	54.9%
Arizona	4.8%	71.9%	4.0%	58.9%
Texas	3.7%	75.6%	5.5%	64.4%
Nevada	3.5%	79.0%	3.4%	67.8%
Illinois	3.3%	82.3%	3.5%	71.2%
Florida	3.0%	85.4%	4.1%	75.3%
New York	1.7%	87.1%	7.8%	83.1%
Ohio	1.2%	88.3%	0.9%	84.1%
Georgia	1.1%	89.5%	1.2%	85.3%
North Carolina	0.9%	90.4%	0.9%	86.2%
Minnesota	0.9%	91.2%	0.8%	87.0%
New Jersey	0.8%	92.0%	1.8%	88.8%
Massachusetts	0.7%	92.8%	1.4%	90.2%
Virginia	0.7%	93.5%	1.8%	92.0%
Maryland	0.7%	94.2%	1.0%	93.1%
Pennsylvania	0.6%	94.9%	0.9%	93.9%

Table 7: Exchanges as % of All CoStar Sales by State: 1997-2014

	Based on:	
State	Number of sales	$ transaction volume
Oregon	16.3%	15.9%
Washington	15.0%	12.0%
California	11.6%	9.9%
Nevada	8.6%	7.7%
Utah	8.5%	7.4%
Colorado	8.4%	8.9%
Hawaii	7.9%	6.2%
Alaska	7.2%	5.8%
Texas	5.1%	5.5%
Arizona	5.0%	5.2%
Montana	4.9%	6.5%
Idaho	3.8%	7.5%
Wyoming	3.5%	4.6%
Minnesota	3.5%	4.6%
Illinois	2.9%	3.6%
New Mexico	2.5%	3.4%
District of Columbia	2.2%	3.9%
Kansas	2.2%	3.3%
Missouri	2.1%	2.6%
North Carolna	2.0%	2.9%
South Carolina	2.0%	2.7%
Mississippi	2.0%	1.3%
North Dakota	2.0%	4.1%
Iowa	2.0%	2.9%

California: 39.7% of all exchanges but 9.9% of all sales in California

Most widely used in Western states

%s in remaining states less than 2%

%s are larger when recent price appreciation has been high

Table 6: Exchanges as a % of All CoStar Sales by CBSA: 1997-2014

CBSA	Based on: Number of sales	Based on: $ transaction volume
Portland-Vancouver-Hillsboro, OR-WA	18%	17%
San Diego-Carlsbad, CA	17%	13%
Seattle-Tacoma-Bellevue, WA	17%	12%
Santa Rosa, CA	15%	14%
San Francisco-Oakland-Hayward, CA	13%	9%
Los Angeles-Long Beach-Anaheim, CA	12%	10%
San Jose-Sunnyvale-Santa Clara, CA	12%	7%
Boulder, CO	11%	14%
Sacramento--Roseville--Arden-Arcade, CA	11%	12%
Oxnard-Thousand Oaks-Ventura, CA	10%	10%
Las Vegas-Henderson-Paradise, NV	9%	8%
Colorado Springs, CO	9%	11%
Denver-Aurora-Lakewood, CO	9%	8%
Tucson, AZ	8%	12%
Riverside-San Bernardino-Ontario, CA	8%	10%
Dallas-Fort Worth-Arlington, TX	7%	7%
Houston-Sugar Land-Baytown, TX	5%	5%
Phoenix-Mesa-Scottsdale, AZ	4%	4%
Austin-Round Rock, TX	4%	3%
Minneapolis-St. Paul-Bloomington, MN-WI	4%	5%
Total US	5%	6%

Again, use of exchanges much higher in Western CBSAs

%s in remaining CBSAs less than 4%

We Believe CoStar is Underreporting Exchanges

- In a prior study using CoStar data (Ling & Petrova, 2008), we found much greater use of exchanges
  - Exchanges represented 27% of sales
- Primary explanation:
  - CoStar has grown significantly since 2007 by acquisitions
    - Acquired firms did not track exchanges as carefully

Evidence from IRS Data: Table 8
(in $billions)

Individuals + Corporations + Partnerships	2011	2010	2009	2008	2007	2003-2011 Sum	2003-2011 Mean
FMV of all like-kind property received (Form 8824, line 17)	$70.8	$78.6	$63.3	$118.4	$199.4	$1,267.8	$140.9
Deferred gain from all industries (From 8824, line 24)	33.7	39.9	33.8	56.1	90.0	577.2	64.1
Deferred gain from RE is 66% of total (based on 2007 data):							
Deferred gain from RE industry	22.2	26.3	22.3	37.0	59.4	381.0	42.3
Estimated deferred tax liability from RE industry *	4.7	5.5	4.7	7.8	12.5	80.0	8.9
Estimated economic loss to Treasury:							
Minimum-9.2% of deferred tax liability	0.4	0.5	0.4	0.7	1.1	7.4	0.8
Average-45.0% of deferred tax liability	2.1	2.5	2.1	3.5	5.6	36.0	4.0
Maximum-64.0% of deferred tax liability	3.0	3.5	3.0	5.0	8.0	51.2	5.7
Deferred gain from RE is 30% of total deferred gain:							
Deferred gain from RE industry	10.1	12.0	10.1	16.8	27.0	173.2	19.2
Estimated deferred tax liability from RE industry *	2.1	2.5	2.1	3.5	5.7	36.4	4.0
Estimated economic loss to Treasury:							
Minimum-9.2% of deferred tax liability	0.2	0.2	0.2	0.3	0.5	3.3	0.4
Average-45.0% of deferred tax liability	1.0	1.1	1.0	1.6	2.6	16.4	1.8
Maximum-64.0% of deferred tax liability	$1.4	$1.6	$1.4	$2.3	$3.6	$23.3	$2.6

- * Estimated deferred tax liability assumes deferred gain would have been taxed at 21%
- But…these estimates of deferred tax liabilities overstate exchange benefits/lost tax revenue

The Impact of Repealing Like-Kind Exchanges in Real Estate

3. Estimated Magnitude of Exchange Tax Benefits

Incremental Value of Exchange
Relative to Fully Taxable Sale

- $INCNPV_t$ = PV of net cash flows if taxpayer **exchanges** into replacement property
  - PV of net CFs if taxpayer **sell**s relinquish property & **purchases** replacement property

Incremental Value of Exchange
Relative to Fully Taxable Sale

- $INCNPV_t$ = PV of net cash flows if taxpayer **exchanges** into replacement property
  - PV of net CFs if taxpayer **sell**s relinquish property & **purchases** replacement property

$$INCNPV_t = [SC_t^1 - EC_t + TDS_t^1 - B_t] - \sum_{i=1}^{n} \frac{\tau_o (DEP_i^{2,s} - DEP_i^{2,e})}{(1+k)^i} - \frac{\tau_{dr} (RECAP_{t+n}^{2,e} - RECAP_{t+n}^{2,s})}{(1+k)^n} - \frac{\tau_{cg} (CG_{t+n}^{2,e} - CG_{t+n}^{2,s})}{(1+k)^n}.$$

deferred tax liability in year *t*

increased depreciation recapture tax on taxable sale of replacement property

reduced PV of annual depreciation deductions *t*

increased capital gain tax on taxable sale of replacement property

- Note: CFs from operations and sale do not affect $INCNPV_t$
- $INCNPV_t$ is fully developed in an appendix

Base-Case Model Parametrization

- Price of relinquished = price of replacement property
- Mortgage debt: same for relinquished & replacement property
- Selling cost in fully taxable sale: 3% of relinquished property's sale price
- Exchange costs: equal to selling costs of a fully taxable sale
- Ordinary income tax rate: 39.6%
- Depreciation recapture tax rate: 25%
- Capital gain tax rate: 23.8%
- After-tax discount rate: 6%
- Non-depreciable land portion of relinquished & replacement property's original tax basis: 20%(no personal property)
- Relinquished & replacement property are both non-residential real property
- **Other key assumptions**: # of years since acquisition of relinquished property ($HOLD^1$), annualized rate of nominal price appreciation since acquisition of relinquished property (π^1), expected holding period of replacement property ($HOLD^2$).

Figure 2: Incremental NPV as a % of Property Value

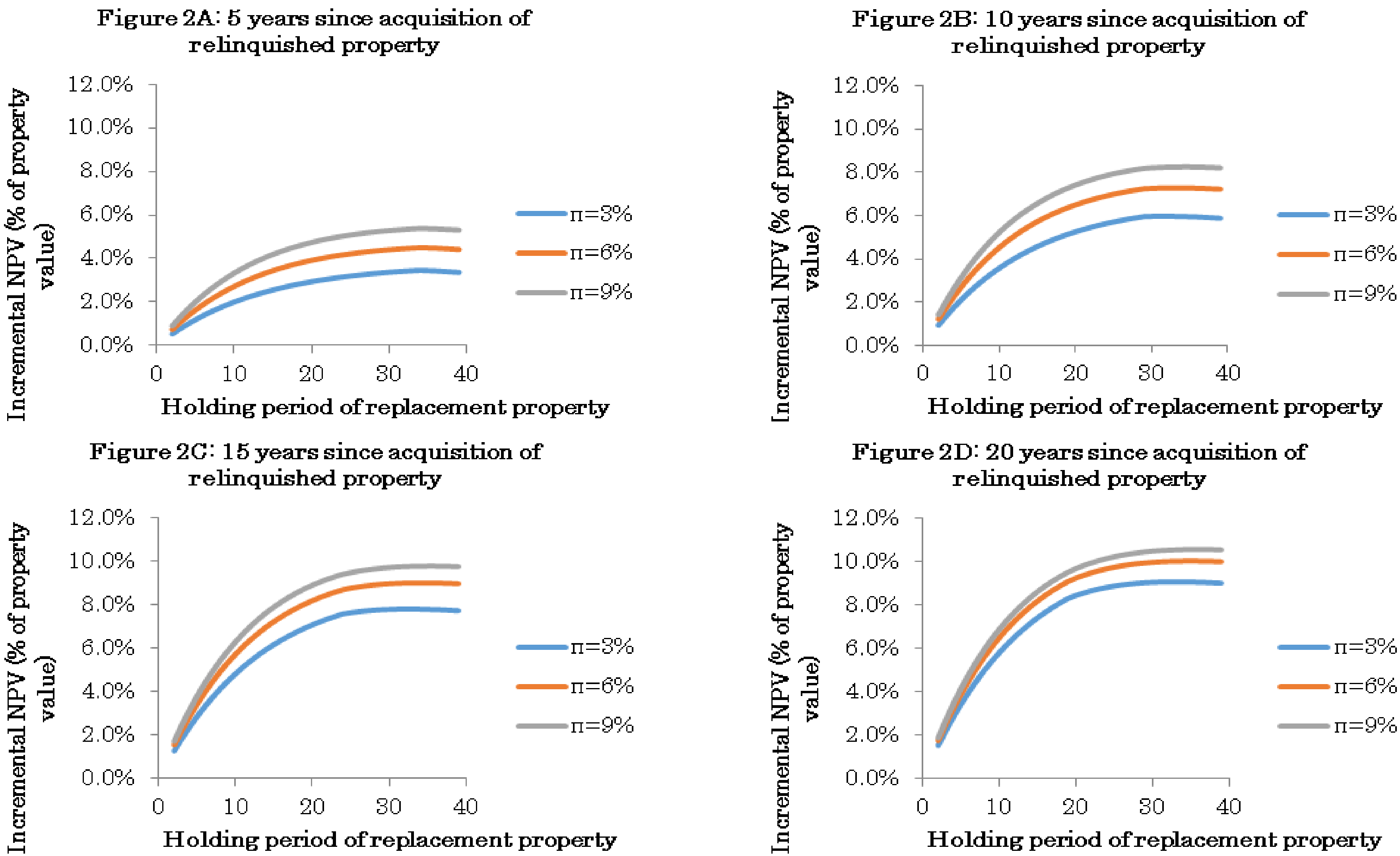


Figure 3: Incremental NPV as a % of Deferred Gain

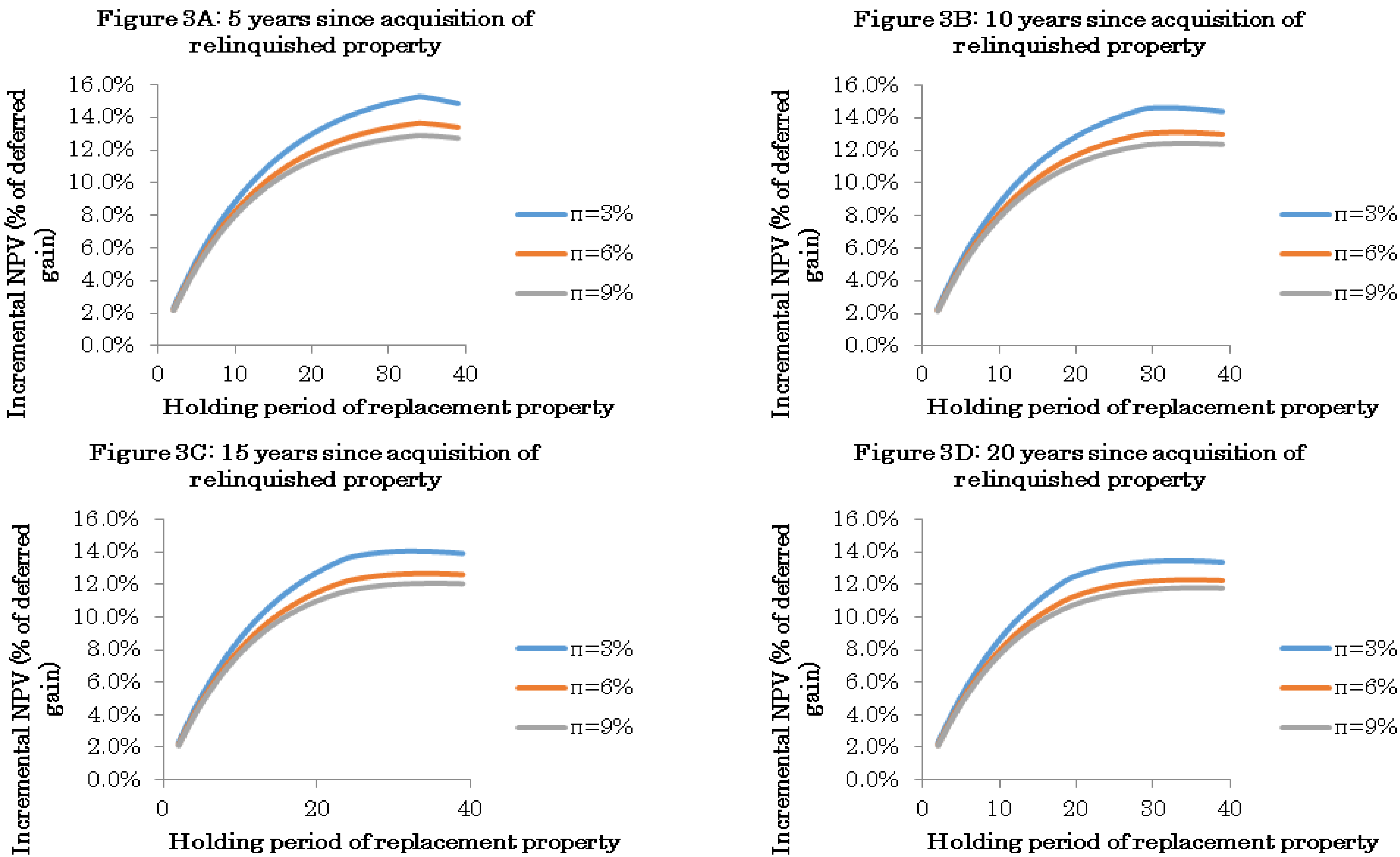


Figure 4: Incremental NPV as a % of Deferred Taxes

Figure 4A: 5 years since acquisition of relinquished property

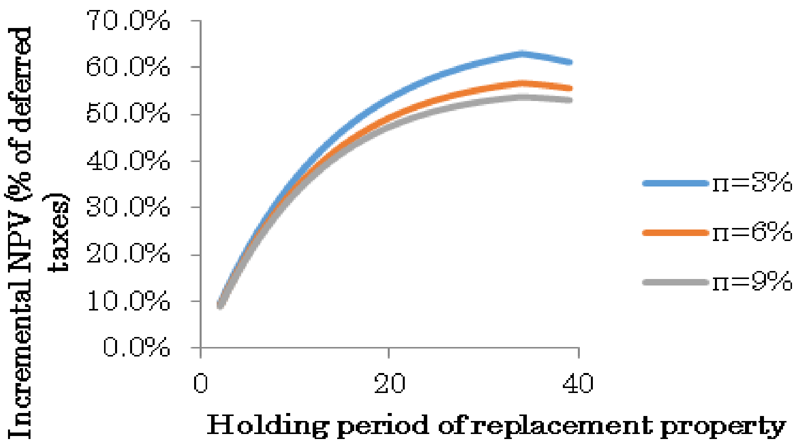


Figure 4B: 10 years since acquisition of relinquished property

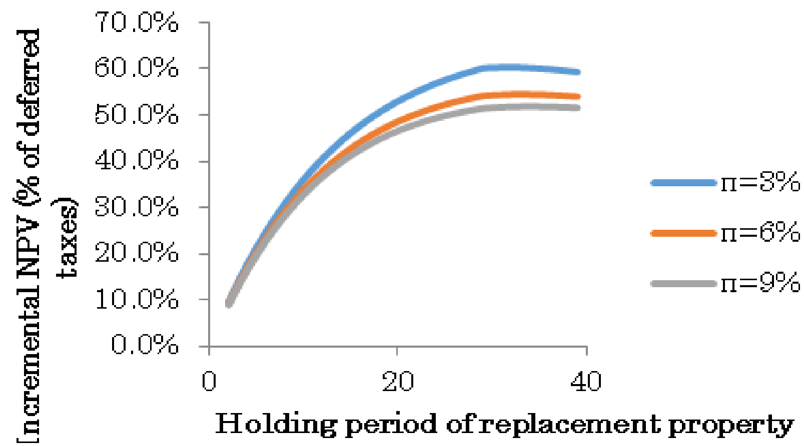


Figure 4C: 15 years since acquisition of relinquished property

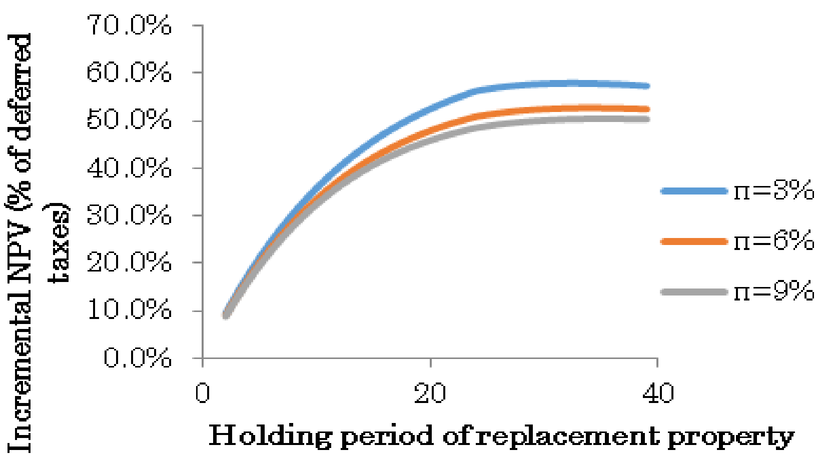


Figure 4D: 20 years since acquisition of relinquished property

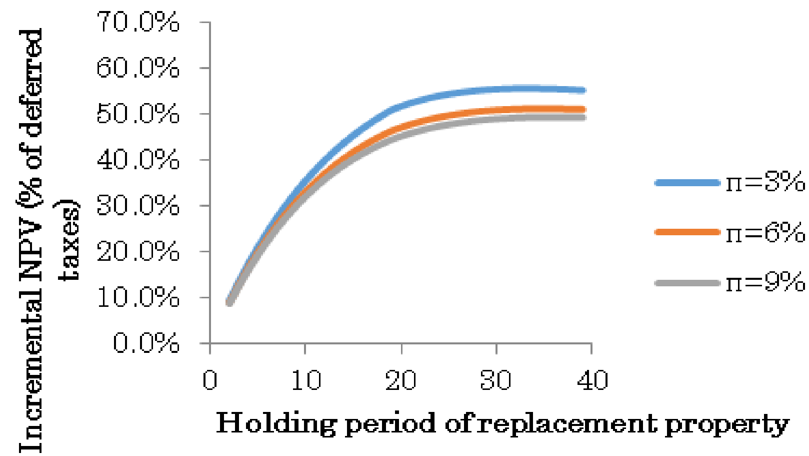


Figure 5: Sensitivity to Assumed Discount Rate

- Tax deferral benefit produced by exchange is immediate
- But…foregone depreciation deductions & increased future capital gain & depreciation tax liabilities occur **in subsequent years**
- Thus, incremental NPV of an exchange to the taxpayer is:
  - increased by a higher discount rate
  - decreased by a lower discount rate

Figure 6: Residential (Apartments) v. Nonresidential

- More rapid depreciation of residential increases immediate benefit of tax deferral
  - More depreciation recapture income to defer
- But…increased deferral benefit is offset by reduced depreciation deductions due to carry-forward of basis & deductions
- Net result?
  - Generally lower incremental NPV from exchange for apartments

Revised Look at Net Benefit/Lost Tax Revenue: Table 8 (in $billions)

Individuals + Corporations + Partnerships	2011	2010	2009	2008	2007	2003-2011 Sum	2003-2011 Mean
FMV of all like-kind property received (Form 8824, line 17)	$70.8	$78.6	$63.3	$118.4	$199.4	$1,267.8	$140.9
Deferred gain from all industries (From 8824, line 24)	33.7	39.9	33.8	56.1	90.0	577.2	64.1
Deferred gain from RE is 66% of total (based on 2007 data):							
Deferred gain from RE industry	22.2	26.3	22.3	37.0	59.4	381.0	42.3
Estimated deferred tax liability from RE industry	4.7	5.5	4.7	7.8	12.5	80.0	8.9
Estimated economic loss to Treasury:							
Minimum-9.2% of deferred tax liability	0.4	0.5	0.4	0.7	1.1	7.4	0.8
Average-45.0% of deferred tax liability	2.1	2.5	2.1	3.5	5.6	36.0	4.0
Maximum-64.0% of deferred tax liability	3.0	3.5	3.0	5.0	8.0	51.2	5.7
Deferred gain from RE is 30% of total deferred gain:							
Deferred gain from RE industry	10.1	12.0	10.1	16.8	27.0	173.2	19.2
Estimated deferred tax liability from RE industry	2.1	2.5	2.1	3.5	5.7	36.4	4.0
Estimated economic loss to Treasury:							
Minimum-9.2% of deferred tax liability	0.2	0.2	0.2	0.3	0.5	3.3	0.4
Average-45.0% of deferred tax liability	1.0	1.1	1.0	1.6	2.6	16.4	1.8
Maximum-64.0% of deferred tax liability	$1.4	$1.6	$1.4	$2.3	$3.6	$23.3	$2.6

- Calculations assume taxpayers would have disposed of their properties in fully taxable sales in the absence of ability to exchange
- Thus, these estimates still overstate exchange benefits/lost tax revenue
  - JCT's "dynamic" revenue estimate (for all exchanges-2015-2019) is < 10% of its tax expenditure estimate
- Treasury's discount rate?

The Impact of Repealing Like-Kind Exchanges in Real Estate

4. Effects of Elimination of Like-Kind Exchanges on Property Values & Rents

Analysis Tool: User Cost of Capital Model

- Discrete-time, partial equilibrium model that measures & values cash flows to equity investor(s) after all operating, finance, and tax expenses (savings) have been paid
- In our application, the model solves for price that equates marginal investor's expected NPV to zero under old tax law parameters
- **Short-run effect** of tax law change on prices is estimated as % reduction in the marginal investor's maximum bid price (value)
- Effects can be calculated holding all other assumptions constant; alternatively, expected GE effects, such as changes in the level of economy-wide interest rates, can also be included
- Full model: see equations (2) and (3)

Short-Run v. Long-Run Effects

- The model [equation (2)] can also be used to solve for the long-run increase in 1st year rents necessary to offset negative tax law change
  - Analogous to calculating change in the user cost of capital (rent/price ratio) induced by the tax change
- Estimated impact of tax law change: compare equilibrium level of rent under current law to rent required after elimination of exchanges
  - Assuming all-in construction costs don't change

- Parameter assumptions based on 2014 4th quarter data

Figure 10: Required Price Decrease After Elimination—Nonresidential

Figure10A: $\tau_{OI} = 39.6\%, \tau_{CG} = 23.8\%, \tau_{DR} = 25\%$

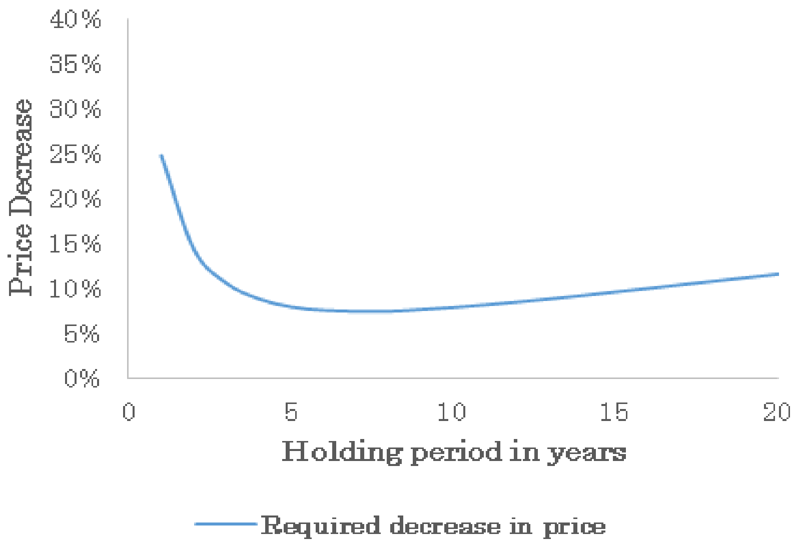
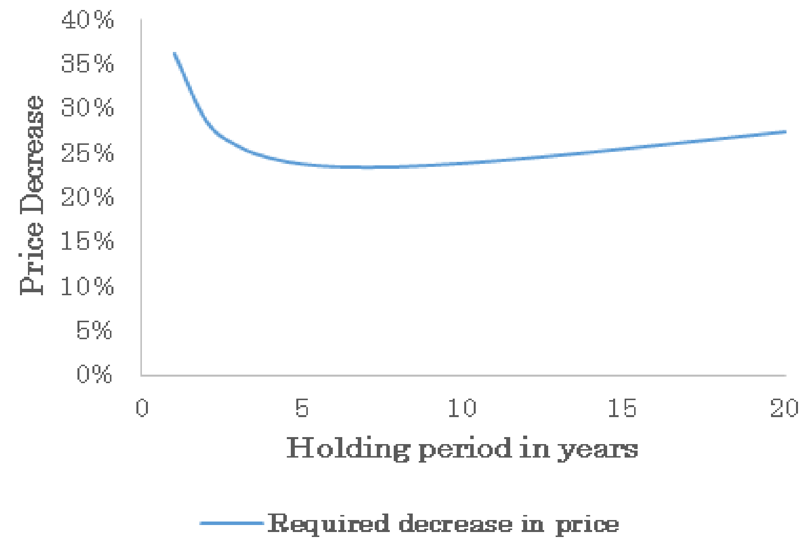


Figure10B: $\tau_{OI} = 52.9\%, \tau_{CG} = 33\%, \tau_{DR} = 38\%$



- Price declines of 8%-12% over holding periods of 3-20 years; 10%-17% for apartments
- Price declines of 23%-27% over holding periods of 3-20 years; 22%-27% for apartments

Such declines would reduce wealth of a large cross-section of households & slow or stop construction in many local markets, thereby putting **downward pressure** on employment & state & local tax receipts

Figure 11: Required Increase in Rents After Elimination—Nonresidential

Figure11A: $\tau_{OI} = 39.6\%, \tau_{CG} = 23.8\%, \tau_{DR} = 25\%$

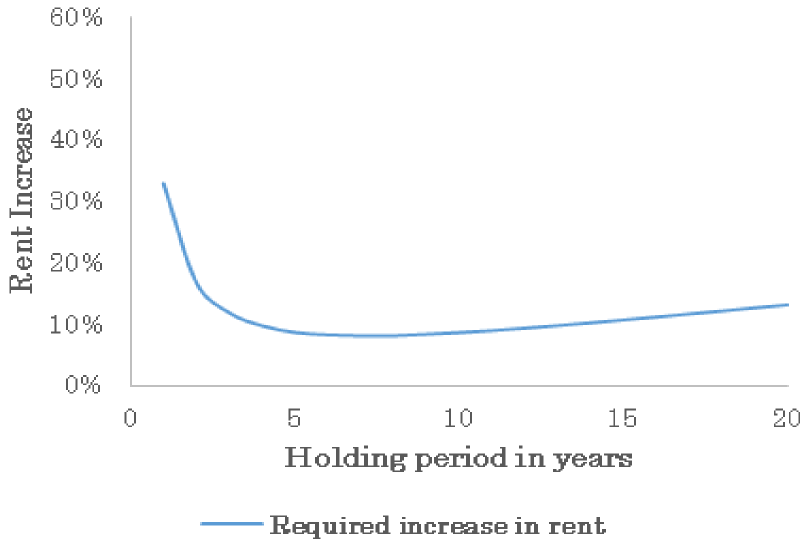


Figure11B: $\tau_{OI} = 52.9\%, \tau_{CG} = 33\%, \tau_{DR} = 38\%$

- Rent increases of 8%-13% over holding periods of 3-20 years; 11%-20% for apartments
- Rent increases of 29%-37% over holding periods of 3-20 years; 28%-38% for apartments

Such increases would reduce the affordability of CRE space for both large & small tenants

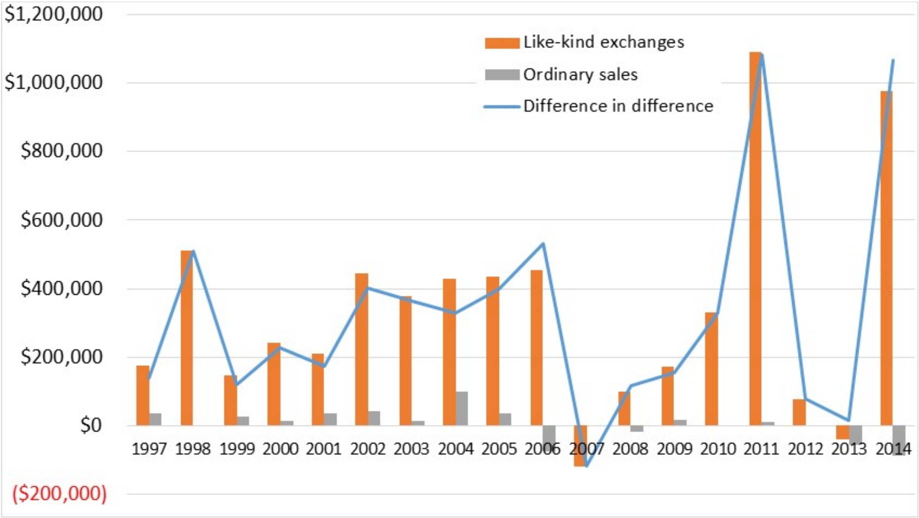
The Impact of Repealing Like-Kind Exchanges in Real Estate

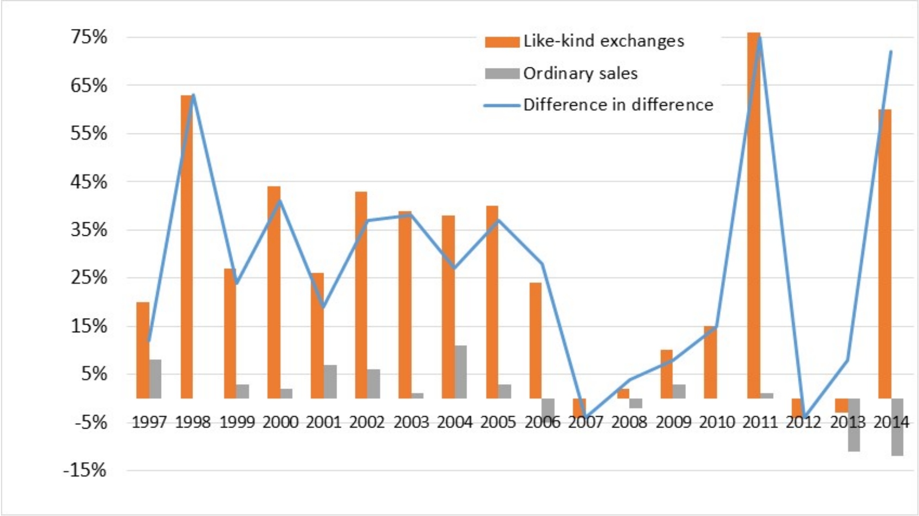
5. Economic Benefits of 1031 Exchanges – Empirical Evidence

Exchanges Are Associated with Higher Investment

- Price difference (replacement – relinquished) is positive in 66% of the matched like-kind exchanges; 51% of the time in ordinary sales
- Difference in replacement and relinquished property price:
  - On average: $305,000, or 33% of value of the relinquished property
  - When $P_{replacement}$-$P_{relinquished}$>0 is $187,500 (-8% of value)
  - When $P_{replacement}$-$P_{relinquished}$<0 is $12,933 (10% of value)

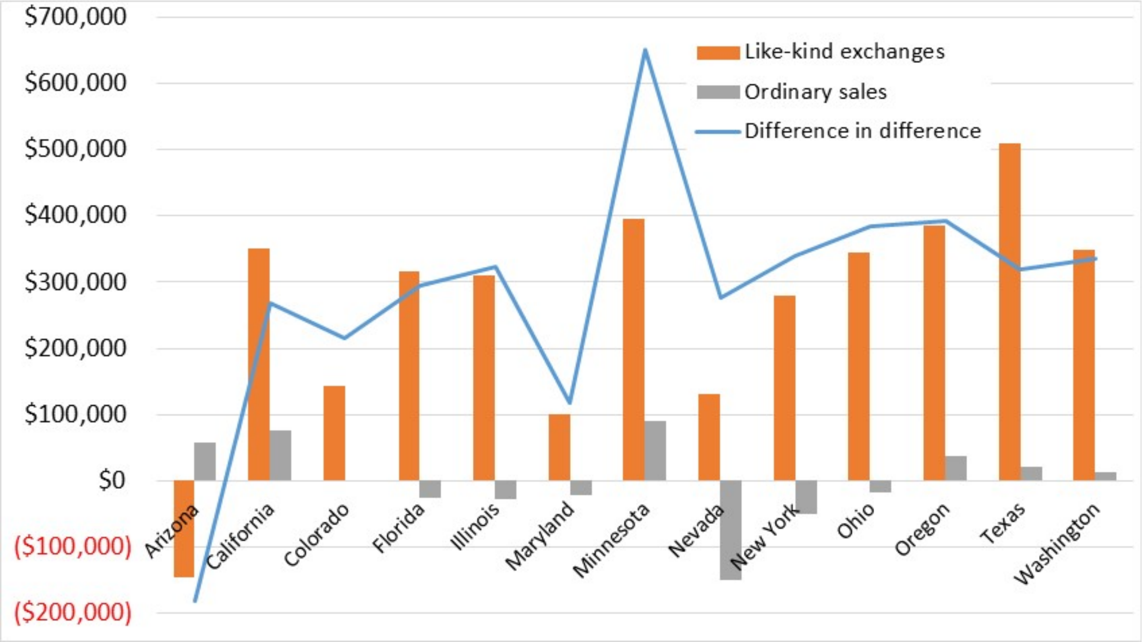
(Replacement – Relinquished) Prices for Exchanges & Ordinary Sales

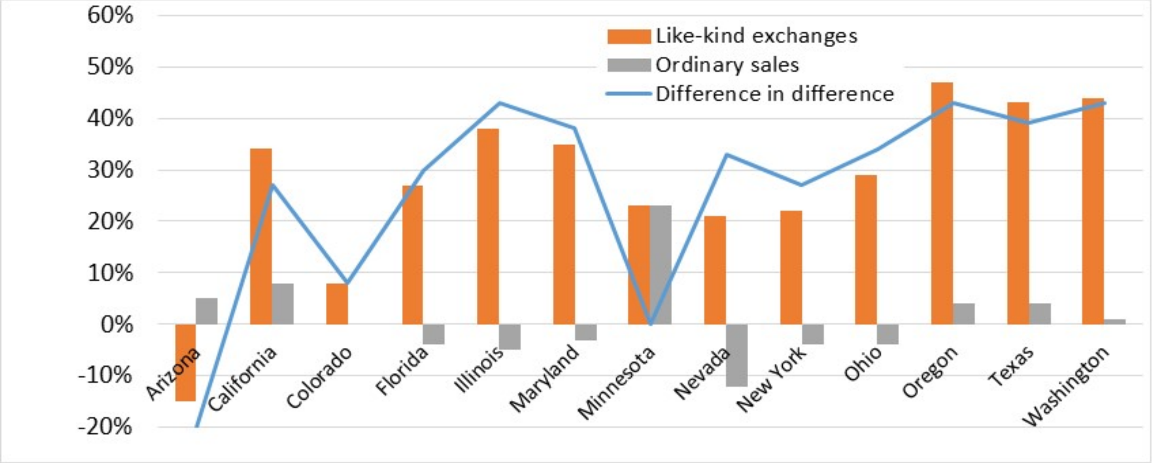




By year

(Replacement – Relinquished) Prices for Exchanges & Ordinary Sales



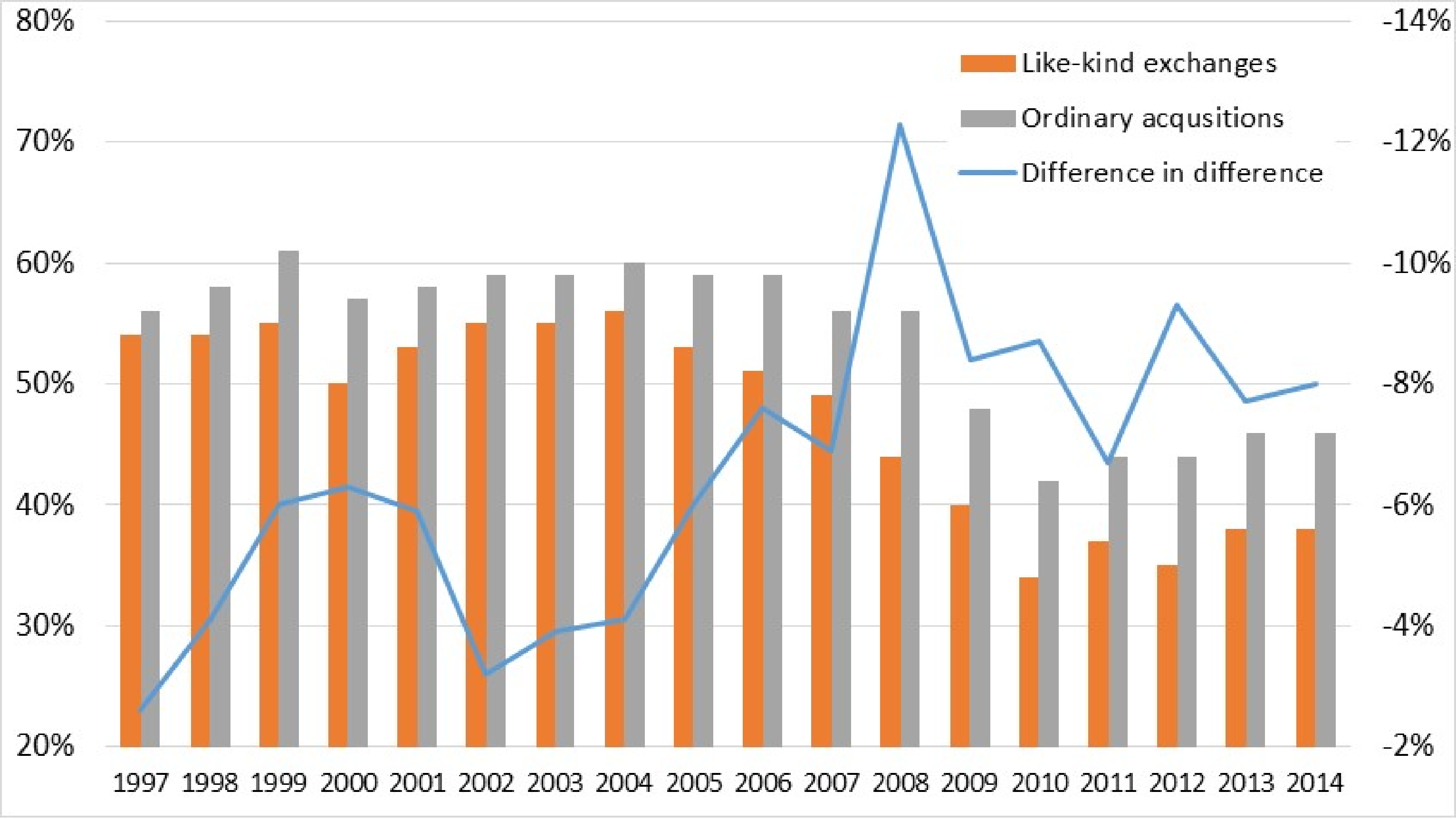


By state

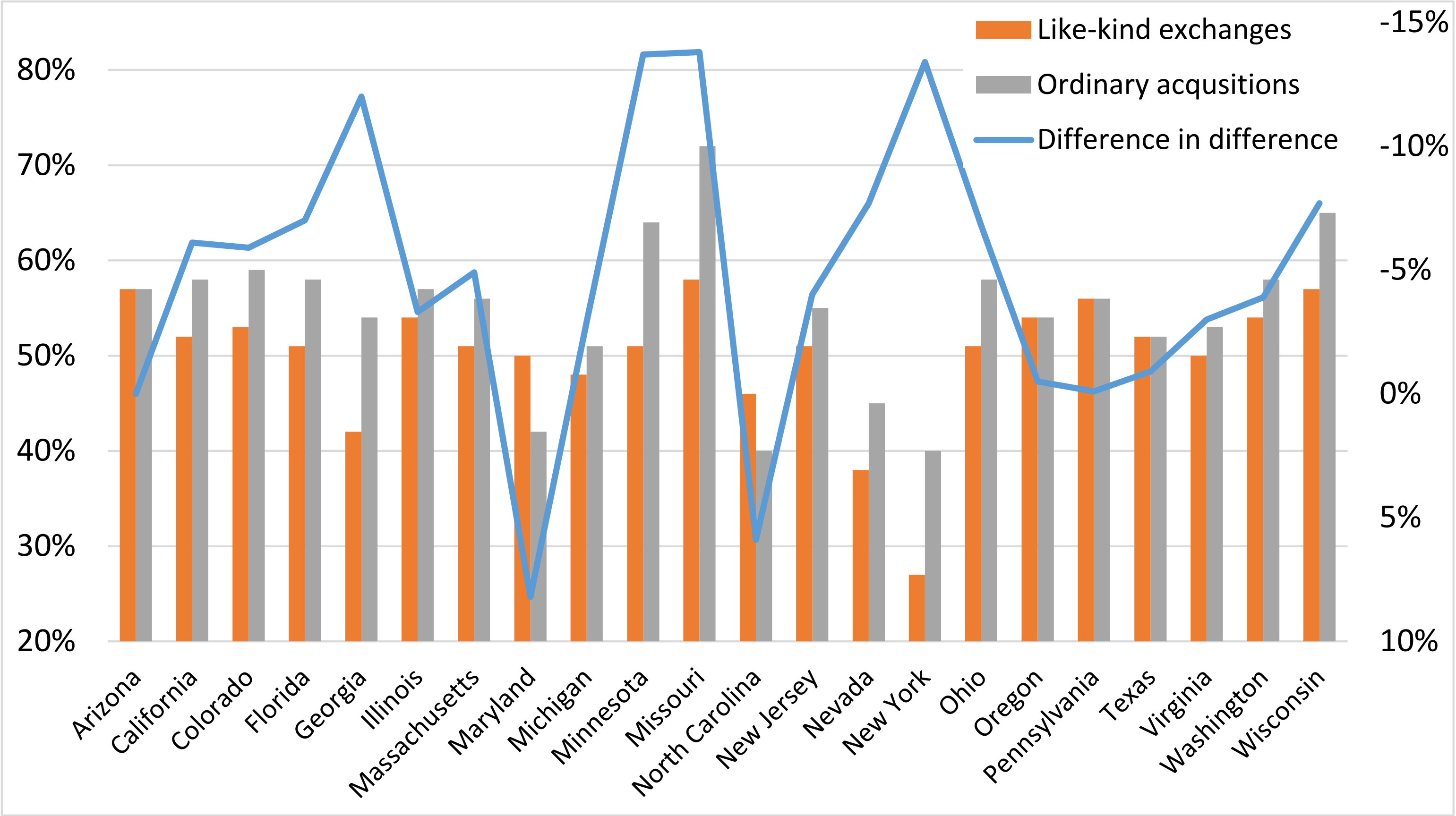
Exchanges Are Associated with Lower Leverage

- Initial leverage used by investors in like-kind exchanges vs. ordinary sales
  - Unbalanced sample: 61% in LKEs vs. 64% in ordinary acquisitions
    - 62% in LKEs vs. 66% in ordinary acquisitions in acquisitions without sales conditions
  - One-on-one (like-kind exchange – sale) matched sample using propensity-score matching: 63% in LKEs vs. 70% in ordinary acquisitions
    - 64% in LKEs vs. 70% in ordinary acquisitions in acquisitions without sales conditions

Lower Leverage in Exchanges Is Robust by Year



Lower Leverage in Exchanges is Robust by State



Replacement Properties in Exchanges Are Associated with Higher CAPX

	Replacement exchange acquisitions		Ordinary acquisitions			
Panel A: Annualized capital expenditures per square foot (all properties)						
	Mean	Std. dev.	Mean	Std. dev.	Dif.	Significance
Capex/sf (excl. LC)	1.53	1.97	1.26	2.18	0.27	P(T>t)=0.22
Tenant improvement/sf	0.55	0.89	0.64	1.03	-0.09	
Building improvements/sf	0.57	0.80	0.39	0.78	0.18	P(T>t)=0.07
Building expansion/sf	0.002	0.016	0.004	0.046	-0.002	
Other capex/sf	0.15	0.49	0.13	0.61	0.02	
Panel B: Annualized capital expenditures per square foot (similar properties)						
Capex/sf (excl. LC)	1.78	2.15	1.38	1.34	0.40	P(T>t)=0.20
Tenant improvement/sf	0.65	0.96	0.77	0.98	-0.13	
Building improvements/sf	0.64	0.87	0.41	0.60	0.24	
Building expansion/sf	0.003	0.018	0.008	0.041	-0.004	
Other capex/sf	0.18	0.56	0.13	0.19	0.05	P(T>t)=0.11

Holding Periods Are Shorter for Investors in Exchanges

Panel A: All properties				
Holding period	Mean	Std. dev.	Min	Max
All sales	6.63	5.09	0.00	17.94
Panel B: Repeat sales				
Holding period	Mean	Std. dev.	Min	Max
All sales	3.97	3.57	0.00	17.94
Exchanges (1)	3.49	2.83	0.00	17.75
Non exchanges (2)	3.98	3.59	0.00	17.94
Difference (1)- (2)	-0.49***			
T-stat	-12.21			
Panel C: Matched sample of repeat sales				
Holding period	Mean	Std. dev.	Min	Max
All sales	3.60	2.85	0.00	17.54
Exchanges (1)	3.38	2.60	0.00	17.30
Non exchanges (2)	3.66	2.92	0.00	17.35
Difference (1)- (2)	-0.28***			
T-stat	-4.26			

88% of the Time Investors Dispose of Properties Acquired in Exchange through a Taxable Sale

	Relinquished 1031 exchange property	Relinquished 1031 exchange property sold through another exchange
Year	Mean	Mean
1997	2.2%	0.4%
1998	4.2%	0.5%
1999	4.5%	1.0%
2000	5.6%	1.5%
2001	6.1%	1.4%
2002	6.8%	1.6%
2003	7.2%	1.8%
2004	7.6%	1.4%
2005	7.8%	1.4%
2006	6.0%	0.9%
2007	4.8%	0.4%
2008	4.1%	0.4%
2009	3.1%	0.1%
2010	2.9%	0.0%
2011	2.9%	0.1%
2012	2.7%	0.0%
2013	2.5%	0.0%
2014	2.4%	0.1%

6. Like-kind Exchanges and Taxes

The Estimated Taxes Paid in LKE Followed by a Taxable Sale vs. Ordinary Sale Followed by an Ordinary Sale Are on Average 19% Higher

	Exchange rolled into an exchange	Exchange followed by an ordinary sale	Ordinary sale followed by an ordinary sale (CG taxes liability >0)
Panel A: Capital gain and depreciation recapture tax liability over the holding period			
Capital gain tax paid	0.0%	19.3%	16.5%
Capital gain tax deferred	24.9%	0.0%	0.0%
Depreciation recapture tax paid	0.0%	3.2%	2.4%
Depreciation recapture tax deferred	8.2%	0.0%	0.0%
Panel B: Annualized capital gain and depreciation recapture tax liability over the holding period			
Annualized capital gain tax paid	0.0%	7.9%	5.5%
Annualized capital gain tax deferred	6.8%	0.0%	0.0%
Annualized depreciation recapture tax paid	0.0%	1.1%	0.5%
Annualized depreciation recapture tax deferred	2.2%	0.0%	0.0%

The Impact of Repealing Like-Kind Exchanges in Real Estate

7. Consequences of Removal of Exchanges Based on Established Micro-economic Effects

Consequences of Removal of Exchanges: Micro Effects

- Our empirical analysis suggest removal of exchanges will lead to:
  - Decrease in investment
  - Increase in holding periods
  - Increase in amount of leverage used to acquire properties
- Our theoretical analysis suggests that repeal of like-kind exchanges would lead to decrease in prices in short-run and an increase in rental rates in the longer run

Consequences of Removal of Exchanges: Macro Effects

- Reduction in growth in CRE markets, resulting from lower investment & decreases in prices, will lead to slower employment growth in sectors closely tied to exchanges, such as construction and financial services

- Removal of like-kind exchanges will increase marginal tax rates for many investors
  - General equilibrium models link the increase (decrease) of marginal tax rates to contraction (expansion) of the economy
  - Impact will be more pronounced in high tax states & in industries that make greater use of exchanges, such as CRE , transportation, and warehousing.
  - In addition to having direct economic effects through increases in the marginal tax rates and the cost of capital, secondary effects will include decreased employment in RE and related sectors.

Conclusions

- Document widespread use of RE like-kind exchanges
- Results of our user cost models and empirical analyses suggest the costs of like-kind exchanges may be overestimated, while their benefits overlooked.
- Elimination of RE exchanges will likely lead to
  - decrease in prices (SR)
  - increase in rents (LR)
  - decrease in RE investment
  - increase in investment holding periods, and
  - increase in use of leverage

The Economic Impact of Repealing or Limiting Section 1031 Like-Kind Exchanges in Real Estate

David C. Ling and Milena Petrova

July 2015

UF UNIVERSITY of FLORIDA

Whitman SCHOOL of MANAGEMENT SYRACUSE UNIVERSITY

Insurance Committee Meeting

Wednesday, March 30th
4:30pm – 6pm
Marriott Marquis, Washington DC

Panelists:
Michael Chu, VP, Arch Insurance
Stephen Kelly, Associate Director, Crystal & Company
Victoria Rostow, SVP-Policy & Regulatory Affairs, NAREIT
James Schibuk, VP, Arch Insurance
Carey Venditti, Shareholder, Greenberg Traurig, LLP
Jeffrey Zaffino, Underwriting Manager, Arch Insurance

NATIONAL ASSOCIATION OF REAL ESTATE INVESTMENT TRUSTS®

♦ ♦ ♦

REITS: BUILDING DIVIDENDS AND DIVERSIFICATION®

NAREIT INSURANCE COMMITTEE MEETING AGENDA

Washington Marriott Marquis
March 30, 2016

NAREIT Insurance Committee Chair:

Michael Horvath, SVP, Risk Management, *Simon Property Group*

NAREIT Executive Staff:

Sheldon Groner, EVP, Finance & Operations

4:30 – 5:00 p.m. **Open Carry Laws – What REITs Need to Know**

Carey Gunn Venditti, Real Estate Practice Shareholder,
Greenberg Traurig

5:00 – 5:30 p.m. **Cyber Insurance – Where Are We? And What Lies Ahead?**

James Schibuk, Vice President
Arch Insurance Group

5:30 – 5:40 p.m. **National Flood Insurance Program – Legislative Update**

Victoria Rostow, Senior Vice President, Policy &
Regulatory Affairs, *NAREIT*

5:40 – 6:00 p.m. **NAREIT Directors & Officers Liability Insurance Program w/*Arch***

- **D&O Insurance Litigation Trends Affecting Real Estate**
- **D&O Policy Coverage**
- **D&O Program Update**

Stephen Kelly, Associate Director
Crystal & Company

Michael Chu, Vice President
Arch Insurance Group

Jeff Zaffino, Underwriting Manager
Arch Insurance Group

♦ ♦ ♦

REIT Wise®

NAREIT's Law, Accounting & Finance Conference

March 30 - April 1
2016

Cyber Insurance- Where Are We? What Lies Ahead?

March 30-April 1, 2016

Cyber Insurance Market Overview

- Coverage first offered in the late 1990's
- Industry Gross Written Premium of approximately $2.5B annually
- Approximately 50 insurers offer some form of cyber insurance
- Rate environment is mixed depending upon the industry
- Average cost per breach of $3.79M in 2014

What does Cyber Insurance Cover?

- 3rd party liability resulting from a privacy violation or a network breach
- 1st party costs for responding to a privacy violation or a network breach including:

-Legal Counsel

-Computer Forensics

-Notification to affected individuals

-Credit Monitoring for affected individuals

- Coverage can also include lost income from a business interruption caused by a network breach

How do Insurers underwrite Cyber Insurance?

- Size of organization and Industry
- Amount and types of confidential information
- Review of internal network controls as provided in the application with specific focus on:
- Perimeter protections
- Incident Response
- Patch Management
- Encryption
- History of Prior Incidents

What information do REITS have that are exposed Cyber Perils?

- Personally Identifiable Information from tenants and employees (e.g. SSN)
- Payment Card Information
- Protected Health Information
- Confidential Corporate Information

How Can REITS protect themselves?

- Employee training and awareness
- Evaluate internal controls to determine if they are appropriate for the amount and types of information your organization has in its possession
- Buy Insurance

Questions?

REIT Wise®

NAREIT's Law, Accounting & Finance Conference

March 30 - April 1 2016

NAREIT

D&O Liability Insurance Program

March 30, 2016

D&O Liability Insurance Program

Agenda

- NAREIT Program Participation Update
- REIT Claims Update
- REIT D&O Underwriting Concerns
- Selecting Your Primary D&O Carrier
- Q&A

D&O Liability Insurance Program

NAREIT Membership Participation Update

- Program Growth
- Strengthening Relationships
- Enhancements in Coverage

REIT Claims Update

- Securities Class Actions up 11% from 2014 to 2015

- Average 4 REITs SCAs/year over past 4 years
  - 2015: 4 SCAs
  - IPO/roll-up, financial/accounting, amending by-laws, self-dealing around M&A

- Increase in non-SCA REIT Claims
  - Since 2010, average 18 claims/year in NAREIT program (0 SCAs)
  - 2015: 29 claims in NAREIT program (0 SCAs)
  - Broader Coverage + REIT Growth + Active Plaintiffs Bar = Increased Claims Frequency & Greater Variety of Claims

REIT D&O Underwriting Concerns

- Mergers & Acquisitions
  - Approx. 9 of 10 deals over $100 million attract litigation
  - Allegations: “Bump-Up” (Target) and “Aiding & Abetting” (Acquirer)
  - Historical Settlements: Non-monetary + Defense Costs + Plaintiff Counsel Fees
  - NAREIT D&O Policy: Removed plaintiffs counsel fee exclusion for Bump-Up
  - End to Disclosure Only Settlements?
    - Delaware & New York have recently rejected
    - Too early to tell whether Maryland will adopt a similar stance
    - If so, could deter frivolous M&A suits (lower frequency), BUT severity/costs could increase as cases drawn out and no quick non-monetary settlements
  - Questions: Rationale for Deal, Consideration, Feedback/Market Reaction, Compensation
  - Best Practices: Evaluate Options/Conduct Fair Process; Documentation

REIT D&O Underwriting Concerns

- Corp. Governance & Shareholder Communication
  - Cyber Security/Data Integrity/Social Engineering
  - FCPA and similar anti-corruption statues
  - Questions: Controls/Practices/Procedures; How any Incidents were Handled

  - Maryland Unsolicited Takeover Act (MUTA)
  - Shareholder Interaction and Communication
    - Activist Investors/Hedge Funds?
  - Questions: Transparency; Shareholder Feedback

REIT D&O Underwriting Concerns

- Joint Venture/Limited Partners
  - Claims: Unwinding JV partnership; alleged mismanagement of venture
  - Insuring Agreement D; Definition of Controlled Entity
  - Questions: Strategy/Goals; JV partners & history
- Regulatory/Investigations
  - Accounting practices compliance
  - Financial metrics and disclosure
  - Inquiry coverage; Investigation of the entity by an investigating authority
  - Questions: Interaction/relationship with regulators

Why the NAREIT D&O Program works for You

- ✓ Financial Strength
- ✓ Commitment to REIT Industry
- ✓ Deep understanding of REIT structure
- ✓ Consistent Underwriting Approach
- ✓ Policy Language protecting YOUR Board
- ✓ Integrated Claims Model
  - ➢ Underwriting and Claims work closely together
  - ➢ Experience handling a wide variety of REIT claims, not just SCAs
- ✓ Focus on Value-Added Service

Contacts

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The integrity of independence.

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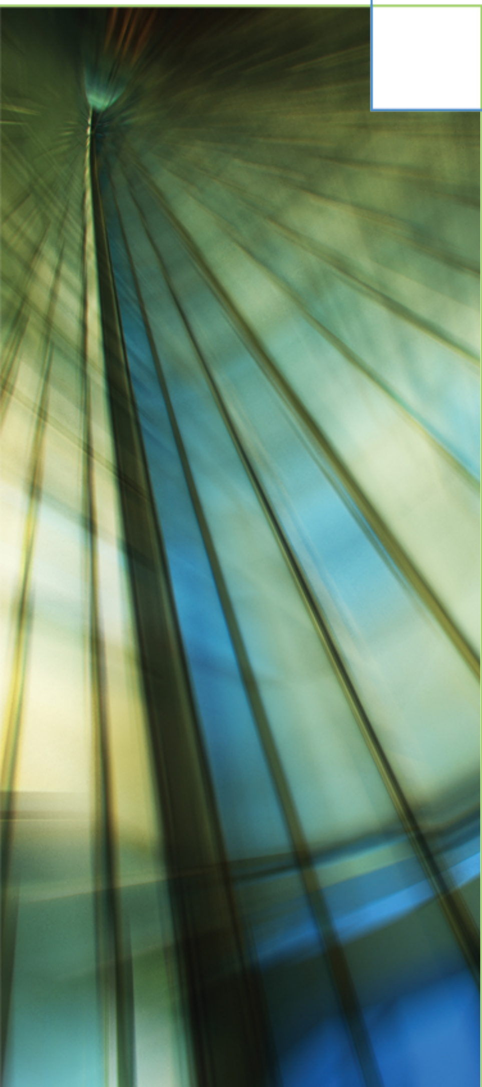

GreenbergTraurig

Open Carry Laws

Carey Gunn Venditti, Esq.
Shareholder, Real Estate Practice
Email: vendittic@gtlaw.com
512.320.7237

GT GreenbergTraurig

OPEN CARRY BY U.S. JURISDICTION

Jurisdiction	Permissive	Licensed	Anomalous/ Rural	Non-Permissive	Comments
Alabama	✓				
Alaska	✓				
American Samoa				✓	Open carry prohibited.
Arizona	✓				
Arkansas	✓				
California			✓		Open carry permitted in rural counties where local ordinances authorize open carry (some with and some without a license requirement).
Colorado	✓				Open carry without a license permitted, except in City and County of Denver (where open carry prohibited by local ordinance pre-dating preemption law).
Connecticut		✓			Handgun open carry with license permitted (licenses granted on Shall-Issue, with Limited Discretion basis). Long gun open carry varies based on local ordinances.
Delaware	✓				
District of Columbia				✓	Open carry prohibited.
Florida				✓	Constitutionality on ban on open carry currently being challenged.
Georgia		✓			Open carry with license permitted (licenses granted on Shall Issue basis).
Guam		✓			FOID card required (Firearm Owner's Identification card).
Hawaii		✓		Actual practice	Licenses rarely issued to ordinary citizens and are valid in the issuing county only.
Idaho	✓				
Illinois				✓	
Indiana		✓			Open carry with license permitted (licenses granted on Shall Issue basis) and recognition of all other states' carry licenses.
Iowa		✓			
Kansas	✓				
Kentucky	✓				
Louisiana	✓				

OPEN CARRY BY U.S. JURISDICTION (cont'd…)

Maine	✓				
Maryland		✓		Actual practice	Handgun licenses rarely issued to ordinary citizens. Long gun open carry without license permitted.
Massachusetts		✓		Actual practice	Handgun open carry with license permitted (licenses issued on May-Issue statewide basis), but issuance varies between localities. In practice, open carry is discouraged and one may be charged with Disorderly Conduct or Breach of Peace if open carry causes public alarm. Long gun open carry prohibited.
Michigan	✓				Open carry without license permitted unless in a vehicle and then a CHL (Concealed Handgun License) is required (CHL granted on Shall-Issue basis).
Minnesota		✓			Open carry with license permitted (licenses granted on Shall Issue basis).
Mississippi	✓				
Missouri		✓			
Montana	✓				
Nebraska		✓			
Nevada	✓				Open carry without license permitted, subject to local ordinances.
New Hampshire	✓				Open carry without license permitted unless in a vehicle and then a CHL is required.
New Jersey		✓		Actual practice	Licenses rarely issued to ordinary citizens. Long gun open carry prohibited.
New Mexico	✓				Statewide open carry does not preempt tribal laws on Native American reservations, except when on a state-owned highway. Some tribes prohibit open carry and others require a tribal permit.
New York				✓	Handgun open carry prohibited unless hunting or at a gun range. Long gun open carry prohibited unless seasonal hunting in designated game reserves.
North Carolina	✓				
North Dakota		✓			
Northern Mariana Islands				✓	

OPEN CARRY BY U.S. JURISDICTION (cont'd…)

Ohio	✓				**Open carry without license permitted unless in a vehicle and then a CHL is required.**
Oklahoma		✓			Open carry without license permitted and recognition of other states' right to carry without license with valid ID from home state.
Oregon			✓		Open carry without license permitted, subject to local ordinances, except that any person with CHL is exempt from local restrictions.
Pennsylvania			✓		
Puerto Rico	✓				
Rhode Island		✓			Open carry of handguns permitted with issuance of license by Attorney General's Office. Long gun open carry without license permitted.
South Carolina				✓	
Tennessee		✓			
Texas		✓			Open carry of handguns permitted with issuance of license. Long gun open carry without license permitted.
U.S. Virgin Islands				✓	
Utah		✓			Open carry without license permitted if firearm is unloaded and exposed; license required to open carry loaded firearm (e.g., a live round of ammunition in the firing chamber of the weapon).
Vermont	✓				
Virginia	✓				Open carry without license permitted, subject to local ordinances prohibiting firearms with more than 7 rounds without license, except that any person with CHL is exempt from local restrictions.
Washington	✓				Open carry without license permitted unless in a vehicle and loaded and then a CHL is required.
West Virginia	✓				
Wisconsin	✓				Open carry without license is permitted, but if do not hold a state CHL or qualifying out of state license, firearm in vehicle must be visible.
Wyoming	✓				

OPEN CARRY BY U.S. JURISDICTION (cont'd…)

Key Terms:

Open carry
The act of publicly carrying a firearm in plain sight.

Preemption
Legislatively enacted state laws limiting or eliminating the ability of local governments to regulate the possession or carrying of firearms.

Prohibited persons
Persons who are prohibited by law from carrying a firearm, *e.g.,* felons, convicts of misdemeanor domestic violence, drug or alcohol addicts, involuntarily committed mental patients.

Permissive
A *Permissive* state has passed full preemption of all firearms laws, with few exceptions. Open carry without a license is permitted for all non-prohibited persons. Such open carry is lawful on foot and in a vehicle. Any person openly carrying a firearm may be detained and cited by law enforcement officials for disorderly conduct or disturbing the peace in certain locations and in circumstances where open carry causes public alarm.

Licensed
A *Licensed* state has passed full preemption of all firearms laws, with few exceptions. Open carry with a license is permitted for all non-prohibited persons. Such open carry is lawful on foot and in a vehicle. In practice however, some of these states have *May-Issue* licensing laws (not *Shall-Issue*) and can be regarded as *Non-Permissive* for open carry, since licensing authorities rarely or never grant licenses to ordinary citizens.

Anomalous
The legality of open carry varies within each such *Anomalous* state, based on local policies. In such states, some local jurisdictions may permit open carry while others may impose varying degrees of restrictions or prohibit open carry entirely.

Rural
In *Rural* states, open carry is generally prohibited, except in unincorporated areas of counties where population densities are below statutorily-defined thresholds. In such rural areas, local authorities have enacted ordinances permitting open carry in such areas (*i.e.,* California). These states are also regarded as *Anomalous* open carry states.

Non-permissive
In *Non-permissive* states, open carry of a handgun is not lawful, or is only lawful under such a limited set of circumstances (*e.g.,* while hunting, while on one's own property/for lawful self-defense) that open carry is effectively prohibited. Some states with *May-Issue* licensing laws are *Non-Permissive* in practice since those authorities are highly restrictive in the issuance of open carry licenses.

Texas: A Case Study of Licensed Open Carry
HB 910 – OPEN CARRY LEGISLATION EFFECTIVE Jan. 1, 2016

> Allows individuals licensed to carry a handgun under Subchapter H, Chapter 411, Government Code, to openly carry the gun, provided it is holstered.

> Subchapter H, Chapter 411, was previously the concealed carry statute.

> Amended Chapter 30, Penal Code to add new Sec. 30.07 in addition to 30.06 to regulate trespass by a license holder with a handgun.

> In essence, the legislature struck the word "concealed" wherever it appeared before the word "handgun" and added new trespass provisions to also apply to open carry.

Texas: A Case Study of Licensed Open Carry

HB 910 - Prohibited Places

> Handguns prohibited in the following locations:

- K-12 school and school bus
- High school, collegiate or professional sporting event
- Polling place
- Court
- Racetrack
- Secured area of an airport
- Bar
- Correctional facility
- Hospital or nursing facility
- Amusement park
- Church
- Any meeting of governmental entity
- While intoxicated

Texas: A Case Study of Licensed Open Carry

HB 910 - Can Prohibit Handguns on Private Property

> Private property owners may continue to prohibit handguns on their premises if they provide proper notification (oral or written).

> Owner *or someone with apparent authority to act for the owner* must provide oral or written communication that carrying a concealed or holstered handgun on the property is forbidden.

> Property manager or other authorized individual acting on behalf of owner may provide the proper notification.

Texas: A Case Study of Licensed Open Carry

HB 910 - Can Prohibit Handguns on Private Property

> HB 910 creates a new type of written notice to make carrying a handgun on a premise illegal trespass:

- 30.06 Notice – Required to prohibit concealed carry - some modifications made in the text of the notice;
- 30.07 Notice – Required to prohibit open carry; and
- If want to prohibit both concealed and open carry, you must post *both* 30.06 and 30.07 Notice.

Texas: A Case Study of Licensed Open Carry

HB 910 - Trespass by Holder of Handgun License

> A party who trespasses in violation of a posted notice is subject to a Class C misdemeanor charge punishable by a fine not to exceed $200.

> If license holder is personally given the notice by oral communication and commits trespass by refusing to leave is subject to a Class A misdemeanor charge, punishable by up to a year in the county jail and/or a $4,000 fine.

GT GreenbergTraurig

Texas: A Case Study of Licensed Open Carry

HB 910 - Written Communication Requirements

- May be a card, document and/or a posted sign.
- Must say:
  - "Pursuant to Section 30.06, Penal Code (trespass by license holder with a concealed handgun), a person licensed under Subchapter H, Chapter 441, Government Code (handgun licensing law), may not enter this property with a concealed handgun.
  - "Pursuant to Section 30.07, Penal Code (trespass by license holder with an openly carried handgun), a person licensed under Subchapter H, Chapter 441, Government Code (handgun licensing law), may not enter this property with a handgun that is carried openly.
- Any sign must additionally:
  - appear in contrasting colors with block letters at least one inch in height;
  - be printed in both English and Spanish; and
  - be displayed in a "conspicuous manner" at each entry to the property.

Texas: A Case Study of Licensed Open Carry

HB 910 – Employer/Employee

- Employer may prohibit employees from carrying firearms on the premises.
- "Premises" means a building or a portion of a building. The term does not include any public or private driveway, street, sidewalk or walkway, parking lot, parking garage, or other parking area, so law only applies to building itself.
- If employee has a license to carry a handgun, or otherwise lawfully possesses a firearm or ammunition, employer <u>cannot</u> prohibit an employee from keeping the employee's firearm or ammunition in a locked privately owned motor vehicle in any parking lot, parking garage or other employer-provided parking area.

Texas: A Case Study of Licensed Open Carry

HB 910 – Analysis (cont'd…)

> Scenario 1 -- Building owner prohibits handguns on the premises

- Determine if prohibiting both concealed and holstered (openly carried) handguns.
- Post the statutory notices at ALL entrances to the building.
- Determine protocol for when someone enters the premises with a visible handgun or displays a concealed handgun if prohibited, *i.e.,* management asks individual to leave versus calling police.
- In this Scenario, owner should proactively enforce the posted prohibition - failure to do so could result in liability.
- Add lease provisions reiterating prohibition.

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Texas: A Case Study of Licensed Open Carry

HB 910 – Analysis (cont'd…)

> Scenario 2 -- Building owner does not prohibit handguns on the premises, but leaves it up to the tenants to prohibit handguns in their leased premises.

> In this Scenario, there is no prohibition for the building owner to enforce, but tenants may be less comfortable in the building.

Texas: A Case Study of Licensed Open Carry

HB 910 – Analysis (cont'd…)

> Licensed gun rights advocates may openly carry holstered handguns into many buildings to test law or otherwise compile evidence of who is posting signs, how certain situations are being handled by business owners, etc.; *see e.g.,* www.Texas3006.com

> This will taper off in a few months after novelty has worn off.

> If used, posted signage or other written communication needs to be in strict compliance with statute.

> Building managers, security personnel, human resources and other relevant personnel must be briefed on the law.

Texas: A Case Study of Licensed Open Carry

HB 910 – Standing Down or Enforcing Security Measures

- Consider leaving issue to tenants to determine if they want to bar handguns (open and/or concealed) from the leased space.
- Significant omission from the new law is no employer immunity from civil actions resulting from an occurrence involving the employee and his or her openly carried firearm, except in cases of gross negligence.
- Likewise, there is no safe harbor for property managers if:
  - An injury occurs and there is a reasonable presumption that a licensed carrier could have prevented the injury by using the handgun.
  - The opposite is true if someone was injured by a licensed handgun carrier and the owner did not properly bar them from the premises.
- Is the safest position to stand down and not usurp the law?
- Preserves argument that no rights were granted and no one stood in the way of the exercise of open or concealed carry rights.

GT GreenbergTraurig

Texas: A Case Study of Licensed Open Carry

HB 910 – Standing Down or Enforcing Security Measures (cont'd…)

- General tort law principles have held that a landowner that voluntarily undertakes to provide building security measures for the benefit of its patrons must do so with reasonable care.
- There is the potential for increased liability if landowner voluntarily undertakes security procedures and is negligent in enforcing and carrying out those security procedures.
- This is the case with all security measures, not just those concerning firearms.
- To the extent that any commercial owner opts to prohibit firearms on premises, the owner must adopt a clear policy regarding enforcement of the firearm prohibition – even if that policy is to call the police in the event of trespass – and ensure that any security measures put into place are consistently followed.

Final Thoughts on Open Carry: Insurance

- What actions, if any, by the insured are being encouraged/required? Stand Down v. Prohibit
- Do policies/rates differ depending on the security measures taken (or not taken) as to open and/or concealed carry?
- What effect do different state laws have on insurance requirements/underwriting standards? Permissive v. Licensed v. Anomalous/Rural v. Non-permissive?
- Thoughts and discussion welcomed on these issues.

REIT Wise®

NAREIT's Law, Accounting & Finance Conference

March 30 - April 1 2016

National Flood Insurance Program (NFIP)
NAREIT Insurance Committee Update

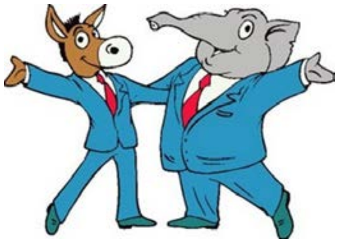
March 30-April 1, 2016

National Flood Insurance Program (NFIP) 2016 Issues

- NFIP Must be Reauthorized in 2017; expires September 30, 2017
- *The Flood Insurance Market Parity and Modernization Act* (H.R. 2901) unanimously passed the House Financial Services Committee on March 2, 2016
- Greater Concern in Scientific Community about Rising Sea Levels and their Implications

The Flood Insurance Market Parity and Modernization Act (HR 2901)

- Its Bipartisan! Passed the House Financial Services Committee on March 2, 2016 by a 53-0 vote



- Sponsored by Reps. Dennis Ross (R-Fla) and Patrick Murphy (D-Fl) with full backing of Committee Chair Jeb Hensarling (R-TX) and Ranking Member Maxine Waters (D-CA)

The Flood Insurance Market Parity and Modernization Act (HR 2901)

- Intended to help facilitate the development of a private and competitive insurance market for flood insurance

- Strongly supported by insurance, banking, mortgage banking , property and financial services stakeholders, including *American Insurance Association, American Bankers Association, Mortgage Bankers Association, NAIC, Financial Services Roundtable, Property Casualty Insurance Association of America, National Association of Home Builders*

- Senate Companion Bill (S. 1679) has been introduced by Senator Dean Heller (R-NV).

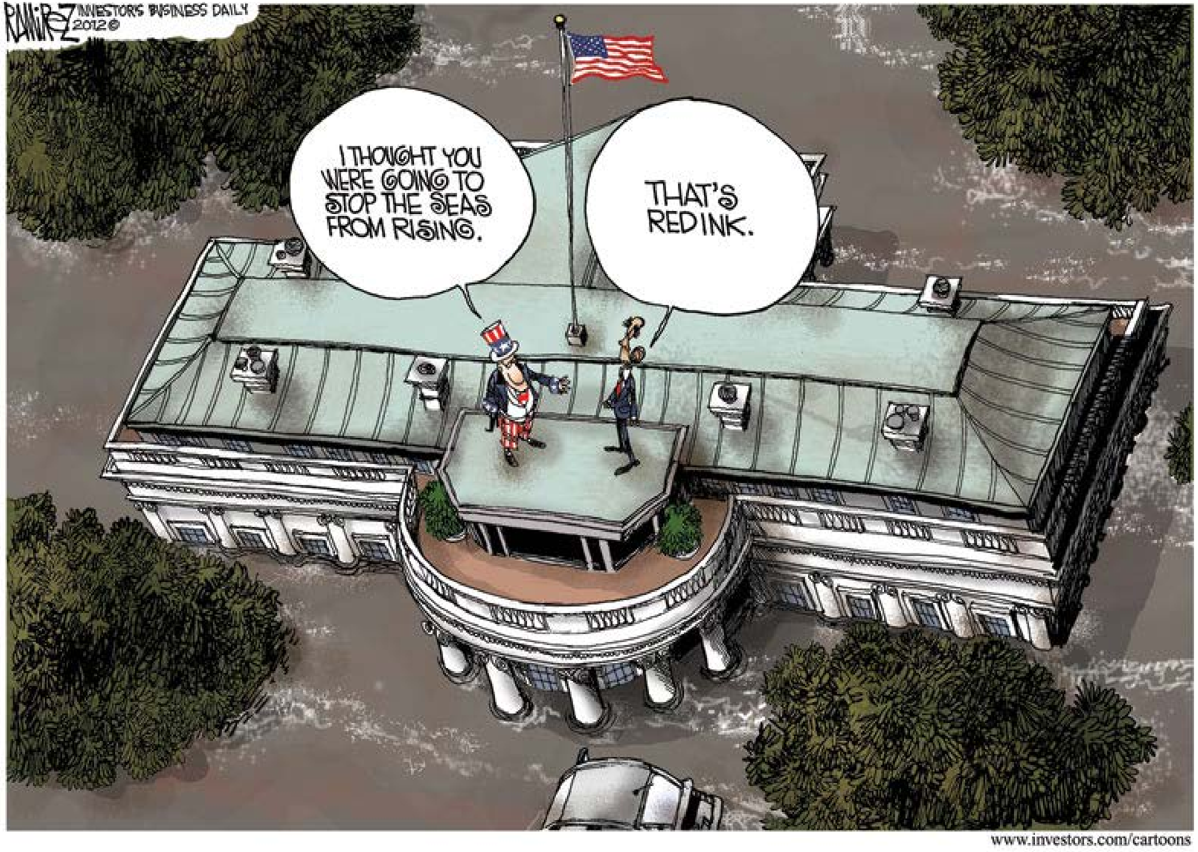
The Flood Insurance Market Parity and Modernization Act (HR 2901)

What does it do?

- Clarifies that flood insurance offered by a private carrier outside of the NFIP can satisfy the Flood Disaster Protection Act's mandatory purchase requirement

- Defines acceptable private flood insurance as a policy providing flood insurance coverage issued by an insurance company that is licensed, admitted, or otherwise approved to engage in the business of insurance in the state or jurisdiction in which the insured property is located.

NFIP 2017 Reauthorization



NFIP 2017 Reauthorization: Issues

- NFIP is INSOLVENT: FEMA Owes Treasury More that $20 billion!
- Flood Risks Are Increasing!
- Everyone Agrees Reforms Are Needed; Everyone Does not Agree WHICH REFORMS are needed!
- Conflicting Goals: Cost Containment and Program Expansion

Flood Risks Are Increasing

Increasing Flood Risks
Agreement that Sea Levels are Rising
Disagreement on Rate of Change

- Intergovernmental Panel on Climate Change: More than three feet by the end of this century;
- United States Army Corps of Engineers: 5 feet by end of century;
- National Oceanic and Atmospheric Administration: Up to 6 ½ feet by end of century.

NFIP 2017 Reauthorization
Program Issues

- Increasing Affordability and Reducing Subsidies: Difficult to do both!
- Improve FEMA Management and Prioritization: Easier said than done!
- Improve Prognostication and Communication of Risk
- Improve Flood Map Accuracy
- Expand Federal Risk Mitigation Programs
- Expand Property Owner Risk Mitigation Incentives

- Expand NFIP Coverage, e.g., business Interruption coverage, etc.
- Expand Commercial Property Owner Access to Federal Funding and Programs!!

NFIP 2017 Reauthorization
Capital Market Options

- Promote Greater Private Reinsurance Market Activity?
- Promote Catastrophe Bond Market Activity?

The Future of the NFIP?

Stay Tuned

State and Local Tax Subcommittee Committee Meeting

Wednesday, March 30th
4:30pm – 6pm
Marriott Marquis, Washington DC

Moderator:
Lisa Schmaltz, Director-Tax Accounting & REIT Compliance, Welltower, Inc.

Panelists:
Sean Kanousis, Principal, PwC
Scott Smith, Partner, BDO USA, LLP
Andrew VandenBrul, Partner-State & Local Tax, KPMG LLP

STATE & LOCAL SUBCOMMITTEE MEETING
(Open to all REITWise® Participants)
Marriott Marquis Washington, DC
Independence E-H
Wednesday March 30th, 2016
4:30 p.m. – 6:00 p.m.

Co-Chairs:

Joseph Gurney, Director-Multistate Tax, Deloitte LLP
Tracy Swearingen, SVP-Taxation, Duke Realty Corporation

Panelists:

Sean Kanousis, Principal, PwC
Lisa Schmaltz, Director-Tax Accounting & REIT Compliance, Welltower, Inc.
Scott Smith, Senior Director, BDO USA, LLP
Andrew VandenBrul, Managing Director-State & Local Tax, KPMG

NAREIT Staff Liaison:

Dara F. Bernstein, VP & Senior Tax Counsel

I. Overview of Legislative Developments (State Implications of PATH Act)

II. Proposed State Tax Legislation: California, Hawaii, PA, and Other States

III. Other Indirect Tax Issues

IV. Audit Activity: What are we seeing?

Note: This meeting may qualify for 1.5 hours of continuing professional education credits, depending on the state. For CLE or CPE credit information, please contact Afia Nyarko at 202-739-9433 or anyarko@nareit.com.

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March 30 - April 1

2016

SALT Subcommittee

March 30, 2016

Panelists

Lisa Schmaltz (Welltower), Moderator

Scott Smith (BDO)

Drew VandenBrul (KPMG)

Sean Kanousis (PwC)

SALT Subcommittee Co-Chairs

Tracy Swearingen (Duke Realty)

Joe Gurney (Deloitte)

AGENDA

I. Overview of Legislative Developments

II. Proposed California Tax Legislation: Political View and Technical Analysis: Repeal of Prop. 13 for Commercial Properties?

III. Other Indirect Tax Issues

IV. Audit Activity: What are we seeing?

I. Overview of Legislative Developments

A. The PATH ACT and State Tax Conformity

1. Built in Gains Tax – 5 Years

a. Where do the states stand?
b. Rolling (IL, NY); Adoption (CA, FL) and Non-Conformity.
c. REIT Specific Provisions

2. Bonus Depreciation

a. Where do the states stand?
b. Rolling (IL, NY); Adoption (CA, FL) and Non-Conformity.
c. REIT Specific Provisions

3. FIRPTA Qualified Foreign Pension Funds

a. Where do the states stand?
b. Conformity with IRC 897 in general
c. IRC 897(l)

B. State FIRPTA

1. Timing
   a. Different than "at-source" withholding
   b. When should we address?
   c. When is it usually addressed?
   d. Best Practices
2. Who is a Nonresident?
   a. Different for different jurisdictions
   b. Organization vs. Qualification
3. Exemptions
   a. Principal place of business
   b. Continue in business exemption
   c. <u>Examples</u>: California, Georgia, Oregon, Maryland

Tennessee – Revenue Modernization Act of 2015

- Adopts "Factor presence nexus" for taxable years beginning after December 31, 2015
  - *J.C. Penney National Bank v. Johnson*
  - Revenue Ruling 06-27
  - Tenn. AG Op. No. 15-37
- Market sourcing effective for taxable years beginning on or after July 1, 2016
- Cloud computing sales/use tax (eff. July 1, 2015): deemed delivery of cloud software
- Overhaul of administrative rules to implement the RMA
  - Proposed rules filed February 25, 2016; comments due/hearing on April 26, 2016
  - Market sourcing rules – modeled after MTC, DC, MA
  - New entity classification rules

Mortgage REITs: Financial Institution classification and special apportionment rules continue to expand

1. Physical Nexus

2. Economic Nexus

3. SINAA
   a. Solicitation
   b. Investigation
   c. Negotiation
   d. Administration
   e. Approval

4. Financial Org/Institution Rules

5. Sourcing of income: Whole loans (sale or interest), securitizations, CMBS

Illinois – H.B. 3086

- Amends definition of "Captive REIT"
  - Effective retroactively to taxable years ending after August 16, 2007
  - Voting power or value of a beneficial interest or shares held in a REIT that are held in a "segregated asset account" of a life insurance company for the benefit of persons or entities that are immune or exempt from federal income tax are <u>not</u> taken into account for purposes of determining if a REIT is a "captive REIT"

Virginia – H.B. 95

- Similar amendment to definition of "Captive REIT" and stock held in segregated accounts of a life insurance company
  - Effective for taxable years beginning on or after January 1, 2016

Nevada – S.B. 483

- Imposes a new "Commerce Tax"
  - Effective July 1, 2015
  - "Nevada gross revenue" of $4 million or more
  - Uses market sourcing approach
  - Tax rates vary based on NAICS classification
  - Proposed rules (issued February 17, 2016) address nexus, "taxable entity," filing requirements, sourcing, and other details

New York State and City Tax Reform

- Economic Nexus enacted for Corps with $1M or greater of New York receipts (NYS)

- Bank Tax eliminated (NYS & NYC)

- NYS corp tax rate reduced to 6.5% but MTA Surcharge increased to 28%, thus overall tax rate if 8.32% (Slight tax increase)

- Capital Tax increased to $5M but will be phased out – 0% by 2021 (NYS)

- Qualified Financial Instruments - 8% rule. In determining New York receipts and net gains from “qualified financial instruments” (generally financial instruments marked to market under IRC § 475 or 1256 (excluding loans secured by real property)), taxpayers may make an annual and irrevocable election to use a fixed percentage method. Under this method, 8% of all net income from qualified financial instruments is included in the apportionment factor numerator. If a taxpayer does not elect the fixed percentage method, receipts and net gains are sourced via a customer based sourcing method (using an individual’s billing address or the commercial domicile of a business).

New York State and City Tax Reform

- Market Sourcing Rules for Services
- Interest sourced to location of real property
- Net Operating Loss – Creates a New York NOL and no longer conforms to IRC 172
- PNOL – For taxable years prior to 2015, NOLs are converted to PNOLs
- Unitary Combined Reporting – (Applies only to Captive REITs and Captive RICs but could require combined reporting for multiple TRSs)
- Partnership nexus creates corporate partner nexus – does it?

New York State and City Tax Reform

- The legislation adopts 'effectively connected' income as the starting point for the corporate tax base calculation for non-US corporations (subject to adjustments).

- For foreign corporations, the legislation disallows exclusions, deductions or credits for (1) income from dividends or interest in stock, securities, or indebtedness but only if such income is treated as effectively connected with the conduct of a US trade or business (IRC § 864); (2) any income exempt from federal taxable income under any treaty, but only if such income is treated as effectively connected in absence of such exemption, provided that the treaty does not prohibit the state’s taxation of such income; and (3) any income that would be treated as effectively connected if such income were not otherwise excluded from gross income under IRC § 103.

New York State and City Tax Reform

Under the legislation, a combined report must be filed by any taxpayer:
1. that owns or controls, directly or indirectly, more than 50% of the capital stock of one or more other corporations or

2. more than 50% of the capital stock of which is owned or controlled either directly or indirectly by one or more other corporations or

3. more than 50% of the capital stock of which, and the capital stock of one or more other corporations, is owned or controlled, directly or indirectly, by the same interests *and*

4. that is engaged in a unitary business with those corporations.

Combined returns include:
1. a captive REIT or a captive RIC that is not required to be included in a combined insurance tax report under Article 33.

2. an alien corporation that satisfies the state ownership and unitary thresholds and that is treated as a domestic corporation under IRC Sec. 7701 or has effectively connected income for the taxable year.

Investment Income

- The legislation redefines investment income to mean income, including capital gains in excess of capital losses, from investment capital (as redefined), to the extent included in computing entire net income, less, in the discretion of the commissioner of finance, any interest deductions allowable in computing entire net income that are directly or indirectly attributable to or investment income. Investment income cannot exceed entire net income.

- The legislation further provides that if investment income, determined without regard to subtracted interest deductions, comprises more than 8% of the taxpayer's entire net income, investment income determined without regard to these deductions cannot exceed 8% of the taxpayer's entire net income. If the amount of interest deductions subtracted exceeds investment income, the excess of such amount over investment income is added back to entire net income.

- In lieu of subtracting from investment income the amount of those interest deductions, a taxpayer may elect to reduce its total investment income by 40%. Investment income does not include any amount treated as dividends under IRC § 78.

Pennsylvania – Capital Stock/Foreign Franchise Tax Phase-Out

- Fully phased-out for tax years beginning after December 31, 2015
- REITs often structured property-holding entities as disregarded partnerships rather than SMLLCs to minimize this tax
- Consider structuring alternatives following phase-out

Missouri – Franchise Tax Phase-Out

- Fully phased-out for tax years 2016 and thereafter

Pennsylvania – Local Gross Receipts Tax Litigation

- *Fish v. Township of Lower Merion*
- PA Supreme Court overturned Commonwealth Court decision on 12/21/15
- Gross receipts from rentals allowed to be subject to local business privilege tax under the Local Tax Enabling Act

Massachusetts – Voluntary Disclosure Program for the Settlement of Uncertain Tax Issues

- Eligibility: "uncertain tax liability" of $100,000 or more
- Anonymous contact with DOR permitted; DOR will notify within 30 days if eligible; taxpayer then has 45 days to accept by filing application and disclosing identity
- April 1, 2016 – May 31, 2016

California – Chief Counsel Ruling 2015-02

- Services provided to a business customer that uses the service to provide a service to its customers
- Treated as a "non-marketing service" and sourced to business customer's location
- "Look-through rule" not applied

District of Columbia – Act 21-307

- Latest in a series of "emergency legislation" that temporarily repeals the "blacklist" of foreign jurisdictions treated as tax havens for combined reporting purposes (this emergency legislation expires May 17, 2016)

Federal Partnership Audit Rules – Overview

- Federal partnership audit rules effective for tax years beginning after December 31, 2017 [Bipartisan Budget Act of 2015]
- Procedural rules for partnership audits and adjustments
- Repeals Tax Equity and Fiscal Responsibility Act (TEFRA)
- Applies to all partnerships, although some partnerships with fewer than 100 partners may be able to opt out
- According to IRS, fewer than half a percent of partnership returns are audited
- Under new rules, partnership will pay the tax, interest and penalties on underpayments with tax calculated by multiplying the net of adjustments times the highest statutory or individual rate
- As an alternative to paying tax, partnerships can issue adjusted K-1's to the partners who then must report the adjustment in the year made
- No amended partnership returns will be filed
- Statute of limitations will be determined based on when the partnership return was filed and considers extensions between the partnership and Treasury
- Partnerships are represented by a "partnership representative" — does not need to be a partner

Federal Partnership Audit Rules – State Considerations

- Generally, state conformity is either rolling or as of a certain date
- Conformity is normally limited to substantive rules and does not extend to administrative provisions
- As a result, state conformity to the new federal partnership audit rules will vary widely
- At its meeting in Salt Lake City on March 2, 2016, the Multistate Tax Commission (MTC) addressed the new federal partnership audit rules as an emerging issue
- Federal adjustments can be small on a per partner basis, especially after allocation or apportionment
- May have a more immediate impact in states with mandatory withholding and composite returns
- If states do not address conformity, there is a question of whether partners will receive sufficient information to prepare an amended return at the state level
- States may not be able to audit partnerships, unless they are “taxpayers”
- Significant questions of the statutes of limitations – partnership’s vs. partners’

Pennsylvania – Intercompany Expense Addback

- Act 52 of 2013, 72 P.S. § 7401(3)1.(t) provides an addback for certain intercompany intangible (and related interest) expenses
- PA DOR Issued Information Notice Corporation Taxes 2016-1 on February 19, 2016, providing the DOR's positions on:
  - Applicable intangible assets
  - Direct or indirect attribution on expenses and costs
  - Embedded intangibles
  - Interest expenses are presumed "directly related" to an intangible expense if engaged in any intangible transaction with an affiliate
  - Exceptions – principal purpose, arm's-length, foreign treaty and conduit
  - Add-back credit – "subject to tax" credit

Other Developments

- Crowdfunding

- California Proposed Dividend sourcing

- Hawaii: Two Proposals to eliminate DPD

- Louisiana: *Bridges v. Polychim USA, Inc.* No. 2014 CA 0307 (La. Ct. App. 4/24/15)

California Proposition 13

- Constitutional Amendment
- Prop 13 reform
- Full vs Partial attribution method

Other Indirect Tax Issues

A. New York Transfer Tax Litigation

(1) *In re GKK 2 Herald LLC*, New York City Tax Appeals Tribunal, No. TAT(H) 13-25(RP)
(2) *In the Matter of the Petition of Jonis Realty/E. 29th Street, LLC*, New York City Tax Appeals Tribunal, No. TAT(H) 09-9R(RP)

B. Property Tax changes in Ownership in Florida and Michigan

(1) *Florida – Form DR-430*

(2) *Michigan – Form L-4260*

C. Sales and Use Tax Issues

Pennsylvania & Philadelphia Realty Transfer Tax Issues

- Taxes imposed on "acquired real estate companies"
  - Transfer of 90% or more of the capital and profits interests in a real estate company within 3 years
  - Interest in a lower-tier real estate company are considered real estate – prevents indirect transfer of a real estate company without taxation
- Combination of transfers of less than 90% direct ownership in a real estate company, along with indirect transfers of the remaining owner(s) may minimize the tax
  - Philadelphia Law Department recently stated that such indirect transfers may be viewed in conjunction with the direct transfers, resulting in imposition of the tax
  - Pennsylvania DOR position appears to differ
- Tax rates are significant
  - Philadelphia – 3% of computed value
  - Pennsylvania – 1% of computed value, plus county tax outside of Philadelphia (generally an additional 1%)

IV. Audit Activity: What are we seeing?

Concurrent Session: City of the Future

Thursday, March 31st
9:45am – 11am
Marriott Marquis, Washington DC

Moderator:
Stephen Theriot, CFO, Vornado Realty Trust

Panelists:
Eamonn Kelly, CMO, Deloitte Consulting LLP
Anita Kramer, SVP Center for Capital Markets & Real Estate, Urban Land Institute
Jesse Tron, VP-Communications, International Council of Shopping Centers

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City of the Future

March 31, 2016

City of the Future

Moderator: Stephen Theriot, CFO, Vornado Realty Trust

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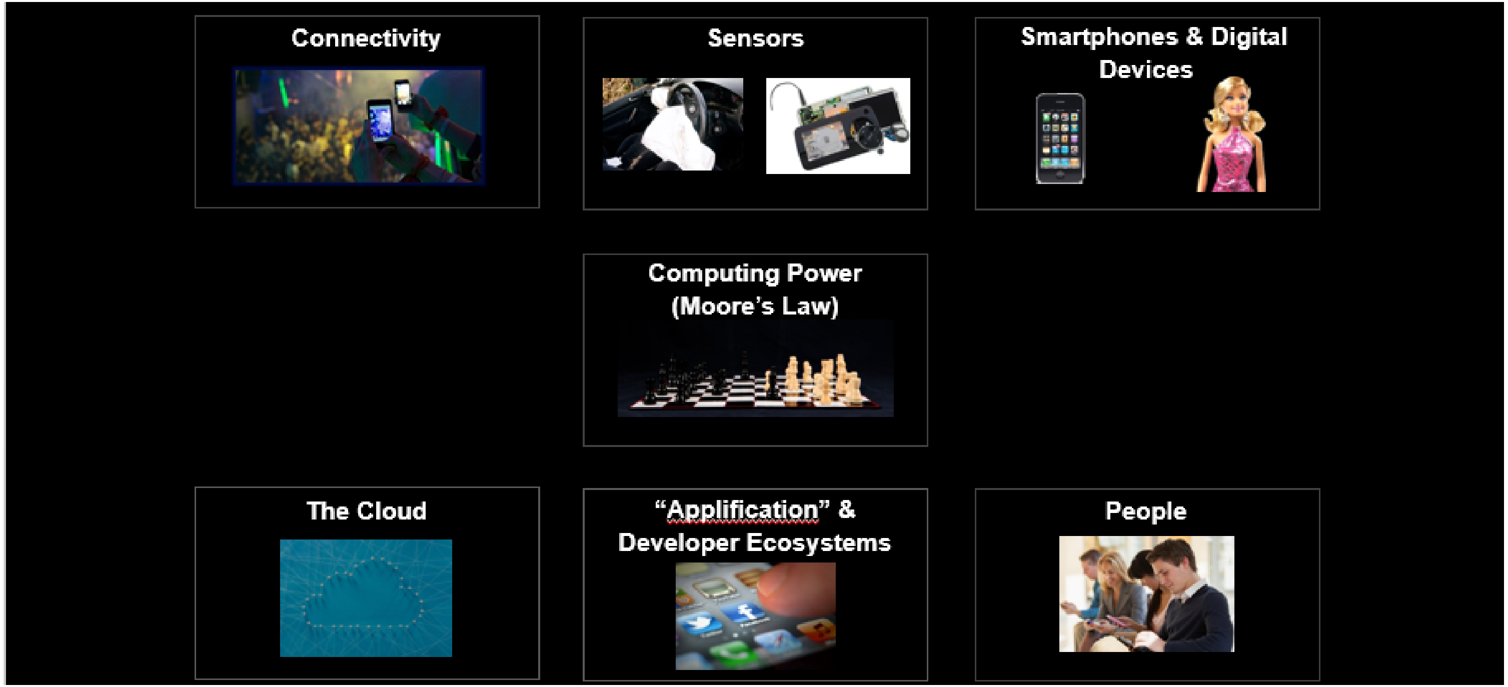
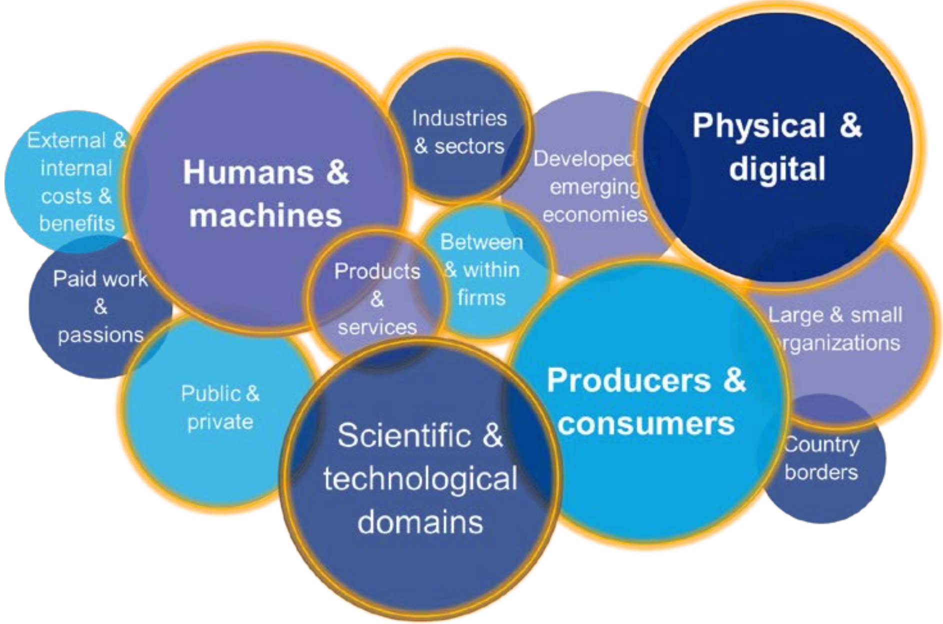
Disruptive Technology & Innovation

TECHNOLOGY ACCELERATION: A PROFOUND SYSTEMIC SHIFT



SO WHAT? - BLURRING BOUNDARIES THAT MATTER!



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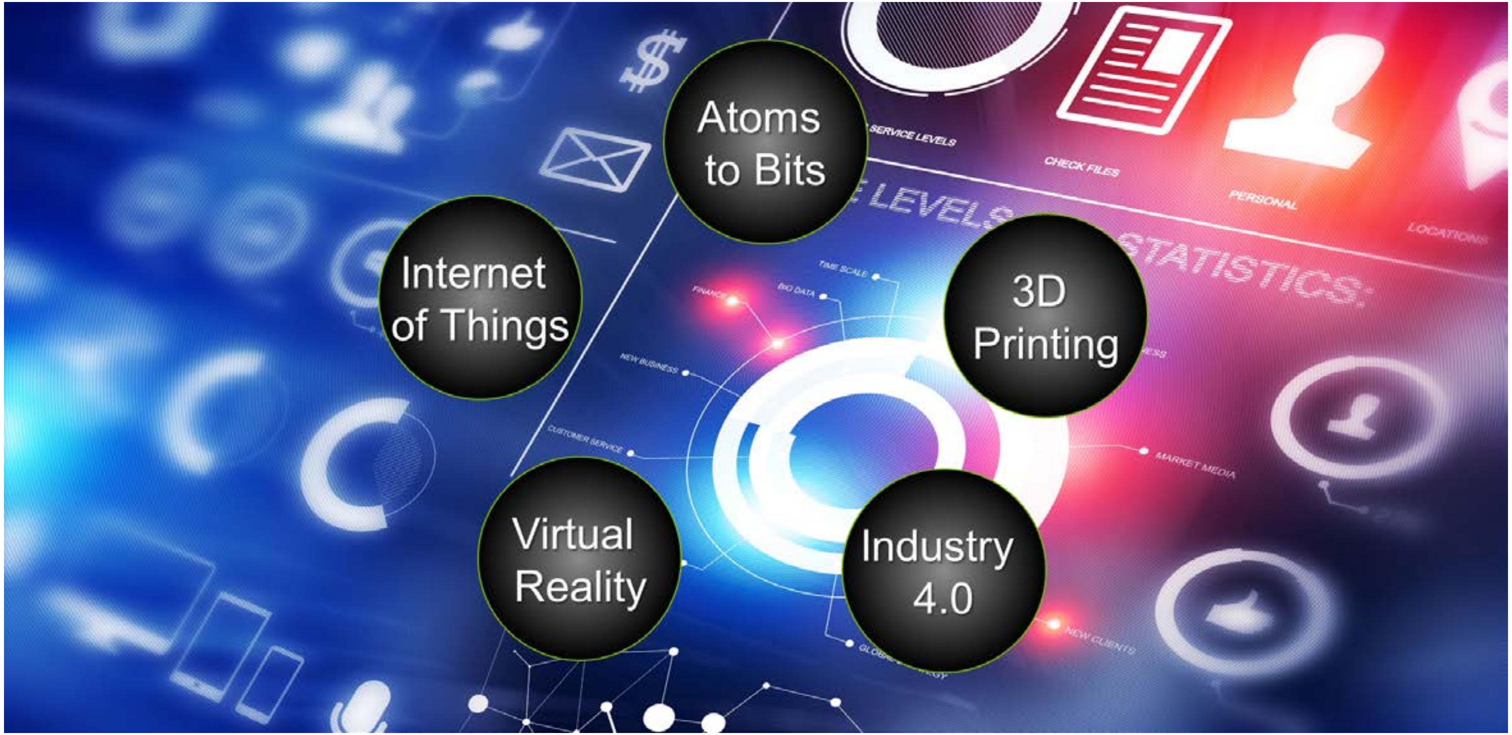
PHYSICAL AND DIGITAL



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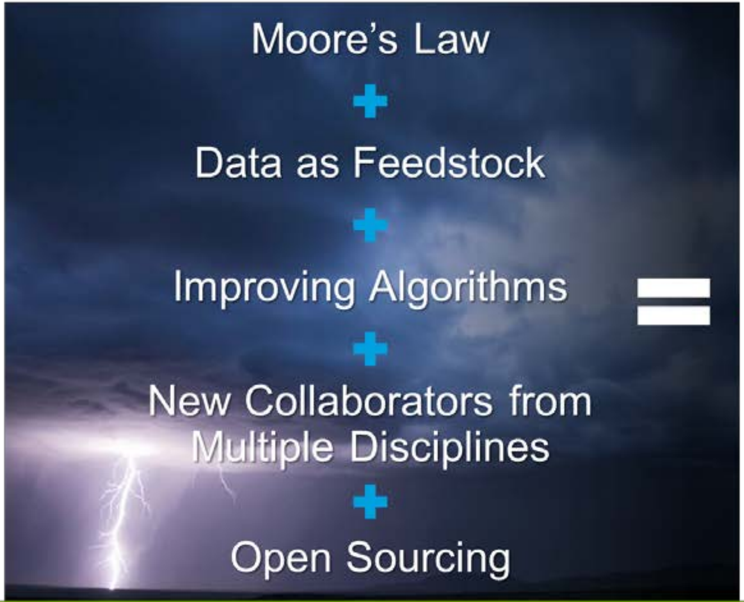
HUMAN AND MACHINE



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A machine learning revolution

…and a new age of robotics

VOICE RECOGNITION ▸ TRANSLATION ▸ VISION ▸ DIAGNOSIS ▸ WRITING ▸ EMOTION ▸ MANIPULATION

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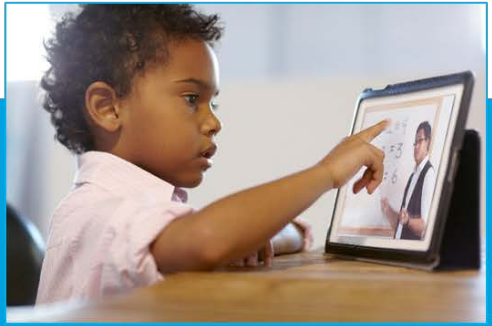
NEW ECOSYSTEMS

LEARNING



WELLNESS

MOBILITY

FOOD

Multi-platform Retailing

INDUSTRY SNAPSHOT

- Year-end 2015 property data results showing healthy returns across key metrics including occupancy rates, net operating income, base rents, cap rates and construction value.

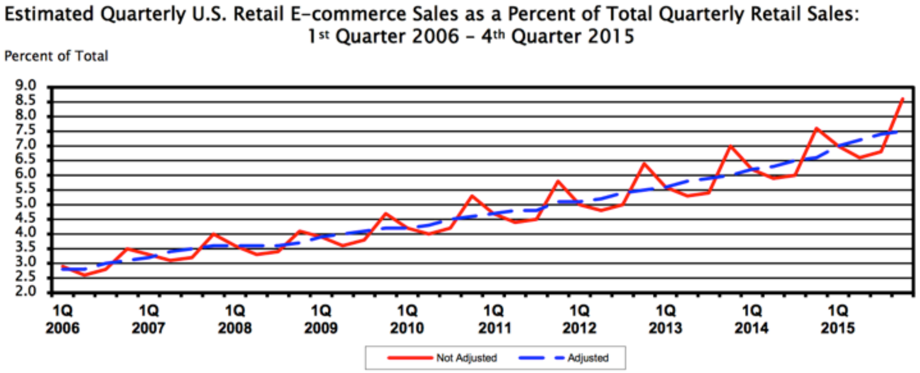
- Shopping center **occupancy rates** reached 93.2% at the end of in Q4 2015–the highest level since Q4 2007.

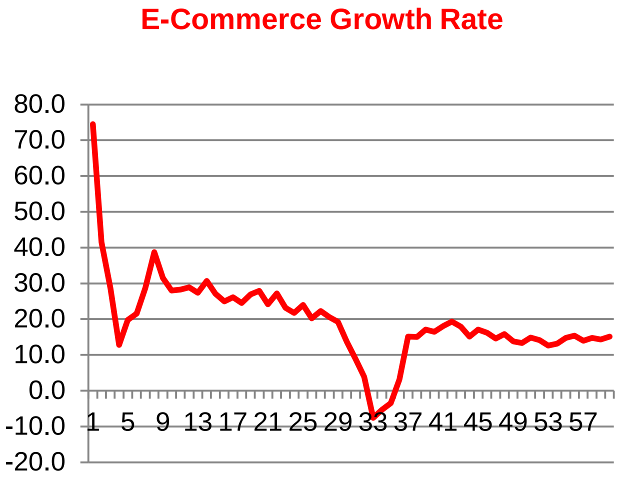
- **Net operating income** (NOI), a key indicator of strength, saw healthy year-over-year gains with a 6.4% increase from 2014 in the shopping center sector–and a 26% increase from 2010.

- Shopping center **base rents** rose 6.4% year-over-year in 2015, the fourth consecutive annual gain and a 23.1% increase from five years ago in 2010.

E-COMMERCE

- While e-commerce sales seem to be rapidly rising, the rate at which e-commerce is growing is actually declining





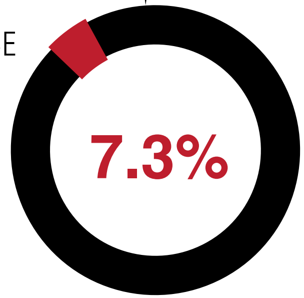
CLICKS *VS.* BRICKS

Not quite the battle you might think.

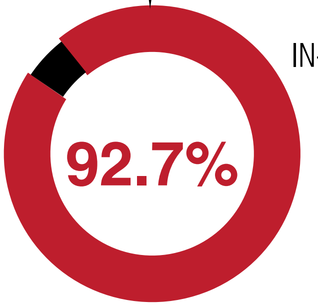
In 2015, online retail sales totaled $341.7 billion, which accounts for 7.3% of total retail sales.

In-store sales totaled $4.35 trillion, which accounts for 92.7% of total retail sales.

E-COMMERCE



IN-STORE



Source: U.S. Census Bureau

CLICKS *TO* BRICKS

FRANK & OAK

BOSTON PROPER

BAUBLEBAR

NASTY GAL

JUSTFAB™

RENTTHERUNWAY

ATHLETA

Source: Chain Store Age

Source: Seattle Times

AMAZON?!

The future of e-commerce: bricks and mortar

Amazon leads the way into the real world as online real estate - once heralded as the next frontier for retail - becomes crowded and expensive

Amazon to open 2nd physical bookstore, this one in Southern California

TECHNOLOGY

How Amazon Could Reinvent the Brick-and-mortar Store Experience

Amazon bets on universities as its brick-and-mortar expansion continues

amazon books

CLICKS *AND* BRICKS

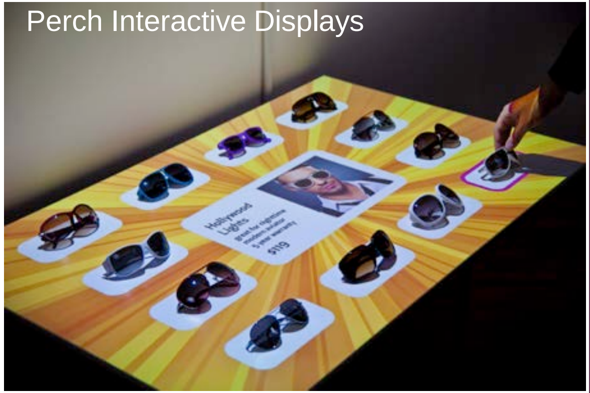
RFID Technology at New Balance

Kate Spade

Burberry Regent Street

Rebecca Minkoff

AdiVERSE



Perch Interactive Displays

Lowe's Holoroom


Sephora Concept Store


Barney's Flagship Ground Floor

deliv
delivery shortened


The Container Store Wearable


Tommy Hilfiger Samsung VR


Samsung Virtual Reality

EXPERIENTIAL RETAIL

STORY NYC


Nordstrom 3D Installment


Bonobos Guideshop

TOMS Shoes flagship store, Venice, CA

Brookfield Place

365 by Whole Foods

Deloitte.

Commercial real estate redefined

How the nexus of technology advancements and consumer behavior will disrupt the industry

Deloitte Center for Financial Services

Contents

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Foreword

Dear colleagues,

In previous editions of our outlooks, we examined the marketplace to offer guidance on what might be of greatest importance to industry leaders in the coming year. But many of these day-to-day challenges and opportunities don't change that much from one year to the next. With that said, we are seeing our clients become increasingly concerned by the potential disruptions they may be facing not just next year, but over the next several years. Industry leaders are increasingly thinking about longer-term strategic issues and how they can stay ahead of the impacts, and so we felt it was necessary to similarly take a longer-term view in our outlooks.

We are delighted to share with you our views on commercial real estate (CRE) industry trends and priorities over the next few years, based on the perspectives and first-hand experience of many of Deloitte's leading practitioners, supplemented by original research from the Deloitte Center for Financial Services.

Making predictions is an inexact science at best, but we are seeing the emergence of a number of dynamics that have great potential to fundamentally change the CRE business over the next decade. Technology developments—mobility, cloud computing, analytics and the Internet of Things, as examples—will have great influence on how properties are constructed, managed, sold, and leased. Several consumer trends, like urbanization and the sharing economy, are already coming together to shape how people live, work, and play. These trends also have changed the way that office space is used, for example, which will continue to evolve over time. And the convergence of additive manufacturing, electronic commerce, and innovative delivery methods will greatly change the "last mile" problem of getting goods to market, with consequent impacts on both retail and warehouse properties.

This outlook is organized to provide the reader with an overview of a few disruptive trends that we find are generating the most energy in client discussions at the moment. We have traced the development of each trend, with some pertinent examples that show how the industry is already, or will be impacted over the next decade. A series of bold predictions, in the form of a "CRE forecast," are offered that are based on our experience and analysis, and each section wraps up with actionable takeaways and strategies executives can consider to seize opportunities through these potentially disruptive clouds. We hope you find this report insightful and informative as you consider your company's strategic priorities for the coming years. Please share your feedback or questions with us. We would value the opportunity to discuss the report directly with you and your team.

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A nexus of technology advancements and consumer behavior changes

Disruption is not a new phenomenon, yet it is a hot topic of discussion in every boardroom today. Many of these discussions center around the potential impact of technology on their business, and while this trend is also not new, nearly every traditional business is feeling the heat more than ever.

The convergence of one or more technologies, such as advanced cloud computing, mobile, social media, and analytics, is leading to fast-paced, big-bang disruptions in many industries. For example, this convergence is enabling high-quality Internet enabled services such as advanced payment systems, Internet of Things, and geolocation services globally. Furthermore, small and large technology companies are leading the charge by constantly experimenting with product innovation.[1] These companies use hackathons and other approaches to innovate products and services that unintentionally obliterate existing businesses.[2] As a result, traditional value chains are being transformed with transfer of power to the consumer. The technology advancements are increasing global interconnectedness, data ubiquity and transparency, and speed of information access and exchange. As a result, disruption in one part of the ecosystem is rapidly spreading to the broader world.

Other evolving trends are rising urbanization and changing global consumption patterns. Urban population is expected to grow to 66 percent of the global population by 2050, as compared to 54 percent and 30 percent in 2014 and 1950, respectively.[3] This rising urbanization is redefining how and where people live, work, and play. Consumption patterns are tilting toward more customized goods and services. Some consumers are increasingly environmentally conscious, preferring to reuse and share goods rather than own and acquire new ones.

We believe the nexus of technology advancements and consumer behavior changes has the potential to redefine urban planning and fundamentally change the CRE demand-supply dynamics and business model, including real estate usage, site location, development, design, valuations, leasing, and financing. That said, as the disruptive trends evolve, regulators will likely have to develop policies and regulations to strike a balance between protecting public interest and enabling innovation.[4] We believe CRE organizations will have to be increasingly cautious about cybersecurity and the appropriate use of data.

In our inaugural longer-term outlook, we have identified four themes that we believe will result in significant disruption for the CRE industry over the next decade:

- Collaborative economy
- Disintermediation of brokerage and leasing
- War for talent
- The last mile

While there is no certainty about the extent of disruption in each of these trends, we firmly believe that CRE companies will have to be agile and flexible in embracing technological innovations to keep pace with their new competitors and maintain their edge. Mark Fields, president and CEO, Ford Motor Company, said "For me, it was exciting to have the opportunity to join a company that simultaneously built one of the world's most complex industrial products and the most interesting consumer products. Fast-forward 26 years, we now make one of the world's ultimate technology products as well."[5] This is one example demonstrating how traditional automotive companies are tackling both current technology-driven innovations, like electric vehicles, as well as emerging disruptions—like driverless cars. Could the CRE industry see similar innovation and disruption in their business?

Collaborative economy

Reshaping CRE demand and use

The collaborative, or sharing economy is a digitized format of the age-old bartering system. Essentially, consumers serve each other directly rather than being served by companies, and pay for the use or access of goods and services rather than own them. Based on the premise of "on demand," technology advancements, consumption and lifestyle patterns, along with societal factors are driving the rapid growth of the collaborative economy. Companies such as Uber and Lyft are leveraging technology to offer on-demand taxi services, while Zipcar provides on-demand car rentals. Combined, these services have reduced the need for car ownership. This trend can be equally applied to CRE, as collaborative space usage is gaining prominence in places where one lives, works, and shops.

Airbnb is an online marketplace for renting accommodations. With over 1.5 million global listings across more than 190 countries and in over 34,000 cities, the company is catering to more than 40 million guests and has revolutionized the concept of renting a wide variety of accommodations for business and leisure travelers.[6] Many consumers believe that it's more convenient to use such a service rather than reserve hotel rooms, and at the same time enjoy the unique customized lodging experience they are able to create for themselves.

In the office sub-sector, WeWork leases large office spaces and sub-leases them on demand. In another variant, companies like LiquidSpace,[7] Regus,[8] and Desks Near Me[9] are online marketplaces for a wide variety of short-term rentals of office space, ranging from day offices, hourly use of office space or meeting rooms, to virtual offices and other uses. In the retail space, online marketplaces such as Storefront offer a platform to brands, designers, and artists to find physical retail space for short duration.[10]

Going forward, we expect driverless cars to take car sharing to the next level. Likewise, real estate space sharing will expand to other property types: For example, WeWork is expanding the sharing concept to residences with WeLive. One of their properties in Crystal City in Arlington, Virginia, will include two floors of cosharing office, apartment, retail, and other shareable spaces.[11]

The success of a collaborative economy could be stymied by regulatory intervention, as many new services are perceived either to affect public interest or to potentially violate existing regulations.[12] Although state and federal governments have yet to develop policies to respond to the growth in the collaborative economy, companies such as Uber, Airbnb, and others are coming under significant regulatory scrutiny in various jurisdictions. For example, in the October 2014 report, "Airbnb in the City," the New York State Attorney General estimated that as many as 72 percent of the units rented through Airbnb were in violation of state zoning regulations or other laws.[13]

How will the collaborative economy impact CRE?

The growth in the collaborative economy will likely create opportunities for incumbents to optimize rates on short-term space, creating more value while allowing tenants to obtain space that more closely meets their demand-based needs.

However, it can also impact the demand for existing real estate. For example, studies suggest that revenues of lower-end hotels are impacted by nearly 8-10 percent in areas with high Airbnb listings.[14] Separately, certain property types such as parking lots may not be required at their existing locations, as driverless cars become operational. (For more details, read our blog, "Commercial real estate sector: Get set to be disrupted by driverless cars.")

Incumbents will find it challenging to manage the use of existing real estate under current leasing and tenant approaches, because they may not have the flexibility to accommodate tenants' varying demand for, and use of space. Companies like LiquidSpace offer large open office spaces that can be adapted to each tenant's unique need by allowing the latter to scale their space requirements up or down based on short- or intermediate-term demand, rather than locking themselves into longer-term leases for more space than they need most of the time (or too little space during periods of rapid growth or project-related demand).

Corporations may reassess the need for long-term leasing of large office spaces as on-demand space availability fits in perfectly with the growing preference for flexi-work of many of their employees. There could potentially be an evolution of multi-tier leases, wherein a cluster of tenants such as WeWork lease large office spaces and subsequently sublease them. This would spur a broader subleasing phenomenon.

Beyond those possibilities, traditional CRE companies will face increased competition from individual real estate owners who are using online marketplaces like Airbnb to rent their physical real estate space.

Our CRE forecast

The growth of the collaborative economy will have far reaching implications for traditional CRE players:

Seizing opportunities through the clouds

Clearly, many existing hotel, office, retail, and health care spaces will likely lose utility as new players in the sharing economy redefine space usage. CRE owners need to rethink their approach to designing, developing, and redeveloping both new and existing spaces to accommodate the need for dynamically configurable spaces by the end tenant. Along with fluid spaces, companies should consider new ways to enhance tenant experience and optimize the value of space to tenants.

Traditional CRE owners may need to change business processes to meet the evolving demand, a daunting challenge to navigate. They can, for example, consider partnering with the coworking startups, as the latter have innovative value propositions and insights. Vornado Realty Trust, for one, is redeveloping existing spaces to make them leasable to WeWork.[15] In another example, W Hotels has partnered with Desks Near Me to provide guests access to premium workspaces.[16] Such collaboration will allow incumbents to use the unused and underutilized spaces more efficiently and maximize the value of their real estate assets.

Many CRE owners may have to adapt to a hybrid approach, as tenants are likely to prefer a mix of long-term lease agreements for core space needs and short-term flexible leases to manage peaks and valleys of workforce and project-related needs. As a result, incumbents will have to reinvent their leasing approach and lease administration processes as their traditional approaches become increasingly irrelevant. They will also have to adapt to a dynamic revenue model because the short-term leasing phenomenon will provide opportunities to drive better demand-based pricing on rental rates, but reduce predictability in their revenue streams.

Disintermediation of brokerage and leasing

Brokerage companies will transform into technology firms

Technological advancements are increasingly automating brokerage and leasing tasks and activities, bringing down barriers between potential tenants and real estate owners. Developments in cloud computing combined with mobile and social media are resulting in cost-effective and real-time availability of property information and are enabling many leasing activities online. This has reduced entry barriers for niche and smaller companies. For example, property listing websites provide several services ranging from basic aggregation of leasable space to offering an online marketplace for CRE owners and prospective tenants. Companies like Hubble[17] and 42Floors[18] provide office space listings in the United Kingdom and USA, respectively. Some also complete lease deals—startups such as Rofo are online marketplaces for property listings and potential tenants that also enable lease deals without broker intervention.[19] Additional relevant information, such as CRE lease comparables (comps), is increasingly accessible, which was available only privately in the past. Companies such as CompStak[20] and DealX[21] use technology to crowdsource lease comps and offer it for public consumption, including information such as tenant name, rent, lease duration, and landlord concessions. In other examples, companies such as Real Massive and VTS have even broader platforms, offering property listings as well as market and other related information to owners, tenants, and brokers. Such online marketplaces are empowering tenants to make more informed decisions without broker intervention.

Indeed, technology enhancements can further disrupt the traditional brokerage model that already obviates the need for human touch by revolutionizing data ubiquity and transparency, and by providing even more information to tenants.

For example, geospatial technologies aid and automate several activities with respect to site analysis, sales, and marketing. They also provide additional information that can allow more informed location-related decision-making for both CRE owners and tenants. In contrast to physical maps, online demography maps and reports for a particular area allow CRE owners to understand the purchasing behavior and socioeconomic status of the end consumers of their existing and potential tenants.[22] These technologies also allow tenants to make efficient and customized analyses that could combine details about a specific property, with market and competitor data. Companies such as eLocations, a global online marketplace, provide detailed location-based information to retail property owners, prospective tenants, and investors on an absolute and comparative basis.[23] The website allows tenants to choose their desired area and match it to a broker listing instantaneously.

Technology enhancements can further disrupt the traditional brokerage model that already obviates the need for human touch by revolutionizing data ubiquity and transparency, and by providing even more information to tenants.

Artificial intelligence and cognitive technologies will allow automation of many tasks that before only humans could do.[24] BrokerSavant's Property Index uses deep learning to scan property flyers, analyze the data, and provide the most relevant property information to the market.[25] DigitalGenius uses its proprietary natural language processing framework to offer scalable and automated human-like conversations, which facilitate communication with online leads and minimize the need for an agent.[26] Online property sites are also using virtual reality technology to offer property tours anytime, anywhere, including showing virtual space design possibilities to meet a prospective tenant's specific needs and tastes. For example, using a remote-control robot called Robot View, Brazilian real estate website VivaReal offers virtual access to model apartments.[27]

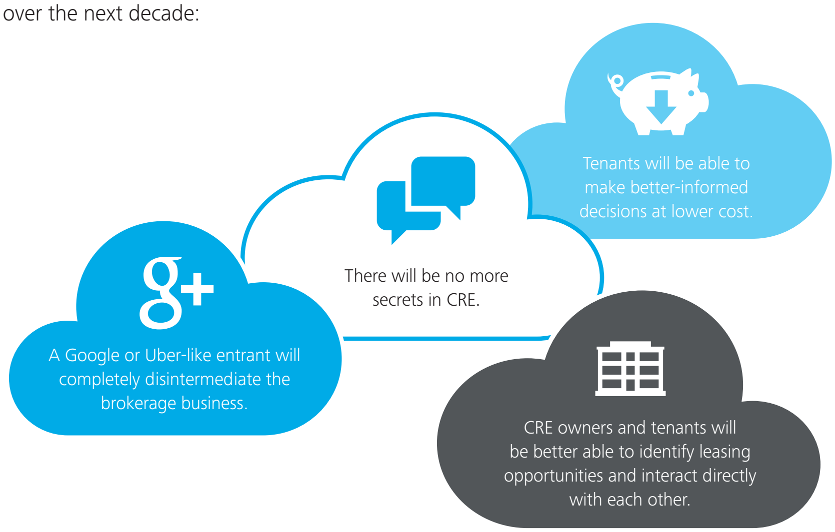
How will disintermediation in brokerage and leasing impact CRE?

The onslaught of technology in the brokerage and leasing business will have a two-fold impact on traditional brokers. On one hand, it enables usage of unproductive CRE by meeting demand and supply gaps in real-time. On the other hand, the rapid automation is making the traditional model for selling and aggregating CRE information inefficient and irrelevant. Armed with technology, new entrants are using innovative client acquisition and servicing strategies, which minimize the need for a broker to complete a CRE lease transaction.

Incumbents will also lose their edge on proprietary data as new entrants aggressively promote data ubiquity and transparency that offers more decision-making ammunition to clients. These factors have the potential to squeeze topline growth and margins from the traditional brokerage business. That said, the technology advancements create an opportunity for incumbents to extract inefficiencies from the current model. We may see a spike in global consolidation as traditional players acquire companies to achieve additional capabilities and scale, or as smaller firms find it unviable to remain in business. (For more on startups and their impact on CRE, read our blog, "Commercial real estate startups: Catalysts for disruption?")

Our CRE forecast

There is every possibility that the current brokerage model will undergo a metamorphosis over the next decade:



Seizing opportunities through the clouds

We believe traditional brokers should consider diversifying their core business focus, from largely brokerage to consultative opportunities in space need and location advisory, as well as property and facility management. Similar to consulting firms, they should redirect their service delivery model toward central client relationship management, rather than regional. Further, incumbents use technology to offer innovative services to clients. To enable this, they should capitalize on their prior experience and client relationships. For instance, companies can combine the rich bank of tenant data with geospatial and cognitive technologies to generate superior insights on future choices.

Alternately, incumbents can consider investing in or collaborating with startups, as this would allow them to combine their client relations with the tools and technologies of the startups. As an example, JLL's HiRise venture is an online marketplace for renting office space, covering all aspects of leasing, including documentation.[28] This trend will be particularly beneficial for smaller companies that not only may lack the capital and infrastructure to enhance their capabilities and scale their operations to accommodate changing tenant expectations, but would also be likely to lose business faster than the larger brokerage firms.

War for talent

Revolutionize demand for office and mixed-use properties

Multiple forces in the employment marketplace are expected to result in a significant war for talent over the next 10 years. Slower US population growth combined with a significant number of soon-retiring baby boomers will potentially slow labor force participation.[29] Separately, employment patterns are likely to change, as health care, community services, and science, technology, engineering, and math (STEM) jobs are likely to be the fastest-growing occupational clusters.[30] Furthermore, cognitive technology-driven automation will eliminate or redesign some existing jobs, and create new kinds of roles.[31] These changes will result in a higher demand for knowledge workers with a minimum of postsecondary education and specialized skills. One estimate suggests that 60 percent of millennials will need to have some form of postsecondary education to fuel economic growth, which means 62 million new degree holders by 2025.[32] Unfortunately, at the current rate, only 39 million Americans will obtain that higher education by 2025, leaving a gap of 23 million.[33]

Can immigration fill the talent gap? We believe the current US immigration laws do not allow for the necessary and continuous flow of international talent with STEM skills to fill the widening gap. The current laws either serve other goals such as enhancing diversity,[34] or there are huge backlogs in immigration categories, where the wait for entry can stretch over decades. There are backlogs in certain categories in which annual caps are reached quickly, and regular surpluses in still other categories are also being observed.[35] Further, the time delays involved in the temporary categories frustrate employers who need to match workers with jobs within tight time constraints.[36] The United States will have to make significant changes to its immigration policies if it hopes to use this population to help bridge the talent gap and remain competitive.

Another transformative trend is the influx of a large proportion of millennials to the workforce, a group that generally demands a different employment experience. Having grown up in a technology-enabled world, Millennials, who will comprise 75 percent of the workforce by 2030, prefer an open and flexible work culture that allows them to work anywhere, anytime.[37] They expect employers to be less hierarchical and to encourage emotional and physical well-being. Globalization, the collaborative economy, and technology are also promoting the virtual work environment, which doesn't necessarily require people to come to their workplaces. Many millennials favor part-time, contract, or freelance employment.[38] An estimated 40 percent of the workforce will be freelancers, temps, independent contractors, and solopreneurs by 2020.[39]

How will the war for talent impact CRE? The talent gap and evolution in the talent marketplace will have a significant impact on where CRE is located and the way it is designed and used. There will be greater demand for integrated urban-lifestyle centers that cater to the live, work, play mantra.

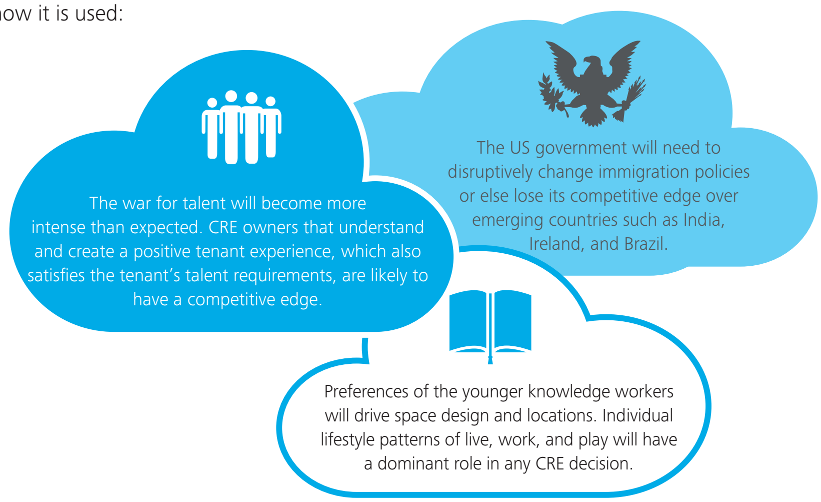
Because of this trend, mixed-use spaces that include office, residence, and recreation options will be favored over stand-alone properties. For example, Chicago's West Loop, which was once packed with large industrial buildings and warehouses, is undergoing this kind of transformation. Offices for large technology firms, retail spaces, and luxury condos are replacing many old industrial buildings.[40] Corporations too would prefer to have workplaces closer to where knowledge workers reside to reduce the latter's commute time.

In essence, office-space demand will tilt in favor of open, flexible, cosharing spaces, a trend made evident by companies such as Google, Facebook, and Hewlett Packard.[41] And the per-employee office space requirement is likely to shrink. According to a Deloitte Canada report, the average office space per employee is projected to decline from 250 square feet in 2000, to 150 square feet in 2017, and companies that have nimble workplaces would see a further decline to 90–100 square feet.[42] Offices could morph into an office-as-a-service model, acting as physical meeting points rather than daily workplaces. Further, the increase in contract workers, or talent preference for flexible work locations, will result in knowledge workers preferring to work from home, with many tenants demanding small offices in their apartments.

Millennials, who will comprise 75 percent of the workforce by 2030, prefer an open and flexible work culture that allows them to work anywhere, anytime.

Our CRE forecast

We believe the war for talent will have a significant impact on where CRE is developed and how it is used:



Seizing opportunities through the clouds

CRE companies should consider a broader set of parameters for any location and design decisions on future development and redevelopment. As the war for talent intensifies, talent dynamics should be an integral factor in location-based decisions, especially for office property owners. Companies should estimate the future workforce using existing employment data, and evaluate areas where knowledge workers are likely to live, work, and play, which in turn would be closer to the regions where they study and grow. Such neighborhoods are likely to see a significant rise in rents. Further, CRE companies should evaluate areas where STEM talent growth will outpace the impact of retiring workers, as these regions will likely see an increase in business investments.[43] A Deloitte study identifies Texas, Florida, Nevada, Arizona, and Utah as the five states that are likely to see such growth by 2030.[44]

CRE companies must also strategize their redevelopment of existing property, tailoring it to the changing talent dynamics. One option could be to refurbish existing buildings. In such cases, property design will play a critical role in meeting the changing needs of the workforce. Companies may need to revamp their design and development teams, to build expertise for mixed-use and flexible properties. Alternately, owners of different property types could consider collaborating with one another to share both their expertise and the nuances of each property type.

Another option could be to dispose of a few existing properties, and acquire and develop new ones. For example, Kilroy Realty has sold nonstrategic office and industrial properties totaling $850 million over the last several years and reinvested the proceeds in both new developments and existing assets that will suit the needs of millennials.[45]

The last mile

Blurring lines between retail and industrial properties

Retailers continue to evaluate and implement innovative solutions to enhance consumer experience by adapting to their changing preferences. Currently, a large part of experiential retailing is being driven by increased competition from the exponential growth (CAGR of approximately 15.5 percent for 2004–2014)[46] in online retailing, a trend that continues to lower entry barriers and fragment the industry. Online retailers are also fulfilling on-demand as well as tailored orders for individual consumers. Another evolving competitive factor likely to challenge retailers is the growth in 3D printing. 3D printing will not only enable small-sized, customized, and on-demand production, but its lower costs may even result in reshoring manufacturing activities. (To learn more about the impact of 3D printing on manufacturing, read our reports on dupress.com.) This essentially means that manufacturers will have the option to move to a build-to-order model rather than build-to-stock, which will allow them to connect, customize, and sell directly to consumers.

Retailers and some retail real estate owners are using different and flexible delivery options such as same-day or next-day delivery to create differentiation at the last mile. For example, Deliv, Amazon Prime, and Google Express are offering same-day delivery.[47] Sidecar Deliveries and UberRUSH are leveraging their driver networks for same-day delivery and instant pick-up and delivery within individual city limits, respectively.[48]

A large part of experiential retailing is being driven by increased competition from the exponential growth in online retailing, a trend that continues to lower entry barriers and fragment the industry.

Indeed, same-day delivery competition is on the rise, as it is an important consideration in consumer purchase decisions. A recent survey suggests that one-in-four shoppers are open to abandoning an online shopping cart in the absence of same-day delivery.[49] It's no surprise that retailers are constantly experimenting with new concepts to improve last-mile delivery. For example, Tower 24, a Germany-based company, and Amazon Locker are offering automated electronic lockers, which can be accessed with a security code to retrieve packages.[50]

We believe the use of drones for last-mile connectivity can result in ground-breaking changes in delivery options. Amazon.com, Inc. with its "Amazon PrimeAir"[51] and Google with its "Wing"[52] are working on enabling package deliveries through the aerial route by using unmanned drones. However, according to industry leaders, the Federal Aviation Administration (FAA) has been slow in developing rules and regulations for commercial use of drones, although it recently allowed Amazon Inc. to test drone delivery.[53] That said, if successful, drones would take the last-mile competition to the next level from same-day to even less-than-an-hour delivery.

How will the last mile impact CRE?

We believe disruption in manufacturing and retail and consequently last mile connectivity will significantly impact retail and industrial properties.

Brick and mortar stores will still remain integral to creating customer experience, but primarily for products that require 'touch and feel' or have significant service components. The store-in-store concept where one retailer provides dedicated space to another retailer in its own store, will also continue to find favor, although there may be less demand for stand-alone stores. As a result, there will be less demand for large stores and weak overall demand for traditional stores. Further out, analysts expect 50 percent of American malls to close by 2030.[54] We believe retail properties will instead be utilized in different ways. They could double up as fulfilment centers, especially for commoditized products that do not necessarily require touch and feel for purchase decisions. Many neighborhood mom-and-pop stores could end up being package pick-up and drop-off points.

On-demand retailing and manufacturing will reduce inventory holding, and potentially the demand for large warehouse spaces. In addition, traditional CRE owners will be challenged by new and innovative on-demand storage space providers such as Lockitron, Boxbee, Roost, and Swapbox.[55] Existing distribution centers developed on a regional basis to serve on the logistical chain between global manufacturers and large box retailers will increasingly be disrupted by smaller, local distribution and fulfillment centers promising efficient, same-day or next-day delivery to the ultimate consumer. As such, there will be fragmentation of warehouse space, with higher demand for smaller warehouses and distribution or fulfillment centers spread out at frequent intervals within city limits.

The upshot is that physical real estate spaces that support last-mile delivery are being preferred by institutional investors over traditional industrial and retail space, which may not bode well for incumbents from a pricing and valuation perspective.[56]

Our CRE forecast

We believe technological developments and consumer demand for speedy delivery will significantly impact last-mile connectivity as well as the demand for both industrial and retail real estate:

Seizing opportunities through the clouds

Retail property owners should continue to try different store formats, tailored spaces, and innovative techniques to enhance end-consumer experience. This would require incumbents to embrace sophisticated technologies. For example, a few large retail property owners have made strategic investments in Deliv to enable same-day delivery for their tenants.[57] Retail property owners can also consider offering tag-reading robots that would use radio frequency identification (RFID) technology to help their tenants optimize in-store inventory.[58] They should continuously evaluate the number, location, and optimal size of stores, based on the need for "touch and feel of products" and consider revamping the nonstrategic stores into fulfillment centers. Ultimately there may be opportunities for retail property owners to become distribution infrastructure providers by using their nonstrategic assets or repurposing vacant space in cities as local distribution hubs for smaller and fragmented retailers.

Distribution and fulfillment centers should be a prominent part of industrial real estate owners' property portfolios. As incumbents plan new development, they will likely benefit from acquiring and developing smaller and flexible spaces within city limits that meet the demands for rapid delivery to end consumers. Alternately, they can partner with the new on-demand storage space providers to offer a mix of long- and short-term leases and extend their tenant-servicing capabilities. Industrial real estate owners will be well served to evaluate both the evolving needs and business strategies of their tenants, as well as the changing requirements of their tenants' end consumers, as these will likely be impacted significantly by technology and new logistical strategies. Accordingly, it will be important for incumbents to evaluate and reposition existing warehouse space, particularly the larger ones, to improve their utility. They can consider multi-tenant solutions to reduce costs and enhance capabilities for manufacturers preferring to sell directly to end consumers. Further, the use of advanced RFID technology, geotagging, and Internet of Things would enable smart, intelligent, and efficient use of space and enhanced services to tenants.

The location of retail stores and distribution centers will be more important than ever. Companies should use geospatial technologies and predictive analytics to identify strategic retail and warehouse locations. They will also need to understand the nuances of managing and operating both industrial and retail properties given the likely overlap in their use.

Disrupt or get disrupted?

The writing is on the wall: CRE usage will undergo a metamorphosis over the next decade

Deeply rooted in the convergence of technology and evolving consumer behavior, the physical and digital worlds are blurring fast. While the collaborative economy will redefine the use of every kind of property, the war for talent will promote demand for mixed-use space. Disintermediation in brokerage and leasing will disrupt and significantly transform the age-old brokerage business. And retailers' and manufacturers' rush to meet ever-increasing consumer demand for speed through last-mile delivery will blur the lines between retail and industrial properties. These disruptive forces have the potential to redefine the current property market segmentation of primary, secondary, and tertiary, and consequently, valuation. Incumbents will have to be smart about their location strategy as property location will be more important than ever. They will have to focus significantly on designing or redesigning flexible physical space that can be customized to tenant and ultimately consumer needs in order to remain relevant.

Incumbents' traditional business models are unlikely to work. They will need to have dynamic strategies and respond with dexterity to the rapid changes in the business landscape. Interestingly, the technology that is disrupting their businesses is the one that will help them meet these new challenges as well. Of course, appropriate cybersecurity measures will be equally critical. Companies will have to re-engineer operations and figure out optimal ways to organize and access talent. As incumbents combat this disruption, intangibles such as tenant relations will be their biggest assets.[59]

We firmly believe that it's a myth that traditional players will remain insulated from these disruptive forces. They will have to make a choice between proactive responses to the evolving business landscape or be disrupted by the new entrants and lose their competitive edge.

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Business ecosystems come of age

Deloitte University Press

Part of the Business Trends series

This report explores how forward-looking leaders and organizations can thrive in a world of business ecosystems.

A CHANGING WORLD

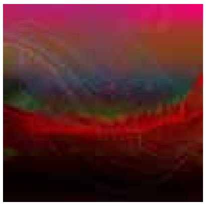
Business ecosystems come of age

Businesses are moving beyond traditional industry silos and coalescing into richly networked ecosystems, creating new opportunities for innovation alongside new challenges for many incumbent enterprises.

Blurring boundaries, uncharted frontiers

Long-standing boundaries and constraints that have traditionally determined the evolution of business are dissolving, allowing new ecosystem possibilities to flourish.

LIBERATING POTENTIALS



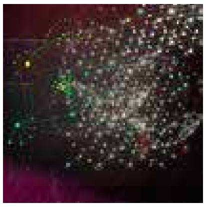
Wicked opportunities

"Wicked problems"—ranging from malaria to dwindling water supplies—are being reframed as "wicked opportunities" and tackled by networks of nongovernmental organizations, social entrepreneurs, governments, and big businesses.

Regulating ecosystems

As ecosystems enable more rapid, cross-cutting innovation, regulators are challenged to create policies and solutions that protect the public's interests and are also dynamic enough to keep pace with innovation.

EVOLVING ENTERPRISE STRATEGIES



Supply chains and value webs

Supply chains are increasingly becoming value webs that span and connect whole ecosystems of suppliers and collaborators; properly activated, they can play a critical role in reshaping business strategy and delivering superior results.

The new calculus of corporate portfolios

The rise of business ecosystems is compelling strategists to value assets according to an additional calculus, often generating different conclusions about what should be owned.

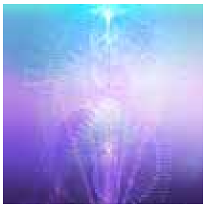
The power of platforms

Properly designed business platforms can help create and capture new economic value and scale the potential for learning across entire ecosystems.

CRITICAL CAPABILITIES

Minimum viable transformation

Leaders are taking lessons from the startup playbook on "minimum viable products" to launch minimum viable transformations—lightweight and readily adaptable versions of potential new business models.



Beyond design thinking

Ecosystems are dynamic and co-evolving communities of diverse actors who create new value through increasingly productive and sophisticated models of both collaboration and competition.

Preface

WELCOME to Deloitte's latest *Business Trends* report.

The purpose of these reports is straightforward: to provide business leaders with fresh and well-informed perspectives on important dynamics that are disrupting "business as usual." While change is nothing new, the speed, scale, and impact of a variety of fundamental shifts—in globalization, technology, and societal expectations—are undeniably transforming the business landscape today. We conduct and share this research as part of our commitment to serve as **guides and "wayfinders"** to our clients as they navigate their new terrain and shape the future.

In periods of disruption, uncertainty and challenge are inevitable. However, these times often also uncover new opportunities. Addressing both risks and potential rewards takes **confidence**, in decisions and actions alike, and in the solid analysis that should precede them. Uncertainty should not be denied or ignored—instead, it should be mastered, and grounded in both a deep understanding of the changes afoot and their potential consequences.

In this report, we focus on a critically important transition that has considerable implications for society, the economy, and businesses everywhere: **the continued rise of "business ecosystems."** Driven particularly by digitization, connectivity, and new modes of collaboration, important core structures of the industrial economy are quickly and dramatically reshaping, as many long-standing boundaries blur and dissolve. The "art of the possible" is expanding—enabling new approaches to serious societal challenges, and new, often platform-based, business models.

In *Business ecosystems come of age* we explore in detail what lies behind these changes, where they might take us, the new options—and threats—they present to many incumbents, and the strategic and operational shifts they enable and demand. We sincerely hope that these perspectives are helpful as you undertake your journey into a fast-changing future.

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Blurring boundaries, uncharted frontiers

By Eamonn Kelly

Ecosystems are dynamic and co-evolving communities of diverse actors who create new value through increasingly productive and sophisticated models of both collaboration and competition.

Read more about our view of business ecosystems in the Introduction.

Long-standing boundaries and constraints that have traditionally determined the evolution of business are dissolving, allowing new ecosystem possibilities to flourish.

Overview

THE business environment has never been static, simple, or certain: Profound change, sometimes abrupt, sometimes gradual, has been reshaping the world for centuries. As recently as 1900, European empires straddled the globe, and the British empire alone contained 400 million people—25 percent of the world's population.[1] Only a tiny minority had ever stepped foot on foreign lands, or even travelled more than 50 miles from their place of birth. Well over 80 percent still lived on farms or rural communities.[2] In the United States, already the world's wealthiest country, life expectancy at birth was 47 years; about 7 percent of students completed high school; 1 percent of citizens held investments in public companies or mutual funds;[3] only 19 percent of women worked for pay;[4] just 3 percent of households were lit by electricity, and less than a third had running water.[5] While scientific knowledge and technological capabilities had progressed greatly since the Enlightenment, they remained almost primitive by today's standards.

But history was in motion. Between 1900 and 1905, Kodak would launch the Brownie—the first mass market camera; Marconi would transmit and receive transatlantic radio signals; the first narrative movie would be watched by millions around the United States in the first "nickelodeons"; the Wright brothers would take flight at Kitty Hawk; Hubert Booth would invent the first modern vacuum cleaner; a young Japanese playing card company, Nintendo, would start trading internationally; Henry Ford would incorporate his eponymous automobile firm; John A. Fleming would create the first practical vacuum tubes; Rutherford and Soddy would introduce their general theory of radioactivity; and the 26-year-old Albert Einstein would propose his theory of relativity and postulate the existence of photons. All of these—and many more events in that one brief historic window—were either enablers or manifestations of a rapidly expanding universe of new knowledge, capabilities, and potential.

Disruptive change is hardly a new phenomenon: Preceding generations have enjoyed and endured rapid shifts arguably even more transformative to their lives and work than those we experience today. And yet, it does appear inevitable that change will continue to accelerate. Knowledge begets knowledge; today's technologies fuel and catalyze each other's development; fast-spreading tertiary education opportunities around the globe are creating tens of millions of new actors in multiple fields of expertise; and massively enhanced connectivity combines, melds, and disseminates this increasingly rich mixture to accelerate learning and innovation.

> Few would dispute the central importance of technology, especially digital technology, as the key source of change in recent decades.

The story of change in our time, however, is not only a story of speed. Even more disruptively, long-standing boundaries and constraints that have powerfully determined the evolution of business, the economy, and society are now blurring and even dissolving. As a result, a new era of extraordinary possibility and potential is unfolding. Unprecedented opportunities are inspiring entrepreneurs and innovators. But these are also challenging incumbent leaders and businesses to adapt and act with confidence in order to thrive in the future.

What's behind this trend?

Many factors are together driving the transformation of the business environment. The global economy has changed beyond recognition. Newly powerful nations and organizations are growing, consuming, and helping to set new rules. Sustainability challenges, demographic shifts, and the needs of a new global "middle class" are increasingly important sources of innovation. Social and cultural shifts occur everywhere, empowered by an increasingly influential generation of entrepreneurial and impact-oriented "digital natives." New ways of collaborating and interacting are creating new organizational forms, business models, and approaches to talent engagement. Evolving societal expectations and scrutiny of businesses are reshaping the regulatory environment and challenging the "license to operate" and "license to grow" for multiple industries.

Fueling all of these, however, is rapid technological advancement. Few would dispute the central importance of technology, especially digital technology, as the key source of change in recent decades. Nor would they deny that it will continue to play an absolutely critical role. As writer Stewart Brand has observed, computing is not like previous technologies—it is "autocatalytic," or self-accelerating, as each development allows the next one to come about faster.[6] Seymour Cray, when told that Apple Inc. had bought one of his Cray supercomputers to help design the next Macintosh computer, declared: "I just bought a Mac to help me design the next Cray!"[7] Computers have also catalyzed rapid advances in other fields, including engineering, materials science, nanotechnology, and biotechnology.

Moore's Law—which defines the remarkable exponential growth in computing power and decline in cost—has held for 50 years, despite recurring concerns it would hit technological limitations.[8] It appears likely to endure longer; yet even if the pace should slow, the stage is already set for continuing digital disruption. After all, the process is still relatively new. The Internet only started entering the mainstream economy less than 20 years ago. Broadband access only overtook far slower dial-up modems about 10 years ago. Mobile devices designed for a digital economy—notably smartphones and tablets—arrived about seven years ago, and cloud computing and storage became truly effective shortly afterward. Even more recently we have witnessed the growing reach and power of software "applications," already altering the worlds of individuals and enterprises alike. Today the "Internet of Things" (connecting objects just as the Internet has connected people) is poised for takeoff. And the ability to analyze and interpret massive amounts of new data will grow, as machine intelligence continues to evolve, generating powerful new insights and predictive capabilities.

Digitization of the economy has already had tremendous impact, but we are only beginning to witness the sheer scale and scope of its transformative power.

The trend

Increasingly, businesses operate in complex, dynamic, and adaptive ecosystems. A variety of phenomena—including feedback loops, stocks and flows, scaling and network effects, power laws, and so on—must be understood to properly appreciate and anticipate how systems behave and might evolve. But one major change is already underway. *The fundamental boundaries that have specified the relationships, interactions, and possibilities of most businesses are rapidly blurring and dissolving*. Historically, when boundaries have moved—geographic, scientific, technological, institutional, or cultural—the results have been momentous. When multiple boundaries shift simultaneously—as happened during the Enlightenment and the Industrial Revolution—truly extraordinary breakthroughs and great strides in human progress occur, through the creation of new connections, possibilities, and ideas.

Many long-standing boundaries have been blurring in recent decades. Industries and sectors have been converging, reducing the clear lines of demarcation originally defined and codified almost 80 years ago.[9] Boundaries between and within firms have been weakening. Old distinctions between products and services are breaking down as businesses traditionally specializing in one seek to integrate the other, to create fuller "solutions" and more compelling experiences that serve customers' growing expectations. The historically profound gaps between the capabilities and influence of large and small organizations are steadily declining. For many individuals, the boundary between paid work and passionate pursuit of interests and hobbies is falling.

Even the respective roles and contributions of the private, civic, and public sectors are blurring. Businesses were historically driven by market values, and the civic sector by moral and social values; governments set the rules and provided public goods. Today, they are merging and becoming increasingly interdependent through new partnerships and collaborations—often in pursuit of shared goals in light of another blurring, as externalities become internalized within market-based solutions. The liberalization of trade policies following the demise of the Soviet Union has served both to soften borders between countries, and also greatly diminish the vast dividing line between the "developed" and "emerging" economies. Cross-fertilization and increasing collaboration across scientific and technological domains are dissolving multiple knowledge boundaries.

These are all crucial changes and are already impacting every sector and almost every business today. But three key types of blurring are poised to have growing and ubiquitous impact.

The human-machine boundary

From the advent of the most basic tools, technologies have always replaced and expanded upon human endeavor. The Industrial Revolution brought widespread mechanization of *routine manual* labor—a process continued ever since through multiple manufacturing innovations. The advent of office machines, especially computers, expanded automation into the *cognitive* domain—again, mainly in routine areas, as software algorithms captured well-codified and rule-based procedures and expertise, enabling faster, cheaper, and more reliable business operations. Meanwhile, since General Motors introduced the first industrial robots in the 1960s, machinery has been steadily extending its reach into *nonroutine* manual work.[10] Recently, for example, the US Navy tested a prototype bipedal firefighting robot equipped with multiple sensing and actuation capabilities.[11] General Electric is designing robots that can, for example, climb and maintain wind turbines.[12]

There will be further machine encroachments into manual work and routine cognitive fields, but the new and transformative blurring boundary today is occurring in the *nonroutine cognitive* domain, which has historically largely defied automation. Artificial Intelligence (AI), including machine learning, natural language processing, knowledge representation, machine-to-machine communication, and automated reasoning, is evolving fast.[13] Investment here has exceeded $17 billion since 2009, with private investment growing around 62 percent a year.[14] The extraordinary consequences are already becoming manifest. Apple's Siri voice recognition software applies natural language recognition to interpret and act upon spoken words. Google Translate has over 500 million active users every month, and now features a "conversation mode" that enables real-time bilingual conversations.[15] Self-driving vehicles have been road tested for millions of miles.[16] Symantec's Clearwell software, designed to address the explosion of "e-discovery" efforts in legal matters, uses language analysis to review and sort hundreds of thousands of documents in just hours.[17] IBM's Watson, having won *Jeopardy!*, is now detecting and diagnosing medical conditions and outlining patient-care plans.[18] Financial services firms such as Betterment and Wealthfront provide automated, customized investment advice. The Associated Press (AP) is implementing a system to automate the writing of corporate earnings reports, allowing reporters to concentrate on tasks that require more ingenuity and add more value—"more journalism and less data processing" in the words of the AP's Lou Ferrera.[19]

Looking ahead, the implications of increasingly autonomous non-human intelligence are profound, though still uncertain. Many, including scientist Stephen Hawking and entrepreneur Elon Musk, have voiced serious, perhaps existential, concerns regarding the potential consequences.[20] More immediately, however, we need only look backward at the transformative impacts of automation on manual and routine cognitive work—growth, productivity, and prosperity, alongside challenging social disruptions—to get a sense of the sheer scale of what likely lies just around the corner.

The producer-consumer boundary

Another clearly drawn line quickly losing resolution is the distinction between producers and consumers. In the first half of the twentieth century, powerful producers forged and dominated the new industrial era; consumers were the passive recipients of their output, far from active participants. In recent decades, increased choice enhanced consumers' power in the marketplace, but they were engaged rarely and weakly, through mechanisms like focus groups. Persuasion prevailed over participation. Even today, many businesses declare themselves "customer-centric," but still strategize around "value chains" that relegate consumers to the far end of increasingly complex production arrangements.

Such approaches are becoming increasingly inadequate as the old boundaries between producers and consumers blur in a variety of ways. Consider YouTube, where millions of users create and share 300 hours of content *every minute*.[21] Today, we also see people contributing real value to many communities of shared interests and needs—related to, for example, particular medical conditions or hobbies—and to blogs, citizen journalism, and other knowledge- and opinion-sharing portals. Five of the ten most popular web content sites worldwide are primarily user-generated.[22]

But consumers have also become deeply engaged in the production of physical products. In some cases, ecosystems of "makers" empowered by newly accessible and affordable technologies, are actually leading the evolution of products—for example, drones.[23] More commonly, consumers help design, improve, and prioritize within existing categories, on powerful platforms established by many firms explicitly for "co-creation." UK-based startup MakieLab, for example, allows customers to create one-of-a-kind 3D-printed dolls using its FabLab app. A similar concept underpins the successful fashion company Threadless, which gets all the graphics for its T-shirts as submitted designs and allows visitors to its site to vote for the ones Threadless should produce. Such approaches are being further spread through the increased deployment of prizes and competitions, and the growing success of crowdsourcing businesses such as Applause, the world's largest open community dedicated to professional testers of software.[24]

Now, the physical and digital worlds are converging rapidly in the form of increasingly "smart" objects.

More recently, peer-to-peer networks have proliferated, enabling individuals to "share" their assets, skills, and time. Businesses like Airbnb, Uber, and SoMoLend, for example, are creating radically different and fast-scaling options in hospitality, mobility, and finance, respectively. In some instances these are making previously "idle" assets productive, thereby benefitting society; but as such networks spread to other parts of the economy, they will threaten the existing business models of many incumbents.[25]

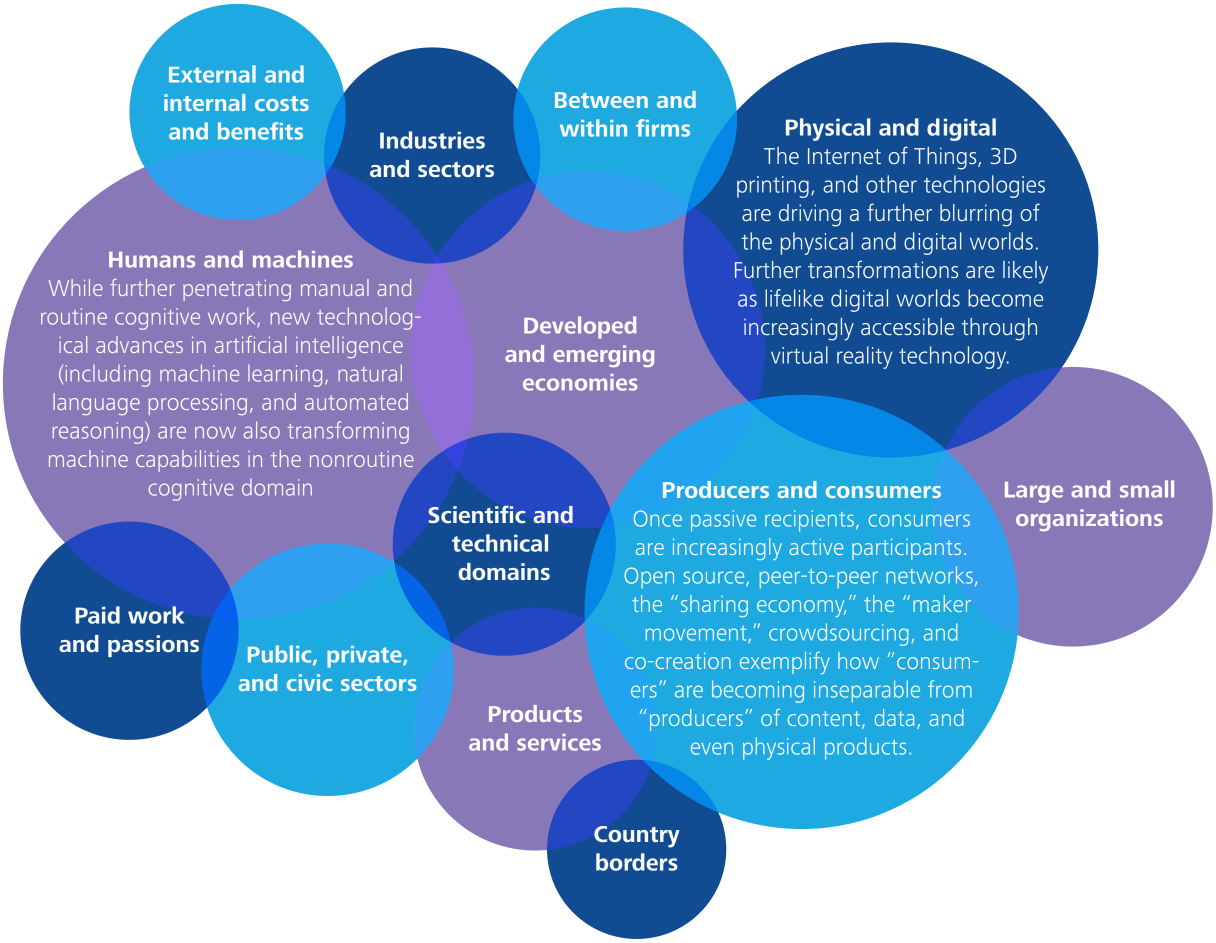
Consumers are also prolific producers of arguably the most valuable commercial resource today—massive volumes of data. Consider the data exhaust captured by Google's aggregation and prioritization of our searches. Or Amazon's "collaborative filtering" which captures our preferences to promote suggestions to like-minded people. And, as companies increasingly enable their customers to customize their own products, services, and experiences, they will accumulate ever more prodigious amounts of individual and collective data. As more of our lives move into the digital arena, almost every action and choice will create and transmit dynamic data with latent value—posing both new opportunities, and new dilemmas.

The physical-digital boundary

Digitization began influencing the physical economy 50 years ago, with information technology automating many business processes. The advent of the Internet increased the pace, scope, and scale of that process, with some commentators initially distinguishing between an "old" physical and "new" digital economy: "E-commerce" was different from "commerce," "bricks and mortar" separate from "online."[26] That boundary, however, quickly blurred, with terms such as "clicks and mortar" and "omni-channel" emerging in retail, for example, to describe a much more blended and integrated reality.

Now, the physical and digital worlds are converging rapidly in the form of increasingly "smart" objects. The Internet of Things (IoT) is enabled by many factors, including increasing capabilities and falling costs of sensors, actuating devices, and wireless connectivity, and the massive expansion of the Internet Protocol registration regime, IPv6. By connecting far-flung devices, objects, and infrastructure, the IoT enables not only remote real-time awareness, but autonomous adjustment and control to optimize performance, while creating yet more data. For example, the Nest Learning Thermostat senses your presence or absence at home, tracks your heating preferences over time, and adjusts temperatures accordingly. By aggregating what it learns from your and every

Figure 1. Fundamental boundaries are rapidly blurring in the business environment and economy



Source: Deloitte analysis.

Graphic: Deloitte University Press | DUPress.com

other household, it continuously improves its algorithms based on large-scale patterns.[27]

The IoT is spreading across the economy. Gartner has estimated about 26 billion connected objects (excluding smartphones and tablets) by 2020;[28] Cisco predicts 50 billion;[29] and Morgan Stanley 75 billion.[30] Every sector, from health care to security, will be altered. But this is not the only technology blurring the boundaries of the physical and digital worlds. 3D printing enables production of an expanding range of physical goods from digital files, from OwnFone's simple yet customizable made-to-order mobile phones to NASA-designed tools that can be printed in space.[31] With significant innovation broadening the array of "printable" materials, this will only accelerate. For example, Organovo is today printing scaled-down human livers,[32] which it sells to pharmaceutical companies for drug-testing purposes, while researchers in Australia have figured out how to print stem cells,[33] a step toward lab-grown hearts and brains. In another interesting twist, AutoDesk has recently offered as a free public beta its Memento software, which enables non-experts to turn digital images (scans or photos) of physical objects back into 3D models that can then be physically printed![34]

Looking ahead, there is perhaps an even more profound blurring of the physical and digital worlds, as advances in virtual reality technology enable increasingly lifelike "alternate" digital worlds. While virtual reality is today deployed primarily in the gaming space, Facebook's recent $2 billion acquisition of Oculus VR perhaps hints at a future of fully immersive connections for maintaining social relationships and sharing information, weaving even more digital threads through the physical fabric of our lives.

Implications

Boundaries typically produce constraints, limiting choices and actions and reducing efficiency. As they diminish, wonderful new opportunities flourish. So, too, does upheaval. The old boundaries and constraints were limiting, but also clarifying. They provided definition and focus, framed what was possible, pointed clearly to sources of advantage, and informed the key elements of business strategy and operations for many decades. Therefore, blurring boundaries are creating extraordinary new potential for the economy and broader society, and enabling remarkable innovation and entrepreneurship; and at the same time, they are also creating new challenges, especially for incumbents who have been masters of the previous game. Successful leaders will have to address increasingly urgent issues regarding cybersecurity and the "fair usage" of data; figure out optimal ways to organize and to access talent; and adopt more dynamic approaches to strategy with far greater built-in optionality.

Cybersecurity and data

The blurring boundary between the physical and digital worlds is a fundamental driver of transformation, creating connections, data, and capabilities that are reshaping almost every part of our lives. But it also presents two substantial and unresolved challenges. First, maintaining a secure, global, open Internet; and second, determining the appropriate use of the mushrooming data we are all generating every day in myriad ways.

Of the various threats to the Internet, the greatest is arguably "hacking"—for fun, for illegal profit, for access to confidential information, for malicious disruption and damage, and for various ideological reasons. The number of detected cyber-attacks increased by nearly 50 percent in 2014 (reaching some 120,000 per day), while identity theft (up 70 percent) and cybersecurity (up 61 percent) were the top two security concerns for American citizens.[35] President Obama's urgent call in his 2015 State of the Union address for more collaboration between government and business on this front raises the prospect of greater collective prioritization—and innovation—for years to come.[36]

Similar collaboration and innovation will also be occurring in the domain of data—their capture, ownership, distribution, and monetization. An order of magnitude more data will be produced in the years ahead, analytics will continue to get far smarter and more predictive, and opportunities to create value will proliferate. Yet critical issues regarding privacy, ethical questions posed by the ability of data to be used in discriminatory ways, and tensions over ownership of and value extraction from data produced through the activities of citizens are all rising.[37] There have been substantial breaches of trust in the past—some occurring because data was not adequately protected from theft or hacking and others because the data was inappropriately exploited by those stewarding it—and there will be more in the future. The resulting erosions in public trust are becoming more costly and are rapidly rising on the corporate agenda as businesses increasingly view the data they are co-creating with customers as one of their more valuable assets.

Evolving organization designs and talent models

Few organizations today bear much resemblance to their counterparts of 30 years ago. As the changing business environment has heightened the imperatives of innovation, agility, and resilience, organization design has changed dramatically. Multiple layers of "command and control" hierarchies have been reduced. Many isolated internal siloes have been connected and integrated. Core competences have been prioritized, the rest assigned to sophisticated supply chains or otherwise outsourced or "virtualized." Key business processes have been automated. Digital technology and connectivity have enabled these developments, which have been transformative. But this journey is far from over. As value creation across ecosystems continues to grow in importance, organizations will continue to be further optimized for effective networking, collaboration, and fluidity.[38]

Recently, talent models in particular have evolved. Long-term employment has been eroding while contracting talent only "as needed" becomes more common. An Intuit report estimates that over 60 million Americans will be "contingent" workers by 2020;[39] 87 percent of executives leading global human resource functions have altered or are considering changes to their talent sourcing strategy;[40] and 70 percent of Millennials expect to spend part of their career working independently.[41] An enabling infrastructure of crowdsourcing and competitions has been growing fast. Specific tasks can increasingly be allocated through TaskRabbit or Amazon Mechanical Turk; entire projects can be planned and responsibilities distributed using, for example, Elance and oDesk; invention ideas can be crowdsourced, designed, and commercialized through Quirky; and marketing needs can be addressed by Tongal's platforms of tens of thousands of creatives. Talent models will be changed further by increased automation of some types of knowledge work. Companies such as HCL Technologies and Wipro are already talking about the "hourglass" structures that will replace existing "pyramids" as artificial intelligence extends deeper into software testing and IT support functions.[42]

Dynamic strategy

More than anything, business leaders will have to adopt new approaches to strategy. Successful business strategy will remain anchored on setting clear aspirations, making well-informed and integrated choices regarding where to play and how to win, and developing the essential capabilities to support these ambitions. However as boundaries blur, the universe of options for creating value is increasing substantially; "winning" increasingly requires collaboration as well as competition with others; essential capabilities need not necessarily be owned or directly controlled; capturing value is becoming more challenging, often requiring the creation of new business models; and the need for enhanced agility means our strategies must be increasingly capable of rapid flex and adaptation.

Approaches to strategy are likely to evolve as a consequence, in a variety of ways that are already becoming evident. More emphasis will be placed on designing and renewing business models that take fuller account of the importance of relationships outside the firm.

More than anything, business leaders will have to adopt new approaches to strategy.

New models for profit capture will proliferate including, for example, subscription-based pricing, "freemium" services, micropayments, and other newly possible tools. Shared, cross-firm approaches to strategy formulation, often built on opening up hitherto closely guarded and proprietary data, is also increasing—notably between large retailers and their suppliers. The use of scenarios that paint alternative futures, first pioneered 45 years ago by Royal Dutch Shell, is likely to become increasingly common. And the smart analysis of increasingly abundant data to detect early signals of directional changes and enable dynamic adjustment of strategies will only rise in importance, with big data and analytics already being the top investment priority among CIOs given additional budget.[43]

What's next?

The significant erosion of long-standing boundaries will likely result in two very different outcomes: **New possibilities** will be discovered and deployed that will have transformative impact; and some **new boundaries** will surely also arise to present different challenges. Writer William Gibson has suggested that "The future is already here—it's just not evenly distributed yet." We have already seen powerful cross-cutting ecosystems transform the once-separate sectors of computing, telecommunications, and media. As digitization spreads everywhere, we must expect similar blending and dynamism across the economy. Just as we have seen the growing phenomenon of temporary "pop-up" restaurants and even retail outlets, might the future hold "pop-up firms"? After all, as writer Clay Shirky has noted, it is becoming increasingly possible to "organize without organizations."[44] Just as automation has started to make serious inroads into non-routine cognitive work domains, might AI move next into the world of creativity? Software programs are, after all, already producing distinctive gallery exhibited drawings and composing music.[45]

New boundaries are already visible as well. Geopolitical tensions that were relieved following the collapse of the Soviet Union appear once more to be rising. Fundamentalist belief systems—an obviously divisive force in human affairs—are proving tragically consequential. While the gap between "rich" and "poor" globally is on some measures declining, the divide between the extraordinary wealth of those at the top (the 10 wealthiest individuals own around half a trillion dollars)[46]—and the vast majority of the rest is of growing concern. Our dynamic economy greatly rewards restless entrepreneurship. Might new fault lines evolve between those well equipped for such a world and those more suited to a steadier and less frenetic world of employment? Inevitably, as old boundaries and frictions disappear, new ones will appear.

Yet if we can figure out how to live together on our shared planet, the future prize is extraordinary. The new art of the possible—from far more effective deployment of assets and resources to collaborative integration of expertise and passion—can help smarten and strengthen Adam Smith's "invisible hand" to create a more sustainable, global, and prosperous civilization. Today, that prize is within our reach, but not yet—not quite—within our grasp. That will perhaps be the greatest challenge ahead, shared by the leaders of today, and tomorrow.

My take

By Paul Saffo

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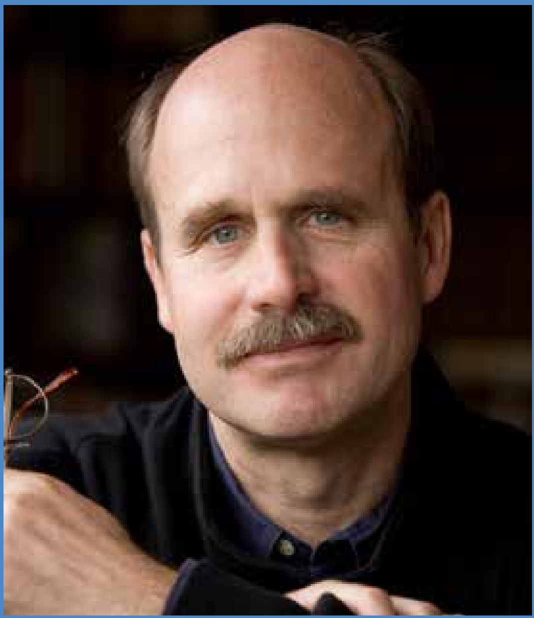
Let's consider the grand sweep of this story. Once upon a time there was just the physical, analog domain. We then started creating and linking digital machines. The resulting bubble of cyberspace was initially small, but it has been growing rapidly since. As it expands, it encroaches on the analog, not in a science fiction kind of way, but in a very real kind of way. Now, even the basic notion of a boundary between digital and the analog is increasingly passé. The world has become more permeable, with much of the most interesting innovation coming from economic "edges" rather than from the historic centers.

"Interfacing" is what once happened through screens, keyboards, and other operating panels that separated humans and machines while still allowing them to connect. Today, we no longer interface with machines—so much as we interact with them. The distinction is subtle, but important because today's more intimate human-machine mingling allows for practically instantaneous and transparent two-way communication enabled by sensors, monitoring, and environmental feedback. Leading firms today are often forced to acknowledge that some of their most important employees are actually machines.

Increasingly, no hard border needs to be crossed in order for insight to exchange "hands" from a person to a thing. Planes, trains, and subways, for example, may still have human operators, but none of them could successfully complete their assigned tasks without guidance, and even fundamental coaching, from machines. The drivers don't need to ask for advice, because the supporting technology is smart enough to simply reach in and offer it. These transactions can be so seamless, and effective, that some organizations are now putting measures in place to guard against human overreliance on technology. For example, next-generation autopilot design now includes machine-generated prompts reminding pilots to remain engaged.



We tend to structure our organizations to reflect our dominant communications systems. In the age of telephony and mainframe computing, organizations were more hierarchical and centralized. As networked communications have evolved, we have increasingly drawn upon organizational designs that are decentralized and even more organic. If I could offer one piece of advice to today's leaders, it would be to read more broadly in ecology and biology. Key ideas like symbiosis and co-evolution are central in that literature and businesses will increasingly need to master them to thrive. Many leaders can also borrow important biological lessons about sharing resources and cross-pollinating ideas in the "intertidal zones" that increasingly link businesses and turn out to be fantastically rich places to innovate.

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The future of mobility

How transportation technology and social trends are creating a new business ecosystem

Deloitte University Press

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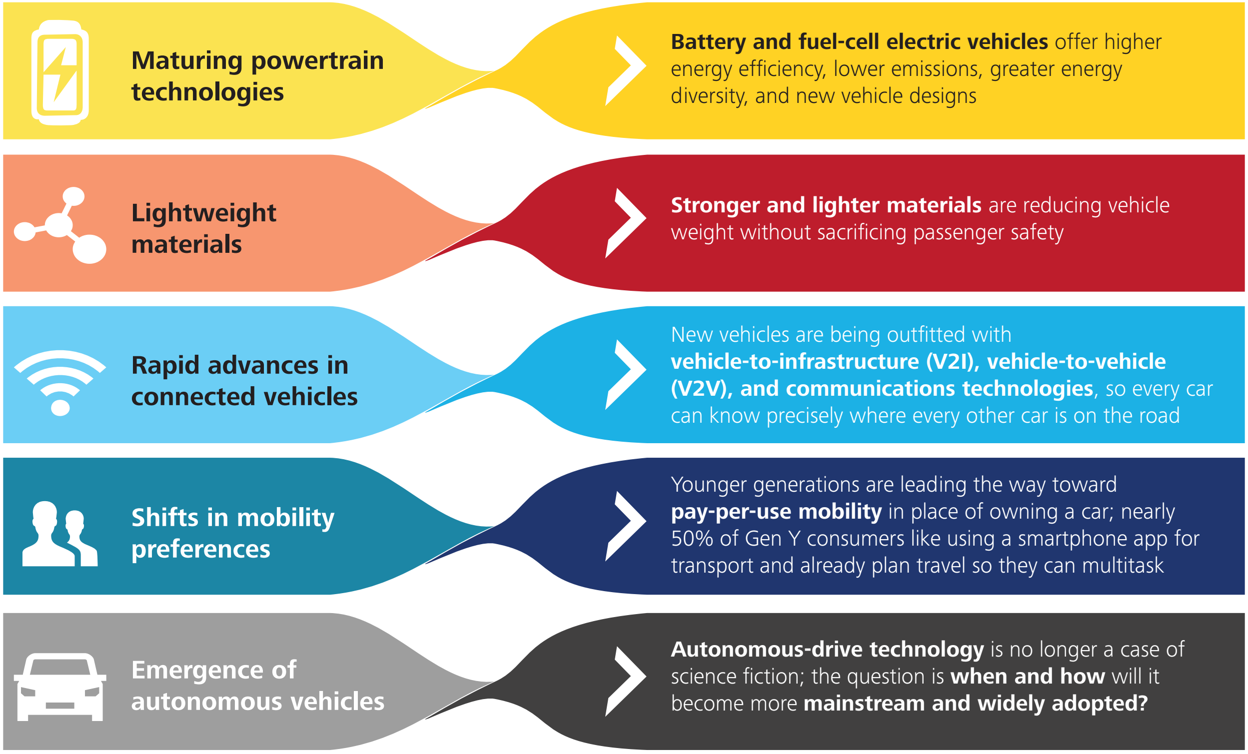
Contents

Introduction

THERE is a critically important dialogue going on across the extended global automotive industry about the future evolution of transportation and mobility. This debate is driven by the convergence of a series of industry-changing forces and mega-trends (see figure 1).

Innovative technologies are changing how companies develop and build vehicles. Electric and fuel-cell powertrains tend to offer greater propulsion for lower energy investment at lower emission levels.[1] New, lightweight materials enable automakers to reduce vehicle weight without sacrificing passenger safety.[2]

Figure 1. Converging forces transforming the future evolution of automotive transportation and mobility



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Further breakthroughs are advancing the introduction of autonomous vehicles; increasingly, daily news reports suggest that driverless cars will soon become a commercial reality.[3] We have already seen rapid advances in the "connected car"—innovations that integrate communications technologies and the Internet of Things to provide valuable services to drivers.[4] Vehicles outfitted with electronic control modules and sensors that enable vehicle-to-vehicle (V2V) and vehicle-to-infrastructure (V2I) communications can proactively suggest re-routings to avoid road hazards and call for assistance in the event of an accident.[5] Soon, cars will routinely gain precise-enough awareness of where they are in relation to other vehicles and potential hazards to take preemptive action to avoid accidents.[6]

Simultaneously, young adults, along with urbanites, are gravitating toward a model of personal mobility consumption based on pay-per-use rather than upfront purchase of a capital asset, which fundamentally challenges today's consumption model centered on personal ownership of cars.[7]

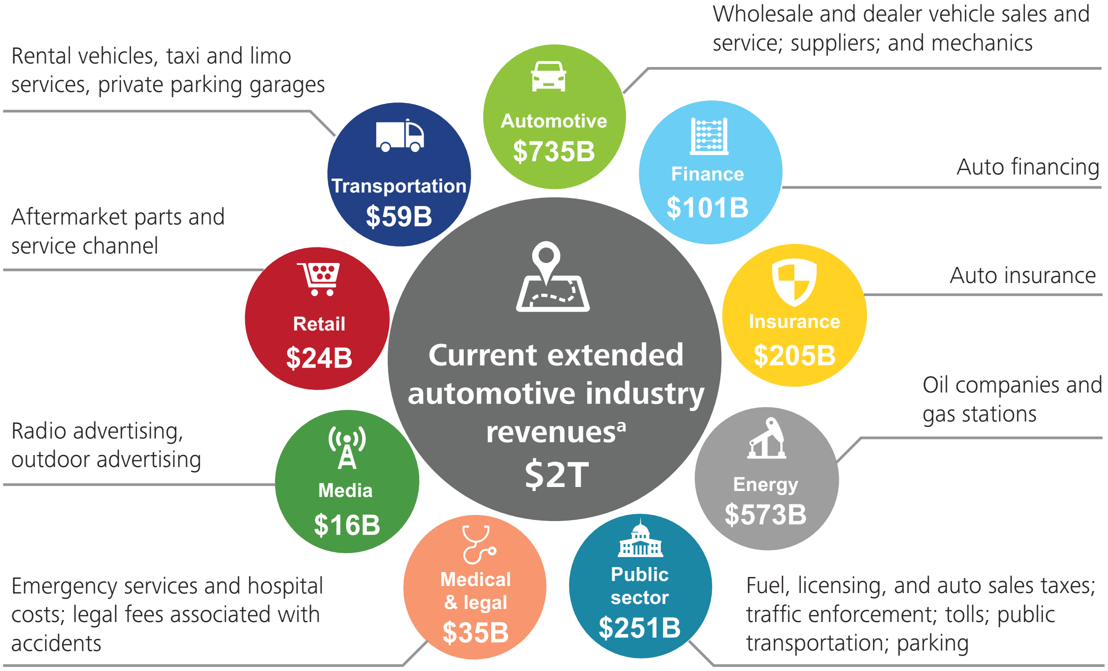
All told, a system that has been well established for a century is on the verge of a major transformation that could result in the emergence of a new ecosystem[8] of personal mobility.

Today's debate centers on whether the extended automotive industry will evolve incrementally toward some future mobility ecosystem or whether change will occur at a more radical pace and in a highly disruptive manner. No one knows the full scope and magnitude of the changes that are to come, what they entail, or how they will evolve, yet these forces have the potential to alter current industry structures, business models, competitive dynamics, value creation, and customer value propositions. We may be on the threshold of change as great as any the industry has ever seen.

The importance of the automotive industry

THERE'S no mystery about why we pay such close attention to the ups and downs of the auto industry—its extended value chain is an essential engine of global economic growth. In the United States, the sector generated $2 trillion of annual revenue in 2014 (see figure 2)—11.5 percent of US GDP[9]—from auto manufacturers, suppliers, dealers, financial services companies, oil companies, fuel retailers, aftermarket services and parts, insurance, public and private parking, public-sector taxes, tolling and traffic enforcement, medical care, and others.

Figure 2. 2014 extended automotive industry revenue



Source: Deloitte analysis based on IBISWorld Industry Reports, IHS, DOT, US Census, EIA, Auto News, TechCrunch. Current revenue represents 2014 figures (or earlier if 2014 data not available) in the United States.
[a]Total revenue is $1.99T.

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At Deloitte, we've been engaged in a deep and broadly ranging study of the extended auto industry, the economics of alternative future states, and the potential impact of each on related industries.[10] We have concluded that change will happen systematically—a rising tide, not a tsunami. At no point will the world be presented with a Manichean choice and collectively decide to plunge all-in to a system of driverless, pay-per-use travel—or else to change nothing at all. Rather, the new personal mobility ecosystem will likely emerge unevenly across geographic, demographic, and other dimensions, and evolve in phases over time.

Two divergent visions

THERE are two profoundly different visions of the future of mobility. Fundamental differences center around whether today's system of private ownership of driver-controlled vehicles remains relatively unchanged or whether we eventually migrate to a driverless system of predominantly shared mobility. There is also a critical difference about the pathway forward.

The "insider" view believes that today's system can progress in an orderly, linear fashion, in which the current industry assets and fundamental structure remain essentially intact. The "disrupter" view envisions a tipping-point approach to a very different future, one that offers great promise and potential societal benefits (see figure 3).

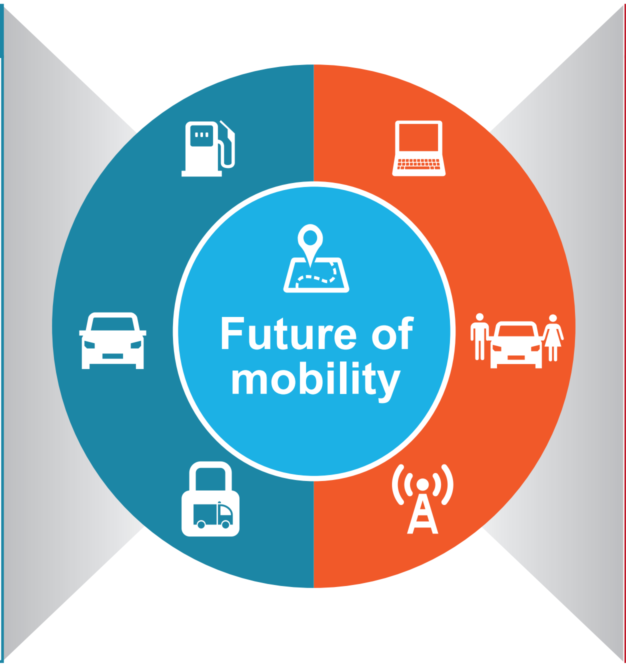
Figure 3. "Insider" and "disrupter" views of the future of mobility

Insider view

The industry will **evolve naturally** and **incrementally** toward a future mobility system that **retains its roots** in what exists today

The key players, major assets, and overall structure of the **current ecosystem can remain intact** while change progresses in an **orderly, linear fashion**

The incumbent mindset appears **dually focused** on sustaining the current model while **testing change in small ways**



Disrupter view

A **whole new age** is dawning featuring **fully autonomous** cars accessible on demand

Before long, a **tipping point** will occur, after which the **momentum of change will become unstoppable**

New entrants, notably Google, Uber, and Apple, **are catalysts** for transformation

Unlike the stakeholders in today's system, they **do not have vested stakes** to protect

Source: Deloitte analysis, based on publicly available information and company websites.

Graphic: Deloitte University Press | DUPress.com

Within the high-tech community, companies are working to arrive at something radically different than today's system of personally owned driver-driven passenger automobiles. According to this perspective, which we label the disrupter view, a new age is dawning, featuring fully autonomous cars accessible on demand. Progress toward it might be measured at first, but before long, a tipping point will occur, after which the momentum of change could gather speed. Imagine a world where the following statements are all true:

- Vehicles hardly ever crash. Autonomous operation removes the cause of almost all accidents: human error.[11]

- Traffic jams are rarities, thanks to sensors allowing for less space between vehicles and guidance systems with real-time awareness of congestion.

- Energy demand drops, since smaller mass and weight allow cars to be propelled by more compact, efficient, and environmentally friendly powertrains.

- Trip costs plummet, with average cost per passenger mile dipping from today's ~$1 per mile to approximately 30¢ per mile, thanks to dramatically higher rates of asset utilization.

- Infrastructure is funded by charges for actual usage, since connected-car technology allows systems to precisely calculate personal road use.

- Parking lots disappear, as the rise of autonomous-drive and carsharing models diminish need.

- Law enforcement ceases to concern itself with traffic, since autonomous vehicles are programmed not to exceed speed limits or otherwise violate traffic laws.

- Speed of deliveries quickens and costs decrease through the rise of fully autonomous networks of long-haul trucks that can operate for more extended time periods and cover longer distances with lower labor costs.

- Seamless multimodal transportation becomes the new norm, as greater system interoperability enables consumers to get from point A to point B via multiple, connected modes of transportation on a single fixed price charged on a single payment system.

Much of the technology already exists to turn this vision into reality, and disrupters are working toward implementing it, catalyzing the transformation. Google's driverless cars have already driven more than 1 million miles in autonomous mode, and the company is running pilot and testing programs with small fleets of fully autonomous vehicles in Mountain View, CA, and Austin, TX.[12] Less technologically dazzling but equally disruptive—and far more mature—are carsharing and ridesharing: The movement that started with Zipcar has more recently spawned the ridesharing concepts of Uber and Lyft; Uber alone delivers 1 million trips per day worldwide[13] and is growing rapidly.

Still, these industry-changing technologies may fail to reach transformational scale—or at least fail to do so within a strategically relevant time frame. Insiders, heavily invested in the current auto industry, see change evolving slowly toward a future that retains its roots in what exists today.

We see the major auto companies pursuing strategies that address the converging forces incrementally, creating future option value while preserving flexibility. These industry players' efforts and investments are yielding a steady stream of benefits for customers. For example, in introducing connected-car technology, manufacturers offer drivers many of the benefits associated with autonomous drive without fundamentally altering how humans currently interact with vehicles.

Automakers are experimenting and inventing, and have passionate voices within their ranks describing much-altered futures. Most have set up offices in Silicon Valley to gain greater proximity to technology development and early-stage funding. Among the noteworthy examples of forward-thinking initiatives are Ford's 25 mobility projects,[14] BMW iVentures,[15] Daimler's engineering advances in intelligent driving,[16] and Cadillac's "super cruise" functionality.[17] In addition, public-private partnerships such as the recently opened Mcity in Ann Arbor, MI, provide a platform to enable more efficient and effective automated vehicle (and feature) testing.[18]

This approach is consistent with historic norms, in which automakers invest in new technologies—e.g., antilock brakes, electronic stability control, backup cameras, and telematics—across higher-end vehicle lines and then move down market as scale economics take hold.[19] In our ongoing conversations with auto-industry leaders, they repeatedly and collectively argue that outsiders simply do not appreciate the sheer complexity of developing a vehicle today, the challenge of introducing new advanced technologies into a vehicle's architecture, or the rigor and inertia of the regulatory environment. All of this encourages incumbents to believe that they can be at the center of actively managing the timing and pace of these converging forces.

But the interplay of the converging forces of change may be less predictable and lead to faster upheaval than they think. Automakers might be overestimating how much power they have to manage the course of future events.

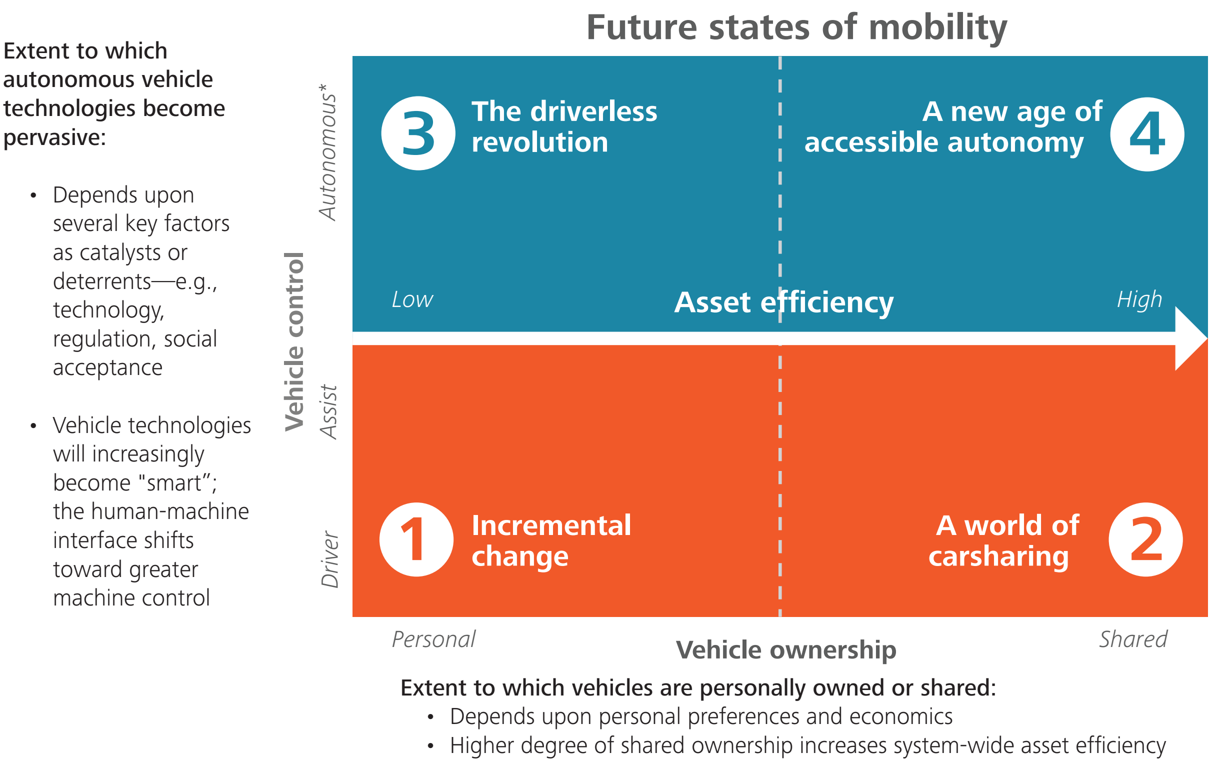
Four futures will coexist

GIVEN the disparate forces shaping the landscape, we envision four different personal mobility futures emerging from the intersection of two critical trends (see figure 4):

- Vehicle control (driver versus autonomous)
- Vehicle ownership (private versus shared)

Our analysis concludes that change will happen unevenly around the world, with different populations requiring different modes of transportation—which means that the four future states may well exist *simultaneously*. In

Figure 4. Four potential future states



Note: Fully autonomous drive means that the vehicle's central processing unit has full responsibility for controlling its operation and is inherently different from the most advanced form of driver assist. It is demarcated in the figure above with a clear dividing line (an "equator").

Graphic: Deloitte University Press | DUPress.com

other words, business leaders will need to prepare their organizations to be capable of operating in four different futures, with distinct sets of customers—beginning in as little as 5–15 years. Here we offer a high-level description of each future state and the conditions that promote its eventual emergence.

Future state 1: Incremental change

This most conservative vision of the future puts heavy weight on the massive assets tied up in today's system, assuming that these assets' owners will neither willingly abandon them nor eagerly transfer capital into new enterprises with uncertain returns. It sees private ownership remaining the norm, with consumers opting for the particular forms of privacy, flexibility, security, and convenience that come with owning vehicles. Importantly, while incorporating driver-assist technologies, this vision assumes that fully autonomous drive won't become widely available anytime soon.

With so little change envisioned, this future state reinforces automakers' reliance on a business model that emphasizes unit sales. They continue to invest in the development and introduction of new vehicle lines with advanced technologies, and dealers retain responsibility for the customer experience. Other industry players are similarly incented to rely on the practices and structures that have been well established for decades.

Future state 2: A world of carsharing

The second future state anticipates continued growth of shared access to vehicles.[20] In this state, economic scale and increased competition drive the expansion of shared vehicle services into new geographic territories and more specialized customer segments. Here, passengers more heavily value the convenience of point-to-point transportation created through ridesharing and carsharing, saving them the hassle of navigating traffic and finding parking spaces. Plus, the system offers options for non-drivers such as seniors, low-income families, and minors without licenses.

In this future state, as the cost per mile decreases, some come to view ridesharing as a more economical, convenient, and sustainable way to get around, particularly for short point-to-point movements (see below for our analysis of the economics of mobility). As shared mobility serves a greater proportion of local transportation needs, multivehicle households can begin reducing the number of cars they own while others may abandon ownership altogether, reducing future demand.

Future state 3: The driverless revolution

The third state is one in which autonomous-drive technology proves to be viable, safe, convenient, and economical, yet private ownership continues to prevail. Collaboration between leading academics, regulatory agencies, and businesses accelerates progress toward this future.[21] Both technology and automotive firms continue investing heavily to increase "V2X" (V2V and V2I) capabilities; in parallel, driverless technology matures, with the success of early pilots fostering quick adoption.

Given that this future state assumes most drivers still prefer owning their own vehicles, individuals seek the driverless functionality for its safety and other potential benefits but continue to own cars for many of the same reasons they did before the advent of autonomous drive. They might even invest more in their vehicles as a new era of customization dawns and it becomes appealing to use vehicles tailored for specific occasions and circumstances.[22] That said, the features in which owners are willing to invest, and the design of the vehicles themselves, may change; this new segment of the market may offer lighter, more technically advanced vehicles that embrace design principles counter to today's four-door, driver-in-front-on-left, gripping-the-steering-wheel reality.

Future state 4: A new age of accessible autonomy

The fourth future state anticipates a convergence of both the autonomous and vehicle-sharing trends. In this future, mobility management companies offer a range of passenger experiences to meet widely varied needs at differentiated price points.[23] The earliest, most avid adopters seem likely to be urban commuters, given the potential for faster trips thanks to reduced distances between highly automated vehicles, and routes enhanced by real-time awareness of conditions. Over time, as smart infrastructure expands and driver usage nears a tipping point, fleets of autonomous shared vehicles could spread from urban centers to densely populated suburbs and beyond.

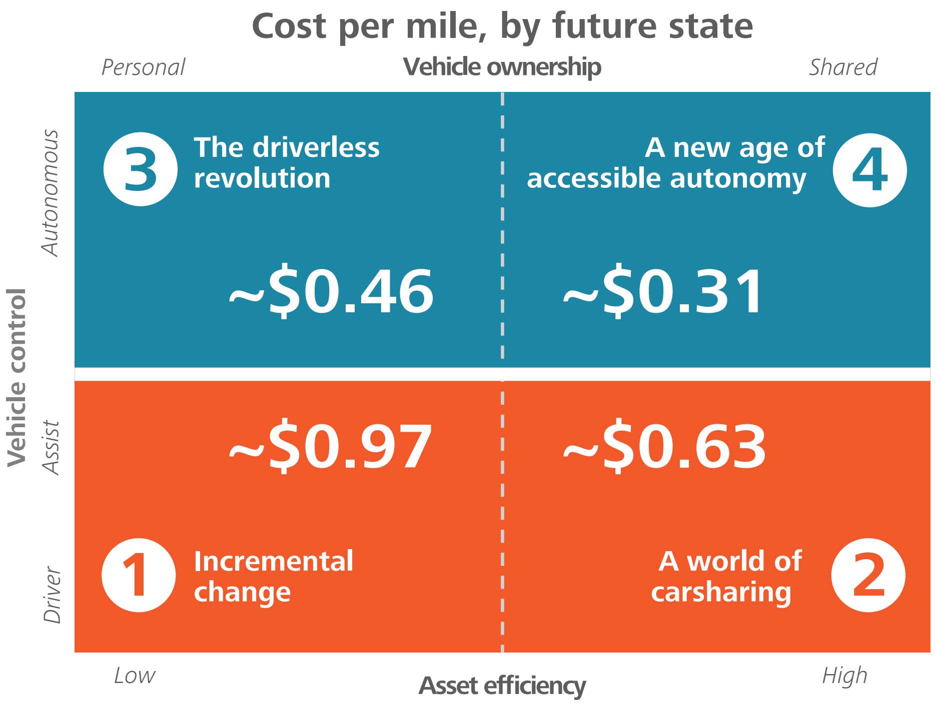
Advanced communications technologies coordinate the customer's point-to-point mobility experience: Intuitive interfaces enable users to order a vehicle pickup within minutes and travel from point A to point B efficiently, safely, and cost-effectively. Vehicle and traffic network systems operators, in-vehicle content-experience providers (e.g., software and infotainment firms), and data owners (e.g., telecoms) could have further opportunities to monetize the value of passengers' attention in transit as well as additional metadata pertaining to system use.

How much per mile?

WE conducted an analysis to calculate the average cost per mile under each of these future states; this analysis shows that consumers could benefit from lower per-mile travel costs in future states 2, 3, and 4 (see figure 5 for a summary of these costs by future state, and figure 6 for a more detailed breakdown of associated costs).

According to our calculations, personally owned vehicles today impose costs of approximately $0.97 per mile. This includes vehicle depreciation, financing, insurance, and fuel, as well as the value of the individual driver's time. By adjusting these key variables for each future state, we have developed high-level directional

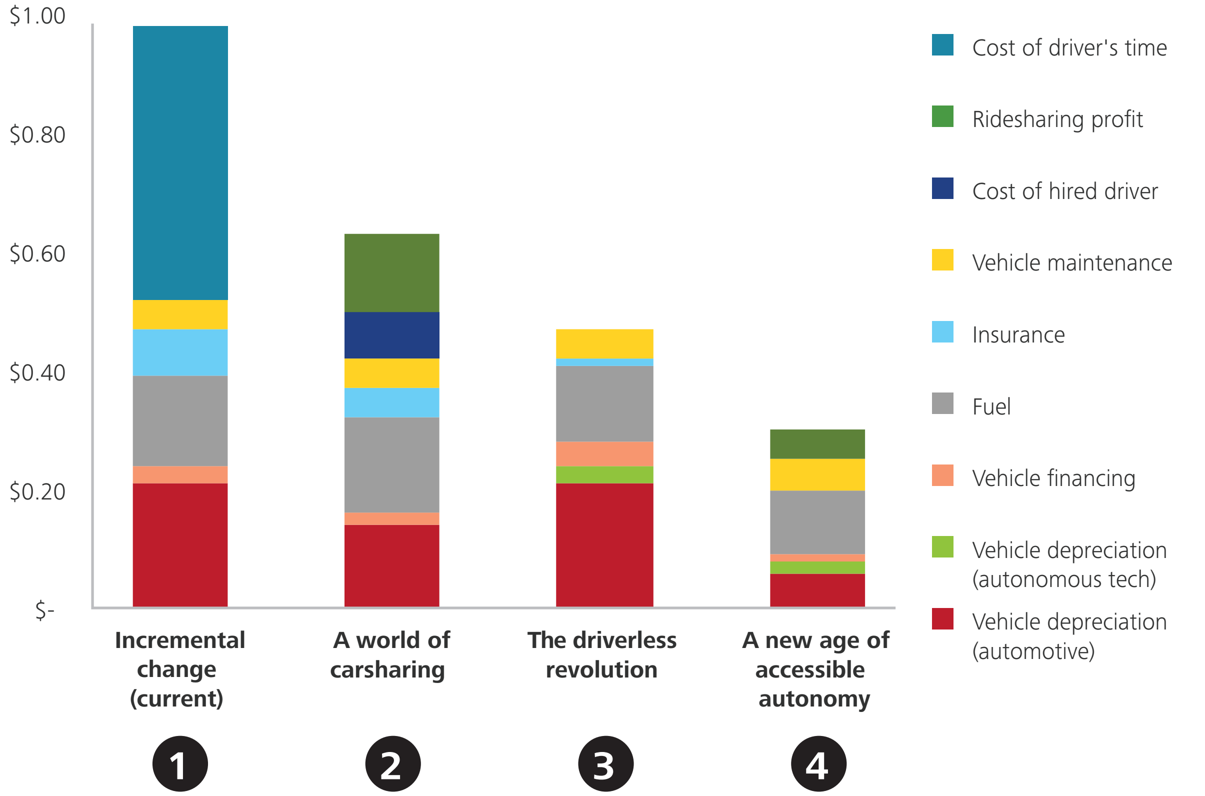
Figure 5. Per-mile summary cost calculations for each future state



Source: Deloitte analysis, based on publicly available information (US DOT, AAA, etc.).
Note: Fully autonomous drive means that the vehicle's central processing unit has full responsibility for controlling its operation and is inherently different from the most advanced form of driver assist. It is demarcated in the figure above with a clear dividing line (an "equator").

Graphic: Deloitte University Press | DUPress.com

Figure 6. Cost per mile breakdown for each future state



Graphic: Deloitte University Press | DUPress.com

estimates of per-mile costs for each future state at maturity.

Our projections indicate that in future state 2 of shared mobility, the economics become more favorable compared to private vehicle ownership, due to greater asset utilization and reduced consumer time spent driving. Over time, the efficiencies of greater asset utilization offset the higher costs associated with employing a driver. Our analysis suggests that a fully scaled shared-service model would cost approximately $0.63 per mile.

If personally owned autonomous-drive vehicles become widely adopted (future state 3), projecting the cost per mile becomes trickier, since calculations depend on the assumptions made for the value of reallocating the driver’s time and productivity. Based on conservative estimates of this time value, future state 3 would cost approximately $0.46 per mile.[24]

And in a world of autonomous shared vehicles (future state 4), our analysis finds the economics to be highly favorable: Cost per mile could drop as low as $0.31 for single-person trips—in other words, lower by roughly two-thirds than the cost of driving today. Savings partly result from key assumptions around the availability of lighter-weight vehicles (for example, two-person pods for as little as $10,000) reducing capital costs, high rates of asset utilization (*much* higher than today’s 4 percent), and the value placed on freeing up driver time for more productive purposes.

The course of change

IN our view, moves from the current state of mobility will likely occur fastest in the direction of shared access, in turn catalyzing the (upward) adoption of autonomous drive. We see this progression occurring in a number of steps, as illustrated in figure 7.

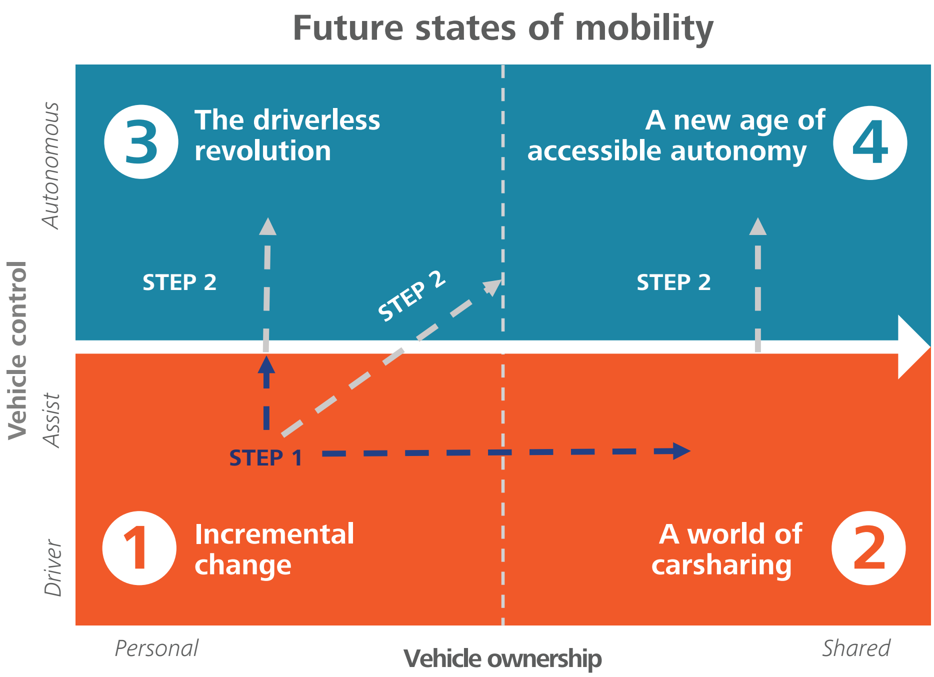
Step 1: Gradual adoption of shared access

The move from pure personal ownership of vehicles to a system more reliant on shared access (i.e., from quadrant 1 to quadrant 2 of

Figure 7. The course of change

Extent to which autonomous vehicle technologies become pervasive:

- Depends upon several key factors as catalysts or deterrents—e.g., technology, regulation, social acceptance
- Vehicle technologies will increasingly become "smart"; the human-machine interface shifts toward greater machine control



Extent to which vehicles are personally owned or shared:

- Depends upon personal preferences and economics
- Higher degree of shared ownership increases system-wide asset efficiency

Note: Fully autonomous drive means that the vehicle's central processing unit has full responsibility for controlling its operation and is inherently different from the most advanced form of driver assist. It is demarcated in the figure above with a clear dividing line (an "equator").

Graphic: Deloitte University Press | DUPress.com

figure 7), is already under way in some parts of the United States. For example, carsharing services, such as Zipcar, have roughly doubled their customer base in the last six years,[25] while ridesharing services, such as Uber, have been adding 50,000 drivers per month and completed 140 million rides worldwide in 2014 alone.[26] The software and hardware systems these services employ to match drivers with riders are evolving rapidly, incorporating information about observed behaviors to improve rider and driver experiences.[27] Furthermore, intense competition offers the prospect of reducing market prices as improved economics related to increased asset utilization take hold.

Step 2: Tipping-point shift to driverless

Currently, wide acceptance of autonomous operation seems much further away than a broad carsharing/ridesharing culture.[28] Sources of delay include the need to address existing technological limitations, such as sensor functioning in all weather and the wide availability of 3D mapping, as well as concerns over cyber security and liability.[29] How quickly these and other issues are addressed will be a key determinant of the pace of adoption for autonomous drive.

Automakers—both in partnership and competition with tech firms—are sequentially and systematically pursuing a shift of control from *driver-only* to *driver-assist* to *autonomous drive*. If driverless technology were the only vector of change, uptake might gradually gain steam, following the pattern of adoption that has become classic to the automotive industry. In our view, this is the pathway from quadrant 1 to quadrant 3, *incremental change* to *driverless revolution*, which is well under way.

However, we also see change progressing along a second, parallel northward vector—from a *world of carsharing* toward a *new age of accessible autonomy*. Along this path, a powerful, additional boost toward driverless adoption is also under way. Uber recently partnered with both Carnegie Mellon University and the University of Arizona to open an Advanced Technologies Center in Pittsburgh and test driverless cars and optics for mapping technologies.[30] Ridesharing services have economic incentives to accelerate the adoption of autonomous vehicles, since it could reduce one of the biggest operational costs in this system: the driver. These companies could capture a significant share of the consumer surplus value generated by reducing this cost. If autonomous drive becomes viable for ridesharing services, it could dramatically accelerate broad adoption, as consumers have greater opportunity to experience the technology while simultaneously realizing significant reductions in the cost of personal mobility.

Finally, other high-tech players are forging a third path to autonomous drive. For example, Google's self-driving car program is testing cars that do not rely on driver-assist progression but, rather, immediately jump to fully autonomous; Google has stated publicly that "taking the driver out of the loop" is the safest path.[31] And in the long term, it is still unclear whether Google intends to choose between supporting shared autonomous mobility, personal ownership, or both.

Rather than following the historical pattern for technological innovation, autonomous driving, when it arrives, could constitute a step-change. And the ensuing changes to the personal mobility ecosystem could unfold much more quickly than many companies can imagine. (See "Forces of delay—or acceleration.")

FORCES OF DELAY—OR ACCELERATION

The inertial forces slowing down the process that Joseph Schumpeter called "creative destruction"[32] in the realm of personal mobility are not to be underestimated. The table below summarizes the key drivers that could either significantly delay or accelerate the adoption of new technologies.

Forces of delay or acceleration	Changes in and/or impacts
Regulation and government	• Global, federal, state, and local—legislation and regulation • Taxation and revenue • Laws governing capture, usage, storage, and transfer of data
Social attitudes	• Perceptions about role of human and machine interface, longstanding notions around vehicle ownership and usage, etc. • Safety • Continued growth of shared economy
Technology development	• Results from early experiments and pilot programs • Emergence of innovation or technology breakthroughs
Privacy and security	• Cyber-security and communication standards and protocols • Protection of personal identification information
Wall Street	• Corporate valuations • Investment capital availability • Level of investment (technology, market introduction, etc.)
Impacts to key stakeholders	• Potential changes to current employment models, including dislocation effects, costs, and change management • Future employment growth opportunities (nature and size) • Stakeholder reactions and next steps (e.g., workers, unions, dealers, employers, government, etc.)

The future for the extended automotive industry

DELOITTE'S recent *Business Trends* report "Business ecosystems come of age"[33] describes a broad pattern by which many of the industries that make up the global economy are undergoing a kind of metamorphosis. What we inherited from the 20th century, the paper states, were "narrowly defined industries built around large, vertically integrated and mainly 'self-contained' corporations"—but in recent years, thanks largely to digital technologies, those monoliths have been fracturing into independent, tightly focused, highly interconnected businesses, many of which perform their specialized functions across former industry lines. We argue, "The fundamental boundaries that have specified the relationships, interactions, and possibilities of most businesses are rapidly blurring and dissolving."[34] The basic human needs that industries were built to serve remain, but serving them is now the work of much more fluid ecosystems. In the future mobility system, the mobility needs that today's industries were built to serve remain, but much more fluid ecosystems will likely emerge to serve them. And this portends significant change to current business models—and partnerships (e.g., between insiders and disrupters) will be critical to deliver new mobility.

Complementary analysis from Deloitte's Center for the Edge argues that a new mobility ecosystem could spark a "virtual" value chain in which the ability to capture, aggregate, and analyze mobility-related data becomes a tremendous source of value. In this vision, value will accrete to those who:

1. Provide end-to-end seamless mobility

2. Manage the mobility network operating system

3. Holistically create and manage the in-vehicle experience

Rewards could be great for players that are able to capture, analyze, and (securely) monetize the awareness of where people travel to, the routes they take to get there, and what they do along the way. While third parties will no doubt pay for access to this information, perhaps the greatest value will be realized by new entrants who emerge as "trusted advisers" to help all of us navigate the new ecosystem and increase our "return on mobility." These companies may also enable the ecosystem to monetize new services and ownership models.

The future mobility system will also need firms to develop and manage the vehicle-operating and traffic network information system that helps direct and control the movement of autonomous vehicles and shared mobility fleets. Technology companies already have access to passenger data and seek to capture this value, but they will likely face challenges from entrants with new business models.[35] Vehicle manufacturers could design and develop vehicles not to accommodate drivers but, rather, to emphasize passenger experience, potentially giving rise to new vehicle structures and forms.

In the meantime, it is reasonable to anticipate a healthy tension between automakers, heavily invested in today's product-centered system, and technological innovators looking to realize a more virtually dependent world of mobility options.[36] And in this case, since shared driverless cars could decrease total auto sales, it's no wonder why carmakers might be reluctant to embrace such a vision.

But there's little question that some version, perhaps multiple versions, of a new ecosystem—one based on shared access and autonomous driving—will indeed eventually emerge. Where and when it does, the change could be profound: lower cost per mile, improved safety, reduced need for parking lots and traffic enforcement, dramatically lower overall environmental impact, and more. Questions revolve around what will happen to today's automotive sector and how these will affect auto OEMs, suppliers, dealers, oil companies, fuel retailers, aftermarket service and parts companies, insurance companies, public and private parking, public-sector traffic enforcement, and others. However the forces of change unfold, every company may need to determine, in Roger Martin's succinct phrasing, "where to play and how to win."[37]

What follows is an initial overview of the enormous scope of change that could affect the key stakeholders in the current system as well as in the new mobility ecosystem.

Global automotive manufacturers (OEMs) face momentous and difficult decisions. The auto industry currently struggles with the fundamental economics of an intensely competitive business with enormous capital requirements; operating margins and return on invested capital remain low.[38] The industry operates with sizeable excess production capacity: Globally, it is possible to produce 113 million vehicles annually, while sales hover around 70 million.[39] In addition, regulatory requirements (such as CAFE, zero-emission vehicles, and safety standards) are becoming ever more stringent and costly.[40] And consumers relentlessly demand that automakers integrate the latest technologies.

OEMs will need to determine if they should evolve from a (relatively) fixed capital production, first-transaction, product-sale business into one centered on being an end-to-end mobility services provider. This would represent a profound business-model change and the development of entirely new capabilities to be competitively and sustainably viable.

At a minimum, they will need to weigh how to meet the needs of a changing landscape as consumers increasingly use shared mobility and become interested in highly tailored, customized, personally owned autonomous-drive vehicles.[41] This could require transforming product-development and innovation capabilities and reconfiguring supply chains and production operating systems to be even more lean, flexible, and "smart customization"-enabled. At the same time, consumers could begin demanding *shared* autonomous vehicles for different kinds of trips, which could spur the creation of more varied vehicle forms. This could drive the development of high-speed, low-cost vehicle assembly operations to create and produce vehicles with lightweight frames, custom experience-focused software, and highly customized, design-focused interiors. Light autonomous-drive vehicles can be made to be highly energy-efficient and, with a longer driving range, might make electric vehicles more viable and help automakers meet stringent regulatory standards.

Automotive suppliers will have to adjust as OEMs transform. As sales of autonomous-drive vehicles grow, suppliers will need lean, agile operations to serve the highly varying needs of the personally owned segment. While most of the core powertrain, chassis, brake systems, and electronic wiring components on such vehicles may be standard, giving suppliers some benefits of operational scale, the packaging for personally owned vehicles will likely be tailored and customized. Building the more standardized vehicles needed for shared mobility solutions could offer large volumes, and the demand will likely be for less complex and lower-value-added products; therefore, the economics in this new marketplace will strongly favor the lowest-cost producers.

Technology firms are driving much of the change under way. Earlier we referred to these firms as the disrupters; their strategic vision is that toppling longstanding institutional structures and frameworks can generate massive value. Unlike the manufacturers and asset holders in today's system, they have few vested stakes in the current automotive ecosystem, and they view the market for mobility as a new frontier. They share a conviction that the system's dominant source of value could be in creating and managing the operating system and in-transit experience as well as mining the data generated.

These companies have shown to be adept at building large, complex information networks and operating systems, introducing artificial intelligence to help minimize human error and randomness, creating compelling environments that drive consumer behavior, and creating digital communities. They view the vehicle as another platform in a multidevice world. Vehicle sensors and personal devices could generate ever-greater amounts of data, with insights producing personalized customer experiences and delivering targeted advertising and services.[42] Integrated information systems can enable effective intermodal transportation. And mobile, wireless, location-based systems can create new opportunities for dynamic-pricing, single-payment, and consumption-based models to become much more prevalent. Technology leaders in general, relative to traditional auto-industry leaders, are in highly advantaged positions to capture this information and virtual-based value.

Cargo delivery and long-haul trucking currently face significant challenges that the future mobility ecosystem could alleviate. In the most ambitious version of the future, cargo transportation and delivery systems could become predominantly driverless through daisy chains or remote operation—an appealing scenario, considering the US trucking industry's growing labor shortages, with as many as 30,000 driver positions unfilled and an annual turnover rate of 92 percent.[43] Autonomous vehicles offer a way to overcome restrictions on hours driven and increase capital utilization. Given long-haul cargo transportation's $700 billion in annual revenues,[44] major fleets such as UPS and USPS have a sizeable economic incentive to actively explore how to operate for more extended time periods, cover longer distances without stops, and reduce the cost of drivers (accounting for 26 percent of operating costs).[45] With such compelling economics, this sector could become an early test bed for driverless technologies.

Insurers face a complex set of strategic questions in how they will continue to grow their business and serve various segments, geographies, and demographic groups depending on which future states of mobility take hold. With $205 billion in premiums for personal liability, collision, and umbrella insurance in play, the stakes are high. Insurers today largely insure the vehicle and not the individual driver; they are currently unable to accurately assess risk associated with new forms of mobility and safety—ridesharing in the short term, and driverless cars and inter-modal transportation in the long term. Insurers need an operating model that fosters innovation and allows them to adapt to a rapidly changing market: As shared mobility continues to become more popular, insurers will need to evolve their business model to be more driver-centric, as there will be fewer vehicles to insure and more drivers using each one. With the emergence of autonomous drive, insurers will have to continue supporting vehicle and driver-centric models while developing new forms of transportation for the more technical, systemic failure risk associated with a driverless vehicle. This new system faces clearly significant issues associated with assigning liabilities: Risk pools morphing will likely force dramatic changes in insurers' cost structure. The flood of new information provided by greater connectivity provides ways to offset these costs through more accurate ways to assign risk.

The US public sector will likely have to figure out how to offset anticipated declines in the $251 billion annually generated from fuel taxes, public-transportation fees, tolls, vehicle sales taxes, municipal parking, and registration and licensing fees. All these revenues are tied to today's reality of individually owned and operated vehicles—for instance, the need for parking diminishes with the rise of autonomous-drive shared mobility. Agencies may need to evaluate alternatives—e.g., taxing "movement" versus ownership. Monetization for road usage in the future could transition to a much more dynamic model based on time of day, market demand, routes traveled, distance, and vehicle form, aligning the use of public assets more directly to usage than today's system. On the other hand, as vehicle volumes decline, municipalities might experience reduced wear and tear on infrastructure and have the opportunity to reallocate parking and other space to more value-adding purposes. Government costs (such as the DMV) could decline significantly and potentially offset some of the public-sector revenue decline.

The value shifts for these and other industries could have a tremendous impact on revenues across the ecosystem. Figure 8 summarizes some of the potential effects of the shift to the future mobility ecosystem. The graphic also includes potential societal benefits expected as a result of autonomous drive and shared mobility technological advances. The analysis does not yet account for new business models that could evolve within the future ecosystem; it is meant to illustrate the potential effects/directional impact that autonomous cars and shared mobility may have on *today's* ecosystem.

Figure 8. Potential value shifts

[a]Deloitte analysis; annual percentage decrease is calculated prior to any changes in fuel mix and is equivalent to a decrease of 10% to 25% of overall US emissions.
[b]2013 figure for US only; global figure is 1.24 million annually (WHO)
[c]Deloitte analysis based on miles driven in the US in 2014 (DOT) and average travel speed in miles per hour (Columbia University)
Source: Deloitte analysis

Graphic: Deloitte University Press | DUPress.com

Conclusions

IN the four futures of the mobility ecosystem, sources of value shift profoundly. With this evolution toward a new ecosystem still taking shape, we want to share some reflections on the strategic and operational implications for legacy incumbents, extended industry participants, and disrupters as they weigh their future direction. Specifically:

1. **Industries rise and fall.** Cycles take long periods to play out, but eventually change occurs.

2. **The potential system benefits and fundamental economics of the disrupter vision are compelling.**

3. **There is a pathway for the existing extended auto industry to lead the transition to the future of personal mobility, but it will require fundamental and expeditious business-model change.** Competing effectively in the future mobility ecosystem requires building new and different capabilities. Everyone in today's extended automotive sector needs to reassess how they will operate and create value while the four states coexist and in the longer term, when autonomous and shared mobility become more mainstream.

4. **The insiders and disrupters need each other.** Unquestionably, fierce competition will characterize the commercial environment around personal mobility. Yet, despite their wariness and differing outlooks and perspectives, automotive incumbents and challenging new entrants will together make up a new ecosystem with high levels of interdependency, mutualism, and symbiosis.

5. **Profound disruption will extend far past the automotive industry.** Every aspect of the modern economy based on the assumption of human-driven, personally owned vehicles will be challenged. Each company in this new ecosystem will have to determine where to play and how to win. As in any time of large-scale transformation, we can expect to see new players, with differentiated capabilities, emerge and change the fundamental dynamics of where and how value is created. Ultimately, the market, in its relentless quest for higher performance at lower cost, will decide who wins and who loses.

Deloitte will continue to periodically share insights about this evolution as part of an ongoing series. We aim to contribute to the dialogue as we all collectively wrestle with the impact and implications of the future of mobility. Our objective is to help to build a bridge between a highly uncertain futuristic vision, the realities of today's industries, and potential pathways to alternative future realities.

Endnotes

1. *Consumer Reports*, "The pros and cons on alternative fuels," February 2014, www.consumerreports.org/cro/2011/05/pros-and-cons-a-reality-check-on-alternative-fuels/index.htm, accessed September 14, 2015.
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    Since the cost-per-mile calculation does not capture all of the changes' implications for each industry affected by the transformation to the future mobility ecosystem, we developed a baseline of the revenue generated by each sector in today's extended US auto industry. We then analyzed the impact of the future mobility ecosystem based on industry-specific hypotheses and macroeconomic analysis. We estimated the change in value from the current industry baseline across the four future states by understanding changes to components of cost per mile today and mapping each cost to the industry that collects the corresponding revenue. We conducted further analysis to estimate a future "steady state" that incorporates adoption rates across all future states. The value shifts are summarized at a sector level to illustrate the potential directional impact that autonomous cars and shared mobility could have on today's extended auto industry. Factoring in availability of data and the scope of the analysis, all data and figures used are from the United States as of 2015 (using 2014 dollars). The analysis does not assume a specific timeline or adoption curve. Rather, it is a blended model of four potential future states intended to provide directional insights about the future at maturity. Forthcoming installments of the Future of Mobility series will include a more detailed explanation of the analysis Deloitte conducted as well as the results.
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WHAT THEY WANT AND WHERE THEY WANT IT

M. Leanne Lachman and Deborah L. Brett

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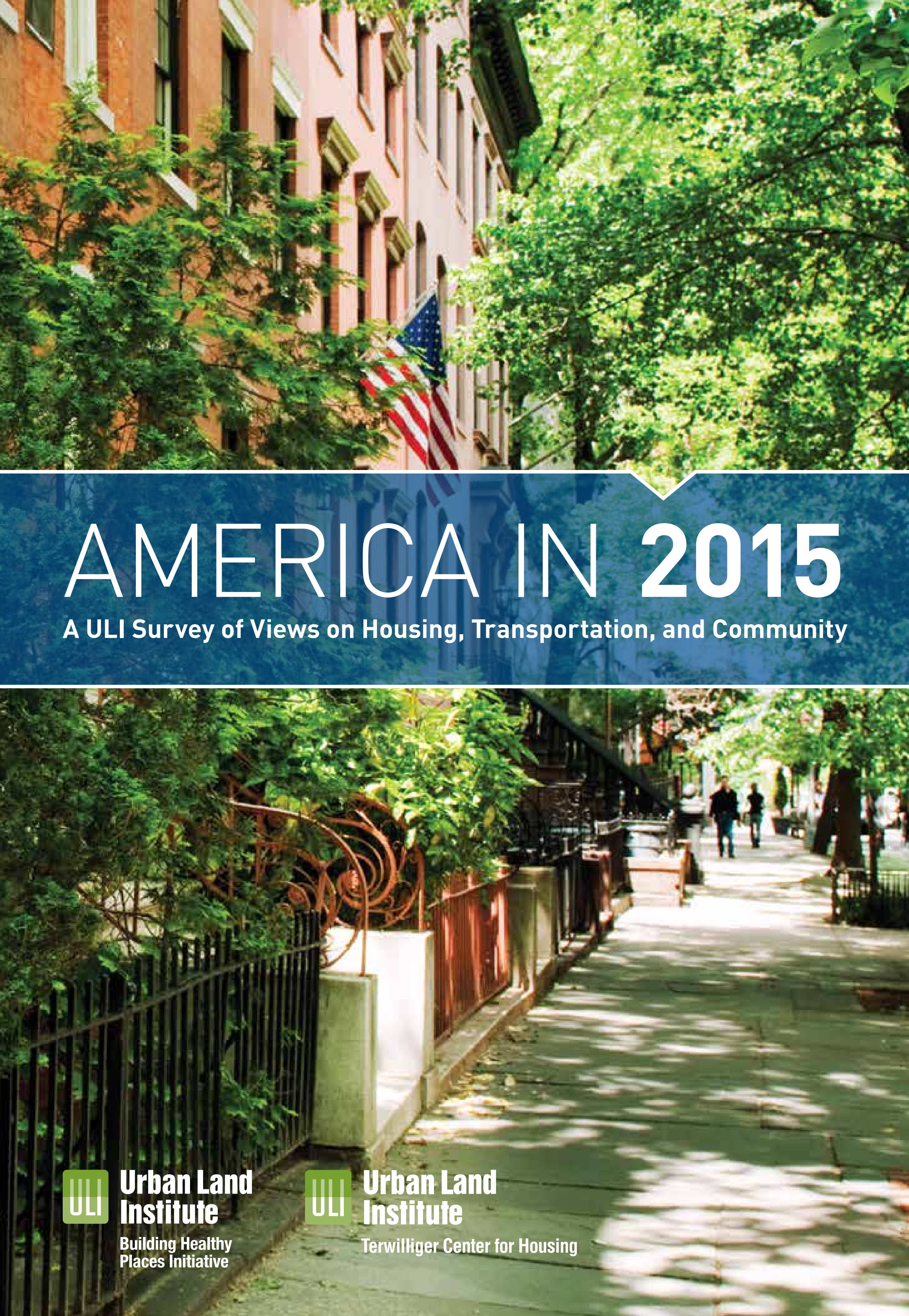


AMERICA IN 2015

A ULI Survey of Views on Housing, Transportation, and Community

Urban Land Institute
Building Healthy Places Initiative

Urban Land Institute
Terwilliger Center for Housing

Infrastructure2014

SHAPING THE COMPETITIVE CITY

Hong Kong's investment in high-quality transit has allowed the city to achieve remarkable densities, a superior quality of life, and protection of environmentally sensitive land areas.

HOW DO REAL ESTATE DEVELOPERS AND INVESTORS—who could pursue opportunities regionally, nationally, or internationally—think about infrastructure? How do city leaders use infrastructure investments to position their cities for real estate investment and economic development? What role does infrastructure play relative to other economic development strategies? And are public and private perceptions and priorities aligned—or do they diverge, and in what ways?

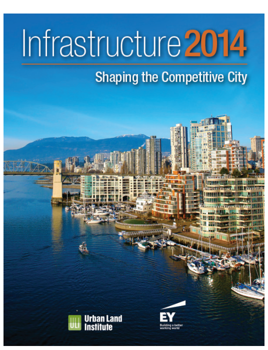
These were the central questions for *Infrastructure 2014: Shaping the Competitive City*, the eighth in an annual series of reports examining infrastructure trends and issues by ULI and EY.

To provide answers, researchers for *Infrastructure 2014* crafted a series of survey questions and asked high-level public officials and private real estate leaders to weigh in. Nearly 250 public sector leaders in local and regional government and over 200 senior-level private developers, investors, and real estate advisers responded to the survey. About 86 percent of survey respondents were based in the United States, with the balance located in countries across the globe.

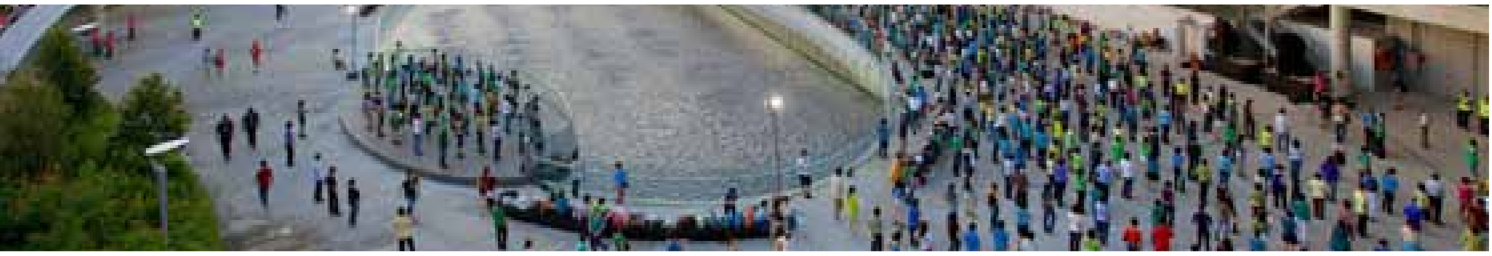
Nearly every city aspires to grow, and high-quality infrastructure—infrastructure that is well maintained, reliable, safe, resilient, and customer friendly—contributes to well-functioning, growth-primed cities—cities that attract new residents and retain existing ones.

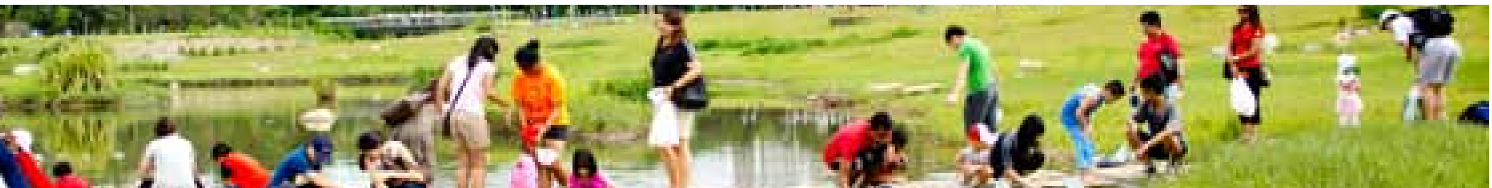
Infrastructure—the physical facilities and systems that support economic activity—is often seen as a driver of real estate and development, especially by those who are in the business of providing it. But do the people actually building and investing in real estate agree? The *Infrastructure 2014* survey tells us "yes"—and a number of other interesting things as well.

On many of the questions asked, there was strong convergence between the public and private sector respondents, and between U.S. and global ones. The survey provides a means for mutual learning and dialogue that can help advance the conversation about the role that infrastructure plays in shaping and promoting growth, infrastructure priorities, and opportunities to improve current practice.



This is a summary of key findings. We invite you to learn more about the *Infrastructure 2014* survey online and read the full report at www.uli.org/infrastructurereport and www.ey.com/realestate.





10 Principles for Liveable High-Density Cities

Lessons from Singapore

Urban Land Institute Singapore

CENTRE for LiveableCities SINGAPORE

Concurrent Session: Due Diligence

Thursday, March 31st
2:45pm – 4pm
Marriott Marquis, Washington DC

Moderator:
Steven Moore, Managing Director, KPMG LLP

Panelists:
Michael McGillis, Facility Assessor, Tetra Tech, Inc.
Baris Ipeker, VP-Investments & Legal Counsel, Federal Realty Investment Trust
Michael Rusche, Director-Asset Manager. EPR Properties

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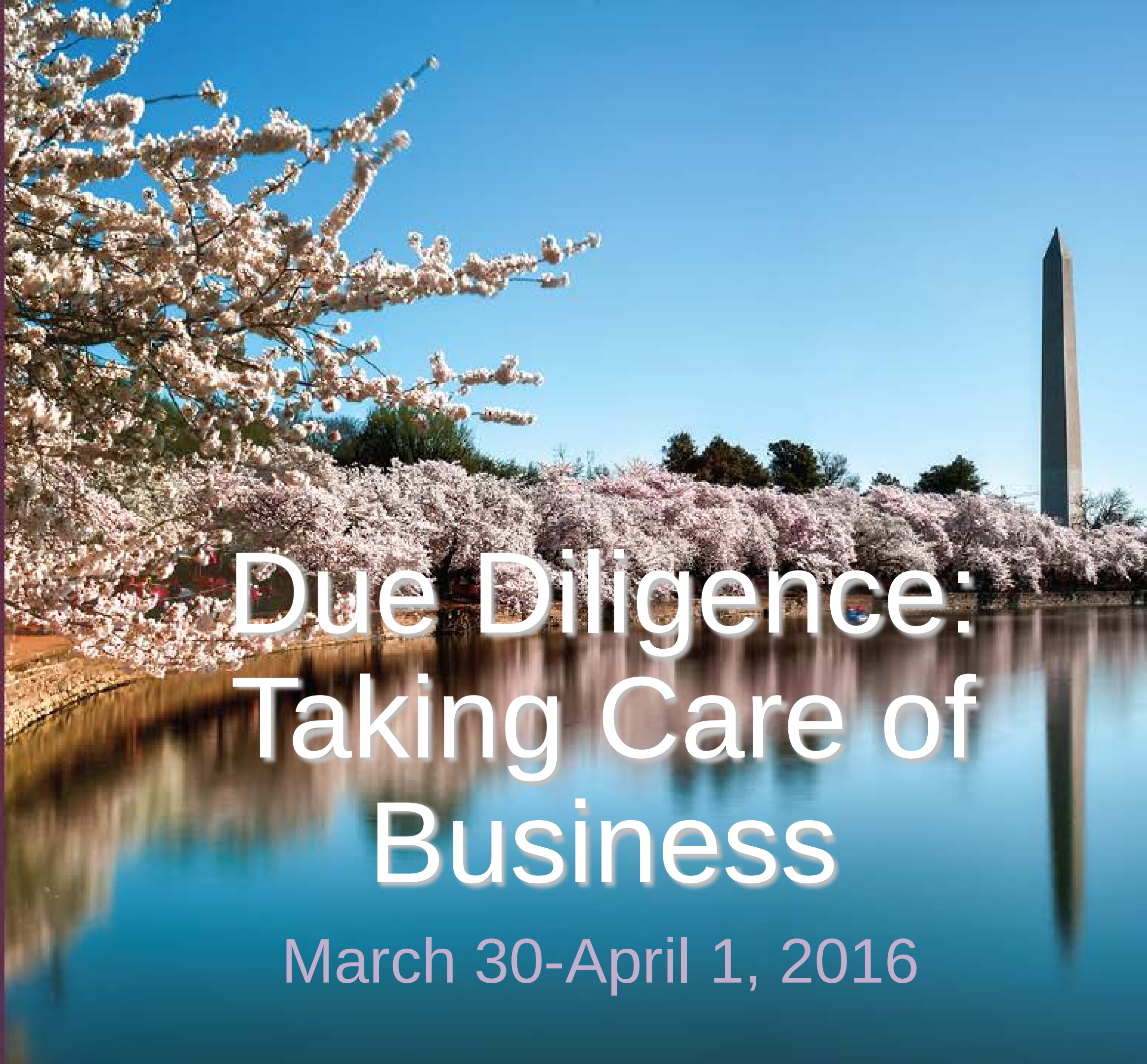
2016



Due Diligence: Taking Care of Business

March 30-April 1, 2016

Panelists

Steven M. Moore
KPMG LLP

Managing Director, Head of US Real Estate Deal Advisory

- Leads a team focused on real estate transaction services
- 20 years of corporate finance and transaction experience
- Advised on over $100 billion of RE financing and $30 billon of RE transactions

Michael J. Rusche
EPR Properties

Director – Asset Management

- Manages the entertainment and retail assets of EPR
- Portfolio over 10 million sf of retail, restaurants, movie theatres and other venues
- Graduate of the University of Kansas with over [XXX] year of real estate experience

Michael McGillis
Tetra Tech, Inc.

Facility Assessor

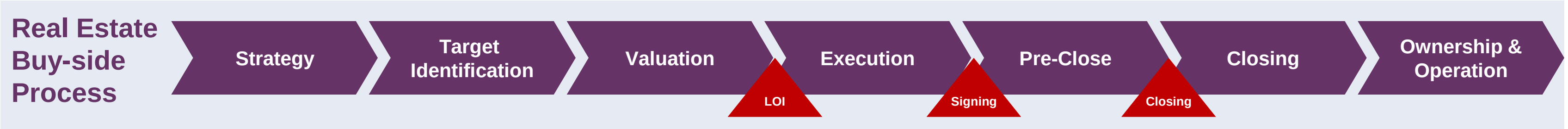
- Specializes in developing and implementing full lifecycle real estate asset management programs
- Over 23 years of experience
- Extensive experience with acquisitions, design, renovation, and restoration

Baris H. Ipeker
Federal Realty Investment Trust

Vice President Investments, Legal Counsel

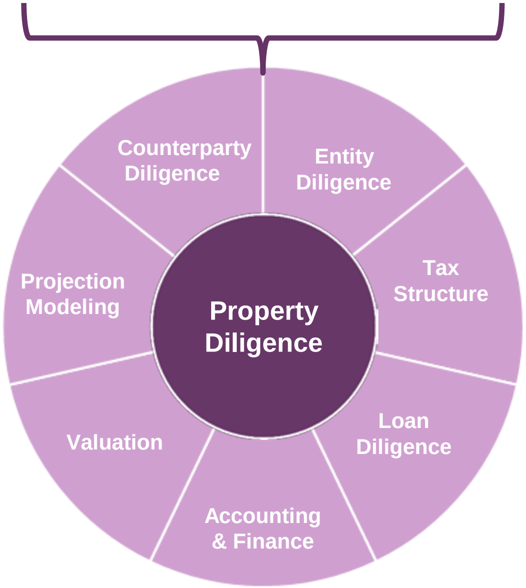
- Responsible for structuring, negotiating and closing acquisitions, dispositions and property secured financings
- Past experience in real estate transactions at Venable LLP
- Alumnus of University of Virginia and JD from Emory

Introduction

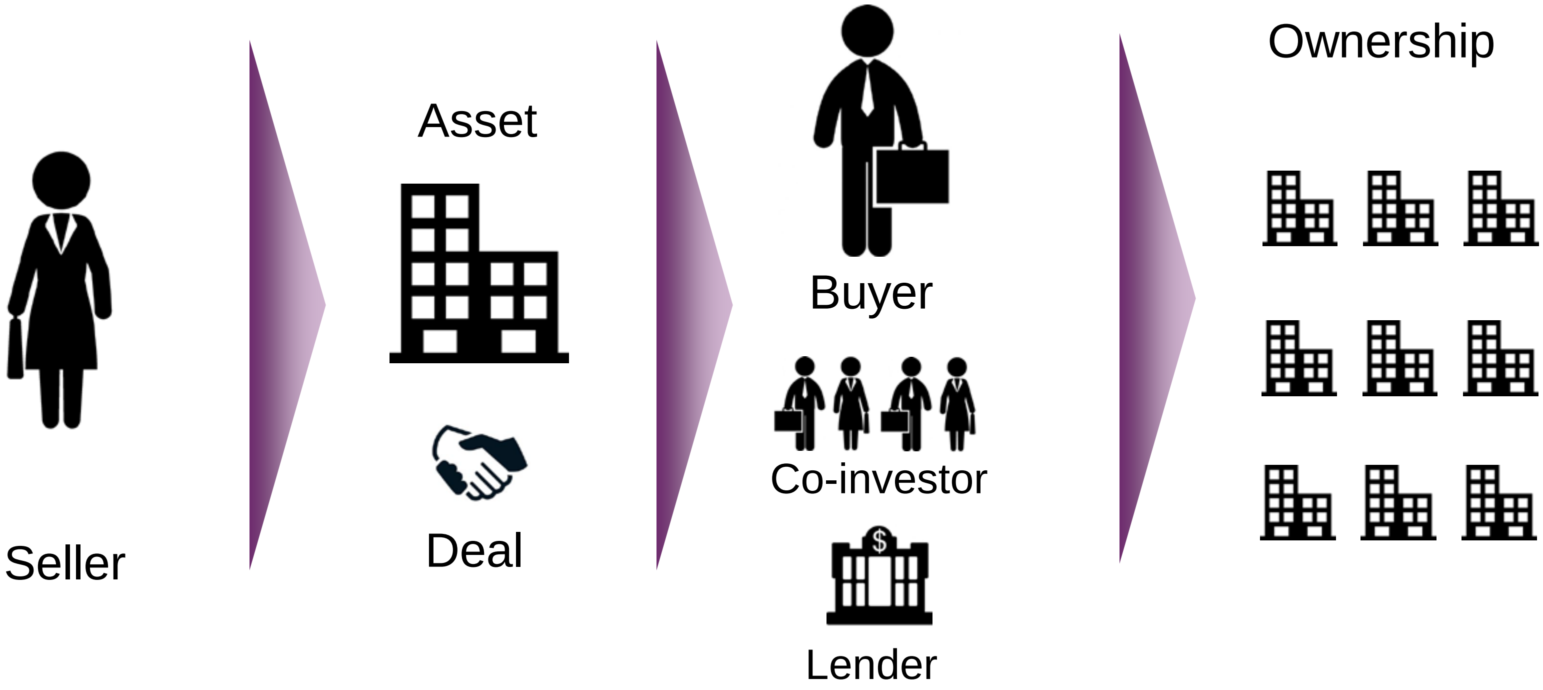


Property Diligence

- Title and Survey
- Zoning for in-place and proposed use
- Environmental considerations and potential pitfalls
- Physical assessment and property condition
- Lease abstracting; Validation of rent rolls, revenues and Argus models
- Tenants analysis with consideration of credit, lease structure and expense allocation
- Analysis of NOI and cash flows
- Market analysis and competitive property comps



Diligence in the Transaction Process



Title & Survey

- Does Seller own the Property?
- Restrictions in deeds or easements?
  - Covenants, Conditions and Restrictions (CCRs) are a detailed list of operating rules and restrictions for the property
  - Does anyone other than the Property owner benefit from the restrictions
  - Does the Property meet all of the requirements
  - Do the restrictions prevent future plans?
- Are there any liens or encumbrances on the Property?
- Is the Property where you think it is?
- Do all of the improvements fit within the boundaries of the Property?
- Do you have setbacks and are your improvements within them?
- Do you have buildings sitting on top of easements?
- Do you have access to public roads?

Zoning

- Is the use of the Property by right?
- Do all of the buildings conform?
- Does the signage comply?
- Does the parking ratio and landscaped area conform?
- What is the zoning process to obtain variances or special permits?
- How long will it take to change zoning if it is not by right?
  - Entitlements
  - Rezoning
  - Costs

Environmental

- Are there any environmental issues at the property? Understand property use (including past use) and onsite operations (Dry Cleaners, Treatment Facilities, Tanks……)
- Phase I & II Environmental Assessment Study – Identify Risks
- Typical Hazards Encountered: materials in soil, in ground water, vapor in buildings, asbestos, mold, tanks, lead, etc.
- If there is an environmental issue, is it:
  - Insurable
  - Quantifiable
  - Within a state clean-up program
  - Easily remediated

Case Study - Environmental

Prior to purchasing the facility, the perspective buyer researched claims that the existing sanitary ponds were not properly sized: Through an evaluation of the ponds, permits, and system it was found that the ponds were properly sized for the facility use, but the amount of ground water infiltration into the system caused to ponds to be inadequately sized to store effluent during months when discharge was limited

PHYSICAL PROPERTY ASSESSMENT

- What's the Typical Size ($) of Each Transaction?
- What's the Typical Size (SF) of Each Transaction?
- How Much do You Spend on Pre-Acquisition Assessments?
- How Much do You Spend on Repairs Following Purchase?
- Where are Your Liabilities?
- Are the Assessments Useful?



PHYSICAL PROPERTY ASSESSMENT

- Collected Information Should be Used for Negotiations and Development of Terms
- Assessments Should be Modified to Cover Item of Greatest Liability
- Information Gathered Should be Adequate to Develop Capital Plans
- Implementation of Asset Management Programs Should be Considered

Case Study - Physical

January 2005

ITEM	Excellent	Good	Fair	Poor	ACTION*	IMMEDIATE NEEDS	CAPITAL RESERVES
SITE IMPROVEMENTS							
Topography		X			NA	0	0
Storm Drain System		X			NM	0	0
Parking Pavement, Curbs & Gutters		X			RR	0	$154,698
Sidewalks		X			NM	0	0
Utilities		X			NM	0	0
Landscaping		X			NM	0	0
Site Lighting		X			NM	0	0
Site & Building Signage		X			NM	0	0
Recreational Facilities/Amenities					NA	0	0
STRUCTURAL SYSTEMS & BLDG ENVELOPE							
Foundations		X			NM	0	0
Structural System Including Floors		X			NM	0	0
Exterior Walls, Patch & Paint		X			RR	0	$70,000
Windows & Frames		X			NM	0	0
Exterior Doors & Frames		X			NM	0	0
Stairs (Interior & Exterior)		X			NM	0	0
Balconies & Upper Floor Walkways		X			NM	0	0
Roof Coverings		X			NM	0	0
Roof Drainage		X			NM	0	0
MECH, ELEC & PLUMBING SYSTEMS							
HVAC		X			RR	0	$234,000
Electrical		X			NM	0	0
Emergency Generator					NA	0	0
Hot & Cold Water Distribution System		X			NM	0	0
Water Heaters		X			NM	0	0
Gas Distribution System		X			NM	0	0
VERTICAL TRANS CONVEYING SYSTEMS							
Elevators/ Escalators					NA	0	0
FIRE/ LIFE SAFETY							
Fire Suppression Systems		X			NM	0	0
Security Alarm Systems		X			NM	0	0
INTERIOR ELEMENTS						0	0
Common Area Finishes		X			RR	0	$23,380
Tenant Area Finishes (Walls, Floors, Ceilings, Etc.)		X			NA	0	0
Interior Doors & Frames		X			NA	0	0
"BARRIER FREE" ACCESSIBILITY (ADA)							
Parking, Signage & Ramps		X			NM	0	0
Common Area Accessibility Including Restrooms		X			NM	0	0
UNINFLATED COSTS						$0	$482,078

January 2004

Case Study - Physical

EIFS replacement	(vert. surfaces)	40,150 sf @ $14/sf	$562,100
	(horiz. surfaces)	760 sf @ $30/sf	$22,800
Ceramic tile replacement		5,600 sf @ $75/sf	$420,000
Clay brick masonry repairs		allowance	$42,000
Roofing repairs	(horiz. surfaces)	allowance	$500,000
	(copings)	5,200 lf @ $22/lf	$114,400
Roofing replacement	(large areas)	192,000 sf @ $8/sf	$1,536,000
	(small areas)	1,800 sf @ $12/sf	$21,600
	(copings)	5,200 lf @ $22/lf	$114,400

With 10% Contingency and 10% GC, Total Estimate - $4,033,300
Report Date: March 2005

Total Spent on Repairs $

OBSERVATIONS AND FINDINGS

The ceramic tile and EIFS facade materials were observed and evaluated for adhesion and method of attachment on selected portions of each of the major faces of the building. The following observations were made:

1. North third of the west wall: Approximately 60% of the EIFS system has delaminated from the wall. Supplemental plates and fasteners were installed to laterally support a portion of the ceramic tile facing that had apparently become delaminated.

2. North third of the east wall: Approximately 40% of the EIFS system has delaminated from the wall. A portion of the ceramic tile and mortar bed was missing and was reported to have fallen off of the wall.

3. West third on the south wall: Approximately 5% of the EIFS system has delaminated from the wall. Supplemental plates and fasteners were installed to laterally support a portion of the ceramic tile cladding that had apparently become delaminated.

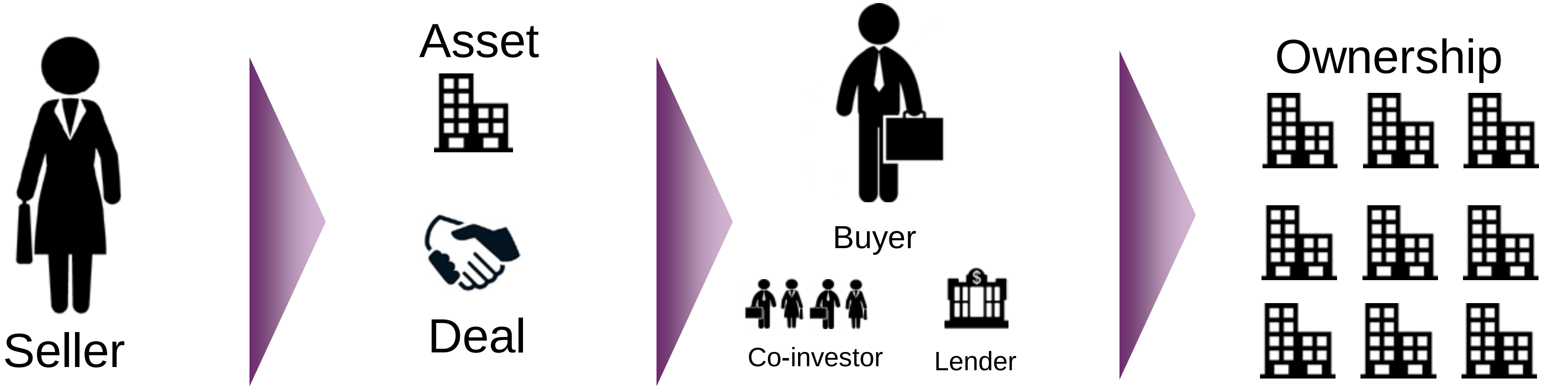
Lease Review

- Confirm the rents in the rent roll
- Uncustomary expenses for the Landlord in leases
- CAM and Taxes
- Confirm that tenants do not have unilateral rights to terminate the lease
- Rights that affect your future development
- Impact on future plans to lease the property
- Rights of first refusal or purchase options

Financial

- Analysis of in-place NOI and cash flows
- Market analysis and competitive property comps
- Property / Argus and Transaction model
- Quality of earnings analysis
- Evaluation of operating platform, controls and reporting functions
- Balance sheet and debt review
- Prorations
- Identification of state and local tax exposures
- Investigation in potential transfer and other taxes
- Tax structuring

Strategic Diligence



- Speed of execution
- Maintain control
- Preposition issues
- Enhance terms

- Facilitate the process
- Identify key issues
- Align perceptions
- Agreement / contracts

- Validate investment
- Assurance / protection
- Process requirement
- Enhance terms

- Foundation of operations
- Identify issues and opportunities

Questions & Answers

Thank You

Additional Information

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Background

- As part of KPMG International's global real estate practice, and working through a coordinated team of more than 1,500 professionals in the U.S. and more than 3,000 professionals in 77 countries worldwide, Steve seeks to provide superior service and solutions to KPMG's clients that beneficially integrate financial and strategic advisory, accounting and tax expertise.

- Steve leads the U.S. Real Estate Deal Advisory practice for KPMG and focuses on real estate advisory, restructuring, company mergers and acquisitions, capital raising and distressed situations.

- In his capacity, Steve serves and expands long-standing relationships with real estate clients across the multi-family, industrial, retail, office, healthcare, lodging and technology infrastructure sub-sectors.

- Steve focuses on transactions, advisory services, equity and debt capital raising for clients including: private equity funds, family offices, institutional investors and management teams of publicly-traded and privately-owned companies, as well as their board members.

Professional and Industry Experience

- Steve has advised on the financing of nearly $100 billion in real estate assets, consummated sale or acquisition transactions representing more than $30 billion in asset or portfolio value and participated extensively in both in-court and out-of-court real estate restructurings.

- Prior to joining KPMG, Steve was a Senior Vice President at Moelis & Company in the Real Estate Investment Banking Group.   Previously, he held investment banking roles at Citigroup, JPMorgan and Houlihan Lokey and he began his professional career in the Strategic Planning Group of the Walt Disney Company.

Michael J. Rusche - EPR Properties

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Background

- Michael J. Rusche is Director - Asset Management for EPR Properties (NYSE: EPR) where he manages the entertainment and retail assets of the company, including more than 10 million square feet of retail centers, restaurants ,movie theatres and other entertainment venues. The portfolio has consistently been more than 99% occupied and includes many of the top performing movie theatres and entertainment based destinations in North America.

- Mike is a graduate of the University of Kansas and began his career in real estate with EPR in 2005. He has engaged in Acquisitions, Asset Management, Development, Redevelopment and Disposition for the company and, over the last ten years, has developed deep relationships within the movie theatre industry while gaining significant insight into the performance of both entertainment based and recreational destinations.

- Mike and his wife Holly are residents of Parkville, MO and together they enjoy many wonderful days, sleepless nights and countless adventures with their daughter Adelaide.

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Background

- Working at Tetra Tech, Inc.: worked with buildings, building systems, and utility systems for over 23 years.
- Graduated from Penn State University with a Bachelor of Architectural Engineering and holds professional licenses in PA and MI.
- Worked with the design, renovation, and restoration of buildings throughout entire career.
- In addition to building design and restoration, Mr. McGillis developed and worked on asset management programs for military, retail, medical, and utility clients.
- Programs encompass the entire lifecycle of assets starting at plan conception, through design & construction, commissioning, turn-over, into maintenance / sustainment, and culminating in divestment.

Baris H. Ipeker - Federal Realty

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- Baris Ipeker is Vice President - Investments, Legal Counsel of Federal Realty Investment Trust. In that capacity, Mr. Ipeker is responsible for structuring, negotiating and closing acquisitions, dispositions and property secured financings for the Trust's real estate portfolio.

- Mr. Ipeker is also responsible for managing the Trust's trademark assets.

- Mr. Ipeker joined Federal Realty Investment Trust in 2003 as Senior Real Estate Counsel, was promoted to Director, Legal Counsel in 2006 and Senior Director - Investments, Legal Counsel in 2010. Recently in 2016, Mr. Ipeker was promoted to Vice President - Investments, Legal Counsel.

- Prior to joining Federal Realty Investment Trust, Mr. Ipeker specialized in real estate transactional work at Venable LLP.

- Mr. Ipeker received a Bachelor of Science in Finance from the McIntire School of Commerce at the University of Virginia and holds a Juris Doctorate from Emory University School of Law.

Concurrent Session: Financial Standards Update

Friday, April 1st
11am – 12:15pm
Marriott Marquis, Washington DC

Moderator:
Christopher Drula, VP-Financial Standards, NAREIT

Panelists:
Christopher Dubrowski, Partner, Deloitte LLP
Michelle Montes, Assurance Partner, EY
Keri Shea, SVP-Finance & Treasurer, AvalonBay Communities, Inc.

Deloitte.

March 2016

Real Estate Spotlight

A Walk-Through of the FASB's New Leases Standard

In This Issue:

The Bottom Line

- On February 25, 2016, the FASB issued its new leases standard, ASU 2016-02.[1] The standard marks the end of the Board's nearly decade-long deliberations with the IASB to address concerns about the current lease accounting requirements.
- The new standard introduces a model that brings most leases onto a lessee's balance sheet. This could significantly change the accounting by real estate lessees, whose leases are typically not included on the balance sheet because they are classified as operating leases under current U.S. GAAP. The new standard retains much of the current lessor model but aligns certain of its underlying principles with those of the new revenue recognition standard (ASC 606[2]).
- The new leases standard will significantly affect lessees and lessors in the real estate industry, including their considerations related to nonlease components, nonlevel rents, initial direct costs, and accounting for sale-leaseback transactions. In addition, real estate lessors will need to understand the ASU's broader implementation implications for lessees as well as the potential for changes in tenant behaviors.
- The new guidance is effective for public business entities for annual periods beginning after December 15, 2018 (i.e., calendar periods beginning after January 1, 2019), and interim periods therein. For all other entities, the ASU is effective for annual periods beginning after December 15, 2019 (i.e., calendar periods beginning on January 1, 2020), and interim periods thereafter. Early adoption is permitted for all entities irrespective of whether such entities elect to early adopt the new revenue standard.

[1] FASB Accounting Standards Update No. 2016-02, *Leases.*
[2] FASB Accounting Standards Codification Topic 606, *Revenue From Contracts With Customers.*

Beyond the Bottom Line

This *Real Estate Spotlight* provides insight into aspects of the new leases standard that are particularly relevant to lessees and lessors in the real estate industry. For a comprehensive overview of the new leases standard, see Deloitte's March 1, 2016, *Heads Up*.

Lessee Accounting

The new standard requires lessees to adopt a right-of-use (ROU) asset approach that brings substantially all leases, with the exception of short-term leases (i.e., those with a lease term of less than 12 months), onto the balance sheet. Under this approach, a lessee records an ROU asset representing its right to use the underlying property during the lease term and a corresponding lease liability (in a manner similar to the current approach for capital leases) regardless of the lease classification. The subsequent accounting for the ROU asset depends on the classification of the lease as either a finance lease or an operating lease (referred to as the "dual-model approach").

A lessee will determine the classification of a lease by using classification criteria that are similar to those under IAS 17.[3] For leases that are considered finance leases, the lessee recognizes interest expense and amortization of the ROU asset in a manner similar to a financed purchase arrangement, which will typically result in greater total expense during the early years of the lease. For leases that are considered operating leases, the lessee will also recognize an ROU asset and lease liability, but will recognize total lease expense on a straight-line basis.

The IASB decided on a different approach for a lessee's subsequent accounting of the ROU asset. Under the IASB's approach, all leases are accounted for as a financed purchase arrangement in a manner consistent with the FASB's guidance on finance leases.

Editor's Note: Under the FASB's dual-model approach, a lease is classified as a finance lease if any of the following criteria are met at the commencement of the lease:

- "The lease transfers ownership of the underlying asset to the lessee by the end of the lease term."
- "The lease grants the lessee an option to purchase the underlying asset that the lessee is reasonably certain to exercise."
- "The lease term is for the major part of the remaining economic life of the underlying asset."[4]
- "The present value of the sum of the lease payments and any residual value guaranteed by the lessee . . . equals or exceeds substantially all of the fair value of the underlying asset."
- "The underlying asset is of such a specialized nature that it is expected to have no alternative use to the lessor at the end of the lease term."

Although the classification criteria are similar to those under current U.S. GAAP, there are some differences that will apply to the real estate industry. First, the ASU requires entities to account for land and other elements separately unless the effects of not doing so are immaterial. Under current U.S. GAAP, the lease classification of land is evaluated separately from the building if its fair value at lease inception is 25 percent or more of the fair value of the leased property and the lease does not meet either the criterion related to transfer of ownership or the bargain purchase option criterion. This change may result in more bifurcation of real estate leases into separate land and building elements that are required to be evaluated separately for lease classification purposes and accounted for separately.

[3] International Accounting Standard 17, *Leases*.

[4] The ASU provides an exception to this lease classification criterion for leases that commence "at or near the end" of the underlying asset's economic life. The ASU indicates that a lease that commences in the final 25 percent of an asset's economic life is "at or near the end" of the underlying asset's economic life.

Editor's Note (continued): Second, the ASU eliminates the bright-line rules under the ASC 840[5] lease classification requirements — namely, whether the lease term is for 75 percent or more of the economic life of the asset or whether the present value of the lease payments (including any guaranteed residual value) is at least 90 percent of the fair value of the leased asset. While removal of the bright-line test could reduce structuring opportunities, the ASU's implementation guidance indicates that entities may use thresholds similar to those they use today in determining lease classification. Therefore, practice may not be significantly altered as a result of this change.

Lessor Accounting

Although initially the boards contemplated overhauling lessor accounting, they agreed to largely retain the current lessor accounting model. The ASU modifies the current U.S. GAAP lease classification criteria and aligns certain of the underlying principles in the lessor model with the new revenue recognition standard. Specifically, to qualify as a sales-type lease (in which a lessor recognizes profit up front), the arrangement must meet the requirements of a sale under the new revenue recognition guidance. On the other hand, if the transaction does not qualify as a sales-type lease, the transaction would be accounted for (1) as a direct financing lease with any profit deferred and recognized as interest income over the lease term or (2) an operating lease.

Editor's Note: The inability to recognize profit up front on a transaction because the arrangement would not be a sale under the new revenue recognition guidance will probably not significantly affect real estate lessors since such lessors typically do not enter into sales-type leases.

The ASU requires the lessor to account for rental income from operating leases on a straight-line basis unless another systematic basis would be more appropriate. However, to the extent that step rents are used to reflect or compensate the lessor for anticipated market rentals or market conditions, the lessor is required to recognize rental income on a systematic basis other than straight-line.

Editor's Note: Under the ASU, a lessor is only required to recognize rental income on a straight-line basis when payments are uneven for reasons other than to reflect or compensate for market rentals or market conditions (e.g., when there is significant front loading or back loading of payments or when there are rent-free periods in a lease). This may have a significant effect on a lessor's recognition of revenue for operating leases related to real estate since many such leases contain step rents that are intended to reflect expected increases in market rents over the lease term.

Lease and Nonlease Components

Lessees and lessors are required to separate lease components and nonlease components (e.g., any services provided) in an arrangement and allocate the total transaction price to the individual components. Lessors would perform the allocation in accordance with the guidance in the new revenue recognition standard, and lessees would do so on a relative stand-alone-price basis (by using observable stand-alone prices or, if the prices are not observable, estimated stand-alone prices). However, lessees are permitted to elect, as an accounting policy by class of underlying asset, not to separate lease components from nonlease components and instead account for the entire contract as a single lease component.

[5] FASB Accounting Standards Codification Topic 840, *Leases*.

Editor's Note: When evaluating whether an activity should be considered part of a lease component or a separate nonlease component, an entity should consider whether the activity transfers a separate good or service to the lessee. For example, maintenance services (including common-area maintenance services) and utilities paid for by the lessor but consumed by the lessee would be separate nonlease components because the tenant would have been required to otherwise contract for these services separately. However, payments for property taxes or insurance would most likely be considered part of the lease component because they do not transfer a separate good or service to the tenant. This treatment could have the effect of increasing a lessee's lease liability since it would include amounts that are currently considered executory costs. From a practical standpoint, however, such amounts are frequently variable and therefore would not be included in the measurement of the lease liability, as discussed below. See Example 12 in ASC 842-10-55-141 through 55-145[6] for three cases that illustrate the evaluation of whether such costs are considered a lease component.

Variable Lease Payments

In its initial measurement of the lease liability and ROU asset (lessee) or the net investment in the lease (lessor), an entity would only include variable lease payments if such payments are tied to an index or a rate. However, the entity would not include variable lease payments that are based on usage or performance of the asset. A lessee would recognize any variable payments not included in the original lease obligation as an expense in the period the obligation is incurred.[7] A lessor would recognize variable lease payments not included in the original net investment in the lease in the period a change occurs in the facts and circumstances on which the variable lease payments are based (e.g., "when the lessee's sales on which the amount of the variable payment depends occur"). Even if a variable lease payment is virtually certain (e.g., contingent upon a retail store's achievement of a nominal sales volume), the payment would not be included in the calculation of a lessee's lease obligation and ROU asset or a lessor's net investment in the lease.

Example — Variable Lease Payments

On January 1, 20Y1, Company A leased a building for five years, payable in annual lease payments of $100,000 at the beginning of each year. The lease is classified as an operating lease and contains a provision that on December 31 of each year, the lease payments will be adjusted by the change in the CPI for the preceding 12 months. At lease commencement, the CPI is 112. The implicit rate in the lease is not known, and A's incremental borrowing rate is 7 percent. Any initial direct costs and lease incentives are ignored in this example.

Determining the Lease Payments

At lease commencement, A makes its first annual payment of $100,000. In addition, A records a lease liability of $338,721 (the present value of the total remaining lease payments discounted at the incremental borrowing rate) and an ROU asset of $438,721 (the total of the lease liability plus the prepaid rent of $100,000). In measuring these amounts, A did not take into consideration the CPI in effect at lease commencement because the rent increase is based on a change in an index as opposed to the index itself.

On December 31, 20Y1 (the lease payment reset date), the CPI has changed to 126, representing a 12.5 percent increase (i.e., calculated as [(126 – 112) ÷ 112]). Accordingly, A's lease payment in year 2 would be $112,500, comprising the fixed amount of $100,000 and the variable amount of $12,500 (calculated as the change in CPI multiplied by the fixed amount). Further, because A was not required to remeasure its lease liability for any other reason (e.g., a modification), there would be no adjustment to the liability to reflect changes in the CPI. That is, incremental amounts that will be paid in the future because of changes in the CPI would also be recognized as variable lease payments in the period the amounts are paid.

Had the rental increases been based on an index (as opposed to a change in an index), the current — or spot — value of the index would have been used to measure the initial lease liability and ROU asset. Changes in the index over the lease term would result in variable lease payments and would not require revision of the lease liability or ROU asset unless the lease is reassessed for other reasons.

[6] FASB Accounting Standards Codification Topic 842, *Leases*, was added by ASU 2016-02.

[7] The period in which the obligation is "incurred" refers to the period when it becomes probable that the specified target that triggers the variable lease payments will be achieved.

Initial Direct Costs

Under the new standard, a lessee includes initial direct costs in the initial measurement of the ROU asset. A lessor's accounting for initial direct costs is similar to that under current U.S. GAAP. That is, for direct financing leases, a lessor defers all initial direct costs and includes them in the initial measurement of the lease receivable. Similarly, for operating leases, a lessor defers the initial direct costs and amortizes them as expenses over the lease term. For sales-type leases, initial direct costs are expensed up front unless the transaction does not result in a profit or loss.

However, the new standard has changed the definition of initial direct costs to align with the definition of incremental cost in the new revenue recognition guidance. Initial direct costs for both lessees and lessors now include only those costs that are incremental to the arrangement and would not have been incurred if the lease had not been obtained.

Editor's Note: The change in the definition of initial direct costs will affect many real estate entities. Costs such as commissions (whether paid to employees or third-party brokers) and payments made to existing tenants to obtain the lease will continue to be considered initial direct costs. By contrast, costs such as allocated internal costs and costs to negotiate and arrange the lease agreement (e.g., professional fees such as those paid for legal and tax advice) are excluded from this definition. This is likely to result in changes in practice for many real estate lessors, which currently capitalize such costs.

Sale-Leaseback Accounting

The FASB also aligned sale-leaseback accounting with the underlying principles in the new revenue recognition standard. Under the new leases guidance, the seller-lessee in a sale-leaseback transaction must evaluate the transfer of the underlying asset (sale) in accordance with ASC 606 to determine whether the transfer qualifies as a sale (i.e., whether control has been transferred to the buyer). The existence of a leaseback by itself would not indicate that control has not been transferred (i.e., it would not preclude the transaction from qualifying as a sale) unless the leaseback is classified as a finance lease. In addition, if the arrangement includes an option for the seller-lessee to repurchase the asset, the transaction would not qualify as a sale unless (1) the option is priced at the fair value of the asset on the date of exercise and (2) alternative assets exist that are substantially the same as the transferred asset and are readily available in the marketplace.

If the transaction does not qualify as a sale, the seller-lessee and buyer-lessor would account for it as a financing arrangement (i.e., the buyer-lessor would account for its payment as a financial asset and the seller-lessee would record a financial liability).

Editor's Note: Sale-leaseback transactions involving real estate that include a purchase option are not expected to meet the criteria to qualify as a sale, regardless of whether the purchase option is at fair value. Each real estate property is unique and not readily available in the marketplace because of various factors such as location and specified use; therefore, the existence of a purchase option on the real estate, whether it is at fair value or not, is evidence that the real estate is not readily available in the marketplace. Accordingly, in a manner similar to current U.S. GAAP, any purchase options on real estate will preclude sale-leaseback accounting for the seller-lessee.

The new standard will also affect the evaluation of sale-leaseback transactions by the buyer-lessor. Under current U.S. GAAP, the buyer-lessor accounts for its purchase and subsequent lease without regard to the seller-lessee's accounting for the transaction. Under the ASU, the buyer-lessor's and seller-lessee's accounting must be symmetrical. Accordingly, the buyer-lessor must assess whether the seller-lessee has achieved a sale under ASC 606 before it can determine its accounting for the purchase of the real estate assets.

Business Impact and Implementation Considerations

The new lease accounting requirements could change how real estate entities do business and could affect tenant behaviors. For example:

- Since the ASU will result in increased leverage on the balance sheet, tenants may want to negotiate shorter-term leases or leases that include more variable lease payments. Such negotiations could result in increased operating costs for both lessees and lessors.
- An increase in shorter-term leases could also result in higher rental rates and, therefore, additional operating costs. This could also affect (1) the lessor's ability to obtain financing, (2) the financing costs on the property, (3) and the fair value of the lessor's property.
- Because most leases will be on the tenants' balance sheets, tenants may be more motivated to consider whether to lease or purchase a property, particularly those that currently enter into long-term, triple-net leases.
- Bringing leases onto the balance sheet will result in increased leverage and affects an entity's key metrics. Real estate entities that are also lessees under lease agreements (e.g., a land lease for one of the real estate entity's properties) should consider whether the increased leverage could result in debt covenant violations or potentially affect lending decisions.
- The new guidance may complicate a tenant's internal approval of new leases or lease modifications since different individuals may need to closely consider the effects on the financial statements. Under current U.S. GAAP, a tenant's decision to enter into an operating lease may not necessarily receive much opposition or challenge from management. However, operating leases potentially will now be scrutinized as much as out-right purchases because of their effect on the balance sheet. In addition, in its decisions related to leases, an entity may need to involve personnel from a number of departments, such as accounting, corporate reporting, treasury, legal, operations, tax, and information technology.

For a discussion of additional implementation considerations, including those related to the application of judgment and estimation, data management, changes to information technology systems, changes to internal controls and the business process environment, debt covenants, and income taxes, see Appendix F in Deloitte's March 1, 2016, *Heads Up*.

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Deloitte.

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Heads Up

In This Issue

FASB Proposes Amendments to Clarify the Definition of a Business

by Lauren Pesa and Stefanie Tamulis, Deloitte & Touche LLP

On November 23, 2015, the FASB issued a proposed ASU[1] that would clarify the definition of a business in ASC 805[2] and provide a framework that an entity can use to determine whether a set of activities and assets (collectively, a "set") constitutes a business.

The FASB issued the proposed ASU in response to stakeholder feedback indicating that the definition of a business in ASC 805 is too broad and that too many transactions are qualifying as business combinations even though many of these transactions may more closely resemble asset acquisitions. Because the current definition has been interpreted broadly, it can be inefficient and costly to analyze transactions and entities may not be able to use "reasonable judgment." The proposed amendments would make application of the guidance more consistent and cost-efficient.

Editor's Note: Concerns about the definition of a business were among the primary issues raised in connection with the FAF's post-implementation review report on FASB Statement No. 141(R), *Business Combinations* (codified in ASC 805).

Significance of the Proposal

An entity uses the definition of a business in ASC 805 in determining whether to account for a transaction as an asset acquisition or a business combination. This distinction is important because the accounting for an asset acquisition significantly differs from the accounting for a business combination. For example, the acquirer's transaction costs are capitalized in an asset acquisition but are expensed in a business combination. Another difference is that in a business combination, the assets acquired are recognized at fair value and goodwill is recognized; in an asset acquisition, however, the cost of the acquisition is allocated to the assets acquired on a relative fair value basis and no goodwill is recognized.

The FASB considered addressing the concern about the definition of a business more directly by attempting to reduce or eliminate differences between the accounting for business combinations and that for asset acquisitions. However, to respond to stakeholder concerns in a timely fashion, the FASB decided to begin this project by clarifying the definition of a business.

[1] FASB Proposed Accounting Standards Update, *Clarifying the Definition of a Business*.
[2] For titles of *FASB Accounting Standards Codification* (ASC) references, see Deloitte's "Titles of Topics and Subtopics in the *FASB Accounting Standards Codification*."

Editor's Note: The definition of a business in ASC 805 also affects other aspects of accounting such as disposal transactions, determining reporting units, and the business scope exception in ASC 810. The proposed amendments would cause fewer sets of assets (and liabilities) to be identified as businesses.

Challenges Related to Applying the Current Definition of a Business

The definition of a business would remain unchanged under the proposed ASU. ASC 805 defines a business as:

> An integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs, or other economic benefits directly to investors or other owners, members, or participants.

The current implementation guidance in ASC 805-10-55-4 states that a "business consists of inputs and processes applied to those inputs that have the ability to create outputs." A business has three elements — inputs, processes, and outputs. All businesses have inputs and processes, and most have outputs, but outputs are not required for a set to be a business. Further, ASC 805-10-55-5 states that "all of the inputs or processes that the seller used" in operating the set do not need to be part of the transaction "if market participants are capable of acquiring the [set] and continuing to produce outputs, for example, by integrating the [acquired set] with their own inputs and processes."

The current implementation guidance does not specify the minimum inputs and processes required for a set to meet the definition of a business, which has led some to interpret the definition of a business broadly. Some have said that a set may qualify as a business even if no processes are acquired when revenue-generating activities continue after an acquisition or if a market participant would be capable of integrating the acquired set with its own processes. For example, some believe that the acquisition of real estate with an in-place lease meets the definition of a business because a market participant is capable of acquiring an input (a building with a lease) and combining it with its own processes (processes to collect rent and maintain the building) to continue generating outputs (rental income). Others have said that the presence of any process can give rise to a business, regardless of the significance of that process.

In addition, ASC 805-10-55-4(c) refers to an output as having "the *ability* to provide a return in the form of dividends, lower costs, or other economic benefits directly to investors or other owners, members, or participants" (emphasis added). Many transactions can provide a return in some form (e.g., the acquisition of a new machine might lower costs). Thus, the definition of outputs has further contributed to broad interpretations of the definition of a business.

Main Provisions of the Proposal

The proposed ASU's Basis for Conclusions indicates that the amendments would "narrow the definition of a business and provide a framework that gives entities a basis for making reasonable judgements about whether a transaction involves an asset or a business." In addition, the proposal provides examples illustrating the application of the amendments to the determination of whether a set is a business.

Single or Similar Asset Threshold

The proposed ASU "would provide a practical way to determine when a [set] is not a business." That is, "when substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset or group of similar identifiable assets," the set would not be considered a business. When this threshold is met, an entity would not need to evaluate the rest of the implementation guidance. The Basis for Conclusions notes that the assessment may be either qualitative or quantitative. In some cases, an entity may be able to qualitatively determine that all of the fair value of the acquisition would be assigned to a single asset or a group of similar assets. An entity may also be able to qualitatively determine that the fair value of the acquisition would be assigned to multiple dissimilar assets, in which case the threshold would not be met. In other cases, an entity may need to perform a quantitative assessment.

In addition, the FASB "decided that the threshold could be met if the fair value is concentrated in a group of similar identifiable assets" (e.g., when "an entity acquires, for example, multiple versions of substantially the same asset type instead of . . . one asset"). The Board further notes that although it intended "to make the analysis practical, the criteria are intended to weigh the need for practicality with the risk that too many items are grouped together to avoid being considered a business."

To avoid inappropriate groupings of assets, the FASB is adding ASC 805-10-55-9C to the proposed ASU. This paragraph indicates that an entity should not combine the following assets into a single asset (or consider them to be similar assets):

a. Tangible and intangible assets (for example, real estate and in-place lease intangibles)
b. Identifiable intangible assets in different major intangible asset classes (for example, customer-related intangibles, trademarks, and in-process research and development), except for groups of identifiable intangible assets that are recognized and measured as a single identifiable asset in accordance with this Topic (for example, complementary intangible assets that have similar useful lives . . .)
c. Financial and nonfinancial assets
d. Different major classes of financial assets (for example, cash, accounts receivable, and marketable securities)
e. Different major classes of tangible nonfinancial assets (for example, inventory, manufacturing equipment, and automobiles).

The following example (reprinted from the proposed ASU) illustrates how to apply the threshold:

Case A: Acquisition of Single-Family Homes

ABC acquires, renovates, leases, sells, and manages single-family residential homes. ABC acquires a portfolio of 10 single-family homes that each have at-market in-place leases. The only elements included in the acquired set are the 10 single-family homes and the 10 in-place leases. Each single-family home includes the land, building, and property improvements. Each home has a different floor plan, square footage, lot, and interior design.

ABC first considers the guidance in paragraph 805-10-55-9A and analyzes whether substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset or group of similar identifiable assets. ABC must first determine whether each single-family home would be considered a single asset for purposes of this analysis. ABC concludes that the land, building, and property improvements can be considered a single asset in accordance with paragraph 805-10-55-9B. That is, the building and property improvements are attached to the land and cannot be removed without incurring significant cost. However, the in-place lease is an intangible asset and cannot be combined with the tangible real estate in accordance with paragraph 805-10-55-9C.

ABC then considers whether the 10 tangible assets (the combined land, building, and property improvements) are similar. Each home is different; however, the nature of the assets (all single-family homes) are similar. As such, ABC concludes that the group of 10 single-family homes is a group of similar assets.

Next, ABC compares the fair value of the group of similar tangible assets with the fair value of the total gross assets acquired (the combined tangible assets plus the 10 in-place lease assets) and concludes that substantially all of the fair value of the gross assets acquired is concentrated in the group of similar tangible assets. That is, the in-place leases in this Example do not have significant fair value. As such, the set is not a business.

Substantive Process

The proposed amendments would clarify that to be "a business, a transaction must include, at a minimum, an input and a *substantive* process" (emphasis added). Further, the Board points out that "the existence of a process (or processes) is what distinguishes a business from an asset because all asset acquisitions have inputs, and, therefore, providing additional guidance related to processes should help differentiate between [groups of] assets and businesses."

The proposed amendments would not change the definition of process, but they would add two different sets of criteria for entities to consider in determining whether a set has a substantive process; these criteria depend on whether a set has outputs.

A Set With No Outputs

When outputs are not present, an entity would need to apply more stringent criteria when determining whether a set has a substantive process (e.g., an early-stage company that has not generated revenues). The proposal points out that "[b]ecause outputs are a key element of a business and [because] a business usually has outputs, . . . when that key element is missing, the other elements should be more significant." Therefore, to qualify as a business, a set that does not have outputs would need to have both an input and a substantive process. The set would include a substantive process "if it includes an organized workforce that has the necessary skills, knowledge, or experience to perform an acquired process (or group of processes) that, when applied to another acquired input or inputs, is critical to the ability to develop or convert that acquired input or inputs into outputs." The existence of any employee does not mean that a set without outputs should be considered a business. The proposal notes that in the evaluation of whether an acquired workforce is performing a substantive process, the following factors should be considered:

a. A process (or group of processes) is not critical if, for example, it is considered ancillary or minor in the context of all the processes required to create outputs.

b. Inputs that the organized workforce could develop (or is developing) or convert into outputs could include the following:

    1. Intellectual property that could be used to develop a good or service

    2. Resources that could be developed to create outputs

    3. Access to necessary materials or rights that enable the creation of future outputs.

    Examples could include technology, mineral interests, real estate, or in-process research and development.

The following example (reprinted from the proposed ASU) illustrates the assessment an entity would perform when a set has no outputs:

Case E: Acquisition of Biotech

Pharma Co. buys all of the outstanding shares of Target Biotech. Target Biotech's operations include research and development activities on several preclinical compounds that it is developing (in-process research and development projects). The set includes the scientists that have the necessary skills, knowledge, or experience to perform research and development activities. In addition, Target Biotech has long-lived tangible assets such as a corporate headquarters, a research lab, and testing equipment. Target Biotech does not yet have a marketable product and, therefore, has not generated revenues.

Pharma Co. first considers the guidance in paragraph 805-10-55-9A and analyzes whether substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset or group of similar identifiable assets. The identifiable assets in the set include multiple in-process research and development projects and tangible assets (the corporate headquarters, the research lab, and the lab equipment). In addition, Pharma Co. concludes that there is fair value associated with the acquired workforce. Pharma Co. also concludes that substantially all of the fair value of the gross assets acquired is not concentrated in a single identifiable asset or group of similar identifiable assets. Furthermore, because of the significant amount of fair value associated with both the tangible assets and the acquired workforce, Pharma Co. does not assess whether the in-process research and development projects are similar (because even if those projects were similar, the threshold would not be met).

Because the set does not have outputs, Pharma Co. evaluates the criteria in paragraph 805-10-55-5A to determine whether the set has both an input and a substantive process. Big Pharma concludes that the criteria in paragraph 805-10-55-5A are met because the scientists make up an organized workforce that has the necessary skills, knowledge, or experience to perform processes that, when applied to the in-process research and development inputs, is critical to the ability to develop those inputs into a good that can be provided to a customer. The presence of a more than insignificant amount of goodwill is another indicator that the workforce is performing a critical process. Thus, the set includes both inputs and substantive processes and is a business.

A Set With Outputs

The Basis for Conclusions indicates that when a set has outputs (i.e., there is a continuation of revenues before and after the transaction), "it is more likely that the set includes both an input and a substantive process when compared with a set that is not generating outputs." Therefore, the criteria for determining whether a set with outputs has a substantive process are less stringent. ASC 805-10-55-5B (added by the proposed ASU) indicates that the set would include a substantive process if any of the following criteria are met:

a. An organized workforce that has the necessary skills, knowledge, or experience to perform an acquired process (or group of processes) that when applied to an acquired input or inputs, is critical to the ability to continue producing outputs. A process (or group of processes) is not critical if, for example, it is considered ancillary or minor in the context of all of the processes required to continue producing outputs.
b. The acquired process (or group of processes), when applied to an acquired input or inputs, contributes to the ability to continue producing outputs and cannot be replaced without significant cost, effort, or delay in the ability to continue producing outputs.
c. The acquired process (or group of processes), when applied to an acquired input or inputs, contributes to the ability to continue producing outputs and is considered unique or scarce.

An organized workforce may signify the existence of a substantive process but would not be required if outputs are present. The Basis for Conclusions states, for example, that "an organized workforce might not be required if the set includes automated processes (for example, through acquired technology, infrastructure, or specialized equipment) or other significant processes that contribute to the ability to continue producing outputs."

Further, ASC 805-10-55-5C (added by the proposed ASU) states, in part:

If a set has outputs, a continuation of revenues does not, on its own, indicate that both an input and a substantive process have been acquired. Accordingly, assumed contractual arrangements that provide for the continuation of revenues (for example, customer contracts, customer lists, and leases [when the set is the lessor]) should be excluded from the analysis . . . of whether a [substantive] process has been acquired.

The following example (reprinted from the proposed ASU) illustrates the assessment an entity would perform when a set has outputs:

Case F: License of Distribution Rights

Company A is a global producer of food and beverages. Company A enters into an agreement to license the Latin American distribution rights of Yogurt Brand F to Company B whereby Company B will be the exclusive distributor of Yogurt Brand F in Latin America. As part of the agreement, Company A transfers the existing customer contracts in Latin America to Company B. Companies A and B also enter into an at-market supply contract in which Company B will purchase all of Yogurt Brand F from Company A. Company A retains all of its manufacturing and distribution capabilities. That is, Company B does not acquire manufacturing inputs and processes or distribution inputs and processes (and does not have any of the intellectual property related to those processes or to direct Company A's processes in any way) but only will purchase finished goods from Company A that it will sell and distribute to end customers in Latin America.

Company B first considers the guidance in paragraph 805-10-55-9A and analyzes whether substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset or group of similar identifiable assets. The identifiable assets that could be recognized in a business combination include the license to distribute Yogurt Brand F, customer contracts, and the supply agreement. Company B concludes that only the license and customer contracts would have fair value assigned to them and that neither asset represents substantially all of the fair value of the gross assets. Company B then considers whether the license and customer contracts are a group of similar intangible assets. Because the license and customer contracts are in different major classes of identifiable intangible assets, they would not be considered similar assets. Therefore, substantially all of the fair value of the gross assets acquired is not concentrated in a single identifiable asset or group of similar identifiable assets, and Company B must evaluate whether the set has both an input and a substantive process.

The set has outputs through the continuation of revenues with customers in Latin America. As such, Company B must evaluate the criteria in paragraph 805-10-55-5B to determine whether the set includes an input and a substantive process that together contribute to the ability to create outputs. Because the customer contracts are excluded from the determination of whether a process is present in accordance with paragraph 805-10-55-5C, the only elements in the set to evaluate to determine whether a substantive process is present are the license and supply agreement, both of which are inputs. That is, Company B did not obtain any process that could be applied to an acquired input to produce or distribute Yogurt Brand F but, rather, only a right to distribute and the access to purchase Yogurt Brand F. Because the set does not include an organized workforce and there are no acquired processes that could meet the criteria in paragraph 805-10-55-5B(b) through (c), the set is not a business because it does not include both an input and a substantive process.

Definition of Outputs

The proposed amendments would change the definition of outputs to "[t]he result of inputs and processes applied to those inputs that provide goods or services to customers, other revenues, or investment income, such as dividends or interest." The definition of outputs would be narrowed to be consistent with ASC 606, which "describes goods or services that are an output of the entity's ordinary activities." However, not every entity has revenues within the scope of ASC 606. Therefore, the Board decided to incorporate into the definition of outputs other types of revenues. For example, the reference to investment income in the definition of outputs in the proposed amendments was included to ensure that the purchase of an investment company could still qualify as a business combination.

Next Steps

Comments on the proposed ASU are due by January 22, 2016. An entity would apply the proposed amendments prospectively to any transaction that occurs on or after the effective date and would not be required to provide any disclosures at transition. The proposal notes that the FASB "will determine the effective date and whether the proposed amendments may be applied before the effective date after it considers stakeholder feedback on the proposed amendments."

At a later date, the Board will discuss clarifying the guidance on partial sales or transfers of assets that are within the scope of ASC 610-20 as well as the corresponding accounting for the retained interests. The FASB also plans to discuss aligning the accounting for acquisitions of assets with that for businesses.

Convergence With IFRSs

The definition of a business in ASC 805 is currently identical to that in IFRS 3.[3] Nevertheless, the interpretation and application of this term in jurisdictions that apply U.S. GAAP do not appear consistent with those in jurisdictions that apply IFRSs (i.e., the definition of a business in IFRS jurisdictions is not applied as broadly). Although the proposed ASU would add implementation guidance to U.S. GAAP that is not found in IFRSs, the FASB intends to more closely align practice under U.S. GAAP with that under IFRSs by narrowing application of the U.S. GAAP definition. Further, the IASB has added a project on the definition of a business to its agenda and is considering making amendments similar to those in the proposed ASU.

[3] IFRS 3, *Business Combinations*.

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Heads Up

In This Issue

Join us on March 15 at 2:00 p.m. EDT for a *Dbriefs* webcast on the new standard.

Bring It On!
FASB's New Standard Brings Most Leases Onto the Balance Sheet

by James Barker, Trevor Farber, Stephen McKinney, and Tim Kolber, Deloitte & Touche LLP

After working for almost a decade, the FASB has finally issued its new standard on accounting for leases, ASU 2016-02.[1] The IASB issued its own version, IFRS 16,[2] in January, and although the project was a convergence effort and the boards conducted joint deliberations, there are several notable differences between the two standards. We have highlighted those in the table below.

The primary objective of the leases project was to address the off-balance-sheet financing concerns related to lessees' operating leases. However, developing an approach that requires all operating leases to be recorded on the balance sheet proved to be no small task. During the process, the boards had to grapple with questions such as (1) whether an arrangement is a service or a lease, (2) what amounts should be initially recorded on the lessee's balance sheet for the arrangement, (3) how to reflect the effects of leases in the statement of comprehensive income of a lessee (a point on which the FASB and IASB were unable to converge), and (4) how to apply the resulting accounting in a cost-effective manner.

Accordingly, the FASB's new standard introduces a lessee model that brings most leases on the balance sheet. The standard also aligns certain of the underlying principles of the new lessor model with those in ASC 606, the FASB's new revenue recognition standard (e.g., evaluating how collectibility should be considered and determining when profit can be recognized). Furthermore, the ASU addresses other concerns related to the current almost-40-year-old leases model. For example, it eliminates the required use of bright-line tests in current U.S. GAAP for determining lease classification. It also requires lessors to provide additional transparency into the exposure to the changes in value of their residual assets and how they manage that exposure.

The new standard, which is effective for calendar periods beginning on January 1, 2019, for public business entities and January 1, 2020, for all other entities (see the Effective Date section for more information), represents a wholesale change to lease accounting, and as a result, entities will face significant implementation challenges during the transition period and beyond, such as those related to:

- Applying judgment and making estimates.
- Managing the complexities of data collection, storage, and maintenance.
- Enhancing information technology systems to ensure their ability to perform the calculations necessary for compliance with reporting requirements.

[1] FASB Accounting Standards Update No. 2016-02, *Leases*. The ASU supersedes FASB Accounting Standards Codification (ASC) Topic 840, *Leases*, and creates ASC 842, *Leases*. For titles of additional ASC references, see Deloitte's "Titles of Topics and Subtopics in the *FASB Accounting Standards Codification*."

[2] IFRS 16, *Leases*. For more information on the IASB's standard, see Deloitte's January 13, 2016, *IFRS in Focus*.

- Refining internal controls and other business processes related to leases.
- Determining whether debt covenants are likely to be affected and, if so, working with lenders to avoid violations.
- Addressing any income tax implications.

See Appendix F of the *Heads Up* for more information about an entity's implementation considerations.

This *Heads Up* provides a comprehensive overview of the FASB's new leases accounting model under ASU 2016-02 and highlights a number of implementation considerations. The *Heads Up* also contains the following appendixes, which expand on certain key aspects of the standard:

- Appendix A — Evaluating Whether an Arrangement Is or Contains a Lease.
- Appendix B — Other Significant Provisions. (Topics discussed include lease modifications, separating lease and nonlease components, and accounting for sale-and-leaseback transactions.)
- Appendix C — Presentation Requirements.
- Appendix D — Disclosure Requirements.
- Appendix E — Transition.
- Appendix F — Implementation Considerations.

A Snapshot of the New Guidance

The table below highlights the key provisions of the new leases accounting model under ASU 2016-02 and IFRS 16.

Key Provision	ASU 2016-02	IFRS 16
Scope	Scope includes leases of all property, plant, and equipment (PP&E) and excludes: • Leases of intangible assets. • Leases to explore for or use nonregenerative resources. • Leases of biological assets. • Leases of inventory. • Leases of assets under construction.	Scope includes leases of all assets (not limited to PP&E). Exceptions are similar to those in ASU 2016-02. Also, lessees can elect to apply the guidance to leases of intangible assets.
Short-term lease	A lessee may recognize the payments on a short-term lease on a straight-line basis over the lease term (in a manner similar to its recognition of an operating lease today). These leases would not be reflected on the lessee's balance sheet. A short-term lease is defined as a lease that has a lease term of 12 months or less and does not include a purchase option that the lessee is reasonably certain to exercise.	A lessee may recognize the payments on a short-term lease on a straight-line basis over the lease term (in a manner similar to its recognition of an operating lease today). These leases would not be reflected on the lessee's balance sheet. A short-term lease is defined as a lease that has a lease term of 12 months or less and does not include a purchase option.

<table>
<tr><th>Key Provision</th><th>ASU 2016-02</th><th>IFRS 16</th></tr>
<tr><td rowspan="2">Definition of a lease</td><td>A lease is defined as a "contract, or part of a contract, that conveys the right to control the use of identified property, plant, or equipmen t (an identified asset) for a period of time in exchange for consideration."</td><td>A lease is defined as a "contract, or part of a contract, that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration."</td></tr>
<tr><td colspan="2">• A leased asset must be specifically identifiable either explicitly (e.g., by a serial number) or implicitly (e.g., the only asset available to satisfy the lease contract).
◦ Substantive substitution rights will need to be considered.
◦ A physically distinct portion of a larger asset could represent a specified asset (e.g., one floor of a building).
◦ A capacity portion of a larger asset will generally not represent a specified asset (e.g., percentage of a storage tank).
• A lease contract conveys the right to control the use of the identified asset for a specified period of time. A customer controls an identified asset when the customer:
◦ Has the right to obtain substantially all of the economic benefits from its use.
◦ Has the right to direct its use.</td></tr>
<tr><td>Leases of low-value assets</td><td>No exemption under U.S. GAAP. However, the FASB believes that an entity will be able to adopt a reasonable capitalization policy under which the entity will not recognize certain lease assets and liabilities that are below a certain threshold.</td><td>A lessee may recognize the payments on a lease of low-value assets on a straight-line basis over the lease term (in a manner similar to its recognition of an operating lease today). These leases would not be reflected on the lessee's balance sheet. IFRS 16 does not define "low value"; however, when the IASB was discussing the exception during deliberations, the Board referred to assets that were less than $5,000.
In addition, an entity will be able to adopt a reasonable capitalization policy under which the entity will not recognize certain lease assets and liabilities that are below a certain threshold.</td></tr>
<tr><td rowspan="2">Lessee accounting</td><td colspan="2">As of the lease commencement date, a lessee recognizes:
• A liability for its lease obligation (initially measured at the present value of the future lease payments not yet paid over the lease term).
• An asset for its right to use the underlying asset (i.e., the right-of-use (ROU) asset) equal to the lease liability, adjusted for lease payments made at or before lease commencement, lease incentives, and any initial direct costs.</td></tr>
<tr><td>The lessee will use the effective interest rate method to subsequently account for the lease liability.
Two approaches are used for subsequently amortizing the ROU asset: (1) the finance lease approach and (2) the operating lease approach.
Under the finance lease approach, the ROU asset is generally amortized on a straight-line basis. This amortization, when combined with the interest on the lease liability, results in a front-loaded expense profile in which interest and amortization are presented separately in the income statement. By contrast, the operating lease approach generally results in a straight-line expense profile that is presented as a single line item in the income statement.
The determination of which approach to apply is based on lease classification criteria that are similar to the current requirements in IAS 17.[3]</td><td>The lessee will use the effective interest rate method to subsequently account for the lease liability.
A single approach (similar to the FASB's finance lease approach) is used to subsequently amortize the ROU asset.</td></tr>
</table>

[3] IAS 17, *Leases*.

<table>
<thead>
<tr><th>Key Provision</th><th>ASU 2016-02</th><th>IFRS 16</th></tr>
</thead>
<tbody>
<tr><td>Lessor accounting</td><td>Retains the current lessor accounting approach for operating and capital (direct financing and sales-type) leases.

However, the lease classification criteria will change, and the treatment of dealer's profit, if any, will be affected:
• A dealer's profit would be recognized up front if the arrangement is a sales-type lease (i.e., the transaction qualifies as a sale under ASC 606).
• A dealer's profit resulting from a direct financing lease, if any, would be deferred and recognized as interest income over the lease term.

Eliminates leveraged lease accounting going forward (existing leveraged leases are grandfathered).</td><td>Retains the current lessor accounting approach for operating and finance leases. A dealer's profit for a finance lease is recognized up front without regard to the revenue guidance in IFRS 15.[4]</td></tr>
<tr><td>Lease term</td><td>Lease term is the noncancelable period in which the lessee has the right to use an underlying asset together with optional periods for which it is reasonably certain that the lessee will exercise the renewal option or not exercise the termination option or in which the exercise of those options is controlled by the lessor. Lessees will be required to reassess the lease term after lease inception if (1) there is a significant event or change in circumstances that is directly attributable to the actions of the lessee, (2) a contract term obliges the lessee to exercise (or not exercise) an option to extend or terminate the lease, or (3) the lessee elects to exercise (or not exercise) an option to renew or terminate the contract that it had previously determined was not reasonably certain to be exercised.

A lessor is not required to reassess the lease term unless the lease is modified and the modified lease is a separate contract.</td><td>Lease term is the noncancelable period in which the lessee has the right to use an underlying asset together with optional periods for which it is reasonably certain that the lessee will exercise the renewal option or not exercise the termination option. Lessees will be required to reassess the lease term after lease inception if (1) there is a significant event or change in circumstances that is directly attributable to the actions of the lessee or (2) the lessee elects to exercise (or not exercise) an option to renew or terminate the contract that it had previously determined was not reasonably certain to be exercised.

A lessor is not required to reassess the lease term unless the lease is modified and the modified lease is a separate contract.</td></tr>
<tr><td rowspan="2">Lease payments</td><td colspan="2">Lease payments include:
• Fixed payments (including in-substance fixed lease payments).
• Variable payments that are based on an index or rate (e.g., LIBOR or the consumer price index (CPI)) calculated by using the index or rate that exists on the lease commencement date (i.e., the spot rate).
• Amounts that it is probable will be owed under residual value guarantees (for lessees), and amounts at which residual assets are guaranteed by a lessee or by a third party (for lessors).
• Payments related to renewal or termination options that the lessee is reasonably certain to exercise.

Lease payments do not include variable lease payments that are based on the usage or performance of the underlying asset (e.g., a percentage of revenues).</td></tr>
<tr><td>Variable payments based on an index or rate would only be reassessed when the lease obligation is reassessed for other reasons (e.g., change in the lease term, modification).</td><td>Variable payments based on an index or rate would be reassessed whenever there is a change in contractual cash flows (e.g., the lease payments are adjusted for a change in the CPI).</td></tr>
<tr><td rowspan="2">Discount rate</td><td colspan="2">• Lessees use the rate charged by the lessor if the rate is readily determinable. If the rate is not readily determinable, lessees will use their incremental borrowing rate as of the date of lease commencement.
• Lessors use the rate they charge the lessee.</td></tr>
<tr><td>Private-company lessees can elect to use a risk-free rate.</td><td>No exemptions provided for private-company lessees.</td></tr>
</tbody>
</table>

4 IFRS 15, *Revenue From Contracts With Customers*.

<table>
<tr><th>Key Provision</th><th>ASU 2016-02</th><th>IFRS 16</th></tr>
<tr><td>Lease modifications</td><td colspan="2">A lease modification is any change to the contractual terms and conditions of a lease.
• A lessee/lessor would account for a lease modification as a separate contract (i.e., separate from the original lease) when the modification (1) grants the lessee an additional ROU asset and (2) the price of the additional ROU asset is commensurate with its stand-alone price.
• Lessees would account for a lease modification that is not a separate contract by using the discount rate as of the modification effective date to adjust the lease liability and ROU asset for the change in the lease payments. The modification may result in a gain or loss if the modification results in a full or partial termination of an existing lease.
• Lessors would account for a lease modification in a manner generally consistent with the modification guidance in ASC 606 or IFRS 15.
• See Appendix B for more information.</td></tr>
<tr><td>Sublease</td><td>The intermediate lessor would classify a sublease by using the underlying asset of the head lease.</td><td>The intermediate lessor would classify a sublease by using the ROU asset of the head lease.</td></tr>
<tr><td>Sale-and-leaseback arrangements</td><td>The transaction would not be considered a sale if (1) it does not qualify as a sale under ASC 606 or (2) the leaseback is a finance lease.
• A repurchase option would result in a failed sale unless (1) the exercise price of the option is at fair value and (2) there are alternative assets readily available in the marketplace.
• If the transaction qualifies as a sale, the entire gain on the transaction would be recognized.</td><td>The transaction would not be considered a sale if it does not qualify as a sale under IFRS 15.
• A repurchase option would always result in a failed sale.
• For transactions that qualify as a sale, the gain would be limited to the amount related to the residual portion of the asset sold. The amount of the gain related to the underlying asset leased back to the lessee would be offset against the lessee's ROU asset.</td></tr>
</table>

Scope

Like the scope under current requirements, the scope of the new guidance is limited to leases of PP&E. The scope excludes (1) leases of intangible assets; (2) leases to explore for or use minerals, oil, natural gas, and similar nonregenerative resources; (3) leases of biological assets; (4) leases of inventory; and (5) leases of assets under construction.

Editor's Note: Under the proposal issued by the boards in May 2013, the scope of the lease accounting guidance would have included inventory (e.g., spare parts and supplies) and construction work in progress (CWIP). However, constituents expressed concerns that if the guidance applied to CWIP, build-to-suit transactions (in which the customer is involved with the construction activity) may be accounted for as leases. In response, the FASB revisited the scope of the guidance in late 2015 and decided to limit it to PP&E. However, it also decided to include guidance on a lessee's control of an underlying asset that is being constructed before lease commencement and related considerations. See Build-to-Suit Arrangements in Appendix B for additional information.

Short-Term Leases

Under the ASU, a lessee can elect (by asset class) not to record on the balance sheet a lease whose term is 12 months or less and does not include a purchase option that the lessee is reasonably certain to exercise (i.e., treat the lease like an operating lease under current U.S. GAAP). When determining whether the lease qualifies for this election, the lessee would include renewal options only if they are considered part of the lease term (i.e., those options the lessee is reasonably certain to exercise — see the Lease Term section below).

A lessee electing this option would recognize lease payments as an expense over the lease term on a straight-line basis. The lessee would also be required to disclose certain information about the short-term lease. If the lease term increases to more than 12 months, or if it is reasonably certain that the lessee will exercise an option to purchase the underlying asset, the lessee would no longer be able to apply the short-term lease exception and would account for the lease as it would other leases.

Example 1 — Short-Term Leases

Scenario 1 — Short-Term Lease Criteria Met

Company A (lessee) enters into an arrangement to lease a crane for a six-month period, with the option to extend the term for up to nine additional months (in three-month increments). After considering the nature of the project, A determines that it expects to use the crane for only nine months and is therefore reasonably certain that it will exercise only one of the three renewal options. Since the lease term is not more than 12 months (in this case 9 months), A would be able to elect the short-term lease exception.

Scenario 2 — Short-Term Lease Criteria Not Met

Company A (lessee) enters into an arrangement to lease a crane for a six-month period, with the option to extend the term for up to nine additional months (in three month increments). The project for which the crane is being used is expected to take 15 months to complete.

After considering the nature of the project, A determines that it expects to use the crane for 15 months and is therefore reasonably certain that it will exercise all three renewal options. Because the expected lease term is greater than 12 months, A would not be able to apply the short-term lease exception; rather, it would be required to record on the balance sheet an ROU asset and corresponding lease liability.

Definition of a Lease

A contract is, or contains, a lease if the contract gives a customer the right to control the use of the identified PP&E (an identified asset) for a period of time in exchange for consideration. Control is considered to exist if the customer has both of the following:

- The "right to obtain substantially all of the economic benefits from use of [an identified] asset."
- The "right to direct the use of that asset."

An entity is required at inception to identify whether a contract is, or contains, a lease. The entity will only reassess whether the contract is or contains a lease in the event of a modification to the terms and conditions of the contract. The inception of a lease is the earlier of the date of an executed lease agreement or the date of commitment by the parties to the principal terms and conditions of the lease.

In many cases, the assessment of whether a contract is or contains a lease will be straightforward. However, the evaluation will be more complicated when an arrangement involves both a service component and a leasing component or when both the customer and the supplier make decisions about the use of the underlying asset. Accordingly, the ASU contains a number of examples of an entity's evaluation of whether a contract is or contains a lease (see ASC 842-10-55-41 through 55-130 in the ASU).

The table below summarizes each key concept related to the definition of a lease. (See Appendix A for more information about the definition of a lease.)

Concept	Requirement[5]	Observation
Use of an identified asset	An asset is typically identified if it is explicitly specified in a contract or implicitly specified at the time the asset is made available for use by the customer. However, if the supplier has substantive rights to substitute the asset throughout the period of use, the asset is not considered "identified."	This requirement is similar to the guidance in ASC 840-10-15 (formerly EITF Issue 01-8[6]). An entity does not need to be able to identify the particular asset (e.g., by serial number) but must instead determine whether an identified asset is needed to fulfil the contract. An entity will need to use significant judgment in distinguishing between a lease and a capacity contract. The standard clarifies that a capacity portion of an asset is an identified asset if it is physically distinct (e.g., a floor of a building). On the other hand, a capacity portion of a larger asset that is not physically distinct (e.g., a percentage of a pipeline) is not an identified asset unless the portion represents substantially all of the asset's capacity.
Substantive substitution rights	A supplier's right to substitute an asset is substantive only if both of the following conditions apply: (1) the supplier has the practical ability to substitute alternative assets throughout the period of use and (2) the supplier would benefit economically from the exercise of its right to substitute the asset.	The FASB established this requirement because it reasoned that if a supplier has a substantive right to substitute the asset throughout the period of use, then the supplier — not the customer — controls the use of the asset. A contract to use a specified type of rail car to transport goods is an example of economic benefit from substitution rights. The supplier benefits from exercise of its right to substitute because it can use its pool of available rolling stock in the most efficient manner.
Right to obtain economic benefits from use of the identified asset	To control the use of an identified asset, a customer must have the right to obtain substantially all of the economic benefits from use of the asset throughout the period of use.	The economic benefits from use of an asset include the primary output and by-products of the asset as well as other economic benefits from using the asset that could be realized from a commercial transaction with a third party.
Right to direct the use of the identified asset	A customer has the right to direct the use of an identified asset throughout the period of use if either (1) the customer has the right to direct how and for what purpose the asset is used throughout the period of use or (2) the relevant decisions about how and for what purpose the asset is used are predetermined and (a) the customer has the right to operate (or direct others to operate) the asset throughout the period of use and the supplier does not have the right to change the operating instructions or (b) the customer designed the asset in a way that predetermines how and for what purpose the asset will be used.	The relevant rights to be considered are those that affect the economic benefits derived from the use of the asset. Some examples of customers' rights that meet the definition are (1) rights to change the type of output produced by the asset, (2) rights to change when the output is produced, and (3) rights to change where the output is produced. On the other hand, rights that are limited to maintaining or operating the asset do not grant a right to direct how and for what purpose the asset is used. The standard illustrates the concept of directing use through design of the asset in an example of a contract to purchase all of the output of a solar farm. In the example, the FASB concludes that although the customer makes no decisions during the life of the farm, it has the right to direct its use as a result of having designed the asset before it was constructed.

[5] Text is adapted from the ASU.

[6] EITF Issue No. 01-8, "Determining Whether an Arrangement Contains a Lease" (codified in FASB Accounting Standards Codification Topic 840, *Leases*).

Lease Classification

An entity is required to determine the classification of a lease as of the lease commencement date.[7] The ASU's classification criteria apply to both lessees (U.S. GAAP only)[8] and lessors (U.S. GAAP and IFRSs). The evaluation focuses on whether control of the underlying asset is effectively transferred to the lessee (e.g., substantially all of the risks and rewards related to ownership of the underlying asset are transferred to the lessee). Therefore, a lease would be classified as a finance lease (from the standpoint of a lessee) or a sales-type lease (from the standpoint of a lessor) if any of the following criteria are met:

- "The lease transfers ownership of the underlying asset to the lessee by the end of the lease term."
- "The lease grants the lessee an option to purchase the underlying asset that the lessee is reasonably certain to exercise."
- "The lease term is for the major part of the remaining economic life of the underlying asset."[9]
- "The present value of the sum of the lease payments and any residual value guaranteed by the lessee . . . equals or exceeds substantially all of the fair value of the underlying asset."
- "The underlying asset is of such a specialized nature that it is expected to have no alternative use to the lessor at the end of the lease term."

Leases that do not meet any of these criteria (i.e., a lease in which the lessee does not effectively obtain control of the underlying asset) would be classified as operating leases by the lessee and as either operating leases or direct financing leases by the lessor.

Editor's Note: Under the ASU's classification criteria, an arrangement that historically was classified by a lessor as a sales-type lease because the lessor transferred a portion of the risks and rewards of the underlying asset to the lessee and a portion to a third party through a residual value guarantee (e.g., residual value insurance) may no longer qualify as a sales-type lease. In the evaluation of whether a lease qualifies as a sales-type lease, the FASB decided to align the definition of control with its new revenue recognition requirements. Accordingly, the evaluation of whether a lease qualifies as a sales-type lease focuses on whether the *lessee effectively obtains control* of the underlying asset rather than whether the *lessor has relinquished control*.

If a lease does not meet any of the criteria for classification as a sales-type lease, the lessor would still need to assess whether it has relinquished control of the underlying asset to the lessee and other parties involved in the transaction. Accordingly, the lessor would classify a lease that does not meet any of the criteria for a sales-type lease as a direct financing lease if (1) the present value of the lease payments and any residual value guarantee (which could be provided entirely by a third party or could consist of a guarantee provided by the lessee along with a third party guarantee)[10] "equals or exceeds substantially all of the fair value of the underlying asset" and (2) it is probable that the lessor will collect the lease payments and any amounts related to the residual value guarantee(s).

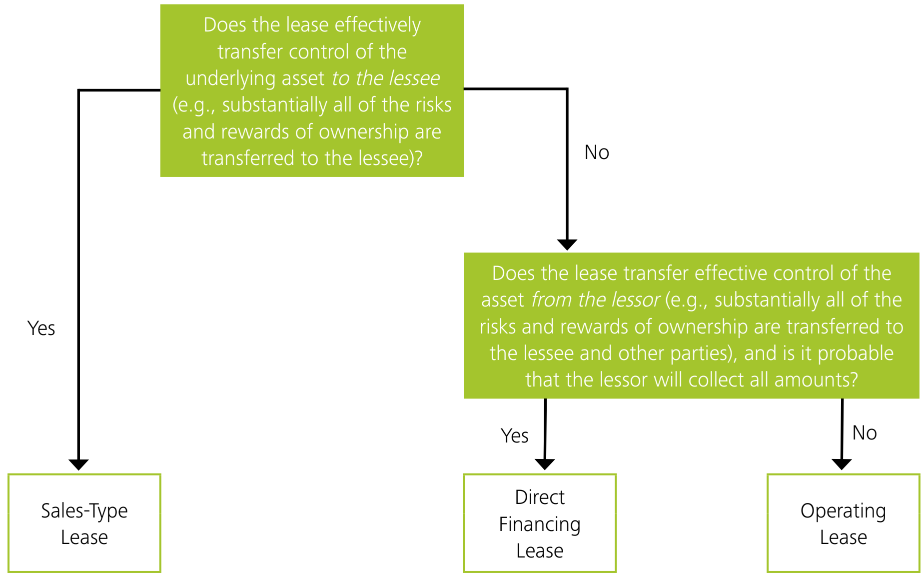
[7] Lease commencement is defined as the date a lessor makes the underlying asset available to a lessee.

[8] A lessee is not required to determine the classification of a lease if the lease is accounted for in accordance with the short-term scope exception. See Appendix B for further details.

[9] The ASU provides an exception to this lease classification criteria for leases that commence "at or near the end" of the underlying asset's economic life. The ASU indicates that a lease that commences in the final 25 percent of an asset's economic life is "at or near the end" of the underlying asset's economic life.

[10] If the present value of lease payments plus a lessee-provided residual value guarantee represents substantially all of the fair value of the underlying asset, the lessor would classify the lease as a sales-type lease.

The following flowchart illustrates the classification of a lease by a lessor:



A lessee is not required to reassess its classification of a lease unless (1) the lease is subsequently modified and the modification is not accounted for as a separate contract or (2) there is a change in the lease term (e.g., there is a change in the assessment of whether the lessee is reasonably certain to exercise a renewal option) or a change in the assessment of the exercise of a purchase option. A lessor would only reassess its lease classification if the lease is subsequently modified and the modification is not accounted for as a separate contract. The accounting underlying each type of lease is discussed in greater detail below in the Lessee Accounting and Lessor Accounting sections.

Editor's Note: While the ASU's classification criteria are similar to those in IAS 17, they are different from the current requirements in U.S. GAAP. As a result, a lease that would have been classified as an operating lease may be classified as a finance lease under the ASU. In addition, as a reasonable approach to assessing significance, an entity is permitted to use the bright-line thresholds that exist under ASC 840 when determining whether a lease would be classified as a finance lease.[11]

In addition, an entity would assess land and other elements in a real estate lease as separate lease components unless the accounting result of doing so would be insignificant. This approach is consistent with the historical approach under IFRSs, but represents a change from current U.S. GAAP guidance, which requires a lessee to account for land and buildings separately only when (1) the lease meets either the transfer-of-ownership or bargain-purchase-price classification criteria or (2) the fair value of the land is 25 percent or more of the total fair value of the leased property at lease inception. This change may result in more bifurcation of real estate leases into separate lease elements.

Lease Term

Under the ASU, the lease term, as determined at lease commencement, is the noncancelable lease period and any optional periods if (1) it is *reasonably certain*[12] that the lessee will exercise a renewal option or not exercise a termination option or (2) the exercise of those options is controlled by the lessor.

[11] Under ASC 840, a lease would be classified as a finance lease if the lease term is 75 percent or more than the remaining economic life of an underlying asset or if the sum of the present value of the lease payments and the present value of any residual value guarantees amounts to 90 percent or more than the fair value of the underlying asset.

[12] The FASB has indicated that "reasonably certain" is substantially the same as the "reasonably assured" threshold under current U.S. GAAP.

When assessing the likelihood of a lessee's exercise of an option, the lessor and lessee would consider the following:

- *Contract-based factors* — The terms of the lease agreement (e.g., a bargain renewal option, a contractual requirement for the lessee to incur substantial costs to restore the asset before returning it to the lessor).
- *Asset-based factors* — Specific characteristics of the underlying asset (e.g., the lessee has installed significant leasehold improvements that would still have economic value when the option becomes exercisable or the facility is in a geographically desirable location with no other viable locations).
- *Entity-specific factors* — The historical practice of the entity, management's intent, and common industry practice.
- *Market-based factors* — Market rentals for comparable assets.

Lessees are required to reassess the lease term when:

- A significant event or change in circumstances occurs that is directly attributable to and clearly within the control of the lessee, and the event or change in circumstances will affect whether the lessee would be reasonably certain to exercise an option to extend the lease, purchase the underlying asset, or terminate the lease.
- A contract term obliges the lessee to exercise (or not exercise) an option to extend or terminate the lease.
- The lessee elects to (1) exercise an option to renew that it had previously determined was not reasonably certain to be exercised or (2) not exercise an option to terminate the contract that it had previously determined was reasonably certain to be exercised.

Lessors would not be required to reassess the lease term unless the lease is modified and the modified lease is a separate contract.

See Appendix B for more information about lease modifications.

Example 2 — Lessee Reassessment of Lease Term

On June 15, 20Y1, Company A leased a building to be used as a storage and distribution warehouse for a 10-year term, with two 5-year renewal options. Company A initially determined that on the lease commencement date it was not reasonably certain that it would exercise either of the renewal options and therefore concluded that the lease term was 10 years.

Scenario 1 — Term Reassessment Would Not Be Required

On January 15, 20Y5, the city in which the warehouse is located significantly improved its highway system, thereby making the warehouse location more desirable for A's distribution needs. This by itself would not result in the need for A to reassess whether it will exercise any remaining renewal options since the significant event or change in circumstances was outside of A's control.

Scenario 2 — Term Reassessment Would Be Required

On January 15, 20Y5, A installed leasehold improvements with a 10-year estimated useful life. The cost of the improvements was significant, and A is now reasonably certain to exercise at least one of its renewal options to avoid losing the value associated with the improvements. In this case, since the change in circumstances is directly attributable to A's actions, reassessment would be required.

Lease Payments

In the calculation of a lessee's lease obligation and ROU asset or a lessor's net investment in the lease, the lease payments are measured as the total of (1) fixed payments, including in-substance fixed payments; (2) variable payments based on an index or a rate; (3) amounts that it is probable a lessee will owe under a residual value guarantee (lessee) or the amount of the residual value guarantee (lessor); and (4) payments related to purchase or termination options that the lessee is reasonably certain to exercise. In addition, in measuring the ROU asset, the lessee would adjust its lease payments for any lease incentives that are paid or payable.

Fixed Payments, Including In-Substance Fixed Payments

Fixed payments are payments that are specified in the lease agreement and fixed over the lease term. Fixed payments also include variable lease payments that are considered in-substance fixed payments (e.g., a variable payment that includes a floor or a minimum amount).

Editor's Note: Even if a variable lease payment is virtually certain (e.g., a variable payment for highly predictable output from a solar farm or a variable payment if a retail store meets a nominal sales volume), such a payment would not be considered an in-substance fixed payment. Therefore, it would not be included in the determination of a lessee's lease obligation and ROU asset or a lessor's net investment in the lease.

Variable Lease Payments

An entity would include variable lease payments that depend on an index or a rate in the initial measurement of the lease liability and ROU asset (lessee) or the net investment in the lease (lessor) by using the spot index or rate at lease commencement. By contrast, the entity would *not* include variable lease payments based on usage or performance of the asset. A lessee would recognize any variable payments not included in the original lease obligation as an expense in the period the obligation is incurred.[13] A lessor would recognize variable lease payments not included in the original net investment in the lease in the period a change occurs in the facts and circumstances on which the variable lease payments are based (e.g., "when the lessee's sales on which the amount of the variable payment depends occur").

A lessee is required to reassess variable lease payments when the lease liability is remeasured as a result of the following:

- The lease is modified and the modification is not treated as a separate contract.
- A contingency upon which a variable lease payment that is excluded from the measurement of lease payments becomes resolved such that the variable payment will now be included in the measurement of the lease payments (e.g., a variable lease payment that is based on a sales target subsequently converts to a fixed lease payment).
- There is a change in:
  - The lease term.
  - The assessment of whether the lessee will exercise a purchase option.
  - The amount that it is probable the lessee will owe under a residual value guarantee.

Any changes related to future periods would result in an adjustment to the lease obligation and ROU asset. A lessor is not required to reassess variable lease payments unless the lease is modified and the modification is not accounted for as a separate contract.

[13] The period in which the obligation is "incurred" refers to the period when it becomes *probable* that the specified target that triggers the variable lease payments will be achieved.

Editor's Note: While the FASB aligned many of the lessor accounting requirements with the new revenue guidance in ASC 606, the treatment of variable consideration under the two models differs significantly. Under ASC 606, variable revenues are estimated and included in the transaction price subject to a constraint, whereas under the leases standard, variable lease payments would generally be excluded from the determination of a lessor's lease receivable. Accordingly, there is a possibility that direct financing leases or sales-type leases that have a significant variable component may result in inception losses for the lessor if the lease receivable plus the unguaranteed residual asset is less than the net carrying value of the underlying asset being leased. This could occur if payments on a lease of, for example, a solar farm are based entirely on the production of electricity (i.e., 100 percent variable). Since many feel that this outcome does not faithfully represent the economics of these transactions, we are considering other possible approaches to applying the new standard to such contracts, including the use of a negative discount rate, which would avoid the inception loss. Lessors that are affected by this issue should consult with their professional advisers and monitor developments during the implementation phase of the ASU.

Example 3 — Variable Lease Payments

On January 1, 20Y1, Company A leased a building for five years, payable in annual lease payments of $100,000 at the beginning of each year. The lease is classified as an operating lease and contains a provision that on December 31 of each year, the lease payments will be adjusted by the change in the CPI for the preceding 12 months. At lease commencement, the CPI is 112. The implicit rate in the lease is not known, and A's incremental borrowing rate is 7 percent. Any initial direct costs and lease incentives are ignored in this example.

Determining the Lease Payments

At lease commencement, A makes its first annual payment of $100,000. In addition, A records a lease liability of $338,721 (the present value of the total remaining lease payments discounted at the incremental borrowing rate) and an ROU asset of $438,721 (the total of the lease liability plus the prepaid rent of $100,000). In measuring these amounts, A did not take into consideration the CPI in effect at lease commencement because the rent increase is based on a change in an index as opposed to the index itself.

On December 31, 20Y1 (the lease payment reset date), the CPI has changed to 126, representing a 12.5 percent increase (i.e., calculated as [(126 − 112) ÷ 112]). Accordingly, A's lease payment in year 2 would be $112,500, comprising the fixed amount of $100,000 and the variable amount of $12,500 (calculated as the change in CPI multiplied by the fixed amount). Further, because A was not required to remeasure its lease liability for any other reason (e.g., a modification), there would be no adjustment to the liability to reflect changes in the CPI. That is, incremental amounts that will be paid in the future because of changes in the CPI would also be recognized as variable lease payments in the period the amounts are paid.

Had the rental increases been based on an index (as opposed to a change in an index), the current — or spot — value of the index would have been used to measure the initial lease liability and ROU asset. Changes in the index over the lease term would result in variable lease payments and would not require revision of the lease liability or ROU asset unless the lease is reassessed for other reasons.

Residual Value Guarantees

The ASU defines a residual value guarantee as a "guarantee made to a lessor that the value of an underlying asset returned to the lessor at the end of a lease will be at least a specified amount." Under current U.S. GAAP, a lessee includes in its minimum lease payments the entire amount of the residual value guarantee, whereas under the ASU, a lessee only includes those amounts that it is probable will be owed under the residual value guarantee at the end of the lease term. A lessee is required to remeasure lease payments when there is a change in the amount that it is probable will be owed by the lessee under a residual value guarantee. Revised lease payments would reflect changes in the amounts that it is probable will be owed by the lessee under residual value guarantees and would be recognized as an adjustment to the lease liability and the ROU asset.

A lessor would include in its lease receivable the full amount at which the residual asset is guaranteed by the lessee or a third party. Unlike a lessee, the lessor would not reflect any changes in the residual value in its lease receivable. However, changes in the unguaranteed residual value would be considered in the overall assessment of whether the net investment in the lease is impaired.

Example 4 — Residual Value Guarantee

A lessor leases equipment to a lessee for five years at $10,000 per year. The lessee guarantees that the equipment will have a residual value of at least $9,000 at the end of the lease. The expected residual value at the end of the lease term is $20,000.

Lessee Accounting

In its lease payment calculation, the lessee would only include the amount that it is probable it will owe under the residual value guarantee at the end of the lease term. Accordingly, the lessee would not include any amount in the initial measurement of the lease liability and ROU asset, because the expected residual value is greater than the guaranteed amount. However, if the expected residual value of the asset subsequently decreased (e.g., to $4,000) and, accordingly, the lessee now believes that it is probable that it will make a payment under the residual value guarantee, the lessee would need to adjust the lease liability and the ROU asset to reflect the present value of the $5,000 expected to be owed.

Lessor Accounting

In the calculation of its lease receivable, the lessor would include the portion of the residual asset that is guaranteed by the lessee (or any other party). Accordingly, in addition to the present value of the five annual lease payments of $10,000, the lessor would include the present value of the $9,000 guaranteed amount in its calculation of the lease receivable. The lessor's net investment in the lease would consist of the total receivable (including the residual value guarantee) and the present value of the unguaranteed residual asset of $11,000. The lessor would not make any subsequent adjustments to its net investment in the lease for changes in the guaranteed residual value. However, changes in the unguaranteed residual value would be considered in the overall assessment of whether the net investment in the lease is impaired.

Editor's Note: As discussed above, under the new standard a lessee would include in its lease payments only those amounts related to a residual value guarantee that it is probable the lessee will owe at the end of the lease term. Lease arrangements (such as a synthetic lease arrangement) in which a significant portion of the lease payments are structured as a residual value guarantee could therefore result in ROU assets and lease liabilities that are significantly lower than those in arrangements in which more of the lessee's obligation takes the form of rents. For example, since many real estate assets are expected to hold their value over the lease term, amounts that it is probable the lessee will owe under residual value guarantees may be nominal. Accordingly, while these arrangements will be brought onto the balance sheet, synthetic leases and other lease arrangements in which a significant portion of lease payments are structured as a residual value guarantee may continue to yield favorable accounting results (e.g., reduced leverage) under the new leasing guidance.

Discount Rate

Under the ASU, the discount rate used by a lessee and a lessor is based on the information available as of the lease commencement date. A lessee should use the rate that the lessor charges in the lease (i.e., the rate implicit in the lease) if that rate is readily determinable. If the rate is not readily determinable, which is generally expected, the lessee should use its incremental borrowing rate as of the date of lease commencement. Lessors should use the rate they charge the lessee (i.e., the rate implicit in the lease) and are not required to reassess the discount rate used when there is a change in lease term. The discount rate must be updated by the lessee if there is a remeasurement of the lease liability unless the remeasurement results from changes in one of the following:

- The lease term or the assessment of whether a purchase option will be exercised, and the discount rate already reflects the lessee's option to extend or terminate the lease or purchase the asset.

- Amounts that it is probable the lessee will owe under a residual value guarantee.
- Lease payments resulting from the resolution of a contingency upon which some or all of the variable lease payments are based.

When there is a modification that does not result in a separate contract, a lessee and lessor would, in certain instances, be required to reassess the discount rate used when accounting for the modified lease. See the Lease Modifications section in Appendix B.

When measuring their lease liabilities, nonpublic business entities are permitted to make an accounting policy election to use the risk-free discount rate for all leases in lieu of their incremental borrowing rate. Using the risk-free rate would result in a larger lease liability and ROU asset.

Lessee Accounting

Initial Measurement

The initial measurement of a lease is based on an ROU asset approach. Accordingly, **all** leases (finance and operating leases) other than those that qualify for the short-term scope exception must be recognized as of the lease commencement date on the lessee's balance sheet. A lessee will recognize a liability for its lease obligation, measured at the present value of lease payments not yet paid (excluding variable payments) and a corresponding asset representing its right to use the underlying asset over the lease term. The initial measurement of the ROU asset would also include (1) initial direct costs (e.g., legal fees, consultant fees, commissions paid) that are directly attributable to negotiating and arranging the lease that would not have been incurred had the lease not been executed and (2) any lease payments made to the lessor before or at the commencement of the lease. The ROU asset would be reduced for any lease incentives received by the lessee (i.e., consideration received from the lessor would reduce the ROU asset).

Subsequent Measurement

Although the FASB and IASB agreed on the lessee's initial measurement of a lease, they differed on the lessee's subsequent measurement of the ROU asset as follows:

- *Dual-model approach (FASB)* — Lessees classify a lease as either a finance lease or an operating lease (see the Lease Classification discussion above).
- *Single-model approach (IASB)* — Lease classification is eliminated, and all leases are accounted for in a manner consistent with the accounting for finance leases under the FASB's approach.

Editor's Note: The FASB adopted a dual-model approach because it believes that all leases are not created equal; that is, some leases are akin to a financing arrangement for the purchase of an asset, while others are simply rental of the underlying property. By contrast, the IASB believes that the single-model approach (i.e., one that eliminates lease classification) has greater conceptual merit and reduces complexity.

Finance Leases

For finance leases, the lessee will use the effective interest rate method to subsequently account for the lease liability. The lessee will amortize the ROU asset in a manner similar to that used for other nonfinancial assets; that is, the lessee would generally depreciate the ROU asset on a straight-line basis unless another systematic method would be appropriate. Together, these expense components would result in a front-loaded expense profile similar to that of a capital lease arrangement under current U.S. GAAP. Entities would separately present the interest and amortization expenses in the income statement.

Operating Leases

For operating leases, the lessee will also use the effective interest rate method to subsequently account for the lease liability. However, the subsequent measurement of the ROU asset would be linked to the amount recognized as the lease liability (unless the ROU asset is impaired). Accordingly, the ROU asset would be measured as the lease liability adjusted by (1) any accrued or prepaid rents, (2) unamortized initial direct costs and lease incentives, and (3) impairments of the ROU asset. As a result, the total lease payments made over the lease term would be recognized as lease expense (presented as a single line item) on a straight-line basis unless another systematic method is more appropriate.

Editor’s Note: While the ASU discusses subsequent measurement of the ROU asset arising from an operating lease primarily from a balance sheet perspective, a simpler way to describe it would be from the viewpoint of the income statement. Essentially, the goal of operating lease accounting is to achieve a straight-line expense pattern over the term of the lease. Accordingly, an entity effectively takes into account the interest on the liability (i.e., the lease obligation consistently reflects the lessee’s obligation on a discounted basis) and adjusts the amortization of the ROU asset to arrive at a constant expense amount. To achieve this, the entity first calculates the interest on the liability by using the discount rate for the lease and then deducts this amount from the required straight-line expense amount for the period (determined by taking total payments over the life of the lease, net of any lessor incentives, plus initial direct costs, divided by the lease term). This difference is simply “plugged” as amortization of the ROU asset to result in a straight-line expense for the period. By using this method, the entity recognizes a single operating lease expense rather than separate interest and amortization charges, although the effect on the lease liability and ROU asset in the balance sheet reflects a bifurcated view of the expense. Note, however, that the periodic lease cost cannot be less than the calculated interest on the lease liability (i.e. the amortization of the ROU asset, or “plug” amount, cannot be negative).

Impairment

Regardless of the lease classification, a lessee would subject the ROU asset to impairment testing in a manner consistent with other long-lived assets. If the ROU asset for a lease classified as an operating lease is impaired, the lessee would amortize the remaining ROU asset under the subsequent measurement requirements for a finance lease — evenly over the remaining lease term unless another systematic method would be appropriate. In addition, in periods after the impairment, a lessee would continue to present the ROU asset amortization and interest expense as a single line item.

Example 5 — Lessee Expense Recognition: Differences Between Subsequent-Measurement Models

A lessee enters into a three-year lease and agrees to make the following annual payments at the end of each year: $10,000 in year 1, $15,000 in year 2, and $20,000 in year 3. The initial measurement of the ROU asset and liability to make lease payments is $38,000 at a discount rate of 8 percent.

The following table highlights the differences in accounting for the lease under the finance lease and operating lease approaches:

	Both Methods	Finance Lease Approach				Operating Lease Approach		
Year	Lease Liability[a]	Interest Expense <X>	Amortization Expense <Y>[b]	Total Lease Expense <X + Y>	ROU Asset	Lease Expense <Z>	Reduction in ROU Asset <Z − X> [c]	ROU Asset
0	$ 38,000				$ 38,000			$38,000
1	31,038	$ 3,038	$ 12,666	$ 15,704	25,334	$ 15,000	$ 11,962	26,038
2	18,520	2,481	12,667	15,148	12,667	15,000	12,519	13,519
3	—	1,481	12,667	14,148	—	15,000	13,519	—
Total		$ 7,000	$ 38,000	$ 45,000		$ 45,000	$ 38,000	

(a) The effective-interest method is used to calculate the lease liability, regardless of the type of lease.

(b) Under the finance lease approach, the ROU asset would be amortized in the same manner as other nonfinancial assets (i.e., typically straight-line).

(c) Under the operating lease approach, amortization expense is calculated as the difference between lease expense and interest expense.

Lessor Accounting

After proposing multiple different amendments to lessor accounting, the FASB ultimately decided to make only minor modifications to the current lessor model. The most significant changes align the profit recognition requirements under the lessor model with those under the FASB's new revenue recognition requirements and amend the lease classification criteria to be consistent with those for a lessee. Accordingly, the ASU requires a lessor to use the classification criteria discussed above to classify a lease, at its commencement, as a sales-type lease, direct financing lease, or operating lease:

- *Sales-type lease* — The lessee effectively gains control of the underlying asset. The lessor would derecognize the underlying asset and recognize a net investment in the lease (which consists of the lease receivable and unguaranteed residual asset). Any resulting selling profit or loss would be recognized at lease commencement. Initial direct costs would be recognized as an expense at lease commencement unless there is no selling profit or loss. If there is no selling profit or loss, the initial direct costs would be deferred and recognized over the lease term. In addition, the lessor would recognize interest income from the lease receivable over the lease term.

  In a manner consistent with ASC 606, if collectibility of the lease payments plus the residual value guarantee is not probable, the lessor would not record a sale. That is, the lessor would not derecognize the underlying asset and would account for lease payments received as a deposit liability until (1) collectibility of those amounts becomes probable or (2) the contract has been terminated or the lessor has repossessed the underlying asset. Once collectibility of those amounts becomes probable, the lessor would derecognize the underlying asset and recognize a net investment in the lease. If the contract has been terminated or the lessor has repossessed the underlying asset, the lessor would recognize the deposit liability and recognize a corresponding amount of lease income.

- *Direct financing lease* — The lessee does not effectively obtain control of the asset, but the lessor relinquishes control. This would occur if (1) the present value of the lease payments and any residual value guarantee (which could be provided entirely by a third party or consist of a lessee guarantee coupled with a third-party guarantee)[14] represents substantially all of the fair value of the underlying asset and (2) it is probable that the lessor would collect the lease payments and any amounts related to the residual value guarantee(s). The lessor would derecognize the underlying asset and recognize a net investment in the lease (which consists of the lease receivable and unguaranteed residual asset). The lessor's profit and initial direct costs would be deferred and amortized into income over the lease term.
- *Operating lease* — All other leases are operating leases. In a manner similar to current U.S. GAAP, the underlying asset remains on the lessor's balance sheet and is depreciated consistently with other owned assets. Income from an operating lease would be recognized on a straight-line basis unless another systematic basis would be more appropriate. That is, a lessor would recognize uneven fixed lease payments (step payments) on a straight-line basis only when the payments are uneven for reasons other than to reflect or compensate for market rentals or market conditions (e.g., when there is significant front-loading or back-loading of payments or when there are rent-free periods in a lease). This may have a significant effect on a lessor's recognition of revenue for operating leases, particularly those related to real estate. Any initial direct costs (i.e., those that are incremental to the arrangement and would not have been incurred if the lease had not been obtained) would be deferred and expensed over the lease term in a manner consistent with the way lease income is recognized.

Editor's Note: Under the FASB's model, the immediate recognition of any profit in the income statement is precluded if control of the asset has not been transferred to the customer in accordance with ASC 606 (i.e., control would not have transferred for direct financing and operating leases). Profit can exist in a direct financing lease, though it would be deferred and recognized over the lease term rather than recognized immediately. In contrast, under IFRS 16, a lessor is not required to evaluate whether the arrangement would qualify as a sale under IFRS 15 in determining whether it can recognize a profit at lease commencement.

Example 6 — Lessor Profit Recognition

A lessor leases equipment to a lessee. The leased asset has a carrying amount of $20,000 and a fair value of $25,000 at lease commencement. The terms of the lease are as follows:

Terms	
Lease term	8 years
Annual lease payments	$3,500 due at the end of each year
Estimated useful life of the underlying asset	12 years
Rate the lessor charges the lessee (implicit rate in the lease)	6.98%
Estimated residual value at the end of the lease term	$7,000

Ownership of the underlying asset does not transfer by the end of the lease, and there is no bargain purchase option. In addition, the leased asset is not specialized, and it is probable that the lessor will collect the lease payments and any amounts related to the residual value guarantee.

[14] If the present value of lease payments plus a lessee-provided residual value guarantee represents substantially all of the fair of the underlying asset, the lessor would classify the lease as a sales-type lease.

Example 6 — Lessor Profit Recognition (continued)

Scenario 1 — Lessee Residual Value Guarantee (Sales-Type Lease)

As part of the lease contract, the lessee guarantees the full residual value of the underlying asset that is expected at the end of the lease.

Analysis

In this scenario, the lessor would conclude that the lease represents a sales-type lease. The lessee effectively gains control of the underlying asset because the present value of the lease payments and the residual value guarantee provided by the lessee represent all of the fair value of the underlying asset, which satisfies one of the five classification criteria for a sales-type lease (i.e., the present value of the lease payments and the residual value guarantee represent substantially all of the asset's fair value). Since control of the underlying asset has effectively transferred to the lessee, the lessor would be permitted to recognize the profit at lease commencement.

Scenario 2 — Third-Party Residual Value Guarantee (Direct Financing Lease)

As part of its risk management program, the lessor obtains a third-party guarantee that the residual value of the underlying asset at the end of the lease will be equal to $7,000.

Analysis

In this scenario, the lessor would conclude that the lease represents a direct financing lease because the lessee **does not** effectively obtain control of the underlying asset. This is because the present value of the lease payments made by the lessee does not represent substantially all of the fair value of the underlying asset (i.e., the present value of the lease payments represents only 84 percent of the fair value of the asset). However, since the present value of the lease payments and the third-party residual value guarantee represent all of the fair value of the underlying asset, and it is probable that the lessor will collect the lease payments and any amounts related to the residual value guarantee, the lease is considered a direct financing lease. Because control of the underlying asset has not effectively transferred to the lessee, the lessor **would not** be permitted to recognize the profit at lease commencement.

Accordingly, although the lessor would derecognize the underlying asset, it would be required to defer the profit and recognize the profit at a constant periodic rate (as part of interest income) over the term of the lease.

Comparison of Sales-Type Lease and Direct Financing Lease

The following table illustrates the accounting for the lease under the sales-type and direct financing approaches:

	Sales-Type Lease			Direct Financing Lease	
Year	Net Investment in Lease (Balance Sheet)	Interest Income	Selling Profit	Net Investment in Lease (Balance Sheet)	Interest Income
0	$ 25,000		$ 5,000	$ 20,000	
1	23,244	$ 1,744		18,953	$ 2,453*
2	21,366	1,622		17,778	2,326
3	19,356	1,491		16,459	2,181
4	17,207	1,350		14,978	2,019
5	12,447	1,200		13,315	1,837
6	14,907	1,040		11,448	1,633
7	9,815	868		9,353	1,404
8	7,000	685		7,000	1,147
Total		$ 10,000	$ 5,000		$ 15,000

* Under the direct financing lease model, the lessor would not recognize the selling profit at lease commencement because the lease does not transfer control of the underlying asset to the lessee. Instead, the lessor would recognize the selling profit through higher interest income over the term of the lease.

Effective Date

The new guidance is effective for public business entities for annual periods beginning after December 15, 2018 (i.e., calendar periods beginning on January 1, 2019), and interim periods therein. For all other entities, the ASU is effective for annual periods beginning after December 15, 2019 (i.e., calendar periods beginning on January 1, 2020), and interim periods thereafter. Early adoption is permitted for all entities. Further, an entity's ability to early adopt the new guidance would not be linked to its adoption of ASC 606.[15]

Editor's Note: Since early adoption is permitted, an entity could conceivably adopt the new standard for its year ended December 31, 2015, if its financial statements have not yet been issued or been made available for issuance. While an entity may believe that there are certain benefits to early adopting (e.g., the ability to derecognize assets and liabilities that resulted from deemed ownership under existing build-to-suit accounting guidance), it should carefully consider the implications of doing so. For example, it will need to ensure that it has systems, processes, and controls in place to appropriately implement the new guidance (see Appendix F for more information). Further, if an entity adopts the ASU before the issuance of any formal implementation guidance, its accounting for lease transactions may differ from that of its peers and thus the risk of regulatory scrutiny may increase.

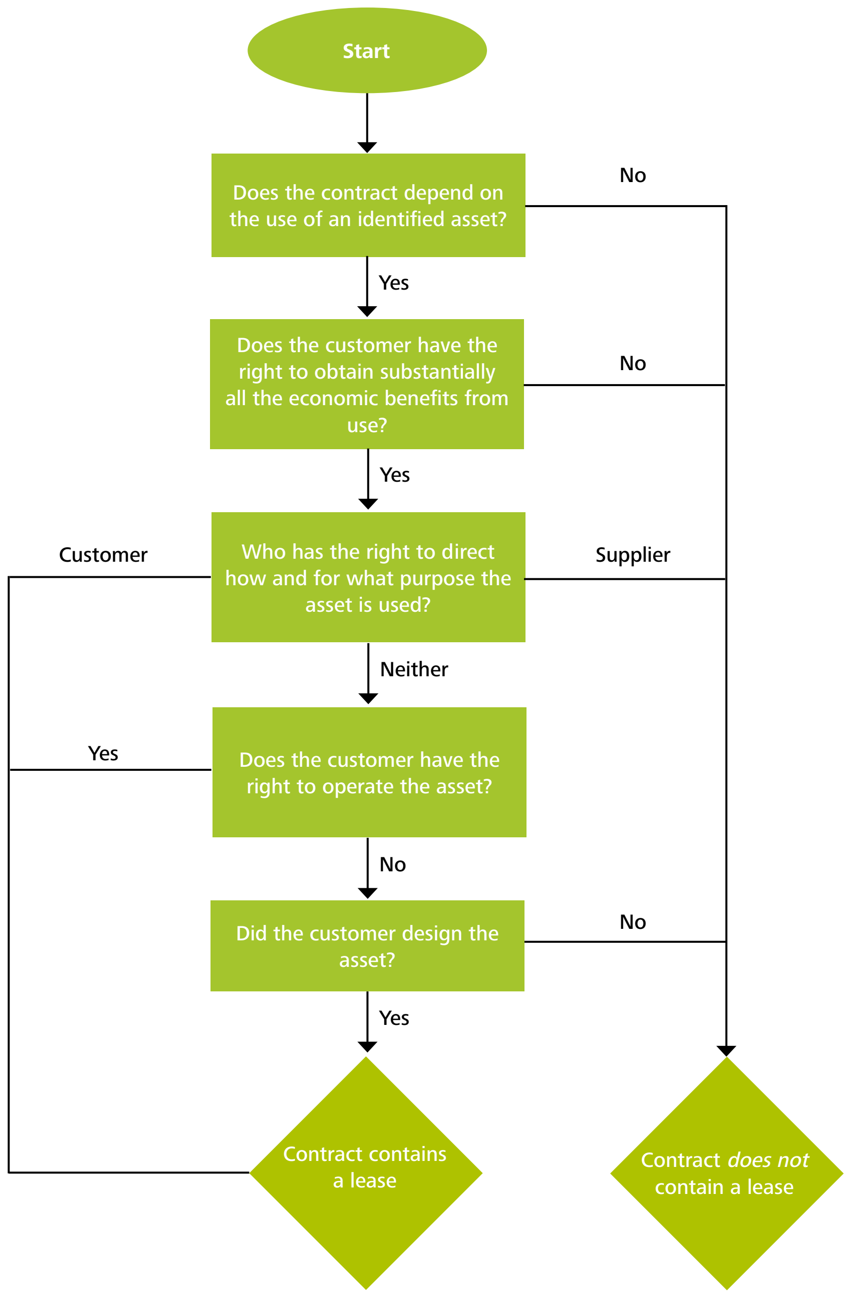
In addition, entities applying U.S. GAAP may adopt the new leases standard before they adopt the new revenue guidance (even though the new revenue standard has an earlier mandatory effective date). On the basis of discussions with the FASB staff, it is our understanding that such early adopters would be expected to apply the relevant guidance in the new revenue standard to the extent that it affects their lease accounting. They would wait to apply all other aspects of the new revenue standard until their full adoption of that standard.

[15] The effective date of IFRS 16 (the IASB's new leases standard) is similar to the FASB's effective date for public business entities. However, the IASB decided that an entity would only be allowed to early adopt IFRS 16 to the extent that the entity has also adopted IFRS 15 (the IASB's new revenue standard).

Appendix A — Evaluating Whether an Arrangement Is or Contains a Lease

The determination of whether an arrangement is or contains a lease is critical under the new requirements. If a lessee concludes that a contract is a service arrangement and not a lease, the lessee is not required to reflect the contract on its balance sheet. However, the lessee's balance sheet will need to reflect any lease arrangement that is not considered to be a short-term lease.

The following flowchart illustrates how to evaluate whether an arrangement is or contains a lease:



ASC 842-10-15-3 states that "[a] contract is or contains a lease if the contract conveys the right to control the use of identified [PP&E] (an identified asset) for a period of time in exchange for consideration." At the inception[16] of a contract, an entity should assess whether a contract is or contains lease. ASC 842-10-15-4 specifies that in determining whether the customer has the right to control the use of the identified asset, an entity would need to evaluate whether the customer has both:

- "The right to obtain substantially all of the economic benefits from use of the identified asset."
- "The right to direct the use of the identified asset."

[16] Lease inception is defined as the "date of the lease agreement or commitment, if earlier."

Use of an Identified Asset

Like current U.S. GAAP, the ASU requires a leased asset to be identifiable either explicitly (e.g., by a serial number) or implicitly (e.g., the only asset available to satisfy the contract). A distinct portion of a larger asset may be the subject of a lease (e.g., a floor of a building). However, a capacity portion of an asset would generally not meet the definition of a lease (e.g., 50 percent of an oil pipeline) unless the arrangement is for substantially all of the capacity of the asset. In addition, the ASU states that "[i]f the customer has the right to control the use of an identified asset for only a portion of the term of the contract," then only that portion of the term of the contract would be considered a lease.

Example A1 — Identified Asset

Scenario 1 — Contract Does Not Contain an Identified Asset

A company enters into a contract with a warehouse operator to store up to 1,000 pallets of spare parts inventory at one of the operator's warehouse locations for a three-year period. The operator's warehouse has capacity to store up to 10,000 pallets of inventory. During the contract period, the warehouse operator can use the remaining space in its warehouse for other storage needs. In addition, the warehouse operator can relocate the customer's pallets within the warehouse any time without incurring significant costs.

Because the customer does not have exclusive use of a specified portion of the warehouse, and the portion being used is not substantially all of the warehouse capacity, there is no identified asset. Although the contract specifies the amount of spare parts inventory that will be held, the warehouse operator can change the inventory's location within its warehouse at any time.

Scenario 2 — Contract Contains an Identified Asset

Assume the same facts as those above, except the 1,000 pallets represent substantially all of the capacity of the operator's warehouse, and the operator cannot relocate the inventory to a different facility.

Since the customer's storage requirement accounts for substantially all of the capacity of the operator's warehouse (more than 90 percent), the arrangement contains an identified asset.

Substitution Rights

An entity must also evaluate whether the supplier has the right to substitute the underlying asset with an alternative asset. If the supplier has substantive substitution rights, the asset in the arrangement would not be identified, and the arrangement would not be considered a lease. For a substitution right to be considered substantive, the following two conditions must be met:

- The supplier must have the "practical ability" to substitute the identified asset. The customer cannot prevent the supplier from substituting the asset, and alternative assets must be readily available to, or readily obtainable by, the supplier. A supplier's right (or obligation) to substitute alternative assets only if the asset is not operating properly would not meet this condition.
- The supplier must economically benefit from the substitution.

An entity should evaluate a substitution right by considering the facts and circumstances at the inception of the contract and would exclude from its assessment circumstances that are not likely to occur over the contract term. The entity should also consider the physical location of the asset. For example, it is more likely that the supplier will benefit from the substitution right if the identified asset is located at the supplier's rather than the customer's premises.

It may be difficult for a customer to determine whether the supplier's substitution right is substantive. For example, the customer may not know whether the substitution right gives the supplier an economic benefit. A customer would presume that a substitution right is not substantive if it is impractical to prove otherwise; accordingly, they must exercise significant judgment in making the determination.

Editor's Note: The requirement that a substitution right be economically beneficial to a supplier is a higher threshold than the requirements in current U.S. GAAP. Accordingly, we expect more arrangements to be subject to lease accounting under the new guidance.

Example A2 — Substantive Substitution Rights: Contract Does Not Contain a Substantive Substitution Right

Company A enters into an arrangement with Supplier B under which B will provide a customized Model 5000 copier to A for two years. Supplier B only has one customized Model 5000 copier. The arrangement allows B to replace the copier at will. However, if a replacement copier were needed, B would need several months to manufacture it. Since B only has one asset that can be used to satisfy the agreement with A and does not have the practical ability to substitute it, B's substitution right is not substantive.

Right to Control the Use of the Identified Asset

A lease differs from a service arrangement because in a lease, the customer effectively obtains control of the identified asset during the lease term. A customer has the right to control an asset if it has the right to do both of the following:

- Obtain substantially all of the economic benefits from the use of the identified asset.
- Direct the use of the identified asset.

Editor's Note: The notion of control under the new standard is closely aligned with that under the FASB's new revenue standard, which states that control is "the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset." However, the definition differs from the concept of control in consolidation guidance, under which design decisions are secondary to ongoing activities (e.g., those activities related to operations and maintenance). Design decisions and those related to operations and maintenance responsibilities have equal weight under the new leases standard.

Obtain Substantially All of the Economic Benefits From the Use of the Identified Asset

To control the use of an identified asset, the customer must have the right to obtain substantially all of the economic benefits from the use of the asset during the contract period. Economic benefits consist of direct or indirect benefits from the use of the asset (e.g., using, holding, or subleasing the asset) and include its primary output and its by-products (e.g., renewable energy credits from using the asset). Because a lease conveys only the right to use (and not ownership of) the underlying asset, benefits related to ownership of an asset (e.g., tax benefits) should not be included in the assessment of whether an arrangement contains a lease. Rather, this evaluation should be limited to those economic benefits resulting from the use of the asset during the contract period that can be realized from a commercial transaction with a third party.

Direct the Use of the Identified Asset

The evaluation of whether a customer has the right to direct the use of an identified asset should focus on the customer's ability to direct the activities that determine "how and for what purpose" the asset is used during the term of the contract. Factors to consider include whether the customer has the right to change (1) the type of output produced by the asset, (2) when the output is produced, (3) where the output is produced and (4) whether the output is produced. However, a requirement that protects the supplier's interest in the asset or related assets, or ensures that the customer complies with laws or regulations (e.g., a contract that specifies the maximum use of an asset or requires prudent operating practices), would not by itself prevent the customer from directing the use of the identified asset.

In situations in which neither the customer nor the supplier has the ability to determine "how and for what purpose" the asset is used during the contract period, the customer should consider whether the relevant decisions are predetermined by the contract or are based on the design of the underlying asset. If the relevant decisions are predetermined and the customer has the right to operate the asset or direct others to operate the asset — and the supplier cannot change the operating instructions — during the period of use, it is presumed that the customer has the ability to direct the use of the asset over the lease term. Similarly, if the customer's involvement in the design of the asset results in the predetermination of the most relevant decisions about "how and for what purpose" the asset is used over the contract term, then it is presumed that the customer controls the use of the asset.

Editor's Note: We anticipate that for certain industries the evaluation of control will require the use of significant judgment under the new standard, especially when the activities associated with the asset are predetermined. Although an entity may not have trouble determining whether the customer or supplier has control over the operating decisions related to the asset, the assessment of whether the customer designed the asset will often be more difficult given the different levels of influence a customer may have over the design decisions (e.g., siting, determining the technology to be used). Accordingly, an entity will need to use judgment when performing this evaluation.

For example, in a solar farm arrangement between a supplier and a utility company, the relevant decisions about how and for what purpose the assets are used are predetermined on the basis of the nature of the asset. Accordingly, the control evaluation would focus on whether the customer (the utility company) (1) has control over the operating decisions related to the asset (typically the operation and management will be performed by the asset owner (the supplier)) or (2) was involved in the decisions about the asset's design before contract inception.

Example A3 — Control of the Use of an Identified Asset

Scenario 1 — Customer Controls the Use of an Identified Asset

Customer A enters into a contract with Supplier B for the use of a specific ship for a four-year period. Supplier B is not permitted to substitute the ship. Customer A decides whether and what cargo will be transported and when and to which ports the ship will sail throughout the contract period, subject to certain restrictions. The restrictions prevent A from sailing the ship in waters where there is a high risk of piracy or from carrying hazardous materials as cargo. During the contract period, B operates and maintains the ship and is responsible for the safe passage of the cargo onboard the ship. Customer A is prohibited from hiring another operator for the ship during the term of the contract or operating the ship itself.

In this scenario, A has the right to control the use of the ship throughout the four-year contract period. That is, A has the right to obtain substantially all of the economic benefits from the use of the ship during the contract period through its exclusive use of the ship. Further, A has the right to direct activities related to the use of the ship because it decides where and when the ship will travel, what cargo it will carry, or whether it will be transporting cargo at any given time. While there are contractual restrictions about where the ship can sail and the nature of the cargo to be transported, these are protective rights and do not prevent A from having the right to direct the use of the asset.

Scenario 2 — Customer Does Not Control the Use of an Identified Asset

Customer A enters into a contract with Supplier B for the transportation of cargo from Greece to New York on a specified ship. The contract identifies the cargo to be transported on the ship as well as the route to be followed. During the contract term, B is responsible for the safe passage of the cargo and B's crew is responsible for operating and maintaining the ship (e.g., A cannot replace the crew under any circumstances).

Customer A **does not** have the right to control the use of the ship because it does not have the right to direct its use. That is, the activities related to the use of the ship during its trip from Greece to New York are predetermined in the contract. In addition, A does not have any decision-making rights about the operation of the ship during the period of use, nor was A involved in the ship's design.

Appendix B — Other Significant Provisions

Lease Modifications

Any change to the contractual terms and conditions of a lease that lead to a change in the scope of or consideration for the lease would be considered a lease modification. When assessing the changes, an entity should first evaluate whether the lease modification is to be accounted for as a separate contract (i.e., separately from the original lease). A lessee or lessor would account for a lease modification as a separate contract when, as a result of the modification, (1) the lessee is granted an additional ROU asset (physically distinct from the original ROU asset) and (2) the price of the additional ROU asset is commensurate with its stand-alone price (in the context of that particular contract). If the modification is considered a separate contract, the lessee or lessor would apply the new requirements to the separate contract.

Example B1 — Modification Resulting in a Separate Contract

Company A (lessee) enters into an arrangement to lease 15,000 square feet of retail space in a shopping mall for 20 years. At the beginning of year 10, A and the lessor agree to amend the original lease to include an additional 5,000 square feet of space adjacent to the existing space currently being leased when the current tenant vacates the property in 18 months. The increase in lease consideration as a result of the amendment is commensurate with the expected market rate for the additional 5,000 square feet of space in the shopping mall. Company A would account for this modification (i.e., the lease of the additional 5,000 square feet) as a separate contract because the modification provides A with a new ROU asset at a price that reflects its stand-alone price. While A would be required to disclose certain information about the lease modification, it would **not** be required to separately record any amounts in its statement of financial position until the separate lease's commencement date (i.e., 18 months from entering into the modification).

If the lease modification is **not a separate contract**, both the lessee and lessor would reassess the lease classification of the modified lease (by using the modified lease terms, including the discount rate as of the effective date of the modification). The lessee would account for the modification as follows:

Modification	Lessee's Accounting
Grants the lessee an additional ROU, changes the lease term (other than through the exercise of a contractual option), or results in a change to the lease consideration.	The lessee would use the updated lease payments and discount rate to revise the lease liability and would recognize any difference between the new lease liability and the old lease liability as an adjustment to the ROU asset.
Modification that reduces the scope of the original lease contract.	The lessee would adjust the lease liability by using the revised lease payments and an updated discount rate, derecognize a proportionate amount of the ROU asset, and recognize any difference as a gain/loss through earnings.

A lessee would subsequently account for the modified lease under the subsequent measurement guidance in the ASU (see discussion in the Subsequent Measurement section).

Example B2 — Modification Not Resulting in a Separate Contract

Company A (lessee) enters into an arrangement to lease 15,000 square feet in a shopping mall for 20 years. At the beginning of year 10, A and the lessor agree to amend the original lease by reducing the annual rental payments from $60,000 to $50,000 for the remaining 10 years of the agreement. Because the modification results in a change only to the lease consideration (i.e., the modification does not result in an additional ROU asset), A would remeasure its lease liability to reflect (1) a 10-year lease term, (2) annual lease payments of $50,000, and (3) A's incremental borrowing rate (or the rate the lessor charges the lessee if such rate is readily determinable) as of the modification's effective date. Company A would recognize the difference between the new and old lease liabilities as an adjustment to the ROU asset.

A lessor would account for a lease modification that is **not a separate contract** as follows:

Original Lease Classification	Lease Classification After the Modification	Lessor's Accounting
Operating lease	Operating lease	Any prepaid or accrued lease rentals are treated as a lease payment on the modified lease.
	Direct financing or sales-type lease	Any deferred rent liability or accrued rent asset is derecognized, and the selling profit or loss is adjusted accordingly (see the Lessor Accounting section for a discussion of the treatment of selling profit or loss for each type of lease).
Direct financing lease	Direct financing lease	The modification is accounted for prospectively by adjusting the discount rate.
	Sales-type lease	The profit or loss on the modification is the difference between the fair value of the underlying asset and the carrying value of the net investment in the lease immediately before the effective date of the modification.
	Operating lease	The modification is accounted for prospectively as an operating lease. The net investment in the lease is reclassified as the initial carrying value of the underlying leased asset.
Sales-type lease	Sales-type or direct financing lease	The modification is accounted for prospectively by adjusting the discount rate.
	Operating lease	The modification is accounted for prospectively as an operating lease. The net investment in the lease is reclassified as the initial carrying value of the underlying leased asset.

Contracts That Contain Multiple Components

An entity is required to identify the lease and nonlease components of a contract that contains a lease. A contract may also contain multiple lease components. The right to use an underlying asset is considered a separate lease component if (1) a lessee can benefit from the use of the underlying asset either on its own or with other resources that are readily available **and** (2) the underlying asset is not highly dependent on or highly interrelated[17] with other assets in the arrangement. Accordingly, a contract may include multiple lease components for different underlying assets.

Notwithstanding its requirement related to identifying lease components, an entity must account for the right to use land and other assets separately unless the effect of doing so would be insignificant to the overall accounting for the transaction (e.g., if a lease includes both land and a building component, and the entity concludes that each component would be classified as an operating lease, accounting for the two lease components together would be reasonable since the overall impact of accounting for the components together would be insignificant).

Editor's Note: When evaluating whether an activity should be considered a separate nonlease component, an entity should consider whether the activity transfers a separate good or service to the lessee. A component includes only those items or activities that transfer a good or service to the lessee. For example, in a real estate lease, maintenance services (including common-area maintenance services or CAM) and utilities paid for by the lessor but consumed by the lessee would be separate nonlease components because the lessee would have been required to otherwise contract for these services separately. However, payments for property taxes or insurance would most likely be considered part of the lease component because they do not transfer a separate good or service to the lessee. Such treatment could have the effect of inflating the lease liability since it would include amounts that are currently considered executory costs. From a practical standpoint, however, such amounts are frequently variable and therefore would not be included in the measurement of the lease liability.

[17] The ASU states that "[a] lessee's right to use an underlying asset is highly dependent on or highly interrelated with another right to use an underlying asset if each right of use significantly affects the other."

When a contract includes both lease and nonlease components, an entity is required to allocate the consideration in the contract to the various elements (except when a lessee is applying the practical expedient discussed below). The ASU provides separate guidance on how lessees and lessors should allocate these amounts.

Allocation by Lessees

Lessees need to first consider whether the stand-alone prices of the various components are observable. If each component has an observable stand-alone price, the lessee would base its allocation on the relative stand-alone price of each component. If only certain components have observable stand-alone prices, the lessee is permitted to estimate stand-alone prices by maximizing observable information for those items that do not have an observable stand-alone price. In addition, a lessee would allocate initial direct costs to the various components in a manner similar to its allocation of lease payments to each component.

Lessees are permitted to elect, as an accounting policy by class of underlying asset, not to separate lease components from nonlease components and instead account for the entire contract as a single lease component. However, when applying this election, a lessee would not be permitted to combine multiple lease components.

Allocation by Lessors

A lessor must consider the allocation guidance in ASC 606 to determine how to allocate the payments between the lease and nonlease components. That guidance allows a lessor to use an estimated selling price when no observable price exists. In addition, a lessor would allocate any capitalized costs, such as initial direct costs, to the components to which the costs are related.

Reallocation

Both lessees and lessors are required to reallocate the consideration in a contract when the contract is modified and the modification is not considered a separate contract. Lessees are also required to reallocate the consideration in the contract upon a reassessment of the lease term or a change in the likelihood that a purchase option will be exercised.

Contract Combinations

An entity is required to combine two or more contracts entered into at or near the same time with the same counterparty if any of the following criteria are met:

- The contracts are negotiated as a package with a single commercial objective.
- The amount of consideration to be paid in one contract depends on the price or performance of the other contract.
- The rights or some of the rights to use underlying assets conveyed in the contracts are a single lease component.

This guidance is generally consistent with the contract combination guidance in ASC 606.

Initial Direct Costs

In a manner consistent with the guidance in ASC 606, initial direct costs for both lessees and lessors would include only those costs that are incremental to the arrangement and would not have been incurred if the lease had not been obtained. This definition is considerably more restrictive than that under current requirements. For example, commissions paid and payments made to existing tenants to obtain the lease are considered initial direct costs, whereas allocated internal costs and costs to negotiate and arrange the lease agreement that would have been incurred regardless of lease execution (e.g., professional fees such as those paid for legal and tax advice) are not.

For sales-type leases, initial direct costs are recognized as an expense at lease commencement unless there is no selling profit or loss on the transaction. If there is no selling profit or loss, the initial direct costs are deferred and recognized over the lease term. For direct financing leases, a lessor would defer and include all initial direct costs in the initial measurement of the lease receivable. For operating leases, a lessor would defer the initial direct costs and amortize them as expenses over the term of the lease.

A lessee would include all initial direct costs in its initial measurement of the ROU asset.

Sale-and-Leaseback Transactions

The seller-lessee in a sale-and-leaseback transaction must evaluate the transfer of the underlying asset (sale) under the requirements in ASC 606 to determine whether the transfer qualifies as a sale (i.e., whether control has been transferred to the customer). The existence of a leaseback by itself would not indicate that control has not been transferred (i.e., it would not preclude the transaction from qualifying as a sale) unless the leaseback is classified as a finance lease. In addition, if the arrangement includes an option for the seller-lessee to repurchase the asset, the transaction would not qualify as a sale unless (1) the option is priced at the fair value of the asset on the date of exercise and (2) alternative assets exist that are substantially the same as the transferred asset and are readily available in the marketplace.

If the transaction does not qualify as a sale, the seller-lessee and buyer-lessor would account for the transaction as a financing arrangement (i.e., the buyer-lessor would account for its payment as a financial asset and the seller-lessee would record a financial liability).

Editor's Note: The ASU will significantly affect equipment sale-and-leaseback arrangements that include purchase options. Under current U.S. GAAP, a sale-and-leaseback transaction of equipment that includes a repurchase option may not result in a failed sale if there are no economic penalties reasonably ensuring that the repurchase option will be exercised. By contrast, under the ASU, any arrangement that includes a substantive repurchase option (e.g., a fixed-price purchase option) would be considered a failed sale because control of the underlying asset is not transferred to the purchaser.

Leaseback Accounting

If the transaction qualifies as a sale, the leaseback is accounted for in the same manner as all other leases (i.e., the seller-lessee and buyer-lessor would account for the leaseback under the new lessee and lessor accounting guidance, respectively).

Gain or Loss Recognition

If a transaction is based on "market" terms, the seller-lessee would immediately recognize the full amount of any gain or loss resulting from the sale (in a manner consistent with the treatment of sales of nonfinancial assets that do not involve a leaseback).[18] However, a transaction based on "off-market" terms would affect the calculation of the gain or loss. Specifically, the ASU requires a seller-lessee and a buyer-lessor to recognize off-market adjustments if there is a difference between (1) the sales price and fair value of the asset sold or (2) the present value of the contractual lease payments and the present value of the lease payments at fair market value. The seller-lessee would account for any difference either as an adjustment to the ROU asset or additional financing from the buyer-lessor that is separate from the lease liability. The buyer-lessor would recognize any difference as a prepayment of rent or additional financing to the seller-lessee that is separate from the lease receivable.

Accounting for Related-Party Leases

Lessees and lessors are required to account for related-party leasing arrangements on the basis of the legally enforceable terms and conditions of the lease rather than the substance of the arrangement. This is a significant change from current U.S. GAAP, under which a lessee and lessor would consider the substance of the contract as well as its legal form. The ASU requires a related-party lease to be accounted for in a manner similar to a lease between unrelated parties. Lessors and lessees are also required to disclose the information required by ASC 850 for all related-party lease arrangements.

Sublease Accounting

When the original lessee subleases the leased asset to an unrelated third party, the lessee becomes the intermediate lessor in the sublease arrangement. As the intermediate lessor of a leased asset, the entity would determine the classification of the sublease independently from its determination of the classification of the original lease (i.e., the head lease). Under the ASU, the intermediate lessor would classify the sublease on the basis of the underlying asset[19] (i.e., it would assess the term of the sublease

[18] By contrast, a seller-lessee applying IFRSs would only recognize gains resulting from the sale to the extent of the amount associated with the residual asset.

[19] The accounting for subleases under the new U.S. GAAP model differs significantly from that under IFRSs, which require the classification to be based on the remaining economic life of the ROU asset.

relative to the remaining economic life of the underlying asset). When evaluating lease classification and measuring the net investment in a sublease classified as a sales-type or direct financing lease, the original lessee (as a sublessor) should use the rate implicit in the lease if it is determinable. If the implicit rate is not determinable, the original lessee would use the discount rate that it used to determine the classification of the original lease.

In addition, offsetting is generally prohibited on the balance sheet and income statement unless the arrangement meets the offsetting requirements of ASC 210-20.

Example B3 — Accounting for a Sublease Under ASC 842

Company A, as lessee, entered into a building lease with a 30-year term. The building has a depreciable life of 40 years. At the end of year 5, A entered into an agreement with Company B under which B would sublease the building for 20 years.

As lessor, A would account for the lease to B (the sublease) as an operating lease because the term of the sublease is not for a major part of the remaining life of the *underlying asset* of the sublease (i.e., the sublease term of 20 years represents only 57 percent of the remaining 35-year life of the building), and A has concluded that no other classification criteria would result in the transfer of control of the underlying asset.

Build-to-Suit Arrangements

The ASU does not carry forward the requirements in current U.S. GAAP on lessee involvement in asset construction or "build-to-suit" leases. That guidance has long been criticized for being difficult to apply and punitive in nature. However, the new standard stipulates that an asset controlled[20] by a lessee during the construction period would be subject to sale-and-leaseback accounting upon completion of construction (i.e., the asset is effectively owned by the lessee during the construction period and is effectively sold — to the legal owner — and leased back upon completion of construction). The ASU provides guidance on how to account for certain costs incurred by the lessee related to the construction or design of the underlying asset if the lessee does not control the asset under construction. Costs incurred for goods or services provided to the lessee as well as other construction-related outflows or inflows for items such as loans, guarantees, and sales of component parts would be accounted for in accordance with other ASC topics.

Editor's Note: The ASU's Basis for Conclusions notes that (1) a lessee can be, and thus should assess whether it is, the owner of an asset under construction before lease commencement and (2) the assessment should be based on control (i.e., when the lessee controls the asset under construction). This is a departure from the requirements under current U.S. GAAP, which focus on construction risk assumed by a lessee, and is another example of the Board's effort to align the guidance on leases and revenue when appropriate. ASC 842-40 provides indicators of a lessee's control of an underlying asset that is under construction. Two of those indicators closely mirror those used by suppliers under ASC 606 to determine whether customers gain control of their work as they perform (i.e., as construction progresses). Under ASC 606, when a supplier's "performance creates or enhances an asset (for example, work in process) that the customer controls as the asset is created or enhanced," the supplier is satisfying its performance obligation over time. A lessee that controls an asset as it is created or enhanced by the supplier's performance owns the asset throughout the work in process and should therefore apply the sale-and-leaseback accounting guidance in ASC 842-40 upon lease commencement. ASC 842-40 also provides indicators of legal ownership of the asset under construction as well as control, through lease or ownership, of the underlying land.

However, it is important to differentiate control of an asset during construction from control of *the right to use an asset* during construction. The latter reflects the lease of an asset under construction, an arrangement that is specifically excluded from the scope of ASC 842.

Leasehold Improvements

In a manner consistent with current U.S. GAAP, a lessee would generally capitalize a leasehold improvement as a separate asset and amortize it over the shorter of its useful life and the remaining lease term. However, a lessee would amortize a leasehold improvement over its useful life (even if such life is longer than the lease term) if (1) the lease transfers ownership of the underlying

[20] ASC 842-40-55-5 provides indicators for lessees to consider when determining whether the lessee controls the underlying asset being constructed.

asset to the lessee at the end of the lease term or (2) it is reasonably certain that the lessee will exercise an option to purchase the underlying asset.

A leasehold improvement acquired in a business combination will be amortized over the shorter of its useful life or remaining lease term as of the acquisition date.

Accounting for Leases at a Portfolio Level

Lessees and lessors are permitted to apply the new lease guidance at a portfolio level if the resulting accounting would not be significantly different from that achieved when they apply the guidance on an individual-lease basis. This would apply to transition accounting as well as on a go-forward basis and is expected to be particularly useful for companies with a significant number of leases with similar economic characteristics. Applying the lease guidance at a portfolio level may facilitate the accounting when judgments or estimates are required under the model (e.g., using a single discount rate for an entire portfolio of leases may be appropriate if the resulting accounting would not be materially different from that resulting from the application of a unique discount rate to each individual lease).

Leveraged Lease Accounting

On the effective date of the new standard, leases previously classified as leveraged leases under ASC 840 would be subject to the guidance in ASC 842-50. This approach is generally consistent with the legacy accounting requirements for leveraged leases and effectively grandfathers that guidance. If a leveraged lease is modified after the ASU's effective date, it would be accounted for as a new lease under the standard's lessee and lessor models. Entities would not be permitted to account for any new lease arrangements as leveraged leases after the ASU's effective date.

Business Combinations

The ASU requires the acquiring entity in a business combination to retain the acquiree's previous lease classification. However, if the business combination results in changes to the contractual terms and conditions of the lease (i.e., a modification) and the modification is not accounted for as a separate contract, the acquirer would classify the lease on the basis of the modified terms. The initial measurement would be as follows:

- *Acquiree is a lessee* — In a manner similar to the short-term lease scope exception, an acquiring entity may, as an accounting policy election by asset class, choose not to recognize assets or liabilities related to acquired leases that have a remaining lease term of 12 months or less as of the acquisition date. For all other leases, the acquiring entity must initially measure (1) the lease liability at the present value of the remaining lease payments (as if the acquired lease were a new lease of the acquiring entity as of the acquisition date) and (2) an ROU asset at the same amount, adjusted to reflect favorable or unfavorable terms of the lease relative to market terms.
- *Acquiree is a lessor* — The initial measurement is based on the classification of the acquired lease:
    - *Operating lease* — The acquiring entity will recognize (separately from the underlying leased asset) (1) an intangible asset if the terms of the acquired lease are favorable relative to market terms and (2) a liability if the terms are unfavorable relative to market terms.
    - *Sales-type or direct financing leases* — The acquiring entity will measure its net investment in the lease (total lease receivable and unguaranteed residual asset) at the fair value of the underlying asset as of the acquisition date. The terms of the lease (favorable or unfavorable) relative to market terms should be considered in the calculation of the underlying asset's acquisition-date fair value.

Appendix C — Presentation Requirements

ASU 2016-02 contains presentation requirements for lessees and lessors that are based on the classification of the lease agreement.

Lessee Presentation Requirements

Statement of Financial Position

An entity is required to present in the statement of financial position, or disclose in its notes to the financial statements, ROU assets and liabilities resulting from finance leases and operating leases. These assets and liabilities should be presented or disclosed separately from each other and from other assets and liabilities. Further, the lessee is required to separately present the current and noncurrent portions of the ROU asset and lease liability.

> **Editor's Note:** The ASU's separate presentation requirement for finance and operating leases may be viewed favorably by preparers because it may reduce an entity's exposure to potential debt covenant violations that could have resulted if all lease liabilities were required to be characterized as debt. See Appendix F for more information.

Statement of Comprehensive Income

Lessees would present the expense related to their lease arrangements as follows:

- *Finance leases* — Interest expense on the lease liability and amortization of the ROU asset would be presented in a manner consistent with the lessee's presentation of interest expense related to its other liabilities and depreciation or amortization of similar assets, respectively. Variable lease payments would be included as an expense in the lessee's income from continuing operations.
- *Operating leases* — Lease expense is included in the lessee's income from continuing operations as a single lease expense amount.

> **Editor's Note:** Entities will need to consider the effect of their lease classification on certain financial statement metrics and non-GAAP measures, such as earnings before interest, taxes, depreciation, and amortization (EBITDA). The interest and amortization expense resulting from a finance lease would typically be excluded from an entity's calculation of EBITDA. By contrast, the entity's EBITDA calculation would include its expense resulting from an operating lease (which is classified as an operating expense in the statement of comprehensive income). Entities should also consider the effects of these changes on other business arrangements such as, for example, employee compensation plans tied to earnings metrics.

Statement of Cash Flows

The presentation of cash flows generally depends on whether the lease is a finance lease or an operating lease:

- *Finance leases* — Payments of principal and interest are presented as cash outflows from financing and operating activities, respectively.
- *Operating leases* — Operating lease payments are presented as cash outflows from operating activities.

However, irrespective of lease classification, both variable lease payments that are not included in the lease liability and payments on short-term leases are presented as cash outflows from operating activities. Further, any cash flows resulting from lease payments used to bring another asset to its intended location for its intended use would be classified in investing activities.

Lessor Presentation Requirements

Statement of Financial Position

A lessor's presentation of a lease agreement depends on whether the lease is a sales-type lease, direct financing lease, or an operating lease:

- *Sales-type and direct financing leases* — The net investment in a lease is separately presented in the statement of financial position.
- *Operating leases* — The underlying asset subject to an operating lease is presented in accordance with other ASC topics (e.g., ASC 360).

Statement of Comprehensive Income

All income resulting from a lease is separately presented in the statement of comprehensive income or disclosed in the notes. An entity that does not separately present lease income in the statement must disclose where in the statement it is included. In addition, any profit or loss resulting from a lease should be recognized at lease commencement in a manner consistent with the lessor's business model (e.g., gross revenue and cost of goods as opposed to profit and loss in a single line item).

Editor's Note: Because the ASU allows a lessor to present profit or loss resulting from a lease in a manner consistent with its business model, the lessor may present such amounts on a gross or net basis. This presentation flexibility is designed to reflect institutions' various business models. For example, a manufacturing entity may enter into a leasing arrangement as opposed to selling directly to customers, whereas a financial institution may enter into a leasing arrangement as a means of providing financing. The standard also acknowledges that a lessor with multiple business models could present profit or loss resulting from leases on a gross or net basis depending on the particular model the lease is related to.

Statement of Cash Flows

Regardless of lease classification, cash inflows related to a lease are presented as cash inflows from operating activities.

Appendix D — Disclosure Requirements

The objective of ASU 2016-02's disclosure requirements is to help financial statement users understand the amounts, timing, and uncertainties of cash flows related to a lease. An entity is required to disclose certain qualitative and quantitative information about its leases, judgments used in applying the leasing guidance, and the related amounts recognized in the financial statements.

Lessee Disclosures

Qualitative Disclosures

A lessee should disclose:

- Information about the nature of its leases and subleases (general description of the lease, variable lease payments, renewal or termination options, residual value guarantees, and restrictions imposed by the lease).
- Leases that have not yet commenced but give the lessee significant rights or impose significant obligations, including the nature of any involvement in the design or construction of the underlying asset.
- Significant assumptions and judgments used in applying the leases standard.
- Main terms and conditions of any sale-and-leaseback transactions.
- Lease transactions with related parties.
- Accounting policy regarding short-term leases.
- Accounting policy election of the practical expedient not to separate lease and nonlease components.

Quantitative Disclosures

A lessee should disclose the following amounts for each period presented (regardless of whether the amounts are capitalized as part of another asset):

- Finance lease costs (i.e., amortization of the ROU asset and interest on the lease liability).
- Operating lease costs.
- Short-term lease costs (except for leases with a term of one month or less).
- Variable lease costs.
- Sublease income, disclosed on a gross basis.
- Gain or loss resulting from sale-and-leaseback transactions.

A lessee should disclose the following amounts separately for its operating and finance leases:

- Separate maturity analyses of its operating lease liabilities and finance lease liabilities (undiscounted cash flows for each of the next five years and a total of the amounts for the remaining years, reconciled to the amounts presented in the statement of financial position).
- Cash paid for amounts included in its determination of lease liabilities (segregated between operating and financing cash flows).
- Supplemental noncash information on lease liabilities arising from obtaining ROU assets.
- Weighted-average remaining lease term.
- Weighted-average discount rate.

For a complete list of the disclosure requirements for lessees, see ASC 842-20-50 and ASC 842-40-50 in the ASU.

Lessor Disclosures

Qualitative and Quantitative Disclosures

A lessor is required to disclose certain qualitative and quantitative information, including:

- Information about the nature of its leases (general description of the lease, variable lease payments, renewal, purchase or termination options).
- Significant assumptions and judgments used in the application of leases guidance.
- Lease transactions with related parties.
- A tabular disclosure of lease-related income, including:
  - Profit and loss recognized at lease commencement for sales-type and direct financing leases.
  - Interest income.
  - Income from variable lease payments not included in the lease receivable.
- The components of the net investment in sales-type and direct financing leases, including the carrying amount of the lease receivable, the unguaranteed residual asset, and any deferred profit on direct financing leases.
- Information about how the entity manages its exposure to risk associated with the residual value of its leased assets.
- A maturity analysis for operating lease payments and a separate maturity analysis for the lease receivable (sales-type and direct financing leases). The maturity analysis should show the undiscounted cash flows to be received in each of the next five years after the reporting date, and a total of the amounts for the years thereafter. The maturity analysis of the lease receivable should be reconciled to the lease receivable balance.
- The information required by ASC 360 for all assets that are subject to an operating lease, presented separately from similar owned assets.

For a complete list of the disclosure requirements for lessors, see ASC 842-30-50 and ASC 842-50-50 (on leveraged lea"eses) in the ASU.

Appendix E — Transition

Transition Requirements

Lessees and lessors[21] are required to use a modified retrospective transition method for existing leases. Accordingly, they would apply the new accounting model for the earliest year presented in the financial statements. The application of this approach is directly linked to the current lease classification under ASC 840 and the new lease classification under ASC 842.

Lessee Requirements

The following table summarizes ASU 2016-02's modified retrospective transition requirements for lessees:

		Current U.S. GAAP (ASC 840)	
		Operating Lease	Capital Lease
New Model (ASC 842)	Operating lease	• Recognize an ROU asset and lease liability at the later of (1) the beginning of the earliest year presented or (2) the lease commencement date. • Measure a lease liability as the present value of the remaining lease payments and expected residual value guarantee discounted by using a rate determined at the later of (1) the beginning of the earliest year presented or (2) the lease commencement date. • Measure an ROU asset equal to the lease liability, adjusted for prepaid/accrued rent, unamortized initial direct costs, impairment of the ROU asset, and the carrying amount of any liability recognized under ASC 420 (i.e., related to exit or disposal cost obligations). • Write off as an adjustment to equity any unamortized initial direct costs that do not meet the ASU's definition of initial direct costs.	• Derecognize the capital lease asset and lease obligation at the later of (1) the beginning of the earliest year presented or (2) the lease commencement date. Any difference between the amounts derecognized would be accounted for similarly to prepaid or accrued rent. • Recognize an ROU asset and lease liability by using (1) the ASU's initial measurement guidance for leases entered into after the beginning of the earliest period presented or (2) the ASU's subsequent measurement guidance that applies to leases entered into before the beginning of the earliest year presented. • Write off as an adjustment to equity any unamortized initial direct costs that do not meet the ASU's definition of initial direct costs.
	Finance lease	• Recognize an ROU asset and lease liability at the later of (1) the beginning of the earliest year presented or (2) the lease commencement date. • Measure a lease liability as the present value of the remaining lease payments and expected residual value guarantee discounted by using a rate determined at the later of (1) the beginning of the earliest year presented or (2) the lease commencement date. • Measure an ROU asset equal to a proportion of the lease liability as of the commencement date, adjusted for the carrying amount of previously recognized prepaid or accrued lease payments and the carrying amount of liabilities recognized under ASC 420. The proportionate amount is based on the remaining lease term (as of the beginning of the earliest period presented) relative to the total lease term. • Write off as an adjustment to equity any unamortized initial direct costs that do not meet the ASU's definition of initial direct costs.	• Recharacterize the capital lease asset as an ROU asset as of the later of (1) the beginning of the earliest year presented or (2) the lease commencement date. • Include in the ROU asset established at transition any unamortized initial direct costs that meet the ASU's definition of initial direct costs. • Write off as an adjustment to equity any unamortized initial direct costs that do not meet the definition of such costs in ASC 842 and are not included in the measurement of the capital lease asset under ASC 840.

Note that there are additional considerations under ASC 842-10-65-1 for modifications of a lease that occur on or after the standard's effective date and do not result in a separate contract.

[21] Lessors must account for leveraged leases under the requirements in ASC 842-50, which are similar to the current requirements in ASC 840 for leveraged leases. However, if the leveraged lease is modified, it would be accounted for as a new lease.

Example E1 — Lessee Transition

A lease with the following terms was accounted for as an operating lease under current U.S. GAAP:

Lease term:	10 years (January 1, 2013, through December 31, 2022).
Adoption date:	January 1, 2019 (beginning of year 7 (4 years remaining)).
Lease payments:	$100 in years 1 through 5; $120 in years 6 through 10 (payments occur at the end of the year).
Discount rate:	4 percent (January 1, 2017).

The table below illustrates the adjustments made to the financial statements as a result of the adoption of the ASU if (1) the lease continues to be classified as an operating lease and (2) the lease is classified as a finance lease.

	Operating Lease				Finance Lease			
	Lease Liability	ROU Asset	Reversal of Straight-Line Accrual	Retained Earnings/ Net Income	Lease Liability	ROU Asset	Reversal of Straight-Line Accrual	Retained Earnings/ Net Income
Adjustment on 1/1/2017 (earliest period presented)	$ 610[(a)]	$ 570[(b)]	$ 40[(g)]	$ 0	$ 610[(a)]	$ 490[(c)]	$ 40[(g)]	$ 80
12/31/2017	534[(d)]	484[(e)]		110	534[(d)]	408[(f)]		106
12/31/2018	436[(d)]	396[(e)]		110	436[(d)]	326[(f)]		103

(a) The lease liability is calculated as the present value of the remaining lease payments ($120 for 5 years and one year at $100 discounted at 4 percent).

(b) The ROU asset under the operating lease model is calculated at the initial amount of the lease liability adjusted for the previously recorded straight-line accrual of $40 (i.e., $570 = $610 – $40).

(c) The ROU asset under the financing approach is calculated in proportion (6 of 10 years remaining) to the lease liability as of the commencement date (present value of all lease payments or $884), reduced by the straight-line accrual of $40 (i.e., $490 = [($884 × 6 ÷ 10) – $40)].

(d) The lease liability is subsequently calculated by using the effective interest method.

(e) The ROU asset is subsequently measured at an amount equal to the lease liability, adjusted for the accrued lease expense of $50 on 12/31/2017 and $40 at 12/31/2018. This results in a straight-line expense of $110 per year.

(f) The ROU asset is subsequently amortized on a straight-line basis ($490 over 6 years or $82 per year).

(g) This amount represents the straight-line lease accrual that results from recording a straight-line annual lease expense of $110 per year for the four years from 2013 to 2016 compared to lease payments totaling $400 during that period.

Lessor Requirements

The following table summarizes the ASU's modified retrospective transition requirements for lessors:

<table>
<tr><th></th><th></th><th colspan="2">Current U.S. GAAP (ASC 840)</th></tr>
<tr><th></th><th></th><th>Operating Lease</th><th>Direct Financing or Sales-Type Lease</th></tr>
<tr><td rowspan="2">New Model (ASC 842)</td><td>Operating lease</td><td>• Continue to recognize the carrying amount of the underlying asset and any lease assets or liabilities at the later of (1) the initial application date or (2) the lease commencement date.
• Write off as an adjustment to equity any unamortized initial direct costs that do not meet the ASU's definition of initial direct costs.</td><td>As of the later of (1) the beginning of the earliest period presented or (2) the lease commencement date:
• Recognize an underlying asset at the carrying amount that would have existed had the lease been classified as an operating lease under ASC 840.
• Derecognize the carrying amount of the net investment in the lease.
• Recognize as an adjustment to equity the difference between the newly recognized asset and the derecognized net investment.</td></tr>
<tr><td>Direct financing or sales-type lease</td><td>As of the later of (1) the beginning of the earliest period presented or (2) the lease commencement date:
• Derecognize the carrying amount of the underlying asset.
• Recognize a net investment in the lease as if the lease had been accounted for as a direct financing lease or sales-type lease since lease commencement.
• Recognize as an adjustment to equity the difference between the newly recognized net investment and the derecognized asset.</td><td>• Continue to recognize a net investment in the lease, at the later of (1) the beginning of the earliest period presented or (2) the lease commencement date, at the carrying amount at that date.
• Before the effective date of the new guidance, the lease should be accounted for under ASC 840.
• Beginning on the effective date, the lease should be accounted for under the ASU.</td></tr>
<tr><td colspan="4">Note that there are additional considerations under ASC 842-10-65-1 for modifications of a lease that occur on or after the standard's effective date and do not result in a separate contract.</td></tr>
</table>

Transition Relief

The ASU offers relief from implementing the standard's transition provisions by permitting an entity (lessee or lessor) to elect not to reassess:

- Whether any expired or existing contract is a lease or contains a lease.
- The lease classification of any expired or existing leases.
- Initial direct costs for any existing leases.

An entity that elects transition relief is required to adopt all three relief provisions and is prohibited from applying the relief on a lease-by-lease basis. In addition, the entity must disclose that it has elected the transition relief package. Separately, the entity is also allowed to use hindsight in its evaluation of the lease term (e.g., renewal, termination, and purchase options for existing leases).

Editor's Note: Electing the transition relief may significantly reduce the burden of adopting the new standard since entities would not be required to revisit old lease contracts and related documentation to reevaluate whether such arrangements meet the new definition of a lease or how to classify them under the ASU. Such an election does not, however, relieve an entity from its obligation to address any errors that may have resulted from the misapplication of past accounting (e.g., improperly accounting for an arrangement as a service rather than a lease or inappropriately classifying a lease as an operating lease rather than a capital lease).

Sale-and-Leaseback Transactions

An entity is required to reassess its conclusion that a sale that was part of a failed sale-and-leaseback transaction continues to be disqualified from the application of sale accounting under ASC 606 upon transition as long as the transaction is still considered to be a failed sale as of the effective date of the new lease accounting guidance. In addition:

- The seller in a sale-and-capital-leaseback transaction is required to recognize any deferred gain or loss that exists as of the later of (1) the earliest period presented or (2) the date of the sale of the underlying asset as follows:
    - If the underlying asset is land only, on a straight-line basis over the remaining lease term.
    - If the underlying asset is not land only and the leaseback is a finance lease, in proportion to the amortization of the ROU asset.
    - If the underlying asset is not land only and the leaseback is an operating lease, in proportion to the total lease cost.
- The seller in a sale-and-operating-leaseback transaction is required to recognize any deferred gain or loss resulting from off-market terms as an adjustment to the leaseback ROU asset (loss) or lease liability (gain) as of the date of initial application. The seller is required to recognize any deferred gain or loss not resulting from off-market terms as a cumulative-effect adjustment to opening equity (if the transaction occurred before the earliest year presented) or earnings in the comparative period (if the transaction occurred within one of the comparative periods presented).

Build-to-Suit Lease Arrangements

The ASU supersedes current guidance on build-to-suit arrangements. A lessee must apply the modified retrospective transition approach to such arrangements. Accordingly, it should derecognize assets and liabilities from build-to-suit transactions under ASC 840 (those assets and liabilities that arose because the lessee was deemed the owner during construction and could not be derecognized under the legacy sale-and-leaseback requirements) as of the later of (1) the earliest financial statement period presented or (2) the date on which the entity was deemed the accounting owner. Any differences between the assets and liabilities derecognized would be recorded as an adjustment to equity on that date. Further, if the construction period ended before the earliest comparative period presented, and the transaction subsequently qualified for and was accounted for as a sale-and-leaseback transaction, the entity should consider the general lessee transition requirements.

Business Combinations

On the effective date of the new guidance, any assets and liabilities related to favorable or unfavorable terms of an operating lease that resulted from prior business combinations would be derecognized upon transition (except for those arising from operating leases under which the entity is a lessor). A lessee would adjust the carrying amount of the ROU asset by a corresponding amount. By contrast, a lessor would make a corresponding adjustment to equity at the beginning of the earliest comparative period presented for its leases that are classified as sales-type or direct financing under ASC 840.

Appendix F — Implementation Considerations

Application of Judgment and Estimation

Entities must apply judgment and make estimates under a number of the new (as well as current) leases requirements. Judgment is often required in the assessment of a lease's term, which would affect whether the lease qualifies for the short-term exemption and therefore for off-balance-sheet treatment. In addition, since almost all leases will be recognized on the balance sheet, an entity's judgment in distinguishing between leases and services becomes more critical under the new guidance.

Editor's Note: In particular, upon transition, entities will need to recognize ROU assets and lease obligations by using an appropriate discount rate on the date of transition (see Appendix E for additional considerations). Compliance with this requirement may be difficult for entities with a significant number of leases since they will need to identify the appropriate incremental borrowing rate for each lease on the basis of factors associated with the underlying lease terms (e.g., lease tenor, asset type, residual value guarantees). In other words, entities would not be permitted to use the same discount rate for all of their leases unless the leased assets and related terms are similar in nature.

Data Management

Entities may have numerous lease agreements at multiple decentralized locations and may, in many instances, maintain their lease data in spreadsheets or physical documents. Consequently, collecting and abstracting the data may be time-consuming and resource-intensive. Further, even if entities already have such information in an electronic format, it may reside in disparate systems or need to be enhanced to ensure that it complies with ASU 2016-02's accounting and disclosure requirements.

In addition, entities may need to gather information required by the ASU that may not be contained in lease agreements. For example, entities may need to acquire information about (1) the fair value of an asset, (2) the asset's estimated useful life, (3) the incremental borrowing rate, and (4) certain judgments related to lease options. Acquiring this data may be particularly challenging for multinational entities whose lease documentation may be prepared in a foreign language and could also vary as a result of local business practices.

As entities identify and collect the data they need for compliance with the ASU's requirements, they should also consider the challenges of ongoing data maintenance. Data gathering and abstraction efforts may take many months to complete, during which time new leases will be executed, renewed, modified, or terminated. Accordingly, management will need to establish an approach to data maintenance and controls during the implementation period and beyond.

Given the relationship between lease maturity disclosures under current guidance and lease liabilities that will be recognized upon adoption of the ASU (and will be subject to modified retrospective transition, which will affect 2017 financial reporting), we believe that in preparing their December 31, 2016, financial statements, entities should strive to ensure that they have identified a complete population of leases.

Information Technology Systems

As a result of implementing the ASU's requirements, entities will most likely need to enhance their existing information technology systems. The extent of such enhancements will be based on the size and complexity of an entity's lease portfolio and its existing leasing systems. As with any change to existing systems, an entity will need to consider the business ramifications (i.e., the potential impact on existing processes, systems, and controls) and the requirements of system users (e.g., the entity's legal, tax, financial planning and analysis, real estate, treasury, and financial reporting functions).

Also, management may need to consider system changes that will enable the entity to estimate, before adoption, the ASU's effect on key performance indicators and metrics, tax filings, debt covenants, or other filings. In addition, to the extent that an entity prepares IFRS statutory reports for foreign subsidiaries, its systems will need to distinguish between the ASU and IFRS 16 and be equipped to handle the differences between the two standards.

Internal Controls and Business Process Environment

To a significant extent, current lease data systems are used for operational purposes and thus some aspects of the related internal controls may be outside of the scope of the internal control requirements of the Sarbanes-Oxley Act of 2002. Given the increased relevance of leasing data to the financial statements as a result of the ASU, entities may face additional scrutiny from auditors and regulators regarding the design and effectiveness of associated controls. Accordingly, entities will need to examine their internal controls related to their processes for capturing, calculating, and accounting for their leases. If additional internal controls or processes are needed, entities may also need to issue organizational communications and establish change management and employee training programs.

In addition, during their implementation of the standard, entities may identify opportunities for potential enhancements to their current processes to achieve future operational efficiencies. For example, entities may seek to automate manually intensive processes or consider organizational changes such as a shared services model.

Debt Covenants

Given the requirement to bring most leases on the balance sheet, many entities will reflect additional liabilities in their balance sheets after adopting the ASU. Such entities should determine whether the increased leverage will negatively affect any key metrics or potentially cause debt covenant violations. This may depend in part on how various debt agreements define and limit indebtedness as well as on whether the debt agreements use "frozen GAAP" covenants. The ASU requires entities to present operating lease liabilities outside of traditional debt, which may provide relief to some entities. Nevertheless, we believe that it will be critical for all entities to determine the ASU's potential effects on debt covenants and begin discussions with lenders early if they believe that violations are likely to occur as a result of adopting the ASU.

Income Taxes

A lease's classification for accounting purposes does not affect its classification for tax purposes. An entity will therefore continue to be required to determine the tax classification of a lease under the applicable tax laws. While the classification may be similar for either purpose, the differences in tax and accounting principles and guidance often result in book/tax differences. Thus, once an entity implements the new standard, it will need to establish a process to account for these differences.

The ASU's requirement for entities to reevaluate their leases under the new guidance presents an opportunity for them also to reassess the tax treatment of such leases as well as their data collection and processes. Since the IRS considers a taxpayer's tax treatment of leases to be a method of accounting, any changes to existing methods may require IRS consent.

Entities should also consider the potential state tax issues that may arise as a result of the new guidance, including how the classification of the ROU asset may affect the apportionment formula in the determination of state taxable income and how the significant increase in recorded lease assets could affect the determination of franchise tax payable.

> **Editor's Note:** Since the potential tax implications are many and varied, it is essential for a company's tax department to be involved in the evaluation of the lease standard as well as in discussions related to policy adoption and system modifications.

Getting Started

Entities should develop a robust plan and establish a cross-functional implementation team to ensure an efficient and timely approach to implementation. In developing such a plan, they should consider doing the following:

- Performing a current-state assessment of their lease portfolio, including lease volume and types, availability of electronic lease data and data gaps, and any potential challenges related to accounting, taxes, or processes.
- Establishing a project plan for managing the implementation effort for multiple functions, business units, and countries, as necessary.

- Developing an approach to, and resources to perform, the abstraction of lease data.
- Determining their specific system requirements and developing a plan for enhancing system capabilities to satisfy the new storage, calculation, and reporting requirements while keeping in mind the associated internal control implications.
- Assessing the effect of the ASU on their key metrics and debt covenants.

By planning properly, entities can help ensure that their transition to the new leases standard is smooth and successful.

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29 July 2015

Technical Line

FASB — final guidance

Applying the new revenue recognition standard to sales of real estate

In this issue:

What you need to know

- Entities will apply the new revenue recognition standard to revenues from sales of real estate to customers.
- When it issued the new standard, the FASB amended other parts of the ASC to address the accounting for the sale of certain nonfinancial assets, including real estate, to noncustomers.
- Entities will need to apply the recognition and measurement principles in the new standard (including estimating variable consideration) to account for gains or losses resulting from the sale of real estate to noncustomers.
- Entities that sell real estate will generally recognize a gain or loss when they transfer control of a property. They will no longer have to apply the prescriptive real estate sales criteria, including evaluation of the buyer's initial and continuing investments and the seller's continuing involvement with the property.

Overview

As part of Accounting Standards Update (ASU) 2014-09, *Revenue from Contracts with Customers*, the Financial Accounting Standards Board (FASB) issued consequential amendments to other sections of the Accounting Standards Codification (ASC or Codification) that will require entities to change how they account for sales of real estate. These amendments include the elimination of existing guidance in ASC 360-20, *Real Estate Sales*, and the addition of ASC 610-20, *Other Income — Gains and Losses from the Derecognition of Nonfinancial Assets*.

Building a better working world

Revenues from sales of real estate to customers (i.e., sales that are part of the seller's ordinary activities) will be recognized using the guidance in ASC 606, *Revenue from Contracts with Customers*. However, entities that sell real estate assets to noncustomers[1] will generally account for these transactions using the guidance in ASC 610-20, which directs entities to apply certain control and measurement principles of ASC 606. These new standards will only be applied by sellers of real estate; purchasers will continue to use existing guidance (e.g., ASC 360-10, *Property, Plant, and Equipment* or ASC 805, *Business Combinations)*.

The elimination of today's guidance for sales of real estate in ASC 360-20 will be a major change for all real estate entities. ASC 360-20 is a complex, rules-based standard that requires entities to evaluate both the form and economic substance of a transaction. For some transactions, the application of ASC 360-20 results in the deferral of sale and/or profit recognition when certain criteria are not met.

The new guidance in ASC 606 and ASC 610-20 replaces the prescriptive literature in ASC 360-20 with a principles-based approach that will require entities to make a number of judgments and estimates. Under the new guidance, entities will generally recognize the sale, and any associated gain or loss, of a real estate property when control of the property transfers.

This publication discusses the implications of applying the recognition and measurement principles of ASC 606 and ASC 610-20 to sales of real estate. Throughout this publication, we compare the accounting for several common real estate sale transactions under the new guidance with the accounting under today's guidance in ASC 360-20.

In our discussion and in many of our examples, we use terminology from ASC 360-20 because the new standard does not describe specific real estate sales transactions. Our use of these terms is intended to help you compare the new guidance with today's guidance. By using these terms, we are not suggesting that entities should continue to use the guidance in ASC 360-20 or analogize to it to account for the sale of real estate once the new standard is effective.

In addition, any conclusions we reached in our examples are based on the facts we described and are subject to change. All arrangements will need to be carefully evaluated under the new guidance, based on the facts and circumstances.

This publication supplements our general Technical Line publication on the new standard and the other real estate industry Technical Line publications we have released. It should be read in conjunction with the following materials:

- *A closer look at the new revenue recognition standard* (SCORE No. BB2771)
- *The new revenue recognition standard — real estate* (SCORE No. BB2811)
- *Gains and losses from the derecognition of nonfinancial assets* (SCORE No. BB3021)

Summary of the new guidance

The new guidance in ASC 606 and ASC 610-20 outlines the principles an entity must apply to measure and recognize revenue and the related cash flows. The core principle is that an entity will recognize revenue at an amount that reflects the consideration it expects to be entitled to in exchange for transferring goods or services to a customer.

The new revenue standard (ASC 606) will be applied using the following five-step model:

Step 1: Identify the contract(s) with a customer

An entity must first identify the contract, or contracts, to provide goods and services to customers. These contracts may be written, oral or implied by the entity's customary business practice but must be legally enforceable and meet specified criteria. That is, the contract must be approved by all parties, and they must be committed to performing their respective obligations, the entity must be able to identify each party's rights regarding goods and services to be transferred and the associated payment terms, the contract must have commercial substance, and the entity needs to conclude it is probable that it will collect the consideration to which it will be entitled for transferring the goods or services to the customer.

Entities will need to consider the laws of their respective jurisdictions (e.g., United States Uniform Commercial Code, state and local real property laws) when determining whether a contract is legally enforceable. In the US, in nearly all real estate arrangements, a signed, written contract specifies the asset to be transferred or management services to be provided in exchange for a defined payment. This generally will result in a straightforward assessment of most of the contract criteria in the standard. The assessment may be different when evaluating transactions that occur in countries outside of the US.

The prescriptive guidance in ASC 360-20 for evaluating a buyer's initial and continuing investment has been replaced with a collectibility assessment in ASC 606.

However, the collectibility criterion may require careful consideration. When assessing collectibility, an entity must conclude that it is probable that it will collect the transaction price. The transaction price is the amount to which the entity expects to be entitled in exchange for the goods or services that will be transferred to the customer, which may be different from the stated contract price.

The transaction price may be less than the stated contract price if an entity concludes that it has offered or is willing to accept a price concession or other discount. Such concessions or discounts are forms of variable consideration (see Step 3: Determine the transaction price section below for further discussion) that an entity would estimate at contract inception and reduce from the contract price to derive the transaction price. The estimated transaction price would then be evaluated for collectibility. The following table illustrates these concepts:

Stated contract price	$ 2,000,000
Price concession - amount entity estimates it will offer (explicitly) or accept (implicitly) as a reduction to the contract price, unrelated to credit risk	($200,000)
Transaction price (assessed for collectibility)	$ 1,800,000

In assessing collectibility, the term "probable" is defined as when "the future event or events are likely to occur." This is consistent with the existing definition in US GAAP. An entity should consider the buyer's intent and ability to pay the amount of consideration when it is due in evaluating whether collectibility of the transaction price is probable.

In many circumstances, an entity may not be willing to accept less than the contract price (i.e., offer a price concession) but is willing to accept the risk of default by the customer of contractually agreed-upon consideration (i.e., credit risk). In these circumstances, the transaction price would not differ from the contract price, and this amount would be evaluated to determine if collection is probable.

How we see it

Entities that sell real estate and provide financing to the buyer may find that more judgment is required to evaluate the collectibility of the transaction price. These entities may be used to applying the strict quantitative criteria in ASC 360-20 for determining whether a buyer's initial and continuing investment is sufficient to allow for sale and profit recognition. This guidance will be eliminated, and there is little guidance in the new standard to help entities evaluate collectibility.[2] Therefore, this assessment may be difficult and necessitate that entities develop new processes and controls to evaluate some arrangements, including those in which the seller provides financing to the buyer.

When seller financing is provided, we believe that entities will need to consider a variety of factors when evaluating collectibility of the transaction price. Those factors may include analysis of commercially available lending terms for similar transactions, down payment sufficiency, projected cash flows of the property, borrower creditworthiness, experience and expertise of the buyer's management team and historical experience of the seller in similar transactions.

Step 2: Identify the performance obligations in the contract

The new revenue standard requires an entity to identify at contract inception all promised goods and services and determine which of these promised goods or services (or bundle of goods and services) represent performance obligations. Promised goods and services represent a performance obligation if (1) the goods or services are distinct (by themselves or as part of a bundle of goods and services) or (2) if the goods or services are part of a series of distinct goods or services that are substantially the same and have the same pattern of transfer to the customer. A promised good or service that is not distinct is combined with other goods or services until a distinct bundle is formed.

A good or service (or bundle of goods and services) is distinct when both of the following criteria are met:

- The customer can benefit from the good or service either on its own or together with other resources that are readily available to the customer (i.e., the good or service is capable of being distinct).
- The entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract (i.e., the good or service is distinct within the context of the contract).

Goods or services that are part of a series of distinct goods or services that are substantially the same and have the same pattern of transfer to the customer are required to be combined into one performance obligation. To meet the same pattern of transfer criterion, each distinct good or service in the series must be considered a performance obligation satisfied over time (discussed in Step 5), and an entity must use the same method to measure the progress of transferring each distinct good or service (e.g., time elapsed). Examples include repetitive services provided on an hourly or daily basis.

Step 3: Determine the transaction price

The transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to the customer and includes:

- An estimate of any variable consideration (e.g., amounts that vary due to discounts or bonuses) using either a probability-weighted expected value or the most likely amount, whichever better predicts the amount of consideration to which the entity will be entitled

- The effect of the time value of money, if there is a financing component that is significant to the contract
- The fair value of any noncash consideration
- The effect of any consideration payable to the customer, such as vouchers and coupons

The transaction price may be constrained because of variable consideration. That is, the standard limits the amount of variable consideration an entity can include in the transaction price to the amount for which it is probable that a significant revenue reversal will not occur when the related uncertainties are resolved. A significant reversal occurs when a change in the estimate results in a significant downward adjustment in the amount of cumulative revenue recognized from the contract with the customer. The transaction price is not adjusted for credit risk.

Step 4: Allocate the transaction price to performance obligations in a contract

An entity must allocate the transaction price to each performance obligation on a relative standalone selling price basis, with limited exceptions. One exception in the standard requires an entity to allocate a variable amount of consideration, together with any subsequent changes in that variable consideration, to one or more performance obligations or one or more (but not all) distinct goods or services promised in a series of goods or services that forms part of a single performance obligation, if specified criteria are met (i.e., terms of the variable payment relate specifically to the entity's efforts to satisfy the performance obligation or transfer the distinct good or service and the allocation of variable consideration is consistent with the objective of allocating the transaction price in an amount the entity expects to be entitled in exchange for transferring the promised goods or services to the customer).

When determining standalone selling prices, an entity must use observable information, if it is available. If standalone selling prices are not directly observable, an entity will need to use estimates based on reasonably available information. Example estimation approaches include an adjusted market assessment approach or an expected cost plus a margin approach.

Step 5: Recognize revenue when (or as) the entity satisfies a performance obligation

Under the new revenue standard, an entity has to determine at contract inception whether it will transfer control of a promised good or service over time. An entity transfers control of a good or service over time (rather than at a point in time) when any of the following criteria are met:

- The customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs.
- The entity's performance creates or enhances an asset (e.g., work in process) that the customer controls as the asset is created or enhanced.
- The entity's performance does not create an asset with an alternative use to the entity, and the entity has an enforceable right to payment for performance completed to date.

Customer simultaneously receives and consumes benefits as the entity performs

In developing their new revenue standards, the FASB and International Accounting Standards Board (IASB, together the Boards) intended for this criterion to address repetitive service contracts (e.g., cleaning services, transaction processing), therefore it is unlikely to be applied when a real estate asset is sold.

However, this criterion may be applicable to a management contract that is retained by the seller of a real estate property. Real estate entities that provide property management and other services will need to carefully evaluate their contracts to determine whether the services performed are simultaneously received and consumed by the customer (i.e., real estate owner). For further discussion of these and other topics affecting the real estate industry, refer to our Technical Line publication, *The new revenue recognition standard — real estate*.

Customer controls asset as it is created or enhanced

The Boards said[3] they believe the customer's control over the asset as it is being created or enhanced indicates that the entity's performance transfers goods or services to a customer over time. For example, in a construction contract in which an entity is building an asset on the customer's land, the customer generally controls any work in process resulting from the entity's performance.

For discussion of the application of this criterion to construction contracts, refer to our Technical Line publication, *The new revenue recognition standard — engineering and construction*.

Asset with no alternative use and right to payment

The Boards acknowledged[4] that the application of the first two criteria could be challenging in certain circumstances. For example, a developer may construct an asset but transfer title of the land and/or building to the customer only upon completion. As a result, a third criterion was added that, if both of the following requirements are met, will require entities to recognize revenue for a performance obligation over time:

- The entity's performance does not create an asset with alternative use to the entity.
- The entity has an enforceable right to payment for performance completed to date.

For further discussion of this criterion and its application to sales of real estate, refer to the section "Sales of real estate by real estate developers" below.

Control transferred at a point in time

Control is transferred at a point in time if none of the criteria for a good or service to be transferred over time is met. For sales of existing real estate properties, transfer of control will generally occur at a point in time.

The Boards included five indicators in ASC 606 for entities to consider when determining whether control of a promised asset has been transferred at a point in time. These indicators include consideration of whether the seller has a present right to payment for the property and whether title to, and physical possession of, the property has been transferred to the buyer.

Scope

ASC 606 applies to all contracts with customers (i.e., parties that have contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities), except for contracts that are specifically excluded from the scope, which include:

- Lease contracts within the scope of ASC 840, *Leases*
- Financial instruments and other contractual rights or obligations (e.g., receivables, debt and equity securities, derivatives)[5]
- Guarantees (other than product or service warranties) within the scope of ASC 460, *Guarantees*

- Nonmonetary exchanges between entities in the same line of business to facilitate sales to customers other than the parties to the exchange within the scope of ASC 845, *Nonmonetary Transactions*

Entities may enter into transactions that are partially within the scope of the new revenue guidance and partially within the scope of other guidance. In these situations, the new guidance requires an entity to first apply any separation and/or measurement principles in the other guidance before applying the revenue standard.

For example, in certain transactions, the seller of a real estate property may agree to support the operations of the property for a period of time or provide a guarantee of the buyer's return on investment. Under today's guidance, because these guarantees either prevent the guarantor from being able to account for the transaction as a sale or recognize in earnings the profit from the sale, these "seller support" guarantees are excluded from the scope of ASC 460 and are instead accounted for using ASC 360-20.

Under the new standard, the presence of a guarantee does not, on its own, affect whether an entity can recognize a sale and the associated profit from the transfer of the property. Instead, the fair value of the guarantee will first be separated from the transaction price and recorded as a liability in accordance with ASC 460.[6] The remainder of the estimated arrangement consideration is allocated among the other elements in the arrangement (e.g., other performance obligations, including the transfer of the asset). The entity then evaluates whether the other performance obligations have been satisfied without considering the guarantee.

Sales of nonfinancial assets

The sale of real estate (i.e., a nonfinancial asset or in substance nonfinancial asset) could be within the scope of ASC 606, if the sale is to a customer, or ASC 610-20, if the sale is to a noncustomer. The new revenue guidance defines a customer as "a party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities in exchange for consideration." The standard does not define the term "ordinary activities" because it was derived from existing guidance. CON 6[7] refers to ordinary activities as an entity's "ongoing major or central operations."

Nonfinancial assets, including real estate properties, are often sold in transactions that would not represent a contract with a customer because the sale of the asset is not an output of the entity's ordinary activities (e.g., the sale by an entity of its corporate headquarters building). If an entity sells a nonfinancial asset to a party that is a customer in other transactions (i.e., the party is purchasing goods or services from the entity that are the output of the entity's ordinary activities), the purchasing party will be considered a customer for the transactions involving the goods or services but not for the sale of the nonfinancial asset.

The FASB amended ASC 360-10 to help entities apply the appropriate guidance when derecognizing a nonfinancial asset (e.g., real estate) sold to a noncustomer. The amended guidance states that sales of nonfinancial assets, including in substance nonfinancial assets, should be accounted for using new guidance in ASC 610-20, unless the contract is with a customer. However, ASC 610-20 does not contain incremental guidance to ASC 606 but rather instructs entities to apply certain control and measurement guidance from ASC 606, including guidance related to:

- Evaluating the existence of a contract
- Measuring the consideration (i.e., determining the transaction price) in the contract
- Determining when control of the nonfinancial asset has transferred (i.e., when a performance obligation is satisfied)

Accounting for contracts that include the sale of a nonfinancial asset to a noncustomer or a customer generally will be consistent, except for financial statement presentation and disclosure. The Boards noted in the Basis for Conclusions[8] in the new standard that there is economically little difference between the sale of real estate that is, or is not, an output of the entity's ordinary activities and that the only difference in the accounting for these transactions should be the presentation in the statement of comprehensive income (i.e., revenue and expense when the sale is to a customer or gain or loss when the sale is to a noncustomer). Entities that sell nonfinancial assets to noncustomers will follow guidance in ASC 360-10 for presenting a gain or loss on the sale of a long-lived asset.

In certain circumstances, neither ASC 606 nor ASC 610-20 will be applied when derecognizing a nonfinancial asset. Instead, the sale of nonfinancial assets in a subsidiary or group of assets that meets all of the following requirements will be accounted for in accordance with the derecognition guidance in ASC 810, *Consolidation*:[9]

- The nonfinancial assets are not being sold to a customer (i.e., they are not outputs of the entity's ordinary activities).
- The nonfinancial assets in a subsidiary or group of assets meet the definition of a business.
- The nonfinancial assets in a subsidiary or group of assets are not in substance nonfinancial assets (e.g., because the group of assets or subsidiary also contains significant financial assets).
- No other scope exceptions in ASC 810-10 apply.

The following table summarizes the appropriate derecognition guidance to apply to common transactions involving real estate:

ASC topic	When applied?	Possible transactions
ASC 606, *Revenue from Contracts with Customers*	Sales to customers of real estate (i.e., nonfinancial assets or in substance nonfinancial assets, regardless of whether they also meet the definition of a "business")	Sales of residences by homebuilders and real estate developers
ASC 610-20, *Other Income - Gains and Losses from the Derecognition of Nonfinancial Assets*	Sales to noncustomers of real estate (i.e., nonfinancial assets or in substance nonfinancial assets, regardless of whether they also meet the definition of a "business")	Sales of commercial properties (e.g., office buildings, hotels, manufacturing facilities) by REITs, real estate funds with historical cost reporting and non-real estate entities
ASC 810-10, *Consolidation - Overall*	Sale (deconsolidation) to noncustomers of real estate in a subsidiary or group of assets that constitutes a "business" that is not, in substance, a nonfinancial asset (e.g., group of assets comprised of both financial and nonfinancial assets)	Sales by any entity of an asset group including real estate that together are a "business" and are not considered in substance nonfinancial assets

How we see it

The FASB did not define an "in substance nonfinancial asset" in the consequential amendments. An entity that derecognizes a subsidiary or group of assets that meet the definition of a business will need to exercise significant judgment to determine whether the transaction also constitutes the transfer of an in substance nonfinancial asset that will be subject to the guidance in ASC 610-20 rather than ASC 810-10.

The FASB has a project[10] on its agenda to clarify the definition of a business. In subsequent phases of this project, the FASB also plans to clarify the accounting for the acquisition or disposal of in substance nonfinancial assets and provide guidance for partial sales. It's not clear whether or when the FASB will issue additional guidance.

Sale and leaseback transactions

While the FASB made it clear that ASC 360-20 should no longer be applied to sales and transfers of real estate, the guidance was retained on sale and leaseback transactions involving real estate that are within the scope of ASC 840-40, *Sale-Leaseback Transactions*. ASU 2014-09 included a number of consequential amendments that narrowed the scope of ASC 360-20, and the FASB stated[11] that entities should not analogize to the retained guidance when evaluating any transaction that is not a sale-leaseback.

Sales of real estate that qualify for full accrual profit recognition under ASC 360-20 will generally continue to meet the criteria for sale and associated profit recognition under the new guidance.

The FASB plans to issue new guidance on leases later this year, including new guidance for sale-leaseback transactions that will eventually replace the guidance in ASC 360-20 and ASC 840-40. Under the proposal, a seller-lessee would use the definition of a sale in ASC 606 to determine whether a sale has occurred in a sale and leaseback transaction (e.g., whether the buyer-lessor has gained control of the underlying asset). In addition, the new leases standard would eliminate existing guidance for sale and leaseback transactions specifically involving real estate. For further information about the forthcoming leases standard, refer to our Technical Line publication, *Final standard on leases is taking shape* (SCORE No. BB2952).

Nonmonetary transactions

The new revenue standard provides guidance for contracts with customers involving the exchange of nonmonetary consideration. As a result, the FASB excluded contracts that fall within the guidance of ASC 606 and ASC 610-20 from the scope of ASC 845. However, the FASB clarified that the exchange of a nonfinancial asset (including an in substance nonfinancial asset) for a noncontrolling ownership interest in the receiving entity will remain within the scope of ASC 845. In addition, the specific guidance in ASC 845 for exchanges of real estate involving monetary consideration will be eliminated.

Sales previously recognized using the full accrual method

ASC 360-20 provides the general principles that full profit on a real estate sale can be recognized if the profit is determinable and the earnings process is virtually complete. ASC 360-20 includes a number of criteria that describe how to determine whether these general principles are satisfied and the appropriate accounting to apply in circumstances in which the criteria are not met. These criteria in ASC 360-20 generally require an assessment of whether:

- The sale has been consummated.
- The buyer's initial and continuing investments demonstrate a commitment to pay for the property.
- The seller's receivable is not subject to future subordination.

- The seller has transferred to the buyer the usual risks and rewards of ownership in a transaction that is in substance a sale and does not have a substantial continuing involvement with the property sold.

Recognition of the full profit when these criteria are satisfied is referred to as the "full accrual method." Many sales of real estate meet the criteria for full accrual profit recognition at the date of sale. For example, the criteria for full accrual recognition are generally satisfied if, upon the closing of a transaction, the buyer pays the full purchase price in cash, obtains title and possession of the property (including the risks and rewards of ownership), and the seller has no further involvement or obligation associated with the property. Even if the full purchase price is not paid in cash (e.g., the sale includes some form of non-subordinated seller financing) or the seller retains a non-prohibited form of continuing involvement, the full accrual criteria could be met if the sale has been consummated and the buyer's initial and continuing investments are sufficient.

It is likely that the timing of sale (and associated profit) recognition for transactions that qualify for full accrual profit recognition under ASC 360-20 will be consistent with the timing of sale (and associated profit) recognition for the same transactions under the new guidance. The new guidance provides that sales of nonfinancial assets (e.g., real estate) will be recognized when control of the asset transfers to the buyer, which will occur when the buyer has the ability to direct the use of, or obtain substantially all of the remaining benefits from, the asset. This will generally occur at the closing of the transaction. The following illustration compares full accrual profit recognition under ASC 360-20 to revenue/gain recognition under ASC 606/610-20.

Illustration 1: Sale recognized using full accrual method in ASC 360-20

An office building is sold for $1 million, and Seller A receives $1 million in cash ($150,000 directly from the buyer and $850,000 of proceeds from a secured first mortgage the buyer entered into with a third-party lender). Seller A is not contingently liable for the mortgage nor does it have any other risks related to the buyer's financing. Seller A transferred title and physical possession of the property to the buyer on the closing date of the transaction and has no continuing involvement with the property.

Future GAAP analysis (ASC 606/610-20):

Seller A determines that control of the building transfers at a point in time (rather than over time) and considers the indicators of control transfer, as well as any other relevant information. Seller A determines that the criteria to recognize revenue (i.e., gain on sale) have been met at closing because title and physical possession of the property were transferred to the buyer, and the contract specifies Seller A's right to payment (which has already been received in this transaction).

Current GAAP analysis (ASC 360-20):

Seller A received the full sales value of the property in cash, without any contingent liability on the debt incurred by the buyer or any other risk related to the buyer's financing. Therefore, the initial and continuing investment requirements are not applicable, and full profit recognition is appropriate assuming all other criteria for recognizing profit under the full accrual method (e.g., Seller A has no prohibited forms of continuing involvement) were satisfied.

Recognition when control of the property has not transferred

If an entity evaluates the indicators described above and concludes that control of the property has not transferred under ASC 606 or ASC 610-20, as applicable, a sale has not occurred and the asset is not derecognized. The entity records any consideration received as a contract liability (e.g., deposit liability), not as revenue/gain, until it concludes that the buyer has obtained control of the property. This accounting will be similar to the "deposit method" in today's guidance, which is applied when there is no consummation of a sale.

Sales for which initial or continuing investment criteria in ASC 360-20 are not met

Under ASC 360-20, collectibility of the sales price is demonstrated by the buyer's commitment to pay for the property. ASC 360-20 includes detailed guidance on evaluating whether the composition and size of the buyer's initial and continuing investments are adequate to demonstrate the buyer's commitment to pay for the property. When the initial or continuing investment tests are not met, the seller is required to defer profit at the sale date and recognize it in later periods using one of the alternative methods provided in ASC 360-20. In certain cases, a seller may determine that the buyer's investment is insufficient to recognize a sale and may instead apply the deposit method.

The new guidance eliminates all of the prescriptive requirements in ASC 360-20 for evaluating the buyer's initial and continuing investment and introduces new judgments that must be made regarding collectibility. The removal of the initial and continuing investment criteria may result in immediate recognition (i.e., gain on sale) for transactions for which gain deferral has been required under ASC 360-20.

Under the new guidance, however, a seller will still have to evaluate, at contract inception, whether it is probable that it will collect the consideration to which it expects to be entitled. The standard also says that entities should assess both the customer's intent and ability (i.e., capacity) to pay the amount to which the entity will be entitled. In some circumstances, the amount of consideration to which an entity will be entitled may be less than the price stated in the contract because the entity might provide a price concession to the customer. Such concessions or discounts are forms of variable consideration that an entity would estimate at contract inception and deduct from the contract price to determine the transaction price. Significant judgment will be required to determine whether an entity's expectation that it will receive less than the stated contract price indicates that the contract amount is not probable of collection or represents a price concession. Refer above to "Summary of the new guidance" section for further discussion of price concessions.

If it is not probable that the entity will collect the transaction price, the arrangement would not be considered a contract under the new guidance until the concerns about collectibility are resolved (i.e., becomes probable the transaction price will be collected). If the entity subsequently determines that the transaction price is probable of collection, the arrangement will then be recognized under the new guidance. Entities will apply similar judgments to those at contract inception (e.g., all parties have approved the contract, payment terms have been identified) when subsequently determining that the transaction price is probable of collection.

The new guidance addresses situations in which an arrangement does not meet the contract criteria (e.g., an entity determines that it is not probable that it will collect the transaction price). In certain circumstances, an entity may receive consideration from a customer (e.g., a down payment) before the contract criteria have been satisfied. When an arrangement doesn't meet the criteria to be accounted for as a contract, any consideration received from the customer is initially accounted for as a liability (not revenue/gain on sale), and assets transferred to the customer are not derecognized. This accounting is required even if the "deposit" exceeds the seller's carrying value of the property (unless one of the criteria noted below is met). The liability is measured at the amount of consideration received from the customer. This approach is similar to the deposit method prescribed in ASC 360-20.

An entity may only recognize consideration received as revenue/gain on sale when it subsequently determines that the agreement meets the criteria of a contract under the new guidance or when either of the following occurs:

- The entity has no remaining obligations to transfer goods or services to the customer, and all, or substantially all, of the consideration promised by the customer has been received by the entity and is nonrefundable.
- The contract has been terminated, and the consideration received from the customer is nonrefundable.

The following illustrates a transaction accounted for under the new standard for which the seller determines at sale closing that the transaction price is not collectible (Illustration 2). Based on changes in the borrower's ability to pay, the seller determines that collectibility is probable in a later period (Illustration 3). In addition, Illustration 2 reflects considerations for determining whether a contract is in the scope of ASC 606 or ASC 610-20.

Illustration 2: Seller financing with collectibility concerns at sale closing

Seller R owns and leases commercial real estate and, on occasion, will dispose of a property that no longer fits its operating or capital strategy. Seller R decides to sell an office building with a carrying value of $800,000 through the sale of its interest in a wholly owned subsidiary. The office building is the sole asset of the subsidiary. Seller R agrees to sell its 100% interest in the legal entity to another real estate operator, Buyer W, for $1,000,000, consisting of $50,000 of cash (paid up front and nonrefundable) and a 10-year nonrecourse first mortgage from Buyer W for $950,000. Substantially all of the office building is leased at acquisition.

Because the seller provided nonrecourse financing, cash flows from operation of the property will be primarily relied upon to service the mortgage. The leases of the largest two tenants in the building expire within the next two years and there is significant uncertainty regarding Buyer W's ability to replace them with new tenants willing to pay comparable rents; therefore, there is uncertainty whether the property will continue to generate the cash flows necessary to service the mortgage. However, Seller R has attempted to dispose of this office building for several years and is willing to accept the risk of this contract since it has the ability to repossess the property, if necessary.

The terms of the contract include required principal payments of $100,000 per year beginning in the second year of the contract, a $150,000 balloon payment at the end of the contract, and interest at a rate of 12% (which reflects the current market conditions and credit characteristics of Buyer W). For purposes of this example, we have ignored the accounting for the interest component.

Analysis: Seller R determines that the transaction is not with a customer because the sale is not part of Seller R's normal business activities of operating and leasing commercial real estate. Therefore, the transaction is outside the scope of ASC 606.

Seller R determines that it should apply ASC 610-20 because it has sold an in substance nonfinancial asset to a noncustomer (i.e., it transferred to Buyer W its 100% interest in a legal entity that held substantially only nonfinancial assets (i.e., an office building)). While the presence of in-place leases would likely have resulted in a conclusion by Seller R that the building was also a business, ASC 610-20 is applied to all sales of in substance nonfinancial assets, regardless of whether the asset sold also constitutes a business.

As a result of the uncertainty about whether the property will generate the cash flow necessary to service the mortgage, Seller R determines at contract inception that collection of the transaction price is not probable. Therefore, the remaining applicable aspects of ASC 606 (i.e., the measurement and derecognition principles) cannot be applied to the arrangement until Seller R is able to conclude that collectibility of the transaction price is probable. Seller R must account for the receipt of the $50,000 non-refundable down payment as a liability and does not derecognize the office building or record a mortgage receivable. Seller R also continues to recognize depreciation of the asset (assumed to be $25,000 per year for purposes of the example).

Dr. Cash	$	50,000		
Cr. Deposit liability			$	50,000
Dr. Depreciation expense	$	25,000		
Cr. Accumulated depreciation			$	25,000

Illustration 3: Subsequent evaluation of collectibility

Following Illustration 2, Seller R continues to assess the contract to determine whether the transaction price is probable of collection. In the second year of the arrangement, Seller R receives a principal payment of $100,000 but continues to believe that collectibility of the remaining balance is not probable because Buyer W has yet to execute new leases for the space that will become available in the near term. As a result, Seller R records the $100,000 payment received as a deposit liability and continues to recognize depreciation of the asset. For purposes of this example, we have again ignored the accounting for the interest component.

In the third year of the arrangement, Seller R receives a $100,000 principal payment and Buyer W has recently entered into new long-term leases with the two largest tenants in the office building.

Analysis: Based on the change in Buyer W's circumstances, in Year 3, Seller R determines that Buyer W has the intent and ability to pay the full amount due and that it is now probable that it will collect the unpaid portion of the transaction price (i.e., the outstanding mortgage receivable). Seller R also determines that control transferred at a point in time (e.g., title to the asset previously transferred when the ownership of the entity owning the real estate was transferred and the buyer has physical possession). Seller R therefore derecognizes the property and recognizes gain on sale and a mortgage receivable for cash consideration that remains outstanding.

Dr. Cash	$	100,000		
Dr. Mortgage receivable	$	750,000		
Dr. Deposit liability	$	150,000		
Cr. Building, net			$	750,000
Cr. Gain on Sale			$	250,000

Note: The mortgage receivable of $750,000 is calculated by subtracting cash payments received from the total selling price ($1,000,000 less the down payment of $50,000 and two subsequent payments of $100,000 each). The gain on sale of $250,000 is calculated by subtracting the carrying value of the asset transferred from the total sales price ($1,000,000 less carrying amount of $750,000, which is comprised of the initial carrying value of $800,000 net of two years of depreciation of $25,000 each).

Accounting under current GAAP (ASC 360-20)

The transaction in these illustrations would not have initially met the initial investment criteria in ASC 360-20. Assuming the sale was consummated, the down payment was not in substance an option, recovery of the cost of the property was reasonably assured and the seller retained no form of prohibited continuing involvement, a sale would have been recognized on the closing date. However, profit would have been recognized using the installment or cost recovery method until the initial and continuing investment criteria were satisfied.

Sales with forms of continuing involvement

Under ASC 360-20, a seller generally cannot recognize profit on the sale of real estate under the full accrual method if it retains continuing involvement in the property without transferring substantially all of the risks and rewards of ownership. ASC 360-20 provides detailed guidance on how to consider the various forms of continuing involvement a seller may have with a property after it has been sold and requires the use of alternative accounting methods (e.g., financing, leasing, performance-of-services, profit-sharing methods) in certain circumstances, based on the nature and extent of the continuing involvement.

The concept of continuing involvement is not a specific consideration in the new guidance. Under the new guidance, a seller focuses on the transfer of control of the property to determine when the performance obligation is satisfied and associated revenue (i.e., gain on sale) or loss is recognized. In addition, an entity will assess whether any aspects of a contract (including those that result in continuing involvement under today's guidance) either represent a separate performance obligation or affect whether control of the real estate has transferred to the buyer. However, activities that were considered continuing involvement under ASC 360-20 may affect whether control transfers or whether an additional distinct promised good or service is present other than the sale of real estate.

Unlike today's guidance, future consideration from a real estate sale may be recognized when control of the property transfers.

The following sections describe a few of the common forms of continuing involvement under ASC 360-20 and compare today's accounting for these transactions to the accounting under the new model in ASC 606 and ASC 610-20.

Seller participates in future profit

In some real estate sales arrangements, the seller participates in future profits (e.g., from the property's operating profits or residual values) without further obligation or risk of loss, in addition to receiving fixed consideration from the sale of the property.

Under today's guidance, a seller may recognize profit from the fixed consideration if all other criteria for full accrual profit recognition in ASC 360-20 have been met. However, any future profit participation is recognized only when those amounts are realized.

Under the new guidance, amounts from future profit participation will represent variable consideration that a seller will need to estimate at contract inception and include in the transaction price when it is "probable" that a significant revenue reversal will not occur when the uncertainties related to the variability are resolved. An entity is required to estimate variable consideration using either the "expected value" approach (i.e., the sum of probability-weighted amounts) or the "most likely amount" approach (i.e., the single most likely outcome), whichever better predicts the amount of consideration to which it will be entitled. That is, the method selected is not meant to be a "free choice." The entity should apply the selected method consistently throughout the contract and update the estimated transaction price at each reporting date.

The Boards indicated[12] that the "most likely amount" approach may be the better predictor when the entity expects to be entitled to only one of two possible amounts (e.g., a contract in which an entity is entitled to receive all or none of a specified performance bonus but not a portion of that bonus). The following provides an illustration of how a real estate entity would estimate variable consideration resulting from future profit participation from a sale of real estate under the new standard.

Illustration 4: Estimating variable consideration

Developer D sells a newly constructed commercial property with a cost basis of $1.9 million for $2.0 million, plus a right to receive 5% of future operating profit from the property for the first year. Developer D has no additional ongoing performance obligations. Developer D determines there are a number of possible outcomes of consideration to be received based on the performance of the property (e.g., the buyer's ability to effectively secure tenants for the entire property at favorable rental rates). The buyer currently has executed leases or letters of intent from prospective tenants for 50% of the property.

Analysis: Developer D determines that the "expected value" approach is the better predictor of the variable consideration since multiple outcomes are possible.

Based on the buyer's current pre-leasing, Developer D estimates the following future profit participation:

Future profit	Probability
$ 50,000	10%
$ 25,000	70%
$ 0	20%

Assume for purposes of this illustration that the constraint, discussed further below, does not limit the amount that can be included in the transaction price at contract inception (i.e., assume it is probable that a significant revenue reversal will not occur). Using a probability-weighted estimate, Developer D would include $22,500 [($50,000 x 10%) + ($25,000 x 70%) + ($0 x 20%)] in the transaction price associated with this variable consideration. That is, the transaction price would be $2,022,500.

Developer D updates its estimate of the transaction price at the next reporting date, and after considering that the buyer now has letters of intent or executed leases for 75% of the property, determines it is now 75% likely to receive future profit participation of $50,000 and 25% likely to receive $25,000. As a result, Developer D's estimate of variable consideration is updated to $43,750 [($50,000 x 75%) + ($25,000 x 25%)] and additional revenue (i.e., gain on sale) of $21,250 ($2,043,750 — $2,022,500) is recognized.

To include variable consideration in the estimated transaction price, the entity has to first conclude that it is "probable" that a significant revenue reversal will not occur when the uncertainties related to the variability are resolved. For purposes of this analysis, "probable" is defined as "the future event or events are likely to occur," consistent with the existing definition in US GAAP. The Boards provided factors that may indicate that revenue is subject to a significant reversal:

- The amount of consideration is highly susceptible to factors outside the entity's influence (e.g., market volatility, judgment or actions of third parties, weather conditions).
- The uncertainty about the amount of consideration is not expected to be resolved for a long period of time.

- The entity's experience (or other evidence) with similar types of contracts is limited or that experience (or other evidence) has limited predictive value.
- The entity has a practice of either offering a broad range of price concessions or changing the payment terms and conditions of similar contracts in similar circumstances.
- The contract has a large number and broad range of possible consideration amounts.

The indicators provided by the Boards are not meant to be an all-inclusive list, and entities may note additional factors that are relevant in their evaluations. In addition, the presence of any one of these indicators does not necessarily mean that it is probable that a change in the estimate of variable consideration will result in a significant revenue reversal.

When an entity is unable to conclude that it is probable that a change in the estimate of variable consideration that *would* result in a significant revenue reversal will not occur, the amount of variable consideration is limited. In addition, when an arrangement includes variable consideration, an entity should update both its estimate of the transaction price and its evaluation of the constraint throughout the term of the contract to depict conditions that exist at each reporting date.

The following provides an illustration of how an entity would apply the constraint in estimating variable consideration under the new standard:

Illustration 5: Evaluating the constraint
Assume the same facts as in Illustration 4 except that the buyer of the property has just begun negotiations with prospective tenants and has not signed lease agreements for a significant amount of space. *Analysis:* Developer D uses the "expected value" approach and estimates it is 25% likely to receive future profit participation of $50,000, 50% likely to receive $25,000 and 25% likely to receive none. Using a probability-weighted estimate (prior to considering the constraint), Developer D would include $25,000 [($50,000 x 25%) + ($25,000 x 50%) + ($0 x 25%)] in the transaction price associated with this variable consideration. That is, the transaction price would be $2,025,000. In this illustration, Developer D concludes that the constraint would be set at $25,000 (i.e., the amount for which it's probable that a significant reversal will not occur), therefore the full $25,000 would be included in the transaction price.

Seller provides management or development services to a buyer

A seller of real estate may agree to provide management services for the buyer for a period of time or commit to develop the property in the future (e.g., construct facilities on the land, provide improvements or amenities, such as roads, sewer lines or parks).

If the real estate property in the transaction is sold to a noncustomer, the sale is within the scope of ASC 610-20, which does not include guidance or refer to ASC 606, for identifying performance obligations and allocating consideration. If providing management or development services would generally be considered part of a real estate entity's ordinary activities, these services would be in the scope of ASC 606. Because the arrangement is partially in the scope of ASC 606 and partially outside, the guidance provided in ASC 606 for identifying performance obligations and allocating consideration will be applied to the entire arrangement since ASC 610-20 does not provide such direction.

To determine the performance obligations in the arrangement, a seller evaluates whether the management or development services are (1) capable of being distinct and (2) distinct within the context of the contract. If an entity concludes that more than one performance obligation is present in the contract, the transaction price is allocated to each based on their relative standalone selling prices. For further discussion, refer to Section 2 and 4 of our Technical Line publication, *The new revenue recognition standard — real estate.*

Development services

ASC 360-20 allows a seller that commits to develop the property sold to recognize profit using the percentage-of-completion method if (1) the seller can reliably estimate the future costs of development and the total profit that will be realized in the arrangement and (2) all other criteria for recognizing profit under the full accrual method have been satisfied.

Under ASC 360-20, if future costs of development can be reasonably estimated (i.e., the transaction would qualify to be accounted for using the percentage-of-completion method) but the transaction is otherwise required to be accounted for using the installment, cost recovery or reduced-profit method because the criteria for using the full accrual method have not been satisfied, both the percentage-of-completion method and the other applicable reduced profit method should be considered in determining the amount of profit to recognize. If a seller cannot reasonably estimate the future costs of development, no profit is recognized until costs can be reliably estimated or development is complete.

Under the new revenue standard, if an entity determines that the property and development services represent separate performance obligations in a contract with a customer, the transaction price is estimated (considering the constraint on any variable consideration) and allocated on a relative basis to each performance obligation based on their standalone selling prices. Revenue is then recognized when (or as) control is transferred. As discussed above, we anticipate that this guidance will also generally be applied when entities enter into these contracts with noncustomers because the transaction is partially in the scope of ASC 606 and partially in the scope of ASC 610-20. The guidance provided in ASC 606 for identifying performance obligations and allocating consideration will be applied to the entire arrangement since ASC 610-20 does not provide such direction.

Illustration 6: Sale of land with development contract

Developer D sells land with a carrying amount of $400,000 to Homebuilder V and agrees to build access roads and develop a recreation facility on the land for total consideration of $1,500,000. The estimated cost to complete the development (i.e., access roads and recreation facility) is $400,000, which is based on Developer D's experience and is considered reliable. Developer D incurs $160,000 in development costs in year 1 and $240,000 in costs in year 2. The standalone selling price of the land is $1,000,000, and the standalone selling price for the development services is $600,000.

Future GAAP analysis (ASC 606/610-20):

The sale of land and corresponding performance of development services are both part of Developer D's ordinary activities, so the entire transaction is within the scope of ASC 606. In contrast, if the sale of land was not part of Developer D's ordinary activities (e.g., if Developer D generally only performed development services and rarely sold raw, undeveloped land), the transaction would be partially in the scope of ASC 610-20 (i.e., sale of land to noncustomer) and partially in the scope of ASC 606 (i.e., performance of development services). In these circumstances where the transaction is partially in the scope of both standards, the guidance in ASC 606 for identifying performance obligations and allocating the transaction price will be applied to the overall arrangement since ASC 610-20 does not include such guidance. The measurement and recognition for the land would be the same under either ASC 606 or ASC 610-20 because ASC 610-20 relies on the concepts of ASC 606.

Developer D evaluates the arrangement and determines that the land and development services are each capable of being distinct and are distinct within the context of the contract, thus representing separate performance obligations under the new revenue standard.

Developer D must allocate the $1,500,000 transaction price based on the relative standalone selling prices of the land and development services. On a relative standalone selling price basis, the land represents 62.5% of the transaction price, or $937,500, and the management services represent 37.5% of the transaction price, or $562,500.

When control of the land transfers, Developer D recognizes revenue (and corresponding profit) based on the amount of the transaction price allocated to the land. The remaining transaction price allocated to the development services is recognized when (or as) control of the improvements is transferred to Homebuilder V.

For example, if Developer D determines that Homebuilder V controls the improvements as they are created, recognition of revenue over time, based on Developer D's selected measure of progress (e.g., cost incurred), may be appropriate. Profit from the total arrangement would be recognized as follows:

Profit recognized at sale closing: $537,500

$937,500 transaction price of land − $400,000 carrying value of land

Profit recognized in Year 1: $65,000

[$562,500 transaction price of development services x ($160,000 costs incurred/$400,000 total development costs)] − $160,000 costs incurred

Profit recognized in Year 2: $97,500

[$562,500 transaction price of development services x ($240,000 costs incurred/$400,000 total development costs)] − $240,000 costs incurred

Current GAAP analysis (ASC 360-20):

If all other criteria for recognizing revenue under the full accrual method in ASC 360-20 have been satisfied, Developer D should account for the arrangement using the percentage-of-completion method as follows:

Projected profit:

Sales value	$ 1,500,000
Costs	
Land	400,000
Development	400,000
	800,000
Total projected profit	$ 700,000

Profit recognized at sale closing: $350,000

($400,000 costs incurred/$800,000 total costs) x $700,000 projected profit

Profit recognized in Year 1: $140,000

($160,000 costs incurred/$800,000 total costs) x $700,000 projected profit

Profit recognized in Year 2: $210,000

($240,000 costs incurred/$800,000 total costs) x $700,000 projected profit

While the total profit recognized in this illustration is the same under either standard, $187,500 of additional profit is recognized at sale closing when the new revenue standard is applied to this transaction.

Management services

Under ASC 360-20, if a seller agrees to provide management services to the buyer of a property, the compensation for those services is excluded from the sales value of the property and recognized separately over the period of the management contract. If the services are provided "free of charge" or at a reduced rate, the seller must impute compensation for the management services (i.e., reduce the sales value of the property by the present value of the market rate of the services).

ASC 606 instead requires the seller to separately estimate the standalone selling prices of the real estate asset and the management services and allocate the transaction price (including any estimates of variable consideration that are not constrained) on a relative basis, assuming the entity determines the contract has two performance obligations. The following illustration compares the potential differences in the recognition of profit for these arrangements under ASC 360-20 and the new standard:

Illustration 7: Sale of land with management contract

Hotel Company M sells a hotel with a carrying value of $1,500,000 for $2,000,000 and agrees to manage the property for three years at no additional cost to Buyer R. The standalone selling price of the hotel is $1,800,000, and the standalone selling price for the management services is $100,000 per year. The current market rate of interest that reflects the credit characteristics of the buyer is 10%.

Future GAAP analysis (ASC 606/610-20):

The sale of a hotel is not part of Hotel Company M's ordinary activities (e.g., Hotel Company M ordinarily operates hotels under management agreements or provides licenses to franchisees and generally does not own and sell hotel properties), so the transaction is partially in the scope of ASC 610-20 (i.e., sale of the hotel to a noncustomer) and partially in the scope of ASC 606 (i.e., performance of management services). In these circumstances, the guidance in ASC 606 for identifying performance obligations and allocating the transaction price will be applied to the overall arrangement since ASC 610-20 does not include such guidance. The measurement and recognition for the hotel would be the same under either ASC 606 or ASC 610-20 because ASC 610-20 relies on the concepts of ASC 606.

Hotel Company M evaluates the arrangement and determines that the hotel and management services are each capable of being distinct and distinct within the context of the contract, thus representing separate performance obligations.

Hotel Company M must allocate the $2,000,000 transaction price based on the relative standalone selling prices of the hotel ($1,800,000) and management services ($100,000 x three years, or $300,000). On a relative basis, the transaction price is allocated as follows: the hotel property 85.7% ($1,800,000/$2,100,000), or $1,714,286, and the management services 14.3% ($300,000/$2,100,000), or $285,714.

Hotel Company M recognizes profit of $214,286 ($1,714,286 — $1,500,000) when control of the property transfers. The $285,714 of transaction price allocated to the management services is recognized over the remaining term of the contract based on Hotel Company M's selected measure of progress (e.g., time elapsed).

Current GAAP analysis (ASC 360-20):

Hotel Company M imputes compensation for the management services to be performed and recognizes that amount over the term of the management contract. The present value of $100,000 per year for three years, discounted at 10%, is $248,695.

If all other criteria for recognizing profit under the full accrual method are satisfied (including the initial and continuing investment tests after reducing the sales value by the consideration imputed for the management services), Hotel Company M recognizes profit of $251,305 ($2,000,000 sales price — $1,500,000 carrying amount — $248,695 discounted management fee) at the time of sale.

While the total profit recognized in this illustration is the same under either standard, $37,029 less is recognized at sale closing when the new standard is applied to this transaction.

Consideration of a significant financing component

Under the new standard, a significant financing component may be present in a contract if the timing of payments explicitly or implicitly provides the customer or the entity (i.e., the seller) with a significant benefit of financing the transfer of goods or services. The standard doesn't provide guidance on evaluating whether a financing component is significant, so entities will have to use judgment when making this determination.

For simplicity, illustrations 6 and 7 don't address the timing of payments in the arrangement (i.e., whether all consideration is paid at closing or a portion is paid as the services are provided). A significant financing component could be in the form of prepayment or a delayed payment. For example, if a contract contains "prepayments" for goods or services that will not be transferred for more than a year, an entity has to evaluate whether the timing of payments indicates that the arrangement contains a significant financing component.

If an entity concludes that the contract contains a significant financing component, the expected consideration is adjusted to reflect the cash selling price of the goods or services. When a contract has more than one performance obligation, such as those illustrated above, entities will need to use judgment when determining whether and how to allocate the financing to each performance obligation. The FASB-IASB Transition Resource Group for Revenue Recognition (TRG) recently discussed this issue and members of the TRG generally agreed that it may be reasonable for entities to apply other guidance in the standard that requires variable consideration and/or discounts to be allocated to one or more (but not all) performance obligations, if certain criteria for applying that guidance are met.[13]

How we see it

There likely will be significant judgment involved in determining whether a significant financing component exists when there is more than one year between the transfer of goods or services and the receipt of arrangement consideration. Entities will need to make sure that they have sufficiently documented their analyses to support their conclusions.

Guarantees of return on investment and seller support of operations

In certain real estate sales contracts, the seller may guarantee the return on, or of, the buyer's investment, while other arrangements may require that the seller initiate or support the property's operations. These two types of arrangements often may be confused, but the distinction is important under ASC 360-20.[14] An obligation to support the property's operations only guarantees that the buyer will recover funds from the seller related to the operating costs of the property for a period of time and does not guarantee that the buyer will receive a return on, or of, its investment.

Under ASC 360-20, if the seller guarantees a return of, or on, the buyer's investment, or agrees to support operations of the transferred real estate, sale accounting may be prohibited or profit may be reduced depending on several factors (e.g., duration and amount of the guarantees or support obligations). Depending on the terms, if the seller is not eligible for the full accrual method, the seller might account for the transaction under the deposit, financing, leasing or profit-sharing methods.

Under the new standard, guarantees included in a real estate sales arrangement are separated and accounted for using the guidance in ASC 460.

Unlike ASC 360-20, the new standard doesn't specify the accounting treatment for guarantees of return/investment or support obligations in contracts with customers. Instead, the seller determines whether these contract elements represent guarantees that are within the scope of ASC 460 (and not within the scope of ASC 606). If so, the seller recognizes a liability for the guarantee based on the estimated fair value and accounts for the guarantee as a separate element in the arrangement (i.e., the sale of real estate and sale of a guarantee). Although this is not explicit in ASC 610-20, entities that enter into these contracts with noncustomers will need to evaluate whether there are elements in the contract other than nonfinancial assets (or in substance nonfinancial assets) and account for those elements in accordance with the applicable literature (e.g., apply ASC 460 to guarantees provided in the contract).

Once the fair value of the guarantee has been determined, the remainder of the estimated arrangement consideration is allocated among the other elements in the arrangement (e.g., the sale of property, management arrangements, development services) in accordance with the revenue recognition standard. An entity recognizes a sale and associated profit when control of the property transfers, an assessment that is not affected by the presence of the guarantee.

The following illustration compares the accounting for an arrangement where the seller guarantees a return on the buyer's investment under ASC 360-20 and under the new revenue standard.

Illustration 8: Guarantee of return on buyer's investment

On 31 December 2018, Developer N sells a newly constructed apartment building with a cost of $1,200,000 to Buyer B for $2,000,000. Developer N guarantees that Buyer B will earn a minimum annual 10% profit in each of the next three years. Developer N's incremental borrowing rate is 5%.

Based on its experience with similar properties, Developer N forecasts that the property's operating results will be as follows:

	2019	2020	2021
Revenues	$ 300,000	$ 380,000	$ 400,000
Operating expenses	350,000	355,000	360,000
Profit (deficit)	(50,000)	25,000	40,000
10% profit	30,000	38,000	40,000
Guarantee requirement	80,000	13,000	N/A

Developer N transfers title to the building, and Buyer B takes possession of the property at the closing date. The sale also meets all of the other criteria for recognizing profit under the full accrual method in ASC 360-20, and Developer N has no other continuing involvement in the property.

Future GAAP analysis (ASC 606):

Developer N's ordinary activities include the construction and sale of real estate properties, thus the sale of the apartment building to Buyer B is a transaction with a customer within the scope of ASC 606.

Developer N concludes that it has provided a financial guarantee to Buyer B that is within the scope of ASC 460. ASC 606 states that Developer N must allocate a portion of the transaction price to the guarantee obligation in accordance with the measurement principles of ASC 460.

Assume that Developer N determines a guarantee obligation of $93,000 in accordance with ASC 460[15] and allocates that amount of consideration to the guarantee and records a liability. The remaining transaction price of $1,907,000 is allocated to the performance obligation representing the sale of the property. Developer N concludes that control of the property has transferred to Buyer B and records profit of $707,000 ($2,000,000 sale price — $93,000 guarantee liability — $1,200,000 cost basis) on the closing date.

Future GAAP analysis (ASC 610-20):

If the transaction illustrated above is with a noncustomer (e.g., the seller is a REIT that ordinarily owns and operates multifamily properties), ASC 610-20 would be applied to the sale of the building. ASC 610-20 does not include guidance similar to ASC 606 regarding the separation of units of accounting and allocation of transaction price to elements within a contract that are outside the scope of ASC 606 (e.g., guarantees). However, entities may have the same accounting result as a transaction with a customer under ASC 606 because the guidance in ASC 460 for guarantees would be applied.

Current GAAP analysis (ASC 360-20):

Because Developer N has guaranteed a return on Buyer B's investment, the deposit method should be applied to this transaction.

Repurchase agreements

Certain agreements for the sale of real estate may include provisions that require, or give an option to, the seller to repurchase the property. These provisions are generally structured in one of three ways:

- Forward option — An entity is obligated to repurchase the property
- Call option — An entity has the right to repurchase the property
- Put option — An entity is obligated to repurchase the property at the buyer's request

ASC 606 addresses the accounting for each of these repurchase provisions. ASC 610-20 does not explicitly refer to the repurchases guidance in ASC 606, but it does reference the transfer of control indicators in ASC 606-10-25-30, which incorporate the repurchases guidance. Therefore, repurchase agreements with customers and noncustomers should be evaluated using the repurchases guidance in ASC 606.

Forward or call option held by the entity

When an entity has the unconditional obligation or right to repurchase a property (i.e., a forward or call option), ASC 606 specifies that the buyer has not obtained control of the property even if the option is at fair value. Instead, the standard requires that an entity account for a transaction that includes a forward or a call option based on the relationship between the repurchase price and the original selling price.

If the entity has the right or obligation to repurchase the property at a price less than the original sales price (considering the effects of the time value of money), the entity would account for the transaction as a lease in accordance with ASC 840.

If the transaction is a sale-leaseback, the guidance in ASC 840-40 (including the guidance in ASC 360-20, which is retained only for sale-leaseback transactions until the Boards' project on lease accounting is finalized), would be applied.

In contrast, if the entity has the right or obligation to repurchase the property at a price equal to or greater than the original sales price (considering the effects of the time value of money), the entity would account for the arrangement as a financing arrangement. If a transaction is considered a financing arrangement, the selling entity would continue to recognize the property and record a financial liability for the consideration received from the customer. The difference between the consideration received from the customer and the consideration subsequently paid to the customer upon repurchase would represent the interest and holding costs, as applicable, that would be recognized over the term of the financing arrangement. If the option lapses unexercised, the entity derecognizes the property and financing liability and recognizes revenue at that time.

The concept of accounting for a forward or call option as a lease or financing arrangement is similar to existing guidance in ASC 360-20. However, under ASC 360-20, an entity can also apply the profit-sharing method if certain criteria are met. The new standard only allows a sale with a corresponding forward or call option to be treated as a lease or a financing arrangement and the likelihood of exercise is not contemplated in the accounting.

Illustration 9: Seller retains call option for amount greater than purchase price

Real Estate Fund E sells an office building to Buyer L on 1 January 2019 for $2.0 million. The contract includes a call option that gives Real Estate Fund E the right to repurchase the asset for $2.2 million on or before 31 December 2020. For simplicity, the time value of money is ignored in this example.

Future GAAP analysis (ASC 606/610-20):

Control of the asset does not transfer to Buyer L on 1 January 2019 because Real Estate Fund E has a right to repurchase the office building. Buyer L is therefore limited in its ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset.

As a result, Real Estate Fund E accounts for the transaction as a financing arrangement because the exercise price is more than the original selling price. Real Estate Fund E does not derecognize the office building and instead recognizes the cash received as a financial liability. Real Estate Fund E also accretes the liability and recognizes interest expense over the two-year period for the difference between the exercise price ($2.2 million) and the cash received ($2.0 million).

If the option subsequently lapses unexercised, the Real Estate Fund E derecognizes the office building and recognizes proceeds of $2.2 million.

Current GAAP analysis (ASC 360-20):

The repurchase option represents continuing involvement that prevents Real Estate Fund E from recognizing a sale or profit under the full accrual method at 1 January 2019. Real Estate Fund E evaluates the likelihood that it will exercise the option to determine whether to account for the transaction as a financing or profit-sharing arrangement.

Written put option held by the buyer

A real estate sales contract may give a buyer the ability to require the seller to repurchase the property at a previously agreed-upon price (i.e., a put option). Under ASC 606, a seller accounts for a contract that includes a put option using one of three methods (i.e., lease, sale with a right of return or financing arrangement) depending on the relationship of the exercise price to the original selling price of the property and whether the buyer has a significant economic incentive to exercise its right.

The determination of whether an entity has a significant economic incentive to exercise its right influences whether the buyer truly has control of the property. A seller has to consider many factors to determine whether a buyer has a significant economic incentive to exercise the put option, including the relationship of the repurchase price to the expected market value of the property at the date of repurchase and the amount of time until the option expires. The standard notes that if the repurchase price is expected to significantly exceed the market value of the property, the buyer has a significant economic incentive to exercise the put option.

How we see it

The new revenue standard does not provide guidance on determining whether the buyer has "a significant economic incentive" to exercise a put option. We believe entities that sell a property subject to a put option will need to estimate the future market price of the property and evaluate other facts and circumstances to determine whether the buyer has a significant economic incentive to exercise the option. This determination will require significant judgment.

A seller will account for a transaction that includes a buyer's put option as either a lease, a sale with a right of return or a financing arrangement.

- *Lease* — If the repurchase price is less than the original selling price and the buyer has a significant economic incentive to exercise the put option, the seller should account for the agreement as a lease because the buyer is effectively paying for the right to use the property for a period of time.
- *Sale with a right of return* — If the repurchase price is less than the original selling price and the buyer does not have a significant economic incentive to exercise its right, the seller should account for the agreement in a manner similar to a sale with a right of return. A repurchase price that is equal to or greater than the original selling price, but less than or equal to its expected market value, should also be accounted for as a sale of a product with a right of return if the customer does not have a significant economic incentive to exercise its right. Refer to Section 5.2.2 of our Technical Line publication, *A closer look at the new revenue recognition standard*, for a discussion of the accounting for the sale of a product with a right of return.
- *Financing arrangement* — If the buyer has the ability to require the seller to repurchase the property at a price that is equal to or greater than the original selling price and greater than the expected market value of the property, the contract is in effect a financing.

Illustration 10: Buyer holds put option with exercise price less than market value

Real Estate Fund E sells an office building to Buyer L on 1 January 2019 for $2.0 million. The contract includes a put option that obligates Real Estate Fund E to repurchase the building at Buyer L's request for $1.9 million on or before 31 December 2020. The market value of the office building is expected to be $1.8 million on 31 December 2020.

Future GAAP analysis (ASC 606/610-20):

At contract inception, Real Estate Fund E assesses whether Buyer L has a significant economic incentive to exercise the put option to determine whether the arrangement should be accounted for as a lease in accordance with ASC 840 or a sale with a right of return. Real Estate Fund E considers all relevant factors and concludes that Buyer L has a significant economic incentive to exercise the put option because the $1.9 million repurchase price significantly exceeds the expected market value of $1.8 million at the date of repurchase.

Real Estate Fund E concludes that control of the building does not transfer to Buyer L because the significant economic incentive to exercise the put option limits Buyer L's ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. Consequently, Real Estate Fund E accounts for the arrangement as a lease in accordance with ASC 840[16] on leases.

Current GAAP analysis (ASC 360-20):

The put option represents continuing involvement that prevents Real Estate Fund E from recognizing a sale or profit under the full accrual method at 1 January 2019. Real Estate Fund E determined that the leasing method described in ASC 360-20 was appropriate for this transaction. Any cash received from Buyer L equal to the repurchase price should be recorded as a liability with the difference between the cash received and the repurchase price representing deferred rental income that should be recognized ratably over the rental period.

Sales of real estate by real estate developers

Under the new standard, there is no special condominium accounting guidance. Instead, any developer may be able to recognize revenue over time (i.e., similar to the percentage-of-completion method) if it can determine that the asset (e.g., building, land parcel, residential unit) under construction has no alternative use and the developer has an enforceable right (throughout the contract) to payment from the customer for performance completed to date.

Real estate developers generally own the land and/or asset until title is transferred at completion of construction. Therefore, they must evaluate whether the asset has no alternative use and a present right to payment from the customer exists. In contrast, a construction contractor builds an asset on the customer's land and the customer owns the work-in-process, generally allowing the contractor to conclude that the customer controls the asset as it is created or enhanced.

Alternative use

An asset created by an entity has no alternative use if the entity is either restricted contractually or practically from readily directing the asset for another use (e.g., selling to a different customer). An entity has to make this assessment at contract inception and does not update its assessment unless the parties to the contract approve a contract modification that substantively changes the performance obligation.

The Boards specified[17] that a contractual restriction on an entity's ability to direct an asset for another use must be substantive (i.e., a buyer could enforce its rights to the promised asset if the entity sought to sell the unit to a different buyer). In contrast, a contractual restriction may not be substantive if the entity could instead sell a different asset to the buyer without breaching the contract or incurring significant costs.

Further, the Boards believe a practical limitation exists if an entity would incur significant economic losses to direct the asset for another use. A significant economic loss may arise when significant costs are incurred to redesign or modify an asset, or when the asset is sold at a significantly reduced price.

A developer may be able to determine that an asset has no alternative use because its characteristics (e.g., location, design, technical specifications, materials) would generally result in a contractual and/or practical limitation to redirect its use to another buyer.

Enforceable right to payment for performance completed to date

An entity has an enforceable right to payment for performance completed to date if, at any time during the contract term, the entity would be entitled to an amount that at least compensates it for work already performed. This enforceable right to payment must exist, even if the buyer can terminate the contract for reasons other than the entity's failure to perform as promised.

The laws or legal precedent of a jurisdiction may affect an entity's conclusion of whether a right to payment is enforceable.

To satisfy this criterion, the amount to which an entity is entitled must approximate the selling price of the goods or services transferred to date, including a reasonable profit margin. Compensation for a reasonable profit margin doesn't have to equal the profit margin expected for complete fulfillment of the contract but must at least reflect either of the following:

- A proportion of the expected profit margin in the contract that reasonably reflects the extent of the entity's performance under the contract before termination by the customer (or another party)
- A reasonable return on the entity's cost of capital for similar contracts (or the entity's typical operating margin for similar contracts) if the contract-specific margin is higher than the return the entity usually generates from similar contracts

Entities are required to consider any laws, legislation or legal precedent that could supplement or override contractual terms. These may vary by country. In addition, the standard clarifies that including a payment schedule in a contract does not, by itself, indicate that the entity has the right to payment for performance completed to date. For example, progress billings collected from a customer may not reflect a reasonable profit margin on work completed to date. The entity has to examine information that may contradict the payment schedule and may represent the entity's actual enforceable right to payment for performance completed to date (e.g., an entity's legal right to continue to perform and enforce payment by the buyer if a contract is terminated without cause).

Measuring progress

When a performance obligation is satisfied over time, the standard allows the use of one of two methods for measuring progress under the contract: an input method or an output method. While the standard requires an entity to update its estimates related to the measure of progress selected, it does not allow a change in methods. A performance obligation is accounted for under the method the entity selects (i.e., either an input or output method) until it has been fully satisfied.

Under an input method, revenue is recognized "on the basis of the entity's efforts or inputs to satisfy the performance obligation … relative to the total expected inputs to the satisfaction of that performance obligation." The standard includes resources consumed, labor hours expended, costs incurred and time elapsed as possible input methods. The standard also notes it may be appropriate to recognize evenly expended inputs on a straight-line basis.

Under an output method, revenue is recognized "on the basis of direct measurements of the value to the customer of the goods or services transferred to date relative to the remaining goods or services promised under the contract." Measurements of output may include surveys of performance completed to date, appraisals of results achieved, milestones reached and time elapsed.

The standard does not say either type of method is preferable, but it says an entity should apply the method it selects to similar arrangements in similar circumstances. If an entity does not have a reasonable basis to measure its progress, the Boards decided that too much uncertainty would exist and, therefore, revenue should not be recognized until progress can be measured. However, if an entity cannot reasonably measure its progress, but expects it will not incur a loss, the new standard requires revenue to be recognized to the extent that costs are incurred until the entity is able to reasonably measure its progress.

The accounting for partial sales of real estate is not specifically addressed in the new standard.

How we see it

Many developers of residential condominium units currently recognize revenue using the percentage-of-completion method that is permitted in ASC 360-20 when certain criteria are met (e.g., construction is beyond a preliminary stage, buyer is unable to require a refund, sales price is collectible). This accounting treatment in ASC 360-20 is not available to other developers of real estate assets that are sold upon completion (e.g., build-to-suit commercial builders and land developers).

Under the new revenue standard, it may be difficult for developers of residential condominiums to conclude that their arrangements meet the criteria for revenue recognition over time. In many jurisdictions (e.g., the US) the developer receives an initial deposit from the buyer but is not entitled to further consideration until the sale of the unit closes. As a result, the developer may be unable to assert that it has an enforceable right to payment for performance completed to date at any point in the contract term.

Partial sales of real estate

Under ASC 360-20, a seller has made a partial sale of real estate if the seller has an equity interest in the buyer or retains an equity interest in the property. The nature of a partial sale of real estate indicates continuing involvement (i.e., retained ownership) in the property by the seller. However, ASC 360-20 allows a seller to recognize profit on the partial sale of real estate at the date of a sale if all other requirements for recognizing profit under the full accrual method have been satisfied. In addition, the seller must be independent of the buyer, and the seller cannot be required to support the operations of the property or its related obligations to an extent greater than its proportionate retained interest.

A partial sale of real estate may also occur if an entity contributes a property to a venture and withdraws cash from the venture that was contributed by another partner. For example, Investor X enters into a transaction with Investor Y in which Investor X contributes real estate with a fair value of $5,000 and Investor Y contributes $2,500 in cash, which Investor X immediately withdraws. The only asset in this venture is the real estate, and after the contributions and withdrawals, each investor has a 50% interest in the venture. Assuming Investor X is not committed to reinvest the $2,500 in the venture, the substance of this transaction is a sale of a one-half interest in the real estate by Investor X for $2,500 in cash.

The new guidance does not specifically address partial sales of real estate. It is unclear whether these transactions are in the scope of ASC 610-20, and thus generally follow the model in ASC 606, or whether existing guidance in another ASC topic (e.g., ASC 810, ASC 323, *Investments — Equity Method and Joint Ventures*) should be applied. If these transactions are within the scope of ASC 610-20, neither ASC 610-20 nor ASC 606 specifies how an entity would view a partial sale of real estate in the context of its evaluation of the indicators of control transfer. For example, absent a clarification by the FASB, some entities may evaluate whether they continue to control the *property* after the partial sale, while others may look to whether control of the *ownership interest* specified in the contract has transferred.

How we see it

The frequency of partial sales of real estate and the lack of clarity in the new guidance could lead to substantial diversity in practice when accounting for these transactions. The FASB has indicated that it may provide further guidance on this issue as part of its project on clarifying the definition of a business.

Contributions of real estate that are not in substance sales

Contributions of real estate by an investor to a real estate venture that are not in substance sales (as described above) will continue to be accounted for under existing guidance in ASC 970-323, *Real Estate — General*, *Investments — Equity Method and Joint Ventures*. This guidance states that an investor that contributes real estate to the capital of a real estate venture should generally record its investment at the book value of the real estate contributed and not recognize a profit on the transaction (i.e., the economic substance of the transaction is a contribution of capital and not a sale of real estate).

Surrender of real estate in satisfaction of an entity's obligation

ASU 2011-10, *Derecognition of in Substance Real Estate — a Scope Clarification,* clarified that the guidance in ASC 360-20 (rather than the derecognition provisions of ASC 810) should be applied to a parent that ceases to have a controlling financial interest in a subsidiary that is in substance real estate as a result of default on the subsidiary's nonrecourse debt.

The FASB's consequential amendments in ASU 2014-09 did not change the exclusion of these transactions from the derecognition provisions of ASC 810. However, entities will now apply the guidance in ASC 610-20 (and therefore the indicators of control transfer in ASC 606-10-25-30) when derecognizing all nonfinancial assets, including real estate, that are transferred in satisfaction of a subsidiary's default on nonrecourse debt.

Under ASC 360-20, derecognition of the in substance real estate by an entity is not appropriate before the date that the reporting entity's interest in the real estate is conveyed to the lender or a third-party purchaser and the subsidiary is released from its debt obligation. The indicators of transfer of control in the new standard include consideration of whether title to the property has transferred and the buyer or lender has obtained the significant risks and rewards of ownership. However, the standard does not specifically address whether the subsidiary must be legally released from its debt obligation in order to derecognize the property.

How we see it

The new revenue standard states that an entity's assessment of whether control of a property has transferred includes, but is not limited to, the five indicators in ASC 606-10-25-30. While we believe that the legal release of the debt obligation is an important factor in determining whether control of a property has transferred, diversity in practice could develop in this area because the standard does not specifically require that this condition be satisfied. Further, timing of transfer of control under ASC 606 may not coincide with the borrower's derecognition of the debt obligation in accordance with relevant debt extinguishment guidance.

Transition and effective date

The new standard is effective for public entities for fiscal years beginning after 15 December 2016 and for interim periods therein. It is effective for nonpublic entities for fiscal years beginning after 15 December 2017 and interim periods within fiscal years beginning after 15 December 2018, and they may elect to adopt the guidance as early as the public entity effective date. Under US GAAP, early adoption is prohibited for public entities.

The FASB voted to defer the effective date of the new standard for both public and nonpublic entities reporting under US GAAP for one year. As proposed, both public and nonpublic entities would be permitted to adopt the standard as early as the original public entity effective date. Early adoption prior to that date would not be permitted.

The IASB, which developed its new revenue standard jointly with the FASB, also voted to adopt a one-year deferral, which would keep the new standards' effective dates converged under IFRS and US GAAP.

All entities will be required to apply the standard retrospectively, either using a full retrospective or a modified retrospective approach. The Boards provided certain practical expedients to make it easier for entities to use a full retrospective approach.

Under the modified retrospective approach, financial statements will be prepared for the year of adoption using the new standard, but prior periods won't be adjusted. Instead, an entity will recognize a cumulative catch-up adjustment to the opening balance of retained earnings (or other appropriate component of equity or net assets) at the date of initial application for contracts that still require performance by the entity (i.e., contracts that are not completed). Entities will need to provide certain disclosures in the year of adoption, (e.g., entities using the modified retrospective approach must disclose the amount by which each financial statement line item is affected as a result of applying the new standard).

How we see it

Entities with deferred revenue balances or failed sales from real estate sales that predate their adoption of the new standard may experience "lost revenue." That's because the deferred amounts or previously unrecognized sales will be reflected in the recasted prior periods (under the full retrospective approach) or as part of the cumulative effect adjustment upon adoption (under the modified retrospective approach), but never reported as revenue in a current period within the financial statements.

The illustration below compares the application of the two transition approaches to a real estate sale for which profit was previously deferred under the installment method. Real estate entities that have previously deferred profit from a sale under another method in ASC 360-20 will need to consider specific transition issues that may arise from each respective method (e.g., interest expense and/or continued depreciation of the property under any of the financing, leasing, profit-sharing or deposit methods).

Illustration 11: Comparison of transition approaches

Developer A, a public entity with a 31 December fiscal year-end, sold a real estate property with a carrying value of $6 million for net proceeds of $11 million. The sale closed on 31 December 2015 but did not qualify for full accrual profit recognition because the terms of the four-year note receivable (i.e., seller financing) provided by Developer A did not meet the initial and continuing investment criteria in ASC 360-20. Under ASC 360-20, Developer A applied the installment method and determined that $1 million of profit should be recognized at the sale date, $1 million in 2016, $1 million in 2017 and $2 million in 2018 when the initial and continuing investment criteria were expected to be satisfied. Developer A will also recognize interest income from the note as it is received.

The illustration assumes that the new revenue standard is effective for Developer A for interim and annual periods beginning 1 January 2018. Management evaluates the new revenue standard and concludes that the terms of the seller financing would not have precluded the recognition of the $5 million of profit at the date of sale (i.e., the transaction price is probable of collection, control of the property has transferred).

Full retrospective approach

Developer A presents three years of comparative financial information in its 2018 annual filings with the Securities and Exchange Commission (SEC). In accordance with ASC 250,[18] the full $5 million of profit from the sale that occurred on 31 December 2015 would be recorded as a cumulative catch-up to retained earnings as of 1 January 2016 in the recasted financial information. Deferred profit of $1 million that was previously recognized in both 2016 and 2017 would no longer be included in the income statements of each respective period.

Quarterly SEC filings of Developer A will also reflect this presentation beginning 31 March 2018.

Modified retrospective approach

The sale of the property by Developer A constitutes a completed contract as defined in the new standard[19] because the property was transferred on 31 December 2015, before the date of initial application by the entity. Under the modified retrospective approach, the new standard is only applied to contracts that are in progress at the date of initial application (i.e., 1 January 2018). Therefore, Developer A would recognize the remaining $2 million of deferred revenue at 1 January 2018 as a cumulative catch-up to retained earnings at the beginning of the period. In contrast to the results under the full retrospective approach, the $1 million of deferred revenue recognized in both 2016 and 2017 continues to be reflected in each respective comparative period.

Developer A also must disclose the $2 million of profit that would have been recognized in 2018 had ASC 360-20 remained in effect.

The new standard defines a completed contract as one in which the entity has fully transferred all of the identified goods and services in accordance with today's revenue guidance before the date of initial application. However, some have questioned whether the Boards actually intended for a contract for which revenue is not yet fully recognized (e.g., a sale of real estate accounted for under one of the alternative methods in ASC 360-20) at the date of transition to be considered a completed contract. The TRG has discussed this issue and the Boards' staffs are working to summarize and clarify the Boards' intent. The answer to what constitutes a completed contract may change the accounting described in Illustration 11. Entities that are currently accounting for the sale of real estate using one of the alternative methods in ASC 360-20 should monitor the activities of the TRG and Boards.

Next steps

It is important for entities to continue to focus on their implementation plans. They should not postpone plans because the FASB has voted for a one-year deferral. Many entities are finding it more difficult to apply the new standard than they initially expected.

Entities should also continue to monitor the discussions of the Boards, SEC staff, the TRG, and hospitality and time-shares industry task forces formed by the AICPA to discuss interpretations and application of the new standard to common transactions. These groups may address issues that affect all real estate entities. In addition, the Board's project to clarify the definition of a business may also result in changes in the accounting for sales of real estate.

Endnotes:

1 The term customer is defined in ASC 606 as "a party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities in exchange for consideration." Throughout this paper, the term "customer" may be used in reference to a transaction under ASC 610-20 in which the counterparty is a "buyer" and not a customer as contemplated in ASC 606. The use of "customer" in such instances is because ASC 610-20 refers to the guidance in ASC 606 and the discussion is focused on the requirements of ASC 606.

2 In March 2015, the FASB voted to propose amending its standard to refine the guidance in the Step 1 collectibility threshold and/or add or amend examples to clarify how the threshold should be applied. The FASB staff is in the process of drafting an Exposure Draft to reflect these tentative conclusions.

3 ASU 2014-09, *Basis for Conclusions,* paragraph 129.

4 ASU 2014-09, *Basis for Conclusions,* paragraph 132.

5 This exclusion includes contracts within the scope of the following Topics: ASC 310, *Receivables*; ASC 320, *Investments — Debt and Equity Securities*; ASC 405, *Liabilities*; ASC 470, *Debt*; ASC 815, *Derivatives and Hedging*; ASC 825, *Financial Instruments*; and ASC 860, *Transfers and Servicing*.

6 Neither ASC 606 nor ASC 460 provides guidance on recognizing revenue associated with a guarantee.

7 Statement of Financial Accounting Concepts No. 6, *Elements of financial statements*.

8 ASU 2014-09, *Basis for Conclusions,* paragraph 497.

9 ASC 810-10-40-3A and ASC 810-10-40-5.

10 For further information about the phases and status of the FASB's project, *Clarifying the Definition of a Business*, refer to the Board's technical agenda at www.fasb.org.

11 ASU 2014-09, *Consequential Amendments*, paragraph 63.

12 ASC 606-10-32-8.

13 For further discussion, refer to our publication, *Joint Transition Resource Group for Revenue Recognition (TRG) items of general agreement* (SCORE No. BB2927).

14 ASC 360-20-40-41 to ASC 360-20-40-44.

15 The $93,000 guarantee value is used in this scenario for illustrative purposes only and may not accurately consider the measurement guidance of ASC 460.

16 The FASB and IASB are jointly deliberating a new leases standard. A final standard is expected in 2015 but an effective date for the new guidance has not been determined.

17 ASU 2014-09, *Basis for Conclusions,* paragraphs 134–141.

18 ASC 250-10-45-5.

19 ASC 606-10-65-1(c)(2).

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Financial Standards Update

April 1, 2016

Agenda - *I Don’t Want to Miss a Thing*

- FASB *Leases* Standard
- FASB *Revenue from Contracts with Customers* Standard
- FASB *Clarifying the Definition of a Business* Project
- FASB *Consolidation* Standard

Faculty

- Moderator
  - Christopher Drula, VP Financial Standards, NAREIT
- Panelists
  - Chris Dubrowski, Partner, Deloitte LLP
  - Michelle Montes, Partner, EY
  - Keri Shea, SVP-Finance & Treasurer, AvalonBay Communities, Inc.

Deloitte.

The new lease accounting standard

How did we get here, anyway?

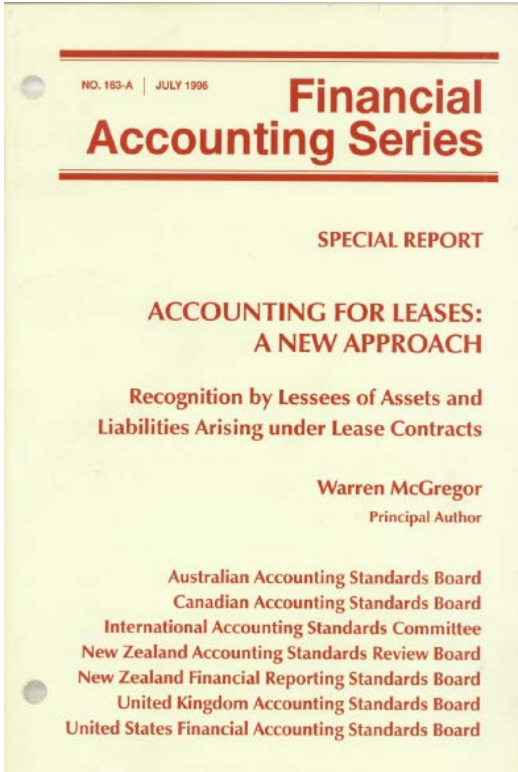
Flawed from the start

Basis for Conclusions, SFAS 13 (1976):

"Some members of the Board who support this Statement hold the view that, regardless of whether substantially all the benefits and risks of ownership are transferred, a lease, in transferring for its term the right to use property, gives rise to the acquisition of an asset and the incurrence of an obligation by the lessee which should be reflected in his financial statements."

Note-all lessees were male in 1976.

Special Report (1996)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Financial Accounting Series

SPECIAL REPORT

ACCOUNTING FOR LEASES:
A NEW APPROACH

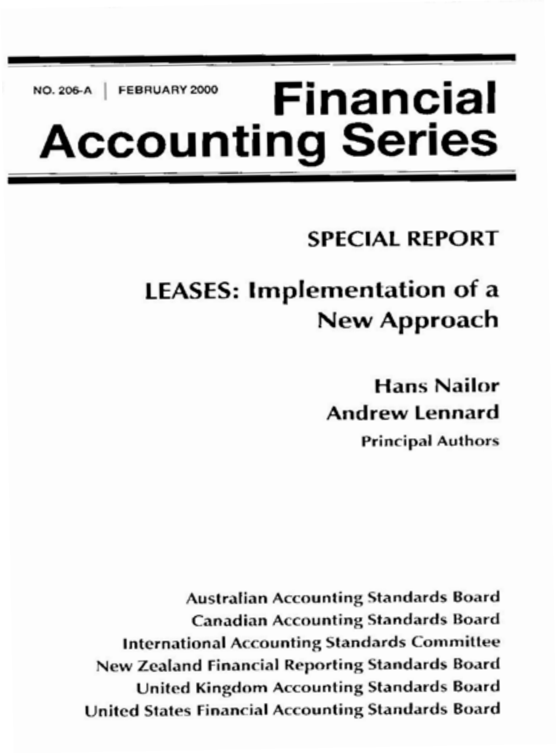
Recognition by Lessees of Assets and Liabilities Arising under Lease Contracts

Warren McGregor
Principal Author

Australian Accounting Standards Board
Canadian Accounting Standards Board
International Accounting Standards Committee
New Zealand Accounting Standards Review Board
New Zealand Financial Reporting Standards Board
United Kingdom Accounting Standards Board
United States Financial Accounting Standards Board

"Thus a lease, by transferring the right to use an item for the lease term…may give rise to the acquisition of an asset and the incurrence of a liability by the lessee, which should be recognized in its financial statements, regardless of whether the lease transfers substantially all the risks and rewards of ownership of that item to the lessee."

Special Report (2000)


NO. 206-A | FEBRUARY 2000

Financial Accounting Series

SPECIAL REPORT

LEASES: Implementation of a New Approach

Hans Nailor
Andrew Lennard
Principal Authors

Australian Accounting Standards Board
Canadian Accounting Standards Board
International Accounting Standards Committee
New Zealand Financial Reporting Standards Board
United Kingdom Accounting Standards Board
United States Financial Accounting Standards Board

"The lease has converted some or all of the lessor's existing asset (the item of property) into a financial asset. Thus, some or all of the lessor's existing property asset should be derecognized and reported as a financial asset-a receivable."

Off-balance sheet=bad; structuring=bad

Bright-line tests bring structuring opportunities

Too many liabilities off-balance sheet

How Leases Play a Shadowy Role in Accounting

Despite a Post-Enron Push, Companies Can Still Keep Big Debts Off Balance Sheets

By Jonathan Weil

Despite the post-Enron drive to improve accounting standards, U.S. companies are still allowed to keep off their balance sheets billions of dollars of lease obligations that are just as real as financial commitments originating from bank

AIG Scrutinized

AIG faces possible SEC action over arrangements regulators say allowed PNC Financial to improperly keep bad loans off the bank's books, page C1.

loans and other borrowings.

OK, let’s do this!

Wall Street Journal, September 23, 2004

Group to Alter Rules On Lease Accounting

BRUSSELS—The International Accounting Standards Board next week will unveil plans to overhaul the rules on accounting for leased assets, the board’s chairman said yesterday.

loans and other borrowings.

SEC Report – June 15, 2005

“Report and Recommendations Pursuant to Section 401(c) of the Sarbanes-Oxley Act of 2002 on Arrangements with Off-Balance Sheet Implications, Special Purpose Entities, and Transparency of Filings by Issuers”

~$1.25 trillion in future lease obligations currently not recognized by lessees; recommends “reconsideration” of lease accounting

The Neverending Story

Original Exposure Draft (ED)

Issued in August 2010	Comment period ended December 2010	786 comment letters received

Revised ED

Issued in May 2013	Comment period ended September 13, 2013	656 comment letters received

Final Standard

Issued on February 25, 2016

Effective Date

2019 for publics, 2020 for private entities

Why did this take so long?

"Nobody wants us to rush through this process only to end up with a standard that needs to be amended and deferred. We want to maximize the likelihood that we have a smooth implementation of these new important standards when we feel that we have completed the process to our satisfaction."

Leslie Seidman, FASB Chairman

Lease classification

CLASSIFICATION CRITERIA
Lessor and lessee would account for a lease as a financing lease when: ✓ *Transfers ownership* by the end of the lease term ✓ Includes a purchase option that the lessee is *reasonably certain* to exercise ✓ Term is for the *major part* of the remaining economic life of the underlying asset ✓ Present value of lease payments and the present value of any residual value guarantees amounts to *substantially all* of the fair value of the underlying asset ✓ The asset is of such specialized nature that it would have no alternative use to the lessor at the end of the lease term

The required bright-line rules in current U.S. GAAP are eliminated, but…
842-10-55-2: "When determining lease classification, one reasonable approach to assessing the criteria…would be to conclude both the following:

1) 75% or more of the remaining economic life of the underlying asset is a major part of the remaining economic life of the underlying asset.
2) 90% or more of the fair value of the underlying asset amounts to substantially all of the fair value of the underlying asset."

Lessee accounting models

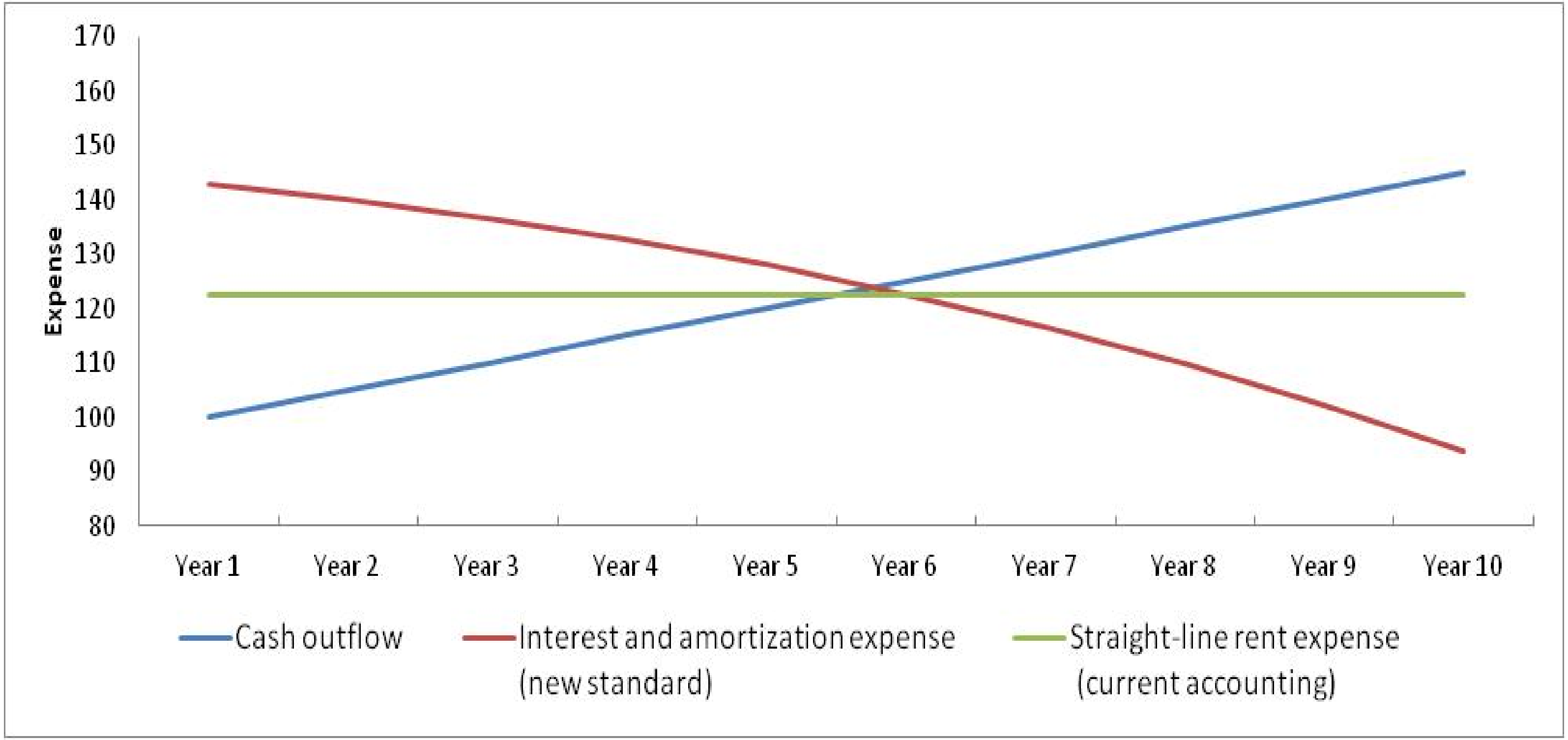
A lessee enters into a three-year lease and agrees to make the following annual payments at the end of each year: $10,000 in year 1, $15,000 in year 2, and $20,000 in year 3. The initial measurement of the right-of-use asset and liability to make lease payments is $38,000 at a discount rate of 8%.

This table highlights the differences in accounting for the lease under the financing approach and straight-line expense approach:

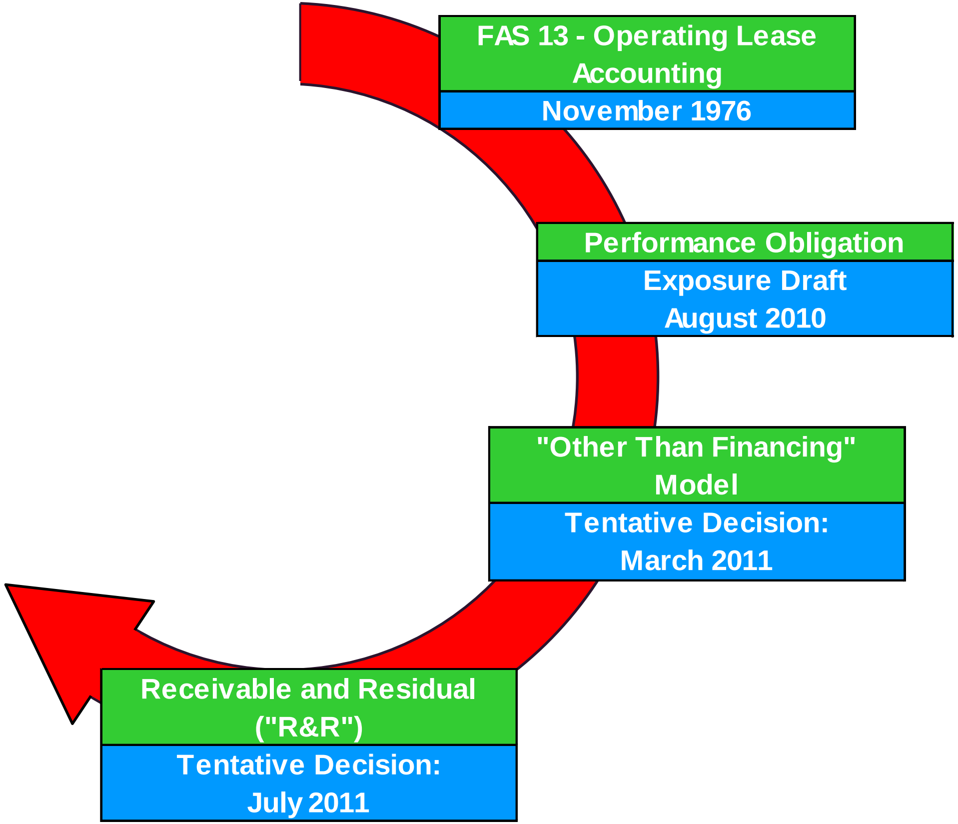
	Both Methods	Financing Approach				Straight-Line Expense Approach		
Year	Lease Liability	Interest Expense <X>	Amortization Expense <Y>	Total Lease Expense <X + Y>	Right-of-Use Asset	Lease Expense <Z>	Reduction in Right-of-Use Asset <Z – X>	Right-of-Use Asset
0	$ 38,000				$ 38,000			$ 38,000
1	31,038	$ 3,038	$ 12,666	$ 15,704	25,334	$ 15,000	$ 11,962	26,038
2	18,520	2,481	12,667	15,148	12,667	15,000	12,519	13,519
3	–	1,481	12,667	14,148	–	15,000	13,519	–
Total		$ 7,000	$ 38,000	$ 45,000		$ 45,000	$ 38,000	

Lessee accounting

Finance lease income statement effect

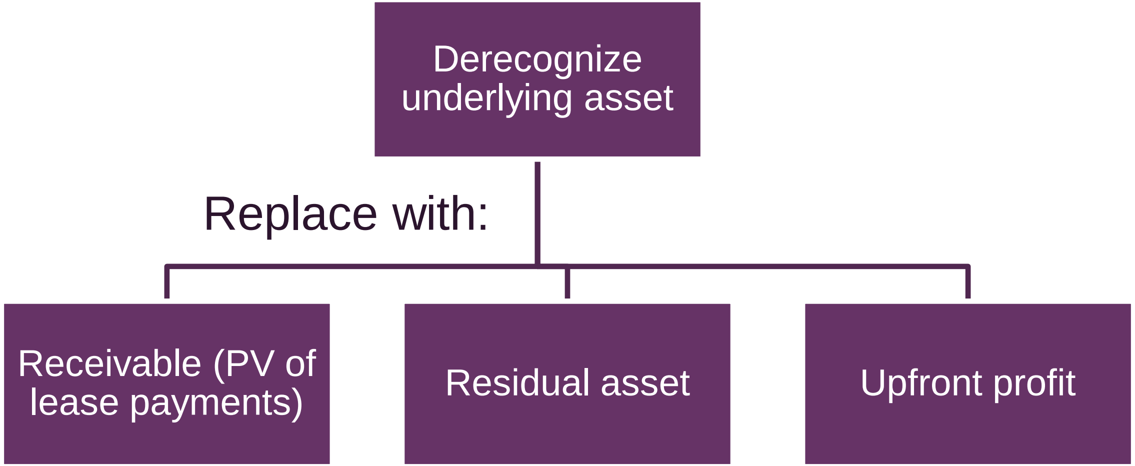


Lessor accounting…



The Receivable and Residual model

- The lessor derecognizes the underlying asset and recognizes
  - A lease receivable measured as the present value of the lease payments, and
  - A residual asset measured on an allocated-cost basis
- Any day-one profit would be recognized



Receivable and residual model-simple calculation?

Calculations necessary for a seven tenant property over a five year period of time

Calculations - Receivable & Residual

Property Cost (at acquisition)	130,000,000
Assumption: All assets are depreciable over a 40 year useful life	
Total square footage	320,000
Discount Rate (basis?)	8%

	Market Rent per SQF		
Year	Floors 1 - 2	Floor 3	Floor 4
Year 1	40	44	48.5
Year 2	42.5	46.5	51
Year 3	45	49	53.5
Year 4	47.5	51.5	56
Year 5	50	54	58.5
Year 6	52.5	56.5	61

Contractual Rent

Unit	Square Footage		Year 1	Year 2	Year 3	Year 4	Year 5	Total
1A	80,000		3,200,000	3,400,000	3,600,000	Vacant	Vacant	10,200,000
2A	80,000		3,200,000	3,400,000	3,600,000	3,800,000	4,000,000	18,000,000
3A	40,000		Vacant	Vacant	1,960,000	2,060,000	2,160,000	6,180,000
3B	40,000		Vacant	1,860,000	Vacant	2,060,000	2,160,000	6,080,000
4A	15,000		727,500	765,000	802,500	840,000	877,500	4,012,500
4B	30,000		1,455,000	1,530,000	Vacant	Vacant	Vacant	2,985,000
4C	35,000		1,697,500	1,785,000	1,872,500	1,960,000	Vacant	7,315,000
Total	320,000		10,280,000	12,740,000	11,835,000	10,720,000	9,197,500	54,772,500

Allocation of Cost per Unit

Total Property Cost 130,000,000

Unit	Square Footage	Market Rent per SQF (at acquisition)	Total Market Rent (at acquisition)	Percentage of Total	Allocation of Cost per Unit
1A	80,000	40	3,200,000	23%	30,144,928
2A	80,000	40	3,200,000	23%	30,144,928
3A	40,000	44	1,760,000	13%	16,579,710
3B	40,000	44	1,760,000	13%	16,579,710
4A	15,000	48.5	727,500	5%	6,853,261
4B	30,000	48.5	1,455,000	11%	13,706,522
4C	35,000	48.5	1,697,500	12%	15,990,942
Total	320,000		13,800,000	100%	130,000,000

Depreciation per Unit Per Year (if subject to depreciation)

Unit	Allocation of Cost per Floor		Year 1	Year 2	Year 3	Year 4	Year 5	Total
1A	30,144,928		753,623	753,623	753,623	753,623	753,623	3,768,116
2A	30,144,928		753,623	753,623	753,623	753,623	753,623	3,768,116
3A	16,579,710		414,493	414,493	414,493	414,493	414,493	2,072,464
3B	16,579,710		414,493	414,493	414,493	414,493	414,493	2,072,464
4A	6,853,261		171,332	171,332	171,332	171,332	171,332	856,658
4B	13,706,522		342,663	342,663	342,663	342,663	342,663	1,713,315
4C	15,990,942		399,774	399,774	399,774	399,774	399,774	1,998,868
Total	130,000,000		3,250,000	3,250,000	3,250,000	3,250,000	3,250,000	16,250,000

PP&E by Unit (Gross)

Unit	Square Footage	At acquisition	End of Year 1	End of Year 2	End of Year 3	End of Year 4	End of Year 5
1A	80,000	-	-	-	-	27,884,058	27,884,058
2A	80,000	-	-	-	-	-	-
3A	40,000	16,579,710	16,579,710	16,579,710	-	-	-
3B	40,000	16,579,710	16,579,710	-	15,750,725	-	-
4A	15,000	-	-	-	-	-	-
4B	30,000	-	-	-	13,021,196	13,021,196	13,021,196
4C	35,000	-	-	-	-	-	14,391,848
Total	320,000	33,159,420	33,159,420	16,579,710	28,771,920	40,905,254	55,297,101

Depreciation Expense (recognized only when the space is vacant)

Unit	Square Footage		Year 1	Year 2	Year 3	Year 4	Year 5
1A	80,000	-	-	-	-	753,623	753,623
2A	80,000	-	-	-	-	-	-
3A	40,000	-	414,493	414,493	-	-	-
3B	40,000	-	414,493	-	414,493	-	-
4A	15,000	-	-	-	-	-	-
4B	30,000	-	-	-	342,663	342,663	342,663
4C	35,000	-	-	-	-	-	399,774
Total	320,000	-	828,986	414,493	757,156	1,096,286	1,496,060

PP&E by Unit (Net of Accumulated Depreciation)

Unit	Square Footage	At acquisition	End of Year 1	End of Year 2	End of Year 3	End of Year 4	End of Year 5
1A	80,000	-	-	-	-	27,130,435	26,376,812
2A	80,000	-	-	-	-	-	-
3A	40,000	16,579,710	16,165,217	15,750,725	-	-	-
3B	40,000	16,579,710	16,165,217	-	15,336,232	-	-
4A	15,000	-	-	-	-	-	-
4B	30,000	-	-	-	12,678,533	12,335,870	11,993,207
4C	35,000	-	-	-	-	-	13,992,074
Total	320,000	33,159,420	32,330,435	15,750,725	28,014,764	39,466,304	52,362,092

Receivable - Beginning of Period

Unit	Square Footage		Beginning Year 1	Beginning Year 2	Beginning Year 3	Beginning Year 4	Beginning Year 5
1A	80,000		8,735,711	6,234,568	3,333,333	-	-
2A	80,000		14,251,157	12,191,250	9,766,550	6,947,874	3,703,704
3A	40,000		-	-	5,295,610	3,759,259	2,000,000
3B	40,000		-	1,722,222	-	3,759,259	2,000,000
4A	15,000		3,181,163	2,708,156	2,159,808	1,530,093	812,500
4B	30,000		2,658,951	1,416,667	-	-	-
4C	35,000		6,029,218	4,814,056	3,414,180	1,814,815	-
Total	320,000		34,856,200	29,086,918	23,969,482	17,811,300	8,516,204

Receivable - End of Period

Unit	Square Footage		End of Year 1	End of Year 2	End of Year 3	End of Year 4	End of Year 5
1A	80,000		6,234,568	3,333,333	-	-	-
2A	80,000		12,191,250	9,766,550	6,947,874	3,703,704	-
3A	40,000		-	-	3,759,259	2,000,000	-
3B	40,000		-	-	-	2,000,000	-
4A	15,000		2,708,156	2,159,808	1,530,093	812,500	-
4B	30,000		1,416,667	-	-	-	-
4C	35,000		4,814,056	3,414,180	1,814,815	-	-
Total	320,000		27,364,696	18,673,871	14,052,040	8,516,204	-

Interest Income (Receivable)

Unit	Square Footage		Year 1	Year 2	Year 3	Year 4	Year 5
1A	80,000		698,857	498,765	266,667		
2A	80,000		1,140,093	975,300	781,324	555,830	296,296
3A	40,000				423,649	300,741	160,000
3B	40,000			137,778		300,741	160,000
4A	15,000		254,493	216,652	172,785	122,407	65,000
4B	30,000		212,716	113,333			
4C	35,000		482,337	385,124	273,134	145,185	
Total	320,000	-	2,788,496	2,326,953	1,917,559	1,424,904	681,296

Residual Asset - Beginning of Period

Unit	Square Footage		Beginning Year 1	Beginning Year 2	Beginning Year 3	Beginning Year 4	Beginning Year 5
1A	80,000		21,409,217	23,380,431	25,533,141	-	-
2A	80,000		15,893,770	17,588,387	19,463,685	21,538,931	23,835,443
3A	40,000		-	-	10,455,114	11,661,315	13,006,674
3B	40,000		-	14,442,995	-	11,576,973	12,959,552
4A	15,000		3,672,098	4,050,536	4,467,975	4,928,434	5,436,346
4B	30,000		11,047,571	11,993,856	-	-	-
4C	35,000		9,961,724	10,921,443	11,973,621	13,127,168	-
Total	320,000	-	61,984,380	82,377,647	71,893,537	62,832,820	55,238,015

Residual Asset - End of Period

Unit	Square Footage		End of Year 1	End of Year 2	End of Year 3	End of Year 4	End of Year 5
1A	80,000		23,380,431	25,533,141	27,884,058	-	-
2A	80,000		17,588,387	19,463,685	21,538,931	23,835,443	26,376,812
3A	40,000		-	-	11,661,315	13,006,674	14,507,246
3B	40,000		-	15,750,725	-	12,959,552	14,507,246
4A	15,000		4,050,536	4,467,975	4,928,434	5,436,346	5,996,603
4B	30,000		11,993,856	13,021,196	-	-	-
4C	35,000		10,921,443	11,973,621	13,127,168	14,391,848	-
Total	320,000	-	67,934,652	90,210,343	79,139,906	69,629,863	61,387,908

Residual Accretion Rate

Unit	Square Footage		Year 1	Year 2	Year 3	Year 4	Year 5
1A	80,000		9.2%	9.2%	9.2%		
2A	80,000		10.7%	10.7%	10.7%	10.7%	10.7%
3A	40,000				11.5%	11.5%	11.5%
3B	40,000			9.1%		11.9%	11.9%
4A	15,000		10.3%	10.3%	10.3%	10.3%	10.3%
4B	30,000		8.6%	8.6%			
4C	35,000		9.6%	9.6%	9.6%	9.6%	

Residual Accretion

Unit	Square Footage		Year 1	Year 2	Year 3	Year 4	Year 5
1A	80,000		1,971,214	2,152,710	2,350,917		
2A	80,000		1,694,616	1,875,299	2,075,246	2,296,511	2,541,369
3A	40,000				1,206,201	1,345,359	1,500,572
3B	40,000			1,307,729		1,382,580	1,547,694
4A	15,000		378,438	417,439	460,459	507,913	560,257
4B	30,000		946,285	1,027,340			
4C	35,000		959,719	1,052,179	1,153,546	1,264,680	
Total	320,000	-	5,950,272	7,832,695	7,246,369	6,797,043	6,149,892

All for nothing, really

	Contractual Cash Flows	Operating Lease Revenue	Receivable & Residual Revenue
Year 1	$ 10,280,000	$ 11,123,750	$ 8,738,768
Year 2	12,740,000	12,983,750	10,159,649
Year 3	11,835,000	11,691,250	9,163,927
Year 4	10,720,000	10,401,250	8,221,947
Year 5	9,197,500	8,572,500	6,831,189
Total	**$ 54,772,500**	**$ 54,772,500**	**$ 43,115,480**

	Operating Lease Deprec. Expense	Receivable & Residual Deprec. Expense
Year 1	$ 3,250,000	$ 828,986
Year 2	3,250,000	414,493
Year 3	3,250,000	757,156
Year 4	3,250,000	1,096,286
Year 5	3,250,000	1,496,060
Total	**$ 16,250,000**	**$ 4,592,980**

	Operating Lease Net Income	Receivable & Residual Net Income
Year 1	$ 7,873,750	$ 7,909,783
Year 2	9,733,750	9,745,156
Year 3	8,441,250	8,406,771
Year 4	7,151,250	7,125,661
Year 5	5,322,500	5,335,129
Total	**$ 38,522,500**	**$ 38,522,500**

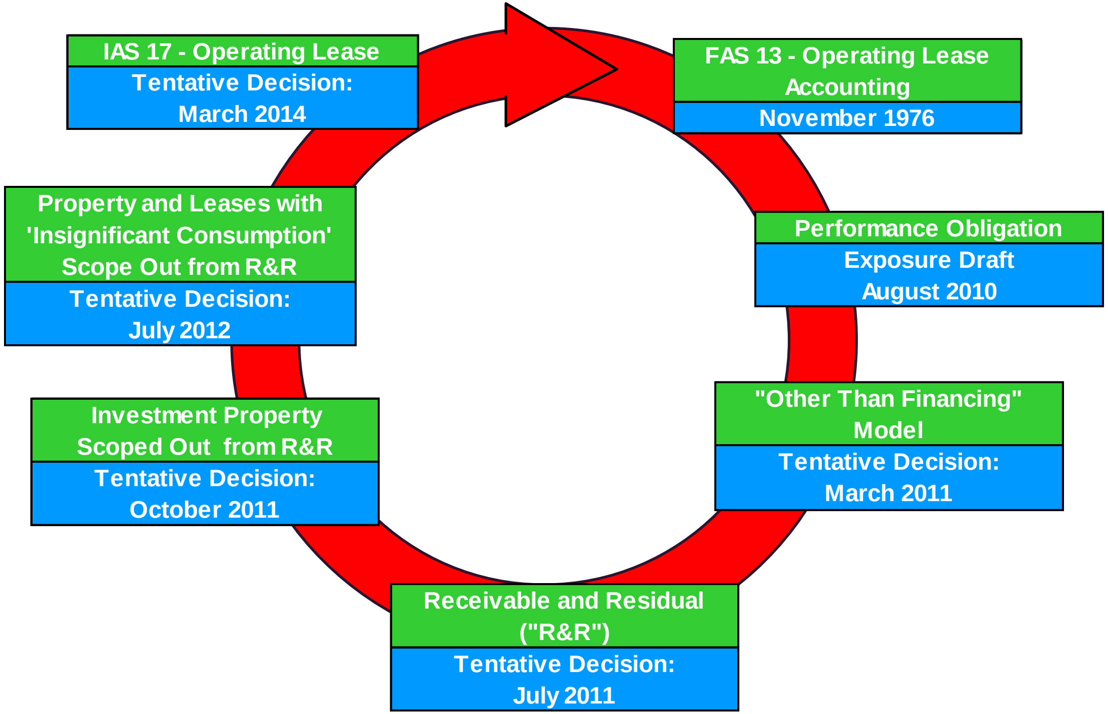
NAREIT spoke, the FASB listened

From the final standard, Basis for Conclusions:

"It would be extremely complicated to apply the approach to leases of portions of a larger asset (that is, when a lessor leases portions of a single asset to multiple parties concurrently, such as one floor of a building)."

Lessor accounting…

“And where I did begin, there I shall end” - Shakespeare



Leases project

Initial direct costs

The Boards decided that only incremental costs would qualify for capitalization.
Costs would be incremental if they would not have been incurred absent the lease being obtained.

Incremental:

- Commissions paid upon execution of a lease (internal or external)
- Payments to existing tenant to incentivize them to terminate their lease

Not incremental:

- Leasing department overhead, unsuccessful efforts
- Advertising, soliciting potential lessees, servicing existing leases
- Costs incurred before lease is obtained, such as legal or tax advice, negotiating the lease, due diligence on potential tenants

This will likely be a change in practice for our industry.

Leases project

Straight-line rent? Not necessarily!

Straight line rent for operating leases

- During redeliberations the FASB and IASB Boards decided that a lessor would recognize rental income on a systematic basis that is not straight line if that basis was more representative of the pattern in which income is earned from the underlying asset
- A lessor would be expected to recognize uneven fixed lease payments on a straight-line basis when the payments are uneven for reasons other than to reflect or compensate for market rentals or market conditions (for example, when there is significant front loading or back loading of payments or when rent-free periods exist in a lease)
- If rent steps are only intended to reflect market rent increases (inflation), can we avoid straight lining?

Leases project

Other interesting items

Sale leaseback transactions

- If the transfer of the asset is determined not to be a sale, the seller-lessee shall not derecognize the transferred asset (accounted for as a financing liability) and the buyer-lessor shall not recognize the transferred asset (accounted for as a receivable)
- Required consistency between seller-lessee and buyer-lessor accounting does not exist in current GAAP-asset can be on both parties' books

Lessee ground lease capitalization

- Existing GAAP allows payments for ground leases to be capitalized during the construction period if the project will be sold or rented
- 842-10-55-21: "…guidance does not address whether a lessee that accounts for the sale or rental of real estate projects under Topic 970 should capitalize rental costs associated with ground and building leases."
- Most ground leases will be "finance leases" on the balance sheet, so will produce interest expense, which will be capitalizable.

Leases project

What about CAM

Standard requires separate accounting for lease and non-lease (services) components of a contract

- Payments by tenant to landlord for taxes and insurance are generally considered part of the lease revenue
- Payments by tenant to landlord for common area maintenance are not part of the lease and should be recognized under the revenue standard

But

BC153: "…it similarly would be reasonable for lessors to account for multiple components of a contract as a single component if the outcome from doing so would be the same as accounting for the components separately (for example, a lessor may be able to conclude that accounting for an operating lease and a related service element as a single component results in the same accounting as treating those two elements as separate components)."

FASB *Revenue from Contracts with Customers* Standard

EY Building a better working world

Revenue recognition

ASU 2014-09

Replaces existing revenue guidance for virtually all industries and arrangements

- ASC 360-20, *Real estate sales,* is superseded

Delayed effective date (ASU 2015-14)

- Public entities – annual periods beginning after 15 December 2017
- Nonpublic entities – additional optional one-year deferral
  - Early adoption allowed for all US GAAP entities as of original public entity effective date (15 December 2016)
  - Early adoption allowed for IFRS entities upon initial issuance of standard

Transition

- Full retrospective – all periods presented using new guidance
- Modified retrospective – new guidance applied only to existing and new contracts in most current period presented; cumulative catch-up recognized at beginning of most current period presented
- SEC Staff provided relief on selected financial data table

Revenue recognition

Summary of the model

Core principle: Recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services

Step 1:	Identify the contract(s) with the customer
Step 2:	Identify the performance obligations in the contract
Step 3:	Determine the transaction price
Step 4:	Allocate the transaction price to the performance obligations
Step 5:	Recognize revenue when (or as) each performance obligation is satisfied

Revenue recognition

Real estate sales summary

Transaction: Real estate sales	Considerations
Scope	➢ May be in the scope of ASC 606, ASC 610-20, or ASC 810 ➢ Customer vs. noncustomer; business and/or in substance nonfinancial asset
Seller financing	➢ Initial and continuing investment criteria in ASC 360-20 removed ➢ Evaluation based on buyer's intent and ability to pay transaction price
Support obligations	➢ Continuing involvement criteria in ASC 360-20 removed ➢ Guarantees 'carved-out' and accounted for under ASC 460
Additional services	➢ May represent separate performance obligation and generally would not limit recognition of gain on sale of real estate
Partial sales	➢ Limited guidance in new standard ➢ FASB addressing as part of Definition of a Business project
Developers	➢ May be able to recognize revenue over time if "no alternative use / right to present payment" criteria are satisfied ➢ Criteria difficult to satisfy for most contracts in the US

Revenue recognition

Real estate sales - example

Developer P sells a hotel with a carrying value of $8m to Buyer Q. Developer P receives $1m of cash and provides seller financing of $9m in the form of a five-year amortizing note receivable.

ASC 360-20	ASC 606 / 610-20
➢ Assuming a sale has been consummated, Developer P evaluates Buyer Q's initial investment (10%) and determines that it is not sufficient to qualify for full accrual profit recognition (ASC 360-20 requires 15% investment for hotels) ➢ Developer P therefore recognizes profit using the cost recovery or installment method, depending on whether the cost of the property is reasonably assured ➢ Assuming all other criteria have been satisfied, Developer P may use the full accrual method in the future when payments received from Buyer Q satisfy both the initial and continuing investment tests	➢ Developer P assesses whether it is probable that it will collect the consideration to which it will be entitled (i.e., the transaction price is collectible). *See following slide.* ➢ If Developer P concludes the consideration is collectible, the sale and associated profit of $2m are recognized when control of the property transfers to Buyer Q ➢ When determining whether control has transferred, Developer P considers whether it has a present right to payment for the asset, as well as whether Buyer Q has legal title and physical possession of the property and has the risks and rewards of ownership

Revenue recognition

Real estate sales – example (continued)

- The transaction price (i.e., amount assessed for collectibility) may be different than the stated contract price if an entity concludes it has offered or is willing to accept a price concession
  - Such concessions or discounts are forms of variable consideration that an entity would estimate at contract inception and reduce from the contract price to derive the transaction price

Stated contract price	**$ 10,000,000**
Price concession - amount entity estimates it will offer (explicitly) or accept (implicitly) as a reduction to the contract price, unrelated to credit risk	**$ (2,000,000)**
Transaction price assessed for collectibility	**$ 8,000,000**

  - When an entity is not willing to accept less than the contract price, but is willing to accept the risk of default by the customer of contractually agreed-upon consideration (i.e., credit risk), the transaction price would not differ from the contract price. This amount would be assessed for collectibility

Revenue recognition

Real estate services and “other” summary

Transaction: Real estate services and “other”	Considerations
Property management services	➢ Evaluate whether services represent a “series of distinct services that are substantially the same and have same pattern of transfer to customer” ➢ Variable consideration related to distinct service within series is allocated to the distinct service ➢ Fixed fees or incentive fees may be recognized differently
Leasing services	➢ Unclear whether services are single performance obligation or indeterminate number of separate performance obligations ➢ Pattern of recognition may be the same for either conclusion
Development services	➢ Considerations similar to those described in “property management services” above
Costs incurred to sell real estate projects	➢ Current guidance in ASC 970 removed ➢ New guidance in ASC 340-40 for costs incurred to obtain a contract

Revenue recognition

Real estate services and “other” summary

Transaction: Real estate leases	Considerations
Lease payments	➢ Not within scope of revenue standard – refer to leases project
Common Area Maintenance (CAM)	➢ Additional service to the lessee and would therefore represent a “non-lease component” that is accounted for under the revenue standard ➢ Pro-rata CAM may meet the criteria for recognizing variable consideration related to a “series of services” ➢ Fixed CAM arrangements would likely require over time recognition using a measure of progress
Real estate taxes and insurance	➢ Real estate taxes and insurance are lease components and not within scope of revenue standard
Sale-leaseback transactions	➢ ASC 360-20 will temporarily remain in codification for purposes of evaluating sale-leaseback transactions involving real estate ➢ A seller-lessee and a buyer-lessor use the new revenue guidance and other criteria to determine whether a sale has occurred. If control of an underlying asset passes to the buyer-lessor, the transaction is accounted for as a sale and a lease by both parties. If not, the transaction is accounted for as a financing by both parties

FASB *Clarifying the Definition of a Business* Project

Clarifying the Definition of a Business

Background

- Current definition of a business too broad
- Cost/effort of evaluation
- Interpretation differences with IFRS
- Impacts on
  - Acquisition accounting – record at fair value vs. relative fair value, treatment of acquisition costs
  - Sale accounting

Clarifying the Definition of a Business

Current Definition

- Business = set of acquired activities and assets that must include inputs and one or more substantive processes that together contribute to the ability to create outputs
- Outputs – not required
- Full set of inputs and processes are not required if can be acquired by market participant
- No minimum input and/or process set required

Clarifying the Definition of a Business

ED Proposed Changes/Clarifications

- Eliminate evaluation of market replacement of any missing elements
- Provide “substantially all” threshold for fair value of gross assets acquired
- Narrow the definition of outputs
- Clarify that existence of continuing revenues (i.e., an in-place lease) is not indicative of substantive process being acquired

Clarifying the Definition of a Business

Challenges

- No defined bright line for “substantially all” screen
- Cannot group tangible and intangible assets (i.e., in-place or above/below market lease intangibles)
- Cannot group mixed use acquisitions
- Does not address difference in acquisition costs between asset and business
- Reference Case H and I in ED

Clarifying the Definition of a Business

NAREIT Comment Letter

- Align business combination guidance with existing asset acquisition guidance
- Amend the significance criteria to include a comparison of assets acquired to existing portfolio
- Add guidance that the acquisition of multiple properties in various stages of development would be considered similar assets

FASB *Consolidation* Standard

EY Building a better working world

Recently completed projects

Consolidation (ASU 2015-02)

New guidance makes targeted changes to ASC 810, *Consolidation*

- Effective for public entities in periods beginning after 15 December 2015
- Early adoption permitted; one year deferral for private entities

Focus of project is rescinding FAS 167 deferral for investment companies, but amendments apply to all

Key amendments include:

- Modification of criteria for determining whether fees paid to a decision maker represent a variable interest (focus on whether fees are at market)
- When assessing whether a partnership (or similar entity) is a VIE:
  - No longer consider substance of a general partner’s investment
  - Focus on whether a simple majority of limited partners have kick-out rights or substantive participating rights

Recently completed projects (cont.)

Consolidation (ASU 2015-02)

- Determination of primary beneficiary
  - Benefits criteria exclude fees at market and commensurate with services provided
  - Consider direct and indirect interests held through related parties
- Voting model for partnerships (and similar entities)
  - Eliminates presumption that general partner controls a limited partnership

Consolidation

VIE determination

Scope | Variable Interest | **Variable Interest Entity** | Primary Beneficiary

Amendments are focused on limited partnerships (LPs) and similar entities (e.g., LLCs)

Changes impact determination of whether equity holders lack the power to direct the activities that most significantly impact the entity's economic performance

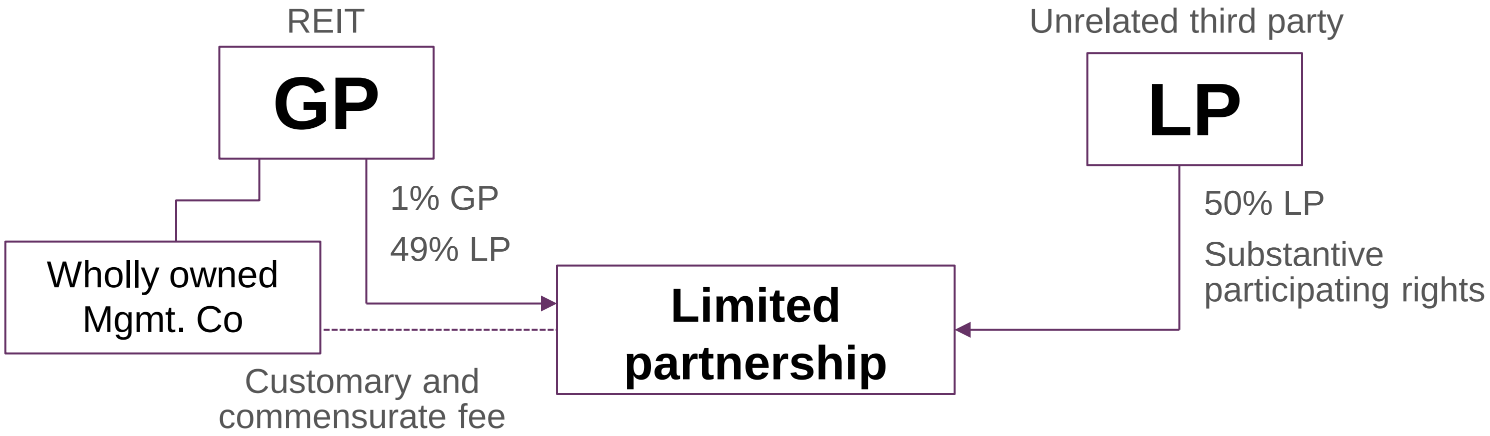
- Evaluation previously focused on whether general partner's at-risk equity investment was substantive

Analysis now based on existence of ***substantive kick-out rights*** or ***substantive participating rights*** held by the limited partners

- Rights are substantive if held by a single limited partner or a simple majority (or lower threshold) of limited partners
- Previously these rights must have been held by a single limited partner

VIE determination

Real estate – example 1

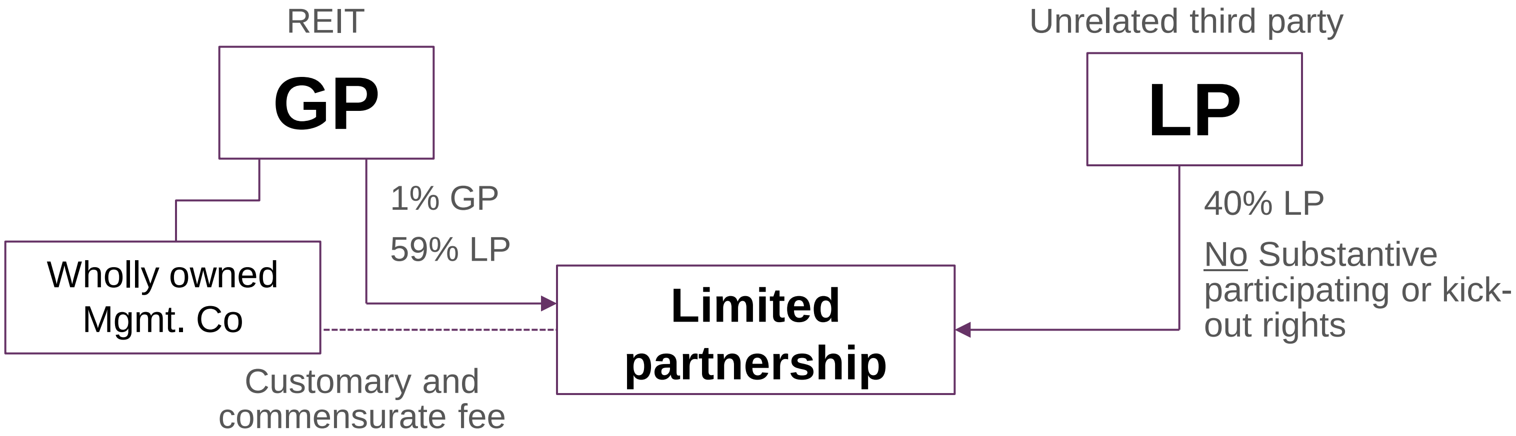


FAS 167: Limited partnership is <u>not</u> a VIE because an at-risk equity holder makes significant decisions. Applying the ASC 810-20 voting model, no party would consolidate

ASU 2015-02: Limited partnership is <u>not</u> a VIE. Applying the amended voting model, no party would consolidate

VIE determination

Real estate – example 2



FAS 167: Limited partnership is not a VIE because an at-risk equity holder makes significant decisions. Applying the ASC 810-20 voting model, REIT would consolidate.

ASU 2015-02: Limited partnership is a VIE because LP's have no susbtantive kick-out or participating rights. REIT would consolidate as Primary Beneficiary.

Questions?

No. 2015-02
Updated 28 July 2015

Technical Line

FASB — proposed guidance

Final standard on leases is taking shape

The new standard could affect companies' decisions about whether to lease or buy assets.

What you need to know

- The FASB and the IASB have substantially completed redeliberations on new leases standards that would require lessees to recognize assets and liabilities for most leases.
- Lessees and lessors applying US GAAP would classify most leases using a principle generally consistent with that of IAS 17, which is similar to current US GAAP but without the bright lines.
- The Boards have made different decisions about lease classification and the recognition, measurement and presentation of leases for lessees and lessors. In some cases, these differences would result in similar transactions being accounted for differently under US GAAP and IFRS.
- The Boards will set effective dates before issuing the new standards. We expect the Boards to issue the standards in the fourth quarter of 2015.

Overview

The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) (collectively, the Boards) have substantially completed redeliberations on new standards that would significantly change the accounting for leases and could have far-reaching implications for a company's finances and operations. This Technical Line is based on the FASB's decisions in redeliberations and supersedes the Technical Line with the same title that we issued on 25 March 2015.

Building a better working world

The standards the FASB and the IASB plan to issue would require lessees to recognize most leases on their balance sheets as lease liabilities with corresponding right-of-use assets. While many aspects of lessor accounting would remain the same, the standard that the FASB plans to issue (the new standard) would eliminate today's real estate-specific guidance and change today's additional lessor classification criteria.[1] It also would change what would be considered initial direct costs. The new standards would incorporate feedback the Boards received from constituents on their 2013 exposure draft[2] (2013 ED).

Like today's guidance in Accounting Standards Codification (ASC) 840, *Leases*, the new standard would require lessees to classify most leases. Leases would be classified as either Type A leases (generally today's capital leases) or Type B leases (generally today's operating leases). As discussed later in this publication, the IASB has decided that lessees would apply a single model for all recognized leases and would have the option not to recognize and measure leases of small assets.

The new standard would require lessors to classify all leases as either Type A leases or Type B leases (generally today's operating leases). There would be three categories of Type A leases for lessors: (1) those with selling profit that is recognized or deferred (generally today's sales-type leases), (2) those with no selling profit (generally today's direct financing leases), and (3) certain leases where collectibility of lease payments is not probable. Leases in the latter category would be recognized and measured in accordance with the new revenue recognition standard (i.e., ASC 606, *Revenue from Contracts with Customers)*. As discussed later in this publication, the IASB also has decided that lessors would apply a dual classification model for all leases.

Leases would be classified using a principle generally consistent with that of International Accounting Standards (IAS) 17, *Leases*, which is similar to US GAAP but without today's bright lines (i.e., the "75% of economic life" and "90% of fair value" tests in ASC 840). The new standard would eliminate today's real estate-specific guidance and would change today's additional lessor classification criteria. Lease classification would be important in determining how and when a lessee and a lessor would recognize lease expense and revenue, respectively, and what assets a lessor would record.

For lessees, the income statement recognition pattern for Type A leases would be similar to that of today's capital leases. The income statement recognition pattern for Type A leases for lessors would be similar to that of today's sales-type or direct financing leases. However, lessors would also evaluate whether a Type A lease, in effect, transfers control of the underlying asset to the lessee when determining whether to recognize or defer recognition of any profit. In addition, for some Type A leases, the recognition and measurement provisions of ASC 606 would apply.

Lessees' and lessors' income statement recognition patterns for Type B leases would be similar to today's patterns for operating leases.

For lessees, recognizing lease-related assets and liabilities could have significant financial reporting and business implications, such as:

- Key balance sheet metrics could change.
- Debt covenants and borrowing capacity might be affected.
- Decisions about whether to lease or buy significant assets might change.

As discussed in Appendix B to this publication, the new standard would eliminate the following lease and lease-related accounting guidance:

- Lessee involvement in asset construction ("build-to-suit" transactions)
- Separate requirements for leases involving real estate
- Leveraged leases that are not grandfathered upon transition

Before issuing a final standard, the FASB plans to revisit interpretive guidance in ASC 840 to determine whether to carry forward guidance it did not include in its 2013 ED. This could result in certain guidance being carried forward to the new standard, such as the following:

- Sale of assets subject to a lease or intended to be leased by the purchaser to a third party
- Lessee maintenance deposits
- The sale of tax benefits associated with a leased asset
- Accounting for a loss on a sublease

The FASB has not yet discussed an effective date but plans to address it before issuing a final standard. Given the current timeline, an effective date of 1 January 2018 or later is likely.

The new standard's transition provisions would be applied using a modified retrospective approach at the beginning of the earliest comparative period presented in the financial statements. For example, if the standard is effective for 2018 for calendar-year companies, a company that presents three years of financial statements would have an effective date of 1 January 2018 and would apply the transition provisions to periods beginning 1 January 2016. Full retrospective application would be prohibited.

This publication discusses how the FASB's standard would be applied and is intended to help companies consider the effects of adopting it. Please note that our publication is based on available information regarding the FASB's decisions in redeliberations. Until a final standard is issued, these decisions are tentative. The FASB may also clarify its decisions in the final standard. The discussions and illustrations in this publication represent our preliminary thoughts.

Contents

Identifying a lease

Scope and scope exclusions (updated July 2015)

The scope of the new standard would be broader than the scope of ASC 840 and would not be limited to leases of property, plant and equipment. The new standard would apply to leases of all assets, except for the following:

- Leases of intangible assets
- Leases to explore for or use natural resources (e.g., minerals, oil, natural gas, similar non-regenerative resources)
- Leases of biological assets, including timber

How we see it

We believe that service concession arrangements[3] within the scope of ASC 853, *Service Concession Arrangements,* would be outside the scope of the new standard because they are currently excluded from the scope of today's guidance on leases. The FASB did not address them in the 2013 ED (and did not discuss them in redeliberations) because ASC 853 was codified after the FASB issued the ED.

A lease conveys the right to control the use of an identified asset.

Key differences between US GAAP and IFRS

Under the IASB's new standard, lessees of intangible assets could, as a policy election, apply the new lease standard, but they would not be required to. However, the IASB's new standard would specifically exclude lessors' leases of intangible assets from its scope.

Refer to Appendix C for a summary of key differences between US GAAP and IFRS.

The requirement in ASC 350-40, *Intangibles — Goodwill and Other — Internal-Use Software,* that required licensees to analogize to ASC 840 for purposes of determining the accounting for a software licensing arrangement was eliminated by Accounting Standards Update (ASU) 2015-05.[4] Instead, customers will account for software licenses that are in the scope of ASC 350-40 in the same manner as licenses of other intangible assets.

Definition of a lease

A lease would be defined as a contract (i.e., an agreement between two or more parties that creates enforceable rights and obligations) that conveys the right to use an asset (i.e., the underlying asset) for a period of time in exchange for consideration. To be a lease, a contract would have to meet both of the following criteria:

- Fulfillment of the contract depends on the use of an identified asset.
- The contract conveys the right to control the use of the identified asset.

Identified asset

The FASB indicated that a contract's dependence on an identified asset is fundamental to the definition of a lease. This concept is generally consistent with the "specified asset" concept in ASC 840. Under the new standard, an identified asset could be either implicitly or explicitly specified in a contract and could be a physically distinct portion of a larger asset (e.g., a floor of a building). However, a capacity portion of an asset that is less than substantially all of that asset's capacity (e.g., 60% of a pipeline's capacity) would not be an identified asset because it is not physically distinct from the remaining capacity of the asset.

Illustration 1 — Identified asset

Scenario A

Assume that Customer X enters into a 12-year contract for the right to use a specified capacity of a supplier's data transmission within a fiber optic cable between New York and London. The contract identifies 3 of the cable's 20 fibers. The 3 fibers are dedicated solely to Customer X's data for the duration of the contract term.

Analysis: The 3 fibers would be identified assets because they are specified in the contract and are physically distinct from the other 17 fibers in the cable.

Scenario B

Assume the same facts as in Scenario A, except that the supplier is free to use any of the cable's 20 fibers, at any time during the contract term, to transmit any of its customers' data, including Customer X's data.

Analysis: The fibers are not identified assets because the contract allows the supplier to use any of the cable's 20 fibers to fulfill its obligations to Customer X, whose portion of the cable's capacity is not physically distinct from the cable's remaining capacity.

A contract would not involve the use of an identified asset if a supplier has the substantive right to substitute the asset used to fulfill the contract. A substitution right would be substantive if both of the following conditions are met:

- The supplier has the practical ability to substitute the asset.
- The supplier can benefit from exercising the right to substitute the asset.

A customer would presume that fulfillment of a contract depends on the use of an identified asset when it is impractical for the customer to evaluate either of these conditions. No presumption for suppliers is necessary because they generally have sufficient information to make such a determination.

Contract terms that allow or require a supplier to substitute other assets only when the underlying asset is not operating properly (e.g., a normal warranty provision) or when a technical upgrade becomes available would not create a substantive substitution right.

The FASB intends for the conditions above to mitigate the risk that customers and/or suppliers would structure arrangements with non-substantive substitution clauses to avoid applying lease accounting.

Illustration 2 — Substitution rights

Scenario A

Assume that an electronic data storage provider (supplier) provides services, through a centralized data center, that involve the use of a specified server (Server No. 9). The supplier maintains many identical servers in a single, accessible location and is permitted to and can easily substitute another server without the customer's consent. Further, the supplier would benefit from substituting an alternative asset, because it allows the supplier flexibility to optimize the performance of its network while incurring only nominal cost.

Analysis: Fulfillment of this contract would not depend on the use of an identified asset. Specifically, the supplier has the practical ability to substitute the asset and would benefit from such a substitution.

Scenario B

Assume the same facts as in Scenario A except that Server No. 9 is customized, and the supplier would not have the practical ability to substitute the customized asset. Additionally, the supplier would not obtain any benefits from sourcing a similar alternative asset. For example, the server may contain the customer's confidential information, requiring the destruction of the asset's primary components (e.g., hardware, software) adding significant costs to the supplier without benefiting the supplier, if substituted.

Analysis: Because it is not practical for the supplier to substitute the asset and the supplier would not benefit from substituting the asset, the substitution right would be non-substantive, and Server No. 9 would be an identified asset. In this scenario, neither of the conditions is met, but it is important to note that both conditions must be met for the supplier to have a substantive substitution right.

How we see it

The requirement that a substitution right must benefit the supplier in order to be substantive is a new concept that could disqualify substitution rights from being considered substantive.

Determining when a customer has the right to direct the use of the identified asset may require judgment.

Right to control the use of the identified asset

A contract would convey the right to control the use of an identified asset if, throughout the contract term, the customer has the right to both:

- Direct the use of the identified asset
- Obtain substantially all of the potential economic benefits from directing the use of the identified asset

Requiring a customer to have the right to direct the use of an identified asset would be a change from ASC 840. A contract may meet ASC 840's control criterion if, for example, the customer obtains substantially all of the output of an underlying asset. Under the new standard, these arrangements would no longer be considered leases unless the customer also has the right to direct the use of the identified asset.

Right to direct the use of the identified asset

A customer has the right to direct the use of an identified asset whenever it has the right to direct how and for what purpose the asset is used, including the right to change how and for what purpose the asset is used, throughout the period of use.

The determination of whether a customer has the right to direct how and for what purpose an asset is used should focus on whether the customer has the right to make the decisions that most significantly affect the economic benefits that can be derived from the use of the underlying asset. This right may include directing how, when, whether and where the asset is used and what it is used for throughout the contract term. Importantly, this right would permit the customer to change its decisions throughout the contract term without approval from the supplier. The customer would not necessarily need the right to operate the underlying asset to have the right to direct its use. That is, the customer may direct the use of an asset that is operated by the supplier's personnel.

If neither the customer nor the supplier directs how and for what purpose the asset is used throughout the period of use (e.g., when the contract specifies how and for what purpose the asset is used or when decisions are made jointly throughout the period of use), the customer would have the right to direct the use of the identified asset in either of the following circumstances:

- The customer has the right to operate the asset or direct others to operate the asset in a manner that it determines (with the supplier having no right to change those operating instructions).
- The customer designed the asset, or caused it to be designed, in a way that predetermines how and for what purpose the asset will be used or how the asset will be operated.

A supplier's protective rights, in isolation, would not prevent the customer from having the right to direct the use of an identified asset. The FASB believes that protective rights typically define the scope of the customer's use of the asset without removing the customer's right to direct the use of the asset. Protective rights are intended to protect a supplier's interests (e.g., interests in the asset, its personnel, compliance with laws and regulations) and might take the form of a specified maximum amount of asset use or a requirement to follow specific operating instructions.

How we see it

- We understand that the FASB does not intend for the assessment of whether a customer has the right to direct "how" and "for what purpose" an asset is used to be two separate determinations. Instead, the assessment would be holistic, encompassing how, when, whether and where an asset is used and what it is used for (including the right to change these decisions) throughout the period of its use.
- We still have questions about how the definition would be applied to certain arrangements. For example, in contracts that include significant services, we believe that determining whether the contract conveys the right to direct the use of an identified asset may be challenging.

Illustration 3 — Right to direct the use of an asset

Customer enters into a contract with Supplier to use Automobile A for a three-year period. Automobile A is specified in the contract. Supplier cannot substitute another vehicle unless Automobile A is not operational (e.g., it breaks down).

Under the contract, Customer operates Automobile A (i.e., drives the vehicle) or directs others to operate Automobile A (e.g., hires a driver). Customer decides how to use the vehicle (within contractual limitations, discussed below). In addition, Customer decides where Automobile A goes as well as when or whether it is used, and what it is used for, throughout the period of use. Customer can also change its decisions throughout the period of use.

Under the contract, Supplier provides scheduled maintenance services and specifies that Customer can use Automobile A for a maximum of 12,000 miles per year without a substantive penalty. In addition, Supplier prohibits certain uses of Automobile A (e.g., moving it overseas) and modifications of Automobile A to protect its interest in the asset.

Analysis: Customer has the right to direct the use of Automobile A. Customer has the right to direct how the vehicle is used, when or whether the vehicle is used, where the vehicle goes and what the vehicle is used for. Customer also has the right to change the aforementioned decisions.

Supplier's limits on annual mileage and certain uses for the vehicle are considered protective rights that define the scope of Customer's use of the asset but do not affect the assessment of whether Customer directs the use of the asset.

Right to obtain substantially all of the potential economic benefits from directing the use of the identified asset

A customer's right to control the use of an identified asset also depends on its right to obtain substantially all of the potential economic benefits from directing the use of the asset during the contract term. The customer can obtain economic benefits either directly or indirectly through the asset's primary outputs (i.e., goods or services) and any byproducts (e.g., renewable energy credits). However, other tax benefits, such as those related to the ownership of the asset (e.g., excess tax depreciation benefits), would not be considered potential economic benefits of use.

How we see it

The term "substantially all" was not defined in the 2013 ED and was not addressed during redeliberations. However, entities might consider the term to mean more than 90%, based on how it is defined in ASC 840 in the context of sale and leaseback transactions. That definition states that "if the present value of a reasonable amount of rental for the leaseback represents 10 percent or less of the fair value of the asset sold, the seller-lessee would be presumed to have transferred to the purchaser-lessor the right to substantially all of the remaining use of the property sold."

The FASB decided against including an additional requirement that, for a contract to contain a lease, a customer must have the ability to derive benefits from directing the use of an identified asset on its own or together with other resources (e.g., goods or services) that are either sold separately (by the supplier or any other supplier) or can be sourced in a reasonable period of time. Some members of the FASB indicated that such a requirement would have made applying the definition more complex, and the costs would have outweighed the benefits. They also noted that the FASB's staff was unable to identify arrangements in which the conclusion would change as a result of the additional requirement.

Cancelable leases

The new standard would apply to contracts that are referred to as "cancelable," "month-to-month," "at will," "evergreen," "perpetual" or "rolling" if they create enforceable rights and obligations. Any noncancelable periods in contracts meeting the definition of a lease would be considered part of the lease term. See the lease term section below.

For example, consider an agreement with an initial noncancelable period of one year and an extension for an additional year if both parties agree. The initial one-year noncancelable period would meet the definition of a contract because it creates enforceable rights and obligations. However, the one-year extension period would not be a contract because either party could unilaterally elect to not extend the arrangement without incurring a substantive penalty.

Short-term leases

Lessees could make an accounting policy election (by class of underlying asset) to apply a method similar to current operating lease accounting to leases with a lease term of 12 months or less (short-term leases). To evaluate whether a lease qualifies for this accounting, the lease term would be determined in a manner consistent with the lease term of all other leases. For example, the lease term would only include periods covered by lease renewal options that a lessee is reasonably certain to exercise and would also include periods covered by lease termination options that a lessee is reasonably certain not to exercise. See the lease term section below.

Illustration 4 — Short-term lease
Scenario A A lessee enters into a lease with a nine-month noncancelable term with an option to extend the lease for four months. At the lease commencement date, the lessee concludes that it is reasonably certain to exercise the extension option because the monthly lease payments during the extension period are significantly below market rates. *Analysis*: The lease term is greater than 12 months (i.e., 13 months). Therefore, the lessee may not account for the lease similar to operating lease accounting under ASC 840 today. Scenario B A lessee enters into a lease with a nine-month noncancelable term with an option to extend the lease for four months. At the lease commencement date, the lessee concludes that it is not reasonably certain to exercise the extension option because the monthly lease payments during the optional extension period are at market rates and there are no other factors that would make exercise of the renewal option reasonably certain. *Analysis*: The lease term is 12 months or less (i.e., nine months). Therefore, the lessee may (subject to its accounting policy, by class of underlying asset) account for the lease in a manner similar to an operating lease under ASC 840 today.

The short-term lease accounting policy election is intended to reduce the cost and complexity of applying the new standard. Lessees making the election would recognize lease expense on a straight-line basis over the lease term. Although such leases would not be recognized on the balance sheet, they would still meet the definition of a lease. As such, certain quantitative and qualitative disclosures would be required for short-term leases if a lessee makes such a policy election.

How we see it

- In its 2013 ED, the FASB proposed making the short-term lease accounting policy election available to lessees and lessors. However, given the FASB's decisions on lessor accounting, we believe the election will not be available to lessors in the final standard.
- The 2013 ED also said that any lease that contains a purchase option would not be considered a short-term lease. Because the FASB did not discuss this provision during redeliberations, it appears that such leases would not be short-term leases under the new standard.

Leases of small assets (IFRS-only)

Key differences between US GAAP and IFRS
The IASB's new standard would include an exemption from its recognition and measurement provisions for leases of small assets for lessees. The IASB's new standard would specify that the exemption only applies to leases of assets that are not dependent on, or highly interrelated with, other leased assets. The Basis for Conclusions to the IASB's new standard would include a discussion of the quantitative threshold that the IASB considers appropriate in applying the exemption. In its redeliberations, the IASB discussed a threshold of $5,000. This was intended to help preparers determine what is meant by "small" and would be expressed in terms of the value of the underlying asset when new. Refer to Appendix C for a summary of key differences between US GAAP and IFRS.

Identifying and separating lease and non-lease components and allocating contract consideration

Identifying and separating lease from non-lease components of contracts

Many contracts contain a lease coupled with an agreement to purchase or sell other goods or services (non-lease components). For these contracts, the non-lease components would be identified and accounted for separately from the lease component (except when a lessee applies the practical expedient as discussed below). The non-lease components may be accounted for as executory arrangements by lessees (customers) or as contracts subject to the new revenue recognition standard (i.e., ASC 606, *Revenue from Contracts with Customers*) by lessors (suppliers).

How we see it

Identifying non-lease components of contracts may change practice for some lessees. Today, entities may not focus on identifying lease and non-lease components because their accounting treatment (e.g., the accounting for an operating lease and a service contract) is often the same. However, because most leases would be recognized on the balance sheet under the new standard, lessees may need to put more robust processes in place to identify the lease and non-lease components of contracts.

Lessees could make a policy election to account for a lease and non-lease components as a single lease component.

Activities or lessor costs in a contract that do not provide the lessee with an additional good or service would not be considered lease or non-lease components, and lessees and lessors would not allocate contract consideration (discussed below) to these activities or costs. An example would be administrative costs a lessor charges a lessee. However, activities or lessor costs such as a lessor providing services (e.g., maintenance, supply of utilities) or operating the underlying asset (e.g., vessel charter, aircraft wet lease) would generally represent non-lease components.

Under current US GAAP, lease-related executory costs (e.g., insurance, maintenance, taxes) are considered part of lease components (or lease elements) for the purpose of separating lease and non-lease elements. However, under the new standard, certain lease-related executory costs, such as maintenance activities, would be non-lease components. Additionally, arrangements that include payments for other items such as taxes and insurance would have to be evaluated to determine whether an additional good or service is being provided to the lessee and whether those items should be considered lease or non-lease components.

Practical expedient — lessees

The new standard would provide a practical expedient that would permit lessees to make an accounting policy election (by class of underlying asset) to account for the lease and non-lease components of a contract as a single lease component. The FASB expects the practical expedient to most often be used when the non-lease components of a contract are not significant when compared with the lease components of a contract.

Lessees that make the policy election to account for the lease and non-lease components of contracts as a single lease component would allocate all of the contract consideration to the lease. Therefore, the initial and subsequent measurement of the lease liability and right-of-use asset would be higher than if the policy election were not applied. See the lessee accounting section below for a discussion of measurement of lease liabilities and right-of-use assets.

Identifying and separating lease components

For contracts that contain the rights to use multiple assets (e.g., a building and equipment), the right to use each asset would be considered a separate lease component if both of the following criteria are met:

- The lessee can benefit from the use of the asset either on its own or together with other readily available resources (i.e., goods or services that are sold or leased separately, by the lessor or other suppliers, or that the lessee has already obtained from the lessor or in other transactions or events).
- The underlying asset is neither dependent on, nor highly interrelated with, the other underlying assets in the contract.

If one or both of these criteria are not met, the right to use multiple assets would be considered a single lease component.

Illustration 5 — Identifying and separating lease components

Scenario A

Assume that a lessee enters into a lease of a warehouse and the surrounding parking lot that is used for deliveries and truck parking. The lessee is a local trucking company that intends to use the warehouse as the hub for its shipping operations.

Analysis: The contract contains one lease component. The lessee would be unable to benefit from the use of the warehouse without also using the parking lot. Therefore, the warehouse space is dependent upon the parking lot.

Scenario B

Assume the same facts as in Scenario A, except that the contract also conveys the right to use an additional plot of land that is adjacent to the parking lot. This plot of land could be developed by the lessee for other uses (e.g., to construct a truck maintenance facility).

Analysis: The contract contains two lease components: a lease of the warehouse (together with the parking lot) and a lease of the adjacent plot of land. Because the adjacent land could be developed for other uses independent of the warehouse and parking lot, the lessee can benefit from the adjacent plot of land on its own or together with other readily available resources. The lessee can also benefit from the use of the warehouse and parking lot on its own or together with other readily available resources.

Allocating contract consideration

Lessees that do not make an accounting policy election to use the practical expedient to account for a lease and non-lease components of a contract as a single lease component would allocate contract consideration to the lease and non-lease components on a relative standalone price basis. Lessees would use observable standalone prices (i.e., prices that the lessor or a similar supplier would charge separately for a similar lease, good or service component of a contract) when available. If observable standalone prices are not available, lessees would be permitted to estimate standalone prices. In doing so, lessees would be required to maximize the use of observable information and to apply estimation methods in a consistent manner. This would be similar to how lessees allocate contract consideration under current US GAAP.

Lessors would be required to apply the new revenue recognition standard (i.e., ASC 606) to allocate contract consideration between the lease and non-lease components of a contract.

Allocating contract consideration — reassessment

Lessees would be required to reallocate consideration upon either:

- A contract modification that is not accounted for as a separate, new lease
- A reassessment of the lease term or a lessee's purchase option (i.e., whether the lessee is reasonably certain to exercise the option)

How we see it

Although the FASB decided to require lessees to reallocate contract consideration upon the reassessment of the lease term or a lessee's purchase option, we believe the FASB intended for lessees to reallocate contract consideration only when a reassessment results in a change to either the lease term or to the lessee's conclusion about whether it is reasonably certain that the lessee will exercise a purchase option.

Lessors would be required to reallocate contract consideration upon a modification that is not accounted for as a separate, new lease.

Modifications resulting in a separate, new lease for lessors and lessees would require consideration to be allocated to the lease and non-lease components (as applicable), as with any new lease. See the lease modifications section below.

Refer to Appendix A for a summary of lessee and lessor reassessment requirements.

Lease modifications (updated July 2015)

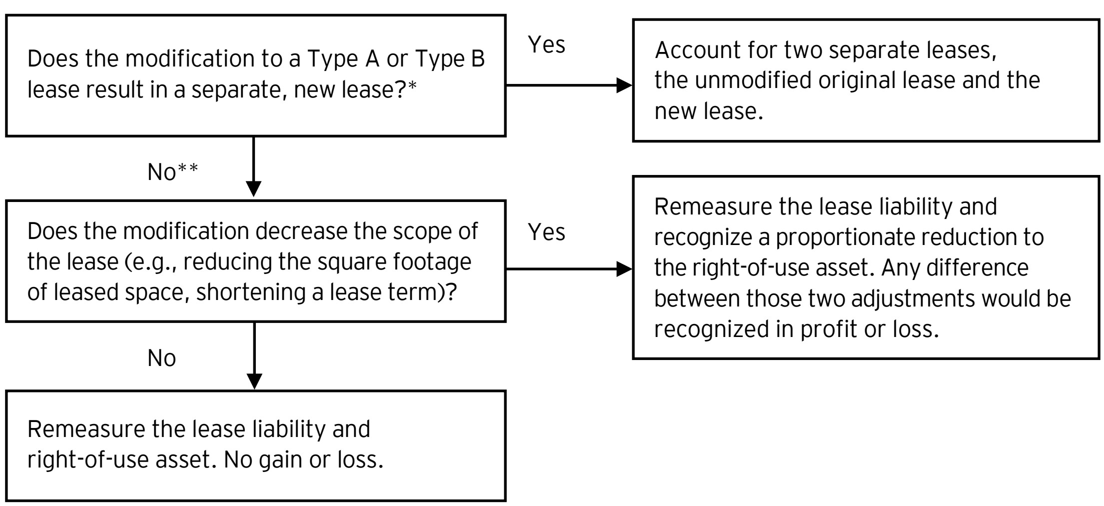
The new standard would define a lease modification as any change to the contractual terms and conditions of a lease that was not part of the original terms and conditions of the lease.

Lessees and lessors would account for a lease modification as a separate, new lease when both of the following conditions are met:

- The modification grants the lessee an additional right-of-use (e.g., an additional underlying asset, the same underlying asset for an additional period of time not contemplated by a renewal option) not included in the original lease.
- The additional right-of-use is priced commensurate with its standalone price.

This type of modification would result in a lessee and lessor accounting for two separate leases, the unmodified original lease and the new lease.

The following decision tree summarizes how lessees would evaluate and account for a lease modification under the new standard:



* Guidance for evaluating whether a modification results in a separate, new lease is discussed above.

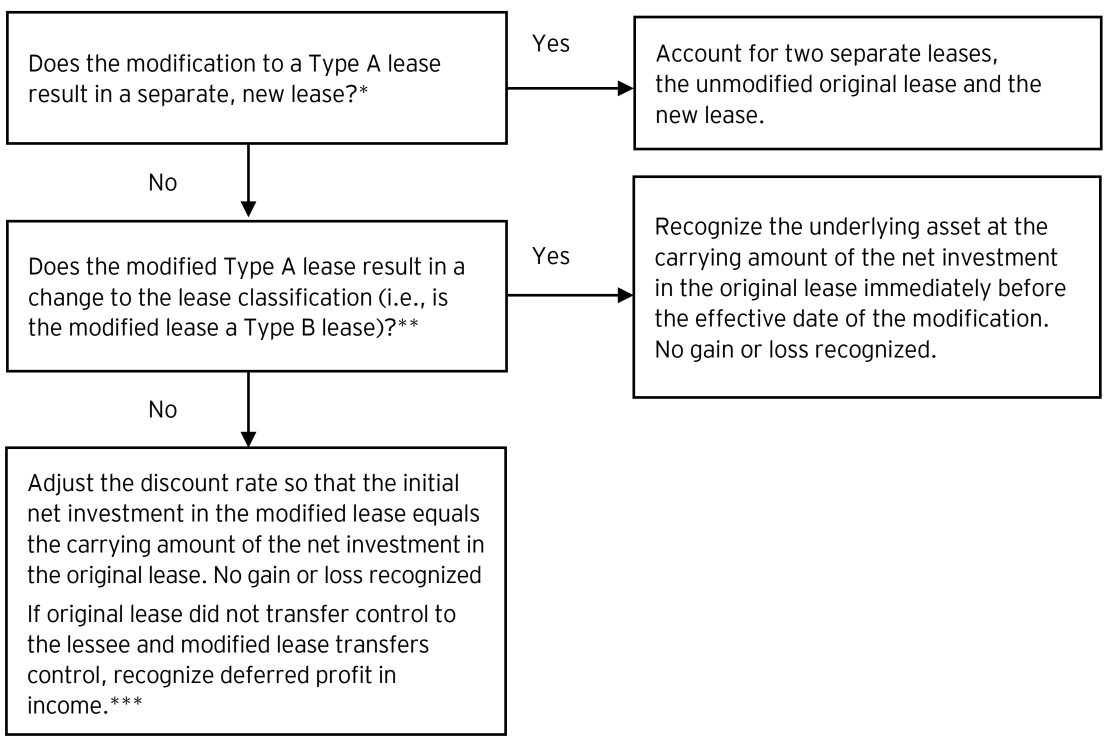
** It is unclear whether the final standard would require lessees to reassess lease classification upon a modification to a Type A or a Type B lease that does not result in a separate, new lease.

As indicated on the decision tree above, for a lease modification that does not result in a separate, new lease, lessees would generally remeasure the existing lease liability and right-of-use asset without affecting profit or loss. However, for a modification that decreases the scope of a lease (e.g., reducing the square footage of leased space, shortening a lease term), lessees would remeasure the lease liability and recognize a proportionate reduction (e.g., the proportion of the change in the lease liability to the pre-modification lease liability) to the right-of-use asset. Any difference between those adjustments would be recognized in profit or loss.

For lessors, a modification that does not result in a separate, new lease (as noted above) would be accounted for as follows:

- A modification to a Type B lease would be, in effect, a new Type B lease. The lease payments would be equal to the remaining lease payments of the modified lease, adjusted for any prepaid or accrued rent from the original lease.
- The accounting for a modification to a Type A lease would depend on whether lease classification changes. That is, lessors would reassess lease classification upon a modification to a Type A lease that does not result in a separate, new lease (as noted above).

The following decision tree summarizes how lessors would evaluate and account for a modification to a Type A lease under the new standard:



* Guidance for evaluating whether a modification results in a separate, new lease is discussed above.

** It is unclear how lessors would reassess classification. For example, the assessment could be made as of the original lease inception date (using modified terms) or at the effective date of the modification.

*** See lessor accounting – determining whether to defer or recognize selling profit section below.

Modification to a Type A lease that does not result in a separate, new lease — no change in lease classification

As indicated in the decision tree above, a lessor would adjust the discount rate used to measure the modified lease so that its initial net investment in the modified lease equals the carrying amount of its net investment in the original lease immediately before the effective date of the modification. No gain or loss would be recognized from such a modification, absent an impairment of the net investment in the lease (i.e., the lease receivable and any unguaranteed residual asset).

However, if the original Type A lease did not, in effect, transfer control of the underlying asset to the lessee (i.e., any initial selling profit was deferred, as discussed in the lessor accounting section), but the modified Type A lease would transfer control, a lessor would adjust the discount rate used to measure the modified lease so that its initial net investment in the modified lease would equal the carrying amount of its net investment in the original lease, exclusive of any deferred selling profit, immediately before the effective date of the modification. That is, lessors would recognize any previously deferred selling profit in income upon such a modification.

Modification of a Type A lease that does not result in a separate, new lease — change in lease classification to a Type B lease

As indicated in the decision tree above, a lessor would recognize the underlying asset at the carrying amount of its net investment in the original lease immediately before the effective date of the modification. No gain or loss would be recognized from such a modification, absent an impairment of the underlying asset.

Refer to Appendix A for a summary of lessee and lessor reassessment requirements.

How we see it

- It is unclear whether the FASB intends to require lessors to reassess lease classification upon a modification to a Type B lease that does not result in a separate, new lease.
- It is also unclear whether the final standard would require lessees to reassess lease classification upon a modification to a Type A or a Type B lease that does not result in a separate, new lease.

Key differences between US GAAP and IFRS
The IASB decided that lessors would account for a modification to a Type A lease that does not result in a separate, new lease in accordance with IFRS 9, *Financial Instruments*. Refer to Appendix C for a summary of key differences.

Contract combinations

The new standard would require that two or more contracts entered into at or near the same time with the same counterparty (or related party) be considered a single transaction if either of the following is met:

- The contracts are negotiated as a package with a single commercial objective.
- The amount of consideration to be paid in one contract depends on the price or performance of the other contract.

These criteria are intended to address the FASB's concern that separately accounting for multiple contracts may not result in a faithful representation of the combined transaction.

Portfolio approach

Many constituents had expressed concerns that the cost of applying the 2013 ED would exceed the benefits for leases involving a large number of assets that have similar characteristics (e.g., leases of a fleet of similar cars). In response, the FASB acknowledged that lessees and lessors would be able to use a portfolio approach (rather than a lease-by-lease approach) when they reasonably expect that doing so would not result in a material difference from accounting for the leases on an individual basis. The new standard would not define "reasonably expect" and "material." Instead, the FASB decided to include a discussion of the portfolio approach in the Basis for Conclusions of the new standard rather than in the text that will appear in the Codification.

Key differences between US GAAP and IFRS

The IASB decided to state explicitly in the authoritative paragraphs of its new standard that lessees and lessors also would be permitted to use a portfolio approach (rather than a lease-by-lease approach) when they reasonably expect that doing so would not result in a material difference from accounting for the leases on an individual basis.

Refer to Appendix C for a summary of key differences between US GAAP and IFRS.

How we see it

The FASB's decision to discuss the portfolio approach in the Basis for Conclusions in its new standard (rather than in the text that will be codified) suggests that the approach would be applied as an accounting convention. That is, a decision to use the portfolio approach would be similar to a decision some entities make today to expense, rather than capitalize, certain assets when the accounting difference is and would continue to be immaterial to the financial statements.

Key concepts

Lessees and lessors would generally apply the same key concepts when they identify, classify, recognize and measure lease contracts, and both lessees and lessors would apply the concepts consistently.

Lease commencement and inception date

The lease commencement date would be the date on which the lessor makes an underlying asset available for use by the lessee. Lessees (except lessees applying the short-term lease exemption) and lessors (for most Type A leases) would initially recognize and measure lease-related assets and liabilities on the commencement date. Entities would consider other standards to determine how to account for and disclose the existence of other rights or obligations created between the lease inception date (i.e., the date on which the principal terms of the lease are agreed to) and the commencement date.

Lease term

Determining the lease term

The lease term would be determined at the lease commencement date based on the noncancelable term of the lease, together with both of the following:

- The periods covered by an option to extend the lease if the lessee is reasonably certain to exercise that option
- The periods after the exercise date of an option to terminate the lease if the lessee is reasonably certain **not** to exercise that option

The FASB decided that the phrase "reasonably certain," which is used in IAS 17 and is generally interpreted as a high threshold, has the same meaning as the phrase "reasonably assured" that is currently used in ASC 840. Therefore, the FASB does not anticipate a significant change in practice.

Purchase options would be assessed in the same way as options to extend the lease term or terminate the lease. The FASB reasoned that purchasing an underlying asset is economically similar to extending the lease term for the remaining economic life of the underlying asset. When a lease contains a purchase option and the lessee is reasonably certain to exercise that option, the lease would be classified as a Type A lease by a lessee. Lessors would be required to also evaluate an additional criterion related to the collectibility of lease payments to determine lease classification when a purchase option is present and it is reasonably certain the lessee will exercise it. See the lease classification section below.

Evaluating lease renewal, termination and purchase options

When initially evaluating the lease term and lease payments (discussed below), the new standard would require lessees and lessors to consider any factors associated with exercising lease renewal, termination and purchase options. The evaluation of whether it is reasonably certain that those options will be exercised would consider all contract-, asset-, entity- and market-based factors, including:

- The existence of a purchase option or lease renewal option and its pricing (e.g., fixed rates, discounted rates, "bargain" rates)
- The existence of a termination option and the amount of payments for termination or nonrenewal
- Contingent amounts due under residual value guarantees
- Costs of returning the asset in a contractually specified condition or to a contractually specified location
- Significant customization (e.g., leasehold improvements), installation costs or relocation costs
- The importance of the leased asset to the lessee's operations
- A sublease term that extends beyond the noncancelable period of the head lease (e.g., a head lease that has a noncancelable term of five years with a two-year renewal option, and the sublease term is for seven years)

Illustration 6 — Determining the lease term

Scenario A

Assume that Entity P enters into a lease for equipment that includes a noncancelable term of four years and a two-year market-priced renewal option. There are no termination penalties or other factors indicating that Entity P is reasonably certain to exercise the renewal option.

Analysis: At the lease commencement date, the lease term would be four years.

Scenario B

Assume that Entity Q enters into a lease for a building that includes a noncancelable term of four years and a two-year, market-priced renewal option. Before it takes possession of the building, Entity Q pays for leasehold improvements. The leasehold improvements are expected to have significant value at the end of four years, and that value can only be realized through continued occupancy of the leased property.

Analysis: At lease commencement, Entity Q determines that it is reasonably certain to exercise the renewal option because it would suffer a significant economic penalty if it abandoned the leasehold improvements at the end of the initial noncancelable period. At lease commencement, Entity Q would conclude that the lease term is six years.

Reassessment of the lease term

After lease commencement, lessees would monitor leases for significant changes that could trigger a change in the lease term. Lessees would be required to reassess the lease term upon the occurrence of significant events or significant changes in circumstances that are within the lessee's control (i.e., market-based events or changes wouldn't trigger a reassessment). The FASB expects that such events, and the related reassessment, would occur infrequently.

If the lease term changes, a lessee would remeasure the lease liability, using revised inputs (e.g., discount rate, allocation of contract consideration) at the reassessment date, and would adjust the right-of-use asset. However, if the right-of-use asset is reduced to zero, a lessee would recognize any remaining amount in profit or loss.

Lessors would not be required to reassess the lease term after lease commencement.

Refer to Appendix A for a summary of lessee and lessor reassessment requirements.

Lease payments

Lease payments would be payments, made by a lessee to a lessor, relating to the right to use an underlying asset during the lease term. The present value of the lease payments (excluding lease incentives received by the lessee) would be recognized as a lease liability by lessees or as part of the net investment in the lease by lessors in Type A leases.

Variable lease payments that depend on an index or a rate would be included in lease payments, but other variable lease payments would not be.

Lease payments would include:

- Fixed lease payments, less any lease incentives received or receivable from the lessor
- Variable lease payments that depend on an index or a rate
- In-substance fixed lease payments structured as variable payments
- The exercise price of a purchase option if the lessee is reasonably certain to exercise that purchase option
- Payments for penalties for terminating a lease, if the lease term reflects the lessee exercising an option to terminate the lease
- Amounts expected to be payable under residual value guarantees (lessee only)
- Fixed payments structured as residual value guarantees (lessor only)

Lease payments would not include payments allocated to the non-lease components of a contract, except when the lessee makes an accounting policy election to account for the lease and non-lease components as a single lease component (as described in the identifying and separating lease from non-lease components of contracts section above).

Variable lease payments that depend on an index or rate

Variable lease payments that depend on an index or a rate would be included in the lease payments using the prevailing index or rate at the measurement date (e.g., lease commencement date for initial measurement). The FASB reasoned that despite the measurement uncertainty associated with changes to index- or rate-based payments, the payments meet the definition of an asset (lessor) and a liability (lessee) because they are unavoidable. These types of variable lease payments are treated differently from other contingent lease payments that do not depend on an index or rate (e.g., lease payments based on usage) because contingent lease payments that do not depend on an index or rate are generally avoidable. See the section on variable lease payments that do not depend on an index or rate below.

Under the new standard, lessees would be required to reassess variable lease payments that depend on an index or rate only when the lease liability is remeasured for other reasons (e.g., due to a change in the lease term). Otherwise, lessees would recognize changes to index- and rate-based variable lease payments in profit or loss in the period of the change (i.e., similar to other variable lease payments).

If a reassessment results in a remeasurement of the lease liability, a lessee would use revised inputs at the reassessment date and would adjust the right-of-use asset, except that:

- The amount of the remeasurement arising from a change in an index or a rate that is attributable to the current period would be recognized in profit or loss.
- If the right-of-use asset is reduced to zero, a lessee would recognize any remaining amount in profit or loss.

Lessors would not be required to reassess variable lease payments that depend on an index or rate.

Refer to Appendix A for a summary of lessee and lessor reassessment requirements.

Key differences between US GAAP and IFRS

Under the IASB's new standard, lessees would reassess variable lease payments that depend on an index or rate when the lease liability is remeasured for other reasons (e.g., due to a change in the lease term) and upon a change in the cash flows resulting from a change in the reference index or rate (i.e., when an adjustment to the lease payments takes effect).

Refer to Appendix C for a summary of key differences between US GAAP and IFRS.

In-substance fixed lease payments structured as variable payments

Some lease agreements include payments that are described as variable but are in-substance fixed payments because the contract terms ensure that the payment of a fixed amount is unavoidable. Such payments would be included in the lease payments at lease commencement and thus used to measure entities' lease assets and lease liabilities.

The exercise price of a purchase option

Entities would consider the exercise price of asset purchase options included in lease contracts consistently with the evaluation of lease renewal and termination options (discussed above). That is, if the lessee is reasonably certain to exercise a purchase option, the exercise price would be included as a lease payment.

Payments for penalties for terminating a lease

The determination of whether to include lease termination penalties as lease payments would be similar to the evaluation of lease renewal options. If it is reasonably certain that the lessee will not terminate a lease, the lease term would be determined assuming that the termination option would not be exercised, and any termination penalty would be excluded from the lease payments. Otherwise, the lease termination penalty would be included as a lease payment.

Amounts expected to be payable under residual value guarantees — lessees only

The new standard would require lessees to include the amounts they expect to pay to the lessor under residual value guarantees as lease payments.

A lessee may provide a guarantee to the lessor that the value of the underlying asset it returns to the lessor at the end of the lease will be at least a specified amount. Such guarantees represent enforceable obligations that the lessee has assumed by entering into the lease. Uncertainty related to a lessee's guarantee of a lessor's residual value affects the measurement of the obligation rather than the existence of an obligation.

Illustration 7 — Residual value guarantee included in lease payments

Entity R (lessee) enters into a lease and guarantees that the lessor will realize $15,000 from selling the asset to another party at the end of the lease. At lease commencement, Entity P estimates that the underlying asset will have a value of $9,000 at the end of the lease.

Analysis: Entity R expects to pay the lessor $6,000 under the residual value guarantee and would include that amount as a lease payment.

How we see it

We expect the FASB to include in the final standard a provision of the 2013 ED that would require the remeasurement of a lessee's lease liability and adjustment of the right-of-use asset if the amounts expected to be payable under residual value guarantees change during the lease term. If the right-of-use asset is reduced to zero, the provision would require the remaining adjustment to be recognized in profit or loss. The FASB did not discuss this provision in redeliberations.

The residual value guarantee reassessment provision would not apply to lessors.

Residual value guarantees — lessors only

Lessors' lease payments would generally exclude amounts receivable under residual value guarantees (from either the lessee or a third party). However, fixed lease payments structured as residual value guarantees (typically from the lessee but possibly from another party) would be included as lease payments.

For example, assume a lessor obtains a guarantee for the entire residual value of the underlying asset from the lessee, also the contract states that the lessor will pay to the lessee, or the lessee can retain, any difference between the selling price of the underlying asset and the residual value guarantee specified in the contract. In these cases, the lessee is exposed to all of the upside and downside risk of changes in the value of the asset, and the lessor would receive a fixed amount (i.e., the guarantee specified in the contract) at the end of the lease. The amount the lessor would receive is economically similar to a fixed balloon lease payment at the end of the lease. Consequently, such amounts would be included as lease payments.

Variable lease payments that do not depend on an index or rate

Variable payments that do not depend on an index or rate, such as those based on performance (e.g., a percentage of sales) or usage of the underlying asset (e.g., the number of hours flown, the number of units produced), would not be included as lease payments. These payments would be recognized in profit or loss when they are incurred (lessee) or earned (lessor), in a manner similar to today's accounting. For example, a variable payment based on the annual sales of a leased store would not be included in the lessee's right-of-use asset or lease liability. Instead, the variable payment would be recognized as an expense (by the lessee) and as income (by the lessor) as the sales at the store occur and an obligation for the lessee to make the contingent payment is created.

Discount rate

Discount rates would be used to determine the present value of the lease payments, which are used to determine lease classification (refer to the lease classification section below) and to measure a lessor's recognized net investment in the lease and the lessee's lease liability. Under the new standard, the rate the lessor charges the lessee would be defined as "the rate implicit in the lease." The rate implicit in the lease would reflect the nature and specific terms of the lease and would be similar to the current definition in US GAAP.

Lessors

Lessors would use the rate implicit in the lease that causes the sum of the following two items:

- The present value of lease payments made by the lessee for the right to use the underlying asset
- The present value of the amount the lessor expects to derive from the underlying asset at the end of the lease (excluding any amount included in lease payments)

To equal the sum of these two items:

- The fair value of the underlying asset
- The lessor's initial direct costs (in the case of Type A leases without recognized selling profit)

A lessor's initial direct costs for Type A leases with recognized selling profit would be expensed at lease commencement, and therefore, would be excluded from the calculation of the rate implicit in the lease for those leases. See the lessor accounting section below.

How we see it

The FASB's decision to define the discount rate as the "rate implicit in the lease" would result in two key changes in practice for lessors. The calculation of the rate implicit in the lease would include the lessor's initial direct costs for Type A leases without recognized selling profit and would exclude investment tax credits that the lessor retains and expects to realize.

Lessees

Lessees would also use the rate implicit in the lease as described above if that rate can be readily determined. When the lessee cannot determine that rate, the lessee would use its incremental borrowing rate. The lessee's incremental borrowing rate would be the rate of interest that the lessee would have to pay to borrow the funds necessary to obtain an asset of a similar value to the right-of-use asset, with similar payment terms (i.e., consistent with the lease term) and security (i.e., collateral) in a similar economic environment. This definition would be generally consistent with the definition in ASC 840.

Under the new standard, lessees that are not public business entities (PBEs)[5] would be permitted to make an accounting policy election to use the risk-free rate for the initial and subsequent measurement of lease liabilities. The risk-free rate would be determined using a period comparable with the lease term. The accounting policy election would be applied to all leases and disclosed in the notes to the financial statements.

Key differences between US GAAP and IFRS
The IASB's new standard would not provide an accounting policy election for lessees to use the risk-free rate for the initial and subsequent measurement of lease liabilities. Refer to Appendix C for a summary of key differences between US GAAP and IFRS.

How we see it

- The rate implicit in the lease would not necessarily be the rate stated in the contract and could reflect the lessor's initial direct costs and estimates of residual value. Therefore, lessees may find it difficult to determine the rate implicit in the lease.
- While using a risk-free rate might reduce complexity for lessees applying the new standard, it would increase the likelihood that the present value of the lease payments and any residual value guaranteed by the lessee would amount to substantially all of the fair value of the leased asset, potentially resulting in a Type A lease. This might dissuade some non-PBE lessees from making a policy election to use a risk-free rate.

Reassessment of the discount rate (updated July 2015)

Lessees would reassess the discount rate only upon a lease modification, a change to the lease term or a change in whether the lessee is reasonably certain to exercise an option to purchase the underlying asset.

If a reassessment results in a change to the discount rate, lessees would remeasure the lease liability using a revised discount rate at the reassessment date and would adjust the right-of-use asset. However, if the right-of-use asset is reduced to zero, a lessee would recognize any remaining amount in profit or loss.

Lessors would be required to reassess the discount rate upon a contract modification to a Type A lease that does not result in a separate, new lease when the modified lease remains a Type A lease (i.e., when lease classification does not change).

Refer to Appendix A for a summary of lessee and lessor reassessment requirements.

Key differences between US GAAP and IFRS

Under the IASB's new standard, lessors would not be required to reassess the discount rate after lease commencement.

Refer to Appendix C for a summary of key differences between US GAAP and IFRS.

Initial direct costs

Initial direct costs would be costs such as commissions that would not have been incurred if a lease had not been executed. Lessees and lessors would apply the same definition of initial direct costs. From the lessor's perspective, initial direct costs would be consistent with the concept of incremental costs in the new revenue recognition standard (i.e., ASC 606).

The new lease standard would require lessors to include initial direct costs in the initial measurement of their net investments in Type A leases. However, initial direct costs related to Type A leases that include recognized selling profit would be expensed at lease commencement. Lessors would recognize initial direct costs associated with Type B leases over the lease term on the same basis as lease income.

The new lease standard would require lessees to include their initial direct costs in their initial measurement of the right–of-use asset. Costs that a lessee incurs in a lease modification that meet the definition of initial direct costs would be included in the measurement of the new right-of-use asset (i.e., for a modification that results in a separate, new lease) or the adjustment to the right-of-use asset (i.e., for a modification that does not result in a separate, new lease).

How we see it

The FASB's clarification that only costs that wouldn't be incurred if a lease hadn't been executed would qualify as initial direct costs would result in two key changes in practice. Lessors' initial direct costs would exclude allocated costs (e.g., salaries) and costs incurred before the lease is executed (e.g., legal advice).

Economic life

The new standard would define the economic life of an asset as either:

- The period over which an asset is expected to be economically usable by one or more users
- The number of production or similar units expected to be obtained from the asset by one or more users

This definition of economic life, while not the same as the definition in current US GAAP, is not expected to significantly change economic life estimates.

Fair value of the underlying asset

Under today's accounting, the fair value of leased property is defined as the price for which the property could be sold in an arm's length transaction between unrelated parties. ASC 820, *Fair Value Measurement*, which provides a framework for measuring fair value, defines fair value within that framework and establishes fair value measurement disclosure requirements. Importantly, the definition of fair value in ASC 820 does not apply to fair value measurements for the purposes of lease classification and measurement (with certain exceptions). That is, the fair value of leased property, which is used in classifying a lease and to determine the maximum amount at which a lessee can record an asset leased under a capital lease, is not a fair value measurement under the framework set out in the current US GAAP guidance.

How we see it

- The 2013 ED did not define fair value of the underlying asset or propose consequential amendments to ASC 820 to remove the scope exception for leases. Because the FASB did not address this topic in redeliberations, we do not anticipate the Board will change the meaning of fair value in the context of leased assets in the new standard.
- It is unclear whether the new standard will contain a "fair value constraint" that would set a maximum amount that could be used when recording a right-of-use asset.

Key differences between US GAAP and IFRS
As discussed above, the definition of fair value in ASC 820 would not apply to fair value measurements for the purposes of lease classification and measurement under the FASB's new standard. However, the measurement and disclosure requirements of IFRS 13, *Fair Value Measurement,* would apply to lease transactions within the scope of the IASB's new standard. Refer to Appendix C for a summary of key differences between US GAAP and IFRS.

Related party leasing transactions

The new standard would require lessees and lessors to account for related party leases on the basis of the legally enforceable terms and conditions of the lease. This would eliminate the current requirement under US GAAP for lessees and lessors to evaluate the economic substance of a lease to determine the appropriate accounting. Under the new standard, lessees and lessors would still be required to apply the disclosure requirements for related party transactions in accordance with ASC 850, *Related Party Disclosures*.

Key differences between US GAAP and IFRS
The IASB's new standard would not have guidance on the accounting for related party leasing transactions. Refer to Appendix C for a summary of key differences between US GAAP and IFRS.

Lease classification (updated July 2015)

Under the new standard, lessees and lessors would classify all leases (with an optional exemption for short-term leases for lessees) using a principle similar to that of IAS 17. The principle in IAS 17 is similar to that of US GAAP but without today's bright lines. The new standard would eliminate ASC 840's real estate-specific guidance and would change its additional lessor classification criteria.

Lessees and lessors would classify leases using a principle similar to the one in IAS 17.

The new standard would require lessees to classify most leases as either Type A leases (generally today's capital leases) or Type B leases (generally today's operating leases). Lease classification would determine how and when a lessee would recognize lease expense.

Lessors would be required to classify all leases as either Type A leases or Type B leases (generally today's operating leases). There would be three categories of Type A leases: (1) those with selling profit that is recognized or deferred (generally today's sales-type leases), (2) those with no selling profit (generally today's direct financing leases), and (3) certain leases where collectibility of lease payments is not probable. Leases in the latter category would be recognized and measured in accordance with ASC 606 (i.e., a deferral of income similar to the new revenue standard). Refer to the lessor accounting section below for discussion of the recognition and measurement of lessors' leases.

Criteria for classification of leases (lessees and lessors)

At lease commencement, a lessee and a lessor would evaluate whether a lease meets any of the following criteria for purposes of lease classification: [6]

- The lease transfers ownership of the underlying asset to the lessee by the end of the lease term.
- The lessee is reasonably certain to exercise an option to purchase the underlying asset.
- The lease otherwise transfers substantially all the risks and rewards incidental to ownership of the underlying asset. Situations that individually or in combination would normally indicate this include:
  - The lease term is for a major part of the remaining economic life of the underlying asset.

- *For lessors* — The sum of the present value of the lease payments and any residual value guaranteed by any third party unrelated to the lessor (including the lessee) amounts to substantially all of the fair value of the underlying asset at lease commencement.
- *For lessees* — The sum of the present value of the lease payments and any residual value guaranteed by the lessee amounts to substantially all of the fair value of the underlying asset at lease commencement.
- The underlying asset is of such a specialized nature that it is expected to have no alternative use to the lessor at the end of the lease term.

A lease would be classified as a Type A lease by lessees if it meets any one of the criteria above. At its May 2015 meeting, the FASB decided that for leases that meet any of the above criteria, a lessor would also consider whether the collectibility of lease payments is probable for purposes of lease classification.

If a lease does not meet any of the criteria above, it would be classified as a Type B lease by lessees and lessors.

Additional lessor classification criterion

Under the new standard, lessors would also be required to evaluate the collectibility of lease payments to determine lease classification. This assessment would also affect a lessor's recognition and measurement of its leases. Refer to the lessor accounting section below.

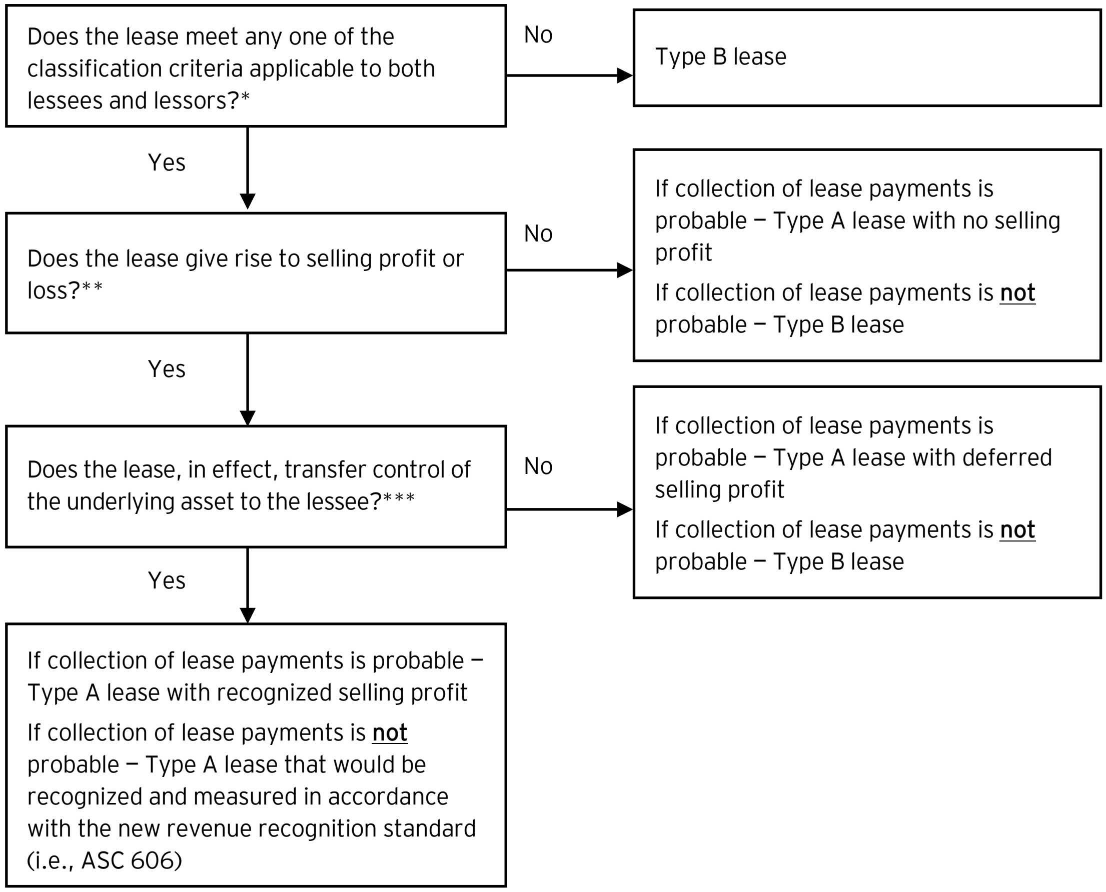
How we see it

Although the new standard's classification principle and criteria would be similar to that in IAS 17 today, there are three notable differences:

- The presence of any one of the IAS 17 classification indicators is not necessarily determinative of lease classification under IFRS today. However, it appears that the presence of any one of the new standard's classification criteria (described above) would result in a lease being classified as Type A for lessees and lessors (subject to the additional lessor collectibility criterion).
- Some of the classification indicators in IAS 17 today were not discussed in redeliberations or included in the new standard's criteria described above (e.g., a lessee's ability to continue the lease for a secondary period at a rent that is substantially lower than market rent, although this criterion may affect lease term and indirectly lease classification under the new standard).
- IAS 17 doesn't explicitly require lessors to assess the collectibility of lease payments for purposes of lease classification.

As a result, we believe the Board could further align the classification criteria with IAS 17 in the final standard.

The decision tree below summarizes the evaluation of lease classification for lessors, including the recognition and measurement alternatives for Type A leases, under the new standard. Note — the FASB could further clarify its decisions on lease classification, recognition and measurement for lessors in the final standard.



* See the criteria for classification of leases (lessees and lessors) section above.

** See the lessor accounting — selling profit or loss section below.

*** See the lessor accounting — determining whether to defer or recognize selling profit section below.

Other lease classification matters

Evaluating 'major part' and 'substantially all'

The terms "major part" and "substantially all" were not defined in the 2013 ED or during redeliberations. However, these terms are used to describe the indicators included today under IFRS to distinguish between finance and operating leases and were introduced into IFRS by borrowing from the bright-line tests used for lease classification in US GAAP.

Residual value guarantees included in the lease classification test

In evaluating the new standard's lease classification criteria, lessees would be required to include in the "substantially all" test the full amounts of residual value guarantees they provide. Lessors would be required to include in this test the full amounts of residual value guarantees provided by unrelated third parties, including the lessee.

Residual value guarantees would be treated differently when determining lease payments. Lessees would include amounts they expect to pay to lessors under residual value guarantees as lease payments. Lessors' lease payments receivable would generally exclude amounts under residual value guarantees (from either the lessee or a third party) unless the residual value guarantee is in-substance a fixed lease payment. Refer to the lease payments section above.

Lease component with the right to use more than one interrelated asset

If a lease component contains the right to use more than one interrelated asset, the primary asset in the component would be used to determine lease classification. The primary asset would be the predominant asset for which the lessee has contracted the right to use. Any other assets in that lease component would facilitate the lessee's use of the primary asset. Entities would also refer to the economic life of the primary asset when making lease classification assessments.

Reassessment of lease classification

At its May 2015 meeting, the FASB decided that lessors would reassess lease classification upon a modification to a Type A lease that does not result in a separate, new lease. Refer to the lease modifications section above.

If a modification to a contract results in a separate, new lease, that new lease would be classified using the criteria described above.

Refer to Appendix A for a summary of lessee and lessor reassessment requirements.

The Boards reached different conclusions on lease classification for lessees and lessors.

How we see it

- It is unclear how lessors would reassess lease classification upon a modification to a Type A lease that does not result in a separate, new lease. For example, the assessment could be made as of the original lease inception date (using the modified terms) or at the effective date of the modification. It is also unclear whether the FASB intends to require lessors to reassess lease classification upon a modification to a Type B lease that does not result in a separate, new lease.
- In addition, it is unclear whether the final standard would require lessees to reassess lease classification upon a modification to a Type A or a Type B lease that does not result in a separate, new lease.

Key differences between US GAAP and IFRS

The Boards reached different decisions that would result is similar transactions being accounted for differently under US GAAP and IFRS.

Lessees

Lessees applying the FASB's new standard would use a dual model to recognize and measure leases with an option not to recognize and measure short-term leases. However, lessees applying the IASB's new standard would use a single recognition and measurement model for all leases (i.e., all leases would be Type A), with options not to recognize and measure both short-term leases and leases of small assets.

The FASB members who favored the dual model indicated that the FASB's new standard would be less costly for preparers to apply and for users to understand because it would use a lease classification principle similar to the one in ASC 840. The IASB members who favored the single model indicated that it is more conceptually sound because they believe that all leases contain a financing element. However, in lieu of the dual model, they did incorporate a small asset exemption. Some IASB members also indicated that the single model would be less costly to apply because preparers would not have to consider a classification test.

Lessors
Both new standards would use a dual model for all leases (i.e., all leases would be Type A or Type B). However, under the FASB's new standard, lessors would consider an additional criterion based on the collectibility of lease payments to classify leases.

Reassessment of lease classification
Lessors applying the FASB's new standard would reassess lease classification upon a modification to a Type A lease that does not result in a separate, new lease. Under the IASB's new standard, lease classification would not be reassessed after lease commencement for any lease.

Refer to Appendix C for a summary of key differences between US GAAP and IFRS.

Lessee accounting

The new standard would require lessees to recognize all leases on the balance sheet, except for short-term leases if they choose to apply that exemption. At the commencement date of a lease, a lessee would recognize a liability to make lease payments (i.e., the lease liability) and an asset representing the right to use the underlying asset during the lease term (i.e., the right-of-use asset).

The initial recognition of the right-of-use asset and the lease liability would be the same for Type A and Type B leases, as would the subsequent measurement of the lease liability. However, the subsequent measurement of the right-of-use asset for Type A and Type B leases would differ.

Initial recognition and measurement

The lease liability would be initially measured based on the present value of the lease payments to be made over the lease term. Lessees would apply the concepts described above to identify the lease components and to determine the lease term, lease payments and discount rate as of the commencement date of the lease. See the key concepts section above.

The right-of-use asset would initially be measured at cost and would consist of all of the following:

- The amount of the initial measurement of the lease liability
- Any lease payments made to the lessor at or before the commencement date, less any lease incentives received from the lessor (see the section on other lessee matters below)
- Any initial direct costs incurred by the lessee (see the section on initial direct costs above)

Subsequent measurement

Lease liabilities — Type A leases

The FASB believes that a lease liability for Type A leases should be accounted for in a manner similar to other financial liabilities (i.e., on an amortized cost basis). Consequently, the lease liability for Type A leases would be accreted using an amount that produces a constant periodic discount rate on the remaining balance of the liability (i.e., the discount rate determined at commencement, as long as a reassessment and a change in the discount rate have not been triggered). Lease payments would reduce the lease liability when paid.

Right-of-use assets — Type A leases

Amortization of the right-of-use asset would be recognized in a manner consistent with existing standards for nonfinancial assets that are measured at cost. Lessees would amortize the right-of-use asset on a straight-line basis, unless another systematic basis better represents the pattern in which the lessee expects to consume the right-of-use asset's future economic benefits. The right-of-use asset would generally be amortized over the shorter of the lease term or the useful life of the right-of-use asset. The amortization period would be the remaining useful life of the underlying asset if the lessee is reasonably certain to exercise a purchase option or if the lease transfers ownership of the underlying asset to the lessee by the end of the lease term.

Illustration 8 — Lessee accounting for a Type A lease

Entity H (lessee) enters into a three-year lease of equipment and concludes that the agreement is a Type A lease because the lease term is for a major part of the remaining economic life of the underlying asset (also three years). Entity H agrees to make the following annual payments at the end of each year: $10,000 in year one, $12,000 in year two and $14,000 in year three. For simplicity, there are no other elements to the lease payments (e.g., purchase options), payments to the lessor before the lease commencement date, lease incentives from the lessor or initial direct costs. The initial measurement of the right-of-use asset and lease liability is $33,000 (present value of lease payments using a discount rate of approximately 4.235%). Entity H uses its incremental borrowing rate because the rate implicit in the lease cannot be readily determined. Entity H determines the right-of-use asset should be amortized on a straight-line basis over the lease term.

Analysis: At lease commencement, Entity H would recognize the lease-related asset and liability:

Right-of-use asset	$ 33,000	
Lease liability		$ 33,000

To initially recognize the lease-related asset and liability

The following journal entries would be recorded in the first year:

Interest expense	$ 1,398	
Lease liability		$ 1,398

To record interest expense and accrete the lease liability using the interest method ($33,000 x 4.235%)

Amortization expense	$ 11,000	
Right-of-use asset		$ 11,000

To record amortization expense on the right-of-use asset ($33,000 ÷ 3 years)

Lease liability	$ 10,000	
Cash		$ 10,000

To record lease payment

A summary of the lease contract's accounting (assuming no changes due to reassessment) is as follows:

	Initial	Year 1	Year 2	Year 3
Cash lease payments		$ 10,000	$ 12,000	$ 14,000
Lease expense recognized				
Interest expense		$ 1,398	$ 1,033	$ 569
Amortization expense		11,000	11,000	11,000
Total periodic expense		$ 12,398	$ 12,033	$ 11,569
Balance sheet				
Right-of-use asset	$ 33,000	$ 22,000	$ 11,000	$ –
Lease liability	$ (33,000)	$ (24,398)	$ (13,431)	$ –

The total periodic expense (i.e., the sum of interest and amortization expense) of a Type A lease would generally be higher in the early periods and lower in the later periods. Because a consistent interest rate would be applied to the lease liability, which decreases as cash payments are made during the lease term, more interest expense would be incurred in the early periods and less would be incurred in the later periods. This trend in the interest expense, combined with the straight-line amortization of the right-of-use asset, would generally result in a front-loaded expense recognition pattern for Type A leases, which is consistent with the subsequent measurement of capital leases under ASC 840.

The separate recognition of interest and amortization expense for Type A leases is consistent with a view that such leases are effectively installment purchases. That is, the lessee is paying to finance the acquisition of the underlying asset that will be consumed during the lease term.

Lease liabilities — Type B leases

Lessees would calculate the lease liability for Type B leases at any point in time as the present value of the remaining lease payments using the discount rate determined at lease commencement, as long as a reassessment and a change in the discount rate hasn't been triggered.

How we see it

While we expect the new standard to describe the subsequent measurement of a Type B lease liability differently from that of a Type A lease liability, from a practical perspective, we expect the result of the subsequent measurement to be the same.

Right-of-use assets — Type B leases

Lessees would subsequently measure the right-of-use asset (absent any impairment) for a Type B lease at the amount of the remeasured lease liability (i.e., the present value of the remaining lease payments), adjusted for any lease incentives received, any cumulative prepaid or accrued rent if the lease payments are uneven throughout the lease term and any lessee initial direct costs. The presence of uneven lease payments or lessee initial direct costs would cause the measurement of the right-of-use asset to differ from that of the lease liability at points throughout the lease term.

Lessees would recognize periodic lease expense for Type B leases on a straight-line basis, similar to today's accounting for operating leases. Throughout the lease term, the lessee would recognize periodic lease expense as ***the greater of*** the following:

(1) The remaining cost of the lease (calculated at the beginning of each period) allocated over the remaining lease term on a straight-line basis, or

(2) The periodic accretion on the lease liability (i.e., the difference between (a) the lease liability at the beginning of the period less payments made during the period and (b) the lease liability at the end of the period)

The remaining cost of the lease (item (1) above) would be calculated as:

- Lease payments (determined at the lease commencement date)
- Plus lessee initial direct costs (determined at the lease commencement date)
- Minus the periodic lease cost recognized in prior periods
- Minus any impairment of the right-of-use asset recognized in prior periods
- Plus or minus any adjustments to reflect changes that arise from the remeasurement of the lease liability not recognized in profit or loss at the date of remeasurement (e.g., the present value of the additional lease payments a lessee is obligated to pay if it exercises a renewal option that it originally was not reasonably certain to exercise)

The periodic accretion on the lease liability might be higher than the remaining cost of the lease allocated over the remaining lease term in the case of a significant impairment of the right-of-use asset.

Illustration 9 — Lessee accounting for a Type B lease

Entity L (lessee) enters into a three-year lease of office space and concludes that the agreement is a Type B lease. Entity L agrees to pay the following annual payments at the end of each year: $10,000 in year one, $12,000 in year two and $14,000 in year three. For simplicity, there are no other elements to the lease payments (e.g., purchase options), payments to the lessor before the lease commencement date, lease incentives from the lessor or initial direct costs. The initial measurement of the right-of-use asset and lease liability is $33,000 using a discount rate of approximately 4.235%. Entity L uses its incremental borrowing rate because the rate implicit in the lease cannot be readily determined. Entity L calculates that the annual straight-line lease expense is $12,000 per year [($10,000 + $12,000 + $14,000) ÷ 3].

Analysis: At lease commencement Entity L would recognize the lease-related asset and liability:

Right-of-use asset	$ 33,000	
Lease liability		$ 33,000

To initially recognize the lease-related asset and liability

The following journal entries would be recorded in the first year:

Lease expense	$ 12,000	
Right-of-use asset		$ 2,000
Cash		$ 10,000
Lease liability	$ 8,602	
Right-of-use asset		$ 8,602

To record lease expense and adjust the right-of-use asset for the difference between cash paid and straight-line lease expense (i.e., accrued rent). To adjust the lease liability to the present value of the remaining lease payments with an offset to the right-of-use asset. The adjustment of $8,602 is calculated as the initially recognized lease liability ($33,000) less the present value of remaining lease payments ($24,398) at the end of Year 1.

A summary of the lease contract's accounting (assuming no changes due to reassessment) is as follows:

	Initial	Year 1	Year 2	Year 3
Cash lease payments:		$ 10,000	$ 12,000	$ 14,000
Income statement:				
Periodic lease expense (straight-line)		12,000	12,000	12,000
Prepaid (accrued) rent for period		$ (2,000)	$ –	$ 2,000
Balance sheet:				
Lease liability	$ (33,000)	$ (24,398)	$ (13,431)	$ –
Right-of-use asset				
Lease liability	$ 33,000	$ 24,398	$ 13,431	$ –
Adjust: prepaid/(accrued) rent (cumulative)	–	(2,000)	(2,000)	–
Right-of-use asset	$ 33,000	$ 22,398	$ 11,431	$ –

Lease expense would be presented in a single line item in the income statement. This presentation is consistent with the concept of the lessee paying to use the asset during the lease term, rather than paying to finance the acquisition of the underlying asset in a Type A lease.

Illustration 10 — Comparing the two types of leases for lessees

This table illustrates the similarities and differences in accounting for the two types of leases discussed in Illustrations 8 and 9:

Type A lease:

Time	Lease liability	ROU asset	Interest expense	Amortization expense	Total expense
Initial	$ 33,000	$ 33,000			
Year 1	$ 24,398	$ 22,000	$ 1,398	$ 11,000	$ 12,398
Year 2	$ 13,431	$ 11,000	1,033	11,000	12,033
Year 3	$ –	$ –	569	11,000	11,569
			$ 3,000	$ 33,000	$ 36,000

Type B lease:

Time	Lease liability	Cumulative prepaid or (accrued) rent[1]	ROU asset	Lease expense
Initial	$ 33,000	$ –	$ 33,000	
Year 1	$ 24,398	$ (2,000)	$ 22,398	$ 12,000
Year 2	$ 13,431	$ (2,000)	$ 11,431	12,000
Year 3	$ –	$ –	$ –	12,000
				$ 36,000

[1] Prepaid and accrued rent amounts would not be presented separately on the balance sheet. Instead, the ROU asset would be presented on the balance sheet net of cumulative prepaid or accrued amounts (if any).

The initial measurement of the right-of-use asset and the lease liability would be the same for Type A and Type B leases. Also, the same total lease expense would be recognized over the life of the arrangement. However, a lessee would generally recognize higher periodic lease expense in the earlier periods of a Type A lease than it would for a Type B lease.

Type A leases would generally have a front-loaded expense recognition pattern.

Changes in foreign currency exchange rates

Lessees would apply ASC 830, *Foreign Currency Matters*, to leases denominated in a foreign currency. Lessees would remeasure the foreign currency-denominated lease liability using the exchange rate at each reporting date. Any changes to the lease liability due to exchange rate changes would be recognized in profit or loss. Because the right-of-use asset is a nonmonetary asset measured at historical cost, it would not be affected by changes in the exchange rate.

Other lessee matters

Impairment

Lessees' right-of-use assets, for both types of leases, would be subject to existing impairment guidance in ASC 360, *Property, Plant, and Equipment*.

ASC 360 requires an analysis of impairment indicators at each reporting period. If any indicators are present, a recoverability test using undiscounted cash flows is performed. If the recoverability test fails, the standard requires a fair value test. Under the new leases standard, if an impairment loss is recognized, the adjusted carrying amount of a right-of-use asset would be its new accounting basis. Consistent with ASC 360, the impairment test for right-of-use assets often would be performed at an asset-group level. The subsequent reversal of an impairment loss for an asset held for use would be prohibited.

How we see it

While lessees would apply existing impairment guidance in the same manner they currently do for assets held under capital leases (generally would be Type A leases), the analysis would be new for current operating leases (generally would be Type B leases). For leases that are not currently on the balance sheet, the requirement to test right-of-use assets for impairment could accelerate expense recognition (i.e., if an impairment occurs).

Lease incentives received or receivable at lease commencement

Lessees often receive incentives (e.g., an up-front cash payment for leasehold improvements or relocation expenses) for entering into a new lease. Today's operating lease accounting requires lessees to recognize lease incentives over the lease term as a reduction of lease expense.

Under the new standard, lease incentives that are receivable from the lessor at the commencement date (i.e., amounts are paid by the lessor after the lease commencement date) would be deducted from lease payments and the corresponding lease liability and right-of-use asset. Separately, lease incentives that a lessee receives from the lessor at or before lease commencement would reduce the initial measurement of the right-of-use asset. Similar to the result under current operating lease accounting, lease incentives would reduce lease expense for both types of leases over the lease term.

Lease incentives not received or receivable at lease commencement

The 2013 ED did not address lease incentives that are contingently receivable by the lessee at the lease commencement date (i.e., lease incentives that are not received or receivable until the occurrence of an event subsequent to lease commencement) nor were such incentives discussed during redeliberations. Examples include reimbursements for moving costs or leasehold improvements that become receivable by the lessee when the lessee incurs these costs.

How we see it

It remains unclear whether and, if so, how incentives that are not received or receivable at lease commencement would be considered in the recognition and measurement of lessees' lease-related assets and liabilities.

Purchase of a leased asset by the lessee during the lease term (updated July 2015)

The new standard would include ASC 840's existing guidance for the purchase of a leased asset by a lessee during the term of a capital lease for both Type A and Type B leases. A lessee would account for the purchase of the leased asset and the related lease termination as a single transaction. The difference between the purchase price and the carrying amount of the lease liability would be recorded as an adjustment to the carrying amount of the asset. No gain or loss would be recognized.

Key differences between US GAAP and IFRS
The IASB did not discuss a lessee's accounting for the purchase of a leased asset during the lease term. Refer to Appendix C for a summary of key differences between US GAAP and IFRS.

Income tax accounting

The new standard would also affect lessees' accounting for income taxes. For lessees, the new standard would change the measurements of lease-related assets and liabilities, including the recognition of amounts that are not on the balance sheet today (i.e., amounts related to leases that are operating leases today), and the expense recognition pattern. These changes would affect many aspects of accounting for income taxes such as the following:

- Recognition and measurement of deferred tax assets and liabilities
- Assessment of the recoverability of deferred tax assets (i.e., the need for and measurement of a valuation allowance)

Presentation

While the new standard would change balance sheet presentation for lessees, the income statement and statement of cash flows presentation requirements for Type A leases and Type B leases would be similar to the current requirements for capital and operating leases, respectively.

The following table summarizes how lease-related amounts and activities would be presented in lessees' financial statements.

Financial statement	Lessee presentation
Balance sheet	▸ **Type A leases:** ▸ Right-of-use assets presented either: ▸ Separately from other assets (e.g., owned assets) ▸ Together with the corresponding underlying assets as if they were owned, with disclosures of the balance sheet line items that include Type A right-of-use assets and their amounts ▸ Lease liabilities presented either: ▸ Separately from other liabilities ▸ Together with other liabilities with disclosure of the balance sheet line items that include Type A lease liabilities and their amounts ▸ **Type B leases:** ▸ Right-of-use assets presented separately from Type A right-of-use assets with disclosure of the related balance sheet line items that include the Type B assets ▸ Lease liabilities presented separately from Type A lease liabilities ▸ The FASB decided not to otherwise specify how lessees would separately present Type B right-of-use assets and lease liabilities except to say the presentation should be rational and consistent with similar leases and appropriate based on the facts and circumstances
Income statement	▸ **Type A leases:** Lease-related amortization and lease-related interest expense would be presented separately (i.e., lease-related amortization and interest expense could not be combined) ▸ **Type B leases:** Lease-related expenses would be presented as a single line of lease or rent expense

<table>
<tr><th>Financial statement</th><th>Lessee presentation</th></tr>
<tr><td>Statement of cash flows</td><td>

Type A leases: Cash payments for the principal portion of the lease liability would be presented within financing activities and cash payments for the interest portion would be presented within operating activities in accordance with ASC 230, Statement of Cash Flows
Type B leases: Cash payments for lease payments would be presented within operating activities
Both types of leases:

Lease payments for short-term leases not recognized on the balance sheet and variable lease payments (not included in the lease liability) would be presented within operating activities
Noncash activity (e.g., the initial recognition of the lease at commencement) would be disclosed as a supplemental noncash item

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Key differences between US GAAP and IFRS
Under the IASB's new standard, cash paid for interest on Type A leases would be presented within operating or financing activities consistent with the entity's policy election under IAS 7, *Statement of Cash Flow*s. Refer to Appendix C for a summary of key differences between US GAAP and IFRS.

Disclosure

The objective of lessee disclosures would be to enable financial statement users to assess the amount, timing and uncertainty of cash flows arising from leases. Lessees would exercise judgment to determine the appropriate level at which to aggregate, or disaggregate, disclosures so that meaningful information will not be obscured by insignificant details or by groupings of items with different characteristics. The disclosure requirements would apply to both public and nonpublic business entities.

Qualitative disclosures

Lessees would be required to disclose the following qualitative information:

- The nature of their leases (and subleases, as applicable), including:
    - A general description of those leases
    - The basis, and terms and conditions, on which variable lease payments are determined
    - The existence, and terms and conditions, of options to extend or terminate the lease (including descriptions of the options that are recognized as part of the right-of-use assets and lease liabilities and those that are not)
    - The existence, and terms and conditions, of lessee residual value guarantees
    - The restrictions or covenants imposed by leases (e.g., those related to dividends or incurring additional financial obligations)
- Information about leases that have not yet commenced but that create significant rights and obligations for the lessee

- Information about the significant judgments and assumptions made in accounting for leases, which might include:
  - The determination of whether a contract contains a lease
  - The allocation of contract consideration between lease and non-lease components
  - The determination of the discount rate
- The main terms and conditions of any sale and leaseback transactions
- Whether an accounting policy election was made for the short-term lease exemption

Lessees would be required to provide these qualitative disclosures in sufficient detail such that the lessee disclosure objective is met.

Quantitative disclosures

Lessees would be required to disclose the following quantitative information:

- Type A lease expense (with amortization of right-of-use assets disclosed separately from interest on lease liabilities)
- Type B lease expense
- Short-term lease expense for such leases with a lease term greater than one month
- Variable lease expense
- Sublease income
- Cash paid for amounts included in the measurement of lease liabilities separately by lease type (i.e., Type A , Type B) and segregated between operating and financing cash flows
- Supplemental noncash information on lease liabilities arising from obtaining right-of-use assets (e.g., for new leases) separately by lease type
- Weighted-average remaining lease term, separately by lease type
- Weighted-average discount rate as of the reporting date, separately by lease type
- Gains and losses arising from sale and leaseback transactions

The new standard would expand lessees' disclosures to include judgments made and assumptions used to account for leases.

Expense items disclosed would also include any amounts capitalized as part of the cost of another asset.

The new standard would not require a specific format for lessees' quantitative disclosures, but would include an example presenting quantitative disclosures in a tabular format.

Lessees would also be required to disclose a maturity analysis of lease liabilities. The maturity analysis would include undiscounted cash flows, on an annual basis, for a minimum of each of the five years after the balance sheet date and a total of the amounts for the remaining years (i.e., the total undiscounted cash flows beyond the fifth year). The analysis would also include a reconciliation of the undiscounted cash flows to the lease liabilities presented on the balance sheet.

Key differences between US GAAP and IFRS
The IASB's new standard would not require specific qualitative disclosures. Instead, lessees would be required to disclose qualitative information necessary to satisfy the lessee disclosure objective. The FASB and the IASB differ on specific lessee quantitative disclosure requirements mainly because of differences in the lessee accounting models. For example, the FASB's new standard would require the disclosure of Type B lease expense, which is not applicable under the IASB's new standard (under which all lessee leases would be Type A). In addition, the FASB would not require a specific format for lessee quantitative disclosures. However, the IASB would require the disclosure to be made in a tabular format unless another format is more appropriate. Refer to Appendix C for a summary of key differences between US GAAP and IFRS.

Lessor accounting (updated July 2015)

As discussed in the lease classification section, lessors would classify all leases as Type A or Type B. There would be three categories of Type A leases, which would affect how those leases are recognized and measured:

- Type A leases with selling profit that is recognized or deferred (similar to ASC 840's sales-type leases)
- Type A leases with no selling profit (similar to ASC 840's direct-financing leases)
- Type A leases that would be recognized and measured in accordance with ASC 606 (also refer to the lease classification section above)

Under the new standard, lessors would account for a Type B lease using an approach similar to ASC 840's operating leases.

Lessors would account for Type A leases with and without selling profit using approaches similar to ASC 840's guidance for sales-type and direct financing leases, respectively. However, there would be two key differences. First, the initial recognition of selling profit (if any) on a Type A lease would be deferred if the lease does not, in effect, transfer control of the underlying asset to the lessee. Second, a lessor would follow the guidance in ASC 606 if a lease would otherwise be a Type A lease with recognized selling profit except that the collection of lease payments is not probable. These differences are discussed further in the lessor accounting concepts section below.

Under the new standard, leveraged lease accounting would be eliminated for new leases after the effective date. That is, lessors would account for new leases, including those that would qualify as leveraged leases under ASC 840, using the classifications discussed above. However, leveraged leases that exist at transition would be grandfathered. Refer to Appendix B for further discussion on leveraged lease accounting.

Lessor accounting concepts

At lease commencement, lessors would apply the key concepts described earlier in this publication to determine the initial direct costs, lease term, lease payments and discount rate. Lessors would also apply the following concepts to recognize and measure their Type A leases.

Net investment in the lease

A lessor's net investment in a Type A lease would consist of the lease receivable and any unguaranteed residual asset.

- Lease receivable — The lease receivable would be the total lease payments (see the lease payments section above) discounted using the rate implicit in the lease and any guaranteed residual asset. Initial direct costs incurred as part of Type A leases without recognized selling profit would be included in the lease receivable. However, initial direct costs related to Type A leases with initially recognized selling profit would be expensed at lease commencement.
- Unguaranteed residual asset — The unguaranteed residual asset would be the lessor's right to the expected unguaranteed value of the leased asset at the end of the lease.
- Deferred selling profit — Selling profit would be deferred and would reduce the lessor's net investment in the lease when the lessor does not, in effect, transfer control of the underlying asset to the lessee.

Selling profit or loss

Selling profit would be the difference (if any) between the fair value of the underlying asset and its carrying amount. Leases that give rise to a manufacturer's or dealer's profit or loss to the lessor normally result when a company uses leasing as a means of marketing its products. A loss upon sale would be recognized immediately, but a loss may indicate that the underlying asset was impaired prior to the transaction.

Determining whether to defer or recognize selling profit – Type A leases with selling profit

For purposes of determining whether selling profit should be initially recognized or deferred, the new standard would require a lessor to determine whether the lease, in effect, transfers control of the underlying asset to the lessee. This evaluation considers the lease classification criteria applicable to lessees and lessors (discussed above), except that the control evaluation would exclude any risks and rewards transferred to parties other than the lessee. For example, a lessor would exclude residual value guarantees or asset buyback commitments from a third party unrelated to the lessee when evaluating whether selling profit can be recognized. Under this evaluation, control would be deemed to have transferred if any one of those lease classification criteria is met and selling profit would be recognized assuming that collectibility of the lease payments is probable.

The new standard would include this additional condition for the recognition of initial selling profit to better align the leases guidance with the principles in the new revenue recognition standard (i.e., ASC 606). That is, a lessor would evaluate the transfer of control of the underlying asset from the **lessee's** perspective and consider the risks and rewards transferred to only the lessee, just as the new revenue recognition standard requires control to be evaluated from the customer's perspective. However, if the lessee does not obtain control of the underlying asset, the lessor would defer any initial selling profit and amortize it over the lease term in a manner that, when combined with the interest income on the lease receivable and the unguaranteed residual asset, would produce a constant periodic rate of return on the lease.

How we see it

A lessor's recognition of initial selling profit for leases of part of a real estate asset (e.g., a floor of a building) under the new standard would be a significant change from current practice.

Key differences between US GAAP and IFRS
Under the IASB's new standard, lessors would be permitted to initially recognize profit (if any) on all Type A leases including those with significant third-party residual value guarantees. Refer to Appendix C for a summary of key differences between US GAAP and IFRS.

Collectibility

The new standard would require lessors to evaluate the collectibility of lease payments to determine lease classification. Refer to the lease classification section above. This assessment would also affect the recognition and measurement of leases. A lessor would follow the guidance in ASC 606 if a lease would otherwise be a Type A lease with recognized selling profit except that the collection of lease payments is not probable. A lessor would apply the recognition and measurement provisions for a Type B lease to a lease that would otherwise be a Type A lease with deferred selling profit or no selling profit except that the collection of lease payments is not probable.

Type B leases

Lessors' Type B leases would be similar to today's operating leases.

Lessors would account for Type B leases in a manner similar to today's operating leases. That is, they would continue to recognize the underlying asset. At lease commencement for Type B leases, lessors would not recognize a net investment in the lease (i.e., a lease receivable and any unguaranteed residual asset) on the balance sheet or initial profit (if any) on the income statement. The underlying asset would continue to be accounted for in accordance with applicable accounting standards (e.g., ASC 360).

Lessors would recognize lease payments from Type B leases over the lease term on either a straight-line basis or another systematic basis if that basis better represents the pattern in which income is earned from the underlying asset. Lessors in a Type B lease would recognize initial direct costs as an expense over the lease term on the same basis as lease income.

In some cases, another systematic basis of accounting might better represent the pattern in which the lessor earns income. For example, variable lease payments that do not depend on an index or rate would be recognized as they are earned (i.e., when the variable payments become receivable). Likewise, "stepped" rent increases that are intended to compensate a lessor for expected increases in market rental rates would be recognized based on the contractual cash flows (i.e., as the stepped payments become receivable). In both examples, revenue would be recognized on a basis other than straight line because it better reflects the pattern in which the revenue is earned.

If lease payments are uneven for reasons other than to compensate the lessor for expected increases in market rentals or changes in market conditions, the lease revenue would be recognized on a straight-line basis. For example, lease payments might be front-loaded or back-loaded or a lease might include a rent-free period. The uneven pattern of these lease payments generally would not be related to the way in which the lessor earns revenue. Therefore, they would not support revenue recognition on a basis other than straight line.

How we see it

Determining that lease payments in a Type B lease should be recognized on a basis other than straight line would likely require judgment. There might not be a clear distinction between increases in scheduled lease payments that reflect the pattern in which lease income is earned (e.g., "stepped" increases intended to compensate the lessor for changes in the market rentals or market conditions) and other scheduled increases that do not.

Type A leases with selling profit — recognized or deferred

Initial recognition and measurement

Upon commencement of a Type A lease with selling profit, lessors would:

- Derecognize the carrying amount of the underlying asset
- Recognize the net investment in the lease
- Recognize, in net income, selling profit on leases in which the lessee, in effect, obtains control of the underlying asset
- Defer selling profit on leases in which the lessee, in effect, does not obtain control of the underlying asset

Subsequent measurement

After lease commencement, lessors would account for a Type A lease with selling profit as follows:

- Recognize interest income (in profit or loss) over the lease term using the rate implicit in the lease on the components of the net investment in the lease, including:
  - Interest on the lease receivable
  - Accretion of the unguaranteed residual asset to its expected undiscounted value at the end of the lease
- Amortize any deferred selling profit as interest income over the lease term in a manner that, when combined with the interest income on the lease receivable and the unguaranteed residual asset, would produce a constant periodic rate of return on the lease — only applicable for Type A leases with selling profit for which control has not transferred to the lessee
- Reduce the net investment in the lease for lease payments received (net of interest income and recognized profit calculated above)
- Separately recognize income from variable lease payments that are not included in the net investment in the lease (e.g., performance- or usage-based variable payments) in the period in which that income is earned

Type A leases with no selling profit

Initial recognition and measurement

Upon commencement of a Type A lease with no selling profit, lessors would:

- Derecognize the carrying amount of the underlying asset
- Recognize the net investment in the lease

Subsequent measurement

After lease commencement, lessors would account for a Type A lease with no selling profit as follows:

- Recognize interest income (in profit or loss) over the lease term using the rate implicit in the lease on the components of the net investment in the lease, including:
  - Interest on the lease receivable
  - Accretion of the unguaranteed residual asset to its expected undiscounted value at the end of the lease

- Reduce the net investment in the lease for lease payments received (net of interest income calculated above)
- Separately recognize income from variable lease payments that are not included in the net investment in the lease (e.g., performance- or usage-based variable payments) in the period in which that income is earned

Type A leases that would be recognized and measured under ASC 606

A lessor would recognize and measure a lease with selling profit that, in effect, transfers control of the underlying asset to the lessee for which collectibility of lease payments is not probable in accordance with the new revenue recognition standard.

If collection of the lease payments for those leases is not probable, the lessor would defer income recognition (i.e., a deferral of income similar to the new revenue standard).

> **How we see it**
>
> Lessors should monitor the discussions of the FASB for any potential amendments to the new revenue recognition standard.

Reassessment

Lessors would not be required to reassess the lease term or lease payments after lease commencement. Refer to Appendix A for a summary of lessee and lessor reassessment requirements. If a lease is modified, refer to the lease modifications section above.

Other lessor matters in Type A leases

Sale of lease receivables

The new standard would require lessors to measure all lease receivables, including those held for sale, at amortized cost.

> **How we see it**
>
> We expect the Basis for Conclusions to indicate that it would be appropriate for lessors to apply the existing financial asset derecognition guidance in ASC 860, *Transfers and Servicing*, when they sell lease receivables, including any guaranteed residual values.

Impairment of the net investment in the lease

The new standard would require lessors to evaluate their entire net investment in the lease (when applicable) for impairment using the guidance in ASC 310. This is a change from the 2013 ED that would have required lessors to apply the impairment guidance in ASC 310 to lease receivables and ASC 360 to the unguaranteed residual asset.

Classification of the underlying asset at the end of a lease

At the end of the lease term, lessors may receive the underlying asset back from the lessee. Under the new standard, lessors would reclassify the carrying amount of the unguaranteed residual asset to the applicable category of assets (e.g., property, plant and equipment). Thereafter, lessors would account for the underlying asset using other applicable accounting guidance (e.g., ASC 360).

Income tax accounting

The new standard could affect lessors' accounting for income taxes. Applying the new standard could change the recognition of lease-related assets (i.e., lease receivables and any unguaranteed residual assets), the measurement of lease-related assets and the derecognition of underlying assets for certain leases that are subject to operating leases today. The new standard also would change the timing of recognition of lease income for some leases. In addition, the special accounting for leveraged leases would be eliminated, except for leveraged leases that exist at the transition date, which would be grandfathered.

These changes could affect many aspects of accounting for income taxes, such as the following:

- Recognition and measurement of deferred tax assets and liabilities
- Assessment of the recoverability of deferred tax assets (i.e., the need for and measurement of valuation allowances)

Presentation

The table below summarizes how lease-related amounts and activities would be presented in lessors' financial statements. The FASB has not addressed presentation of Type A leases that would be recognized and measured in accordance with the new revenue recognition standard.

Financial statement	Lessor presentation
Balance sheet	‣ **Type A leases:** ‣ Lease assets (i.e., lease receivables and unguaranteed residual assets) would be presented separately from other assets ‣ Lease receivables and unguaranteed residual assets could be presented separately from each other or, if presented together (i.e., the net investment in the lease), they would be separately disclosed in the notes ‣ **Type B leases:** Underlying assets would be presented in accordance with applicable guidance
Income statement	‣ **Both types of leases:** Income arising from leases would be presented separately from other activity, or disclosed in the notes (along with the corresponding line item(s) in the income statement), although when leasing activity is material, public business entities would be required to present such activity separately ‣ **Type A leases:** ‣ Profit or loss recognized at the commencement date would be presented on either a gross or net basis, based on the lessor's business model ‣ Lessors that use leasing as an alternative means of realizing value from goods they would otherwise sell would present lease revenue and cost of goods sold on a gross basis (i.e., revenue and costs in separate line items) ‣ Lessors that use leases for the purpose of providing finance would present the gain or loss on a net basis (i.e., in a single line item) ‣ Interest on the net investment in the lease would be presented as interest income
Statement of cash flows	‣ **Both types of leases:** Cash lease payments received would be presented within operating activities

Disclosure

The disclosures that would be required for lessors are intended to help financial statement users understand the amount, timing and uncertainty of lease-related cash flows. These disclosures would include the amounts of recognized lease-related assets and liabilities, significant judgments and assumptions about lease terms, payments, the existence of residual value guarantees and options to extend or terminate a lease. Lessors would exercise judgment to determine the level at which to aggregate, or disaggregate, the disclosures. Disclosures would need to be disaggregated or aggregated at an appropriate level so that the information is meaningful to the financial statement users and is not obscured by insignificant details or by grouping items with different characteristics. The FASB has not addressed disclosures for Type A leases that would be recognized and measured in accordance with the new revenue recognition standard.

General disclosure requirements

Lessors would be required to disclose information about the nature of leases, such as:

- A general description of the leases
- The basis, and terms and conditions, on which variable lease payments are determined
- The existence, and terms and conditions, of options to extend or terminate the lease
- The existence, and terms and conditions, of options for a lessee to purchase the underlying asset

Lessors would be required to disclose more information about how they manage the risks related to residual values of assets under lease.

As noted above, the new standard would also require lessors to disclose information about the significant judgments and assumptions made in accounting for leases. For example, a lessor might disclose information about its judgments and assumptions associated with:

- The determination of whether a contract contains a lease
- The identification of the lease and non-lease components of a contract
- The allocation of the consideration in a contract between the lease and non-lease components
- The initial measurement of the residual asset included in the net investment in the lease
- Any other means by which the lessor reduces its residual asset risk (e.g., buyback agreements, variable lease payments for lessee use in excess of specified limits)

Lessors would also disclose lease income recognized in the reporting period, in a tabular format. The disclosure would include:

- For Type A leases:
    - Profit or loss recognized at the commencement date (presented gross or net, consistently with the lessor's business model)
    - The interest income on net investments in leases (i.e., lease receivables and unguaranteed residual assets), either individually for each component of the net investment or in the aggregate
- For Type B leases, lease income relating to lease payments
- Lease income relating to variable lease payments not included in the measurement of net investments in Type A leases

Other quantitative and qualitative disclosures — Type A leases

Under the new standard, lessors would be required to qualitatively and quantitatively explain significant changes in residual values of assets under Type A leases. However, disclosure of significant changes in the lease receivable portion of the net investment would follow other US GAAP.

Key differences between US GAAP and IFRS
Under the IASB's new standard, lessors would be required to explain significant changes in the net investment in both qualitative and quantitative terms. Refer to Appendix C for a summary of key differences between US GAAP and IFRS.

To help financial statement users understand and evaluate liquidity risks of lease-related cash flows, lessors would be required to disclose a maturity analysis of undiscounted cash flows to be received, on an annual basis, for five years after the balance sheet date, and in total thereafter, that comprise Type A lease receivables and a reconciliation to lease receivables presented on the balance sheet (or in the notes).

Other quantitative disclosures — Type B leases

Lessors would be required to provide a separate maturity analysis of the undiscounted future lease payments to be received for Type B leases, as of the reporting date. The maturity analysis would include undiscounted cash flows to be received, on an annual basis, for five years after the balance sheet date, and in total thereafter.

For assets leased under Type B leases, lessors would be required to disclose the same information that is currently required under ASC 360 for property, plant and equipment (e.g., balances by major class, accumulated depreciation, a general description of method of computing depreciation).

Other considerations

Subleases

Lessees often enter into arrangements to sublease a leased asset to a third party while the original lease contract remains in effect. In these arrangements, one party acts as both the lessee and lessor of the same underlying asset. The original lease is often referred to as a head lease, the original lessee is often referred to as an intermediate lessor and the ultimate lessee is often referred to as the sub-lessee.

Intermediate lessor accounting

An intermediate lessor would assess sublease classification independently of the classification assessment that it makes as the lessee of the same asset. Under the new standard, an intermediate lessor would consider the lease classification criteria with reference to the underlying asset when classifying a sublease. See the lease classification section above.

Key differences between US GAAP and IFRS
Under the IASB's new standard, intermediate lessors would be required to consider the right-of-use asset when determining sublease classification. Refer to Appendix C for a summary of key differences between US GAAP and IFRS.

An intermediate lessor generally would account for a head lease (as a lessee) and a sublease (as a lessor) as two separate lease contracts. However, when contracts are entered into at or near the same time, an intermediate lessor would be required to consider the criteria for combining contracts (i.e., whether the contracts are negotiated as a package with a single commercial objective or the consideration to be paid in one contract depends on the price or performance of the other contract. See the contract combinations section above for more information. If either criterion is met, the intermediate lessor would account for the head lease and sublease as a single combined transaction.

Today's guidance for subleases that are loss contracts would be eliminated. Therefore, intermediate lessors would assess right-of-use-assets that are subject to a sublease for impairment under the long-lived asset impairment provisions of ASC 360. Refer to Appendix B for a summary of current US GAAP lease and lease-related accounting guidance that would be eliminated under the new standard and guidance that may be eliminated pending further FASB discussions.

Sub-lessee accounting

The FASB concluded that a sub-lessee would classify the sublease by referring to the underlying asset rather than by referring to the right-of-use asset arising from the head lease.

Presentation

Intermediate lessors would generally present sublease revenues on a gross basis.

Intermediate lessors would not be permitted to offset lease liabilities and lease assets that arise from a head lease and a sublease, respectively, unless those liabilities and assets meet the requirement of ASC 210-20, *Balance Sheet — Offsetting*, for offsetting financial instruments. Intermediate lessors would apply the principal-agent guidance from the new revenue recognition standard (refer to ASC 606-10-55-36 through 55-40) to determine whether sublease revenue should be presented on a gross or net basis (i.e., reduced for head lease expenses). The FASB expects that intermediate lessors would generally present sublease revenue on a gross basis.

How we see it

Various aspects of the new standard (e.g., the principal-agent considerations for sublease revenue) would align with the new revenue recognition standard (i.e., ASC 606). Lessors should familiarize themselves with the new revenue standard because it could also influence their accounting for leases. In addition, lessors should monitor developments as the Board considers amending the new revenue standard.

Disclosure

In addition to the lessee and lessor disclosure requirements discussed previously, the new standard would require an intermediate lessor to disclose the following information relating to its subleases:

- A general description of the leases
- The basis, and terms and conditions, on which variable lease payments are determined
- The existence, and terms and conditions, of options to extend or terminate the lease
- The existence, and terms and conditions, of residual value guarantees provided by the sub-lessee
- The restrictions or covenants imposed by leases (e.g., those related to dividends or incurring additional financial obligations)

Business combinations

Classification of acquired leases

The new standard would require an acquirer to classify acquired leases using the contractual terms and conditions at the commencement date of the lease. If the contractual terms and conditions of a lease are modified as part of the business combination, the acquirer would classify the new lease based on the contractual terms and conditions of that new lease.

How we see it

- Under the new standard, no lease assets and liabilities would be recognized for acquired leases that have a remaining term of 12 months or less. We believe the acquirer would generally recognize lease payments on a straight-line basis over the remaining lease term following the business combination.
- It is unclear whether the acquirer's accounting for leases with a remaining term of 12 months or less would preclude the recognition of assets and liabilities for off-market contract terms or in-place leases. Precluding the recognition of these assets and liabilities would be inconsistent with the principles in ASC 805, *Business Combinations*, that typically result in the recognition of assets and liabilities for both the in-place leases and related off-market terms of contracts.

Acquiree in a business combination is a lessee

Initial measurement of a lease

The acquirer would measure the acquired lease liability as if the lease contract were a new lease at the acquisition date. That is, the acquirer would apply the new standard's initial measurement provisions, using the present value of the remaining lease payments at the acquisition date. The acquirer would follow the guidance for determining the lease term, lease payments and discount rate. The right-of-use asset would be measured at an amount equal to the recognized liability, adjusted to reflect both of the following:

- Favorable or unfavorable terms of the lease, relative to market terms
- Any other intangible asset associated with the lease, which may be evidenced by market participants' willingness to pay for the lease even if it is at market terms (e.g., a lease of gates at an airport, a lease of retail space in a prime shopping area that provides entry to the market or other future economic benefits that qualify as an intangible asset)

Because the off-market nature of the lease would be captured in the right-of-use asset, the acquirer would not separately recognize an intangible asset or liability for favorable or unfavorable lease terms relative to market. The classification of the lease would not affect the initial measurement of the lease liability or the right-of-use asset.

Subsequent measurement of a lease

The subsequent measurement of an acquired lease liability and right-of-use asset would be determined using the subsequent measurement guidance for pre-existing lease arrangements (refer to the lessee accounting section above).

Acquiree in a business combination is a lessor

Initial measurement of a lease when the acquiree is a Type A lessor

The acquirer would measure a lease receivable as if the lease contract were a new lease at the acquisition date (i.e., measured at the present value of the remaining lease payments). The acquirer would use the key concepts described previously to determine the lease term, lease payments and discount rate. An unguaranteed residual asset would be initially measured as the difference between the acquisition date fair value of the underlying (acquired) asset and the initial measurement of the lease receivable portion of the net investment in the lease. The acquirer would take into consideration the terms and conditions of the lease (e.g., off-market terms) when calculating the acquisition date fair value of the underlying asset. An acquirer would not recognize a separate intangible asset or liability for favorable or unfavorable terms, relative to market.

Initial measurement of a lease when the acquiree is a Type B lessor

Underlying assets subject to Type B leases would remain on the lessor's balance sheet. Therefore, when an acquiree is a lessor, an underlying asset subject to a Type B lease would be recognized on the acquirer's balance sheet and initially measured at fair value. The acquirer would consider the terms and conditions of the lease (e.g., off-market terms) when measuring the fair value of the underlying asset (e.g., a building). No separate intangible asset or liability for favorable or unfavorable terms relative to market would be recognized.

Subsequent measurement of a lease

The subsequent measurement of the net investment in a Type A lease would be determined using the subsequent measurement guidance for pre-existing lease arrangements (see the lessor accounting section above). The subsequent measurement of the underlying asset subject to a Type B lease would be determined using other applicable accounting guidance (e.g., ASC 360).

To determine how to account for a sale and leaseback transaction, a seller-lessee would consider the control criteria in the new revenue standard.

How we see it

The FASB did not revisit its 2013 proposals on leases acquired in business combinations in redeliberations. The FASB may need to align the new guidance in the final standard to reflect its decisions on lease classification and lessee and lessor accounting.

Sale and leaseback transactions

Because lessees would recognize most leases on the balance sheet (i.e., all leases except for short-term leases depending on the lessee's accounting policy election), sale and leaseback transactions would no longer provide lessees with a source of off-balance sheet financing.

A seller-lessee would use the definition of a sale in the new revenue recognition standard (i.e., ASC 606), in conjunction with additional guidance described below, to determine whether a sale has occurred in a sale and leaseback transaction. The seller-lessee would assess whether the buyer-lessor has gained control of the underlying asset. Control of an underlying asset refers to the ability to direct the use of the asset and obtain substantially all of the remaining benefits from the asset.

If control of an underlying asset passes to the buyer-lessor, the transaction would be accounted for as a sale and a lease by the lessee. If not, the transaction would be accounted for as a financing.

The FASB decided to retain the guidance in the 2013 ED that a buyer-lessor would account for the purchase of the underlying asset consistent with the guidance that would apply to any other purchase of a nonfinancial asset (i.e., without the presence of the leaseback).

How we see it

We generally expect more transactions to be accounted for as sales and leasebacks under the new standard than under today's standard.

Ability to direct the use of an underlying asset

While the concepts of "control" in the new leases standard and the new revenue recognition standard (i.e., ASC 606) are similar, a key difference exists. Under the new leases standard, the right to control the use of an underlying asset would involve the right to direct how and for what purpose the asset is used throughout the period of its use. Under ASC 606, control will be based on a broader consideration of rights with respect to the asset over its entire useful life.

The presence of a leaseback, in and of itself, would not preclude a sale. However, the FASB decided that a sale and a purchase would not occur when a leaseback involves a Type A lease from the seller-lessee's perspective. The FASB believes that a lessee's Type A lease is effectively a financed purchase of the underlying asset. Therefore, it would be inappropriate for a seller-lessee to account for the sale of an underlying asset that it concurrently repurchases. Instead, these transactions would be accounted for as financings.

While a seller's repurchase option would generally preclude sale accounting under ASC 606, the new leases standard would specify that repurchase options would not preclude sale accounting when **all** of the following conditions are met:

- The option is exercisable only at the then-prevailing fair market value (i.e., at the time of exercise) of the underlying asset.
- The underlying asset is a non-specialized asset.
- The underlying asset is readily available in the marketplace.

The FASB believes that such a repurchase option is effectively non-substantive in the context of a sale and leaseback transaction and therefore should not preclude sale accounting in such a transaction. The FASB staff indicated that it believes real estate would not meet the non-specialized asset condition above.

How we see it

- During redeliberations, the FASB discussed an example of a leased automobile and appeared to agree that such an asset would generally be non-specialized and would be readily available in the marketplace. However, determining when an underlying asset is non-specialized and readily available in the marketplace could require judgment.
- In a sale and leaseback transaction, it is unclear whether options to extend a lease for the remaining economic life of the underlying asset would be evaluated in the same manner as purchase options under the new revenue standard (i.e., ASC 606).

Key differences between US GAAP and IFRS

Under the IASB's new standard, no sale would occur when the seller-lessee has a substantive repurchase option. The IASB does not plan to provide further guidance about when repurchase options would be considered substantive. Additionally, sale accounting is not prohibited for Type A leasebacks because all leases are Type A leases for lessees under the IASB's new standard.

Refer to Appendix C for a summary of key differences between US GAAP and IFRS.

Transactions in which the buyer-lessor obtains control of the underlying asset

Accounting for the sale

When the seller-lessee transfers control of the underlying asset to the buyer-lessor in a sale and leaseback transaction, the seller-lessee would do each of the following:

- Derecognize the underlying asset
- Recognize a lease liability and right-of-use asset for the leaseback (subject to the optional exemption for short-term leases)
- Recognize the gain or loss, if any, immediately (adjusted for off-market terms)

Key differences between US GAAP and IFRS
Under the IASB's new standard, gain recognition would be limited to the portion related to the buyer-lessor's residual asset. The remaining gain would be recognized as a reduction to the initial measurement of the seller-lessee's right-of-use asset and thus reflected as a reduction in amortization of the right-of-use asset over the term of the leaseback. Refer to Appendix C for a summary of key differences between US GAAP and IFRS.

Accounting for the leaseback

When a sale occurs, both the seller-lessee and the buyer-lessor would account for the leaseback in the same manner as any other lease (i.e., in accordance with the lessee and lessor guidance, respectively, with adjustments for any off-market terms).

Adjustment for off-market terms

The sale transaction and the ensuing lease are generally interdependent and negotiated as a package. Consequently, in some cases the transaction could be structured with a negotiated sales price above fair value and with lease payments for the ensuing lease above the then-current market rates, or vice-versa. Under either scenario, the off-market terms could distort the gain on sale (or disposition) and the recognition of lease expense for the ensuing lease. To ensure that the gain or loss on disposition and the lease-related assets and liabilities associated with such transactions are not understated or overstated, the FASB decided to require adjustments for any off-market elements of sale and leaseback transactions.

The off-market adjustments would be determined using the fair value of the underlying asset or the market lease payments, whichever provides the more readily determinable evidence. Entities would be expected to maximize the use of observable prices and information when determining which measure is the most appropriate to use.

When the sale price is (or the total lease payments are) less than the underlying asset's fair value (or the total market lease payments), a seller-lessee would increase the initial measurement of the right-of-use asset. This treatment would be similar to the accounting for lease prepayments under the new standard. When the sale price is (or the total lease payments are) greater than the underlying asset's fair value (or the total market lease payments), a seller-lessee would recognize an additional financial liability (i.e., additional financing received from the buyer-lessor) separately from the lease liability.

Buyer-lessors would also be required to adjust the purchase price of the underlying asset for any off-market terms. Such adjustments would be recognized as lease prepayments made by the seller-lessee or as additional financing provided to the seller-lessee.

Adjustments would not be made to reflect either the fair value of the purchase and sale or the current market rates for the lease in sale and leaseback transactions among related parties. Refer to the related party leasing transactions section above.

Disclosure

A seller-lessee in a sale and leaseback transaction would be required to disclose:

- The main terms and conditions of the transaction
- Any gains or losses arising from the transaction separately from gains or losses on disposal of other assets

Effective date and transition

Effective date

The FASB has not yet discussed an effective date but plans to address it in the fourth quarter of 2015.

How we see it

Given the current timeline, we believe an effective date of 1 January 2018 or later is likely.

A final standard is not likely to be effective before 1 January 2018.

Transition

The new standard's transition provisions would be applied as of the beginning of the earliest comparative period presented in the financial statements (date of initial application). For example, assuming an effective date of 1 January 2018, a calendar-year company that presents three-year comparative financial statements would apply the transition provisions on 1 January 2016 (i.e., the beginning of the earliest comparative period presented).

Lessees and lessors would be required to apply the new standard using a modified retrospective approach for all leases existing at, or entered into after, the date of initial application, with an option to use certain transition relief (discussed below).

Lessees and lessors would be prohibited from using a full retrospective transition approach.

Lessee transition — capital leases

For capital leases existing at, or entered into after, the date of initial application, a lessee would:

- Initially recognize a Type A right-of-use asset and lease liability at the later of (1) the date of initial application and (2) the date of initial recognition under ASC 840, measured at the carrying amount of the capital lease asset and capital lease obligation under ASC 840
- Recognize as part of the Type A right-of-use asset any unamortized initial direct costs not included in the capital lease asset under ASC 840 that would have qualified for capitalization under the new standard and write-off costs that would not have qualified for capitalization under the new standard as an adjustment to equity
- Subsequently measure the Type A right-of-use asset and lease liability in accordance with the subsequent measurement guidance in ASC 840 in the periods prior to the effective date

Beginning on the effective date, lessees would subsequently measure the Type A right-of-use asset and lease liability in accordance with the subsequent measurement guidance in the new standard, except that a lessee would not remeasure the Type A right-of-use asset or lease liability for changes in the amount the lessee expects to pay under residual value guarantees unless it remeasures the asset or liability for other reasons (e.g., because of a change in the lease term resulting from a reassessment). If a lease is modified after the effective date or the lease liability is remeasured for any reason, lessees would account for the lease under the new standard. For lease modifications, this would be the case, regardless of whether the modification results in a separate lease.

Lessee transition — operating leases

For operating leases existing at, or entered into after, the date of initial application, a lessee would:

- Initially recognize a Type B right-of-use asset and lease liability at the later of (1) the date of initial application and (2) lease commencement
- Initially and subsequently measure the lease liability at the present value of the sum of the following items unless the lease is modified or the lease liability is required to be remeasured on or after the effective date:
  - The remaining minimum rental payments (as described under ASC 840)
  - Any amounts the lessee expects to pay to satisfy a residual value guarantee
- Use a discount rate established in accordance with the new leases standard as of the later of (1) the date of initial application and (2) lease commencement
- Measure the Type B right-of-use asset throughout the lease at an amount equal to the lease liability, adjusted for any prepaid or accrued rent, lease incentives or unamortized initial direct costs that would have qualified for capitalization under the new leases standard
- Write off, as an adjustment to equity, any unamortized initial direct costs that would not have qualified for capitalization under the new leases standard

Beginning on the effective date, lessees would account for a lease modification or remeasurement of the lease liability under the new standard. For lease modifications, this would be the case, regardless of whether the modification results in a separate lease.

Lessor transition — sales-type and direct financing leases

For sales-type and direct financing leases existing at, or entered into after, the date of initial application, a lessor would:

- Not reassess whether a sales-type lease would have qualified for up-front selling profit recognition in accordance with the new leases standard
- Initially recognize a net investment in the lease at the later of (1) the date of initial application and (2) lease commencement, measured at the carrying amount of the net investment in the lease under ASC 840
- Include in the net investment in a direct financing lease any unamortized initial direct costs that were capitalized in accordance with ASC 840
- Subsequently measure the net investment in the lease in accordance with the subsequent measurement guidance in ASC 840 in the periods prior to the effective date

Beginning on the effective date, the lessor would subsequently measure the net investment in the lease in accordance with the subsequent measurement guidance in the new standard. If the lease is modified after the effective date, lessors would account for the lease under the new standard, regardless of whether the modification results in a separate lease.

Lessor transition — operating leases

For operating leases existing at, or entered into after, the date of initial application, the carrying amount of the underlying asset and any lease assets or liabilities (for example, prepaid or deferred rent) would be the same as that recognized under ASC 840 at the later of (1) the date of initial application and (2) lease commencement.

A lessor would recognize any initial direct costs that would have qualified for capitalization under the new leases standard as an expense over the lease term on the same basis as lease income. Those costs that would not have qualified for capitalization under the new standard would be written off as an adjustment to equity.

If a lessor had previously securitized receivables arising from leases that were classified as operating leases in accordance with ASC 840, the lessor would account for those transactions as secured borrowings in accordance with other GAAP.

Other considerations — transition relief (policy election)

Lessees and lessors would be permitted to make an accounting policy election to apply the following relief which must be elected as a package and must be consistently applied to all leases (i.e., an entity cannot choose which provisions to apply or which leases to apply them to). In addition, an entity that is both a lessee and a lessor must make the election regarding relief for all leases.

Lessees and lessors could elect not to reassess all of the following:

- Whether any expired or existing contracts are or contain leases
- Lease classification for any expired or existing leases
- Initial direct costs for any expired or existing leases (i.e., whether those costs would have qualified for capitalization under the new leases standard)

Lessees and lessors would also be permitted to make an accounting policy election to use hindsight with respect to lease renewals and purchase options when accounting for existing leases. This relief may be elected separately or in conjunction with the package of relief described above. An entity would have to make an accounting policy election (i.e., it could not elect this relief on a lease-by-lease basis).

How we see it

Because the current accounting for operating leases and service contracts is similar, determining whether an arrangement is a lease or service contract might not have been a focus for many entities. Given the consequences of the new standard, the effects of treating an arrangement as a service instead of a lease may be material when it may not have been material in the past. This may require some entities to revisit the assessment made under ASC 840.

Disclosures

Lessees and lessors would be required to provide transition disclosures in accordance with ASC 250, *Accounting Changes and Error Corrections*, without the disclosure of the effect of the change on income from continuing operations, net income, any other affected financial statement line item and any affected per-share amounts for the current period and any prior periods that are adjusted.

Sale and leaseback transition

A seller-lessee would reassess whether there was a sale in a sale and leaseback transaction only when the transaction is still being accounted for as a "failed sale" (i.e., a financing) under ASC 840, at the effective date of the new standard. Transactions previously determined to be sales by a seller-lessee would not be reassessed.

However, a seller-lessee would account for any deferred gain or loss on a transaction previously accounted for as a sale and leaseback as follows:

- For leasebacks classified as capital leases, the entity would continue amortizing the gain or loss in the same manner as under ASC 840.
- For leasebacks classified as operating leases, the entity would recognize any deferred gain or loss not resulting from off-market terms as an adjustment to equity. Any deferred amount that is the result of off-market terms would be recognized as an adjustment to the right-of-use asset if the amount is a loss or as a financial liability if it is a gain.

Seller-lessees would account for the leaseback in accordance with the lessee transition requirements.

Build-to-suit arrangement transition

As discussed in Appendix B, build-to-suit accounting would be eliminated under the new standard. As part of transition, lessees would be required to apply a modified retrospective transition approach for build-to-suit lease arrangements existing at, or entered into after, the date of initial application.

An entity that has recognized assets and liabilities as a result of the build-to-suit guidance in ASC 840 would derecognize those assets and liabilities at the later of (1) the date of initial application and (2) the date that the lessee is determined to be the accounting owner of the asset under existing build-to-suit guidance. Any difference between the amounts of the assets and the liabilities derecognized would be recorded as an adjustment to equity at that date. The lessee would then follow the general lessee transition guidance for the lease.

Key differences between US GAAP and IFRS

While the FASB's new standard would prohibit the use of a full-retrospective transition approach, the IASB's new standard would permit such an approach.

The FASB would require adoption of its new standard using a modified retrospective transition approach. The IASB would permit such a transition approach. However, the FASB and the IASB would require the modified retrospective approach to be applied differently and would provide different types of transition relief.

Refer to Appendix C for a summary of key differences between US GAAP and IFRS.

Endnotes:

[1] ASC 840-10-25-42 requires lessors to consider all four lease classification criteria in paragraph 840-10-25-1 and both of the following criteria: (a) collectibility of the minimum lease payments is reasonably predictable, and (b) no important uncertainties surround the amount of unreimbursable costs yet to be incurred by the lessor under the lease.

[2] See Proposed Accounting Standards Update (Revised), *Leases (Topic 842),* on the FASB's website.

[3] A service concession arrangement is an arrangement between a public-sector entity grantor and an operating entity under which the operating entity generally operates the grantor's infrastructure (e.g., an airport, road, bridge, tunnel) for a specified period of time. Refer to our Financial reporting developments publication, *Lease accounting*, for further information.

[4] ASU 2015-05, *Customer's Accounting for Fees Paid in a Cloud Computing Arrangement*.

[5] See ASC Master Glossary for definition of public business entity.

[6] For lessees, see the Lessee Accounting Model March 2014 staff paper 3A paragraph 36. For lessors, see the Lessor Accounting Model March 2014 staff paper 3C paragraph 19.

Appendix A: Summary of lessee and lessor reassessment requirements (updated July 2015)

	Lessees	Lessors
Allocating contract consideration	Reallocate contract consideration upon either of the following events: ▸ A contract modification that is not accounted for as a separate, new lease. ▸ A reassessment of the lease term or whether the lessee is reasonably certain to exercise an option to purchase the underlying asset.	Reallocate contract consideration upon a contract modification that is not accounted for as a separate, new lease.
Lease term	Reassess upon the occurrence of significant events or changes in circumstances that are within the lessee's control (i.e., market-based events or changes would not trigger a reassessment).	No requirement to reassess after lease commencement.
Variable lease payments that depend on an index or rate	Reassess when the lease liability is remeasured for other reasons (e.g., due to a change in the lease term).	No requirement to reassess after lease commencement.
Amounts expected to be payable under residual value guarantees — lessees only	Remeasure the lease liability and adjust the right-of-use asset if the amounts expected to be payable under residual value guarantees change during the lease term. Recognize the remaining adjustment in profit or loss if the right-of-use asset is reduced to zero.	Not applicable for lessors because lease payments would generally exclude amounts receivable under residual value guarantees (from the lessee or a third party).
Discount rate	Reassess upon a lease modification, a change to the lease term or a change to the assessment of whether a lessee is reasonably certain to exercise an option to purchase the underlying asset.	Reassess upon a modification to a Type A lease that does not result in a separate, new lease when the modified lease remains a Type A lease (i.e., when lease classification does not change).
Lease classification	It is unclear whether lessees would reassess lease classification upon a modification to a Type A or Type B lease that does not result in a separate, new lease.	Reassess upon a modification to a Type A lease that does not result in a separate, new lease. It is unclear whether lessors would reassess lease classification upon a modification to a Type B lease that does not result in a separate, new lease.

Appendix B: US GAAP guidance that would be eliminated and guidance the FASB may eliminate (updated July 2015)

This appendix discusses accounting guidance that the FASB would eliminate under the new standard. This appendix also discusses interpretive guidance in ASC 840 that the FASB did not include in its 2013 ED. At its May 2015 meeting, the FASB indicated that its staff plans to revisit this guidance to determine whether to would be carried forward to the new standard.

Guidance that would be eliminated under the new standard

Lessee involvement in asset construction ('build-to-suit' transactions)

Build-to-suit lease transactions involve various forms of lessee involvement in the construction of an asset for the lessee's own use. Under ASC 840, a lessee is considered the owner of an asset during the construction period if it takes on substantially all of the construction-period risks. If the lessee is considered the owner of the asset during the construction period, a deemed sale and leaseback of the asset would occur when construction of the asset is completed and the lease term begins. The 2013 ED proposed eliminating this guidance. In the Basis for Conclusions in the 2013 ED, the FASB said entities would apply other existing guidance (e.g., ASC 360) when costs are incurred to construct or design an asset before that asset is ready for use. If the lessee controls the underlying asset before the lease commencement date, the lessee would apply the sale and leaseback provisions of the new standard.

How we see it

Absent additional guidance, it is not clear how lessees and lessors would determine what, if any, assets to record in certain arrangements (e.g., when leasehold improvements are constructed by or on behalf of the lessee). In many instances, judgment would be required to determine whether the lessee is constructing leasehold improvements or leasing fully built-out space.

Separate requirements for leases involving real estate

ASC 840 requires both lessees and lessors to account for leases involving real estate according to their classification as capital, sales-type, direct financing or operating using their respective criteria. However, certain additional tests are necessary, and the land, building and equipment components of a lease are accounted for separately in some instances. The unique treatment of real estate in lease transactions is consistent with the accounting recognition that real estate is different from equipment by its nature. Just as there are distinct rules for real estate sales transactions (until the effective date of ASC 606 and ASC 610), there are also distinct rules for leases involving real estate and sale and leaseback transactions involving real estate.

How we see it

The elimination of today's real estate-specific guidance, including the restrictions for sale and leaseback transactions, would be a major change. We would generally expect more sale and leaseback transactions involving real estate to be accounted for as sales and subsequent leasebacks under the new standard than under today's guidance. In addition, we would expect more leases of real estate to result in up-front selling profit recognition (i.e., for Type A leases).

Leveraged leases that are not grandfathered upon transition

Leveraged lease arrangements existing at transition would be grandfathered. Thus, we expect the new standard to retain the subsequent measurement guidance for leveraged leases currently in ASC 840.

After transition, entities would apply the new standard to all newly recognized leases, including those that would have been classified as leveraged leases under ASC 840 today. For such leases, entities would apply other relevant US GAAP (e.g., ASC 740, *Income taxes*, ASC 470, *Debt*) to account for the non-lease components of such transactions.

How we see it

It is unclear how modifications or extensions of leveraged leases that are grandfathered would be accounted for under the new standard.

Guidance that may be eliminated pending further FASB discussions

Sale of assets subject to a lease or intended to be leased by the purchaser to a third party

ASC 840 provides guidance for the sale of property subject to an operating lease, or property that is leased or intended to be leased by a third-party purchaser. Such transactions should not be treated as sales when the seller retains substantial risks of ownership, unless the seller is able to determine that the buyer will lease the asset to a third party under a sales-type or direct financing lease.

How we see it

If the FASB eliminates this guidance, we would generally expect lessors to look to the new revenue recognition standard (i.e., ASC 606) or ASC 610-20, *Other Income — Gains and Losses from the Derecognition of Nonfinancial Assets*, to determine whether a sale has occurred.

Lessee maintenance deposits

Under certain lease arrangements, a lessee may be contractually or legally responsible for repair and maintenance of the leased asset during the term of the lease arrangement. In addition, the lease arrangement may require the lessee to make deposits (also commonly referred to as maintenance reserves or supplemental rent) with the lessor to protect the lessor if the lessee does not properly maintain the leased asset (i.e., the lessor would use the funds to restore the leased asset to proper working order).

Under a typical maintenance deposit lease arrangement, the lessor is contractually required to reimburse the lessee a portion of the deposit as qualifying maintenance activities are performed and paid for by the lessee. If the deposits paid to the lessor exceed the costs incurred for maintenance activities, certain lease arrangements state that the lessor is entitled to retain such excess amounts at the expiration of the lease arrangements, whereas other lease arrangements require the lessor to refund such excess amounts to the lessee.

Today, ASC 840 provides guidance for maintenance deposits that are paid by the lessee and refunded only if the lessee performs specified maintenance activities. Such arrangements should be considered deposit assets (by the lessee) if it is probable that the deposits will be refunded. The cost of maintenance activities should be expensed or capitalized by the lessee, as appropriate, when the underlying maintenance is performed. If the likelihood of a maintenance deposit being refunded to the lessee is less than probable, the deposit should be recognized as additional rent expense. If it is probable at inception of the lease that a portion of the deposits will not be refunded, the lessee should recognize a pro-rata portion of the deposits as expense as they are paid.

The sale of tax benefits associated with a leased asset

Periodically, companies enter into transactions that are, in substance, sales of tax benefits through tax leases. These transactions are commonly referred to as "double-dip" transactions as their objective is to provide to more than one entity a deduction in separate tax jurisdictions (e.g., Switzerland, US). The transaction generally involves the sale of a depreciable asset or an interest in an asset (or through a sales-type lease — commonly referred to as a "head lease") to an investor in a foreign jurisdiction in consideration for cash proceeds and an obligation by the seller to lease back the asset under a capital or operating lease. ASC 840 provides guidance on identifying and accounting for sales of tax benefits.

Accounting for a loss on a sublease

An entity may enter into a sublease that will result in a loss. ASC 840 provides guidance on determining when and how a loss is recorded based the type of sublease (i.e., operating, direct financing or sale-type sublease).

If the FASB does not retain the existing guidance, under the new standard intermediate lessors would assess right-of-use-assets that are subject to a sublease for impairment under the long-lived asset impairment provisions of ASC 360.

Appendix C: Key differences between US GAAP and IFRS (updated July 2015)

	US GAAP (FASB)	IFRS (IASB)
Scope and scope exclusions	The scope of the new standard would not apply to leases of intangible assets.	The scope of the new standard would not apply to lessors' leases of intangible assets. However, lessees of intangible assets could apply the new standard but would not be required to.
Leases of small assets (IFRS-only)	No exemption for leases of small assets.	*For lessees only* — Recognition and measurement exemption for leases of certain low-value assets (i.e., small assets).
Lease modifications (updated July 2015)	The accounting for a modification to a Type A lease that does not result in a separate, new lease, would depend on whether lease classification changes. Refer to the lease modifications section.	The accounting for a modification to a Type A lease that does not result in a separate, new lease, would be in accordance with IFRS 9, *Financial Instruments*.
Portfolio approach	Guidance would be included in the non-authoritative Basis for Conclusions.	Guidance would be included in the authoritative paragraphs of the new standard.
Variable lease payments that depend on an index or rate — lessee reassessment	Reassess only when lease liability is remeasured for other reasons (e.g., due to a change in lease term).	Reassess upon remeasurement of lease liability for other reasons and upon a change in the cash flows resulting from a change in the reference index or rate (i.e., when an adjustment to the lease payments takes effect).
Discount rate — lessees	Accounting policy election for lessees that are not public business entities to use the risk-free rate to determine the present value of lease payments (for all leases).	No accounting policy election for lessees to use the risk-free rate for the initial and subsequent measurement of lease liabilities.
Reassessment of the discount rate (updated July 2015)	Reassess upon a modification to a Type A lease that does not result in a separate, new lease when the modified lease remains a Type A lease (i.e., when lease classification does not change).	No reassessment after lease commencement.
Fair value of the underlying asset	Definition of fair value in ASC 820 would not apply to fair value measurements for the purposes of lease classification and measurement (with certain exceptions).	The measurement and disclosure requirements of IFRS 13, would apply to lease transactions within the scope of the new standard.
Related party leasing transactions	Entities would be required to account for related party leasing transactions on the basis of the legally enforceable terms and conditions of the lease.	No guidance for related party leasing transactions.

<table>
<tr><th></th><th>US GAAP (FASB)</th><th>IFRS (IASB)</th></tr>
<tr><td>Lease classification — lessees</td><td>Leases (with an optional exemption for short-term leases) would be classified as Type A or Type B, and there would be no initial measurement difference between them.

Differences would result in the recognition, measurement and presentation of leases for lessees.</td><td>Leases (with optional exemptions for short-term leases and leases of small assets) would be Type A leases.</td></tr>
<tr><td>Lease classification — lessors</td><td>Leases would be classified as Type A or Type B. However, lessors would consider an additional criterion based on collectibility of lease payments.</td><td>Leases would be classified as Type A or Type B.</td></tr>
<tr><td>Determining whether to defer or recognize selling profit — Type A leases with selling profit</td><td>Recognize initial selling profit in a Type A lease only if lessee obtains control of the underlying asset, as that would be defined in the new standard, and collection of lease payments is probable.</td><td>Recognize initial selling profit for all Type A leases with selling profit.</td></tr>
<tr><td>Reassessment of lease classification — lessors</td><td>Reassess upon a modification to a Type A lease that does not result in a separate, new lease.</td><td>No reassessment after lease commencement.</td></tr>
<tr><td>Purchase of a leased asset by the lessee during the lease term (updated July 2015)</td><td>No gain or loss recognized. The difference between the purchase price and the carrying amount of the lease liability would be recorded as an adjustment to the carrying amount of the asset.</td><td>No guidance for the purchase a leased asset by the lessee during the lease term</td></tr>
<tr><td>Presentation — statement of cash flows — lessees</td><td>Cash paid for interest on Type A leases would be presented within operating activities.</td><td>Cash paid for interest on Type A leases would be presented within operating or financing activities consistent with the entity's policy election under IAS 7, Statement of Cash Flows.</td></tr>
<tr><td>Disclosure — qualitative disclosures — lessees</td><td>Would include a specific list of qualitative disclosure requirements.</td><td>Would not include specific qualitative disclosure requirement.</td></tr>
<tr><td>Disclosure — quantitative disclosures — lessees</td><td colspan="2">‣ The FASB and IASB differ on specific lessee quantitative disclosure requirements mainly because of differences in the lessee accounting models. For example, the FASB's new standard would require disclosure of Type B lease expense, which is not applicable under the IASB's new standard (under which all leases would be Type A leases).

‣ The FASB would not require a specific format for lessee quantitative disclosures. However, the IASB would require the disclosures to be made in a tabular format, unless another format is more appropriate, and presented in a single note or separate section of the notes to the financial statements.</td></tr>
<tr><td>Other quantitative and qualitative disclosures — Type A leases — lessors</td><td>Qualitative and quantitative disclosure of significant changes in the residual value component of the net investment.</td><td>Qualitative and quantitative disclosure of significant changes in the net investment.</td></tr>
</table>

	US GAAP (FASB)	IFRS (IASB)
Intermediate lessor accounting — classification of a sublease	For purposes of lease classification, the intermediate lessor would consider the underlying asset the leased asset.	For purposes of lease classification, the intermediate lessor would consider its right-of-use asset as the leased asset.
Sale and leaseback transactions — determining whether a sale has occurred	No sale occurs when either: ▸ Leaseback is a Type A lease. ▸ Seller-lessee has a substantive repurchase option. ▸ Fair value (date of exercise) repurchase options for non-specialized assets that are readily available in the marketplace would **not** preclude a sale (i.e., option would be non-substantive).	No sale occurs when the seller-lessee has a substantive repurchase option with no further guidance for non-specialized assets that are readily available in the marketplace. Sale accounting is not prohibited for Type A leasebacks because all leases are classified as Type A leases by lessees.
Sale and leaseback transactions — accounting for gains	Recognize gain in full.	Recognition of gain would be limited to the portion related to the residual asset. The remaining gain would be recognized as a reduction to the initial measurement of right-of-use asset, thus reflected as a reduction in amortization of the right-of-use asset over term of the leaseback.
Transition	▸ While the FASB's new standard would prohibit the use of a full retrospective transition approach, the IASB's new standard would permit such an approach. ▸ The FASB would require adoption of its new standard using a modified retrospective transition approach. The IASB would permit such a transition approach. However, the FASB and the IASB would require the modified retrospective approach to be applied differently and would provide different types of transition relief.	

No. 2014-23
28 August 2014

Technical Line

FASB — new guidance

The new revenue recognition standard — real estate

Revenue recognition practices of all real estate entities may be affected by the new standard.

What you need to know

- Real estate entities will need to exercise more judgment when applying the new revenue standard than they do today when measuring and recognizing gains and losses on property sales using ASC 360-20, *Real Estate Sales*.
- Entities that sell real estate subject to the revenue standard will generally be able to recognize revenue and associated profit when control of the property transfers. An evaluation of the buyer's initial and continuing investments or the seller's continuing involvement with the property will no longer be required. However, entities must still assess the collectibility of the transaction price using the principles of the new revenue standard.
- Fees for property management and other services may be recognized differently due to the new requirements to estimate variable consideration and to determine the number of performance obligations contained in the contract.
- The new standard is effective for public entities[1] for fiscal years beginning after 15 December 2016 and for interim periods therein. It is effective for nonpublic entities for fiscal years beginning after 15 December 2017 and interim periods within fiscal years beginning after 15 December 2018.

Overview

Real estate entities will need to evaluate their revenue recognition practices as a result of the new revenue recognition standard jointly issued by the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) (collectively, the Boards). The new revenue recognition standard will supersede virtually all revenue recognition guidance in US GAAP and IFRS, including industry-specific guidance that real estate entities use today.

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The new standard provides guidance for accounting for all revenue arising from contracts with customers and affects all entities that enter into contracts to provide goods or services to customers (unless those contracts are in the scope of other US GAAP guidance such as the leasing literature).

The standard's consequential amendments provide a new model for measuring and recognizing gains and losses on the sale of certain nonfinancial assets (e.g., property and equipment, including real estate) to noncustomers that are otherwise not in the scope of the new revenue recognition guidance. Accounting for contracts that include the sale of a nonfinancial asset to a noncustomer or a customer generally will be consistent, except for financial statement presentation and disclosure. Entities that sell nonfinancial assets to noncustomers will follow guidance in Accounting Standards Codification (ASC) 360-10 for presenting a gain or loss on the sale of a long-lived asset.

The new revenue recognition model for the sale of real estate differs significantly from the prescriptive rules in ASC 360-20, *Real Estate Sales.* The new principles-based approach is largely based on the transfer of control. As a result, more transactions will likely qualify as sales of real estate, and revenue (i.e., gain on sale) will be recognized sooner than it is under today's accounting.

The accounting for management fees and other fees that vary based on performance (e.g., percentage of the property's revenues or net operating income) will also change. A property manager will have to estimate, at contract inception, the variable consideration to which it will be entitled and for which it is probable that a significant revenue reversal will not occur. This amount will then be recognized in the period as the performance obligation is satisfied.

This publication considers key implications for the real estate industry and provides an overview of the revenue recognition model with a focus on entities that:

- Own, operate and sell real estate assets
- Provide real estate property management services
- Engage in hospitality management activities
- Construct and sell single-family homes and residential developments (e.g., condominiums)

This publication supplements our Technical Line, *A closer look at the new revenue recognition standard* (SCORE No. BB2771), and should be read in conjunction with it.

Real estate entities also may want to monitor the discussions of both the Boards' Joint Transition Resource Group for Revenue Recognition (TRG) and a task force formed by the American Institute of Certified Public Accountants (AICPA) to focus on hospitality and time-sharing issues. The Boards created the TRG to help them determine whether more implementation guidance or education is needed. The TRG won't make formal recommendations to the Boards or issue guidance. The AICPA's hospitality and time-sharing industry task forces are two of 16 industry task forces the AICPA has formed to help develop a new Accounting Guide on Revenue Recognition and to aid industry stakeholders in implementing the standard. Any views discussed by the TRG or guidance produced by the AICPA are non-authoritative.

The views we express in this publication are preliminary. We may identify additional issues as we analyze the standard and entities begin to interpret it, and our views may evolve during that process. As our understanding of the standard evolves, we will issue updated guidance.

Contents

1 Summary of the new model

The new guidance in ASC 606, *Revenue from Contracts with Customers*, outlines the principles an entity must apply to measure and recognize revenue and the related cash flows. The core principle is that an entity will recognize revenue at an amount that reflects the consideration to which it expects to be entitled in exchange for transferring goods or services to a customer.

The principles in the new standard will be applied using the following five steps:

1. Identify the contract(s) with a customer
2. Identify the performance obligations in the contract
3. Determine the transaction price
4. Allocate the transaction price to the performance obligations in the contract
5. Recognize revenue when (or as) the entity satisfies a performance obligation

An entity will need to exercise judgment when considering the terms of the contract(s) and all of the facts and circumstances, including implied contract terms. An entity also will have to apply the requirements of the new standard consistently to contracts with similar characteristics and in similar circumstances.

On both an interim and annual basis, an entity generally will have to provide more disclosures than it does today and include qualitative and quantitative information about its transactions accounted for under the new standard and significant judgments made (and changes in those judgments). On an interim basis, US GAAP will require more disclosure than will be required under IFRS.

Transition and effective date

The new standard is effective for public entities for fiscal years beginning after 15 December 2016 and for interim periods therein. It is effective for nonpublic entities for fiscal years beginning after 15 December 2017 and interim periods within fiscal years beginning after 15 December 2018, and they may elect to adopt the guidance as early as the public entity effective date. Under US GAAP, early adoption is prohibited for public entities.

All entities will be required to apply the standard retrospectively, either using a full retrospective or a modified retrospective approach. The Boards provided certain practical expedients to make it easier for entities to use a full retrospective approach.

Under the modified retrospective approach, financial statements will be prepared for the year of adoption using the new standard, but prior periods won't be adjusted. Instead, an entity will recognize a cumulative catch-up adjustment to the opening balance of retained earnings (or other appropriate component of equity or net assets) at the date of initial application for contracts that still require performance by the entity (i.e., contracts that are not completed). Entities will need to provide certain disclosures in the year of adoption, such as the amount by which each financial statement line item is affected as a result of applying the new standard.

How we see it

Entities that are recognizing profit from the sale of a real estate property using one of the alternative recognition methods in ASC 360-20 (e.g., installment method, cost recovery method, deposit method) will need to carefully evaluate the transition approaches in the new standard.

Entities with deferred revenue balances or failed sales from real estate sales that predate their adoption of the new standard may experience "lost revenue." That's because the deferred amounts or previously unrecognized sales will be reflected in the recasted prior periods (under the full retrospective approach) or as part of the cumulative effect adjustment upon adoption (under the modified retrospective approach), but never reported as revenue in a current period within the financial statements.

The illustration below compares the application of the two transition approaches to a real estate sale for which profit was previously deferred under the installment method. Real estate entities that have previously deferred profit from a sale under another method in ASC 360-20 will need to consider specific transition issues that may arise from each respective method (e.g., interest expense and/or continued depreciation of the property under any of the financing, leasing, profit-sharing or deposit methods).

Illustration 1-1: Comparison of transition approaches

Developer A, a public entity with a 31 December fiscal year-end, sold a real estate property with a carrying value of $6 million for net proceeds of $11 million. The sale closed on 31 December 2014 but did not qualify for full accrual profit recognition because the terms of the four-year note receivable (i.e., seller financing) provided by Developer A did not meet the initial and continuing investment criteria in ASC 360-20. Under ASC 360-20, Developer A applied the installment method and determined that $1 million of profit should be recognized at the sale date, $1 million in 2015, $1 million in 2016, and $2 million in 2017 when the initial and continuing investment criteria were expected to be satisfied. Developer A will also recognize interest income from the note as it is received.

The new revenue standard is effective for Developer A for interim and annual periods beginning 1 January 2017. Management evaluates the new revenue standard and concludes that the terms of the seller financing would not have precluded the recognition of the $5 million of profit at the date of sale.

Full retrospective approach

Developer A presents three years of comparative financial information in its 2017 annual filings with the Securities and Exchange Commission (SEC). In accordance with ASC 250,[2] the full $5 million of profit from the sale that occurred on 31 December 2014 would be recorded as a cumulative catch-up to retained earnings as of 1 January 2015 in the recasted financial information. Deferred profit of $1 million that was previously recognized in both 2015 and 2016 would no longer be included in the income statements of each respective period.

Quarterly SEC filings of Developer A will also reflect this presentation beginning 31 March 2017.

Modified retrospective approach

The sale of the property by Developer A constitutes a completed contract as defined in the new standard[3] because control of all goods (i.e., the property) was transferred on 31 December 2014, before the date of initial application by the entity. Under the modified retrospective approach, the new standard is only applied to contracts that are in progress at the date of initial application (i.e., 1 January 2017). Therefore, Developer A would recognize the remaining $2 million of deferred revenue at 1 January 2017 as a cumulative catch-up to retained earnings at the beginning of the period. In contrast to what happens when the full retrospective approach is used, the $1 million of deferred revenue recognized in both 2015 and 2016 continues to be reflected in each respective comparative period.

Developer A also must disclose the $2 million of profit that would have been recognized in 2017 had ASC 360-20 remained in effect.

2 Scope

ASC 606 applies to all contracts with customers to provide goods or services in the ordinary course of business, except for contracts that are specifically excluded from the scope, which include:

- Lease contracts within the scope of ASC 840, *Leases*
- Insurance contracts with the scope of ASC 944, *Financial Services — Insurance*
- Financial instruments and other contractual rights or obligations (e.g., receivables, debt and equity securities, derivatives)[4]
- Guarantees (other than product or service warranties) within the scope of ASC 460, *Guarantees*
- Nonmonetary exchanges between entities in the same line of business to facilitate sales to customers other than the parties to the exchange within the scope of ASC 845, *Nonmonetary Transactions*

Entities may enter into transactions that are partially within the scope of the new revenue recognition guidance and partially within the scope of other guidance. In these situations, the new guidance requires an entity to first apply any separation and/or measurement principles in the other guidance before applying the revenue standard.

For example, in certain transactions, the seller of a real estate property may agree to support the operations of the property for a period of time or provide a guarantee of the buyer's return on investment. Under today's guidance, because these guarantees either prevent the guarantor from being able to account for the transaction as a sale or recognize in earnings the profit from the sale, these "seller support" guarantees are excluded from the scope of ASC 460 and are instead accounted for using ASC 360-20.

Under the new standard, the presence of the guarantee does not, on its own, affect whether an entity can recognize a sale and the associated profit from the transfer of the property. Instead, the fair value of the guarantee will first be separated from the transaction price and recorded as a liability in accordance with ASC 460[5]. The remainder of the estimated arrangement consideration is allocated among the other elements in the arrangement (e.g., other performance obligations, including the transfer of the asset). The entity then evaluates whether the other performance obligations have been satisfied without considering the guarantee.

In addition, the new standard may affect arrangements involving leases. While ASC 840 provides guidance on allocating an arrangement's consideration between a lease and lease-related executory costs, this guidance refers to ASC 606 for direction on allocating the total consideration between the deliverables subject to ASC 840 and those that are not within the scope of ASC 840. Accordingly, the estimated transaction price should be allocated between the deliverables within the scope of ASC 840 and any deliverables within the scope of the revenue guidance based on the relative standalone selling price of each deliverable (see Chapter 6).

How we see it

In its recent redeliberations of the proposed leases standard,[6] the FASB tentatively concluded that lessors would be required to apply the new revenue standard to allocate contract consideration between the lease and non-lease components of a contract.

The FASB staff also indicated that activities and costs, such as a lessor's promise to provide services (e.g., common area maintenance or CAM) or pay for utilities consumed by the lessee, would represent non-lease components. If this tentative decision is reflected in any final leasing standard, revenue from these non-lease components will be recognized in accordance with the new revenue standard.

2.1 Contracts with customers

The new revenue guidance defines a customer as "a party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities in exchange for consideration." The standard does not define the term "ordinary activities" because it was derived from existing guidance. Under today's guidance, CON 6[7] refers to ordinary activities as an entity's "ongoing major or central operations."

Property management services provided by real estate investment trusts (REITs) and companies in the hotel and hospitality industry are examples of services that are the output of an entity's ordinary activities. In addition, the sale of a home by a homebuilder or a residential condominium unit by a real estate developer would also represent ordinary activities.

In contrast, an entity that sells a commercial property that it had used as its corporate headquarters to a real estate entity would likely conclude that its decision to dispose of that asset is not an output of its ordinary activities and, therefore, does not represent a contract with a customer. However, as described in Section 2.2 below, the FASB also added derecognition guidance in its consequential amendments for the sale of nonfinancial assets and in substance nonfinancial assets (e.g., a legal entity that primarily holds nonfinancial assets) that are not the output of an entity's ordinary activities.

2.2 Sales of nonfinancial assets (including in substance nonfinancial assets)

Judgment will be required when determining whether to apply ASC 606, ASC 610-20 or ASC 810-10 to sales of real estate.

Nonfinancial assets are often sold in transactions that would not represent a contract with a customer because the sale of the asset is not an output of the entity's ordinary activities (e.g., the sale of a former corporate headquarters building by an electronics manufacturer). The Boards noted in the Basis for Conclusions[8] in the new standard that there is economically little difference between the sale of real estate that is, or is not, an output of the entity's ordinary activities and that the only difference in the accounting for these transactions should be the presentation in the statement of comprehensive income (i.e., revenue and expense when the sale is to a customer or gain or loss when the sale is to a noncustomer).

The FASB amended ASC 360-10, *Property, Plant, and Equipment*, to provide direction on applying the appropriate guidance when derecognizing a nonfinancial asset (e.g., real estate). The amended guidance states that sales of nonfinancial assets, including in substance nonfinancial assets, should be accounted for using new guidance in ASC 610-20, *Other Income — Gains and Losses from the Derecognition of Nonfinancial Assets*, unless the contract is with a customer (i.e., a party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities in exchange for consideration). If the contract is with a customer, ASC 606 will apply. However, ASC 610-20 does not contain incremental guidance to ASC 606 but rather instructs entities to apply certain control and measurement guidance from ASC 606, including guidance related to:

- Evaluating the existence of a contract (see Chapter 3)
- Measuring the consideration (i.e., determining the transaction price) in the contract (see Chapter 5)
- Determining when control of the nonfinancial asset has transferred (i.e., when a performance obligation is satisfied) (see Chapter 7)

Accounting for contracts that include the sale of a nonfinancial asset to a noncustomer or a customer generally will be consistent, except for financial statement presentation and disclosure. Entities that sell nonfinancial assets to noncustomers will follow guidance in ASC 360-10 for presenting a gain or loss on the sale of a long-lived asset.

The amended guidance in ASC 360-10 also indicates that there may be certain circumstances in which neither ASC 606 nor ASC 610-20 are applied when derecognizing a nonfinancial asset. The sale (deconsolidation) of real estate in a subsidiary or group of assets to noncustomers that meets both of the following requirements is accounted for in accordance with the derecognition guidance in ASC 810, *Consolidation:*

- It is a business
- It is not also an in substance nonfinancial asset (because the group of assets or subsidiary also contains significant financial assets)

It is important to note that, if both criteria are met, ASC 810 is applied whether or not the assets transferred are in a legal entity. The following table summarizes the application of the appropriate derecognition guidance for common real estate sales transactions:

ASC topic	When applied?	Possible transactions
ASC 606	Sales of real estate (i.e., nonfinancial assets or in substance nonfinancial assets, regardless of whether they also meet the definition of a "business") to customers	Sales of residences by homebuilders and real estate developers
ASC 610-20	Sales of real estate (i.e., nonfinancial assets or in substance nonfinancial assets, regardless of whether they also meet the definition of a "business") to noncustomers	Sales of commercial properties (e.g., office buildings, hotels, manufacturing facilities) by REITs, real estate funds and non-real estate entities
ASC 810-10	Sale (deconsolidation) of real estate in a subsidiary or group of assets that constitutes a "business" and is composed of both substantial financial and nonfinancial assets to noncustomers	Sales by any entity of real estate and substantial financial assets that together are a "business"

How we see it

The FASB did not define an "in substance nonfinancial asset" in the consequential amendments. As a result, entities may consider making judgments similar to those they make today when determining whether a group of assets or subsidiary is "in substance real estate" under ASC 360-20. [9]

An entity that derecognizes a subsidiary or group of assets that meet the definition of a business will need to exercise significant judgment to determine whether the transaction also constitutes the transfer of an in substance nonfinancial asset that will be subject to the guidance in ASC 610-20 rather than ASC 810-10.

The FASB currently has a project[10] on its agenda to clarify the definition of a business. In this project, it also hopes to clarify the accounting for the acquisition or disposal of an in substance nonfinancial asset. The timing and outcome of this project are unclear.

2.3 Sale-leaseback transactions

While the FASB made it clear that ASC 360-20 should no longer be applied to sales and transfers of real estate, the guidance on sale-leaseback transactions involving real estate that are within the scope of ASC 840-40, *Sale-Leaseback Transactions,* was retained. A number of amendments were made to narrow the scope of ASC 360-20, and the FASB specifically stated[11] that entities should not analogize to the retained guidance when evaluating any transaction that is not a sale-leaseback.

The Boards' current joint project on leases is expected to provide new guidance for sale-leaseback transactions that will eventually replace the guidance in ASC 360-20 and ASC 840-40. However, the timing of a new leases standard is unclear.

2.4 Nonmonetary transactions

As discussed in Section 5.3, the new standard provides guidance for contracts with customers involving the exchange of nonmonetary consideration. As a result, the FASB has excluded contracts that fall within the guidance of ASC 606 and ASC 610 from the scope of ASC 845. The specific guidance in ASC 845 for exchanges of real estate involving monetary consideration also has been eliminated. The FASB clarified that the exchange of a nonfinancial asset (including an in substance nonfinancial asset) for a noncontrolling ownership interest in the receiving entity is within the scope of ASC 845.

3 Identify the contract with the customer

To apply the new revenue guidance, an entity must first identify the contract, or contracts, to provide goods and services to customers. Such contracts may be written, oral or implied by the entity's customary business practice but must be enforceable by law and meet specified criteria. These criteria include approval of the contract by all parties and their commitment to perform their respective obligations, the ability to identify each party's rights regarding goods and services to be transferred and the associated payment terms, and whether the contract has commercial substance.

In addition, before an arrangement with a customer is considered a contract in the scope of the new revenue guidance, an entity must conclude that it is probable that it will collect the transaction price. The transaction price is the amount to which the entity expects to be entitled in exchange for the goods or services that will be transferred to the customer as opposed to the contract price. The term "probable" is defined as "the future event or events are likely to occur," consistent with the definition in ASC 450, *Contingencies*. To assess collectibility, an entity should evaluate the customer's ability and intent to pay the transaction price when due.

The prescriptive guidance in ASC 360-20 for evaluating a buyer's initial and continuing investment has been replaced by the collectibility assessment in the new standard.

The transaction price may be less than the stated contract price if an entity concludes that it has offered or is willing to accept a price concession or other discount. Such concessions or discounts are forms of variable consideration (see Section 5.2) that an entity would estimate at contract inception and reduce from the contract price to derive the transaction price. The estimated transaction price would then be evaluated for collectibility. The following table illustrates these concepts:

Stated contract price	$ 2,000,000
Price concession - amount entity estimates it will offer or accept as a reduction to the contractual price	($200,000)
Transaction price	$ 1,800,000

How we see it

In most real estate arrangements, a signed, written contract specifies the asset to be transferred or management services to be provided in exchange for a defined payment. This generally will result in a straightforward assessment of most of the contract criteria.

However, entities that sell real estate and provide financing to the buyer may find that more judgment is required to evaluate the collectibility of the transaction price. These entities may be used to applying the strict quantitative criteria in ASC 360-20 for determining whether a buyer's initial and continuing investment is sufficient to allow for sale and profit recognition, which has been eliminated. In contrast, there is little guidance in the new standard to help entities determine whether the terms of seller-provided financing, and the borrower's ability to fulfil those terms, still allow the collectibility threshold to be met.

The new standard provides guidance for entities to follow when an arrangement does not meet the criteria of a contract.

3.1 Contract modifications

A contract is modified when there is a change in the scope or price (or both). Changes to existing contracts, such as change orders or upgrades during the construction of a home or condominium, are examples of contract modifications.

An entity must determine whether the modification should be accounted for as a separate new contract or as part of the existing contract. Two criteria must be met for a modification to be treated as a separate new contract: (1) the additional goods and services are distinct from the goods and services in the original arrangement and (2) the amount of consideration expected for the added goods and services reflects the standalone selling price of those goods or services. In this respect, only modifications that *add* distinct goods and services to the arrangement can be treated as separate new contracts. In determining the standalone selling price for the new contract, entities have some flexibility, depending on the facts and circumstances.

Only contract modifications that add distinct goods or services can be treated as separate contracts.

A contract modification that does not meet the criteria to be accounted for as a separate new contract is considered a change to the original contract and is treated as either the termination of the original contract and the creation of a new contract or as a continuation of the original contract, depending on whether the goods or services to be provided after the contract modification are distinct. A modification is accounted for on a prospective basis (i.e., as a termination of the original contract and creation of a new contract) if the goods and services to be provided as a result of the modification are distinct from the goods and services in the original contract, but the consideration does not reflect the standalone selling price of the new goods or services. The remaining consideration is allocated to the remaining performance obligations. An entity should account for a modification as a continuation of the original contract if the remaining goods or services to be provided are not distinct from the goods and services already provided and therefore, form part of a single performance obligation that is partially satisfied at the date of the modification. Such modifications are accounted for on a cumulative catch-up basis. See Chapter 4 for further discussion of identifying performance obligations in the contract.

4 Identify the performance obligations in the contract

After identifying the contract, an entity will evaluate the contract terms and its customary business practices to identify all promised goods or services within the contract and determine which of those promised goods or services (or bundle of promised goods or services) should be accounted for as separate performance obligations (i.e., the unit of account for purposes of applying the standard). The revenue standard identifies several activities common to real estate entities that are considered promised goods and services, including the sale of goods produced or resale of goods purchased (e.g., real estate properties); the performance of a contractually agreed-upon task for a customer (e.g., property management); and the construction, manufacture or development of an asset on behalf of a customer.

Promised goods and services represent a performance obligation if (1) the goods or services are distinct (by themselves or as part of a bundle of goods and services) or (2) if the goods and services are part of a series of distinct goods and services that are substantially the same and have the same pattern of transfer to the customer.

4.1 Determination of distinct

The new standard outlines a two-step process for determining whether a promised good or service (or a bundle of goods and services) is distinct:

- Consideration at the level of the individual good or service (i.e., the goods or services are capable of being distinct)
- Consideration of whether the good or service is separately identifiable from other promises in the contract (i.e., the good or service is distinct within the context of the contract)

Both of these criteria must be met to conclude that the good or service is distinct. When the criteria are met, the individual units of account must be separated.

In many cases, goods or services are capable of being distinct but may not be distinct within the context of the contract. The standard provides factors to determine whether goods or services are not separately identifiable and should be combined as one performance obligation (i.e., they are not distinct in the context of the contract). These factors, if present, would indicate that goods and/or services should be combined:

- The entity integrates the good or service with other goods or services promised in the contract into a bundle that represents the combined output described in the contract.
- The good or service significantly modifies or customizes another good or service promised in the contract.
- The good or service is highly dependent on, or highly interrelated with, other goods or services promised in the contract.

If an entity determines that the promised good or service does not meet both criteria (i.e., capable of being distinct and distinct within the context of the contract), and thus is not distinct, the entity has to combine that good or service with other promised goods or services until a distinct bundle is formed. This distinct bundle is accounted for as a single performance obligation, illustrated in the following example:

Illustration 4-1: Construction of a residential home

Homebuilder B enters into a contract to build a new home for a customer on land owned by Homebuilder B. Ownership of the home and land are transferred to the customer when construction is completed. The homebuilder is responsible for the overall management of the project and identifies various goods and services to be provided, including design work, procurement of materials, site preparation and foundation pouring, framing and drywall, mechanical and electrical work, installation of fixtures (e.g., windows, doors, cabinetry) and finishing work.

Analysis: Homebuilder B first evaluates whether the customer can benefit from each of the various goods and services either on their own or together with other readily available resources. Homebuilder B determines that these goods and services are regularly sold separately to other customers by other contractors. Therefore, the customer could generate economic benefit from each of the goods and services either on their own or together with the other goods and services that are readily available to the customer, although they would have to be provided in the context of a different property. Consequently, Homebuilder B determines that the goods and services are capable of being distinct.

Homebuilder B then evaluates whether the goods and services are distinct within the context of the contract. Homebuilder B determines that the contract requires that it provide a significant service of integrating the various goods and services (the inputs) into the new home (the combined output). Therefore, Homebuilder B's promise to transfer the various individual goods and services in the contract are not separately identifiable from other promises in the contract. That is, the various goods and services are all conveyed via a completed home.

Because both criteria for identifying a distinct good or service are not met, Homebuilder B determines the goods and services are not distinct and accounts for all of the goods and services in the contract as a single performance obligation. See Chapter 7 for discussion of satisfaction of performance obligations.

It is unclear how amenities provided by a homebuilder or residential condominium developer will be accounted for under the new guidance. Often, amenities are sold or transferred in connection with the sale of individual units of a real estate project. In evaluating these transactions, entities should consider:

- The parties involved (e.g., customer and homeowner's association)
- Whether separate performance obligations exist and what they are (e.g., goods or services)
- To which parties the promises (potentially performance obligations) are made

How we see it

All real estate entities will need to determine whether separate performance obligations exist within their contracts. We expect these judgments may be more complex for homebuilders, developers of residential condominiums and entities that, in addition to property sales, provide property management services because the nature of these contracts requires the entity to perform multiple activities that may (or may not) represent separate performance obligations.

4.2 Series of distinct goods and services that are substantially the same and that have the same pattern of transfer

As mentioned above, goods and services that are part of a series of distinct goods and services that are substantially the same and have the same pattern of transfer to the customer must be accounted for as a single performance obligation to that customer if both of the following criteria are met:

- Each distinct good or service in the series that the entity promises to transfer consecutively represents a performance obligation that would be satisfied over time (see Section 7.1) if it were accounted for separately.
- The entity would measure its progress toward satisfaction of the performance obligation using the same measure of progress for each distinct good or service in the series (see Section 7.1.4).

Property management services (e.g., maintenance, janitorial, leasing, back office), would likely meet both criteria. However, because property management service contracts are usually composed of multiple underlying activities, significant judgment may be required to determine which activities within a services contract would meet both criteria. The following illustrates how a real estate entity might evaluate performance obligations in a property management contract:

Entities that provide property management services will need to determine which activities comprise a series of distinct services.

Illustration 4-2: Identifying performance obligations in a property management contract

Operator R enters into a five-year contract with Owner S to provide property management services for a regional mall. The contract stipulates that Operator R will perform the following functions:

- Manage day-to-day operations of the mall for a fee of 5% of the property's quarterly lease revenues
- Provide leasing services for a fee of $5 per square foot for new lease agreements and $3 per square foot for renewal lease agreements

Operator R evaluates each of the services provided in the contract to identify whether separate performance obligations are present. Operator R also considers the underlying activities that comprise each of the services to determine whether they meet the criteria to be accounted for as a single performance obligation (or whether the service may be several performance obligations).

Operator R also determines that the leasing services are distinct from the management services (i.e., the leasing and management services are not combined to form a single performance obligation). Both services are capable of being distinct and are distinct in the context of the contract because the services are not highly interrelated with one another. The activities that are necessary to perform the day-to-day management of the property are independent of those that are required to negotiate and execute leases with tenants.

Analysis of management services

Operator R first evaluates the activities that must be performed in order to manage the day-to-day operations of the property. Operator R identifies a number of activities that comprise the overall property management services, including maintenance, janitorial, security, landscaping, snow removal, tenant relationship management and back office support. While each of these activities are individually capable of being distinct, Operator R concludes that they are not distinct within the context of the contract because the ultimate objective of the management services is to perform any activities that are necessary to ensure the property is open and operating as intended.

In addition, Operator R determines that the management services represent a series of services that are substantially the same and have the same pattern of transfer to Owner S. While the specific activities that occur each day may vary slightly (e.g., landscaping may occur in the summer while snow removal occurs in the winter), the overall service of property management is substantially the same and has the same pattern of transfer (i.e., transfers daily) over the term of the contract. Further, each distinct service represents a performance obligation that would be satisfied over time (i.e., over the length of the contract, not at a point in time) and has the same measure of progress (e.g., time elapsed), thereby meeting the stated criteria.

Analysis of leasing services

Operator R then evaluates the activities that comprise the leasing services. Operator R identifies several activities that occur throughout the leasing process, including monitoring of upcoming vacancies, new tenant identification, proposal preparation, lease negotiation and document preparation. While certain of these activities may be capable of being distinct (i.e., document preparation could be outsourced), Operator R concludes they are not distinct within the context of the contract because the ultimate objective of the leasing services is to execute individual leases with tenants to maintain the overall occupancy of the property.

Operator R will need to define the leasing performance obligation by determining whether the leasing services are a single performance obligation or a number of performance obligations (i.e., the execution of each lease).

How we see it

As illustrated above, entities will need to first determine which services in the contract are distinct and therefore could represent separate performance obligations. Then, these services will need to be evaluated to determine whether they are substantially the same, have the same pattern of transfer and meet the two criteria discussed above and therefore must be combined into one performance obligation. This evaluation may require significant judgment when a property manager performs activities beyond day-to-day operation of the property.

For example, a retail property manager may be responsible for identifying and executing leases with seasonal tenants, attracting on-site events (e.g., automobile tent sales) or placing advertising or promotional signage around the property. If an entity determines that these activities represent separate performance obligations, and the contract does not specify separate revenues that reflect the standalone selling prices of these services, the base management fee must be allocated to each separate performance obligation (see Chapter 6).

5 Determine the transaction price

The transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties. The entitled amount is meant to reflect the amount that the entity has rights to under the present contract and may differ from the contractual price (e.g., if the entity expects or intends to offer a price concession).

The consideration promised in a contract may include fixed or variable amounts. When determining the transaction price, entities must estimate the variable consideration expected to be received. The requirement to estimate variable consideration at contract inception in property management contracts and certain real estate sales agreements may represent a significant change for real estate entities. The transaction price also will include the fair value of any noncash consideration, the effect of a significant financing component (i.e., the time value of money) and the effect of any consideration payable to a customer.

5.1 Variable consideration

The transaction price may vary in amount and timing as a result of discounts, credits, price concessions, incentives or bonuses. In addition, consideration may be contingent on the occurrence or nonoccurrence of a future event or earned as a percentage of an underlying measure (e.g., sales, profits, operating performance).

An entity is required to estimate variable consideration using either the "expected value" approach (i.e., the sum of probability-weighted amounts) or the "most likely amount" approach (i.e., the single most likely outcome), whichever better predicts the amount of consideration to which it will be entitled. That is, the method selected is not meant to be a "free choice." The entity should apply the selected method consistently throughout the contract and update the estimated transaction price at each reporting date.

The Boards indicated[12] that the most likely amount approach may be the better predictor when the entity expects to be entitled to only one of two possible amounts (e.g., a contract in which an entity is entitled to receive all or none of a specified performance bonus but not a portion of that bonus). The following provides an illustration of a real estate entity estimating variable consideration resulting from future profit participation from a sale of real estate.

Illustration 5-1: Estimating variable consideration

Developer D sells a newly constructed commercial property with a cost basis of $1.9 million for $2 million, plus a right to receive 5% of future operating profit from the property for the first year. Developer D has no additional ongoing performance obligations. Developer D determines there are a number of possible outcomes of consideration to be received based on the performance of the property (i.e., the buyer's ability to secure tenants for the entire property at favorable rental rates). The buyer currently has executed leases or letters of intent from prospective tenants for 50% of the property.

Analysis: Developer D has to determine whether the "expected value" or "most likely amount" approach better predicts the variable consideration to be received. Developer D determines that the "expected value" approach is the better predictor of the variable consideration since multiple outcomes are possible.

Based on the buyer's current pre-leasing, Developer D estimates the following future profit participation:

Future profit	Probability
$ 50,000	10%
$ 25,000	70%
$ 0	20%

Assume for purposes of this illustration that the constraint, discussed further below, does not limit the amount that can be included in the transaction price at contract inception (i.e., assume it is probable that a significant revenue reversal will not occur). Using a probability-weighted estimate, Entity A would include $22,500 [($50,000 x 10%) + ($25,000 x 70%) + ($0 x 20%)] in the transaction price associated with this variable consideration. That is, the transaction price would be $2,022,500.

Developer D updates its estimate of the transaction price at the next reporting date, and after considering that the buyer now has letters of intent or executed leases for 75% of the property, determines it is now 75% likely to receive future profit participation of $50,000 and 25% likely to receive $25,000. As a result, Developer D's estimate of variable consideration is updated to $43,750 [($50,000 x 75%) + ($25,000 x 25%)] and additional revenue (i.e., gain on sale) of $21,250 ($2,043,750 — $2,022,500) is recognized.

5.1.1 *Constraining estimates of variable consideration*

The constraint may be applied to variable consideration resulting from the sale of real estate or property management arrangements.

To include variable consideration in the estimated transaction price, the entity has to first conclude that it is "probable" that a significant revenue reversal will not occur when the uncertainties related to the variability are resolved. For purposes of this analysis, "probable" is defined as "the future event or events are likely to occur," consistent with the existing definition in US GAAP. The Boards provided factors that may indicate that revenue is subject to a significant reversal:

- The amount of consideration is highly susceptible to factors outside the entity's influence (e.g., market volatility, judgment or actions of third parties, weather conditions).
- The uncertainty about the amount of consideration is not expected to be resolved for a long period of time.
- The entity's experience (or other evidence) with similar types of contracts is limited or that experience (or other evidence) has limited predictive value.
- The entity has a practice of either offering a broad range of price concessions or changing the payment terms and conditions of similar contracts in similar circumstances.
- The contract has a large number and broad range of possible consideration amounts.

The indicators provided by the Boards are not meant to be an all-inclusive list, and entities may note additional factors that are relevant in their evaluations. In addition, the presence of any one of these indicators does not necessarily mean that it is probable that a change in the estimate of variable consideration will result in a significant revenue reversal.

For example, when determining how the constraint affects the estimate of variable consideration, sellers of real estate and property managers will need to consider a variety of factors, including their experiences with similar arrangements, uncertainties that may exist in the latter years of a long-term contract, and market and other factors that may be outside of their control. All entities will want to make sure they sufficiently and contemporaneously document the reasons (including supporting and non-supporting evidence considered) for their conclusions.

When an entity is unable to conclude that it is probable that a change in the estimate of variable consideration that *would* result in a significant revenue reversal will not occur, the amount of variable consideration is limited. In addition, when an arrangement includes variable consideration, an entity should update both its estimate of the transaction price and its evaluation of the constraint throughout the term of the contract to depict conditions that exist at each reporting date.

The following provides an illustration of the application of the constraint to the estimation of variable consideration:

Illustration 5-2: Evaluating the constraint
Assume the same facts as in Illustration 5-1 except that the buyer of the property has just begun negotiations with prospective tenants and has not signed lease agreements for a significant amount of space. *Analysis:* Developer D uses the "expected value" approach and estimates it is 25% likely to receive future profit participation of $50,000, 50% likely to receive $25,000 and 25% likely to receive none. Using a probability-weighted estimate (prior to considering the constraint), Entity A would include $25,000 [($50,000 x 25%) + ($25,000 x 50%) + ($0 x 25%)] in the transaction price associated with this variable consideration. That is, the transaction price would be $2,025,000. Because the constraint would be set at $25,000 (i.e., the amount for which it's probable that a significant reversal will not occur), the full $25,000 may be recognized.

How we see it

While the Boards noted in the Basis for Conclusions[13] that entities should evaluate the magnitude of a potential revenue reversal relative to total consideration (i.e., fixed and variable), the Boards did not include any quantitative guidance for evaluating the significance of the amount. This will require entities to use significant judgment when making this assessment.

5.2 Price concessions

As discussed in Chapter 3, before determining that a contract is in the scope of the new standard, an entity has to assess whether it is probable that it will collect the consideration to which it expects to be entitled in exchange for transferring goods or services (i.e., the transaction price). When determining the transaction price, an entity must evaluate its intention or willingness at the outset of the contract to accept less than the stated contract price (i.e., offer or accept a price concession). A price concession is a form of variable consideration and, as such, must be considered when estimating the amount an entity expects to receive under the contract.

5.3 Noncash consideration

The new standard specifies that when an entity receives, or expects to receive, noncash consideration (e.g., in the form of goods or services), the fair value of the noncash consideration (measured in accordance with ASC 820, *Fair Value Measurement)* is included in the transaction price. If an entity cannot reasonably estimate the fair value of the noncash consideration, it should measure the noncash consideration indirectly by reference to the estimated standalone selling price of the promised goods or services to the customer.

5.4 Significant financing component

A significant financing component may exist when the receipt of consideration does not match the timing of the transfer of goods or services to the customer (i.e., the consideration is prepaid or is paid well after the services are provided). Entities will not be required to adjust the transaction price for this component if the financing is not significant to the contract. Further, an entity is not required to assess whether the arrangement contains a significant financing component unless the period between the customer's payment and the entity's transfer of the goods or services is greater than one year.

When an entity concludes that a financing component is significant to a contract, it determines the transaction price by discounting the amount of promised consideration. The entity uses the same discount rate that it would use if it were to enter into a separate financing transaction with the customer. The discount rate has to reflect the credit characteristics of the borrower in the arrangement; using a rate explicitly stated in the contract that does not correspond with market terms in a separate financing arrangement would not be acceptable. Subject to certain limitations, the transaction price will need to be accreted when there is a prepayment that is determined to be a significant financing component.

6 Allocate the transaction price to the performance obligations

Once the separate performance obligations are identified and the transaction price has been determined, the standard generally (with some exceptions) requires an entity to allocate the transaction price to the performance obligations in proportion to their standalone selling prices (i.e., on a relative standalone selling price basis).

To allocate the transaction price on a relative selling price basis, an entity must first determine the standalone selling price (i.e., the price at which an entity would sell a good or service on a standalone basis at contract inception) for each performance obligation. Generally, the observable price of a good or service sold separately provides the best evidence of standalone selling price. However, in many situations, standalone selling prices will not be readily observable. In those cases, the entity has to estimate the standalone selling price.

The standard discusses three estimation methods: (1) an adjusted market assessment approach, (2) an expected cost plus a margin approach and (3) a residual approach, but these are not the only estimation methods permitted. The standard allows an entity to use any reasonable estimation method (or combination of approaches), as long as it is consistent with the notion of a standalone selling price, maximizes the use of observable inputs and is applied on a consistent basis for similar goods and services and customers.

Under ASC 360-20, an entity that sold an asset and retained a management contract at a below market rate was required to use a prevailing rate to "impute" compensation for the management services. The new standard requires the seller to separately estimate the standalone selling prices of the real estate asset and the management services and allocate total consideration received in the contract on a relative basis.

How we see it

Entities that regularly provide third-party management services should already be equipped to make these estimates. However, entities that infrequently provide these services on a standalone basis, but elect to do so in connection with the sale of a real estate asset, may need to develop new processes to estimate the standalone selling price and retain sufficient documentation to support the reasonableness of their calculations.

Under the relative standalone selling price method, once an entity determines the standalone selling price for the performance obligations in an arrangement, the entity allocates the transaction price to those performance obligations based on the proportion of the standalone selling price of each performance obligation to the sum of the standalone selling prices of all of the performance obligations in the arrangement.

6.1 Exceptions to the relative standalone selling price method

The standard requires an entity to use the relative standalone selling price method to allocate the transaction price except in two circumstances. The first exception requires an entity to only allocate a discount in a contract to the specific goods or services to which it relates rather than proportionately to all of the separate performance obligations. To apply this exception, the entity must meet certain criteria[14] that are unlikely to be satisfied in most types of real estate contracts.

Property managers may allocate variable consideration to the period in which the related services were performed, if certain criteria are met.

The second exception requires variable consideration to be allocated entirely to a specific part of a contract, such as one or more (but not all) performance obligations or one or more (but not all) distinct goods or services promised in a series of distinct goods or services that forms part of a single performance obligation, if both of the following criteria are met:

- The terms of a variable payment relate specifically to the entity's efforts to satisfy the performance obligation or transfer the distinct good or service (or to a specific outcome from satisfying the performance obligation or transferring the distinct good or service).
- Allocating the variable amount of consideration entirely to the performance obligation or the distinct good or service is consistent with the standard's overall objective of allocating revenue in an amount that depicts the amount of consideration to which the entity expects to be entitled in exchange for transferring the promised goods or services to the customer.

In the Basis for Conclusions[15], the Boards discussed an example of a contract to provide hotel management services for one year (i.e., a single performance obligation that is a series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer) for which the consideration is variable and based on the operating results of the property. In this example, the variable consideration (e.g., management fees) that relates specifically to an entity's efforts to transfer the services for a certain period within a contract (e.g., a month, a quarter), which are distinct from the services provided in other periods within the contract, are allocated to those distinct periods instead of being spread over the entire performance obligation.

The following illustration depicts the application of this exception by a property manager that determines that the services it is providing represent a single performance obligation:

Illustration 6-1: Property management fees

On 1 January 2018, Operator E enters into a one-year contract with a shopping center owner to provide property management services. Operator E receives a 5% management fee based on the shopping center's quarterly lease revenues, as defined in the agreement. This is a form of variable consideration.

Analysis: Operator E concludes that the management services represent a single performance obligation recognized over time because it determines that it is providing a series of distinct services that are substantially the same and have the same pattern of transfer (i.e., the services transfer to the customer over time and Operator E uses time elapsed to measure progress).

Operator E determines that the transaction price is allocated to each individual quarter because the quarterly management fee relates specifically to the entity's efforts to satisfy the performance obligation during each quarter, and the allocation is consistent with the objective of allocating an amount that depicts the consideration to which the entity expects to be entitled in exchange for transferring the promised services.

For example, if the revenue generated by the property was $2.0 million in the first quarter of 2018, Operator E would recognize revenue of $100,000 ($2.0 million x 5%) at 31 March 2018.

How we see it

Property managers will need to evaluate their contracts to determine whether the exception for allocating variable consideration will apply to contracts that are based on a percentage of the operating results of the underlying property, including contracts that an entity concludes contain only one performance obligation. Some entities will find that applying the exception and therefore recognizing management fees that relate specifically to the entity's efforts to transfer the service in a distinct period is relatively straightforward. However, certain contracts may contain multiple revenue streams that relate to a single performance obligation. For example, in addition to a variable fee, a contract could also include a fixed fee that would generally be recognized over the term of the contract using the entity's selected measure of progress (e.g., time elapsed).

Some property management contracts contain incentive fees that are based on the performance of the underlying property over a different period than the base management fees (e.g., annually versus quarterly). The following illustration depicts the complexity that entities may face and the significant judgment that may be required when recognizing revenues from these arrangements:

Illustration 6-2: Incentive-based fees

Assume the same facts as in Illustration 6-1 except that Operator E also receives a fee of 2% of the property's annual net operating income (NOI). The shopping center has stabilized occupancy, and no significant tenant vacancies are expected during the term of the agreement. The shopping center is located in a region that periodically receives significant snow accumulation from December through May, which results in extensive snow removal costs in certain years.

Analysis: Operator E evaluates variable consideration in the form of the incentive fee. While most of the property's operating costs are predictable, Operator E determines that the variability of snow removal costs can significantly affect NOI of the property. Because of the potential variability in NOI, Operator E uses the "expected value" approach and concludes that there is an equal (33.3%) likelihood of the property generating NOI of \$1.2 million, \$1.5 million and \$1.8 million. Based on this approach, Operator E initially estimates that it will earn \$30,000 [.02 x ((\$1.2 million x 33.3%) + (\$1.5 million x 33.3%) + (\$1.8 million x 33.3%))] from the incentive fee.

In this scenario, the incentive fee is based on the annual NOI of the property; however, Operator E must determine whether any of the variable consideration should be recognized in the distinct period (i.e., quarter) when the underlying services were performed. Operator E considers whether it is probable that a significant reversal in the incentive fees will not occur prior to the end of the annual period. This assessment requires consideration of the unique facts and circumstances of the arrangement.

Assume Operator E cannot conclude at contract inception that a significant reversal of revenue from the incentive fees is probable to not occur because NOI could be significantly affected by snow removal costs. Snow removal costs result from factors that are beyond its influence (e.g., future weather patterns). Therefore, Operator E applies the constraint to the annual incentive fee and only includes in the allocable transaction price the fees that would be earned from the estimated outcome of NOI for which it is probable that a significant reversal in incentive fees will not occur, or \$24,000 (\$1,200,000 x .02). Operator E would subsequently update its estimate of the transaction price (and its evaluation of the constraint on variable consideration) at each reporting period.

7 Satisfaction of performance obligations

Under the new standard, an entity recognizes revenue when (or as) it satisfies a performance obligation by transferring a promised good or service to a customer. A good or service is considered to be transferred when the customer obtains control. Control of the good or service refers to the ability to direct its use and to obtain substantially all of its remaining benefits (i.e., the right to cash inflows or reduction of cash outflows generated by the good or service). Control also means the ability to prevent other entities from directing the use of and receiving the benefit from a good or service.

The standard indicates that an entity has to determine at contract inception whether it will transfer control of a promised good or service over time. If an entity does not satisfy a performance obligation over time, the performance obligation is satisfied at a point in time. These concepts are explored further in the following sections.

7.1 Performance obligations satisfied over time

An entity transfers control of a good or service over time (rather than at a point in time) when any of the following criteria are met:

- The customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs.
- The entity's performance creates or enhances an asset (e.g., work in process) that the customer controls as the asset is created or enhanced.
- The entity's performance does not create an asset with an alternative use to the entity, and the entity has an enforceable right to payment for performance completed to date.

7.1.1 Customer simultaneously receives and consumes benefits as the entity performs

In some instances, the assessment of whether a customer simultaneously receives and consumes the benefits of an entity's performance will be straightforward (e.g., daily cleaning services for which the simultaneous receipt and consumption by the customer is readily evident). However, in circumstances in which simultaneous receipt and consumption is less evident, the standard clarifies that revenue recognition over time is appropriate if "an entity determines that another entity would not need to substantially reperform the work that the entity completed to date if that other entity were to fulfill the remaining performance obligation to the customer." In making this determination, entities will not consider practical or contractual limitations that limit transfer of the remaining performance obligation.

Real estate entities that provide property management and other services will need to carefully evaluate their contracts to determine whether the services performed are simultaneously received and consumed by the customer (i.e., real estate owner). It may be apparent that services such as routine and recurring maintenance, cleaning and "back-office" functions meet the criteria for recognition of revenue over time. However, determining whether other services, such as leasing or development activities, are simultaneously received and consumed by the real estate owner, or that another entity would not need to substantially reperform activities completed to date, will require significant judgment. These judgments will also be affected by an entity's conclusion about the number of performance obligations (i.e., single or multiple) in the contract (see Chapter 4).

How we see it

As part of its redeliberations of the proposed leases standard, the FASB tentatively decided that services included in leasing contracts (e.g., CAM) may represent non-lease components that will be recognized in accordance with the new revenue standard. Real estate lessors should follow developments in this area as these decisions[6] are tentative and may change before the Boards complete the leases project. Real estate entities may need to consider whether these services are simultaneously received and consumed by their tenants to determine the appropriate recognition method to apply.

7.1.2 Customer controls asset as it is created or enhanced

The second criterion to determine that control of a good or service is transferred over time is that the customer controls the asset as it is being created or enhanced. For example, many construction contracts also contain clauses indicating that the customer owns any work-in-progress as the contracted item is being built.

We plan to discuss the application of this criterion to construction contracts in our upcoming Technical Line, *Revenue recognition — engineering and construction services*.

7.1.3 Asset with no alternative use and right to payment

The laws or legal precedent of a jurisdiction may affect an entity's conclusion of whether a present right to payment is enforceable.

The last criterion to determine that control is transferred over time has the following two requirements that must both be met:

- The entity's performance does not create an asset with alternative use to the entity.
- The entity has an enforceable right to payment for performance completed to date.

Asset with no alternative use

An asset created by an entity has no alternative use if the entity is either restricted contractually or practically from readily directing the asset to another use (e.g., selling to a different customer). An entity has to make this assessment at contract inception and does not update its assessment unless the parties approve a contract modification that substantively changes the performance obligation.

The Boards specified that a contractual restriction on an entity's ability to direct an asset for another use must be substantive (i.e., a buyer could enforce its rights to the promised asset if the entity sought to sell the unit to a different buyer). In contrast, a contractual restriction may not be substantive if the entity could instead sell a different unit to the buyer without breaching the contract or incurring significant additional costs.

Further, a practical limitation exists if an entity would incur significant economic losses to direct the unit for another use. A significant economic loss may arise when significant costs are incurred to redesign or modify a unit or when the unit is sold at a significantly reduced price.

Enforceable right to payment for performance completed to date

An entity has an enforceable right to payment for performance completed to date if, at any time during the contract term, the entity would be entitled to an amount that at least compensates it for work already performed. This right to payment must be present, even in instances in which the buyer can terminate the contract for reasons other than the entity's failure to perform as promised.

To meet this criterion, the amount to which an entity is entitled must approximate the selling price of the goods or services transferred to date, including a reasonable profit margin. Compensation for a reasonable profit margin doesn't have to equal the profit margin expected for complete fulfillment of the contract but must at least reflect either:

- A proportion of the expected profit margin in the contract that reasonably reflects the extent of the entity's performance under the contract before termination
- A reasonable return on the entity's cost of capital for similar contracts

The standard clarifies[16] that including a payment schedule in a contract does not, by itself, indicate that the entity has the right to payment for performance completed to date. The entity has to examine information that may contradict the payment schedule and may represent the entity's actual right to payment for performance completed to date (e.g., an entity's legal right to continue to perform and enforce payment by the buyer if a contract is terminated without cause).

7.1.4 *Measuring progress*

When a performance obligation is satisfied over time, the standard provides two methods for measuring progress under the contract: an input method or an output method. While the standard requires an entity to continuously update its estimates related to the measure of progress selected, it does not allow a change in methods. A performance obligation is accounted for under the method the entity selects (i.e., either the input or output method) until it has been fully satisfied.

Under an input method, revenue is recognized "on the basis of the entity's efforts or inputs to satisfy the performance obligation … relative to the total expected inputs to the satisfaction of that performance obligation." The standard includes resources consumed, labor hours expended, costs incurred and time elapsed as possible input methods. The standard also notes it may be appropriate to recognize evenly expended inputs on a straight-line basis.

Under an output method, revenue is recognized "on the basis of direct measurements of the value to the customer of the goods or services transferred to date relative to the remaining goods or services promised under the contract." Measurements of output may include surveys of performance completed to date, appraisals of results achieved, milestones reached and time elapsed.

The standard does not say either method is preferable, but it says an entity should apply the method it selects to similar arrangements in similar circumstances. If an entity does not have a reasonable basis to measure its progress, the Boards decided that too much uncertainty would exist and, therefore, revenue should not be recognized until progress can be measured.

7.2 Control transferred at a point in time

Control is transferred at a point in time if none of the criteria for a good or service to be transferred over time is met. In many situations, the determination of *when* that point in time occurs is relatively straightforward. However, in some circumstances, this determination is more complex.

The Boards provided indicators for entities to consider when determining whether control of a promised asset has been transferred:

- The entity has a present right to payment for the asset.
- The customer has legal title to the asset.
- The entity has transferred physical possession of the asset.

- The customer has the significant risks and rewards of ownership of the asset.
- The customer has accepted the asset.

None of these indicators are meant to be individually determinative. The Boards also clarified that the indicators are not meant to be a checklist, and not all of them must be present to determine that the customer has gained control. An entity has to consider all relevant facts and circumstances to determine whether control has transferred. For example, the presence of a repurchase option in a contract may indicate that the customer has not obtained control of the asset, even though it has physical possession.

How we see it

Entities that sell a real estate asset will generally be able to recognize revenue and associated profit when control of the property transfers (i.e., at a point in time) presuming all other requirements are met. In most real estate transactions, control will transfer when the buyer obtains legal title and physical possession of the asset. Sellers of real estate are no longer required to consider the initial and continuing investment and continuing involvement criteria in ASC 360-20, although they must conclude on the collectibility of the transaction price. Today, real estate sales are often structured to meet the restrictive criteria in ASC 360-20. For example, the criteria create a disincentive for selling a property with 100% seller financing.

8 Other measurement and recognition topics

The new revenue standard includes guidance for licenses and warranties that may result in changes in practice for certain real estate entities. The FASB also issued consequential amendments to ASC 970, *Real Estate — General,* which is commonly applied to real estate transactions.

8.1 Licenses of intellectual property

The standard provides guidance for recognizing revenue from distinct licenses of intellectual property, which includes licenses granted by hospitality entities, that differs slightly from the overall model.

When the license is the only promised item in the contract, the specific license guidance is applicable to that license. However, licenses of intellectual property are frequently included in multiple-element arrangements with promises for additional goods and services that may be explicit or implicit. For example, a hospitality entity may license its brand for use by a hotel owner and also provide marketing and reservation management services. If an entity determines that a license is not distinct from other promised goods or services in the contract, the promise to grant a license and (some or all) of the other promised goods or services should be accounted for as a single performance obligation and the specific guidance for recognizing revenue for distinct licenses is not applied.

For distinct licenses, entities need to determine whether they have provided their customers with either (1) the right to access the entity's intellectual property as it exists throughout the license period, including any changes to that intellectual property (i.e., right to access) or (2) the right to use the entity's intellectual property as it exists at the point in time when the license is granted (i.e., right to use). We generally expect that right-to-use licenses will be uncommon in the real estate industry; thus, the remainder of our discussion focuses on licenses that provide a right to access.

An entity provides the customer a right to access its intellectual property when it is required to undertake activities that significantly affect the licensed intellectual property and the customer is therefore exposed to positive or negative effects resulting from those changes. These activities can be part of an entity's ongoing and ordinary activities and customary business practices (i.e., they do not have to be activities the entity is undertaking specifically as a result of the contract with the customer).

License agreements between hospitality entities and hotel owners generally provide the hotel owner with the right to access the license. Hospitality entities regularly undertake activities that may positively or negatively affect the license and associated brand, rather than directly transfer other goods and services to the customer that should be considered separate performance obligations. Those activities may include analyzing the customer's changing preferences and implementing product and service improvements, pricing strategies, marketing campaigns and operational efficiencies to support the brand name.

The Boards concluded that a license that provides an entity with the right to access intellectual property is satisfied over time "because the customer simultaneously receives and consumes the benefit from the entity's performance of providing access," including the related activities undertaken by entity.

The standard also provides an exception for determining the transaction price when the arrangement includes sales- or usage-based royalties on licenses of intellectual property. The standard requires that this particular type of variable consideration not be included in the estimate of variable consideration, as discussed in Section 5.1. Instead, these amounts are recognized only upon the later of when the subsequent sale or usage occurs or the satisfaction (in whole or in part) of the performance obligation to which some or all of the sales- or usage-based royalty has been allocated.

8.2 Warranties

Warranties are commonly included in arrangements to sell goods or services, whether explicitly stated or implied based on the entity's customary business practices. The new standard identifies two types of warranties.

Warranties that promise the customer that the delivered product is as specified in the contract are called "assurance-type warranties." The Boards concluded that these warranties do not provide an additional good or service to the customer (i.e., they are not separate performance obligations). By providing this type of warranty, the selling entity has effectively provided a quality guarantee. For example, homebuilders and developers of residential condominiums often provide various warranties against construction defects and the failure of certain operating systems for a period of time. Under the standard, the estimated cost of satisfying these warranties is accrued in accordance with the current guidance in ASC 460-10 on guarantees.

Warranties that provide a service to the customer in addition to assurance that the delivered product is as specified in the contract are called "service-type warranties." If the customer has the option to purchase the warranty separately or if the warranty provides a service to the customer beyond fixing defects that existed at the time of sale, the entity is providing a service-type warranty. The Boards determined that this type of warranty represents a distinct service and is a separate performance obligation. Therefore, the entity allocates a portion of the transaction price to the warranty based on the estimated standalone selling price of the warranty. The entity then recognizes revenue allocated to the warranty over the period the warranty service is provided. Service-type warranties are infrequent in the real estate industry.

8.3 Real estate project costs

Today's guidance in ASC 970, *Real Estate — General*, addresses the costs incurred to sell real estate projects (e.g., model units, advertising, sales overhead) and rent real estate projects. It also prescribes the accounting for amenities such as golf courses, clubhouses, swimming pools and parking facilities. The FASB amended the guidance for costs incurred to *sell* real estate projects, and they will be accounted for under the new guidance for costs incurred in obtaining a contract that the FASB added in ASC 340-40, *Other Assets and Deferred Costs — Contracts with Customers*. Costs incurred to *rent* real estate projects and the accounting for amenities will continue to follow the guidance in ASC 970.

The new standard amends the guidance for costs incurred to sell real estate projects.

Under ASC 340-40, incremental costs of obtaining a contract (i.e., costs that would not have been incurred if the contract had not been obtained) are recognized as an asset if the entity expects to recover them. Recovery can be direct (i.e., through reimbursement under the contract) or indirect (i.e., through the margin inherent in the contract). As a practical expedient, the standard permits an entity to immediately expense contract acquisition costs when the asset that would have resulted from capitalizing such costs would have been amortized in one year or less.

The standard cites sales commissions as an example of an incremental cost that may require capitalization. For example, sales commissions that are directly related to sales achieved during a time period would likely represent incremental costs that would require capitalization. In contrast, some bonuses and other compensation that is based on other quantitative or qualitative metrics (e.g., profitability, EPS, performance evaluations) likely do not meet the criteria for capitalization because they are not directly related to obtaining a contract. In addition, costs incurred for model units, advertising and sales overhead may not qualify to be capitalized under ASC 340-40 because they are not incremental costs of obtaining a contract.

ASC 340-40 also includes guidance for recognizing costs incurred in fulfilling a contract that are not in the scope of another topic. For most real estate entities, costs incurred in fulfilling a contract (e.g., the costs to construct a building such as materials and labor) are already within the scope of another topic (e.g., ASC 360, *Plant, Property, and Equipment*) and therefore are excluded from the scope of ASC 340-40. ASC 340-40 also provides guidance on amortization and impairment.

Next steps

Real estate entities should perform a preliminary assessment on how they will be affected as soon as possible so they can determine how to prepare to implement the new standard. While the effect on entities will vary, some may face significant changes in revenue recognition. All entities will need to evaluate the requirements of the new standard and make sure they have processes and systems in place to collect the necessary information to implement the standard, even if their accounting results won't change significantly or at all.

Real estate entities also may want to monitor the discussions of the Boards, SEC staff, the TRG, and hospitality and time-shares industry working groups formed by the AICPA to discuss interpretations and application of the new standard to common transactions. These working groups may address issues that affect all real estate entities.

Public entities also should consider how they communicate the changes caused by the new standard with investors and other stakeholders, including their plan for disclosures about the effects of new accounting standards discussed in SEC Staff Accounting Bulletin (SAB) Topic 11.M. The SEC staff has indicated it expects an entity's disclosures to evolve in each reporting period as more information about the effects of the new standard becomes available, and the entity should disclose its transition method once it selects it.

Endnotes:

[1] The FASB defined public entity for purposes of this standard more broadly than just entities that have publicly traded equity or debt. The standard defines a public entity as one of the following: (1) a public business entity (PBE), (2) a not-for-profit entity that has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market, or (3) an employee benefit plan that files or furnishes financial statements with the SEC.

[2] ASC 250-10-45-5.

[3] ASC 606-10-65-1(c)(2).

[4] This exclusion includes contracts within the scope of the following Topics: ASC 310, *Receivables*; ASC 320, *Investments — Debt and Equity Securities*; ASC 405, *Liabilities*; ASC 470, *Debt*; ASC 815, *Derivatives and Hedging*; ASC 825, *Financial Instruments*; and ASC 860, *Transfers and Servicing*.

[5] Neither ASC 606 nor ASC 460 provides guidance on recognizing revenue associated with a guarantee.

[6] Minutes of the 22 May 2014 FASB Board Meeting.

[7] Statement of Financial Accounting Concepts No. 6, *Elements of financial statements*.

[8] ASU 2014-09, *Basis for Conclusions,* paragraph 497

[9] Refer to Chapter 1 of our Financial reporting developments, *Real Estate Sales*.

[10] Minutes of the 29 May 2013 FASB Board Meeting.

[11] ASU 2014-09, *Consequential Amendments*, paragraph 63

[12] ASC 606-10-32-8

[13] ASU 2014-09, *Basis for Conclusions,* paragraph 217

[14] ASC 606-10-32-37

[15] ASU 2014-09, *Basis for Conclusions,* paragraph 285

[16] ASC 606-10-55-15

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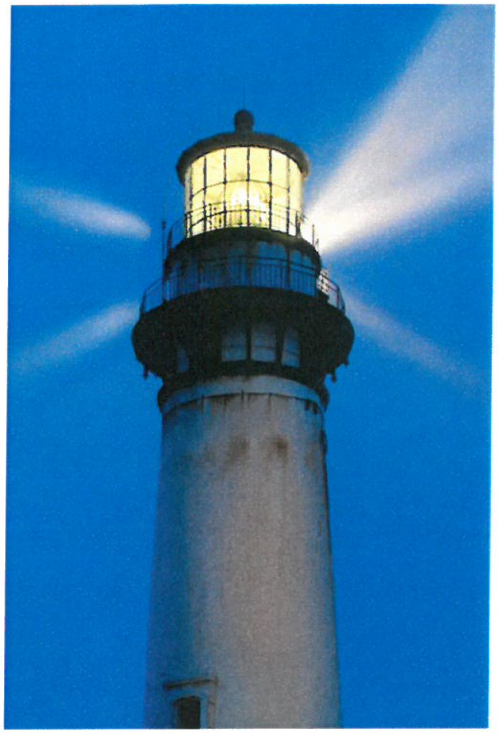

FASB and IASB to Propose Amendments to Principal-Agent Guidance in Revenue Standard

At their June 2015 joint meeting, the FASB and IASB decided to propose amendments to their respective revenue recognition standards to clarify how the principal versus agent guidance should be applied for determining whether revenue should be presented gross (as a principal) or net (as an agent).[1]

Key Facts

- This will be the FASB's **third exposure draft** to improve the understandability and operability of the revenue standard since its issuance in May 2014, although this will be the first proposed amendment to the principal-agent guidance. In addition, the FASB issued an exposure draft proposing to defer the standard's effective date by one year.[2]
- The FASB's proposal will not amend principal-agent guidance in existing U.S. GAAP.[3]
- The IASB intends to issue a single exposure draft containing all of its proposed amendments to its standard.

Key Impact

- The **Boards'** decisions aim to minimize diversity in practice while maintaining substantial convergence between U.S. GAAP and IFRS.

Contents

[1] FASB Accounting Standards Update No. 2014-09, Revenue from Contracts with Customers, available at www.fasb.org; IFRS 15, Revenue from Contracts with Customers.

[2] FASB Proposed Accounting Standards Update, Deferral of the Effective Date, April 29, 2015, available at www.fasb.org.

[3] FASB ASC Subtopic 605-45, Revenue Recognition – Principal Agent Considerations, available at www.fasb.org.

Gross versus Net Revenue Reporting

Gross versus net revenue reporting has been a complex issue for years. Arrangements that involve multiple parties providing goods or services to customers require a reporting entity to exercise significant judgment in evaluating whether it is a principal (presenting revenue gross) or an agent (presenting revenue net) in the transaction. Current U.S. GAAP includes indicators to be evaluated in making this determination. Applying these indicators has often been challenging for preparers, particularly in an evolving economic environment that now includes virtual goods and services.

The revenue standard supersedes existing principal-agent guidance and requires an entity to determine if the nature of its performance obligation is to provide specified goods or services to the customer (the entity is a principal) or to arrange for another party to provide those goods or services (the entity is an agent). The standard specifies that an entity is a principal if it controls the goods or services before transferring them to the customer. The standard also provides indicators of when an entity is acting as an agent.

Principal versus Agent Considerations

Questions have arisen about how the control principle in the implementation guidance interacts with the agency indicators. Some question whether the control principle should be applied independently of the indicators (e.g., based on how control is evaluated elsewhere in the revenue standard) or whether the agency indicators are part of the control assessment. Some have suggested that the indicators are confusing because they do not directly answer the question of whether an entity controls goods or services before transfer. Also, some have questioned whether, and if so how, some indicators should be weighted more heavily than others, particularly when indicators provide contradictory evidence.

Determining whether an entity controls goods or services is particularly difficult in contracts for the transfer of a nonphysical item (e.g., a software developer sells its app through another party's website) or the provision of some services (e.g., an entity arranges for its advertising to be placed on another party's website through a virtual advertising exchange). In those situations it may not be clear how the control principle interacts with the agency indicators. It also may not be clear which party is responsible for fulfilling the contract, what constitutes inventory risk, how to identify an entity's promise, or how to identify the customer.

The Boards decided to retain the control principle as the basis for determining whether an entity is a principal or an agent. To facilitate this determination, the Boards decided to propose four amendments to the revenue standard.

Entities Must Identify the Nature of the Specified Good or Service Provided to the Customer. This could include a right to goods or services (e.g., an airline ticket) or a bundle of goods or services that are not distinct from each other. This amendment's objective is to more clearly link the unit of account in the principal-agent analysis with the guidance on identifying performance obligations.

Clarify How an Entity Can Control a Service. The standard would state that an entity that is a principal controls a right to a service to be performed by a third party, which gives the entity the ability to direct the third party on the entity's behalf. For example, an entity enters into a maintenance services contract with a customer and engages a third party to perform those services under the entity's direction.

Re-frame Indicators to Provide Evidence of When an Entity Controls a Specified Good or Service. These indicators would be provided instead of indicators of when the entity is an agent. Although the amendment would not provide guidance on how to weight the indicators, it would clarify that certain indicators may be more or less persuasive based on facts and circumstances. The indicators are not intended to be all-inclusive.

Revise Examples. Some examples in the revenue standard would be revised and others would be added, specifically those focused on linking the principal-agent conclusion to the notion of control and illustrating how the indicators should be used to support the evaluation of control.

The joint staff paper included an example in which a retailer does not obtain title to its inventory, except momentarily at the point of sale (referred to as flash title). The Boards discussed the example and agreed that the retailer controls the products before they are transferred to the end customer and is therefore the principal in the transaction. However, the Boards expressed reluctance to include the example in the proposed amendments as they believe contracts are often unique, and changes in facts and circumstances could result in a different conclusion.

IASB Actions on Principal versus Agent Considerations

The IASB reaffirmed its prior decision to add examples to IFRS 15 to clarify the application of the principal versus agent guidance.[4] The IASB also agreed with the FASB's clarifications to the principal versus agent guidance and will propose similar amendments to IFRS 15.

Estimating Gross Revenue

In some arrangements in which another party is involved in making an entity's goods or services available to a customer, the entity may be the principal but does not know the price paid by the end customer to the other party. For example, an app developer sells its products through a social media intermediary. The intermediary pays the app developer a fixed amount for each product sold. However, the intermediary does not report to the app developer the amounts charged to the end customers.

In current practice, some companies report the amount received from the other party as revenue. Other companies report the estimated amount charged to the end customer as revenue and the difference between the estimated amount and the amount received as a cost.

The FASB directed the staff to perform additional outreach about whether an entity applying the amended principal versus agent guidance could reach a conclusion that it was a principal in a transaction with an end customer when the entity uses an intermediary and does not know the price (or will not know the price) charged by the intermediary (i.e., the intermediary is not the entity's customer). Once it has these results, the FASB will decide whether additional amendments to the standard are needed to achieve consistency in practice.

[4] IFRS 15, Revenue from Contracts with Customers.

IASB Actions on Estimating the Transaction Price

The IASB decided not to amend its standard to estimate the transaction price as a principal because the issue only affects a limited population of contracts. Feedback from constituents indicated that they were generally able to apply judgment and reach reasonable conclusions.

Next Steps

The FASB and IASB will issue separate exposure drafts on principal versus agent considerations with clarifications and additional examples. Prior to issuing its exposure draft, the FASB will discuss how to estimate gross revenue at a future Board meeting. The FASB and IASB expect to have joint redeliberations on their respective exposure drafts on principal-agent guidance.

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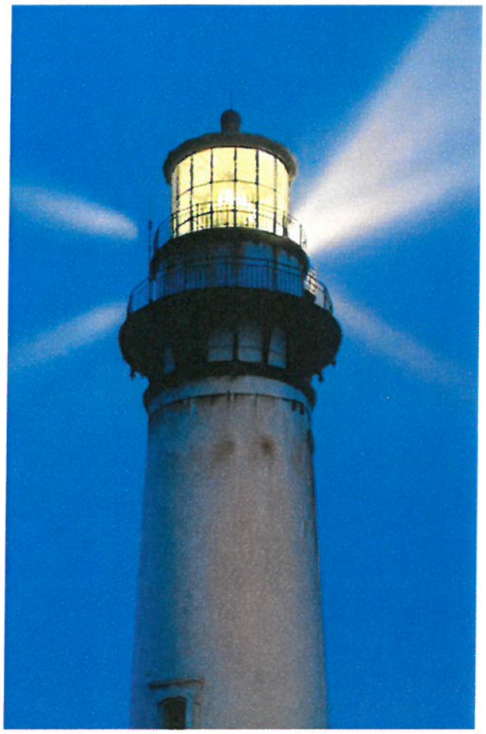

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FASB Balloons Balance Sheet with New Lease Accounting Standard

The FASB's new lease accounting standard ushers in a new era in which lessees will recognize most leases on-balance sheet.[1] This will increase their reported assets and liabilities – in some cases very significantly. Lessor accounting remains substantially similar to current U.S. GAAP but with some important changes.

Well before the new standard becomes effective, lessees and lessors will need to assess how widespread its effects will be so they can plan for necessary business and process changes.

Effective Dates and Transition

	The entity is ...	
Question	**... a public business entity[2]**	**... any other type of entity**
When does Topic 842 take effect?	Annual and interim periods in fiscal years beginning after **12/15/2018**	• Annual periods beginning after **12/15/2019** • Interim periods in fiscal years beginning after **12/15/2020**
Can entities early adopt?	Yes, all entities can adopt Topic 842 immediately	
What is the transition method?	Modified retrospective, with elective reliefs, which requires application of the new guidance for all periods presented	

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[1] FASB ASC Topic 842, Leases, issued February 25, 2016. Topic 842 replaces ASC Topic 840, Leases (current U.S. GAAP). Both are available at www.fasb.org.

[2] This includes (a) not-for-profit entities that have issued or are conduit bond obligors for securities that are traded, listed, or quoted on an exchange or an over-the-counter market and (b) employee benefit plans that file or furnish financial statements with or to the U.S. Securities and Exchange Commission.

Modified Retrospective Transition

Lessees and lessors will apply the new guidance at the beginning of the earliest period presented in the financial statements in which they first apply the new standard. This may significantly change comparative period balance sheets from what was previously reported for many lessees.

The modified retrospective approach includes elective reliefs that all lessees and lessors may apply in transition. These include:

Must be elected as a package	• At the adoption date, the entity may elect not to reassess: – Whether expired or existing contracts contain leases under the new definition of a lease; – Lease classification for expired or existing leases; and – Whether previously capitalized initial direct costs would qualify for capitalization under the new standard
May be elected individually or with the other practical expedients	• The entity may use hindsight in determining the lease term and in assessing impairment of right-of-use (ROU) assets

An entity that elects to apply all of the practical expedients will, in effect, continue to account for leases that commence before the effective date in accordance with current U.S. GAAP unless the lease is modified (or remeasured) on or after the effective date, except that lessees are required to:

- Recognize a ROU asset and a lease liability for all operating leases at each reporting date based on the present value of the remaining minimum rental payments under current U.S. GAAP; and
- Apply the new requirements with respect to changes in estimates that affect lease accounting during the lease term (i.e., reassessments as discussed further below) beginning on the effective date.

The new standard also provides specific transition guidance for sale-leaseback transactions, build-to-suit leases, leveraged leases, and amounts previously recognized for leases in business combinations. This guidance will, for example, conform the determination of whether a lessee in a build-to-suit lease arrangement will recognize the entire underlying asset on its balance sheet to the requirements in the new standard.

Key Impacts to Lease Accounting

Lessees Will Recognize Most Leases on-Balance Sheet. All leases, including operating leases, will be recognized on-balance sheet via a *ROU asset* and *lease liability*, unless the lease is a short-term lease (i.e., one with an accounting lease term of *12 months or less*). This may require a substantial effort to identify all of the entity's leases and accumulate the lease data necessary to apply the new guidance. Lease classification will determine whether a lease is reported as a financing transaction in the income statement and statement of cash flows.

New Judgments Are Required to Identify a Lease. The definition of a lease is the new test for whether a transaction is on- or off-balance sheet. While the new definition is similar to current U.S. GAAP and will yield similar results in most cases, some arrangements that currently contain a lease no longer will. In addition, a new requirement to determine whether the customer has the right to direct the use of the identified asset will require significant new judgments.

Lessee Reassessments Will Require New Processes and Controls. Lessees will be required to reassess, and potentially change, aspects of their accounting for leases (e.g., assessments of the lease term, lessee purchase options, and lease classification) during the lease term, and remeasure lease assets and lease liabilities even if there is not a lease modification.

Accounting for Executory Costs. All (or a portion of) fixed payments by the lessee to cover lessor costs related to ownership of the underlying asset (e.g., property taxes or insurance – also referred to as executory costs) that do not represent payments for a good or service will be considered *lease payments* and reflected in the measurement of lease assets and lease liabilities by lessees (and in the lessor's net investment in the lease for sales-type and direct financing leases). Under current U.S. GAAP, payments for executory costs, including those to reimburse lessors for costs related to the underlying asset, are excluded from *minimum lease payments* and, therefore, from lease accounting.

Collectibility Considerations and Variable Payments Will Affect Lessors' Accounting in New Ways. While the new lessor accounting guidance is generally consistent with current U.S. GAAP, the new standard changes how lessors account for leases in which collectibility of the lease payments is uncertain. Lessors may now have to recognize some lease payments received as liabilities in those cases. The new standard also may affect leases for which there are significant variable payments because they no longer will be classified as operating leases solely due to the extent of variable payments. This may result in a negative implicit rate for the lease or loss recognition at lease commencement.

Fewer Lease Origination Costs Will Be Capitalizable. The new standard has a narrow definition of *initial direct costs* that will require lessors and lessees to recognize more lease origination costs as expenses when incurred. Only incremental costs incurred as a result of the lease being executed (e.g., commissions) meet the new definition and can be capitalized. Accordingly, costs incurred to negotiate and arrange a lease that are *not incurred only as a result of executing the lease* (e.g., legal fees and certain internal employee costs) – some of which are capitalized under current U.S. GAAP – will now be expensed when incurred. This could particularly affect lessors that incur significant costs in the lease origination process.

Expanded Quantitative and Qualitative Disclosures. The new standard requires lessees and lessors to disclose more qualitative and quantitative information about their leases than current U.S. GAAP does. Entities should consider whether they have appropriate systems, processes, and internal controls to capture completely and accurately the lease data necessary to provide those expanded disclosures.

Significant Changes to Sale-Leaseback Accounting Will Affect Seller-Lessees and Buyer-Lessors. The new standard essentially eliminates sale-leaseback accounting as an off-balance sheet financing proposition. This is because seller-lessees will recognize a ROU asset and lease liability in place of the underlying asset (and any asset financing repaid with the sale proceeds). In addition, under the new guidance:

- There likely will be fewer failed sales in sale-leaseback transactions involving real estate, but there may be more failed sales in equipment sale-leaseback transactions.
- Buyer-lessors will have to consider the same sale guidance in the new revenue recognition standard as seller-lessees to determine whether they have purchased the underlying asset, which may result in a failed purchase.[3] A buyer-lessor accounts for a failed purchase as a financing arrangement (i.e., a loan to the seller-lessee) rather than the acquisition of an asset and a lease.
- Seller-lessees will recognize the entire gain from the sale of the underlying asset (i.e., the difference between the selling price and the carrying amount of the underlying asset) at the time the sale is recognized rather than over the leaseback term.

Current Build-to-Suit Lease Guidance Replaced. The new guidance on determining when a lessee controls an underlying asset before lease commencement probably will result in fewer transactions where the lessee is considered the accounting owner of an asset during the construction period than current U.S. GAAP.[4] This means that fewer build-to-suit lease arrangements will become subject to the sale-leaseback accounting requirements. The changes to the sale-leaseback guidance also make it easier for lessees to remove real estate assets recognized during the construction period from their books. Finally, the transition provisions of the new standard will permit many entities to derecognize *build-to-suit* assets and liabilities that have remained on the balance sheet after the end of the construction period under current U.S. GAAP.

[3] FASB ASC Topic 606, Revenue from Contracts with Customers, available at www.fasb.org.

[4] FASB ASC paragraphs 840-40-55-2 through 55-16.

Tell Me More

This section provides more information about some of the key differences between the new lease accounting standard and current U.S. GAAP.

A lessee will recognize a ROU asset and a lease liability on its balance sheet for most leases, which is a significant change from current U.S. GAAP.

Most Leases on-Balance Sheet for Lessees

Under the new standard, a lessee will recognize a (financial) lease liability and a (nonfinancial) ROU asset for all leases, including operating leases, with a term greater than 12 months on its balance sheet.[5] This effectively means that lessees will appear more asset-rich, but also more heavily leveraged. On-balance sheet recognition for most leases shifts the critical accounting determination from lease classification under current U.S. GAAP to whether a contract is, or contains, a lease under the new standard.

The current accounting model for lessees distinguishes between capital leases, which are recognized on-balance sheet, and operating leases, which are not. The lease classification distinction continues to exist in the new standard, but it now affects how lessees measure and present lease expense and cash flows – not whether the lease is on- or off-balance sheet.

Changes Introduced by Topic 842			
Lease Classification	**Balance Sheet**	**Income Statement**	**Statement of Cash Flows**
Finance Leases	✔ Similar to capital lease accounting under current U.S. GAAP		
Operating Leases	⚠ **Recognized on-balance sheet under Topic 842**	✔ Similar to operating lease accounting under current U.S. GAAP	

KPMG Observation

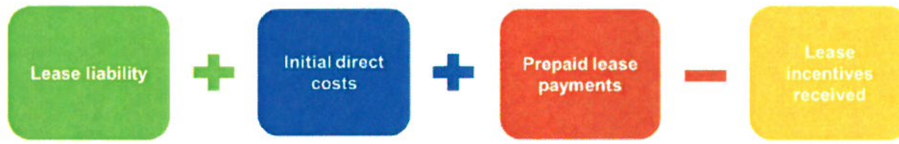
Recognizing ROU assets and lease liabilities for all leases other than short-term leases will enhance balance sheet transparency. Currently, many analysts adjust financial statements for off-balance sheet lease obligations. After the new requirements are applied, analysts will be able to see an entity's own assessment of its lease liabilities, calculated using a methodology that all entities reporting under U.S. GAAP must follow. However, because analysts do not all evaluate leases in the same way or for the same reasons, they may continue to make adjustments to lessee financial statements after the new standard becomes effective.

[5] Lessees may *elect*, by class of underlying asset, not to recognize short-term leases on the balance sheet and instead account for them in the same manner as current operating leases.

Measurement of the Lease Liability and the ROU Asset

Under the new standard, the lease liability at lease commencement and throughout the lease term (for both finance and operating leases) equals the present value (PV) of the unpaid *lease payments*, discounted at the *rate implicit in the lease* (if known) or the lessee's *incremental borrowing rate*. *Lease payments* exclude contingent payments other than in-substance fixed payments.

The ROU asset (for finance and operating leases) is initially measured as:



Subsequent measurement of the ROU asset (i.e., after lease commencement) depends on the classification of the lease. ROU assets, whether resulting from a finance lease or an operating lease, are subject to the long-lived asset impairment guidance.[6] After a ROU asset is impaired, it is measured in the manner depicted below for finance lease ROU assets, regardless of lease classification.

Finance Lease

The ROU asset is amortized generally on a straight-line basis over the lease term.

ROU assets that are impaired are measured in the same manner as finance lease ROU assets after the impairment, regardless of lease classification.

Operating Lease

The subsequent measurement of the ROU asset in an operating lease can be determined in either of two ways, which yield the same carrying amount.

- **Method 1 – Amortize the ROU Asset**

The amortization of the ROU asset each period equals the difference between the straight-line lease cost for the period (which is effectively the

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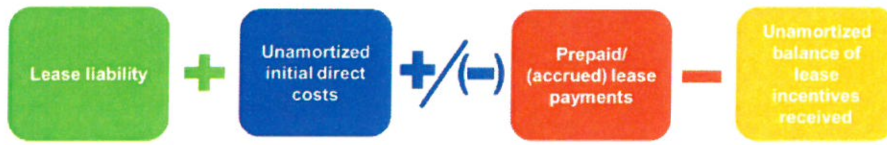
[6] FASB ASC Topic 360, Property, Plant, and Equipment, available at www.fasb.org.

cost recognized for operating leases under current U.S. GAAP) and the periodic accretion of the lease liability using the effective interest method.

- **Method 2 – Derive the ROU Asset from the Lease Liability**

  The carrying amount of the ROU asset is derived from the carrying amount of the lease liability at the end of each reporting period as illustrated below.



  Method 2 is what a lessee would use if it does not want to recognize ROU assets and lease liabilities for operating leases until it closes its books during the financial reporting process. Under this method, at each reporting date, the lessee creates a journal entry to (1) credit a lease liability for the present value of the remaining unpaid lease payments, (2) reverse other accrual-based operating lease accounting balances reflected in the balance sheet (i.e., prepaid or accrued rent, unamortized initial direct costs, and unamortized lease incentives), and (3) debit a ROU asset for the balancing amount.

Example – Subsequent Measurement of Operating ROU Asset

Assume a 5-year operating lease with annual payments (in arrears) of $100 that increase by $5 per year and a discount rate of 6%. Also assume that the lessee incurs $10 of initial direct costs. At lease commencement the lease liability equals $461 and the ROU asset equals $471 (the lease liability plus the initial direct costs). The lessee will recognize straight-line lease cost of $112 each year of the lease, which includes $2 in amortization of initial direct costs.

Method 1

Year 1 amortization of the ROU asset is $84, calculated as the Year 1 lease cost – Year 1 accretion of the lease liability ($112 – [$461 × 6%]). The end of Year 1 carrying amount of the ROU asset is therefore $387 ($471 – $84).

Year 2 amortization of the ROU asset is $89, calculated as the Year 2 lease cost – Year 2 accretion of the lease liability ($112 – [$389 × 6%]). The end of Year 2 carrying amount of the ROU asset is therefore $298 ($387 – $89).

Method 2

At the end of Year 1 the lessee has an accrued rent balance of $10 ($110 lease cost excluding amortization of initial direct costs – $100 lease payment) and unamortized initial direct costs of $8 ($10 – $2 in Year 1 amortization). The carrying amount of the lease liability at the end of Year 1 is $389 (present value of remaining unpaid lease payments discounted at 6%). Therefore, at the end of Year 1 the carrying amount of the ROU asset is $387 ($389 – $10 + $8).

Example – Subsequent Measurement of Operating ROU Asset
At the end of Year 2 the lessee has an accrued rent balance of $15 ($110 lease cost excluding amortization of initial direct costs – $105 lease payment + previous accrued rent balance of $10) and unamortized initial direct costs of $6 ($10 – $2 in Year 1 amortization – $2 in Year 2 amortization). The carrying amount of the lease liability at the end of Year 2 is $307 (present value of remaining unpaid lease payments discounted at 6%). Therefore, at the end of Year 2 the carrying amount of the ROU asset is $298 ($307 – $15 + $6).

KPMG Observations

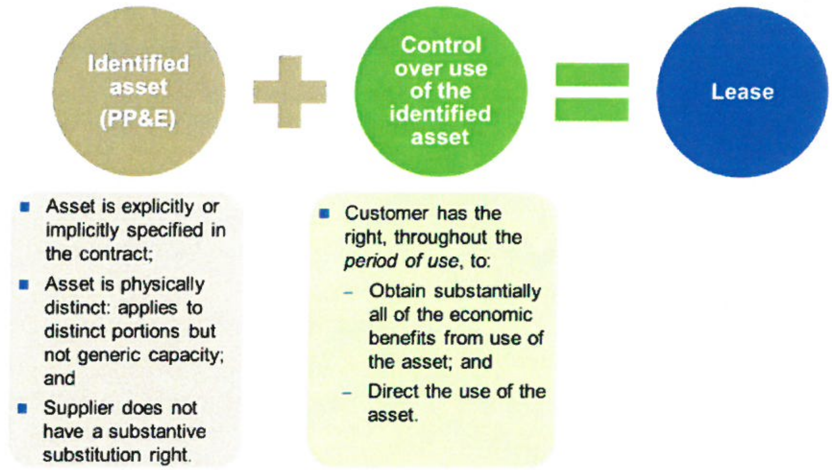
Method 2 is the only method described in the new standard. In the standard's Basis for Conclusions, the FASB indicated that this method will permit many entities to perform the new accounting for operating leases without significant changes to systems or processes. However, we believe Method 2 generally will not be practicable to apply for entities other than those with few leases that are relatively straightforward. Method 2 is inherently a manual process that likely will be unwieldy when applied to a large portfolio of leases, especially in the context of the more complex circumstances that will arise under the new standard (e.g., modifications, remeasurements, impairments, and issues related to foreign exchange).

We believe Method 1 will more readily enable a lessee to implement systems, processes, and internal controls where lease liabilities and ROU assets are tracked separately in a manner more consistent with other assets and liabilities. It is more likely to be effective for addressing the more complex circumstances outlined above that are likely to arise for many lessees.

Additional judgments will be required in determining whether a contract contains a lease. Correctly identifying leases will have a greater effect on financial reporting than under current U.S. GAAP because this is the new on- / off-balance sheet test.

Identifying a Lease

A lease exists under the new standard when a contract conveys to the customer the right to control the use of identified property, plant, or equipment for a period of time in exchange for consideration. The definition of a lease embodies two conditions that are familiar under current U.S. GAAP: (1) there is an identified asset in the contract that is land or a depreciable asset (i.e., property, plant, and equipment), and (2) the customer has the right to control the use of the identified asset.



While those two conditions appear similar to the requirements under current U.S. GAAP, important details have changed. Most notably, determining whether the customer has the right to control the use of an identified asset is now closely aligned with how control is defined and applied in the new revenue recognition standard. This is because there is now both a "benefits" element and a "power" element to the evaluation of control.

In most cases, a customer will have the right to direct the use of an identified asset if it can direct (and change) how and for what purpose the asset will be used throughout the period of use by controlling what, when, and/or how much output the asset produces. However, if the asset's use is predetermined before the beginning of the lease term (e.g., in the contract or by the asset's design), a customer is still deemed to direct the use of the asset if it (a) has operational control over the asset or (b) designed those aspects of the asset that predetermine how and for what purpose it will be used throughout the lease term.

KPMG Observations

In general, we believe that most arrangements that meet the definition of a lease under current U.S. GAAP will continue to meet the definition of a lease under the new standard. However, because of the new direct-the-use aspect of the definition, *some* contracts that were previously considered to be leases under current U.S. GAAP will not meet the new definition of a lease. This is most likely to be the case for arrangements that meet the current definition of a lease solely because the customer receives substantially all of the output or utility from the identified asset (e.g., some power purchase or outsourcing arrangements). Judgment will be required in applying the new definition, and companies will have to familiarize themselves with the changes from current U.S. GAAP, in particular the new guidance about directing the use of an identified asset.

Lease Accounting Requires Circumstance-Driven Reassessments by Lessees

Given the pervasive, and potentially material, effect that the lease reassessment guidance will have on a lessee's financial statements, lessees will need to implement new processes and controls to address the new risk points. This effort likely will need to involve cross-functional coordination to ensure timely identification of events requiring revisions to lease accounting.

The new standard requires a lessee to revise (or update) its lease accounting by remeasuring its lease liability in any of the following circumstances:

1. There is a change in the assessment of the lease term;
2. There is a change in the assessment of whether the lessee will exercise an option to purchase the underlying asset;
3. There is a change in the amount probable of being owed by the lessee to satisfy a residual value guarantee; or
4. A contingency is resolved that results in some or all of the variable lease payments that were to be paid over the remainder of the lease term becoming fixed. For example, if the payments for Years 2-10 of a retail store lease will be based on 10 percent of Year 1 retail store sales, at the end of Year 1, the lease payments for Years 2-10 become fixed payments.

A lessee reassesses the lease term (#1) or the likelihood that a purchase option will be exercised (#2) only when a significant event or a significant change in circumstances occurs that is within the lessee's control and directly affects whether the lessee is reasonably certain to exercise a renewal or a purchase option (i.e., a triggering event). The new standard identifies example triggering events, including a decision by the lessee to construct significant leasehold improvements that are expected to have substantial economic value at the end of the lease term or to enter into a sublease that effectively requires exercise of a renewal option.

The accounting steps a lessee must undertake depend on the circumstances.

	Circumstance			
Accounting Steps	**1**	**2**	**3**	**4**
Remeasure and reallocate the consideration in the contract to the remaining lease and non-lease components of the contract.	✔	✔	✔	✔
Remeasure the lease liability to reflect the revised lease payments, using a discount rate determined at the remeasurement date.[7]	✔	✔	✘	✘
Remeasure the lease liability to reflect the revised lease payments, using the original discount rate.[7]	✘	✘	✔	✔
Adjust the amount of the ROU asset by the amount of the remeasurement of the lease liability. However, once the ROU asset is reduced to zero, then the remaining amount of the lease liability remeasurement is recognized in the income statement.	✔	✔	✔	✔

[7] When the *lease payments* are remeasured, variable lease payments that depend on an index or a rate are remeasured using the index or rate as of the remeasurement date.

Accounting Steps	Circumstance			
	1	2	3	4
Reassess the lease classification at the remeasurement date based on the circumstances at that date (e.g., fair value and remaining economic life of the underlying asset at the remeasurement date).	✓	✓	✗	✗
If there is a change in lease classification, adjust the remaining lease cost recognition pattern and presentation in the income statement and statement of cash flows prospectively.	✓	✓	✗	✗

KPMG Observations

The reassessment and remeasurement guidance applicable to lessees is a significant change from current U.S. GAAP, which generally does not require revisions to lease accounting for lessees or lessors unless the terms and conditions of the contract are modified. Lessees will have to implement processes and controls to monitor for events or changes that require revisions to the accounting for a lease.

Some Executory Costs May Be Included in Lease Assets and Lease Liabilities

Payments to cover the lessor's costs of ownership, such as property taxes and insurance, are no longer excluded from lease accounting as they are under current U.S. GAAP.

The new standard only governs the accounting for leases. If there are lease and non-lease (e.g., service) components of a contract, lessors must apply the new standard to the lease component(s) and other GAAP to the non-lease component(s). Lessees have the option to either separately account for lease and non-lease components or account for any non-lease components as part of the lease component to which they relate. An entity separates lease and non-lease components of a contract and allocates the contract consideration to those components generally on a relative stand-alone price basis, which is broadly consistent with current U.S. GAAP. However, the guidance in the new standard may change how an entity identifies, separates, and allocates contract consideration to the components of a contract.

Specifically, the new standard states that lessee payments for lessor ownership costs of an underlying asset (e.g., property taxes or insurance) do not transfer a good or service to the lessee and, therefore, are not components of the contract. Therefore, none of the consideration in the contract is allocated to those items. Instead, payments for those items are allocated to the lease and non-lease components on the same basis as the remainder of the consideration in the contract (i.e., generally on a relative stand-alone price basis). If there are no non-lease components, fixed payments for those costs will be accounted for entirely as *lease payments*. This treatment represents a change from current U.S. GAAP, under which all executory costs are excluded from minimum lease payments.

Current U.S. GAAP	Topic 842
All executory costs excluded from minimum lease payments	Executory costs that do not represent payments for a good or service are allocated to the lease and non-lease components in the same manner as all other payments in the contract

KPMG Observations

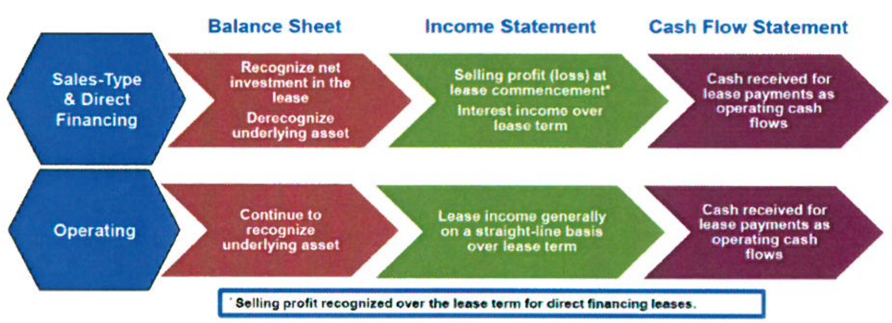
Lessees making fixed payments that cover the lessor's ownership costs for items like property taxes or insurance will recognize larger lease assets and lease liabilities than they would have if the new standard had retained the previous guidance that excluded all executory costs from lease payments. Maintenance services (e.g., common area maintenance) generally transfer a good or service to the lessee other than the right to use the underlying asset and are, therefore, a non-lease component of the contract. As a result, consideration is allocated to those services and that consideration generally is excluded from lease payments by lessees that elect to separately account for lease and non-lease components, and by lessors.

Because variable payments do not meet the new standard's definition of *lease payments*, lessees may account differently for economically similar leases based solely on how their payments are structured. All (or a portion of) payments that are structured as a direct pass-through of the lessor's actual costs are likely to meet the definition of variable lease payments, which a lessee will exclude from the measurement of its ROU asset and lease liability (and a lessor from its net investment in the lease), but be required to disclose. Conversely, all (or a portion of) fixed payments designed to cover lessor ownership costs will meet the definition of lease payments and be included in the measurement of the lessee's ROU asset and lease liability (and the lessor's net investment in the lease for sales-type and direct financing leases).

Although Topic 842 does not substantially change lessor accounting, there are some important changes lessors should take note of.

Changes to Lessor Accounting

The new standard does not substantially change lessor accounting from current U.S. GAAP as illustrated below.



In addition, most of the key definitions and concepts underlying the lessor accounting model are generally consistent with current U.S. GAAP (e.g., what is included in lease assets, the discount rate, and the lease classification test). However, there are some important changes that lessors should be aware of.

Collectibility

Under current U.S. GAAP, if collectibility of the *minimum lease payments* is not *reasonably predictable*, a lease is classified as an operating lease (i.e., it cannot be classified as a sales-type, direct financing, or leveraged lease). Topic 842 eliminates this reasonably predictable criterion and introduces new requirements with respect to collectibility.

- Uncertainty about the collectibility of the lease payments no longer will preclude a lease from being classified as a sales-type lease. However, if collectibility of the lease payments, plus any amount necessary to satisfy a residual value guarantee provided by the lessee, is not probable in a sales-type lease, the lessor will (a) continue to recognize the underlying asset and (b) recognize lease payments received as a deposit liability generally until the earliest date that:
  - Collectibility becomes probable;
  - The contract is terminated and the lease payments received are nonrefundable; or
  - The lessor has repossessed the underlying asset, has no further obligations to the lessee under the contract, and the lease payments received are nonrefundable.
- For leases that are not sales-type leases, if collectibility of the lease payments and any amount necessary to satisfy a residual value guarantee (provided by the lessee or a third party) is not probable, the lease must be classified as an operating lease. Cumulative lease income is then limited to the amount of the lease payments (including variable lease payments) that have been paid unless the assessment of collectibility changes during the lease term.

Significant Variable Lease Payments

Current U.S. GAAP contains conditions under which lessors often classify leases with predominantly variable payments as operating leases even if the lease meets one of the four primary criteria to be classified as a sales-type or direct financing lease (e.g., the lease term is more than 75 percent of the asset's estimated economic life).[8] Operating lease classification for these leases eliminates the potential for up-front loss recognition solely because the present value of the minimum (i.e., non-variable) lease payments and unguaranteed residual value is less than the asset's carrying amount at lease commencement. However, those conditions are eliminated by the new standard. As a result, these leases are likely to be classified as sales-type or direct financing leases under the new standard, creating the potential for loss recognition at lease commencement.

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[8] The primary classification criteria are in FASB ASC paragraph 840-10-25-1 and the other conditions are in ASC paragraph 840-10-25-42.

KPMG Observations

For leases with significant variable lease payments (e.g., in some renewable energy arrangements), the undiscounted sum of (a) the lease payments and (b) the estimated residual value of the underlying asset at the end of the lease term may be less than the underlying asset's fair value and/or carrying amount at lease commencement. If so, sales-type lease classification for these leases will require loss recognition at lease commencement when the discount rate used in measuring the lessor's net investment in the lease is positive even if the lessor expects the lease to ultimately be profitable. This does not seem to best reflect the economics of these leases.

The new standard requires the lessor to use the *rate implicit in the lease* as its discount rate to measure its net investment. That rate is defined in a way that generally requires the present value of (a) the lease payments and (b) the estimated residual value of the underlying asset at the end of the lease term to be no less than the underlying asset's fair value at lease commencement. For leases with significant variable lease payments, following that definition could mean that the lessor would be required to use a negative discount rate. It also could mean that no loss would be recognized at lease commencement unless the fair value of the underlying asset was less than its carrying amount.

It is not clear whether the FASB considered the possibility (or expected) that discount rates might be negative under the new standard's requirements. In addition, it is not clear to what extent the fact that the Board's new revenue recognition standard may require up-front loss recognition in arrangements with significant variable (or contingent) consideration even if the seller expects the arrangement to ultimately be profitable factored into its consideration of these leases. We expect the accounting for these transactions to generate further debate given the interplay between sales-type lease accounting and the new revenue recognition standard, and the current ambiguity around the Board's intent about lessor discount rates in these leases.

A Narrower Definition of Initial Direct Costs

The new definition of *initial direct costs* includes only those "incremental costs of a lease that would not have been incurred if the lease had not been obtained" (e.g., commissions or payments made to existing tenants to obtain the lease), which is a more narrow definition than in current U.S. GAAP. Accordingly, costs that an entity is permitted to capitalize as initial direct costs under current U.S. GAAP, such as external legal fees incurred to negotiate a lease or draft lease documents or allocations of internal employee costs for time spent directly related to negotiating or arranging a lease, will now be expensed when incurred.

KPMG Observations

While this issue is expected to affect lessors more than lessees, the narrowed definition of initial direct costs also may affect lessees that previously capitalized or deferred costs that do not meet the new, narrower definition. For some lessors the new definition may result in recognizing more expenses at the start of a lease and higher margins over the lease term.

Leveraged Lease Accounting Eliminated Prospectively

The new standard eliminates leveraged lease accounting for all leases that commence on or after the effective date of the new guidance. A lessor with a leveraged lease that commences before the effective date of the new standard will continue to apply leveraged lease accounting to that lease unless it is modified on or after the effective date. A lessee's exercise of an option to renew or extend a leveraged lease when exercise previously was not considered reasonably assured is considered a lease modification for this purpose.

Expanded Quantitative and Qualitative Disclosures

Increased disclosure requirements may necessitate additional systems capabilities, processes, and controls for lessees and lessors.

The new standard's disclosure objective is to provide financial statement users sufficient information to assess the amount, timing, and uncertainty of cash flows arising from leases. To achieve that objective, lessees and lessors will disclose qualitative and quantitative information about lease transactions. This generally will result in increased information being disclosed compared to current U.S. GAAP. Accordingly, entities will need to evaluate whether they have appropriate systems, processes, and internal controls to capture complete and accurate lease data necessary to prepare the financial statement notes.

<table>
<tr><th>Lessees</th><th>Lessors</th></tr>
<tr><td colspan="2">Example Qualitative Disclosures
• Information about leases
– Nature of variable payment arrangements
– Termination, renewal, and purchase options
• Significant accounting judgments and estimates</td></tr>
<tr><td>• Leases that have not yet commenced, but that create significant rights and obligations for the lessee, including involvement in construction or design of the underlying asset</td><td>• Information about how the lessor manages residual asset risk, including information about residual value guarantees and other means of limiting that risk</td></tr>
<tr><td colspan="2">Example Quantitative Disclosures</td></tr>
<tr><td>• Amortization of ROU assets and interest on lease liabilities (including amounts capitalized) for finance leases
• Operating lease cost
• Variable lease cost
• Short-term lease cost</td><td>• Table of lease income:
– Selling profit (or loss) recognized at lease commencement for sales-type leases and interest income for sales-type and direct financing leases
– Operating lease income
– Variable lease income</td></tr>
</table>

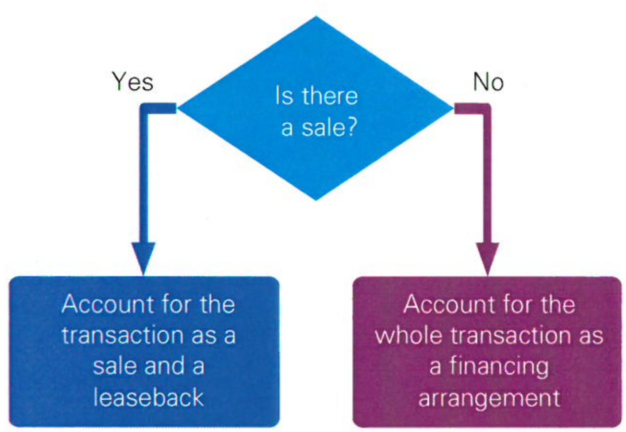
Lessees	Lessors
• Weighted-average remaining lease term, separately for finance and operating leases • Weighted-average discount rate as of the balance sheet date, separately for finance and operating leases • Maturity analysis of lease liabilities, reconciling undiscounted cash flows to the recognized lease liabilities, separately for finance leases and operating leases	• Maturity analysis of lease receivables, reconciling the undiscounted cash flows to the recognized lease receivables (for sales-type and direct financing leases), and of future lease payments (for operating leases) • For operating leases, general property, plant, and equipment disclosures by significant class of underlying asset separately from those disclosures for the lessor's other owned assets

Although Topic 842 eliminates sale-leaseback transactions as an off-balance-sheet financing proposition, sale-leaseback transactions still may attract interest because a seller-lessee generally will be able to recognize any gain on the sale in full at the sale date and the balance sheet effect of the leaseback may be less significant than that of the asset and related financing.

Sale-Leaseback Accounting Substantially Changed

Topic 842 essentially eliminates sale-leaseback accounting as an off-balance sheet financing proposition by requiring the seller-lessee to account for the leaseback in the same manner as other leases – i.e., on-balance sheet for most leases. However, some of the off-balance sheet benefits of sale-leaseback accounting are preserved as, in many cases, the amount of the ROU asset and the lease liability recognized may be substantially less than the previous carrying amounts of the underlying asset and any related financing.

If the transaction qualifies for sale accounting (i.e., the sale leg of the transaction meets the contract identification and transfer of control requirements for a sale in the new revenue recognition standard), a seller-lessee's balance sheet will reflect an asset that represents the seller-lessee's right to use the underlying asset and a liability to make the leaseback payments. However, if the sale-leaseback transaction does not qualify for sale accounting, the seller-lessee, *and* the buyer-lessor, will account for the whole arrangement as a financing transaction.



KPMG Observation

In a significant change from current U.S. GAAP, the buyer-lessor is required to evaluate whether a sale of the underlying asset has occurred based on the sale guidance in the new revenue recognition standard and, if a sale has not occurred, to account for the transaction as a financing arrangement. Under current U.S. GAAP, a failed sale for the seller-lessee is not accounted for as a failed purchase by the buyer-lessor. This may complicate the accounting by buyer-lessors, particularly for sale-leaseback transactions with significant variable payments that do not qualify for sale/purchase accounting.

Recognition of Gains on Sale No Longer Will Depend on the Rights Retained by the Seller-Lessee

Under current U.S. GAAP, the timing of gain recognition on the sale in a sale-leaseback transaction depends on the rights retained by the seller-lessee. In contrast, when a sale-leaseback transaction qualifies for sale accounting under the new standard, the seller-lessee is required to recognize the full amount of the gain (which will be adjusted for off-market terms, if any) when the buyer-lessor obtains control of the underlying asset. This is consistent with the guidance that will apply to the sale of any nonfinancial asset under either the new revenue recognition standard (if the sale is to a customer) or the other income accounting guidance (if the sale is to a non-customer).[9]

Different Sale-Leaseback Accounting Provisions for Real Estate and Assets Other Than Real Estate Eliminated

The new standard eliminates the different accounting for sale-leaseback transactions involving real estate versus other assets that exists in current U.S. GAAP. Under the new standard, the same guidance applies to all sale-leaseback transactions regardless of the type of underlying asset.

Sale-Leaseback Accounting Easier to Achieve for Real Estate Than under Current U.S. GAAP; More Difficult for Other Assets

The new standard stipulates that a sale is recognized in a sale-leaseback transaction when the transaction meets the contract identification and transfer of control requirements for the sale of goods in the new revenue recognition standard. It also includes additional guidance for recognizing a sale in a sale-leaseback transaction:

- The leaseback by itself does not preclude a sale-leaseback transaction from meeting the sale requirements in the new revenue recognition standard;
- A sale (purchase) is not recognized if the leaseback would be classified as a finance lease by the seller-lessee (sales-type lease by the buyer-lessor); and
- An option for the seller-lessee to repurchase the underlying asset results in a failed sale unless (a) the option strike price is the fair value of the asset at the option exercise date ***and*** (b) alternative assets that are substantially the same as the underlying asset are readily available in the marketplace.

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[9] FASB Topic 610, Other Income, available at www.fasb.org.

KPMG Observations

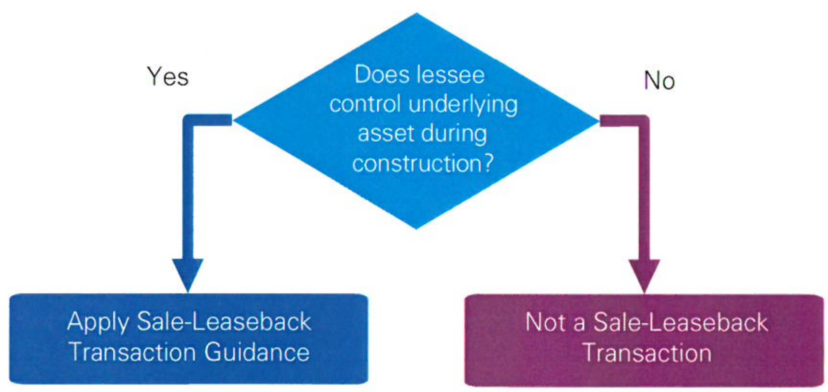
In the United States, equipment sale-leaseback transactions often include an option for the seller-lessee to repurchase the equipment. This does not result in a failed sale under current U.S. GAAP unless the option is a bargain repurchase option. Because most repurchase options will preclude a sale, the new standard will make it more difficult for many equipment sale-leaseback transactions to qualify for sale-leaseback accounting than under current U.S. GAAP.

Conversely, current U.S. GAAP requires failed sale accounting for real estate sale-leaseback transactions if the seller-lessee has any continuing involvement (including a repurchase option at any strike price) with the real estate other than a normal leaseback. As a result, failed sales are common in real estate sale-leaseback transactions. Because the new standard supersedes the continuing involvement provisions in current U.S. GAAP, and the sale requirements in the new revenue recognition standard are comparatively less difficult to meet, it generally will be easier for real estate sale-leaseback transactions to qualify for sale-leaseback accounting under the new standard than under current U.S. GAAP. However, a seller-lessee repurchase option generally will still preclude sale-leaseback accounting for a real estate sale-leaseback transaction, even if the strike price of the option is the fair value of the real estate on the exercise date. This is because two real estate assets typically will not be considered substantially the same.

Current Build-to-Suit Lease Accounting Guidance Replaced

Current U.S. GAAP addresses a lessee's involvement with the construction of an asset that the lessee will lease when construction is complete (i.e., build-to-suit lease accounting). Under that guidance, the transaction is subject to the sale-leaseback guidance if the lessee is deemed to be the accounting owner of the asset during the construction period because it has substantially all of the construction period risks (or meets other specified criteria).

The new standard supersedes the current build-to-suit lease accounting guidance and stipulates that a lessee is the accounting owner of an asset under construction when it *controls* that asset before the lease commencement date. The new standard includes implementation guidance to assist entities in determining whether the lessee controls an underlying asset that is under construction.



The new standard further specifies that payments made by a lessee for the right to use the underlying asset are not costs related to the construction or design of the underlying asset but are lease payments regardless of when the payments are made (e.g., before lease commencement) or how the payments are made (e.g., contribution of construction materials). When a lessee incurs costs related to the construction or design of an underlying asset for which it is not considered the accounting owner during the construction period, it will account for them as lease payments unless they relate to goods or services provided to the lessee (in which case it will account for them under other U.S. GAAP).[10]

KPMG Observations

The new guidance about when a lessee controls an asset under construction that it will lease is similar to the guidance in the new revenue recognition standard about when a customer controls an asset under construction (or that is being modified) that it will purchase.

We believe the new guidance will result in fewer instances where the lessee is deemed to be the accounting owner of an asset that is under construction, but those instances will still occur. However, importantly, when a lessee is deemed to be the accounting owner of an asset under construction, the changes to the sale-leaseback guidance in the new standard may make it easier for the lessee to derecognize the underlying asset at the end of the construction period.

Summary of Similarities and Differences between U.S. GAAP and IFRS

On January 13, 2016, the IASB issued IFRS 16, *Leases*, which requires lessees to recognize ROU assets and lease liabilities on-balance sheet for leases that are not short-term or of assets with a low value when new (e.g., $5,000 or less). IFRS 16 introduces a single, on-balance sheet lessee accounting model that is similar to the current accounting under IFRS for finance leases (and U.S. GAAP for capital leases). Lessor accounting will remain similar to current practice, (i.e., lessors will continue to classify leases as finance and operating leases).

IFRS 16 is effective for companies that apply IFRS for annual periods beginning on or after January 1, 2019. Earlier application is permitted for entities that apply IFRS 15, *Revenue from Contracts with Customers*, at or before the date of initial application of IFRS 16.

Although some key aspects of Topic 842 and IFRS 16 are converged (e.g., the definition of a lease and the recognition of most leases on-balance sheet), many are not, including the following:

- Lessee accounting model, including reassessment requirements for variable lease payments that depend on an index or rate;
- Lessor profit recognition for some leases;

[10] For example, FASB ASC Topic 330, Inventory, and Topic 360, Property, Plant and Equipment, available at www.fasb.org.

- Recognition and measurement exemption for leases of low-value assets under IFRS 16;
- Classification of subleases by the sublessor;
- Accounting for leases between related parties;
- Gain recognition on sale-leaseback transactions; and
- Transition requirements and alternatives.

Our summary table provides additional information about the similarities and differences between Topic 842 and IFRS 16.

Staying Informed

KPMG will host a CFO Financial Forum Webcast on March 7, 2016, to provide an overview of the new standard. This spring KPMG also will:

- Release an Issues In-Depth that provides a more comprehensive analysis of the new lease accounting standard.
- Host a series of CFO Financial Forum Webcasts to discuss specific aspects of the new standard in more detail.

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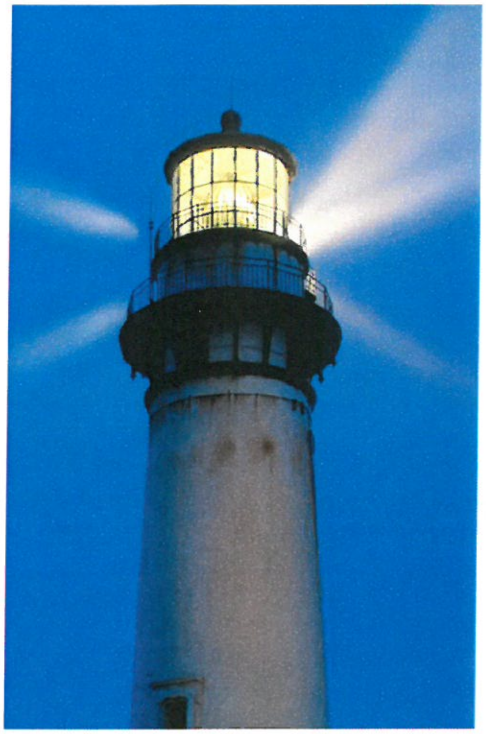

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FASB Completes Technical Redeliberations on Leases

The FASB met on October 7 to discuss comments received and related follow-up issues on the external review of its proposed leases standard. The Board will meet in early November to discuss effective date and cost-benefit considerations. The Board plans to issue a final leases standard by the end of 2015.

Key Facts

- Approximately 600 comments were received from external reviewers, though the FASB staff noted that many comments overlapped.
- The Board made decisions on three sweep issues to complete its technical decisions on the project.[1]
    - The lease modification guidance will be more closely aligned with the lease reassessment guidance.
    - Initial direct costs in sales-type leases will be deferred and recognized over the lease term if there is no selling profit (loss).
    - Lessors will present the net investment in sales-type and direct financing leases separate from other assets in the statement of financial position and will disclose the components of the net investment.
- The amount of expense recognized by lessees for operating leases will be measured like finance leases following an impairment of the lease.
- Private companies will not have additional reliefs other than the election to use a risk-free discount rate in measuring lease liabilities.

Key Impacts

- The standard setting on the leases project is almost over. Entities should begin planning their implementation efforts if they haven't done so already.
- Lease accounting for modifications that change the lease term will be consistent with the guidance on lease reassessments, which will reduce potential structuring opportunities.
- Lessor lease accounting will remain substantially consistent with current U.S. GAAP.[2]

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[1] A sweep issue is a topic the FASB staff identifies for consideration or reconsideration by the Board.

[2] ASC Topic 840, Leases, available at www.fasb.org.

The guidance developed by the FASB staff to address impairment of operating leases suggests the staff likely had significant discretion in deciding how to respond to external review comments.

Summary of External Review Comments

In July 2015, the FASB distributed the leases external review draft to a select group of stakeholders with a deadline for comments of mid-August, 2015. The FASB staff received approximately 600 comments on the external review draft. At the October 7 FASB meeting, the FASB staff indicated that many of the comments were duplicative. In their view only three required further discussion by the Board, which the staff identified as sweep issues (see below). The staff noted that where comments expressed disagreement with Board decisions the staff generally took no action. For other comments, the staff indicated that revisions to the language in the external review draft would be made to clarify the guidance where necessary.

Lessee Accounting after Impairment of an Operating Lease. One issue that the staff indicated did not require further decision-making by the Board—although the staff plans to amend the draft standard—related to the accounting by lessees after impairment of an operating lease.[3] The staff noted that the guidance in the external review draft would have required the expense for an operating lease after an impairment charge to be determined in a way that would not result in balanced accounting entries. Consequently, the staff determined that the expense for operating leases following an impairment charge should be determined in the same way as it would be for finance leases.[4] Specifically, after an impairment of an operating lease right-of-use asset, the remaining balance of the right-of-use asset would be amortized generally on a straight-line basis over the remaining lease term and added to the periodic accretion of the lease liability to determine total lease expense each period. This is the same methodology that would be used for finance leases that are not impaired and would result in an uneven pattern of total expense that is front-loaded following the date of an operating lease impairment.

KPMG Observations

The FASB staff decided that the pattern of lease expense for an operating lease following an impairment of the lease should be consistent with the pattern of expense for an operating lease for which an onerous contract liability is recognized in accordance with ASC Topic 420, *Exit or Disposal Cost Obligations*. That guidance results in a pattern of expense for an operating lease that is essentially the same as the pattern of expense for a capital lease under current U.S. GAAP. Although this decision appears different than the Board's previous decision that the pattern of expense for an operating lease should generally be straight-line, even following an impairment, it seems consistent with the Board's more recent decision to make minimal changes to the way in which periodic expense would be measured for operating leases under the new guidance.

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[3] Operating leases were referred to as Type B leases in the FASB's Proposed Accounting Standards Update (Revised), Leases, May 16, 2013 (the 2013 Exposure Draft), available at www.fasb.org.

[4] Finance leases were referred to as Type A leases in the 2013 Exposure Draft.

Sweep Issues Discussed

Lease Modifications That Extend the Lease Term

The Board discussed issues stemming from the proposed lease modification guidance that considered the right to use an underlying asset for an additional period of time as an additional right of use, separate from the original right to use the underlying asset. The Board also discussed peripheral issues related to the lessor lease modification guidance and lessee reassessment guidance.

Whether the Use of an Underlying Asset for an Additional Period of Time Is a Separate Right of Use. Under the proposed guidance, a lease modification granting a lessee the right to use the same underlying asset for an additional period of time would result in the lessee recognizing the additional lease liability and related right-of-use asset only when the additional period begins. That right of use would be considered separate from the original right of use whether or not the price for the additional period of use is commensurate with its stand-alone price. For example, assume a lessee originally entered into an agreement with a lessor to lease equipment for five years with no renewal options. At the end of Year 2, the lessee and lessor agree to modify the lease to extend its term for an additional five years from the original lease term expiration. Under the Board's previous decisions, the lease liability and related right-of-use asset for the extension period would not be recognized until the beginning of Year 6.

Conversely, the proposed guidance on lease reassessments would require lessees to revise the measurement of the right-of-use asset and lease liability when the lessee takes an action that changes the assessment of whether the exercise of a renewal option is reasonably certain to be exercised. Assume the example above was changed so that the lease included a five-year renewal option that was not included in the lease term for accounting purposes. If the lessee took an action at the end of Year 2 of the lease that made it reasonably certain that the lessee would exercise that renewal option, then the lessee's right-of-use asset and lease liability would be remeasured at the end of Year 2 to include the non-variable lease payments during the renewal period.

In addition, the Board previously decided that when a lease is modified and the additional right of use (in this case the right to use the underlying asset for an additional period of time) is commensurate with its stand-alone price, an entity would not reassess lease classification. Continuing with our original example, assume the equipment's remaining economic life is seven years at the modification date and rent during the 5-year extension period is commensurate with its stand-alone price. Because the additional period of use would be considered a separate lease, an entity would not reassess lease classification even though the lessee now benefits from the equipment's use for a major part of its remaining economic life. This indicates that the lease has become a finance lease rather than an operating lease.

To address these issues, the Board decided that the lease term is an *attribute* of the lease. Therefore, the Board concluded a lease modification that merely extends the term of the underlying asset's use would be recognized when the modification is executed.

Lessor's Lease Modification Guidance. As a result of considering the lease term an attribute of the lease, the Board discussed some of the potential asymmetries that may arise between the proposed lessor and lessee lease accounting guidance as well as the revenue guidance in ASC Topic 606.[5] However, the Board decided not to modify the lease accounting guidance for lessors, in part because it wants lessor accounting to remain substantially aligned with current U.S. GAAP.

Lessee Reassessment of Lease Classification. Under the proposed guidance, a lessee would reassess lease classification only if the lease is modified and the modification is not accounted for as a separate lease. A reassessment of the lease term would not cause a lessee to reassess lease classification. A reassessment could occur because the lessee elects to exercise a renewal option provided in the original lease or because the lessee constructs significant leasehold improvements that make it reasonably certain the lessee will exercise a renewal or purchase option.

The Board decided that when a lessee reassesses the lease term or a lessee option to purchase the underlying asset, it would be required to reassess lease classification. This requirement also would apply when the lease term or likelihood of purchase option exercise changes as a result of a lease modification. This issue was relevant only for lessees because lessors would not reassess the lease term or a lessee purchase option consistent with current U.S. GAAP.

KPMG Observations

The decisions by the Board to consider the lease term an attribute of the lease and to require a reassessment of lease classification in more situations than under the previously proposed guidance would remove the significant accounting differences between the lease modification and lease reassessment guidance that could have created structuring opportunities.

The Board's decision not to change the lessor lease modification guidance is consistent with feedback it received that the lessor accounting model under current U.S. GAAP essentially is not broken and should not be fundamentally changed. It is another example of the disconnect that will exist between lessee and lessor accounting under the new leases standard.

Recognition of Initial Direct Costs in Sales-Type Leases

At their May 2014 joint Board meeting, the FASB and IASB decided that initial direct costs should include only incremental costs that an entity would not have incurred if the lease had not been obtained (executed). This is a change from the current U.S. GAAP definition to conform to the contract cost deferral guidance in ASC Subtopic 340-40.[6] In addition, the FASB decided that a lessor would not capitalize initial direct costs for leases in which the customer effectively obtains

[5] ASC Topic 606, Revenue from Contracts with Customers, available at www.fasb.org.

[6] ASC Subtopic 340-40, Other Assets and Deferred Costs – Contracts with Customers, available at www.fasb.org.

control of the underlying asset through the lease (i.e., a sales-type lease).[7] Instead, a lessor would recognize as an expense initial direct costs associated with those leases at lease commencement.

Constituents that commented on the external review draft noted that the draft guidance on initial direct costs would change the timing of expense recognition for lessors such as banks that function as financing intermediaries. Under current U.S. GAAP those lessors classify leases in which the customer effectively obtains control of the underlying asset through the lease as direct financing leases or leveraged leases when the lease does not give rise to selling profit or loss. Under either classification, initial direct costs are deferred and amortized over the lease term. Some external reviewers questioned whether the external review draft guidance was consistent with the FASB's expressed intent not to significantly change lessor accounting.

At its October 7 meeting, the Board decided to require initial direct costs incurred as a result of entering into a sales-type lease to be deferred and recognized over the lease term *if there is no selling profit or selling loss* (excluding consideration of the initial direct costs) on the lease. This would result in recognition outcomes that are generally consistent with current U.S. GAAP.

KPMG Observations

The Board's revised decision on lessor accounting for initial direct costs is consistent with ASC Subtopic 340-40, which requires deferred contract costs to be recognized in the income statement on the same basis as the transfer to the customer of the goods or services to which the costs relate. This occurs because lessors that enter into sales-type leases in which there is no selling profit or loss in effect provide a financing service to the customer (lessee).

In addition, the Board's decision is consistent with its desire not to substantially change lessor accounting, and it would retain convergence in the accounting for initial direct costs with the forthcoming IFRS guidance on leases.

Lessor Presentation of Its Net Investment in the Lease

The FASB revisited its previous decision to permit lessors to separately present the components of the net investment in leases other than operating leases either in the statement of financial position or in the notes to the financial statements. Those components comprise the lease receivable, unguaranteed residual value, and deferred selling profit (if applicable). The FASB did not previously decide that lessors would be required to separately present the total net investment in leases other than operating leases in the statement of financial position. The Board's discussion was primarily in response to concerns expressed by external reviewers about complexities within the lessor

[7] The Board referred to these leases as sales-type leases, although they were referred to as Type A leases in the 2013 Exposure Draft.

presentation requirements and a potential lack of consistency with some of the Board's other lessor accounting decisions.

The Board decided to require lessors to separately present the net investment in leases other than operating leases on the face of the statement of financial position. The Board acknowledged that disaggregated information on the components of the net investment is beneficial for the financial statement users, and decided to require lessors to disclose the components of the net investment without specifying where that information should be provided in the financial statements. Consequently, lessors would have the flexibility to disclose the components of the net investment in the statement of financial position or the notes to the financial statements.

Private Company Council Considerations

At their July 2015 meeting, Private Company Council (PCC) members raised continuing concerns about the FASB's lease accounting proposals including:

- ***Recognition of Leases on the Balance Sheet and the Lessee Accounting Model.*** The PCC requested that nonpublic lessees be required to recognize lease assets and liabilities only when the lessee is expected to consume more than an insignificant portion of the underlying asset. For leases that do not qualify for on-balance sheet accounting, lessees would recognize lease expense generally on a straight-line basis, similar to the accounting for operating leases under current U.S. GAAP.
- ***Presentation of Lease Assets and Liabilities on the Balance Sheet.*** If the final leases standard will require lessees to recognize all leases (other than short-term leases) on the balance sheet, the PCC recommended that, for nonpublic lessees, the lease asset and liability be presented in a linked manner, or adjacent to each other, on the balance sheet. Therefore, only the net amount of the lease asset and liability would affect the lessee's assets or liabilities on the balance sheet.

At its October meeting, the FASB decided not to provide different recognition or presentation requirements for nonpublic companies. In the Board's view, all leases give rise to a lease asset and liability for lessees, and the new guidance should extend to both public and nonpublic companies. Additionally, the Board believes that allowing linked presentation is beyond the scope of the leases project, and would require significant time to sufficiently address.

Under the Board's previous decisions, a nonpublic company may elect to use a risk-free discount rate as the lessee's incremental borrowing rate. The Board decided that this is the only exception that will be provided solely for nonpublic companies in the final leases standard.

Next Steps

The Board will meet early in November to discuss effective date and cost-benefit considerations. Based on the outreach performed and feedback received by the FASB throughout this project, including financial statement users' expressed desire for better information in lessees' financial statements and the FASB's attempts to minimize process and system changes where possible, the Board expects to issue its final leases standard by the end of 2015.

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Summary of Decisions Reached in Redeliberations

<table>
<tr><th colspan="3">Redeliberations of 2013 Exposure Drafts</th></tr>
<tr><th>Topic</th><th>FASB Decisions</th><th>IASB Decisions</th></tr>
<tr><td>Definition of a Lease</td><td colspan="2">• A contract will contain a lease if:
– Fulfillment of the contract depends on the use of an identified asset, and
– The contract conveys the right to control the use of the identified asset for a period of time in exchange for consideration, or neither the customer nor the supplier controls the use of the identified asset throughout the period of use, and
• The customer has the right to operate the asset (and the supplier has no right to change those operating instructions) throughout the period of use, or
• The customer designed the asset, or caused it to be designed, in a way that predetermines during the period of use how and for what purpose it will be used</td></tr>
<tr><td rowspan="2">Practical Expedients and Targeted Reliefs</td><td colspan="2">• Optional lessee exemption for short-term leases – i.e., leases with a lease term of ≤ 12 months
• Portfolio-level accounting will be permitted if it does not differ materially from applying the requirements to individual leases (e.g., discount rate or lease term)</td></tr>
<tr><td>• No exemption for leases of low-value assets</td><td>• Optional lessee exemption for leases of low-value assets (e.g., leases of assets with a value of $5,000 or less when new), even if material in aggregate</td></tr>
<tr><td>Lessee Accounting Model</td><td>• Dual-lease accounting model
• Lease classification test based on classification criteria under current IFRS on leases[8]
• All leases on-balance sheet: lessee will recognize a right-of-use (ROU) asset and lease liability
– Finance leases will be treated as the purchase of an asset on a financed basis
– Operating leases generally will have straight-line recognition of total lease cost</td><td>• Single lease accounting model
• No lease classification test
• All leases on-balance sheet: lessee will recognize a right-of-use (ROU) asset and lease liability
– Treated as the purchase of an asset on a financed basis</td></tr>
</table>

[8] IAS 17, Leases.

<table>
<tr><th colspan="3">Redeliberations of 2013 Exposure Drafts</th></tr>
<tr><th>Topic</th><th>FASB Decisions</th><th>IASB Decisions</th></tr>
<tr><td rowspan="4">Lessor Accounting Model</td><td colspan="2">• Dual lease accounting model
• Lease classification test based on IAS 17 classification criteria
• Operating lease accounting model based on current IFRS operating lease accounting[9]</td></tr>
<tr><td>• Sales-type and direct financing lease accounting model based on current U.S. GAAP accounting for sales-type and direct financing leases with recognition of net investment in lease comprising lease receivable and residual asset[10]</td><td>• Finance lease accounting model based on current IFRS finance lease accounting with recognition of net investment in lease comprising lease receivable and residual asset</td></tr>
<tr><td>– Selling profit will not be recognized on commencement of leases that qualify as direct financing leases, even if the carrying amount and fair value of the underlying asset are different</td><td>– There will be no restriction on recognizing selling profit on commencement for finance leases</td></tr>
<tr><td>• Existing leveraged leases will be grandfathered and exempt from applying the new standard</td><td>• N/A – leveraged lease accounting does not exist under IFRS</td></tr>
<tr><td>Related-Party Leasing Transactions</td><td>• Account for leases between related parties based on their contractual terms, even if they differ from the substance of the arrangement
• Disclose lease transactions between related parties</td><td>• N/A – the IASB did not address related-party leasing transactions in its proposals</td></tr>
<tr><td>Lease Term and Purchase Options</td><td colspan="2">• Payments for optional (e.g., renewal) periods and purchase options will be included in lease accounting if it is reasonably certain that the lessee will exercise those options, consistent with the high threshold in current U.S. GAAP
• Lessees will reassess renewal and purchase options if there is a significant event or change in circumstances that is within the control of the lessee – e.g., construction of significant leasehold improvements
• No reassessment of renewal and purchase options by lessors</td></tr>
</table>

[9] Operating leases were referred to as Type B leases in the 2013 Exposure Draft.

[10] Sales-type and direct financing leases were referred to as Type A leases in the 2013 Exposure Draft.

<table>
<tr><th colspan="3">Redeliberations of 2013 Exposure Drafts</th></tr>
<tr><th>Topic</th><th>FASB Decisions</th><th>IASB Decisions</th></tr>
<tr><td>Initial Direct Costs</td><td colspan="2">• Initial direct costs will include only incremental costs that an entity would not have incurred if it had not obtained the lease (e.g., commissions or payments made to existing tenants to obtain the lease)
• Lessees will include initial direct costs in the initial measurement of the ROU asset and amortize the costs over the lease term
• Initial direct costs will be included in determining the lessor's implicit rate unless the lease is a sales-type lease for which there is a selling profit or loss recognized at lease commencement (in which case initial direct costs will be expensed)
• Lessors will include initial direct costs for:
– Sales-type leases in the initial measurement of the lease receivable unless there is a selling profit (loss) on the lease, in which case initial direct costs will be expensed at lease commencement, and
– Direct financing leases in the initial measurement of the lease receivable
• Lessors will capitalize initial direct costs for operating leases and amortize the costs over the lease term in the same pattern as lease income</td></tr>
<tr><td rowspan="3">Discount Rate</td><td colspan="2">• The lessee's discount rate will be the lessor's implicit rate if available, otherwise, the lessee's incremental borrowing rate
– The value used to determine the lessee's incremental borrowing rate will be the cost of the ROU asset
• Lessees will reassess the discount rate when there is:
– A change in the lease term or the assessment of whether the lessee is, or is not, reasonably certain to exercise a purchase option, and
– A lease modification</td></tr>
<tr><td>• Nonpublic business entity lessees will be permitted to elect as an accounting policy to use a risk-free discount rate</td><td>• N/A – no unique guidance for nonpublic business entities</td></tr>
<tr><td colspan="2">• The lessor's discount rate will be the rate implicit in the lease (i.e., the implicit rate)
– Initial direct costs will be included in determining the implicit rate unless the lease is a sales-type lease for which a selling profit or loss is recognized at lease commencement
• Lessors will reassess the discount rate when there is a lease modification</td></tr>
</table>

<table>
<tr><th colspan="3">Redeliberations of 2013 Exposure Drafts</th></tr>
<tr><th>Topic</th><th>FASB Decisions</th><th>IASB Decisions</th></tr>
<tr><td rowspan="2">Variable Lease Payments</td><td colspan="2">• Lease payments used in the initial measurement of lease assets and liabilities will include:
– Variable payments based on an index or rate using prevailing (spot) rates or indices at lease commencement, and
– Variable payments that represent in-substance fixed payments (consistent with current practice)
• No reassessment of variable lease payments by lessors
• Variable payments that are not based on an index or rate and are not in-substance fixed payments will be excluded from the measurement of lease assets and liabilities and recognized as expense as incurred or income as earned</td></tr>
<tr><td>• Lessees will reassess variable lease payments based on an index or rate only when lease payments are remeasured for other reasons (e.g., a reassessment due to a change in the lease term)</td><td>• Lessees will reassess variable lease payments based on an index or rate when:
– Lease payments are remeasured for other reasons (e.g., a reassessment due to a change in the lease term)
– There is a contractual change in the cash flows (i.e., when an adjustment to the lease payments based on an index or rate takes effect under the terms of the lease)</td></tr>
<tr><td>Arrangements with Lease and Non-lease Components; Contract Combinations</td><td colspan="2">• Activities (or costs of the lessor) that do not transfer a good or service to the lessee (e.g., taxes and insurance on the property) will be considered part of the lease (i.e., not separate components in a contract)
• Lessors will always separate lease and non-lease components and allocate consideration using the new revenue standard's guidance (i.e., on a relative stand-alone selling-price basis)
– Reallocate consideration when there is a contract modification that is not accounted for as a separate, additional lease
• Lessees will choose an accounting policy by class of underlying asset to either:
– Separate lease and non-lease components and allocate consideration based on relative stand-alone prices of components, maximizing the use of observable information
• Reallocate consideration when: (a) there is a reassessment of either the lease term or whether exercise of a lessee purchase option is reasonably certain, or (b) there is a contract modification that is not accounted for as a separate, additional lease</td></tr>
</table>

<table>
<tr><th colspan="3">Redeliberations of 2013 Exposure Drafts</th></tr>
<tr><th>Topic</th><th>FASB Decisions</th><th>IASB Decisions</th></tr>
<tr><td></td><td colspan="2">– Account for lease and non-lease components together as a single lease component
• Two or more contracts entered into at or near the same time will be combined into a single transaction if:
– The contracts are negotiated as a package with a single commercial objective, or
– The amount of consideration to be paid in one contract depends on the price or performance of the other contract</td></tr>
<tr><td>Lease Modifications</td><td colspan="2">• Lease modifications will be defined as any change to the contractual terms and conditions of a lease that was not part of the original terms and conditions
• A modification will be considered a separate lease when it grants the lessee an additional ROU that was not included in the original lease and that ROU is priced commensurate with its stand-alone price in the context of that particular contract
• For lessees, when a modification is not considered a separate, additional lease:
– If the modification does not reduce the lessee's ROU (e.g., right to use the leased asset for an additional time period), the ROU asset will be adjusted by the amount of the adjustment to the lease liability
– If the modification reduces the lessee's ROU, the modification will be treated as a full or partial early termination of the lease with a resulting income statement effect
• For lessors, when a modification is not considered a separate, additional lease:
– Operating lease modifications will be treated as a new lease, and
• If the modified lease is a sales-type or direct financing lease, the lessor will adjust the discount rate so that the initial net investment in the modified lease is measured in accordance with the new standard, net of any prepaid or accrued rent
• If the modified lease is an operating lease, the lessor will consider prepaid or accrued rent as part of the lease payments for the new lease
– Finance lease modifications
• If the modified lease is a sales-type or direct financing lease, the lessor will adjust the discount rate so that the initial net investment in the modified lease equals the carrying amount of the net investment in the original lease[11]</td></tr>
</table>

[11] The new leases standard will include specific guidance for how to account for a lease modification if the original lease is a direct financing lease and the modified lease is a sales-type lease.

<table>
<tr><th colspan="3">Redeliberations of 2013 Exposure Drafts</th></tr>
<tr><th>Topic</th><th>FASB Decisions</th><th>IASB Decisions</th></tr>
<tr><td></td><td colspan="2">If the modified lease is an operating lease, the lessor will recognize the underlying asset at the carrying amount of the net investment in the original lease</td></tr>
<tr><td rowspan="2">Subleases</td><td colspan="2">A lessee-sublessor will account for the head lease and the sublease as two separate contracts unless those contracts meet the contract combinations guidance
The head lease will be accounted for in accordance with the requirements for lessee accounting
The sublease will be accounted for in accordance with the requirements for lessor accounting
A lessee-sublessor will not offset lease liabilities and assets arising from a head lease and sublease unless they meet the financial instruments requirements for offsetting in U.S. GAAP or IFRS as applicable
A lessee-sublessor will not offset lease income from a sublease and lease cost from a head lease unless it meets the requirements for offsetting in other U.S. GAAP or IFRS (e.g., the new revenue standard)[12]</td></tr>
<tr><td>A sublessor will consider the underlying asset rather than the ROU asset to be the leased asset in determining the classification of the sublease</td><td>A sublessor will consider the ROU asset to be the leased asset in determining the classification of the sublease</td></tr>
</table>

[12] Members of both Boards believe it is unlikely that sublease income and head lease cost will qualify to be offset if the sublease is classified as an operating lease.

<table>
<tr><th colspan="3">Redeliberations of 2013 Exposure Drafts</th></tr>
<tr><th>Topic</th><th>FASB Decisions</th><th>IASB Decisions</th></tr>
<tr><td rowspan="5">Sale-Leaseback Transactions</td><td colspan="2">Determining Whether a Sale Has Occurred
• A sale-leaseback of the underlying asset will be recognized if the requirements for sale recognition in the new revenue standard are met. The existence of the leaseback will not, on its own, result in a conclusion that control of the asset has not been conveyed to the buyer-lessor.</td></tr>
<tr><td>• If the leaseback would be classified as a sales-type lease, then sale recognition will be precluded
• A repurchase option held by the seller-lessee in a sale-leaseback transaction will preclude sale recognition unless:
– The strike price to repurchase the asset is its fair market value at the date of option exercise, and
– The underlying asset is readily available and non-specialized</td><td>• N/A – single model approach for lessee accounting
• If the seller-lessee has a substantive repurchase option with respect to the underlying asset, sale recognition will be precluded</td></tr>
<tr><td colspan="2">• Both the seller-lessee and the buyer-lessor will account for a sale-leaseback transaction that does not qualify for sale accounting as a financing transaction</td></tr>
<tr><td colspan="2">Accounting for a Sale/Purchase
• A buyer-lessor will account for the purchase of an asset in a sale-leaseback transaction that qualifies for sale accounting consistent with the guidance that applies to the purchase of a nonfinancial asset
• A seller-lessee will account for any loss on a sale-leaseback transaction that qualifies for sale accounting consistent with the guidance that applies to any other sale</td></tr>
<tr><td>• Any gain recognized by a seller-lessee on a sale-leaseback transaction that qualifies for sale accounting will be measured consistent with the guidance that applies to any other sale, subject to any adjustment for off-market terms</td><td>• Any gain recognized by a seller-lessee on a sale-leaseback transaction that qualifies for sale accounting will be restricted to the amount that relates to the buyer-lessor's residual interest in the underlying asset, subject to any adjustment for off-market terms</td></tr>
</table>

Redeliberations of 2013 Exposure Drafts		
Topic	**FASB Decisions**	**IASB Decisions**
	Accounting for the Leaseback • If a sale-leaseback transaction qualifies for sale accounting, the leaseback will be accounted for in the same manner as any other lease	
	Accounting for Off-market Terms • Any potential off-market adjustment will be measured as the more readily determinable of: – The difference between the fair value of the underlying asset and the sales price, or – The difference between the present value of fair market value lease payments and the present value of the contractual lease payments • A *deficiency* in the transaction terms versus market terms will be accounted for as a prepayment of rent • An *excess* in the transaction terms versus market terms will be accounted for as additional financing provided by the buyer-lessor to the seller-lessee	
Lessee Presentation – Balance Sheet	• Lessees will present finance lease ROU assets and lease liabilities either as separate line items on the balance sheet or disclose them separately in the notes to the financial statements – If not separately presented on the balance sheet, lessees will: • Present finance lease ROU assets on the balance sheet as if the underlying asset were owned • Disclose in the notes the line items on the balance sheet in which finance lease ROU assets and lease liabilities are included and their amounts	
	• Lessees will not include operating ROU assets and lease liabilities in the same line items as finance ROU assets and lease liabilities on the balance sheet – If not separately presented on the balance sheet, lessees will disclose in the notes the line items on the balance sheet in which operating ROU assets and lease liabilities are included and their amounts	• N/A – no operating lease classification

Redeliberations of 2013 Exposure Drafts		
Topic	**FASB Decisions**	**IASB Decisions**
Lessee Presentation – Statement of Cash Flows	• Lessees will classify cash paid for: – Principal on finance lease liabilities as financing activities – Interest on finance lease liabilities in accordance with the requirements relating to interest paid under U.S. GAAP guidance on cash flows[13] – Operating leases, variable lease payments, and leases that are not recognized on-balance sheet (e.g., some short-term leases) as operating activities	• Lessees will present cash paid for: – Principal on lease liabilities as financing activities – Interest on lease liabilities as either operating or financing activities based on the lessee's accounting policy choice under IFRS guidance on cash flows[14] – Variable lease payments and leases that are not recognized on-balance sheet (e.g., some short-term leases) as operating activities • Lessees will disclose total lease payments in the notes to the financial statements
Lessee Disclosures	• *Objective*: Enable financial statement users to understand the amount, timing, and uncertainty of cash flows arising from leases	
	• Lessees will disclose the following *qualitative* information: – Nature of leases (and subleases) – Leases that have not yet commenced, but that create significant rights/obligations – Significant lease accounting judgments and assumptions – Main terms and conditions of sale-leaseback transactions – Whether an accounting policy election was made for the short-term lease exemption	• Lessees will disclose other information, in addition to the quantitative disclosures, in sufficient detail to satisfy the lessee disclosure objective

[13] FASB ASC Topic 230, Statement of Cash Flows, available at www.fasb.org.

[14] IAS 7, Statement of Cash Flows.

<table>
<tr><th colspan="3">Redeliberations of 2013 Exposure Drafts</th></tr>
<tr><th>Topic</th><th>FASB Decisions</th><th>IASB Decisions</th></tr>
<tr><td rowspan="6"></td><td colspan="2">• Lessees will disclose the following quantitative information:</td></tr>
<tr><td>In any format the lessee considers appropriate</td><td>In a tabular format, unless another format is more appropriate</td></tr>
<tr><td colspan="2">– Amortization of ROU assets and interest on lease liabilities (including capitalized interest)</td></tr>
<tr><td>• For finance leases only
– N/A</td><td>• Amortization split by class of underlying asset
– Additions to ROU assets
– Carrying amount of ROU assets, split by class of underlying asset</td></tr>
<tr><td colspan="2">– Short-term lease cost (when lease term > 30 days)
– Variable lease cost
– Sublease income
– Gains (losses) on sale-leaseback transactions</td></tr>
<tr><td>– Operating lease cost
– N/A
– Cash paid for lease payments, separately for finance and operating leases and segregated between operating and financing cash flows
– Supplemental noncash information on lease liabilities exchanged for ROU assets, separately for finance and operating leases
– Weighted-average remaining lease term, separately for finance and operating leases
– Weighted-average discount rate as of the balance sheet date, separately for finance and operating leases</td><td>– N/A
– Expense relating to leases of low-value assets
– Total cash outflow for leases
– N/A</td></tr>
</table>

<table>
<tr><th colspan="3">Redeliberations of 2013 Exposure Drafts</th></tr>
<tr><th>Topic</th><th>FASB Decisions</th><th>IASB Decisions</th></tr>
<tr><td></td><td>– A maturity analysis of lease liabilities for each of the first five years after the balance sheet date and in total thereafter, including a reconciliation of undiscounted cash flows to lease liabilities on the balance sheet</td><td>– A maturity analysis of lease liabilities in accordance with IFRS guidance on financial instruments, separate from the maturity analysis for other financial liabilities[15]</td></tr>
<tr><td>Lessor Presentation</td><td colspan="2">• Lessors will present lease assets and liabilities and income and expense generally consistent with the current IFRS guidance on leases
• Lessors will classify all cash inflows from leases as operating activities in the statement of cash flows</td></tr>
<tr><td>Lessor Disclosures</td><td colspan="2">General
• A lessor will disclose the following information about its leases:
– A general description of its leases
– The basis, and terms and conditions, on which variable lease payments are determined
– The existence, and terms and conditions, of options to extend or terminate the lease
– The existence, and terms and conditions, of options for a lessee to purchase the underlying asset
– Information about the significant assumptions and judgments made in accounting for its leases, which may include:
• The determination of whether a contract contains a lease
• The allocation of the consideration in contracts that contain a lease between lease and non-lease components
• The initial measurement of the residual asset
• Information about managing the risk associated with the residual asset
– A table of lease income received during the reporting period
– A maturity analysis of (a) the undiscounted cash flows comprising a lessor's lease receivables (for sales-type and direct financing leases), and (b) the undiscounted future lease payments (for operating leases) for each of the first five years and a total thereafter</td></tr>
</table>

[15] IFRS 7, Financial Instruments: Disclosures.

Redeliberations of 2013 Exposure Drafts		
Topic	**FASB Decisions**	**IASB Decisions**
	• For sales-type and direct financing leases, the amounts included in the maturity analysis will be reconciled to the balance of lease receivables presented separately in the balance sheet or disclosed separately in the notes. A lessor will present the operating lease maturity analysis separately from the maturity analysis required for sales-type and direct financing leases.	
	Operating Leases • General property, plant, and equipment disclosures for assets subject to operating leases by significant class of underlying asset separately from those disclosures for the lessor's other owned assets	
	Direct Financing Leases	*Finance Leases*
	• An explanation of the significant changes in the balance of unguaranteed residual assets and deferred selling profit	• A qualitative and quantitative explanation of the significant changes in the net investment in finance leases during the reporting period
Lessee Transition	• Modified retrospective transition: – Required for all leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements – Will not require transition accounting for leases that expired prior to the date of initial application	• Full retrospective approach or modified retrospective approach: – Under the modified retrospective approach, a lessee will not restate comparative information – At initial application date, recognize the cumulative effect of application as an adjustment to the opening balance of retained earnings (or other equity component as appropriate)
	• Lessees may elect certain specified reliefs, which must be elected as a package and applied to all leases.	• N/A
	• Lessees may use hindsight in evaluating whether payments for lease renewals and purchase options should be included in lease payments when accounting for existing leases. This practical expedient may be elected separately or in conjunction with	• N/A

Redeliberations of 2013 Exposure Drafts		
Topic	**FASB Decisions**	**IASB Decisions**
	the package of specified reliefs, and must be applied to all leases	
Lessor Transition	• Modified retrospective transition – Required for all leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements – Will not require any transition accounting for leases that expired prior to the date of initial application	• Continue to apply existing accounting for any leases that are ongoing at the date of initial application, except for intermediate lessors in a sublease • Intermediate lessors in subleases reassess each ongoing operating sublease at the date of initial application to determine whether under the new standard it is classified as an operating lease or a finance lease, based on the remaining contractual terms of the head lease and the sublease • For subleases that were classified as operating leases under current IFRS guidance on leases, but finance leases under the new standard, account for the sublease as a new finance lease entered into on the date of initial application
	• Lessors may elect certain specified reliefs, which must be elected as a package and applied to all leases	• N/A
	• Lessors may use hindsight in evaluating whether payments for lease renewals and purchase options should be included in lease payments when accounting for existing leases. This practical expedient may be elected separately or in conjunction with the package of specified reliefs, and must be applied to all leases	• N/A

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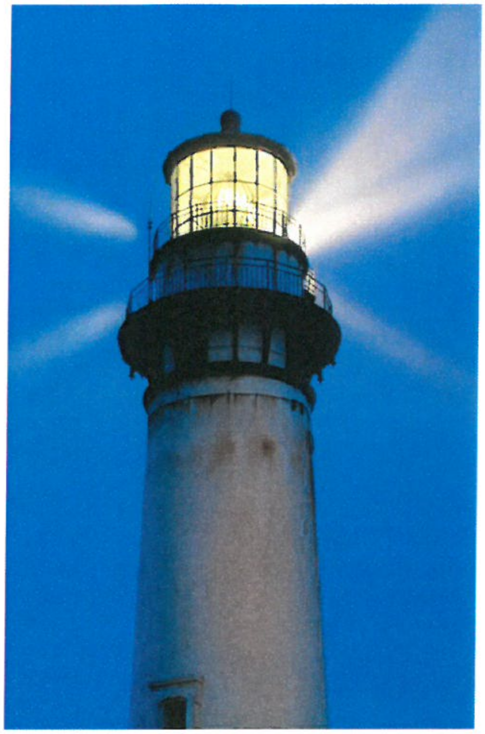
Defining Issues®

July 2015, No. 15-30



Contents

FASB Finalizes One-Year Deferral of the Revenue Standard

At its July 9, 2015 meeting, the FASB agreed to defer by one year the mandatory effective date of its revenue recognition standard, but will also provide entities the option to adopt it as of the original effective date.[1]

Key Facts

The FASB agreed to the following mandatory effective dates for its revenue standard:

- Public business entities and certain not-for-profit entities[2] will be required to adopt the revenue recognition standard in annual reporting periods beginning after December 15, 2017, and interim periods within those annual periods.
- All other entities will be required to adopt the standard in annual reporting periods beginning after December 15, 2018, and interim reporting periods within annual reporting periods beginning after December 15, 2019.
- Early application will be permitted for all entities, but not before the original effective date for public business entities (i.e., annual reporting periods beginning after December 15, 2016).
- The option to use either a retrospective or cumulative-effect transition method will not change.

Key Impacts

Entities that elect to wait for the new effective date to adopt the standard will have an extra year to more effectively implement changes to their accounting systems, processes, and internal controls.

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[1] FASB Accounting Standards Update No. 2014-09, Revenue from Contracts with Customers, available at www.fasb.org.

[2] This includes not-for-profit entities that have issued, or are conduit bond obligors for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market.

Background

In response to the FASB's exposure draft[3] and other outreach activities, many stakeholders indicated that additional time is needed to develop accounting policies, update information technology systems, and change processes and internal controls.[4] More time also is required to consider the effect on taxes, contracts, and debt covenants, and to train employees.

In addition to the systems and policy concerns, the FASB was influenced by its ongoing consideration of potential amendments to make the standard more operational and limit the potential for diversity to develop in practice.[5] In the February and March 2015 joint FASB/IASB meetings, the FASB agreed to propose several amendments to its standard.

The IASB issued an exposure draft on May 19, 2015 that also proposes a one-year deferral of its revenue recognition standard.[6] The comment period on that proposal ended on July 3, 2015. Based on comment letters received, the IASB's constituents generally support a one-year deferral. The IASB's final decision on whether to defer its standard is expected at its scheduled meeting during the week of July 20.

Deferral Decision

The FASB agreed to defer by one year the mandatory effective date of the standard despite requests by some constituents for a longer deferral. The Board concluded that a one-year deferral is sufficient, in part because it expects standard-setting to be substantially complete by the end of 2015. Also, the Board indicated that deferring for more than one year could delay the implementation process and decrease comparability from a convergence standpoint. A deferral period of more than one year also would result in a longer period of non-comparability among U.S. GAAP preparers between early adopters and those adopting at the mandatory date.

The following chart summarizes the effective date for public business entities and certain not-for-profit entities with calendar year-ends versus the effective date for other entities with calendar year-ends:

Year-end	Mandatory Adoption Date	Early Adoption Date
Public business entities and certain not-for-profit entities		
December 31	January 1, 2018 (including the quarter ending March 31, 2018)	January 1, 2017 (including the quarter ending March 31, 2017)

[3] FASB Proposed Accounting Standards Update, Revenue from Contracts with Customers: Deferral of the Effective Date, April 29, 2015, available at www.fasb.org.

[4] See KPMG's Defining Issues Nos. 15-12 and 15-25, available at www.kpmginstitutes.com.

[5] See KPMG's Defining Issues Nos. 15-5 and 15-11, available at www.kpmginstitutes.com.

[6] IFRS 15, Revenue from Contracts with Customers.

Year-end	Mandatory Adoption Date	Early Adoption Date
Nonpublic entities		
December 31	January 1, 2019 (with mandatory application for interim reporting for the first interim period ending after January 1, 2020 and the option to apply it to the first interim period ending after January 1, 2019)	January 1, 2017 (with the option to apply it in the first interim period ending after January 1, 2017 or the first interim period ending after January 1, 2018), or January 1, 2018 (with the option to apply it in the first interim period ending after January 1, 2018 or the first interim period ending after January 1, 2019)

Next Steps

SEC registrants with calendar year-ends that plan to adopt the standard on January 1, 2018 using the retrospective transition method will present 2016–2018 information under the new revenue recognition standard. Until the period of adoption, SEC registrants will need to update their disclosures regarding plans for adopting the standard including when they plan to adopt and how they plan to transition as their plans become more concrete.[7] Entities should use the additional time to ensure their information technology systems are appropriately capturing the information needed for reporting and disclosure purposes.

Many entities will need to make modifications to their accounting policies, information technology systems, business processes, and internal controls before the effective date. They should use the additional time provided by the deferral to continue their implementation efforts.

Entities should monitor future developments as the Boards continue to explore clarifying amendments for certain aspects of the standard. Entities also will need to consider issues identified in future meetings of the Transition Resource Group for Revenue Recognition.

Contributing authors: Brian K. Allen, Prabhakar Kalavacherla, Paul H. Munter, Brian J. Schilb, and Maricela Frausto

Earlier editions are available at: http://www.kpmg-institutes.com

[7] SEC Staff Accounting Bulletin Topic 11.M, Disclosure of the Impact That Recently Issued Accounting Standards Will Have on the Financial Statements of the Registrant When Adopted in a Future Period, available at www.sec.gov.

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Defining Issues®

November 2015, No. 15-56

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FASB Proposes to Clarify the Definition of a Business

Responding to stakeholder feedback, the FASB is proposing a new framework to determine whether a set of assets and activities is a business, which would narrow the current definition.[1]

Key Facts

Under the proposed Accounting Standards Update (ASU), an integrated set of activities and assets (a set) is a business if it has, at a minimum, an input and a substantive process that together contribute to the ability to create outputs. The proposal includes an initial screening test (A) that reduces the population of potential businesses before an entity analyzes whether there is an input and a substantive process in the set (B). The following is an overview.

A **Is substantially all of the fair value of the gross assets acquired concentrated in a single (group of similar) identifiable asset(s)?**

If yes, the set is not a business. If no...

B **Evaluate whether an input and a substantive process exist... Does the set have outputs?**

If yes...	**If no...**
The set is a business if it includes: • Organized workforce with skills, knowledge, or experience critical to continue producing outputs; • Process that cannot be replaced without significant cost, effort, or delay; **or** • Process that is considered unique or scarce.	The set is a business if it includes: • Organized workforce with skills, knowledge, or experience to perform an acquired process (group of processes) that, when applied to other acquired input(s), is critical to the ability to develop or convert the acquired input(s) into outputs.

Key Impact

Industries that are likely to be most affected are real estate, life sciences, and extractive, with fewer transactions being identified as acquiring or selling a business.

[1] Proposed Accounting Standards Update, Clarifying the Definition of a Business, November 23, 2015, available at www.fasb.org.

Why Does the Definition of a Business Matter?

Some of the differences in accounting for the acquisition of a business versus a group of assets may be significant. Examples of these differences follow.

Scope Broader Than Acquisitions

Consideration of the proposal is likely to focus on the acquisition of a business.

However, the definition of a business affects many areas of accounting and financial reporting, including acquisitions and disposals, and the applicability of the variable interest entity consolidation requirements.

Asset	Business
Initial Measurement	
Purchase price allocated on a relative fair value basis. No goodwill or bargain purchase gain (see below) is recognized.	Identifiable assets and liabilities generally measured at fair value. Goodwill or bargain purchase gain may be recognized.
Direct Acquisition-Related Costs	
Capitalized and included in purchase price.	Generally expensed as incurred.
Bargain Purchase Amount	
Allocated to identifiable nonfinancial assets and liabilities on a relative fair value basis.	Recognized immediately in earnings as a gain.
Contingent Consideration	
Not recognized until contingency is resolved.	Recognized at the acquisition date fair value. Subsequent changes to the fair value of liability-classified contingent consideration are recognized in earnings.
In-Process R&D	
Purchase price allocated to in-process R&D and then expensed unless it has an alternative future use.	Capitalized at fair value and accounted for as an indefinite-lived intangible asset until completion or abandonment of the project.

Examples That Illustrate the Proposal

Some Assets Could Be Grouped in Applying the Screening Test

In applying the screening test (A), a single identifiable asset generally would include any identifiable asset or group of assets that could be recognized and measured as a single identifiable asset in a business combination (e.g., complementary intangible assets that have similar useful lives).

Examples of assets that generally would not be combined include tangible and intangible assets; identifiable intangible assets in different major intangible asset classes; financial and nonfinancial assets; different major classes of financial assets; and different major classes of tangible nonfinancial assets.

Example 1: Real Estate[2]

Facts

- REIT purchases all of the outstanding shares of Building Co. from Seller.
- Building Co. holds a multi-tenant corporate office park with six 10-story office buildings leased to maximum occupancy. Seller manages its properties centrally and manages the operations of Building Co. with its own employees.
- REIT acquires the land, buildings, and in-place leases (at market), and assumes vendor contracts for outsourced cleaning and security. Seller's employees that perform leasing (e.g., sales and underwriting), tenant management, financing, and other strategic management processes are not acquired.
- REIT plans to replace the property management and employees with its own internal resources.

Analysis

A REIT first considers whether substantially all of the fair value of the gross assets acquired is concentrated in a single (or group of similar) identifiable asset(s). Although the in-place leases are at market value, REIT concludes that their fair value is significant and that the fair value of the gross assets acquired is not concentrated in either the leases or the tangible assets.

B The set has continuing revenues through the in-place leases, and therefore, has outputs. REIT concludes that the processes performed through the cleaning and security contracts (the only processes acquired) are considered ancillary or minor in the context of all of the processes required to create outputs in the real estate industry (i.e., leasing, tenant management, financing, and management of building operations). REIT also concludes that the cleaning and security processes could easily be replaced with little cost, effort, or delay, and are not considered unique or scarce.

Conclusion

The acquired set does not include both an input and a substantive process and, therefore, would not be considered a business.

KPMG Observations

Fewer real estate transactions would qualify as business acquisitions (as illustrated in Example 1) under the proposal than qualify today, but it may be difficult to determine whether assets are combined or considered similar in applying the screening test (A). There is limited guidance in the proposal beyond the examples, and judgment would be required.

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[2] Based on Case H in the Proposed ASU.

Outputs Do Not Automatically Mean That There Is a Business

In Example 2, no revenue (outputs) is currently being generated.

However, if the acquired set does have outputs, a continuation of revenues generated from an acquired set would not, on its own, indicate that a substantive process has been acquired (see Example 1). Therefore, assumed contractual arrangements that provide for the continuation of revenues (e.g., customer contracts, customer lists, and leases when the set is the lessor), would be excluded from determining whether there is a substantive process.

In addition, the definition of outputs would be amended to align better with the new revenue standard, focusing on providing "goods or services to customers, other revenues, or investment income, such as dividends or interest…"[4]

Example 2: Life Sciences[3]

Facts

- Pharma Co. buys all of the outstanding shares of Target Biotech.
- Target Biotech's operations include R&D activities on several preclinical compounds that it is developing (in-process R&D projects).
- Pharma Co. acquires the scientists who have the necessary skills, knowledge, or experience to perform R&D activities.
- Target Biotech has long-lived tangible assets such as corporate headquarters, a research lab, and testing equipment.
- Target Biotech does not yet have a marketable product and, therefore, has not generated revenues.

Analysis

A

Pharma Co. concludes that substantially all of the fair value of the gross assets acquired is not concentrated in a single (or group of similar) identifiable asset(s).

This is because the fair value of the gross assets is not concentrated but rather spread across a number of items, both tangible (the corporate headquarters, a research lab, and testing equipment) and intangible (the in-process R&D projects plus the acquired workforce). These assets are not similar for the purpose of applying the screening test.

B

Pharma Co. concludes that the scientists make up an organized workforce that has the necessary skills, knowledge, or experience to perform processes that, when applied to the in-process R&D inputs, are critical to the ability to develop those inputs into outputs.

Conclusion

The set includes both inputs and substantive processes and would be a business.

KPMG Observations

The proposal includes a number of examples to help constituents understand how the FASB intends its framework to be applied. The examples cover a variety of industries and transactions not covered in this *Defining Issues*, including oil and gas, manufacturing, and the acquisition of intellectual property and single-family homes.

[3] Based on Case E in the Proposed ASU.

[4] FASB Accounting Standards Update No. 2014-09, Revenue from Contracts with Customers, available at www.fasb.org.

Proposed Transition and Effective Date

An entity would apply the proposal prospectively to transactions that occur on or after the effective date. The Board will determine the effective date and consider whether to permit early adoption after it receives stakeholder feedback. No disclosures would be required at transition.

Convergence

The proposal would create a new difference between U.S. GAAP and IFRS because the current definition of a business under U.S. GAAP is converged with the IFRS definition. However, stakeholder feedback obtained by the FASB indicated that the definitions are applied differently under U.S. GAAP and IFRS, with the definition being applied more broadly under U.S. GAAP.

KPMG Observations

The IASB's recent post-implementation review of its standard on business combinations revealed stakeholder concerns about the challenges in applying the definition of a business.[5]

In October 2015, the IASB discussed the definition of a business and tentatively decided to propose changes to IFRS 3 that are the same as the amendments proposed by the FASB. In November 2015, the IFRS Interpretations Committee confirmed that issuing an amendment similar to the FASB's proposal would help resolve practical problems under IFRS.

Next Steps

Comments on the proposed ASU are due by January 22, 2016. The FASB will review the comments and determine whether to finalize the ASU as proposed.

The FASB's project to clarify the definition of a business includes two additional phases that remain under discussion, with no time frame for issuing exposure drafts. The first phase relates to partial sales or transfers of, and the corresponding acquisition of partial interests in, a nonfinancial asset or assets. The second phase relates to aligning the recognition and measurement guidance for assets versus businesses.

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Earlier editions are available at: http://www.kpmg-institutes.com

[5] Post-implementation Review of IFRS 3 Business Combinations – Report and Feedback Statement, available at www.ifrs.org.

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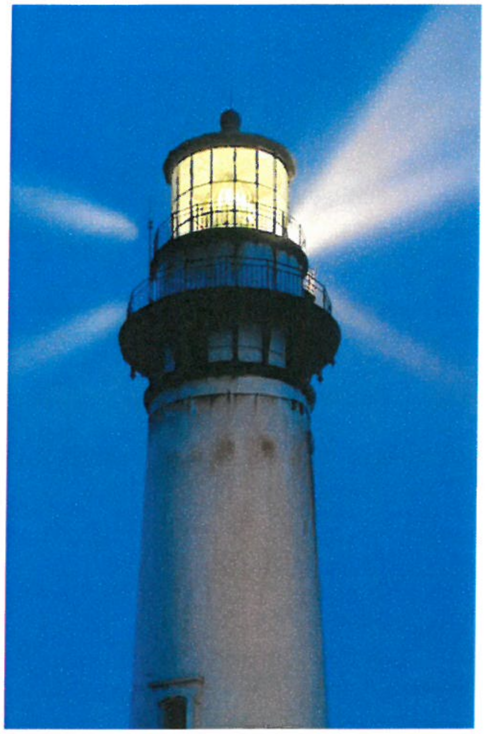

FASB Proposes Further Amendments to Revenue Standard

The FASB invited constituents to comment on a proposed Accounting Standards Update (ASU) intended to clarify the application of the new revenue standard with respect to the guidance on collectibility, the date to measure noncash consideration, presentation of sales taxes, and transition.[1] The comment deadline is November 16, 2015.

Key Facts

The FASB is proposing amendments to:

- Clarify when to recognize revenue for nonrefundable consideration received before collectibility of the entire amount to which the entity expects to be entitled is probable;
- Clarify the guidance on derecognition of an asset transferred to a customer;
- Specify for transition that a completed contract is one in which all (or substantially all) of the revenue has been recognized under current U.S. GAAP before the revenue recognition standard is adopted;
- Add a practical expedient that would not require the evaluation of each contract modification from contract inception through the date of adoption;
- Add a policy election to present taxes collected from customers on behalf of governmental authorities on a net basis; and
- Clarify that noncash consideration is measured at contract inception.

Key Impacts

- The FASB's objective with the proposed amendments is to make the standard more operational without significantly changing the underlying principles.
- The proposed FASB amendments are not expected to be considered by the IASB, which could result in differences between how the two Boards' revenue recognition standards are applied.[2]

Contents

[1] FASB Proposed Accounting Standards Update, Narrow-Scope Improvements and Practical Expedients, available at www.fasb.org.

[2] IFRS 15, Revenue from Contracts with Customers.

Collectibility

The proposals clarify when to recognize revenue when collectibility is not probable.

The revenue standard specifies that a contract does not exist for purposes of the revenue recognition model (Step 1) unless collectibility of the consideration to which the entity expects to be entitled is probable.[3] This determination is based on the customer's ability and intention to pay the amount when due. Because Step 1 is a gateway to the revenue recognition model, no revenue is recognized when an entity concludes that collectibility is not probable. This prohibition on revenue recognition also applies to any nonrefundable consideration received. If collectibility of the entire amount to which the entity expects to be entitled is never deemed probable of being collected, the entity does not recognize revenue until either (1) the entity has no remaining performance obligations and substantially all of the consideration has been received and is nonrefundable, or (2) the contract is terminated and all amounts received are nonrefundable. These criteria are referred to as the "alternate recognition model."

The FASB's proposed amendments would add a third event to the alternate recognition model. Under the proposed additional event, when collectibility of the entire amount to which the entity expects to be entitled is not probable, an entity would recognize revenue in the amount of nonrefundable consideration received when the entity has transferred control of the goods or services, the entity has stopped transferring additional goods or services and has no obligation to transfer additional goods or services, and the consideration received from the customer to date is nonrefundable.

The FASB's proposed amendments would include implementation guidance and examples to illustrate the objective and application of the collectibility threshold. The FASB also is proposing to amend Example 1 in the revenue standard to clarify that assets are derecognized when control of the asset transfers to the customer. This may precede the point when revenue is recognized. In that case, the entity would recognize a loss when the asset is derecognized.[4]

Completed Contracts at Transition

Completed contract is redefined for purposes of applying the transition requirements.

An entity that applies the cumulative-effect transition approach when adopting the revenue recognition standard will apply it to contracts that are not completed as of the initial application date. Additionally, the application of certain practical expedients available to an entity that applies the full retrospective approach is impacted by the definition of a completed contract for transition purposes.

The transition guidance currently states that a contract is completed if the entity has *transferred* all of the goods and services identified under current U.S. GAAP. While the transfer of goods and services is a new concept in the revenue standard, it differs from the earned and realized notion embedded in much of legacy U.S. GAAP. This difference in underlying concepts may create transition difficulties because an entity may have transferred all of the goods and services to the customer but not yet recognized all of the revenue. This might occur, for

[3] FASB Accounting Standards Update No. 2014-09, Revenue from Contracts with Customers, available at www.fasb.org. For additional examples on the proposed amendments and comparison to IASB's proposals, please see Defining Issues Nos.15-38, FASB to Clarify Revenue Standard's Collectibility and Completed Contracts Guidance, and 15-11, FASB and IASB to Propose Additional Revenue Clarifications, both available at www.kpmginstitutes.com.

[4] FASB ASC paragraphs 606-10-55-95 through 55-98, available at www.fasb.org.

example, when the amount due from the customer is not fixed or determinable at the date the goods and services were transferred to the customer.

The FASB's proposed amendments would redefine a completed contract for transition purposes as one for which all (or substantially all) of the revenue was recognized under legacy U.S. GAAP.

Example 1: Impact of Change in Definition of Completed Contract

A publicly traded, calendar year-end company sells products to distributors and regularly grants price concessions and accepts product returns. The company's accounting policy is to recognize revenue when the distributors sell the products to end customers (sell-through).

On December 15, 2017, the company delivers products to a distributor. On January 1, 2018, the company adopts the revenue standard using the cumulative-effect transition approach before the distributor has sold any products.

Absent the FASB's proposed amendments, the company likely would conclude that the contract is completed because control of the products has transferred to the distributor prior to the adoption date. As the distributor sells the products, the company receives cash. However, the standard is not clear on how the cash receipts should be accounted for. One interpretation would have required cash receipts to be recognized directly into equity.

Under the FASB's proposed amendments, the company concludes that the contract is not completed at the date of adoption because substantially all of the revenue had not been recognized under legacy U.S. GAAP. The company would apply the standard retrospectively to the contract. The new standard would result in revenue being recognized on December 15, 2017, after giving effect to the constraint on variable consideration. Therefore, the company would recognize a cumulative catch-up to equity on the date of adoption.

The FASB's proposed amendments also specify that an entity using the cumulative-effect transition approach would be permitted, but not required, to apply that transition approach to all contracts whether completed or not at the date of transition.

The IASB has not proposed similar amendments to IFRS 15. If the IASB and FASB do not remain converged on this transition topic, multi-national companies adopting the standard using the cumulative-effect approach could have different populations of contracts to which they apply the new standard. This could result in incremental efforts to adopt the standard for multi-national companies. Differences between a company's U.S. GAAP and IFRS financial statements could occur for a period of time even though the guidance in the standards is largely converged.

Practical Expedients upon Transition

The revenue standard requires that contract modifications are accounted for either prospectively or through a cumulative catch-up adjustment depending on the specific circumstances of the modification.

The FASB has proposed a practical expedient that would not require an evaluation of each contract modification from contract inception through the date of adoption. For an entity electing the practical expedient, modified contracts would be accounted for during transition by:

- Identifying all satisfied and unsatisfied performance obligations from inception of the original contract to the Contract Modification Adjustment Date (CMAD);
- Determining the transaction price based on the information available at the CMAD using total consideration to which the entity is entitled for all performance obligations (satisfied and unsatisfied) in the contract; and
- Allocating the transaction price to the performance obligations at the CMAD based on the historic stand-alone selling price of each good or service.

The beginning of the earliest period presented would be the CMAD under the retrospective transition approach. The date of initial application would be the CMAD under the cumulative-effect transition approach. Modifications occurring after the CMAD would be accounted for using the standard's contract modifications guidance.

The FASB's proposed amendments would not require an entity electing the retrospective transition approach to disclose the current period impacts of adopting the standard, which would have required an entity to account for contracts under both the standard and current U.S. GAAP in the period of adoption. This change would align the standard with IFRS.

Sales Tax Presentation: Gross versus Net

The standard supersedes current U.S. GAAP guidance that allows a policy election to present taxes collected from customers on behalf of governmental authorities either gross or net.[5] The standard requires a company to evaluate each tax in each jurisdiction in which it operates to determine whether taxes are amounts collected on behalf of third parties that would be excluded from the transaction price.

The FASB has proposed a practical expedient that would allow an entity to elect an accounting policy to present these taxes on a net basis. If the entity does not elect to apply the practical expedient, it would be required to analyze whether an individual tax should be included in the transaction price. An entity would be required to disclose its use of this practical expedient. The FASB decided to use the same scope that is in ASC paragraph 605-45-15-2(e), which includes sales, use, value added, and some excise taxes.

[5] FASB ASC paragraphs 605-45-50-3 and 50-4, available at www.fasb.org.

Noncash Consideration

The revenue standard requires that noncash consideration be measured at fair value. If an entity cannot reasonably estimate the fair value of noncash consideration, it is measured indirectly by reference to the selling price of the goods or services promised to the customer. However, the standard does not specify *when* to measure noncash consideration at fair value. This differs from current U.S. GAAP where the measurement date of equity-based consideration is the earlier of the vesting date or the performance commitment date.[6]

The FASB's proposed amendments specify that noncash consideration be measured at contract inception. This is generally consistent with the measurement of the transaction price when it consists of cash consideration. The FASB is proposing to update Example 31 in the standard to be consistent with its decision on the measurement date.[7]

The FASB is also proposing that the constraint applies only to variability caused by reasons other than the form of the consideration. Determining whether a change in fair value was caused by the form of the noncash consideration or other reasons and deciding how to allocate changes between these reasons may be challenging.

Example 2: Application of the Constraint to Noncash Consideration

On January 1, 2018, Company A enters into a contract to provide services to Customer Z for one year. In exchange, Company A will receive 1,000 common shares of Customer Z on December 31, 2018. If Company A achieves a performance milestone, it will be entitled to an additional 200 shares.

Company A considers the factors associated with the constraint on variable consideration in determining whether it expects to be entitled to the additional shares. However, changes in the share price subsequent to the measurement date of January 1, 2018, is not variable consideration. Therefore, the constraint is not applied to those changes (i.e., variation due to the form of noncash consideration).

Next Steps

Companies should evaluate the FASB's proposed amendments and consider submitting a comment letter by the November 16, 2015, deadline.

[6] FASB ASC paragraph 505-50-30-18, available at www.fasb.org.

[7] FASB ASC paragraph 606-10-55-247, available at www.fasb.org.

Separately, the FASB previously issued its exposure draft on principal versus agent guidance with comments due by October 15, 2015.[8]

The FASB is expected to discuss the comment letters on its exposure draft on licenses and performance obligations in early October.[9]

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[8] FASB Proposed Accounting Standards Update, Principal versus Agent Considerations (Reporting Revenue Gross versus Net), August 31, 2015, available at www.fasb.org.

[9] FASB Proposed Accounting Standards Update, Identifying Performance Obligations and Licensing, May 12, 2015, available at www.fasb.org.

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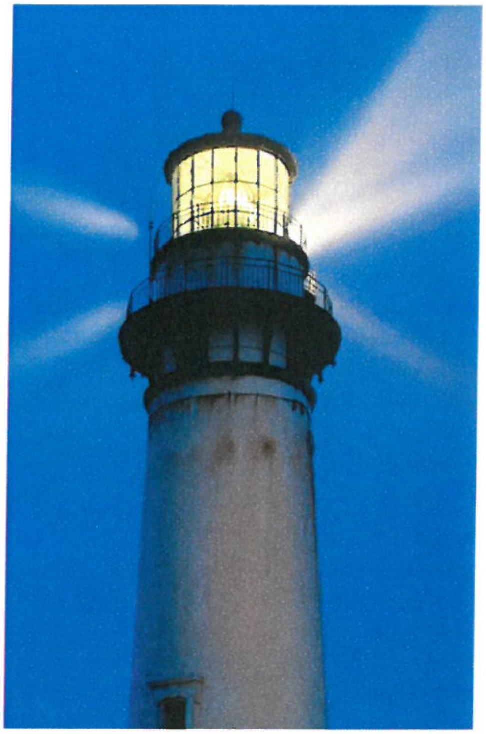

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FASB Redeliberates Revenue Guidance on Licensing and Performance Obligations

On October 5, 2015, the FASB redeliberated and, in general, tentatively decided to adopt its proposed revenue guidance on accounting for licenses of intellectual property and identifying performance obligations.[1] The redeliberations were held in response to comment letters on the FASB's proposed Accounting Standards Update (ASU) and its staff's outreach efforts.

Key Facts

The Board tentatively decided to:

- Clarify the timing of recognition for revenue from licenses of intellectual property (IP), including the guidance for sales- and usage-based royalties;
- Amend the criteria for determining whether goods or services are performance obligations;
- Specify that an entity is not required to identify as a performance obligation goods or services that are immaterial in the context of the contract;
- Add a policy election to account for shipping and handling services provided after control of the goods transfers to the customer as a fulfillment activity; and
- Retain the requirement that goods and services that meet specified criteria be accounted for as a series (i.e., a single performance obligation).

Key Impacts

- The FASB's amendments are not fully converged with the IASB's proposed amendments. However, the Boards hope that the wording differences will not result in significantly different outcomes in practice, excluding areas where the FASB has provided additional practical expedients (e.g., shipping and handling).[2] The IASB is proposing more limited clarifications to its standard. The comment deadline on the IASB's exposure draft is October 28, 2015.
- For entities that license IP, the timing of revenue recognition may be significantly different from current practice.

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[1] FASB Proposed Accounting Standards Update, Identifying Performance Obligations and Licensing, May 12, 2015, available at www.fasb.org.

[2] IASB Exposure Draft ED/2015/6, Clarifications to IFRS 15, available at www.ifrs.org.

The Board's clarifications to determining the nature of an IP license are consistent with the proposed ASU.

Determining the Nature of an Intellectual Property License

The revenue recognition standard provides implementation guidance on whether revenue related to a distinct IP license is recognized over time or at a point in time.[3] A license that provides a right to access the entity's IP as it exists throughout the license period is an over-time performance obligation. A license that provides a right to use the entity's IP as it exists when the license is granted to the customer is a point-in-time performance obligation.

The Board tentatively agreed to amend the implementation guidance on IP licenses to require an entity to classify IP into one of two categories.

- ***Functional IP.*** IP is functional if the customer derives a substantial portion of the overall benefit from the IP's stand-alone functionality. Functional IP would generally include software, biological compounds, drug formulas, and completed media content (e.g., films, television shows, and music). Consideration for functional IP would generally be recognized as revenue at the point in time when control of the IP transfers to the customer. However, if the functionality of the IP is expected to substantively change during the license period as a result of activities of the entity, and the customer is contractually or practically required to use the updated IP, then the consideration would be recognized as revenue over time.
- ***Symbolic IP.*** IP is symbolic if it does not have significant stand-alone functionality, and substantially all of the customer's benefit is derived from its association with the licensor's ongoing activities. Symbolic IP would generally include brands, trade names such as sports team logos, and franchise rights. Consideration for symbolic IP would generally be recognized as revenue over the license period using a measure of progress that reflects the licensor's pattern of performance.

KPMG Observations

Some comment letter respondents suggested eliminating the guidance on over-time recognition of revenue for functional IP. The Board decided to retain the guidance because the customer may not obtain substantially all of the remaining economic benefits of the IP at the beginning of the license term. The Board's decision will require an entity to first decide whether the licensed IP is functional or symbolic. If the IP is functional, an entity will then need to apply additional criteria to determine whether revenue related to functional IP is recognized over time. Although over-time revenue recognition for functional IP is not expected to occur frequently, application of the guidance will require judgment.

[3] FASB ASC paragraphs 606-10-55-59 to 55-64, available at www.fasb.org.

Other respondents pointed out that symbolic IP does not always involve ongoing activities to support the IP. In those cases, the customer is able to obtain substantially all of the remaining economic benefits of the IP at the beginning of the license term. Although the Board considered adding an exception to the guidance on symbolic IP, it decided not to do so because of concerns about complexity. Consequently, all symbolic IP would result in over-time revenue recognition.

Applying the Sales- and Usage-based Royalties Exception

The Board's clarifications to the royalties exception are consistent with the proposed ASU. The Board did not define predominant and did not expand the exception to sales or in-substance sales of IP.

The revenue recognition standard includes an exception to the guidance on estimating variable consideration for sales- and usage-based royalties on IP licenses. The standard prohibits an entity from estimating these forms of variable consideration. Instead, it specifies that an entity can only recognize revenue for a sales- or usage-based royalty for an IP license at the later of (a) when the subsequent sale or usage occurs, or (b) the performance obligation has been satisfied or partially satisfied. The FASB discussed the fact that the *later of* guidance was intended to ensure that revenue is not recognized prior to the satisfaction of the performance obligation.

When an IP license includes other goods or services, the Board agreed to clarify that an entity either applies, in its entirety, the royalties exception or the general guidance on variable consideration (including the constraint). The royalties exception must be applied when the royalty is given in exchange for a distinct IP license or when the IP license is the *predominant* item to which the royalty relates. The FASB has not proposed providing guidance on the definition of predominant, but has acknowledged that determining when a license is the predominant item may require significant judgment. For arrangements that contain both an IP license and other non-IP goods or services, this determination may give rise to significant judgments about the amount of the transaction price and timing for the recognition of variable consideration that relates to a sales- or usage-based royalty.

The Board discussed expanding the scope of the royalties exception to sales of intellectual property. However, the Board decided not to expand the royalties exception beyond the guidance discussed above. The Board decided that the royalties exception should apply to all licenses, even if in-substance it is a sale (e.g., a worldwide, perpetual, or exclusive license). The legal form of the arrangement will be the driving factor to determine whether the royalties exception applies.

Other Clarifications on Licenses

When to Determine the Nature of an Intellectual Property License

The Board reaffirmed its previous tentative decision that when an IP license is not distinct from other goods or services in a contract, it may be necessary to determine the nature of the license to determine whether the performance obligation (a bundle of goods or services including the license) is satisfied over time or at a point in time. For example, if a license is bundled with goods or services that are provided over a period shorter than the license term, an entity may need to consider the nature and term of the license when determining the pattern for revenue recognition of the bundled arrangement.

The Board's clarifications on when to determine the nature of an IP license are consistent with the proposed ASU.

KPMG Observations

The Board's tentative decision on when to apply the licensing guidance for a bundled performance obligation is based on the notion that an entity is always supposed to consider the nature of its promise when determining an appropriate method for measuring progress. The amendment clarifies the original revenue standard, which specified that the licensing guidance only applies to distinct licenses of intellectual property. The Basis for Conclusions in the original revenue standard, however, noted that in some cases the combined good or service may have a license as its primary or dominant component. Some believed that it is appropriate to apply the licensing guidance to bundled arrangements only when the license is the primary or dominant good or service in the contract. The amendments would make the licensing guidance for determining whether to recognize revenue at a point in time or over time more broadly applicable to arrangements where the license is not the primary or dominant good or service. An entity would not have to apply the licensing guidance to every performance obligation that includes IP. Rather, an entity would consider whether the licensing guidance is necessary to understand the nature of the entity's promise and the period over which the performance obligation is satisfied.

In addition, the guidance is different than the guidance on sales- or usage-based royalties, which is expected to be amended to specify that the royalties exception applies to bundled arrangements only if the royalty predominantly relates to an IP license.

Contractual Restrictions

The Board's clarifications to contractual restrictions are consistent with the proposed ASU.

The Board also tentatively agreed to clarify that contractual restrictions on time, geography, or a licensee's ability to use or access the underlying IP are attributes of the license and do not impact the number of performance obligations in the contract. These restrictions define the scope of the license rather than the number of distinct licenses in the arrangement. For example, a license that allows a television station to broadcast a movie on four specific dates during the license term would generally be a single performance obligation. However, some contractual restrictions are not restrictions on the licensee's ability to use or access the IP. For example, if the licensee has the right to use or access the IP for two distinct periods of time, the period between the license periods is substantive, and the licensor has the ability to grant the right to use or access the IP to another party during that intervening period, then the contract would include more than one performance obligation.

KPMG Observations

The Board acknowledged that there have been a number of questions raised about applying the guidance on contractual restrictions. Specifically, the questions have centered around which contractual restrictions are attributes of the license and which restrictions give rise to separate performance obligations. The Board decided that it would move forward with the amendments in the proposed ASU. However, it plans to discuss those amendments with the Transition Resource Group for Revenue Recognition (TRG) at the next TRG meeting on November 9, 2015. If the TRG members have significant concerns with the operability of the proposed guidance, then perhaps the Board would consider making further changes to this guidance. However, the Board plans to proceed with the other amendments and clarification even if further changes on contractual restrictions are deemed necessary.

The Board's clarifications to identifying promised goods or services are consistent with the proposed ASU. However, the Board will also provide cost guidance for services that are immaterial in the context of the contract.

Identifying Promised Goods or Services

The first step in identifying performance obligations is to identify the goods or services promised in the contract. The standard states that promised goods or services are not limited to the goods or services that are explicitly stated in the contract. Rather, the contract may include promises that are implied by an entity's customary business practices, published policies, or specific statements if, at the time of entering into the contract, those promises create a valid expectation of the customer that the entity will transfer goods or services to the customer. However, administrative tasks an entity must undertake to fulfill a contract that do not transfer goods or services to the customer are not performance obligations.[4]

[4] FASB ASC paragraphs 606-10-25-16 to 25-17, available at www.fasb.org.

The Board tentatively agreed to amend the standard to specify that an entity is not required to identify as a performance obligation those goods or services to be transferred to the customer that are immaterial in the context of the contract. This guidance was provided in an attempt to make implementation of the revenue standard less costly for some preparers.

The Board emphasized that immaterial in the context of the contract is a qualitative and quantitative assessment based on what may be important to the customer. This is a different concept than materiality that is applied to the financial statements as a whole, which focuses on information that is important to financial statement users.

KPMG Observations

Several comment letter respondents indicated that the term immaterial could lead to complexity when applying the guidance because it would introduce a new materiality concept. It is as yet unclear to what degree immaterial in the context of the contract includes other quantitatively small-dollar items that would not have been considered inconsequential or perfunctory, a commonly understood concept within legacy U.S. GAAP.[5]

The Board decided to provide guidance that will require costs associated with promises deemed to be immaterial in the context of the contract to be accrued when the goods or services are provided to the customer.

Distinct in the Context of the Contract

The Board's clarifications to distinct in the context of the contract are consistent with the proposed ASU.

The process of identifying performance obligations requires an entity to determine which goods and services are distinct. A good or service is distinct if the customer can benefit from it on its own or with other resources that are readily available to the customer *(capable of being distinct)* and the promise to transfer the good or service is separately identifiable *(distinct in the context of the contract)*. While the first criterion is similar to the stand-alone value notion that exists in current U.S. GAAP, the second criterion is new.[6]

The Board tentatively agreed to amend the guidance on distinct in the context of the contract, consistent with the proposed ASU.

- Explanatory language will be provided to better articulate the principle. The revised language will indicate that the objective when considering whether promised goods or services are separately identifiable is to determine whether the nature of the entity's overall promise in the contract is to transfer (a) each of those separate goods or services, or (b) a combined item (or items) to which the promised goods or services are inputs.

[5] SEC Staff Accounting Bulletin Topic 13.A.3.c, available at www.sec.gov.

[6] FASB ASC paragraph 605-25-25-5(a), available at www.fasb.org.

- The factors for determining what is distinct in the context of the contract will be revised to more closely relate to the separately identifiable principle. In addition, the factors will refer to the goods and services in the contract as a bundle to focus the analysis on when goods or services significantly affect each other.
- Examples will be added to demonstrate how the separation guidance should be applied.

KPMG Observations

In general, the rearticulated principle, related indicators, and additional examples represent an improvement to the revenue recognition standard. These changes should be helpful to stakeholders in determining whether goods or services are distinct within the context of the contract.

Series Guidance

The revenue standard requires that if promised goods or services are (1) distinct; (2) substantially the same; (3) transferred to the customer over time; and (4) the same measure of progress would be used for each individual good or service, then the aggregate promised goods or services in the contract *must* be accounted for as a single performance obligation (the series guidance).[7]

Applying the series guidance impacts the accounting related to the allocation of variable consideration, contract modifications, and changes in the transaction price. Some had previously informed the FASB that this guidance was overly complex for some arrangements.[8] In the proposed ASU, the Board asked constituents whether they believe the series guidance should be optional.

Although some respondents favored making the series guidance optional, others indicated this would result in lack of comparability. Additionally, the IASB is not currently considering making its series guidance optional. The Board decided that it would *not* make the series guidance optional. That is, if the criteria for applying the series guidance are met, an entity must treat the series as a single performance obligation. The Board also instructed the FASB staff to ensure appropriate education was provided for the series guidance because the Board believes that many of the questions arose because of a lack of understanding.

The revenue standard also requires that an entity disclose the aggregate amount of the transaction price allocated to performance obligations that are unsatisfied or partially satisfied at the end of the reporting period and provide an explanation about when the entity expects to recognize this amount as revenue.[9] The Board considered whether to exempt entities that are subject to the series guidance from this disclosure requirement. The Board determined that further analysis was needed before it could conclude that changes in the disclosure requirements are appropriate.

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[7] FASB ASC paragraph 606-10-25-14b, available at www.fasb.org.

[8] See KPMG Defining Issues No. 15-13, Revenue Transition Group Discusses Consideration Payable to a Customer, Series Guidance, available at www.kpmg-institutes.com.

[9] FASB ASC paragraph 606-10-50-13, available at www.fasb.org.

KPMG Observations

Although entities *must* apply the series guidance if certain criteria are met, the Board is aware of the difficulties associated with disclosing the amount allocated to unsatisfied performance obligations when an entity's performance obligation is a series and the variable consideration is allocated entirely to each distinct good or service.

However, the Board decided not to provide an exemption from the disclosure requirements until it obtains a more comprehensive understanding of preparers' concerns and potentially about other disclosure requirements in the standard. The Board emphasized that it is not interested in reopening a broad discussion on the disclosure requirements of the revenue standard. However, it is aware that many companies are just beginning to develop an understanding of the standard's disclosure requirements. Entities should consider sharing other concerns about disclosures either formally or informally with the Board because it may consider making some limited exemptions.

Accounting for Shipping and Handling Services

The Board's clarifications to shipping and handling are consistent with the proposed ASU. However, the Board will also provide cost guidance for shipping and handling.

An entity may bill a customer for shipping and handling services in addition to the stated price of the goods or services. Unlike current U.S. GAAP, the revenue recognition standard does not provide specific guidance for the presentation of shipping and handling fees when an entity charges separately for them.[10] However, it defines the transaction price as the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer, which generally would include amounts charged for shipping and handling.

The more significant question is whether the entity is required to identify shipping and handling services as a performance obligation (whether or not it charges the customer for these services) when it concludes that it has transferred control of the goods to the customer before the product is shipped. The Board tentatively concluded that it will provide a policy election that would allow an entity to choose to account for shipping and handling either as a fulfillment cost or as a promised service when transfer of control of the goods occurs before the goods are shipped. The Board decided to provide guidance requiring costs associated with shipping and handling activities to be accrued when control of the related goods has transferred to the customer and the entity has determined that it will not account for shipping and handling as a separate performance obligation.

[10] FASB ASC paragraphs 605-45-45-19 to 45-21, available at www.fasb.org.

Example: Shipping and Handling Services

An entity sells a product to a customer and ships the product with FOB shipping point terms. The entity has a customary business practice of replacing products if they are damaged in transit (synthetic FOB destination). The entity must determine whether control transfers at the shipping point or if control does not transfer until it arrives at the customer's location. If the entity concludes that control of the goods transfers at the shipping point, the entity could treat the shipping as a separate performance obligation. This would result in recognizing revenue allocated to the goods when they are shipped, and revenue allocated to the shipping performance obligation would be recognized as shipping occurs.

Alternatively, the entity could elect to treat the shipping as a fulfillment cost. This would result in all of the revenue being recognized when the goods are shipped and accruing the cost of shipping.

If the entity concludes that control of the goods transfers when the goods arrive at the customer's location, then the entity would treat the shipping as a fulfillment cost, and recognize all of the revenue when the goods are delivered to the customer's location.

The FASB noted that the cost of shipping and handling that occurs *prior* to the customer obtaining control of the goods is a fulfillment cost rather than a performance obligation.

KPMG Observations

Under current U.S. GAAP entities may have arrangements with FOB shipping point terms that are accounted for as FOB destination arrangements (i.e., synthetic FOB destination) because the entity has determined that risks and rewards do not pass to the customer at shipping point (e.g., the entity has a business practice of covering damage to the product that occurs in the shipping process or providing the customer with a replacement product if the product is lost in transit). All entities will need to consider the indicators included in the revenue standard to determine when control transfers, which may require significant judgment and may lead to diversity in practice. In particular, entities that currently recognize revenue when the goods arrive at the customer location based on synthetic FOB destination terms may determine that under the revenue standard control transfers to the customer when the goods are shipped and will need to make a policy election to account for the shipping services as a fulfillment activity or a performance obligation. The IASB is not proposing a similar amendment. Consequently, this could be an area that results in divergent outcomes.

Next Steps

The FASB intends to issue an Accounting Standards Update covering these topics before the end of 2015.

The FASB recently issued an exposure draft on other narrow-scope improvements and practical expedients with comments due by November 16, 2015.[11] In addition, the FASB previously issued an exposure draft to amend the guidance on determining whether the entity is a principal or an agent with comments due by October 15, 2015.[12]

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[11] FASB Proposed Accounting Standards Update, Narrow-Scope Improvements and Practical Expedients, September 30, 2015, available at www.fasb.org.

[12] FASB Proposed Accounting Standards Update, Principal versus Agent Considerations (Reporting Revenue Gross versus Net), August 31, 2015, available at www.fasb.org.

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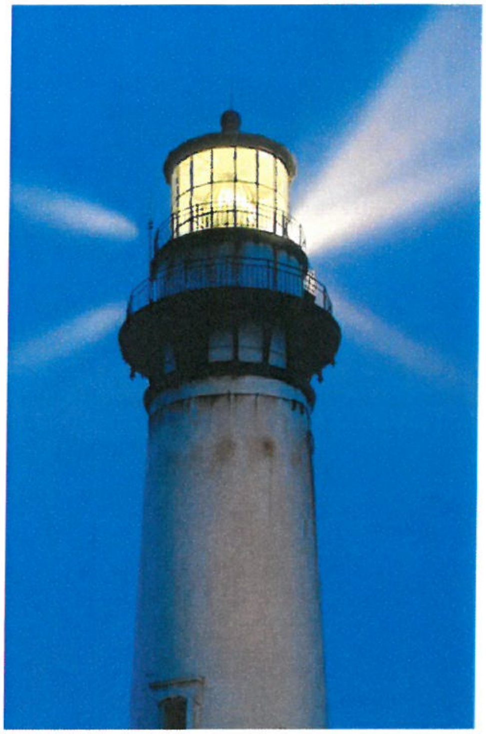

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FASB Sets 2019 Effective Date for New Leases Standard

At its November 11 meeting, the FASB set the effective dates of the new leases standard and decided to permit early adoption. The FASB also discussed cost-benefit considerations and a follow-up issue related to lease classification to complete its due process. The FASB plans to issue a final leases standard in January 2016.

Key Facts

- Public business entities, certain not-for-profit entities, and certain employee benefit plans will be required to apply the new leases standard for interim and annual periods in fiscal years beginning after December 15, 2018.
- All other entities will be required to apply the new leases standard for fiscal years beginning after December 15, 2019, and interim periods in fiscal years beginning one year later.
- Early adoption will be permitted for all entities.
- Entities will not apply the lease-term criterion when evaluating classification of a lease that begins near the end of an asset's economic life.[1]

Key Impacts

- Issuance of the new leases standard is just around the corner. Entities should start assessing how it will affect them if they haven't already done so.
- Entities can elect to early adopt the leases standard beginning in 2016.
- Determining whether an asset is *near the end* of its economic life will involve judgment. Using the 25 percent threshold currently in U.S. GAAP to make that judgment will be considered a *reasonable approach.*[2]
- When the lease term begins near the end of an asset's economic life, entities will apply the other lease-classification criteria to determine whether the lessee obtains control of the underlying asset.

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[1] The lease-term criterion: Is the lease term for the major part of the underlying asset's remaining economic life?

[2] ASC Topic 840, Leases, available at www.fasb.org.

Adoption Date Considerations

Except for early adoption, the FASB's decision on effective date for public business entities aligns with the IASB's recent decision for its leases standard.[3]

Because the leases standard can be early adopted on issuance, entities could decide to adopt it before they adopt the new revenue standard.[4]

The FASB decided not to align the effective date of the new leases standard with the revenue standard. Early adoption will allow entities to adopt the leases standard *before* the revenue standard.

KPMG Observations

The alignment of the effective dates for the FASB's and IASB's leases standards will make it easier for global entities to prepare their financial statements.

Given the interplay between the new leases and revenue standards, entities should consider their facts and circumstances and potential benefits of adopting the leases and revenue standards concurrently. Implementation challenges may arise when entities adopt the leases standard at the effective date. For example, current U.S. GAAP lease accounting guidance contains specific real estate sale-leaseback accounting guidance that was not carried forward to the new leases and revenue standards.

Lease Classification Issue

Current U.S. GAAP and the forthcoming leases standard include similar lease classification tests, including a lease-term criterion. However, current U.S. GAAP is more prescriptive than the leases standard will be.

The FASB received feedback that current operating leases with lease terms beginning near the end of an asset's economic life may be classified as finance leases under the proposed guidance solely based on the asset's age. Under current U.S. GAAP, when the lease term falls within the last 25 percent of an asset's total estimated economic life, the lease-term criterion is not applied.

The FASB decided to include a similar exception in the new standard without requiring the use of the bright line. While determining whether an asset is near the end of its economic life will require judgment, entities may apply the 25 percent threshold in current U.S. GAAP as a *reasonable approach* to make that judgment.

KPMG Observations

Interestingly, no concerns were raised about the fair value lease-classification criterion, although a similar exception exists for end-of-life leases when applying that criterion under current U.S. GAAP.

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[3] IFRS 16, Leases, available at www.ifrs.org.

[4] ASC Topic 606, Revenue from Contracts with Customers, available at www.fasb.org.

Under the forthcoming standard, lease classification will be based on whether the lease gives the lessee control of the underlying asset. One criterion indicating control transfer is when the asset is so specialized that it is expected to have no alternative use to the lessor at lease expiration. With the FASB's decision, lease classification will now potentially be different from current guidance based solely on an asset's uniqueness.

Because this issue is specific to U.S. GAAP, it will create an additional difference with IFRS 16.

Cost-Benefit Considerations

The FASB concluded that the benefits of the new leases standard will outweigh implementation costs, and that financial statement users will receive better information under the new standard.

- For lessees, all leases (except short-term leases) will be recognized on balance sheet, which will improve comparability between entities and reduce differences related to how financial statement users adjust the financial reporting for leases.
- More information will be disclosed in the financial statement notes for both lessees and lessors to provide a more complete picture of their leasing activities and exposure (e.g., asset risk and, for lessors, credit risk).

The FASB believes implementation and ongoing compliance costs with the new standard will not be as significant as they would have been under the 2010 and 2013 exposure drafts. Through redeliberations, the FASB made decisions it believes will reduce the necessary changes to systems and processes for both lessees and lessors.

Staying Informed

The FASB expects to issue an Accounting Standards Update in January 2016. KPMG will issue a *Defining Issues®* about the new standard when it is issued followed by an *Issues In-Depth* with a more comprehensive analysis of the new standard.

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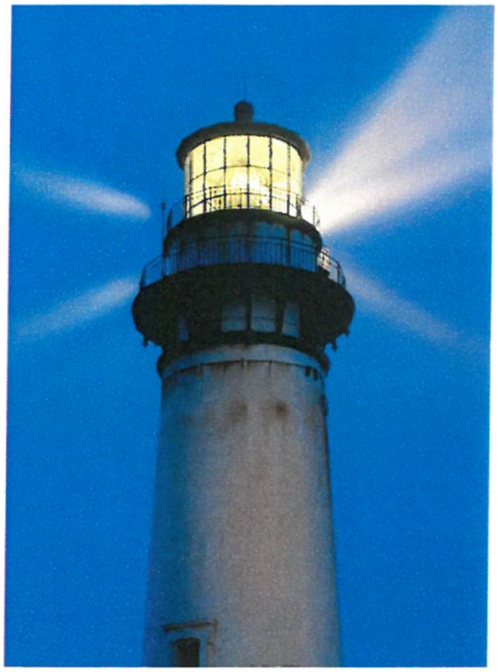

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Revenue Transition Resource Group Discusses Nine Issues

The Joint Transition Resource Group for Revenue Recognition (TRG) met for the fifth time on July 13, 2015, and discussed nine issues related to the joint FASB/IASB revenue recognition standard.[1] This edition of *Defining Issues* summarizes the key points discussed at the meeting.

Key Facts

- Fees charged by credit-card issuing banks to cardholders are generally outside the scope of the revenue standard under U.S. GAAP. Because IFRS does not have explicit guidance on the accounting for credit card fees, differences between IFRS and U.S. GAAP could arise.
- Depending upon the facts and circumstances of an arrangement, the standard's guidance related to allocating variable consideration to the distinct goods or services that constitute a series may be applied to many service contracts as a practical accommodation.
- Consideration payable to a customer that is a reduction of revenue generally will be accounted for as variable consideration. The guidance on the timing of the recognition of consideration payable to a customer would only apply in the limited circumstance that an entity does not have the intention or an established practice of providing a payment to its customers at contract inception.
- TRG members had differing views on how to define a completed contract when applying the transition guidance.[2] This will be discussed again at the next TRG meeting.

Key Impacts

- Applying the series guidance could simplify application of the revenue model for some IT outsourcers, transaction processors, and other long-term service providers.
- TRG members generally agreed with the FASB and IASB staff's views on most of the issues, which likely means that the Boards will not undertake standard setting on those issues.

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[1] Transition Resource Group papers are available at www.fasb.org and www.ifrs.org. FASB Accounting Standards Update No. 2014-09, Revenue from Contracts with Customers, and IFRS 15, Revenue from Contracts with Customers.

[2] FASB ASC paragraph 606-10-65-1(c)(2), available at www.fasb.org, and IFRS.C2(b).

Consideration Payable to a Customer

This topic has been discussed at two previous meetings including the March 31, 2015, TRG meeting. However, technology issues prevented the U.S. and international TRG members from holding a joint discussion.

The standard states that consideration payable to a customer includes amounts that an entity pays, or expects to pay, to a customer or to other parties that purchase the entity's goods or services from the customer. An entity should treat consideration payable to a customer as a reduction of the transaction price, unless the payment is in exchange for a distinct good or service, and the entity can reasonably estimate the fair value of the good or service. The guidance on consideration payable to a customer states that it is recognized at the *later of* when the entity recognizes revenue or when the entity pays or promises to pay the consideration (later of guidance). However, because consideration payable to a customer can be included in the transaction price, it also can be a form of variable consideration.

Because the timing of recognition would differ if it is deemed to be variable consideration versus using the later of guidance, stakeholders have asked when the guidance on consideration payable to a customer and variable consideration should be applied.

Example 1: Variable Consideration versus Consideration Payable to a Customer

Manufacturer A sells its product to Distributor A for $100 on December 1 and recognizes revenue at that time. Manufacturer A has a history of offering a $25 cash-back rebate to end-consumers in the following February.

Under the variable consideration guidance, Manufacturer A would reflect the $25 rebate in its transaction price on December 1 based on its previous business practice and intent to continue to offer this incentive. Under the later of guidance, the transaction price would be reduced in February when Manufacturer A pays the rebate to the end consumer.

In the March meeting, TRG members had differing views on whether payments made to customers should be evaluated at the contract level or more broadly at the customer-relationship level. U.S. members noted that evaluating payments broadly at the customer-relationship level is consistent with current U.S. GAAP.[3] However, many believe that the new standard was not written in that way. Most TRG members indicated that something between the broad customer-relationship view and narrow customer contract level was appropriate.

In the July meeting, both U.S. and international TRG members observed that a reasonable application of either view should result in similar financial reporting outcomes. Members also had differing views about how broadly payments within the distribution chain should be evaluated. Some members stated that customers are only those parties that are within the direct distribution chain.

[3] FASB ASC Section 605-50-25, available at www.fasb.org.

Others thought a broader view of a customer's customer should be used, citing the reference in the Basis for Conclusions to situations where an entity is acting as a marketing agent.[4] These marketing companies view the principal as their customer, but they also may view the principal's end customer (i.e., customer's customer) as their customer and therefore believe this guidance should be applied to them.

TRG members generally agreed that an entity's customer might include a customer's customer that extends beyond the direct distribution chain, and that sometimes an entity may have more than one customer. As a consequence, judgment will be needed to evaluate a specific fact pattern to determine whether a payment is treated as a reduction of revenue.

Variable consideration is estimated and included in the transaction price at contract inception and at each subsequent financial reporting date, differing from the recognition timing under the later of guidance. TRG members generally agreed that the guidance can be reconciled because not all consideration payable to a customer is variable consideration. However, this discrepancy puts pressure on determining, at contract inception, whether the entity intends to provide an incentive. This evaluation will include an assessment of the entity's past practices and other activities that could give rise to an expectation at contract inception that the transaction price is variable. The later of guidance would only be used when the entity does not have this history and has no expectation of providing incentives, which the TRG expects will occur only in limited circumstances when an entity has not implicitly (including through its customary business practices) or explicitly promised a payment to the customer at contract inception.

Credit Card Fees and Loyalty Programs

The revenue standard excludes from its scope other contractual rights and obligations that are within the scope of certain ASC Topics, including receivables. Current U.S. GAAP includes guidance on accounting for credit-card fees as part of the receivables guidance.[5] Because credit card fees may entitle the cardholder to other services (e.g., airport lounge access or roadside assistance), some have questioned whether all services embedded within the credit-card fee arrangement are within the scope of the receivables guidance or whether some of those services should be separated from the credit card fee and included in the scope of the revenue standard.

Current U.S. GAAP states that credit card fees can cover many cardholder services.[6] To the extent a fee compensates the entity for a service provided during the loan commitment period, the separate components of a commitment fee are not identifiable and reliably measurable to allow for separate accounting recognition for each component part.[7]

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[4] ASU No. 2014-09, Revenue from Contracts with Customers, paragraphs BC92 and BC255, available at www.fasb.org.

[5] FASB ASC Subtopic 310-20, Receivables—Nonrefundable Fees and Other Costs, available at www.fasb.org.

[6] FASB ASC paragraphs, 310-20-05-03 and 25-15, available at www.fasb.org.

[7] FASB Statement No. 91, Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases, paragraph BC48, available at www.fasb.org.

Instructions for submitting an issue to the TRG can be found on the FASB's Web site.

The next TRG meeting is scheduled for November 9, 2015.

The FASB staff's outreach showed that under current practice credit card fees are accounted for using the receivables guidance. In addition, constituents noted that the revenue standard scopes out transactions that are within the scope of the receivables guidance and pointed out that the revenue standard did not change the scope of the receivables guidance. Therefore, they believe that credit card fees continue to be within the scope of the receivables guidance and outside of the revenue standard's scope. While the FASB staff generally agreed with that view, it also noted that a credit card issuing bank should not assume that all of its arrangements are outside the scope of the revenue standard. In particular, the FASB staff was concerned about potential arrangements being labelled as credit-card lending arrangements, when the substance is clearly the sale of other goods or services. The TRG members generally agreed with the FASB staff's analysis.

Questions have also arisen about whether loyalty programs included in credit card arrangements are within the scope of the revenue standard. Similar to the analysis above, the determination is based on whether the credit card fee that gives the right to participate in the loyalty program falls within scope of the receivables guidance or the revenue standard. Therefore, the card-issuing bank should evaluate its specific facts and circumstances.

Under IFRS, arrangements within the scope of the financial instruments standard are scoped out of the revenue standard.[8] Because IFRS does not have explicit guidance on the accounting for credit card fees, TRG members noted that differences between IFRS and U.S. GAAP could arise.

Series Provision and Allocation of Variable Consideration

At contract inception an entity is required to account for each good or service or bundle of goods or services as a performance obligation if (a) they are distinct, or (b) they are a series of distinct goods or services that are substantially the same and have the same pattern of transfer to the customer (the series provision). The series provision was included in the standard to simplify the accounting for repetitive services and to promote consistency in identifying performance obligations.[9]

In a contract to provide a repetitive service, such as a monthly cleaning service, an entity would treat the promise to provide cleaning services as a single performance obligation rather than treating each increment of service (e.g., year, month, day, or hour) as a performance obligation. Based on previous TRG discussions, the FASB included a question in its recent exposure draft about whether the series guidance should be optional.[10]

[8] IFRS 9, Financial Instruments.

[9] ASU 2014-09, BC113, available at www.fasb.org, and IFRS 15.BC113.

[10] FASB Proposed Accounting Standards Update, Identifying Performance Obligations and Licensing, available at www.fasb.org.

Consideration of Whether Goods or Services Are Distinct and Substantially the Same

Stakeholders have questioned how to determine when more than one good or service is considered substantially the same. More specifically, the question is whether *all* of the tasks in each increment of service need to be substantially the same.

The FASB and IASB staff noted that an entity must first determine whether its promise is to provide goods or services or to stand ready to provide goods or services when requested by the customer.[11] If the nature of the promise is the delivery of a specified quantity of a service, the evaluation should consider whether each service is distinct and substantially the same. If the promise is to stand ready or to provide a single service for a period of time (i.e., there is not a specified quantity to be delivered), the evaluation would likely focus on whether each time increment, rather than the underlying activities, is distinct and substantially the same.

An entity also should consider which of the three criteria for concluding that a performance obligation is satisfied over time is met.[12] If a performance obligation is satisfied over time because the customer simultaneously receives and consumes the benefits of the services as the entity performs, that may indicate that each increment of service is capable of being distinct. If a promise is satisfied over time based on either of the other criteria, the nature of that promise could be for a single specified good or service and would not generally represent a series (e.g., a promise to provide a piece of equipment or a professional opinion).

TRG members generally agreed with the staff that a promise to perform an unspecified quantity of services for a fixed price represents an obligation to stand ready to perform the underlying services. Given the nature of the entity's promise to stand ready to perform, each day of service may be distinct because the customer can benefit from each one on its own and each day of service is separately identifiable. Even if the individual activities vary from day to day, the nature of the overall promise (e.g., hotel management services) is substantially the same. However, an entity will need to carefully evaluate specific facts and circumstances when its stand-ready obligation involves goods or services that are occasionally or sporadically provided and that do not align with the manner in which variable consideration is contractually determined.

Evaluating Whether Consideration Is Variable

TRG members agreed that the determination of whether an arrangement includes variable consideration depends on the evaluation of the entity's underlying promise. If the consideration to be received is based on the quantity of goods or services provided by the entity and the quantity is not specified in the arrangement, the transaction price is variable. TRG members agreed that an entity should consider all substantive contract terms, including contractual minimums, that could make all or a portion of the consideration fixed.

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[11] TRG Paper 16 for the January 25, 2015, TRG meeting, available at www.fasb.org and www.ifrs.org.

[12] FASB ASC paragraph 606-10-25-27, available at www.fasb.org, and IFRS 15.35.

Additionally, some TRG members noted that the November 9, 2015, meeting is expected to include a discussion of optional goods and services, which might also affect this analysis.

Allocation of Transaction Price

The standard requires variable consideration to be allocated to one or more distinct goods or services in a series if specified criteria are met.[13] The TRG members discussed various fact patterns and agreed that allocating variable consideration entirely to a distinct good or service may be acceptable when (1) the fee is the same over the duration of the contract; (2) the fee declines in a manner commensurate with the decline in the entity's cost to deliver the goods or services; (3) the fee is commensurate with the entity's standard pricing practices with similar customers; or (4) the fee is commensurate with the value of the goods or services delivered to the customer.

Applying the series guidance to a broader population of service contracts is not explicitly required by the standard. However, if the guidance is applied in a reasonable way when supported by the fact pattern, it will allow revenue to be recognized for amounts billed and modifications accounted for prospectively. When this approach is not appropriate for a fact pattern, the entity will need to estimate prices and quantities for services to be performed in the future and account for modifications using a cumulative catch-up approach.

Example 2: Allocation of Transaction Price

A company agrees to provide outsourced IT services to a customer for five years. Unit pricing is specified in the contract and is billed based on the quantity of each service provided during the period.

The company determines that the services are not separately identifiable and therefore has a single performance obligation. The customer simultaneously receives and consumes the benefits of the service as the company performs, which means the performance obligation is satisfied over time. The volumes of each type of service are undefined. Each day of service could be viewed as a distinct service, leading the company to conclude that it is providing a series of distinct services.

Rather than forecasting service quantities to estimate the transaction price for a single performance obligation to deliver IT outsourcing services over a five-year period, the company allocates the variable consideration associated with services provided in a day to the distinct increment of service (the day). At the end of each month, assuming the company has determined the contractual pricing is representative of the value to the customer, the company recognizes revenue based on the amount billed. Modifications to the contract are likely to be accounted for prospectively because additional services are distinct from the services in the original contract.

If the entity concluded that the contract included multiple performance obligations satisfied over time (not a series), the entity would estimate the quantities of services to be provided to estimate the transaction price. The

[13] FASB ASC paragraphs 606-10-32-39 to 32-41, available at www.fasb.org, and IFRS 15.84 to 86.

Example 2: Allocation of Transaction Price

transaction price would be allocated to the performance obligations and recognized as each of those services is provided. As actual quantities are determined, the entity would update the transaction price and allocate to the performance obligations on the same basis as at contract inception. Modifications to the contract that add services that are not distinct from the services in the original contract would be accounted for on a cumulative catch-up basis.

Practical Expedient for Measuring Progress

For performance obligations that are satisfied over time, an entity should identify the method that most faithfully depicts the pattern of transfer of control of the goods or services to the customer. This may be either an input or output method depending on the specific facts and circumstances of an arrangement. As a practical expedient, an entity may recognize revenue using the amount it has the right to invoice, if the amount directly corresponds with the value delivered by the entity to the customer.[14] In addition, an entity may use a similar practical expedient when disclosing information about its remaining performance obligations.[15]

Similar to the discussion on the application of the series guidance, some stakeholders have questioned whether the practical expedient can be applied to contracts with rates that change during the contract term (such as rates based on forward market prices, rates with a contractual minimum, or contracts with volume discounts) or contracts that contain multiple goods and services. The TRG generally agreed that in order for an entity to apply the practical expedient one of the following circumstances must exist:

- The price needs to change during the contract period in response to changes in the value of the goods or services to the customer;
- All of the goods or services in the contract qualify for the practical expedient; or
- The existence of a contractual minimum is nonsubstantive (i.e., the entity expects that amounts will be exceeded).

An entity will need to use judgment to assess whether the right to consideration from a customer corresponds directly to the value to the customer for the performance completed to date. In addition, if a contract contains an upfront fee, rebates, or volume discounts, an entity will need to use judgment to determine whether the payments or future discounts relate to a specific good or service. The significance of the amount in relation to the contract also will need to be evaluated when determining whether the right to payments corresponds to the value to the customer. The more significant these amounts are when they do not relate to the transfer of a good or service, the more difficult it will be for the entity to conclude that the practical expedient applies to its arrangement.

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[14] FASB ASC paragraph 606-10-55-18, available at www.fasb.org, and IFRS 15.B16.

[15] FASB ASC paragraph 606-10-50-14, available at www.fasb.org, and IFRS 15.121.

An entity will need to apply similar judgment to determine whether it can apply the practical expedient on the disclosure of remaining performance obligations.

Measuring Progress for Multiple Goods or Services in a Single Performance Obligation

If an entity satisfies a performance obligation over time, the standard requires it to recognize revenue by measuring its progress toward complete satisfaction of the performance obligation using a single method.[16] The objective when measuring progress is to depict an entity's performance in transferring control of goods or services to a customer.

Although stakeholders agree the guidance is clear that only one measure of progress can be used, some stakeholders have expressed concern that it could be challenging to select and apply a single method when the entity is transferring control of multiple goods or services over time that have been combined into a single performance obligation.

TRG members generally agreed that using multiple methods of measuring progress for the same performance obligation would not be appropriate. While acknowledging that selecting a single measure of progress will require significant judgment in some situations, the TRG members generally agreed that evaluating the nature of the entity's overall promise will help identify an appropriate measure of progress for the bundle of goods and services.

For example, in an arrangement where an entity promises to provide a software license (right to use intellectual property) and integration services that will customize the software to add significant new functionality, the entity likely would conclude that the software and installation services are not separately identifiable and should be combined into a single performance obligation. TRG members generally agreed that the measure of progress should be based on a method that reflects the entity's progress toward completion of the customized software solution. In other words, revenue would be recognized over the period that the integration services are performed.

In another example, assume a professional services entity provides a professional opinion to a customer, and it concludes that the arrangement meets the criteria for recognition of revenue over time (the fee is a fixed amount plus reimbursement of out-of-pocket expenses). Because a single method of revenue recognition is required, the entity may need to estimate the total consideration, including the reimbursement of out-of-pocket expenses, and then use a single attribution method such as direct labor hours for recognizing the estimated revenue over the period that the professional services are provided.

TRG members emphasized that difficulties in identifying a single measure of progress may mean that the entity needs to revisit its assessment of whether the goods or services are distinct.

[16] FASB ASC paragraph 606-10-25-32, available at www.fasb.org, and IFRS 15.40.

Determining When Control of a Commodity Transfers

When a commodity is not accounted for as a derivative (i.e., normal purchase normal sale exception is applied), stakeholders have questioned whether control of the commodity transfers to a customer over time or at a point in time. Specifically, when evaluating whether a customer simultaneously receives and consumes the benefits of a commodity as the seller produces the commodity, some believe the seller should evaluate only the inherent characteristics of the commodity. Others believe the seller should also consider other factors including the contract terms, infrastructure of the parties, and other delivery mechanisms.

For example, considering other factors beyond the inherent characteristics of the commodity might lead a gas producer to conclude that its performance obligation is satisfied over time if the gas is continuously fed into a customer's power plant and immediately consumed.

Conversely, the gas producer would conclude that its performance obligation is satisfied at a point in time if the gas is transferred into a storage facility. This is important because distinct goods or services that are substantially the same and that transfer over time are a series. This may allow companies to recognize the amounts billed as revenue. Distinct goods or services that transfer at a point in time are not eligible for the series guidance. These contracts require the entity to estimate the prices and quantities when determining the transaction price and to allocate the transaction price to the performance obligations perhaps based on the projected quantities to be delivered.

TRG members generally agreed with the staff that the entity should consider all relevant facts and circumstances when evaluating whether the promise to deliver a commodity is transferred over time or at a point in time. They emphasized that evaluating the overall nature of the promise will assist the entity in assessing whether the performance obligation is satisfied over time or at a point in time. The staff agreed to include in the minutes of the meeting examples to illustrate the different outcomes. It is possible that this issue may be reconsidered after additional examples are developed and significant differences in accounting outcomes are identified.

Accounting for Restocking Fees and Related Costs

An entity sometimes charges a customer a restocking fee when a product is returned. The restocking fee is intended to compensate the entity for costs associated with a product return or the reduced selling price an entity may charge when re-selling the product to another customer. TRG members agreed that restocking fees for products expected to be returned should be included as part of the estimated transaction price when control transfers. They said a returned product subject to a restocking fee is similar to a partial return right (i.e., the customer receives a partial refund).

TRG members agreed that the costs related to restocking should be reflected when control of the product transfers as a reduction in the carrying amount of the asset expected to be recovered. This is consistent with the guidance that specifies that any expected costs to recover returned products should be included by reducing the carrying amount of the asset recorded for the right to recover those products.[17]

Practical Expedient for Portfolio of Contracts

The revenue standard includes a practical expedient that allows an entity to account for a portfolio of contracts with similar characteristics as a single unit if the entity reasonably expects that the financial reporting impact would not be materially different from applying the standard to each individual contract. The standard also requires an entity to estimate variable consideration using either the expected value method or the most likely amount when determining the transaction price. The entity's estimate of variable consideration is further constrained to the extent that it is probable (highly probable under IFRS) that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty is resolved.

Stakeholders have questioned whether an entity is using the portfolio method when it considers evidence from similar contracts to develop an estimate using the expected value method. TRG members generally agreed that estimates using the expected value method are made at the contract level, not at the portfolio level. These estimates generally are developed using a portfolio of data when the entity has a sufficiently large number of similar transactions or other history, and that doing so is not using the portfolio practical expedient.

Because of this confusion, some stakeholders have also questioned whether the estimated transaction price under the expected value method can be an amount that is not a possible outcome of an individual contract. For example, an entity enters into contracts with similar terms with a large number of customers. The terms of the contract include a performance bonus related to the timing of completing the contract. Based on historical experience, the bonus amounts and the probabilities of achieving the bonus follow.

Bonus Amount	Probability of Occurrence
$0	15%
$50	40%
$100	45%

[17] FASB ASC paragraph 606-10-55-27, available at www.fasb.org, and IFRS 15.B25.

The estimated transaction price using an expected value method is $65 ([$0 x 15%] + [$50 x 40%] + [$100 x 45%]). The entity further concludes that the constraint does not apply because the entity is sufficiently confident in its estimate. Some believe that the transaction price is $65 because that is the estimate using the expected value method. The contract includes three possible outcomes of which $50 is the probable amount that can be achieved when viewed at a contract level (85 percent likely to achieve at least $50). Therefore, some believe the transaction price is $50 because the outcome could not be $65.

The TRG members generally agreed that when an entity has a sufficient population of similar transactions and uses this data to estimate the transaction price using the expected value method, the transaction price may be an amount that is not a possible outcome for an individual contract. TRG members emphasized that an entity would need to have a sufficiently large number of similar transactions to conclude that the expected value method is the best estimate of the transaction price.

An entity may need to use judgment to determine whether:

- Its contracts with customers are sufficiently similar;
- Contracts from customers in which the expected value is derived are expected to remain consistent with subsequent contracts; and
- The volume of similar contracts is sufficient to develop an expected value.

Completed Contracts at Transition

An entity that applies the modified retrospective approach when adopting the standard will apply it to contracts that are not completed as of the initial application date.

The transition guidance states that a contract is considered completed if the entity has transferred all of the goods and services identified under current U.S. GAAP/IFRS. The concept of transferring control of all goods and services is a new concept in the standard that differs from recognition concepts and rules embedded in legacy U.S. GAAP. This difference in underlying principles may create transition difficulties.

The TRG discussed whether an entity should define a completed contract as a contract in which the goods and services have been delivered, or a contract in which all revenue has been recognized under legacy U.S. GAAP. For contracts considered completed at the initial date of adoption, TRG members discussed whether it is permissible for an entity to recognize revenue based on legacy U.S. GAAP after the effective date of the revenue standard because doing so would result in mixed-GAAP. U.S. TRG members generally agreed that a mixed-GAAP approach would not be in accordance with the standard, but that following this approach could make some revenue disappear because the subsequent settlement or collections would not be reflected as revenue under either legacy U.S. GAAP or the revenue standard.

Example 3: Completed Contracts at Transition

A publicly traded, calendar year-end company sells its products to a distributor on December 15, 2017. The company's accounting policy is to recognize revenue subsequent to the delivery of the related goods when the amounts are due and payable from the distributor. These amounts are not considered fixed or determinable at the time the goods are delivered to the distributor so the entity is on a sell-through basis for revenue recognition under current U.S. GAAP.

The company adopts the revenue standard on January 1, 2018, using the cumulative-effect method of transition. The amounts for the sale of the products are not yet due and payable to the company. The company could conclude that its contract is completed at the date of adoption because it has transferred the goods prior to adoption, even though it has not yet recognized all the revenue from that transaction. Thus, the contract would be outside the scope of the revenue standard.

It is unclear whether subsequent cash collections would be recognized as revenue under legacy U.S. GAAP, or if the cash collections would be recognized as additions to beginning retained earnings.

Some FASB members noted that further consideration of the treatment of completed contracts at transition was warranted, and they requested the FASB staff to prepare further analyses and examples.

Next Steps

The FASB and IASB are working on potential changes to their standards.

- ***Effective Date.*** At its meeting on July 9, 2015, the FASB agreed to defer the effective date of its standard for one year.[18] The IASB is expected to consider the effective date of its standard at its July 22, 2015, meeting.
- ***Principal versus Agent Guidance.*** At their joint June meeting, the FASB and IASB agreed to propose amendments to their respective standards to clarify how the principal versus agent guidance should be applied for determining whether revenue should be presented gross (as a principal) or net (as an agent).[19] Before issuing its exposure draft, the FASB will discuss how to estimate gross revenue when the principal does not have visibility into the selling price to the end customer at a future Board meeting.

[18] See Defining Issues No. 15-30, FASB Finalizes One-Year Deferral of the Revenue Standard, available at www.kpmg-institutes.com.

[19] See Defining Issues No. 15-27, FASB and IASB to Propose Amendments to Principal-Agent Guidance in Revenue Standard, available at www.kpmg-institutes.com.

- ***Licenses of Intellectual Property and Identifying Performance Obligations.*** The comment letter period related to the FASB's exposure draft for identifying performance obligations and licensing of intellectual property ended on June 30, 2015. The FASB is in the process of evaluating comment letters and is expected to begin redeliberations soon.
- ***Transition Practical Expedients, Sales Tax Presentation, Measurement of Noncash Consideration, and Collectibility.*** The FASB expects to issue its exposure draft with a 45-day comment period by August 2015.
- ***IASB Plans.*** The IASB plans to issue a single exposure draft. The IASB exposure draft will propose less extensive changes to the standard than those addressed or to be addressed in the FASB exposure drafts. The IASB expects to issue its exposure draft in July 2015.
- ***Next TRG Meeting.*** The TRG's next meeting is scheduled for November 9, 2015.

Contact us: This is a publication of KPMG's Department of Professional Practice 212-909-5600

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Earlier editions are available at: http://www.kpmg-institutes.com

EUROPEAN PUBLIC
REAL ESTATE ASSOCIATION

13 September 2013

International Accounting Standards Board
30 Cannon Street
London, EC4M 6XH
United Kingdom

Financial Accounting Standards Board
401 Merritt 7
PO Box 5116
Norwalk, Connecticut 06856-5116

Re: FASB File Reference No. 2013-270, *Leases (Topic 842)*, a revision of the 2010 proposed FASB Accounting Standards Update, *Leases (Topic 840)* & IASB Exposure Draft – *Leases* (ED/2013/6)

Dear Sir/Madam,

We are pleased to submit this letter on the International Accounting Standards Board's (IASB) and Financial Accounting Standards Board's (FASB) (collectively "the Boards") Exposure Draft: Leases. We are submitting these comments on behalf of the undersigned investors and property sector analysts. As major investors into property and investment property companies (including REITs) these financial statement users have a strong interest in ensuring that the reporting related to investment property is relevant and transparent.

Recognition of investment property and rental income in line with current IFRS

We are fully supportive of the conclusion reached by the Boards to allow lessors of investment property to continue to recognise the investment property on the lessor's Balance Sheet and full rental income on the lessor's Income Statement for the vast majority of leases. The proposed accounting provides decision-useful information on which to base our evaluation of the investment quality of investment properties and companies that own and operate portfolios of investment property. In addition, the proposed accounting is broadly consistent with current accounting guidance for most commercial real estate leases under both IFRS and U.S. GAAP.

As stated in our letter of November 2010, information regarding the full amount of rental income is fundamental to investors in assessing the performance and investment quality of investment property companies. That is why International Accounting Standard No 40 *Investment Property* (IAS 40) is well supported by industry financial statement preparers reporting under IFRS and industry financial statement users. It requires a property company to disclose the fair value of its property and reports full rental income in the profit and loss account.

We acknowledge the Boards' recognition of IAS 40 in the proposed guidance for accounting by lessees that control property through leasehold interests. Under the proposed accounting, companies that lease property that qualifies as investment property under IAS 40 would be accounted for as investment property. This would include the choice to report these properties at fair value.

Finally, we want to reiterate our previously expressed view that removing the visibility over the investment property, as well as the full rental income, would represent a step backward in terms of investment property companies communicating effectively the profitability and financial position of the company to investors, analysts, and other users.

The investors identified below would be pleased to meet with the Boards or staff to discuss in more detail the views of users of the financial statements of investment property companies.

If you would like to discuss this matter with us, please contact either Andrew Saunders at andrew.saunders@epra.com or George Yungmann at gyungmann@nareit.com.

We thank the FASB and IASB for the opportunity to comment on the Boards' Exposure Drafts with respect to this very important project.

Respectfully submitted,

Investment institutions

Name	**Organisation**	**Property AUM (€million)**	**E-mail**
John Robertson	RREEF	36,700	CONTACT DETAILS PROVIDED SEPARATELY
Guido Bunte	Cornerstone Real Estate Advisers	29,600	
Roger Lees	Aviva Investors	28,500	
Rafael Torres Villalba	All Pension Group (APG)	25,000	
Marc Halle	Pramerica/Prudential	23,400	
Rogier Quirijns	Cohen & Steers	22,300	
Alex Jeffrey	M&G Real Estate	19,000	
Simon Robson	CBRE Clarion Securities	17,400	
Hans Op 't Veld	PGGM Investments	15,400	
Timothy Pire	Heitman	15,300	
Patrick Sumner	Henderson Global Investors	13,000	
Theodore Bigman	Morgan Stanley Investment Management	12,100	

Investment institutions contd.

Bill Hughes	Legal & General Property	10,900	CONTACT DETAILS PROVIDED SEPARATELY
Andrew Jackson	Standard Life Investments	10,400	
Craig Mitchell	Dexus Property Group	9,400	
Saker Nusseibeh	Hermes Real Estate Inv Management	6,500	
Robert Oosterkamp	AEW Global Advisors	6,030	
Stephen Tross	Bouwinvest REIM	6,000	
James Rehlaender	European Investors, Inc	5,100	
Jan Willem Vis	BNP Paribas Investment Partners	3,000	
Jos Short	Internos Global Investors	2,000	
Mark Townsend	Asset Value Investors	1,800	
Frank Haggerty	Duff & Phelps Investment Management	1,400	
Steven Brown	American Century Investments	1,400	
Matthijs Storm	Kempen & Co	1,100	
Vincent Bruyère	Degroof Fund Management Company	250	
Charles Fitzgerald	V3 Capital Management LP	190	

Investment analysts

Name	Organisation	Email
John Lutzius, Mike Kirby	Greenstreet Advisors	CONTACT DETAILS PROVIDED SEPARATELY
Harm Meijer	JP Morgan	
Bart Gysens	Morgan Stanley	
Jan Willem van Kranenburg	ABN AMRO	
Alex Moss	Consilia Capital	
Nick Webb	Exane BNP Paribas	
Steven Sakwa	ISI Group	

NATIONAL ASSOCIATION OF
REAL ESTATE INVESTMENT TRUSTS®

February 15, 2012

Ms. Susan M. Cosper
Technical Director
File Reference No. 2011-220
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, Connecticut 06856-5116

Re: Proposed Accounting Standards Update—*Consolidation (Topic 810): Principal versus Agent Analysis*

Dear Ms. Cosper:

This letter is submitted in response to the request for public comment by the Financial Accounting Standards Board (FASB or the Board) with respect to its proposed Accounting Standards Updates on *Consolidation (Topic 810): Principal versus Agent Analysis* (the Proposed Update).

NAREIT is submitting these comments on behalf of the Real Estate Equity Securitization Alliance (REESA). This alliance includes the following organizations:

- Asia Pacific Real Estate Association, APREA
- British Property Federation, BPF
- European Public Real Estate Association, EPRA
- National Association of Real Estate Investment Trusts (United States), NAREIT
- Property Council of Australia, PCA
- Real Property Association of Canada, REALpac

The purpose and activities of REESA are discussed in Appendix I. Members of the organizations identified above would be pleased to meet with the Board or staff to discuss any questions regarding our comments on the Proposed Update.

1875 I Street, NW, Suite 600, Washington, DC 20006-5413
Phone 202-739-9400 Fax 202-739-9401 REIT.com

We thank the FASB for the opportunity to provide further input on the Consolidation proposal. If you would like to discuss our comments, please contact George Yungmann, NAREIT's Senior Vice President, Financial Standards, at 202-739-9432 or Christopher Drula, NAREIT's Senior Director, Financial Standards, at 202-739-9442.

Respectfully submitted,

George Yungmann
Senior Vice President, Financial Standards

Christopher T. Drula
Senior Director, Financial Standards

cc: Ms. Susan Lloyd, Senior Director, Technical Activities, International Accounting Standards Board

Comment Letter Submitted by the

National Association of Real Estate Investment Trusts (United States), NAREIT

On behalf of the following members of the
Real Estate Equity Securitization Alliance (REESA):

Asian Pacific Real Estate Association, APREA

British Property Federation, BPF

European Public Real Estate Association, EPRA

National Association of Real Estate Investment Trusts (United States), NAREIT

Property Council of Australia, PCA

Real Property Association of Canada, REALpac

In response to the

Proposed Accounting Standards Update—*Consolidation (Topic 810): Principal versus Agent Analysis*

Issued by the

Financial Accounting Standards Board

November 3, 2011

NATIONAL ASSOCIATION OF
REAL ESTATE INVESTMENT TRUSTS®

February 15, 2012

Technical Director
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, Connecticut 06856-5116

Re: Proposed Accounting Standards Update—*Consolidation (Topic 810): Principal versus Agent Analysis*

Dear Sir/Madam:

REESA is made up of seven representative real estate organizations around the world grounded in one or more facets of securitized real estate equity. REESA's broad mission is to improve the opportunities for investment in securitized real estate equity around the globe.

REESA strongly supports the harmonization of global accounting and financial reporting and understands the importance of achieving a high quality universal set of accounting standards. We have been fully engaged in the Boards' discussions on major convergence projects and have actively participated in meetings with the Boards and their staff with respect to these projects. REESA greatly appreciates the opportunities to express our global views through these meetings and comment letters.

One of REESA's goals is to achieve consistent financial reporting by companies that own and operate real estate. REESA has achieved significant consensus on over a dozen accounting standards proposed by the FASB and the International Accounting Standards Board (IASB) (collectively, the Boards) and has submitted comment letters that reflect these global consensus.

REESA commends and supports the Boards' efforts to continue to develop high-quality accounting standards and particularly supports the FASB's efforts to converge U.S. Generally Accepted Accounting Principles (GAAP) with International Financial Reporting Standards (IFRS).

REESA recognizes that differences remain in the FASB's and IASB's consolidation models. However, REESA embraces the changes that the FASB has proposed to align the guidance in US GAAP on determining principal versus agent (and related disclosures) with the guidance in IFRS. We believe that the Proposed Update will improve the comparability of financial statements and disclosures prepared in accordance with U.S. GAAP and IFRS. Therefore, REESA believes that the Proposed Update is a step in the right direction in order to achieve ultimate convergence of U.S. GAAP with IFRS at some point in the future.

We very much appreciate the Board's focus on the Consolidation proposal and the opportunity to share our views with the Board. We welcome the Board's questions on our comments.

Respectfully submitted,

APREA

Asia Pacific Real Estate Association

BPF BRITISH PROPERTY FEDERATION

British Property Federation

EPRA EUROPEAN PUBLIC REAL ESTATE ASSOCIATION

European Public Real Estate Association

NAREIT

National Association of Real Estate Investment Trusts (United States)

PROPERTY COUNCIL of Australia

Property Council of Australia

REALpac Real Property Association of Canada Association des biens immobiliers du Canada

Real Property Association of Canada

Appendix I

REESA – The Real Estate Equity Securitization Alliance

REESA is made up of seven real estate organizations around the world grounded in one or more facets of securitized real estate equity. REESA's broad mission is to improve the opportunities for investment in securitized real estate equity around the globe. The REESA member organizations are:

- Asia Pacific Real Estate Association, APREA
- Association for Real Estate Securitization in Japan, ARES
- British Property Federation, BPF
- European Public Real Estate Association, EPRA
- National Association of Real Estate Investment Trusts, NAREIT®
- Property Council of Australia, PCA
- Real Property Association of Canada, REALpac

REESA has responded positively to the challenges presented by the developments in the global economy and, in particular, the global real estate markets. The benefits of collaboration on a global scale are increasingly valuable on major industry issues such as the sustainability of the built environment, tax treaties, corporate governance and research.

The formation of REESA was, in part, a direct response to the challenge and opportunity presented by the harmonization of accounting and financial reporting standards around the world. Given the size and importance of the real estate industry, our view is that there are considerable benefits to be gained by both accounting standard setters and the industry in developing consensus views on accounting and financial reporting matters, as well as on the application of accounting standards.

Since its formation REESA members have exchanged views on a number of accounting and tax related projects and shared these views with regulators and standards setters. These projects include:

- FASB/IASB Lease Accounting
- FASB/IASB Financial Statement Presentation
- FASB/IASB Reporting Discontinued Operations
- FASB/IASB Revenue Recognition
- FASB/IASB Effective Dates and Transition Methods
- IASB Fair Value Measurement
- IASB Income Tax
- IASB Real Estate Sales – IFRIC D21
- IASB Capitalization of Borrowing Costs – IAS 23
- IASB Accounting for Joint Arrangements – ED 9
- IASB Consolidated Financial Statements – ED 10
- IASB 2007/2008/2009 Annual Improvements to IFRS
- OECD developments on cross border real estate flows and international tax treaties

NATIONAL ASSOCIATION OF
REAL ESTATE INVESTMENT TRUSTS®

September 18, 2013

Technical Director
File Reference No. 2013-270
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, Connecticut 06856-5116

International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Submitted via electronic mail to director@fasb.org

Re: FASB File Reference No. 2013-270, *Leases (Topic 842)*, a revision of the 2010 proposed FASB Accounting Standards Update, *Leases (Topic 840)* & IASB Exposure Draft – *Leases* (ED/2013/6)

Dear Sir/Madam:

This letter is submitted in response to the request for public comment by the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) (collectively, the Boards) with respect to the FASB Proposed Accounting Standards Update (Revised) on *Leases (Topic 842) Leases* and the IASB Exposure Draft - *Leases* (ED/2013/6) (collectively, the Revised Proposed Updates).

NAREIT is submitting these comments on behalf of the following member organizations of the Real Estate Equity Securitization Alliance (REESA):

- Asia Pacific Real Estate Association (APREA)
- British Property Federation (BPF)
- European Public Real Estate Association (EPRA)
- National Association of Real Estate Investment Trusts in the United States (NAREIT®)
- Property Council of Australia (PCA)
- Real Property Association of Canada (REALpac)

REESA is a global alliance of representative real estate organizations and seeks to promote equity investment in real estate on a securitized basis. Together, the members of REESA represent the vast majority of constituent companies in the FTSE EPRA/NAREIT Global Real Estate Index. REESA focuses on cross-border investment, international taxation, financial reporting standards initiatives and education outreach to investors. REESA members represent major operating real estate companies (including REITs) – companies that acquire, develop, lease, manage and opportunistically sell investment property.[1]

Members of the organizations identified above would be pleased to meet with the Boards or staff to discuss any questions regarding our comments on the Revised Proposed Updates.

We thank the Boards for the opportunity to provide further input on the Revised Proposed Updates. If you would like to discuss our comments, please contact George Yungmann, NAREIT's Senior Vice President, Financial Standards, at 202-739-9432, or Christopher Drula, NAREIT's Vice President, Financial Standards, at 202-739-9442.

Respectfully submitted,

George Yungmann
Senior Vice President, Financial Standards

Christopher Drula
Vice President, Financial Standards

[1] REESA's broad mission is to improve the opportunities for investment in securitized real estate equity around the globe. The purpose and activities of REESA are discussed further in Appendix I.

REESA comments and recommendations on FASB File Reference No. 2013-270, *Leases (Topic 842)*, a revision of the 2010 proposed FASB Accounting Standards Update, *Leases (Topic 840)* & IASB Exposure Draft – *Leases* (ED/2013/6)

Preserve the Type B Lease Accounting Model for Property that Recognizes Lease Income on a Straight-line Basis

REESA commends the Boards for their extensive consultation and thoughtful response to our comments. We strongly support the Revised Proposed Updates to allow most lessors of property to continue to recognize the full rental income and underlying property. Total lease income and the visibility over the underlying property are fundamental for investors to be able to assess the performance and investment quality of property companies. This view has been communicated via a submission to the Boards from global real estate investors and industry analysts, and is included as Appendix II to this letter. Removing these metrics would adversely impact the information that property companies communicate to investors, financial analysts and other users of financial statements and would represent a major step backwards in the global industry's efforts to provide meaningful information to financial statement users. In this respect, the proposed model for property is a clear improvement on the model originally proposed in the first exposure draft.

The Revised Proposed Updates would provide financial statement users with information that faithfully represents the underlying economics of *most* property leases for lessors/landlords. As outlined in previous submissions[2] as well as discussions with the Boards and staff, we do not believe that the receivable and residual lessor accounting model is operational for investment property.

Our discussions with real estate analysts reveal that analysts would be forced to unwind the accounting results from the receivable and residual model to effectively evaluate the investment quality of our member companies. This is a significant concern, as analysts would be making buy or sell recommendations based on unaudited financial information provided by our member companies.

We therefore urge the Boards to collaborate on a converged accounting model for property that preserves:

- the property as a single unit of account on balance sheet;

- the recognition of lease income on the income statement generally on a straight-line basis; and,

- the option to present the fair value of right-of-use assets that meet the definition of investment property on the balance sheet in accordance with International Accounting Standard 40 *Investment Property*.

[2] http://www.reit.com/Portals/0/PDF/REESACommentLetter07112011.pdf

We understand that certain of the Boards' constituents may advocate that all leases be accounted for under a single approach. REESA would not object to this conclusion and would fully support it so long as the single approach mirrors the currently proposed approach for Property or Type B leases. In addition, we believe that the vast majority of financial statement preparers and users support the straight-line lease expense pattern yielded by the approach proposed for Type B leases.

We caution the Boards that a conclusion to provide only one approach to accounting for all leases that would require the proposed accounting for Type A leases would not be operational for lessors of multi-tenant investment property. The basis for this view is thoroughly discussed in REESA's July 11, 2011 submission to the Boards[3].

Additional Enhancements to the Revised Proposals

REESA recommends that the Boards consider the following enhancements to the Revised Proposals:

Clearly articulate the definition of "lease term"

REESA concurs with the Revised Proposal that defines the lease term as the non-cancellable period for which a lessee has the right to use the property.

However, we recommend that the current concept of 'reasonably certain' be retained because:

- the Board has acknowledged in BC 140 that the current concept works well in practice and the threshold is expected to be similar to the current concept of 'reasonably certain'; and,

- the definition of 'significant economic incentive' may be less clear than 'reasonably certain.'

We understand that the Boards are concerned that entities would structure shorter term leases with more renewals. However, there is an economic disincentive for lessees to do this as lessors would be able to reset rental payments to the then-current market rent, which would generally increase the fixed rental payments.

In addition, it is common for new lease incentives to be negotiated when the terms of a renewal are being negotiated. In our view, recognizing the lease incentive on a straight-line basis beyond the non-cancellable period of the lease is inappropriate.

Further, REESA is concerned about the continuous reassessment of the lease term. While the

[3]http://www.fasb.org/cs/BlobServer?blobkey=id&blobnocache=true&blobwhere=1175822733314&blobheader=application%2Fpdf&blobcol=urldata&blobtable=MungoBlobs

Revised Proposals only require reassessment when a lessee has, or no longer has a significant economic incentive to renew, or terminate a lease, we question whether practically this is any different to requiring a reassessment at each reporting date.

Classify leases based on the comparison of lease term to the total economic life, rather than to the remaining economic life

REESA agrees with the Revised Proposal that would require the comparison of the lease term to the economic life of the property and the lease payments to the fair value of the property as an appropriate basis for determining whether or not a lessor should apply Type B accounting**.** However, the lease term should be compared to the total economic life, rather than the remaining economic life of the property.

While this scenario is unlikely to arise frequently in the real estate industry, it is not appropriate for a five year lease of property with a ten year remaining economic life to be recognized differently from a five year lease of property with a five year remaining economic life (where the total economic life of both properties was originally 50 years).

Rental payments made by the tenant to the landlord relate partly to the floor space being occupied, but also more significantly to the location of the property. This is demonstrated through different rates per square metre being charged for properties of the same quality in different locations. The value of the location continues to exist at the end of the building's economic life and the landlord holds the residual interest in the property. This enables redevelopment should the landlord choose which would further extend the economic life of the building.

It would therefore not be appropriate to reflect a five year lease of property with a five year remaining economic life (where the total economic life was originally 50 years) as a type A lease, unless the present value test is met.

Assessment of land and buildings together

We agree with paragraphs 842-10-25-9 (FASB exposure draft (FASB ED)) and 33 (IASB exposure draft (IASB ED)) that land and buildings should be assessed together for the purpose of determining the appropriate classification of a lease. However, we are concerned that the Revised Proposed Updates would require the economic life of the building would always be considered to be the economic life of the underlying asset for the purposes of classifying the lease. There are circumstances in which the land element is significantly more valuable than the building. In these cases, it is incorrect to default to the remaining economic life of the building because the land is the more valuable underlying asset and represents the primary asset.

Therefore, we recommend that the guidance in paragraphs 842-10-25-10 (FASB ED) and 33 (IASB ED) be deleted from the final standards. This would ensure that preparers are able to apply the principles in paragraphs 842-10-25-9 (FASB ED) and 33 (IASB ED) in making the determination of the primary asset when a lease contains multiple elements.

Consistently apply the consumption principle to long-term land leases

It is common for real estate companies to lease land under land-only leases, especially in central business districts and other areas where land is owned by local governments. Many of these long-term leases may meet the proposed criteria that define a Type A lease based on the relationship between the present value of the lease payments and the fair value of the land at the lease commencement date. Classifying these long-term land leases as Type A leases is clearly contrary to the overarching consumption principle in the Proposal.

The conclusion that a lease of land should invariably be classified as a Type B lease is also supported by the following discussion taken from the Snapshot: Leases published by IFRS in May 2013[4]:

> *A lessee that enters into a Type A lease, in effect, acquires the part of the underlying asset that it consumes, which is typically paid for over time in the form of lease payments. Accordingly, a lessee would present amortization of the right-of-use asset in the same line item as other similar expenses (for example, depreciation of property, plant, and equipment) and interest on the lease liability in the same line item as interest on other, similar financial liabilities.*
>
> *In contrast, the lease payments made in a Type B lease would represent amounts paid to provide the lessor with a return on its investment in the underlying asset, i.e., a charge for the use of the asset. That return or charge would be expected to be relatively even over the lease term. Accordingly, those payments for use are presented as one amount in a lessee's income statement and recognized on a straight-line basis.*
> *The presentation of cash outflows in the cash flow statement is consistent with the presentation of expenses in the income statement. For Type A leases, the principal portion of cash payments is presented within financing activities and the interest portion within operating or financing activities. Cash payments for Type B leases are presented as one.*

REESA believes that the accounting described above supports the conclusion that land leases represent Type B leases based on the consumption principle.

Further, under current US GAAP, land only leases are considered operating leases unless it is probable that a purchase option would be exercised. One indication that this would occur would be the existence of a bargain purchase option at the end of the lease term.

We understand that the Boards discussed the accounting for long-term land leases at some point in the process of developing a converged leases standard. We believe that the conclusion reached at that time was made prior to the Boards' conclusion to use the consumption principle to distinguish Type A and Type B leases. We urge the Boards to reconsider its conclusion with respect to accounting for land-only leases and strongly recommend that the final standard

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[4] http://www.ifrs.org/Current-Projects/IASB-Projects/Leases/Exposure-Draft-May-2013/Documents/Snapshot-Leases-May-2013.pdf

require that all land leases be classified and accounted for as Type B leases consistent with the Proposal's consumption principle.

At the same time, REESA strongly supports the lessee requirement in the IASB ED for leases to be reported as investment property under IAS 40. Paragraph 35 of the IASB ED makes clear that a lessee shall not classify a lease as a Type A or a Type B lease if it chooses to measure the ROU asset in accordance with the fair value model in IAS 40.

REESA – The Real Estate Equity Securitization Alliance

REESA is made up of seven real estate organizations around the world grounded in one or more facets of securitized real estate equity. REESA's broad mission is to improve the opportunities for investment in securitized real estate equity around the globe. The REESA member organizations are:

- Association for Real Estate Securitization in Japan (ARES)
- Asia Pacific Real Estate Association (APREA)
- British Property Federation (BPF)
- European Public Real Estate Association (EPRA)
- National Association of Real Estate Investment Trusts in the United States (NAREIT®)
- Property Council of Australia (PCA)
- Real Property Association of Canada (REALpac)

REESA has responded positively to the challenges presented by the developments in the global economy and, in particular, the global real estate markets. The benefits of collaboration on a global scale are increasingly valuable on major industry issues such as the sustainability of the built environment, tax treaties, corporate governance and research.

The formation of REESA was, in part, a direct response to the challenge and opportunity presented by the harmonization of accounting and financial reporting standards around the world. Given the size and importance of the real estate industry, our view is that there are considerable benefits to be gained by both accounting standard setters and the industry in developing consensus views on accounting and financial reporting matters, as well as on the application of accounting standards.

Since its formation REESA members have exchanged views on a number of accounting and tax related projects and shared these views with regulators and standards setters. These projects include:

- FASB *Investment Companies*
- FASB *Investment Property Entities*
- IASB *Investment Entities*
- FASB *Consolidation: Principle versus Agent Analysis*
- IASB *Agenda Consultation 2011*
- FASB/IASB *Accounting for Leases*
- FASB/IASB *Financial Statement Presentation*
- FASB/IASB *Reporting Discontinued Operations*
- FASB/IASB *Revenue from Contracts with Customers*
- FASB/IASB *Effective Dates and Transition Methods*
- IASB *Fair Value Measurement*
- IASB *Income Tax*

♦

- IASB *Real Estate Sales – IFRIC D21*
- IASB *Capitalization of Borrowing Costs – IAS 23*
- IASB *Accounting for Joint Arrangements – ED 9*
- IASB *Consolidated Financial Statements – ED 10*
- IASB *2007/2008/2009 Annual Improvements to IFRS*
- OECD developments on cross border real estate flows and international tax treaties

EUROPEAN PUBLIC
REAL ESTATE ASSOCIATION

13 September 2013

International Accounting Standards Board
30 Cannon Street
London, EC4M 6XH
United Kingdom

Financial Accounting Standards Board
401 Merritt 7
PO Box 5116
Norwalk, Connecticut 06856-5116

Re: FASB File Reference No. 2013-270, *Leases (Topic 842)*, a revision of the 2010 proposed FASB Accounting Standards Update, *Leases (Topic 840)* & IASB Exposure Draft – *Leases* (ED/2013/6)

Dear Sir/Madam,

We are pleased to submit this letter on the International Accounting Standards Board's (IASB) and Financial Accounting Standards Board's (FASB) (collectively "the Boards") Exposure Draft: Leases. We are submitting these comments on behalf of the undersigned investors and property sector analysts. As major investors into property and investment property companies (including REITs) these financial statement users have a strong interest in ensuring that the reporting related to investment property is relevant and transparent.

Recognition of investment property and rental income in line with current IFRS

We are fully supportive of the conclusion reached by the Boards to allow lessors of investment property to continue to recognise the investment property on the lessor's Balance Sheet and full rental income on the lessor's Income Statement for the vast majority of leases. The proposed accounting provides decision-useful information on which to base our evaluation of the investment quality of investment properties and companies that own and operate portfolios of investment property. In addition, the proposed accounting is broadly consistent with current accounting guidance for most commercial real estate leases under both IFRS and U.S. GAAP.

As stated in our letter of November 2010, information regarding the full amount of rental income is fundamental to investors in assessing the performance and investment quality of investment property companies. That is why International Accounting Standard No 40 *Investment Property* (IAS 40) is well supported by industry financial statement preparers reporting under IFRS and industry financial statement users. It requires a property company to disclose the fair value of its property and reports full rental income in the profit and loss account.

We acknowledge the Boards' recognition of IAS 40 in the proposed guidance for accounting by lessees that control property through leasehold interests. Under the proposed accounting, companies that lease property that qualifies as investment property under IAS 40 would be accounted for as investment property. This would include the choice to report these properties at fair value.

Finally, we want to reiterate our previously expressed view that removing the visibility over the investment property, as well as the full rental income, would represent a step backward in terms of investment property companies communicating effectively the profitability and financial position of the company to investors, analysts, and other users.

The investors identified below would be pleased to meet with the Boards or staff to discuss in more detail the views of users of the financial statements of investment property companies.

If you would like to discuss this matter with us, please contact either Andrew Saunders at andrew.saunders@epra.com or George Yungmann at gyungmann@nareit.com.

We thank the FASB and IASB for the opportunity to comment on the Boards' Exposure Drafts with respect to this very important project.

Respectfully submitted,

Investment institutions

Name	**Organisation**	**Property AUM (€million)**	**E-mail**
John Robertson	RREEF	36,700	CONTACT DETAILS PROVIDED SEPARATELY
Guido Bunte	Cornerstone Real Estate Advisers	29,600	
Roger Lees	Aviva Investors	28,500	
Rafael Torres Villalba	All Pension Group (APG)	25,000	
Marc Halle	Pramerica/Prudential	23,400	
Rogier Quirijns	Cohen & Steers	22,300	
Alex Jeffrey	M&G Real Estate	19,000	
Simon Robson	CBRE Clarion Securities	17,400	
Hans Op 't Veld	PGGM Investments	15,400	
Timothy Pire	Heitman	15,300	
Patrick Sumner	Henderson Global Investors	13,000	
Theodore Bigman	Morgan Stanley Investment Management	12,100	

Investment institutions contd.

Bill Hughes	Legal & General Property	10,900	CONTACT DETAILS PROVIDED SEPARATELY
Andrew Jackson	Standard Life Investments	10,400	
Craig Mitchell	Dexus Property Group	9,400	
Saker Nusseibeh	Hermes Real Estate Inv Management	6,500	
Robert Oosterkamp	AEW Global Advisors	6,030	
Stephen Tross	Bouwinvest REIM	6,000	
James Rehlaender	European Investors, Inc	5,100	
Jan Willem Vis	BNP Paribas Investment Partners	3,000	
Jos Short	Internos Global Investors	2,000	
Mark Townsend	Asset Value Investors	1,800	
Frank Haggerty	Duff & Phelps Investment Management	1,400	
Steven Brown	American Century Investments	1,400	
Matthijs Storm	Kempen & Co	1,100	
Vincent Bruyère	Degroof Fund Management Company	250	
Charles Fitzgerald	V3 Capital Management LP	190	

Investment analysts

Name	**Organisation**	**Email**
John Lutzius, Mike Kirby	Greenstreet Advisors	CONTACT DETAILS PROVIDED SEPARATELY
Harm Meijer	JP Morgan	
Bart Gysens	Morgan Stanley	
Jan Willem van Kranenburg	ABN AMRO	
Alex Moss	Consilia Capital	
Nick Webb	Exane BNP Paribas	
Steven Sakwa	ISI Group	

NATIONAL ASSOCIATION OF
REAL ESTATE INVESTMENT TRUSTS®

June 30, 2015

Ms. Susan Cosper
Technical Director
File Reference No. 2015-250
Financial Accounting Standards Board
401 Merritt 7
PO Box 5116
Norwalk, Connecticut 06856-5116
director@fasb.org

Delivered Electronically

Re: Proposed Accounting Standards Update *Revenue from Contracts with Customers (Topic 606) Identifying Performance Obligations and Licensing*

Dear Ms. Cosper:

This letter is submitted by the National Association of Real Estate Investment Trusts® (NAREIT) to provide input on the Proposed Accounting Standards Update *Revenue from Contracts with Customers (Topic 606) Identifying Performance Obligations and Licensing* (the Proposal or ED). This letter provides comment only on the issue of clarifying the guidance on when promised goods and services are distinct for purposes of identifying performance obligations.

NAREIT agrees that the Financial Accounting Standards Board (FASB or Board) should clarify the guidance for identifying performance obligations. However, we do not believe that the proposed clarifications (or the original language in Topic 606) provide sufficient clarity on an issue of great importance to our member companies – whether commitments by the lessor/landlord to pay property taxes, maintain insurance, and provide common area maintenance related to leased real estate should be treated as being distinct from the obligation to provide the leased space to the lessee. We therefore request that the FASB clarify that such obligations are not distinct from the leased space either through an example or revised wording as it finalizes the amendments proposed in the ED, and make corresponding changes for the accounting guidance on separating lease and non-lease components that is included within the Proposed *Leases* standard.

NAREIT is the worldwide representative voice for real estate investment trusts (REITs) and publicly traded real estate companies with an interest in U.S. real estate and capital markets. NAREIT's members are REITs and other real estate businesses throughout the world that own, operate and finance commercial and residential real estate. NAREIT's members play an important role in providing diversification, dividends, liquidity and transparency to investors through their businesses that operate in all facets of the real estate economy.

REITs are generally deemed to operate as either Equity REITs or Mortgage REITs. Our members that operate as Equity REITs acquire, develop, lease and operate income-producing real estate. Our members that operate as Mortgage REITs finance housing and commercial real estate, by originating mortgages or by purchasing whole loans or mortgage backed securities in the secondary market.

A useful way to look at the REIT industry is to consider an index of stock exchange-listed companies like the FTSE NAREIT U.S. All REITs Index which covers both Equity REITs and Mortgage REITs. This Index contained 221 companies representing an equity market capitalization of $926 billion at April 30, 2015. Of these companies, 180 were Equity REITs representing 93.3% of total U.S. stock exchange-listed REIT equity market capitalization (amounting to $864 billion)[1]. The remainder, as of April 30, 2015, is represented by 41 stock exchange-listed Mortgage REITs with a combined equity market capitalization of $62 billion.

NAREIT Comments

NAREIT concurs that the guidance in Topic 606 on determining whether promised goods or services are "distinct in the context of the contract" would benefit from additional clarity. NAREIT's main focus relating to the identification and separation of performance obligations has been voiced in previous comment letters submitted in response to both the *Revenue Recognition* and *Leases* Proposals. The issue that NAREIT identified deals with whether lessor commitments to pay property taxes, maintain insurance and perform common area maintenance should be bifurcated from revenue from space rent. Preparers and auditors have questioned whether this was the Board's intention when the Board deliberated the separation of performance obligations in the new *Revenue from Contracts with Customers* standard as well as the separation of lease and non-lease components in the new *Leases* proposal.

Based on our reading of the current *Leases* revised exposure draft, lease revenue may be required to be separated between lease and non-lease components. Lease components would be subject to the new *Leases* accounting guidance, while non-lease components would be subject to the new *Revenue from Contracts with Customers* standard. Because Topic 606 may require that revenue within its scope be presented separately from other revenue, separation would effectively result in a need to present lease revenue separately from revenue from the related tax, insurance and CAM services.

In our view, commitments to pay taxes, maintain insurance, and perform common area maintenance that are included in a lease agreement are highly interdependent and highly

[1] https://www.reit.com/sites/default/files/reitwatch/RW1505.pdf at page 21.

interrelated[2] with the use of the leased real estate. The lessee would not be able to use the leased space in an office building or a shopping center if the real estate:

- was subject to a tax lien,
- did not have an active insurance policy to satisfy its debt agreement on the property, or
- was not properly maintained.

The purpose of the transaction is to lease space in exchange for market rent. Lessees cannot go to the market and separately contract for tax collection services, separate insurance contracts for the structure of a specific office space on/within a floor of a building, or contract with cleaning and maintenance services to clean the common area contiguous to the tenant's space. Given the highly interrelated nature of the tenant reimbursements and the space rent, we believe that the income statement should reflect all of these payments in a single line item[3]. While we believe that the application of the principles of Topic 606, as issued, does not require that such promises be treated as performance obligations distinct from the leased space, some audit firms have espoused different views. As such, while we believe the language in the Proposal also would not require tax, insurance and CAM commitments to be treated separately, we are concerned that differing views will continue.

In order to ensure proper application of the new *Leases* and *Revenue from Contracts with Customers* standards, NAREIT recommends that the Board include an illustrative example that demonstrates how the standards would apply to lease agreements containing tenant reimbursements. NAREIT would be happy to assist the Board in developing an illustration consistent with market realities for inclusion in the final standards.

We thank the FASB for the opportunity to comment on the Proposal. If you would like to discuss our views in greater detail, please contact George Yungmann, NAREIT's Senior Vice President, Financial Standards, at gyungmann@nareit.com or 202-739-9432, or Christopher Drula, NAREIT's Vice President, Financial Standards, at cdrula@nareit.com or 202-739- 9442.

[2] http://www.fasb.org/jsp/FASB/Document_C/DocumentPage?cid=1176166005104&acceptedDisclaimer=true at paragraph 606-10-25-21(c).
[3] In order to meet the needs of investors, NAREIT believes that components of lease revenue that vary directly with related costs (as is often the case is a so-called "net lease", in which a fee is stated for the leased space, with allocations of applicable costs paid in addition to that stated fee) should be disclosed in the notes to the financial statements. To the extent that the lease agreement includes a single rental payment, with no additional amounts paid for allocation of common costs, NAREIT believes the needs of investors would be met with disclosure of the costs incurred for these items, as opposed to requiring an artificial bifurcation of revenue. In our view, these disclosures would adequately convey information about the risks either taken on by the lessor, or passed on to the lessee.

Respectfully submitted,

George L. Yungmann	Christopher T. Drula
Senior Vice President, Financial Standards	Vice President, Financial Standards

♦ ♦ ♦
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September 12, 2013

Ms. Susan Cosper
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director@fasb.org

International Accounting Standards Board
30 Cannon Street
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United Kingdom

Delivered Electronically

Re: File Reference No. 2013-270, *Leases (Topic 842)*, a revision of the 2010 proposed FASB Accounting Standards Update, *Leases (Topic 840)*

Dear Ms. Cosper:

This letter is submitted by the National Association of Real Estate Investment Trusts® (NAREIT) in response to the Proposed Accounting Standards Update (Proposed ASU or the Proposal) from the Financial Accounting Standards Board (FASB) and International Accounting Standards Board (IASB) combined (the Boards) *Leases*.

NAREIT is the worldwide representative voice for real estate investment trusts (REITs) and publicly traded real estate companies with an interest in U.S. real estate and capital markets. NAREIT's members are REITs and other businesses throughout the world that own, operate and finance income-producing real estate, as well as those firms and individuals who advise, study and service those businesses.

REITs are generally deemed to operate as either Equity REITs or Mortgage REITs. Our members that operate as Equity REITs acquire, develop, lease and operate income-producing real estate. Our members that operate as Mortgage REITs finance housing and commercial real estate, by originating mortgages or by purchasing whole loans or mortgage backed securities in the secondary market.

A useful way to look at the REIT industry is to consider an index of stock exchange-listed companies like the FTSE NAREIT All REITs Index, which covers both Equity REITs and Mortgage REITs. This Index contained 189 companies representing an equity market capitalization of $670.4 billion[1] at June 30, 2013. Of these companies, 150 were Equity REITs representing 90.7% of total U.S. listed REIT equity market capitalization (amounting to $608.3 billion). The remainder, as of June 30, 2013, was 39 publicly traded Mortgage REITs with a combined equity market capitalization of $62.1 billion.

This letter has been developed by a task force of NAREIT members, including members of NAREIT's Best Financial Practices Council (the Council). Members of the task force include financial executives of both Equity and Mortgage REITs, representatives of major accounting firms, institutional investors and industry analysts. The financial executives representing Equity REITs are involved in all property sectors of the REIT industry – regional malls, shopping centers, multi-family residential, office, health care, lodging/resorts and industrial. These task force members have a working knowledge of leases related to all of these property types.

NAREIT is a member of the global Real Estate Equity Securitization Alliance (REESA) and supports the views expressed in this organization's comment letter submitted to the Boards.

Executive Summary

NAREIT and its global partners represented in REESA have been active in the Boards' process toward developing a high quality converged standard for accounting and reporting for leases. We have provided input to the Boards and staff on several occasions, through face-to-face meetings with the Boards, through meetings of the Boards, through participation on the Boards' leases working group and via comment letters on the Boards' various proposals. Additionally, NAREIT and REESA have provided support for the Boards' staff on tentative decisions during the Boards' re-deliberations process.

All of this input to the Boards has had one purpose – to achieve an accounting and reporting model that would provide enhanced decision-useful information to our industry's global financial statement users.

The Boards' Response to this Global Real Estate Industry Input

We acknowledge the Boards' thoughtful response to all of the input provided by NAREIT and REESA. While we have a number of suggested modifications to the proposed accounting and reporting model, we strongly support the Boards' conclusions with respect to the property, Type B, model. We believe that this model would provide financial statement users with information that faithfully represents the underlying economics of a landlord's economic position in the great majority of property leases.

[1] http://returns.reit.com/reitwatch/rw1307.pdf at page 21

The Possibility of One Approach to Lease Accounting

We understand that certain constituents of the Boards may advocate that all leases be accounted for under a single approach. NAREIT would not object to this conclusion and would fully support it so long as the single approach mirrors the currently proposed approach for Property or Type B leases. We believe that the vast majority of financial statement preparers and users support the straight-line lease expense pattern yielded by the approach proposed for Type B leases.

We caution the Boards that a conclusion to provide only one approach to accounting for all leases that would require the proposed accounting for Type A leases would not be operational for lessors of multi-tenant investment property. The basis for this view is thoroughly discussed in REESA's July 11, 2011 submission to the Boards[2].

Recommended Modifications to the Proposed ASU

Accounting for Land-Only Leases

It is common for real estate companies to lease land under land-only leases, especially in central business districts and other areas where land is owned by local governments. Then, real estate companies typically develop buildings and related improvements that they lease to third parties. Many of these long-term land-only leases may meet the proposed criteria that define a Type A lease based on the relationship between the present value of the lease payments and the fair value of the land at the lease commencement date. However, classifying these long-term land leases as Type A leases is clearly contrary to the overarching consumption principle in the Proposal.

A conclusion that a lease of land should be accounted in accordance with the guidance provided for Type B leases is fully supported by the following discussion taken from the *Snapshot: Leases* published by IFRS Foundation in May 2013 [3]:

> *A lessee that enters into a Type A lease, in effect, acquires the part of the underlying asset that it consumes, which is typically paid for over time in the form of lease payments. Accordingly, a lessee would present amortization of the right-of-use asset in the same line item as other similar expenses (for example, depreciation of property, plant, and equipment) and interest on the lease liability in the same line item as interest on other, similar financial liabilities.*
>
> *In contrast, the lease payments made in a Type B lease would represent amounts paid to provide the lessor with a return on its investment in the underlying asset, i.e. a charge for the use of the asset. That return or charge would be expected to be relatively even over the lease term. Accordingly, those payments for use are presented as one amount in a lessee's income statement and recognized on a straight-line basis.*

[2] http://www.fasb.org/cs/BlobServer?blobkey=id&blobnocache=true&blobwhere=1175822733314&blobheader=application%2Fpdf&blobcol=urldata&blobtable=MungoBlobs

[3] http://www.ifrs.org/Current-Projects/IASB-Projects/Leases/Exposure-Draft-May-2013/Documents/Snapshot-Leases-May-2013.pdf

> *The presentation of cash outflows in the cash flow statement is consistent with the presentation of expenses in the income statement. For Type A leases, the principal portion of cash payments is presented within financing activities and the interest portion within operating or financing activities. Cash payments for Type B leases are presented as one.*

NAREIT believes that the accounting described in the IFRS Foundation *Snapshot: Leases* above supports the conclusion that land leases represent Type B leases based on the consumption principle.

Recommendation

NAREIT understands that the Boards discussed the accounting for long-term ground leases at some point in the process of developing a converged leases standard. We believe that the conclusion reached at that time was made prior to the Boards' conclusion to use the consumption principle to distinguish Type A and Type B leases. We urge the Boards to reconsider their conclusion with respect to accounting for land-only leases and strongly recommend that the final standard require that all ground leases be classified and accounted for as Type B leases consistent with the Proposal's consumption principle.

Accounting and Reporting for Tenant Reimbursements of Landlord Costs

A significant issue raised by the Proposed ASU is how the Proposal would impact the accounting for *tenant reimbursables* paid to a landlord for the landlord's costs of maintaining *landlord's property* – property required to allow tenants to benefit from space leased from landlord. These costs represent a portion of the tenant's total cost to occupy his/her specific space – the right-of-use asset. The Proposed ASU defines *lease payments* as *payments made by a lessee to a lessor relating to the right to use an underlying asset during the lease term.* Tenant reimbursements of landlord's costs to maintain the common elements of a commercial real estate property are directly related to the tenant's right to use the tenant's space. For example, a tenant could not achieve the economic benefits of his specific space in a retail center without the property's parking lot, common areas of the center, elevators and the like. None of these tenant reimbursables represent payments for services to the tenant or to the tenant's space – the asset underlying the ROU. NAREIT therefore believes that these tenant reimbursements of landlord's costs to maintain common elements of the property represent *lease payments* and should be reported as lease income.

These tenant reimbursables of landlord's costs to maintain the landlord's property would not include payments to the landlord for non-lease services. For example, payments by the tenant for landlord services to maintain *tenant's space* (the underlying asset) or to provide services that are not directly related to the tenant's occupancy of space would represent non-lease income and be accounted for under the Boards' revenue recognition standard.

Recommendation

There has been significant debate among industry participants and accounting firms as to the accounting for tenant reimbursables of landlord costs under the Proposed ASU. We, therefore, suggest that the Boards clarify the accounting for these reimbursements of *landlord's costs associated with landlord's property.*

Reporting under Both Type A and Type B Leases

While the great majority of property leases would qualify as Type B leases, a real estate company may lease some properties under leases that meet the definition of a Type A lease. This situation raises two significant issues.

First, the model of applying the receivable and residual approach to a simple multi-tenant office building, which we created and shared with the Boards' Leases staff, clearly illustrated to us and to the staff that this approach to lessor accounting would not be operational for multi-tenant properties. This situation would be exacerbated if the investment property is carried at fair value.

Second, the reporting for leases based on two lessor accounting models in a company's financial statements would be very confusing to financial statement users.

Recommendation

We recommend that the Boards eliminate this potential reporting issue by requiring that all leases of property be considered Type B leases.

Further Consider the Definition of Property

We believe the Boards have narrowed the definition of *property* to a significant extent. We recommend that the Boards further consider its definition in the Proposed ASU and clarify the Proposal's definition.

Under current U.S. GAAP, "integral equipment" that is subject to a lease is treated as real estate. The FASB Codification Manual Master Glossary defines integral equipment as "any physical structure or equipment attached to real estate that cannot be removed and used separately without incurring significant cost[4]." Therefore, structures such as cell towers are treated as real estate under current U.S. GAAP.

The Proposal introduces a new definition of *property* that would represent a fundamental change to the revenue recognition pattern for leases related to cell towers and similar property. Because these assets would not be considered "land, building, or parts of a building," leases of this property would be classified as Type A leases. In our view, leases of these types of assets should be accounted for as property – not equipment; they are long-lived permanent structures that are

[4] https://asc.fasb.org/glossary&letter=I

attached to the ground. We believe that clarifying the definition of "property" to include "integral equipment" would provide a more principles-based approach to lease classification.

NAREIT continues to support the Boards' efforts to develop a converged global standard for lease accounting and would welcome an opportunity to discuss our views on the Proposed ASU with the Boards. If there are questions regarding this comment letter, please contact either George Yungmann at 202-739-9432 or gyungmann@nareit.com or Christopher Drula at 202-739-9442 or cdrula@nareit.com.

Respectfully submitted,

George L. Yungmann

George L. Yungmann
Senior Vice President, Financial Standards

Christopher T. Drula

Christopher T. Drula
Vice President, Financial Standards

cc: Paul Beswick, Chief Accountant, Securities and Exchange Commission

January 21, 2016

Ms. Susan M. Cosper
Technical Director
File Reference No. 2015-330
Financial Accounting Standards Board
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P.O. Box 5116
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director@fasb.org

Delivered electronically

RE: Proposed Accounting Standards Update – *Business Combinations (Topic 805) – Clarifying the Definition of a Business*

Dear Ms. Cosper:

This letter is submitted by the National Association of Real Estate Investment Trusts® (NAREIT) to provide input on the Proposed Accounting Standards Update – *Business Combinations (Topic 805) – Clarifying the Definition of a Business* (the Proposal).

NAREIT is the worldwide representative voice for real estate investment trusts (REITs) and publicly traded real estate companies with an interest in U.S. real estate and capital markets. NAREIT's members are REITs and other real estate businesses throughout the world that own, operate and finance commercial and residential real estate. NAREIT's members play an important role in providing diversification, dividends, liquidity and transparency to investors through their businesses that operate in all facets of the real estate economy.

REITs are generally deemed to operate as either Equity REITs or Mortgage REITs. Our members that operate as Equity REITs acquire, develop, lease and operate income-producing real estate. Our members that operate as Mortgage REITs finance housing and commercial real estate, by originating mortgages or by purchasing whole loans or mortgage backed securities in the secondary market.

A useful way to look at the REIT industry is to consider an index of stock exchange-listed companies like the FTSE NAREIT All REITs Index which covers both Equity REITs and Mortgage REITs. This Index contained 225 companies representing an equity market capitalization of $935 billion at November 30, 2015. Of these companies, 184 were Equity REITs representing

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94.1% of total U.S. stock exchange-listed REIT equity market capitalization (amounting to $880 billion)[1]. The remainder, as of November 30, 2015, is represented by 41 stock exchange-listed Mortgage REITs with a combined equity market capitalization of $55 billion.

This letter has been developed by a task force of NAREIT members, including members of NAREIT's Best Financial Practices Council (the Council). Members of the task force include financial executives of both Equity and Mortgage REITs, representatives of major accounting firms, institutional investors and industry analysts.

NAREIT supports the Board's objective

NAREIT supports the Board's objective in addressing constituent concerns that the definition of a business in current U.S. GAAP is applied too broadly, resulting in many transactions qualifying as businesses while purchasers view them as asset acquisitions. This phenomenon has been pervasive in the real estate industry since the implementation of FAS 141(R) where the acquisition of even a single property by a REIT is generally required to be accounted for as a business combination. Further, preparers and auditors have struggled to understand why the acquisition of an investment property is accounted for as a business combination, but treated as an asset disposition upon sale of the investment property (a sale of real estate).

What adds further complexity to the asset versus business determination is the difference in application by companies that report pursuant to U.S. GAAP and International Financial Reporting Standards (IFRS). Despite the fact that the words in GAAP and IFRS are identical, real estate companies across the globe that report under IFRS generally account for acquisitions of investment properties as asset acquisitions, while companies that report under U.S. GAAP account for the same types of transactions as business combinations. NAREIT appreciates the Board's efforts to address this divergence in application.

NAREIT Recommendation – Align the accounting guidance for business combinations with existing asset acquisition guidance

While NAREIT appreciates the Board's efforts in pursuing clarified guidance to address what constitutes an asset versus a business, NAREIT believes that the Board could achieve its objective in a much simpler manner. Rather than redefining what would qualify as a business, NAREIT strongly believes that the board should align the accounting guidance for business combinations with existing asset acquisition guidance. A major difference between business combinations guidance and asset acquisition guidance under today's GAAP is whether acquisition transaction costs are capitalized or expensed. NAREIT believes that eliminating this difference by requiring the capitalization of acquisition costs whether a transaction is considered an asset acquisition or a business combination would provide the following benefits to both the preparer and user community alike:

[1] https://www.reit.com/sites/default/files/reitwatch/RW1512.pdf at page 21.

- Simplify accounting by eliminating a need for an evaluation of what constitutes an asset acquisition or a business combination;

- Help converge the accounting results for acquisitions of investment property as between IFRS and U.S. GAAP;

- Mirror the accounting for real estate acquisitions with economics of the transaction; and,

- Eliminate the need by financial statement users in the real estate industry to reverse the expensing of acquisition costs when evaluating the economic earnings prospects of real estate companies.

Other Comments

In the event that the Board decides to pursue the issuance of the Proposal, NAREIT recommends the following clarifications to the Proposal:

- Clarify the wording in paragraph 805-10-55-78 to include the italicized terms below:

    - Although the leases are at market *rates*, REIT concludes that the fair value of the in-place lease *intangible asset is* significant and that the fair value of the gross assets acquired is not concentrated in either the leases or the tangible assets.

        - Without these changes, the wording leads the reader to believe that the analysis would compare the fair value of in-place leases with the fair value of the operating property. This is a circular analysis, given that the fair value of the building is measured by the present value of cash flows to be received under in-place leases.

- Amend the criteria for the evaluation of similar asset types to include a comparison of the types of assets acquired with the acquirer's existing portfolio of assets.

    - For example, if a real estate company that owns and manages a portfolio of office buildings and, therefore has an operating platform focused on office buildings, acquires office properties to add to its portfolio, the acquisition should be accounted for as an asset purchase.

    - Further, some REITs do not own and operate a single asset type. NAREIT groups these REITs into the diversified sector (*e.g.,* a REIT that owns shopping malls, parking lots, and apartment buildings). Many times, these different types of properties are acquired together in single transactions. We believe that the acquisition of different types of assets should be accounted for as an asset acquisition to the extent that the transaction is consistent with the acquirer's business model. If the Board does not provide this clarification, the preparer may be left to debate with his or her auditor whether this acquisition represents similar assets or multiple assets which could provide an uneconomic result that the transaction should be accounted for as a business combination (particularly noting that if acquired separately, they would be asset acquisitions).

- Add guidance that clarifies that the acquisition of multiple properties that are in various stages of development would still be considered similar assets.

    - Along the same lines as the preceding bullet, REITs can acquire a group of assets that are in various stages of development (*e.g.*, buildings under construction, vacant buildings, and operating properties). NAREIT recommends that the Board clarify that a transaction that includes properties at different stages of development would be considered similar in nature. The business purpose of acquiring the group of assets serves the same purpose – to add investment property to the company's current portfolio of investment properties. In our view, the economics of the transaction is more akin to an asset acquisition than a business combination.

NAREIT continues to support the FASB's *Clarifying the Definition of a Business* Project. If there are questions regarding this comment letter, please contact either George Yungmann at 202-739-9432 or gyungmann@nareit.com or Christopher Drula at 202-739-9442 or cdrula@nareit.com.

Respectfully submitted,

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Senior Vice President, Financial Standards

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Vice President, Financial Standards

NATIONAL ASSOCIATION OF
REAL ESTATE INVESTMENT TRUSTS®

May 29, 2015

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Delivered Electronically

Re: Proposed Accounting Standards Update *Revenue from Contracts with Customers (Topic 606) Deferral of Effective Date*

Dear Ms. Cosper:

This letter is submitted by the National Association of Real Estate Investment Trusts® (NAREIT) to provide support and input to the Proposed Accounting Standards Update *Revenue from Contracts with Customers (Topic 606) Deferral of Effective Date* (the Proposal). For reasons discussed further below, NAREIT agrees that the Financial Accounting Standards Board (FASB or Board) should defer the effective date of *Revenue from Contracts with Customers* Standard (the *Revenue Recognition* Standard).

NAREIT is the worldwide representative voice for real estate investment trusts (REITs) and publicly traded real estate companies with an interest in U.S. real estate and capital markets. NAREIT's members are REITs and other real estate businesses throughout the world that own, operate and finance commercial and residential real estate. NAREIT's members play an important role in providing diversification, dividends, liquidity and transparency to investors through their businesses that operate in all facets of the real estate economy.

REITs are generally deemed to operate as either Equity REITs or Mortgage REITs. Our members that operate as Equity REITs acquire, develop, lease and operate income-producing real estate. Our members that operate as Mortgage REITs finance housing and commercial real estate, by originating mortgages or by purchasing whole loans or mortgage backed securities in the secondary market.

A useful way to look at the REIT industry is to consider an index of stock exchange-listed companies like the FTSE NAREIT U.S. All REITs Index, which covers both

Equity REITs and Mortgage REITs. This Index contained 220 companies representing an equity market capitalization of $966 billion at March 31, 2015 Of these companies 179 were equity REITs representing 93.6% of total U.S. stock exchange-listed REIT equity market capitalization (amounting to $904 billion)[1]. The remainder, as of March 31, 2015, is represented by 41 stock exchange-listed mortgage REITs with a combined equity market capitalization of $62 billion.

NAREIT Recommendation

NAREIT concurs with the Proposed Deferral of the *Revenue Recognition* Standard. While NAREIT does not have a strong preference for a one year or two year deferral, NAREIT recommends that the Board align the effective date with that of other standard setting on the Board's agenda that will impact the real estate industry (*i.e., Leases, Clarifying the Definition of a Business*, and *Revenue Recognition – Identifying Performance Obligations and Licenses* Projects).

Revenue Recognition and Leases Projects

Through our evaluation of exposure drafts and observing the Boards' ongoing re-deliberations, NAREIT has identified the following examples where the *Revenue Recognition* and *Leases* Projects are interrelated:

- Scope - The *Revenue Recognition* Standard clearly excludes leases from the scope of the standard. Similarly, if a contract does not meet the definition of a lease within the *Leases* Proposal, then the contract would probably be subject to the *Revenue Recognition* Standard for the party providing the service.

- Accounting for Sales-type Leases by Manufacture/Dealers – While leases are outside the scope of the new *Revenue Recognition* Standard, accounting for sales-type leases would be in scope. The timing of profit recognition will be determined by whether control has passed from the seller to the purchaser pursuant to the new *Revenue Recognition* Standard.

- Sale-leaseback transactions – While leases are outside the scope of the new *Revenue Recognition* Standard, accounting for sales would be in scope. Whether or not sales treatment is achieved will impact the ensuing treatment of the lease transaction.

- Collectability – Collectability of rent by the lessor assessed pursuant to the new *Revenue Recognition* Standard will affect the lessors' accounting (We note here in passing that both Type A lease receivables and residual values and Type B lease receivables will be subject to the new impairment guidance under development).

[1] https://www.reit.com/sites/default/files/reitwatch/RW1504.pdf at page 21.

Revenue Recognition – Identifying Performance Obligations and Licenses and *Leases* Projects

An area that continues to be of particular interest is the accounting treatment for tenant reimbursements by lessors. In a situation where a gross lease is negotiated between a landlord and tenant, the lease agreement will specify a single amount that the tenant will pay in rent. This amount will include other items beyond the payment to rent the space, including common area maintenance, taxes, insurance, and perhaps other services. Preparers and auditors alike continue to grapple with whether a portion of the rent payment should be allocated to these other embedded items. In our view, the answer to this question could have a significant impact on the financial statements. For example, this could impact the amount of the lease payables and receivables recognized on the balance sheet, income statement presentation, and footnote disclosure in the lease commitment table.

Revenue Recognition and *Accounting for Sales of Real Estate*

The determination of whether real estate meets the definition of a business under the FASB's *Clarifying the Definition of a Business* Project could have a significant impact on accounting for sales of real estate including, most notably, partial sales of real estate. If real estate does not meet the definition of a business, the accounting treatment of the sale will presumably follow the new *Revenue Recognition* Standard. If real estate meets the definition of a business, the accounting treatment for the sale may ultimately be outside the scope of the *Revenue Recognition* Standard, and be subject to Consolidation guidance. A complicating scenario that has not yet been addressed by the new *Revenue Recognition* Standard is the accounting treatment for partial sales of real estate. With the removal of sections of Accounting Standards Codification (ASC) 360 *Property, Plant, and Equipment* that deals with sales of real estate (formerly FAS 66 *Accounting for Sales of Real Estate*), questions surround how to account for partial sales of real estate.

Transition

Because of the significance of these other Projects and their interrelationship to the *Revenue Recognition* Standard, NAREIT does not support an option to early adopt the *Revenue Recognition* Standard. Further, NAREIT values comparability across the industry to be of utmost importance so that investors and analysts can readily compare the operating performance of NAREIT member companies.

We thank the FASB for the opportunity to comment on the Proposal. If you would like to discuss our views in greater detail, please contact George Yungmann, NAREIT's Senior Vice President, Financial Standards, at gyungmann@nareit.com or 202-739-9432, or Christopher Drula, NAREIT's Vice President, Financial Standards, at cdrula@nareit.com or 202-739- 9442.

Respectfully submitted,

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NATIONAL ASSOCIATION OF REAL ESTATE INVESTMENT TRUSTS®

July 25, 2014

Chairman Russell Golden
Financial Accounting Standards Board
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Norwalk, Connecticut 06856-5116

Delivered Electronically

Subject: Lease Accounting Project, Accounting for Initial Direct Leasing Costs

Dear Chairman Golden:

The National Association of Real Estate Investment Trusts (NAREIT®) is submitting this unsolicited comment letter to provide the Financial Accounting Standards Board (FASB) its views on the financial reporting implications of the proposed accounting for initial direct leasing costs on companies that own, operate and lease portfolios of investment property.

NAREIT is the worldwide representative voice for real estate investment trusts (REITs) and publicly traded real estate companies with an interest in U.S. real estate and capital markets. NAREIT's members are REITs and other real estate businesses throughout the world that own, operate and finance commercial and residential real estate. NAREIT's members play an important role in providing diversification, dividends, liquidity and transparency to investors through their businesses that operate in all facets of the real estate economy.

REITs are generally deemed to operate as either Equity REITs or Mortgage REITs. Our members that operate as Equity REITs acquire, develop, lease and operate income-producing real estate. Our members that operate as Mortgage REITs finance housing and commercial real estate, by originating mortgages or by purchasing whole loans or mortgage backed securities in the secondary market.

A useful way to look at the REIT industry is to consider an index of stock exchange-listed companies like the FTSE NAREIT U.S. Real Estate Index, which covers both Equity REITs and Mortgage REITs. This Index contained 209 companies representing an equity market capitalization of $804 billion at May 31, 2014. Of these companies, 169 were equity REITs representing 91.2% of total U.S. listed REIT equity market capitalization (amounting to $733 billion)[1]. The remainder, as

[1] http://www.reit.com/sites/default/files/reitwatch/RW1406.pdf at page 21.

♦ ♦ ♦

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of May 31, 2014, was 40 publicly traded mortgage REITs with a combined equity market capitalization of $71 billion.

Implications of Recent Tentative Decision on "Initial Direct Costs"

At the joint meeting held on May 21, 2014, the Boards tentatively decided that "initial direct costs" should include only incremental costs that an entity would not have incurred if the lease had not been obtained (executed) (for example, commissions or payments made to existing tenants to obtain the lease). These costs could include external and certain internal costs but would not include allocations of internal costs, for example, regular salaries of employees engaged in arranging and negotiating leases.

The decision to allow the capitalization of *only* incremental costs represents a major change from existing U.S. GAAP and, in practice, IFRS. Currently, many companies capitalize all internal direct leasing costs provided that they are able to clearly identify those costs as directly attributable to obtaining successful lease agreements. The costs capitalized are not required to be incremental. Under the proposed accounting, significant internal costs of leasing may not be considered *incremental*. In our view, there is no conceptual basis for, in effect, accounting for direct *internal* leasing costs related to signed leases differently than direct *external* leasing costs.

The implication of no longer permitting the capitalization of a major portion of *direct* costs of internal efforts in securing tenant leases would have a significant detrimental impact on the operating results of NAREIT's member companies and potentially their share prices. This divergence of accounting for direct leasing costs between internal and external costs would clearly result in the lack of comparable operating results between companies having similar substantive leasing efforts despite similarity in economics. In the event that the Board continues in the direction of its May 21 decision, NAREIT is concerned that the proposed accounting standard would create structuring opportunities by encouraging companies to outsource their leasing function to third parties to achieve the most advantageous accounting result. Investors would be harmed if issuers undertake non-economic steps merely to achieve better financial statement results.

The Critical Nature of Leasing Investment Property

Leases generate rental revenue, which is the most important element in generating earnings, cash flow and in the valuation of an investment property. The cash flow from an investment property is the basis on which the property is valued and this property value directly impacts the share price of real estate investment trusts. See Exhibit I *REIT Valuation; The NAV-based Pricing Model* for a full discussion of the relationship between property cash flows (driven primarily by lease revenue), property values and the evaluation of share price.

Generally, a company will develop a leasing plan for each project. These plans identify spaces in each property that are or that will become vacant. With the help of market research, management assigns target rents for each space. Similarly, before making a decision to acquire or develop a property, management will evaluate the market and develop a leasing plan as a critical part of evaluating whether the project's cash flows will generate an adequate economic return.

These leasing plans are typically executed by the internal leasing staff; in some cases supplemented by external leasing resources. Achieving the leasing targets underlies the growth in operating performance of an investment property. Internal leasing staff is generally compensated at a base salary often plus bonuses based on achievement of overall leasing targets. These costs support the same business function as external leasing resources and are generally less costly and more effective than external leasing agents.

The critical nature of leasing in the effort to maximize returns from investment property is evidenced by the significant disclosures made by companies about the impact of leasing on future operating performance. These disclosures are contained in a REIT's Management's Discussion and Analysis, as well as in the company's supplemental reporting materials. See Exhibit II, *Duke Realty Supplemental Information* first quarter 2014, particularly the *Property Information* section, for an illustration of lease and tenant information generally included in a REIT's supplemental materials.

Because of the critical nature of leasing, most of NAREIT's member companies maintain internal leasing staff. They are an integral part of the management team and not simply hired guns with no long-term stake in the company's success. It would be a step backward in reporting the economics of investment property operating performance if the direct costs of this critical internal leasing staff were accounted for differently from the costs of external leasing resources, which, may not be aligned with the company's long-term success.

Further, it would be a very unfortunate result if the proposed accounting forced companies to abandon the most effective leasing structure (internal leasing staff) for a structure external to the management of the company or to dramatically change their compensation arrangements with their leasing staff in order to achieve a desired accounting outcome with limited change in overall economics. There seems to be three possible alternatives for structuring the leasing function under the FASB's most recent decision:

- Maintain current internal structure and expense a significant portion of the cost of internal leasing staff, even when direct efforts result in signed lease agreements;

- Maintain an internal structure but modify the compensation structure to pay staff based on a minimal base salary plus a commission for signed leases (we assume this arrangement would meet the *incremental* criteria for capitalizing leasing costs); or,

- Engage external leasing services, which our industry firmly believes may be less effective and more expensive, and therefore an economic drag on operating results.

NAREIT believes strongly that the proposed Leases standard, which was not intended to change the general model for lessor accounting, should not provide impetus for restructuring a REIT's leasing function to be able to properly capitalize all direct leasing costs.

Current Accounting for Internal Leasing Costs

While practice is mixed in some IFRS jurisdictions, most investment property companies in North America have developed systems to capture the cost of internal leasing effort *directly* related to signed leases. These costs are capitalized and amortized over the term of the related lease in accordance with the guidance in Topic 840 of the U.S. GAAP Accounting Standards Codification (ASC) and, as applied in practice, paragraph 38 of IAS 17, *Leases*.

ASC 840-20-25-18 states "The costs directly related to those activities shall include only that portion of the employees' total compensation and payroll-related fringe benefits directly related to time spent performing those activities for that lease and other costs related to those activities that would not have been incurred but for that lease."

IAS 17 paragraph 38 states that "(I)nitial direct costs are often incurred by lessors and include amounts such as commissions, legal fees and internal costs that are incremental and directly attributable to negotiating and arranging a lease."

In Agenda paper 11A of the March 22-23, 2011 meeting of the IASB/FASB, the staff recommendation was "that *initial direct costs* should be defined as: Costs that are directly attributable to negotiating and arranging a lease that would not have been incurred had the lease transaction not been made." It was also noted that "(V)ery little feedback about the definition of initial direct costs was received. The staff thinks that the definition in the ED is appropriate and **consistent with current lease guidance under Topic 840 and IAS 17. The staff notes that the proposed definition is not intended to change current practice for how initial direct costs are defined"** [emphasis added].

Absent the Board overturning its May 21, 2014 decision, it appears that the Boards will change current practice despite the intentions previously expressed by both the Boards and their respective staff. To emphasize, the current accounting practice that reflects the direct relationship between rental revenues and the cost to generate that revenue has been applied for decades and results in the most relevant measurement of operating performance of real estate companies and should be able to be continued.

The Boards' Due Process

NAREIT respectfully, but strongly, objects to the way in which the accounting for initial direct leasing costs was handled in the *Leases* project exposure drafts. The language used in the May 2013 Revised Exposure Draft (the Revised ED) was quite similar to the guidance in Topic 840, particularly when considering the implementation guidance. While Topic 840 did not use the word "incremental" to qualify leasing costs for capitalization, the definition of incremental was similar to the language in Topic 840, which allowed the capitalization of all direct internal costs related to signed leases.

In addition, some constituents were confused based on their view that the definition of initial direct costs in the Revised ED appeared to be inconsistent with the examples provided in the Implementation Guidance.

As a result, NAREIT believes that many constituents concluded that the standard would not change current accounting practice for initial direct leasing costs, and therefore, did not object to this guidance in the Revised ED. It seems as though the Boards have based a major decision on short-circuited constituent input.

IFRIC's Review of this Matter

NAREIT understands that the IFRS Interpretations Committee (IFRIC) discussed this matter in November 2013 and April 2014 and concluded, for a number of reasons, not to add the topic of accounting for *incremental costs* to its agenda. NAREIT is aware of two comment letters that discuss the practice of maintaining internal leasing staff and the basis for capitalizing the costs of all direct internal, as well as external, leasing resources. These letters are attached as Exhibit III (*i.e.*, Real Property Association of Canada (REALpac)) and Exhibit IV (*i.e.*, EY).

NAREIT's Recommendation: Develop a Comprehensive and Consistent Accounting Standard for Costs (both Direct and Indirect).

NAREIT understands that the accounting treatment for costs is an area that varies widely within U.S. GAAP. Costs come in varying types and definitions (*e.g.*, commitment fees, credit card fees and costs, loan syndication fees, loan origination fees and direct loan origination costs, interest costs, insurance acquisition costs, costs of acquiring non-financial assets, etc.) and U.S. GAAP permits capitalization of costs in certain circumstances.

Given the wide diversity of accounting treatment for cost within U.S. GAAP, NAREIT recommends that the FASB forgo further evaluation of accounting for initial direct cost within the *Leases* project. In our view, a robust and comprehensive analysis of cost accounting treatment that would cut across all GAAP literature should be added to the FASB's agenda. We believe that this project would provide a comprehensive cost accounting model and eliminate inconsistencies as a result of dealing with costs on a piece-meal basis in future standard setting.

We offer the following citations as examples of the spectrum of accounting models for capitalizing and expensing costs:

Costs that are Fully Capitalized

The following excerpt is taken from ASC *Property, Plant and Equipment*.

> ASC 360-10-30-1 Paragraph 835-20-05-1 states that the historical cost of acquiring an asset includes the costs necessarily incurred to bring it to the condition and location necessary for its intended use. As indicated in that paragraph, if an asset requires a period of time in which to carry out the activities

> necessary to bring it to that condition and location, **the interest cost incurred during that period as a result of expenditures for the asset is a part of the historical cost of acquiring the asset** [emphasis added].

The following excerpt is taken from the *Financial Instruments – Recognition and Measurement* 2013 Proposal. NAREIT observes that there is no proposed change from current GAAP for loan origination costs. We also note that it appears that the Boards are treating direct finance leases in a different manner when they are economically similar to a loan.

> Direct Loan Origination Costs
>
> Direct loan origination costs represent costs associated with originating a loan. Direct loan origination costs of a completed loan shall include only the following:
>
> a. Incremental direct costs of loan origination incurred in transactions with independent third parties for that loan
>
> b. Certain costs directly related to specified activities performed by the lender for that loan. Those activities include all of the following:
>
>   1. Evaluating the prospective borrower's financial condition
>   2. Evaluating and recording guarantees, collateral, and other security arrangements
>   3. Negotiating loan terms
>   4. Preparing and processing loan documents
>   5. Closing the transaction.
>
> The costs directly related to those activities shall include only that portion of the employees' total compensation and payroll-related fringe benefits directly related to time spent performing those activities for that loan and other costs related to those activities that would not have been incurred but for that loan. See Section 310-20-55 for examples of items.

The following excerpt is taken from the *Insurance Contracts* Proposal.

> ASC 944-30-25-1 An insurance entity shall capitalize only the following as acquisition costs related directly to the successful acquisition of new or renewal insurance contracts:
>
> a. Incremental direct costs of contract acquisition

> b. The portion of the employee's total compensation (excluding any compensation that is capitalized as incremental direct costs of contract acquisition) and payroll-related fringe benefits related directly to time spent performing any of the following acquisition activities for a contract that actually has been acquired:
>
> 1. Underwriting
>
> 2. Policy issuance and processing
>
> 3. Medical and inspection
>
> 4. Sales force contract selling.
>
> c. Other costs related directly to the insurer's acquisition activities in (b) that would not have been incurred by the insurance entity had the acquisition contract transaction(s) not occurred.
>
> d. Advertising costs that meet the capitalization criteria in paragraph 340-20-25-4.

Costs that are Partially Capitalized

The following excerpt is taken from ASC *Receivables*.

> ASC 310-20-25-6 **Bonuses based on successful production of loans that are paid to employees involved in loan origination activities are partially deferrable as direct loan origination costs** under the definition of that term. Bonuses are part of an employee's total compensation. The portion of the employee's total compensation that may be deferred as direct loan origination costs is the portion that is directly related to time spent on the activities contemplated in the definition of that term and results in the origination of a loan [emphasis added].

The following excerpts are taken from the recently issued *Revenue from Contracts with Customers* Standard.

> ASC 340-40-55-1 Example 1 illustrates the guidance in paragraphs 340-40-25-1 through 25-4 on incremental costs of obtaining a contract, paragraphs 340-40- 25-5 through 25-8 on costs to fulfill a contract, and paragraphs 340-40-35-1 through 35-6 on amortization and impairment of contract costs.
>
> > > > Example 1—Incremental Costs of Obtaining a Contract
> 340-40-55-2 An entity, a provider of consulting services, wins a competitive bid to provide consulting services to a new customer. The entity incurred the following costs to obtain the contract:

External legal fees for due diligence	$15,000
Travel costs to deliver proposal	25,000
Commissions to sales employees	10,000
Total costs incurred	$50,000

> 340-40-55-3 In accordance with paragraph 340-40-25-1, the entity recognizes an asset for the $10,000 incremental costs of obtaining the contract arising from the commissions to sales employees because the entity expects to recover those costs through future fees for the consulting services. The entity also pays discretionary annual bonuses to sales supervisors based on annual sales targets, overall profitability of the entity, and individual performance evaluations. In accordance with paragraph 340-40-25-1, the entity does not recognize an asset for the bonuses paid to sales supervisors because the bonuses are not incremental to obtaining a contract. The amounts are discretionary and are based on other factors, including the profitability of the entity and the individuals' performance. The bonuses are not directly attributable to identifiable contracts.
>
> 340-40-55-4 The entity observes that the external legal fees and travel costs would have been incurred regardless of whether the contract was obtained. Therefore, in accordance with paragraph 340-40-25-3, those costs are recognized as expenses when incurred, unless they are within the scope of another Topic, in which case, the guidance in that Topic applies.

Costs that are Fully Expensed

The following excerpt is taken from ASC *Business Combinations*.

> ASC 805-10-25-23 Acquisition-related costs are costs the acquirer incurs to effect a business combination. These costs include finder's fees; advisory, legal, accounting, valuation, and other professional and consulting fees; general administrative costs, including the costs of maintaining an internal acquisitions department; and costs of registering and issuing debt and equity securities. **The acquirer shall account for acquisition-related costs as expenses in the periods in which the costs are incurred and the services are received**, with one exception. The costs to issue debt or equity securities shall be recognized in accordance with other applicable GAAP [emphasis added].

Conclusion

NAREIT objects to the Board's conclusion with respect to initial direct leasing costs, and respectfully requests that the Board reverse the decision in order to preserve current practice. On numerous occasions, the Board has asserted that the intention was not to change current lessor accounting; however, the Board's decision with respect to leasing costs would change the accounting by many lessors of investment property. As we have said in our previous letters to the Boards, we do not believe that current lessor accounting model is broken, and fail to see the reason to create inconsistent accounting results between significant direct internal and external leasing costs that do not reflect the underlying economics of obtaining successful lease agreements.

NAREIT would like to meet with the Board to discuss our views in greater detail. Please contact George Yungmann, NAREIT's Senior Vice President, Financial Standards, at gyungmann@nareit.com or 202-739-9432 to arrange a time for this meeting. If you have questions regarding this letter, please contact George Yungmann or Christopher Drula, NAREIT's Vice President, Financial Standards, at cdrula@nareit.com or 202-739-9442.

Respectfully submitted,

George Yungmann
Senior Vice President, Financial Standards
NAREIT

Christopher T. Drula
Vice President, Financial Standards
NAREIT

cc: Chairman Hans Hoogervorst
International Accounting Standards Board

Exhibit I

REIT Valuation
The NAV-based Pricing Model

Green Street Advisors

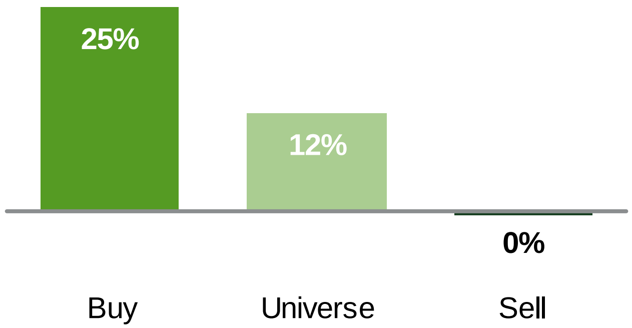
It's All Relative

Our NAV-based Pricing Model has served as the backbone of our stock selection process for over twenty years. The model is designed to assess relative valuations; i.e., it identifies the REITs that are most/least attractively valued.

The model combines NAV – a great starting point and high quality estimates are essential – with the factors that impact the premiums at which REITs should trade: franchise value, balance sheet risk, corporate governance, and overhead. The compartmentalized nature of the model forces discipline to consider all relevant valuation issues.

An Impressive Track Record

20+Yr Annualized Total Return of Green Street's Stock Recommendations*



* Past performance (as of 5/30/14) can not be used to predict future performance. Please see recommendation track record disclosure on page 20

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This report is an excerpt from REIT Valuation: Version 3.0 of our Pricing Model

Table of Contents

Sections

Executive Summary

Overview

- Our NAV-based pricing model has been a driver of our stock recomendations for over twenty years
- It has played an instrumental role in our successful recommendation track record
- The compartmentalized nature of the model forces discipline to consider all relevant valuation issues

The Basics

- NAV is the starting point - the value of a REIT is a function of the value of the assets it owns
- Warranted share price = NAV plus or minus a premium for future value added by management
- Franchise value, balance sheet risk, corporate governance and G&A impact the size of the premium
- It is a relative valuation model: roughly equal number of Buys and Sells at all times
- Relative approach anchors around average sector premiums at which REITs trade

The Components

- Franchise values are inherently subjective, but objective inputs help
  - Management Value Added (MVA) shines a bright light on performance attributable to mgm't
  - Total returns relative to peers are also important
  - Balance sheet acumen scores give credit for broad financing menus and low debt costs
- Balance sheets are important; less leverage is better
  - REITs with less leverage have delivered far better returns
  - Investors usually ascribe higher NAV premiums to REITs with low leverage
- Corporate Governance scoring system ranks REITs in a systematic fashion
- The impact of G&A is readily quantified and is dealt with apart from the other factors
  - Differences in G&A are large; they warrant large differences in unlevered asset value premiums

Overview: A Disciplined Approach Toward Stock Selection

A Key Driver of Success: The Green Street NAV-based pricing model is designed to assess the valuation of any REIT relative to sector-level peers. The discipline and rigor the model embodies have played a pivotal role in the two-decade-long success of our recommendation track record. While the model is designed to be neutral with regard to whether REITs in aggregate are cheap or expensive, investors can employ other Green Street analytic tools to help assess overall valuation and/or sector allocation issues.

Company Research

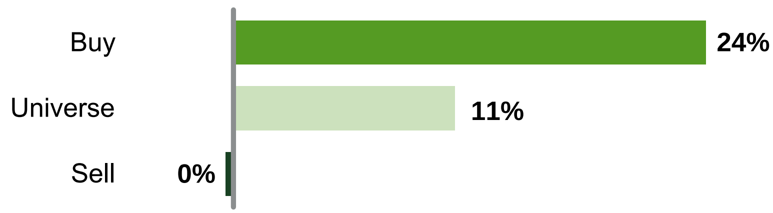
NAV-Based Pricing Model

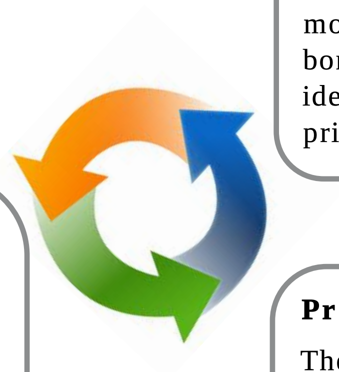
NAV
+ Warranted Premium to NAV
= Warranted Share Price

Stock Recomendations

The NAV-based Pricing Model, coupled with heavy analyst input, drives our stock recommendations. The recommendations are always market and sector neutral.

20+Yr Annualized Returns of Green Street's Recommendations*





Macro Research

Overall REIT Valuation

The ***RMZ Forecast Tool***, published monthly, assesses overall REIT valuation vs. bonds and stocks. Has proven very helpful in identifying periods when REITs are badly mis-priced.

Property Sector Allocation

The ***Commercial Property Outlook***, published quarterly, addresses sector-level valuation questions with a focus on the long term. It is based on extensive research we've published on long-term sector performance and cap-ex requirements.

* Past performance can not be used to predict future performance. Please see recommendation track record disclosure on page 20

Overview: Why Use NAV?

Because We Can: Most equity investors focus a great deal of attention on P/E multiples and/or yields, so it is fair to question why NAV should be the primary valuation benchmark for REITs. The short answer is that investors elsewhere would use NAV if they could, but the concept doesn't translate well to companies that are not in the business of owning hard assets. Because the value of a REIT is, first and foremost, a function of the value of the assets it owns, NAV is a great starting point for a valuation analysis.

Too Simplistic

~~Dividend Yield~~

~~FFO Yield or Multiple~~

~~AFFO Yield or Multiple~~

Far Better

Net Asset Value "NAV"

Good NAV estimates are critical and they require serious resources

Discounted Cash Flow "DCF"

We use DCF internally to double-check results

There is More to it Than Just NAV

Compartmentalized Analysis Looks at Relevant Factors

NAV: The Starting Point

+

The Warranted Premium to NAV

Warranted premiums are a function of:

– Premiums Ascribed by the Market to Other REITs
– Franchise Value
– Balance Sheet Risk
– Corporate Governance
– Overhead (G&A expenses)

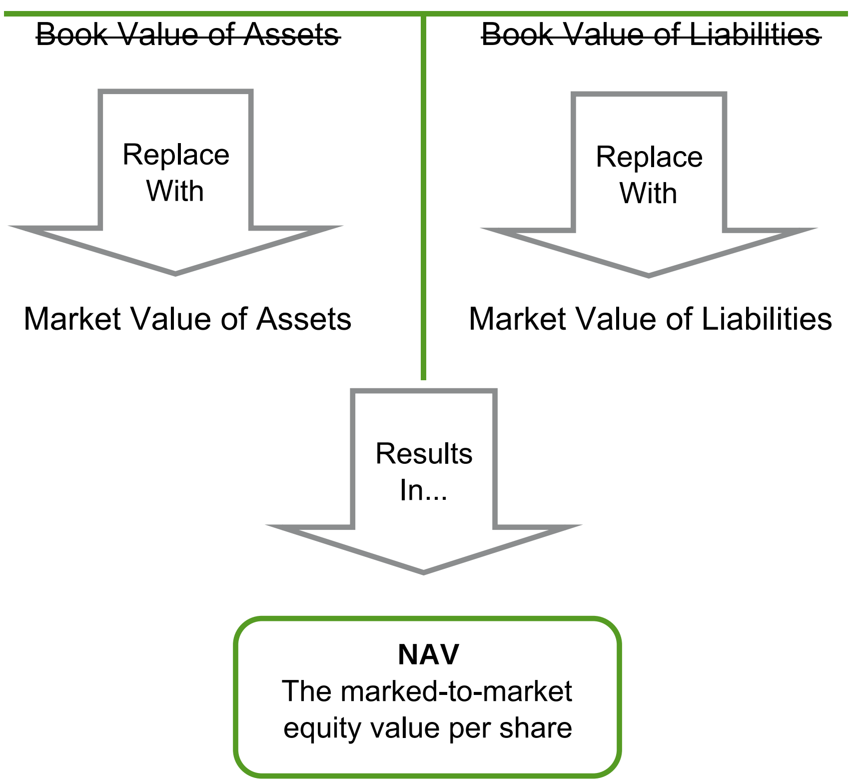
Warranted Share Price

Used to compare valuations *relative* to those of other REITs. It's fair to call it "relative intrinsic value."

Overview: What is NAV?

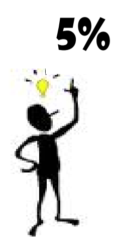
Mark It to Market: An NAV-based valuation methodology is only as good as the underlying estimate of NAV. High-quality estimates of marked-to-market asset value require a great deal of effort and resources, but the estimate can be reasonably precise when done properly. It is also important to mark-to-market the right-hand side of the balance sheet, as the cost of in-place debt can stray substantially from prevailing market. Many market participants skip this important step.

REIT Balance Sheet



Common Question: *Many REIT investors and analysts do not mark debt to market. Is it really necessary?*

Imagine: Two identical office buildings, except that one is encumbered by a 60% LTV mortgage carrying a 7% interest rate with another five years to run, while the other has an identical loan at a 5% rate. Which building will command the higher price?



The answer is obvious to any real estate market practitioner. Building prices are profoundly impacted by assumed debt, and a high-cost mortgage negatively impacts pricing. The same holds true when those buildings are held by a REIT and if the debt is unsecured rather than secured. Marking assets to market without doing the same for liabilities yields the wrong answer.

Overview: NAV - A Simplified Example

Calculating NAV - A Simplified Example

Balance Sheet for REIT XYZ (X's $1,000)

	Book Value	***Analyze Market Value and Replace***	***Current Value***
Real Estate Assets			
Operating Real Estate	$6,000,000	A	$9,350,000
			$2,250,000
Construction in Progress	$500,000	B	$550,000
Land	$200,000	C	$162,000
Equity in Unconsolidated JVs	$1,000,000	D	$0
		D	
Value of Fee Businesses	$0	E	$500,000
Other Assets	$100,000	F	$68,625
Total Assets	$7,800,000		$12,880,625
Liabilities	$5,000,000	G	$5,250,000
			$1,500,000
Preferred Stock	$500,000		$500,000
Shareholders Equity	$2,300,000		$5,630,625
Fully Diluted Shares	200,000	H	204,750
NAV	$11.50		$27.50

The Adjustments:

A. Operating Real Estate: The most important part of an NAV analysis, this step invloves calculating a 12-month forward estimate of NOI and applying an appropriate cap rate. The quality of the analysis rests on an in-depth knowledge of prevailing cap rates, the quality/location of the real estate, and other required industry- and company-specific adjustments.

B. Construction in Progress: Adjustments to the book value of CIP reflect the extent to which stabilized yields are likely to exceed an appropriately high risk-adjusted return bogey.

C. Land: Land values can be much higher or lower than book.

D. Joint Venture Accounting is a Mess: Because of that, we present a pro-rata allocation of JV assets and liabilities. There is no reliable way to otherwise value JV interests, as leverage within the JV typically renders more simplified approaches useless. A pro-rata allocation also does a much better job of showing leverage that may be embedded, but otherwise hidden, in JV investments.

E. Fee Income: Some REITs generate asset management/property management fees associated with JV structures. This fee income can be lucrative, and the range of appropriate multiples to apply is dependent on the quality of the fee stream. This value is not reflected on GAAP balance sheets.

F. Other Assets: REITs often have a material amount of intangible assets, which are deducted for this exercise.

G. Liabilities: Mark-to-market adjustments are necessary where: subsidized financing is present, or market interest rates are materially higher or lower than contract rates on the REIT's debt.

H. Fully Diluted Shares: All in-the-money options, converts, etc. need to be included in the share count.

This report is an excerpt from REIT Valuation: Version 3.0 of our Pricing Model

Overview: NAV - More on Operating Real Estate

Calculating NAV - More on Operating Real Estate

Income Statement for REIT XYZ (X's $1,000)

Three Months Ending XXX	
GAAP Net Operating Income (NOI)	$149,500
Adjustments	
Straight-Line Rent (A)	($1,250)
NOI of Properties Acquired During Quarter (B)	$1,750
Quarterly Pace of Net Operating Income	$150,000
Annual Pace NOI	$600,000
Estimated Growth Over Next 12 Months	$12,000
12-Month Look-Forward NOI Estimate	$612,000
Cap Rate (C)	6.5%
Value of Operating Real Estate	$9,350,000

The Adjustments:

A. Straight-Line Rent: GAAP requires that companies report average rental revenue over the term of the lease. For example, GAAP rent for a 10-yr lease with a starting rent of $50/sqft and 2% annual escalators is $55/sqft. Phantom income items like straight-line rent need to be deducted to arrive at "cash" NOI.

B. Acquisitions: Properties acquired during the quarter will contribute less to reported NOI than they would have had they been owned the full period. Reported NOI needs to be adjusted upward when this is the case.

C. Cap Rate: The convention in the real estate industry is to quote pricing in terms of the first-year yield on investment. This measure is known as the capitalization rate (cap rate). Cap rates are the most critical input in the NAV analysis. An in-depth understanding of the location, age, and general desirability of the real estate portfolio coupled with a good handle on prevailing cap rates is essential to coming up with good estimates. The cap rate for the entire porttfolio is shown here, but the analysis is typically done on a market-by-market basis.

Overview: Where Do Green Street NAVs Come From?

Hard Work: Green Street takes its NAVs very seriously. We devote a great deal of resources toward deriving the best possible estimates of NAV because it has always been the driver of our valuation conclusions.

Kicking the Tires

Extensive property visits
Deep market contacts - public & private
Lengthy coverage of most REITs
Strategic partner: Eastdil Secured

A Large Research Team

25 full-time research professionals in US
We take NAV seriously
It has always driven our Pricing Model

Real Estate Data Sources

Green Street's property databases are extensive
We also use other research vendors
Local leasing and sales brokers

Cap-ex: the 500-Pound Gorilla

Capitalized costs are big and they need to be considered
They vary a lot even among REITs in the same sector
Cap-ex is broadly misunderstood…we have studied extensively
Market participants underestimate cap-ex
Cap-ex policies influence the cap rate used

Overview: Warranted Premiums to NAV

NAV Plus or Minus? Prospective future total returns for any REIT are a function of how its real estate portfolio is likely to perform, as well as the value that its management team is likely to add or detract. Our Pricing Model provides a systematic assessment of the four key variables - franchise value, corporate governance, balance sheet risk, and overhead - that typically distinguish REITs that deliver "real estate plus" returns from those in the "real estate minus" camp.

Warranted Premium to NAV for a REIT is a Function of...

Prevailing Premiums for Sector Peers Based on Prevailing Share Prices

The *net* value that a management team is likely to add or detract in the future

Our Pricing Model tallies up a total score on the variables below and ranks each REIT relative to sector peers

Franchise Value
A gauge of management's propensity to add or detract value

Corporate Governance
Our governance scoring system provides an annual review

Balance Sheet Risk
Capital Structure plays a big role in how REITs are valued

Capitalized Value of Unusual G&A
This can be readily quantified and is dealt with apart from the other factors that impact premiums

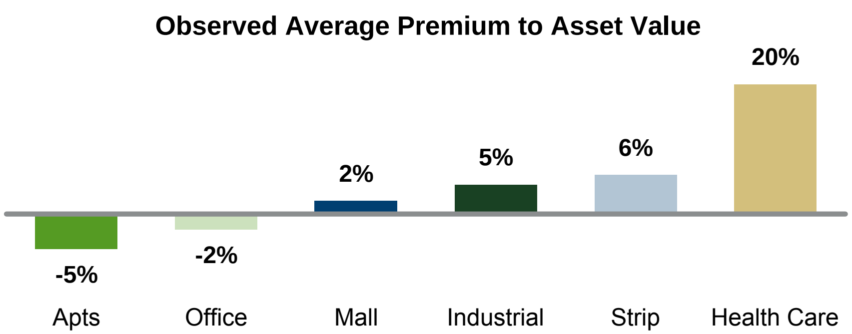
Which is it, NAV or UAV?

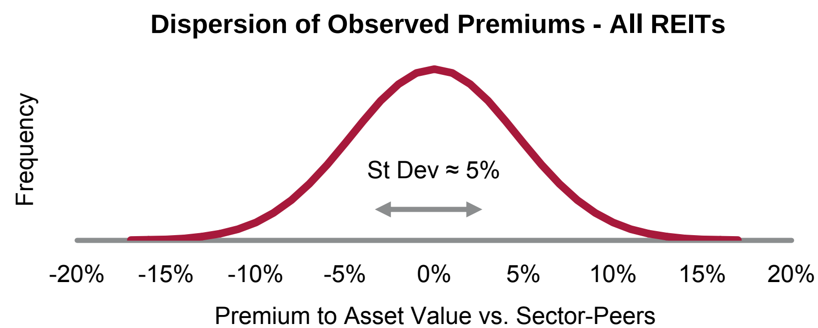
The investment world focuses on premiums to **NAV**, which are impacted by leverage, but the mechanics of our model strip out the distortions leverage can cause by focusing on premiums to **unlevered asset value (UAV)**. Even though the model is UAV-centric, the many references herein to NAV are employed to better speak the language most commonly used in our industry.

Overview: The Influence of Property Sectors

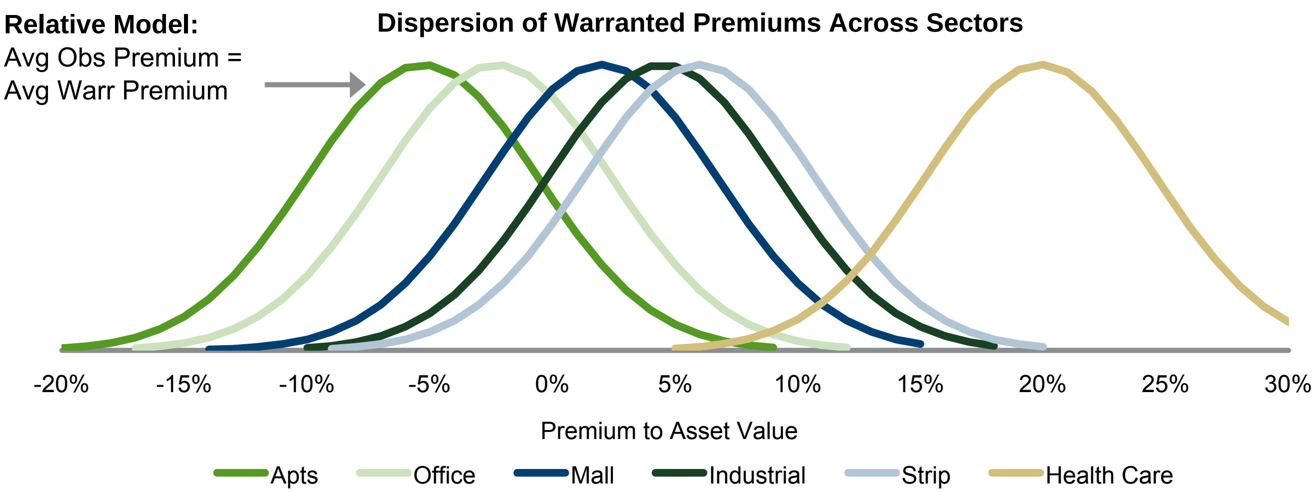
A Normal World: The starting point in calculating the warranted premium for any REIT is the sector-average premium ascribed by the market at current share prices. An assumption is made that the dispersion of observed premiums for the entirety of our coverage universe serves as a good indicator of how premiums should be dispersed in any given sector. REITs that stack up better in the Pricing Model relative to their sector peers are then ascribed better-than-average warranted premiums, and vice versa.

Each sector tends to march to its own drummer on average premiums… …to which the dispersion of premiums for all REITs can be applied





Relative Model:
Avg Obs Premium =
Avg Warr Premium



Why Sector Premiums Vary

There are three primary reasons:
1) REIT investors often disagree with private-market valuations
2) Some sectors may offer more lucrative growth opportunities.
3) A sector full of "A-students" should trade better

The model is neutral with regard to sector valuations.

Franchise Value: What is it?

An Important Assessment: Franchise value and G&A are the most important drivers of UAV premiums. Franchise value pertains to the value that a management team is likely to create in the future, which is a question best addressed by combining objective tools with subjective input from experienced analysts.

Franchise Value: a Forward-Looking Concept

Franchise value is an estimate of the relative value that a management team is likely to add or detract in coming years. Our analysts determine franchise value based on a wide variety of objective inputs and subjective assessments.

Subjective Factors

Lessons from REIT History

Simplicity is a virtue

Activity ≠ Value Added

Development is a tough business

Capital allocation skills are critical

Other Factors to Consider

Will past performance recur?

Has there been a strategy change?

Has management learned lessons?

Objective Metrics

Past Performance	Balance Sheet Management
Management Value Added (MVA)	Balance Sheet Acumen Score
Total Returns to Shareholders	Full Menu of Options is good
	Cheap debt → UAV Premium

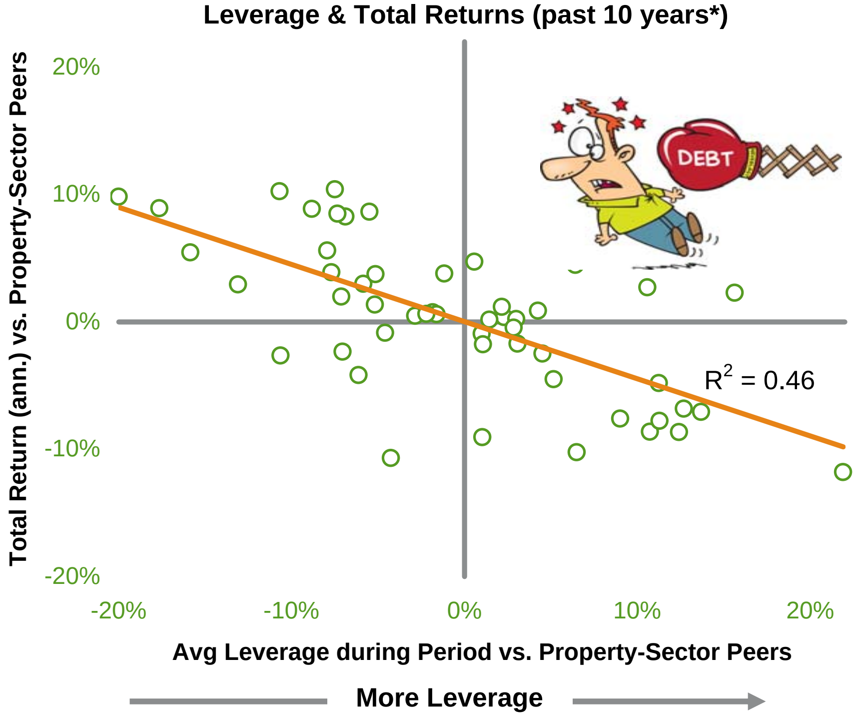
Franchise Score

The objective metrics help guide the analyst, but the ultimate score is entirely at his/her discretion.

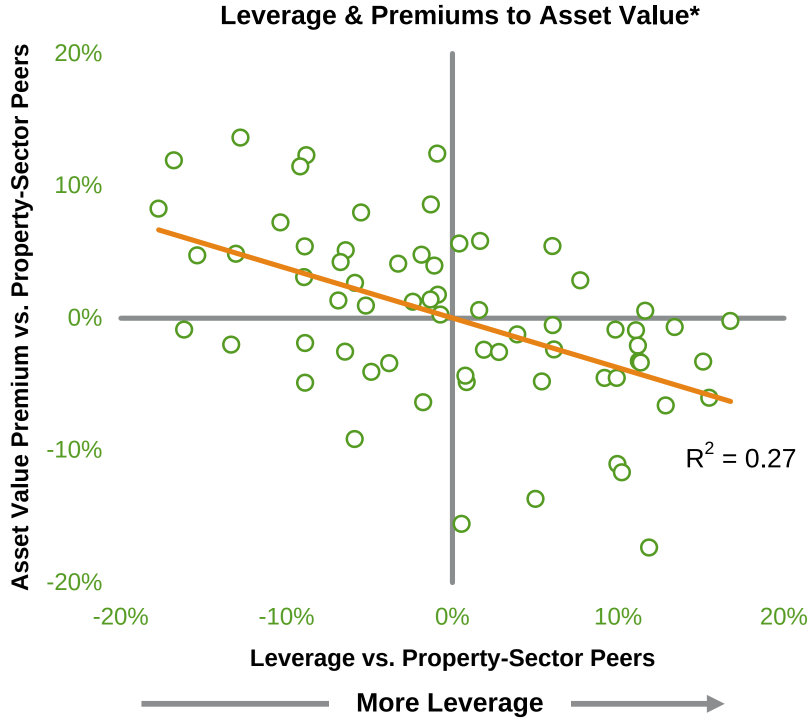
Balance Sheet Risk: Balance Sheets Matter

Low Leverage is Better: Even though property prices have risen more than 50% over the last ten years, REITs that have employed less leverage have delivered far better returns over that time period than REITs with higher leverage. The same statement has held true over the vast majority of ten-year periods since the Modern REIT era commenced in the early-'90s. Not surprisingly, investors are willing to ascribe much higher NAV premiums to REITs with low leverage.

Leverage has Impacted Total Returns
A 10% variance in the lev'g ratio has been associated with a 5% gap in total returns. Every year!



Leverage has a Big Impact on Pricing
A 10% variance in the lev'g ratio currently equates to a 4% variance in the UAV premiums at which REITs trade



* Charts are from Oct 2, 2012 Heard on the Beach. Left chart uses total returns from Aug '02 to Aug '12; right is based on stock pricing as of Sept '12.

Corporate Governance

Green Street's Governance Scoring System: Our governance ranking system, which is published annually, differs in two key respects from those provided by other evaluators: 1) our familiarity with the companies allows for subjective input; and 2) issues unique to REITs (e.g., the 5 or fewer rule) are ignored by others. Scoring is on a 100-point basis with the key inputs highlighted below. REITs with higher governance scores typically trade at larger premiums to asset value.

Category	Max Points	Ideal Structure
Board Rating:		
Non-staggered Board	20	Yes
Independent Board	5	80+%
Investment by Board Members	5	Large Investment by Numerous Members
Conduct	25	No Blemishes, Fair Comp, Leadership
Total	**55**	
Anti-Takeover Weapons:		
State Anti-takeover Provisions	12	Opt out/Shareholders Approve Change
Ownership Limits from 5/50 Rule	5	Limit Waived for Ownership by other REITs
Shareholder Rights Plan	10	Shareholders Must Approve Implementation
Insider Blocking Power	8	No Veto Power
Total	**35**	
Potential Conflicts of Interest:		
Business Dealings with Mgmt.	6	No Business Dealings
Divergent Tax Basis of Insiders	4	Basis Near Share Price
Total	**10**	
Perfect Score	**100**	

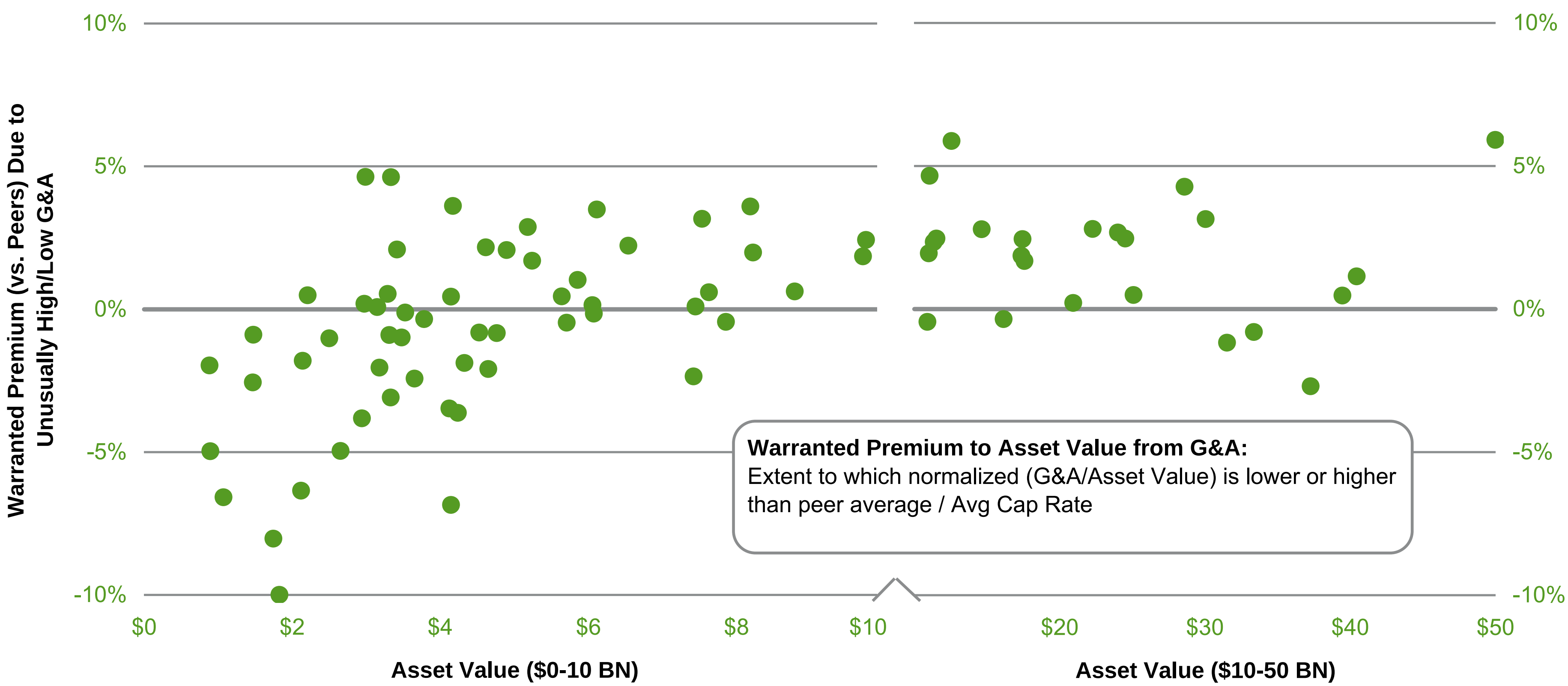
Anti-Takeover Weapons

There are only a handful of REITs where insiders hold a blocking position, but it's a big deal where it exists. Because of that, a cap is placed on how many points a REIT where blocking power is present can score on anti-takeover rankings. After all, the anti-takeover provisions don't matter much if insiders control the vote.

Overhead: A Strong Connection with Size

Big is Better: A dollar of cash flow devoted to G&A is worth the same as a dollar of cash flow at the property level, and efficiency differences between REITs can have a profound impact on share valuation. The impact on appropriate unlevered valuations can be calculated by capping those differences at the all-REIT cap rate and adding or subtracing that figure directly as a warranted premium to unlevered asset value. Not surprisingly, big REITs are more efficient when it comes to overhead, and this efficiency should translate into higher relative valuations.

Company Size and Warranted Premiums Attributable to G&A



This report is an excerpt from REIT Valuation: Version 3.0 of our Pricing Model

Frequently Asked Questions

Answers to Frequently Asked Questions

Q. Net Asset Value (NAV) estimates are far from precise. It's very common to see NAV estimates for a given REIT spanning a broad range, with some being as much as 30% higher than others. Why base a model on such an imprecise estimate?

A. NAV is admittedly an imprecise estimate of value. It may be best to consider NAV as the midpoint of a reasonable range in which a figure at least 5% higher or lower than the midpoint might be accurate. Reasonable minds can disagree within this range. However, this lack of precision should not be viewed as a serious shortcoming. Every valuation methodology lacks precision, and alternative methodologies are almost certainly less precise than NAV. For instance, where do appropriate Price/Earnings (P/E) multiples come from? EBITDA multiples? An NAV-based approach componentizes the valuation question into discrete pieces and incorporates private-market pricing information, attributes that should yield a higher level of precision than a broad-brush approach to entity valuation. When analyst estimates of NAV fall well outside a reasonable range, this probably reflects the quality of the analysis, as opposed to the metric's quality. In addition, most analysts only mark-to-market the left-hand side of the balance sheet; Green Street marks-to-market the right-hand side too. NAV calculations require a great deal of time, energy, and expertise to get right; big errors likely occur when shortcuts are taken.

Q. An NAV analysis is only as good as the cap rate applied to net operating income (NOI). Where does Green Street get its cap rates?

A. The choice of cap rates is the most important input in our model. Our analysts spend a great deal of time talking to market participants (e.g., REIT executives, private real estate participants, brokers, etc.), compiling databases of comparable transactions, reading trade publications, reviewing findings of providers of transaction information, and understanding the extent to which contractual rents are above or below market.

Q. As the REIT industry continues to mature, analysts and investors will inevitably value these stocks the same way the vast majority of other stocks are valued. Approaches based on P/E multiples, EBITDA multiples, or discounted cash flow models will take the place of a REIT-centric concept like NAV. After all, no one tries to figure out the NAV of General Motors or Microsoft, so why bother to do so with REITs?

A. The simple answer to this question is that investors in other sectors would use NAV if they could. However, their inability to do so relegates them to using generally inferior metrics. Thoughtfully applied alternative approaches to valuation should result in similar answers to an NAV-based approach, but these other methods must be used with caution.

Frequently Asked Questions (continued)

Q. REITs are more than just a collection of assets. Management matters a lot, and an NAV-based approach can't possibly factor that in.

A. Contrary to a widespread misperception, the use of an NAV-based model is consistent with a view that management is important. As long as an NAV-based model provides output with a sizable variance in company-specific warranted premiums/discounts, that model is implicitly acknowledging that management matters significantly. Capital allocation and balance sheet management are by far the key differentiators of management capabilities.

Q. Many REITs own hundreds of properties spread across the U.S., and an asset-by-asset appraisal would take an enormous amount of time. How can an analyst know the value of any given portfolio?

A. A reasonable NAV estimate can be derived if disclosure at the portfolio level is sufficient to allow for a comparison of the characteristics of a given portfolio with the characteristics of properties that have traded hands. No two portfolios are exactly the same, but plenty of pricing benchmarks exist to allow for adjustments based on portfolio location, quality, lease structure, growth prospects, etc.

Q. REITs have broad latitude in how they expense many operating costs. Can an NAV-based approach be fooled if a REIT inflates NOI by moving costs to the General & Administrative (G&A) expense line?

A. Yes. This is why an explicit valuation adjustment for G&A expense is included in our pricing model. It identifies companies that shift expenses in ways that are inconsistent with those of its peers.

Q. An NAV analysis derived from real estate NOI seemingly ignores capital expenditures (cap-ex). How does cap-ex factor into the analysis?

A. One of the easiest ways to make big mistakes in an NAV analysis is to utilize simple rules of thumb with regard to cap-ex. Most rules of thumb undercount the magnitude of cap-ex. In addition, the range of appropriate reserves varies hugely by property sector, property quality, and accounting practices. Each factor needs to be addressed before choosing the cap-ex reserve to utilize for a particular portfolio. The real estate portfolios in any sector that offer the highest quality, best growth, and lowest risk should be accorded the highest valuation multiples (lowest cap rates), and vice versa. Thus, it is important to rank the portfolios relative to each other and to then ensure "economic" cap rates (based on NOI less a cap-ex reserve) line up in this manner. An analysis that does not back out cap-ex costs, and is instead based off of nominal cap rates, will generate misleading relative conclusions.

Frequently Asked Questions (continued)

Q. NAV is a backward looking metric.

A. Real estate markets are active and liquid, and when buyers and sellers agree on deal terms (e.g., cap rates, price/square foot, etc.), those terms reflect their views of future prospects. When prevailing cap rates are applied to a REIT's forward-looking NOI estimate, the result is an estimate of value that is as forward looking as any other approach toward valuing stocks.

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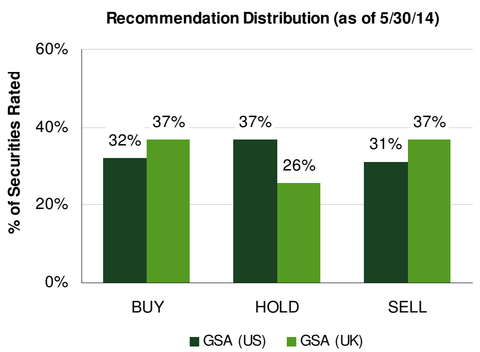
- Green Street will furnish upon request available investment information supporting the recommendation(s) contained in this report.

At any given time, Green Street publishes roughly the same number of "BUY" recommendations that it does "SELL" recommendations.



Green Street's "BUYs" have historically achieved far higher total returns than its "HOLDs", which, in turn, have outperformed its "SELLs".

Year	Buy	Hold	Sell	Universe[3]
2014 YTD	17 7%	14 6%	10 8%	14 4%
2013	4 1%	0 6%	1 7%	2 2%
2012	24 5%	24 7%	18 9%	23 0%
2011	18 9%	7 6%	4 7%	7 6%
2010	43 3%	32 8%	26 6%	33 8%
2009	59 0%	47 7%	6 0%	37 9%
2008	28 1%	30 9%	52 6%	37 3%
2007	6 9%	22 4%	27 8%	19 7%
2006	45 8%	29 6%	19 5%	31 6%
2005	26 3%	18 5%	1 8%	15 9%
2004	42 8%	28 7%	16 4%	29 4%
2003	43 3%	37 4%	21 8%	34 8%
2002	17 3%	2 8%	2 6%	5 4%
2001	34 9%	19 1%	13 0%	21 1%
2000	53 4%	28 9%	5 9%	29 6%
1999	12 3%	9 0%	20 5%	6 9%
1998	1 6%	15 1%	15 5%	12 1%
1997	36 7%	14 8%	7 2%	18 3%
1996	47 6%	30 7%	18 9%	32 1%
1995	22 9%	13 9%	0 5%	13 5%
1994	20 8%	0 8%	8 7%	3 1%
1993	27 3%	4 7%	8 1%	12 1%
Cumulative Total Return	**10566 3%**	**856 2%**	**1 8%**	**961 4%**
Annualized	**24 5%**	**11 2%**	**0 1%**	**11 7%**

The results shown in the table in the upper right corner are hypothetical; they do not represent the actual trading of securities. Actual performance will vary from this hypothetical performance due to, but not limited to 1) advisory fees and other expenses that one would pay; 2) transaction costs; 3) the inability to execute trades at the last published price (the hypothetical returns assume execution at the last closing price); 4) the inability to maintain an equally-weighted portfolio in size (the hypothetical returns assume an equal weighting); and 5) market and economic factors will almost certainly cause one to invest differently than projected by the model that simulated the above returns. All returns include the reinvestment of dividends. Past performance, particularly hypothetical performance, can not be used to predict future performance.

(1) Results are for recommendations made by Green Street's North American Research Team only (includes securities in the US, Canada, and Australia). Uses recommendations given in Green Street's "Real Estate Securities Monthly" from January 28, 1993 through May 23, 2014. Historical results from January 28, 1993 through October 1, 2013 were independently verified by an international "Big 4" accounting firm. The accounting firm did not verify the stated results subsequent to October 1, 2013. As of October 1, 2013, the annualized total return of Green Street's recommendations since January 28, 1993 was: Buy +24.5%, Hold +10.9%, Sell -0.3%, Universe +11.5%.

(2) Company inclusion in the calculation of total return has been based on whether the companies were listed in the primary exhibit of Green Street's "Real Estate Securities Monthly". Beginning April 28, 2000, Gaming C-Corps and Hotel C-Corps, with the exception of Starwood Hotels and Homestead Village, were no longer included in the primary exhibit and therefore no longer included in the calculation of total return. Beginning March 3, 2003, the remaining Hotel companies were excluded.

(3) All securities covered by Green Street with a published rating that were included in the calculation of total return. Excludes "not rated" securities.

Per NASD rule 2711, "Buy" = Most attractively valued stocks. We recommend overweight position; "Hold" = Fairly valued stocks. We recommend market-weighting; "Sell" = Least attractively valued stocks. We recommend underweight position.

Green Street will furnish upon request available investment information regarding the recommendation

Exhibit II

SUPPLEMENTAL INFORMATION

FIRST QUARTER 2014

Duke REALTY

RELIABLE. ANSWERS.

Exhibit II

Duke REALTY

Table of Contents

Duke Realty Corporation 600 East 96th Street, Suite 100 Indianapolis, IN 46240 317-808-6005 FAX 317-808-6770

Duke Realty Corporation

About Duke Realty

Duke Realty Corporation ("Duke Realty") specializes in the ownership, management and development of bulk industrial, suburban office and medical office real estate. Duke Realty is the largest publicly traded, vertically integrated office/industrial/medical office real estate company in the United States. The company owns, maintains an interest in or has under development approximately 154.1 million rentable square feet in 22 major U.S. metropolitan areas. Duke Realty is publicly traded on the NYSE under the symbol DRE and is listed on the S&P MidCap 400 Index.

Duke Realty's Mission Statement

Our mission is to build, own, lease and manage industrial, office and healthcare properties with a focus on customer satisfaction while maximizing shareholder value.

Structure of the Company

Duke Realty has elected to be taxed as a Real Estate Investment Trust (REIT) under the Internal Revenue Code. To qualify as a REIT, we must meet a number of organizational and operational requirements, including a requirement to distribute at least 90% of our adjusted taxable income to our shareholders. Management intends to continue to adhere to these requirements and to maintain our REIT status. As a REIT, we are entitled to a tax deduction for some or all of the dividends we pay to shareholders. Accordingly, we generally will not be subject to federal income taxes as long as we distribute an amount equal to or in excess of our taxable income to shareholders. We are also generally subject to federal income taxes on any taxable income that is not distributed to our shareholders. Our property operations are conducted through a partnership in which Duke Realty is the sole general partner owning a 99 percent interest at March 31, 2014. This structure is commonly referred to as an "UPREIT." The limited partnership ownership interests in this partnership (referred to as Units) are exchangeable for shares of common stock of Duke Realty. Duke Realty is also the sole general partner in another partnership which conducts our service operations.

Exhibit II

Product Review

Bulk Distribution Industrial Properties: Duke Realty owns interests in 503 bulk distribution industrial properties encompassing more than 127.8 million square feet (83 percent of total square feet). These properties are primarily warehouse facilities with clear ceiling heights of 28 feet or more. This also includes 37 light industrial buildings, also known as flex buildings, totaling 2.3 million square feet.

Suburban Office Properties: Duke Realty owns interests in 167 suburban office buildings totaling more than 19.6 million square feet (12 percent of total square feet).

Medical Office Properties: Duke Realty owns interests in 72 medical office buildings totaling more than 5.7 million square feet (4 percent of total square feet).

Retail Properties: Duke Realty owns interests in 5 retail buildings encompassing more than 936,000 square feet (1 percent of total square feet).

Land: Duke Realty owns or controls through options or joint ventures more than 5,600 acres of land located primarily in its existing business parks. The land is ready for immediate use and is primarily unencumbered by debt. More than 86 million square feet of additional space can be developed on these sites and all of the land is fully entitled for either office, industrial, or medical office.

Service Operations: As a fully integrated company, Duke Realty provides property and asset management, development, leasing and construction services to third party owners in addition to its own properties. Our current property management base for third parties includes more than 4.3 million square feet.

Exhibit II

Investor Information

Research Coverage

Bank of America/Merrill Lynch	Jamie Feldman	212.449.6339
Barclays	Ross Smotrich	212.526.2306
BMO Capital Markets	Paul Adornato	212.885.4170
Citi	Kevin Varin	212.816.6243
Cowen and Company	James Sullivan	646.562.1380
Edward Jones & Co.	Ashtyn Evans	314.515.2751
Green Street Advisors	Eric Frankel	949.640.8780
J.P. Morgan	Tony Paolone	212.622.6682
Morgan Stanley	Vance Edelson	212.761.0078
RBC Capital Markets	Mike Salinsky	440.715.2648
R.W. Baird	Dave Rodgers	216.737.7341
S&P Capital IQ	Erik Oja	212.438.4314
SunTrust Robinson Humphrey	Ki Bin Kim	212.303.4124
Stifel Nicolaus & Co	John Guinee	443.224.1307
UBS	Ross Nussbaum	212.713.2484
Wells Fargo Securities	Brendan Maiorana	443.263.6516

Timing

Quarterly results will be announced according to the following approximate schedule:

First Quarter	Late April
Second Quarter	Late July
Third Quarter	Late October
Fourth Quarter and Year-End	Late January

Duke will typically publish other materials of interest to investors according to the following schedule:

Report	1st Quarter	2nd Quarter	3rd Quarter	4th Quarter	Due Date
Form 10Q	May	August	November		
Supplemental Materials	Late April	Late July	Late October	Late January	
Annual Report					March
Proxy Statement					March
Form 10-K					March
News Releases					As Appropriate

The above information is available on Duke Realty's web site at http://www.dukerealty.com

Stock Information

Duke Realty’s common stock is traded on the New York Stock Exchange (symbol: DRE).
Duke Realty’s Series J preferred stock is traded on the New York Stock Exchange (symbol: DRE PRJ).
Duke Realty’s Series K preferred stock is traded on the New York Stock Exchange (symbol: DRE PRK).
Duke Realty’s Series L preferred stock is traded on the New York Stock Exchange (symbol: DRE PRL).

Senior Unsecured Debt Ratings:

Standard & Poor's	BBB
Moody's	Baa2

Inquiries

Duke Realty welcomes inquiries from stockholders, financial analysts, other professional investors, representatives of the news media and others wishing to discuss the company. Please address inquiries to, Investor Relations, at the address listed on the cover of this guide. Investors, analysts and reporters wishing to speak directly with our operating officers are encouraged to first contact the Investor Relations department. Interviews will be arranged as schedules permit.

Common Stock Data (NYSE:DRE):

	1st Quarter 2013	2nd Quarter 2013	3rd Quarter 2013	4th Quarter 2013	1st Quarter 2014
High price*	17.16	18.80	17.56	17.23	17.03
Low price*	13.94	14.29	14.12	14.18	14.48
Closing price*	16.98	15.59	15.44	15.04	16.88
Dividends paid per share	.170	.170	.170	.170	.170
Closing dividend yield	4.0%	4.4%	4.4%	4.5%	4.0%

FFO and AFFO Reporting Definitions

Funds from Operations ("FFO"): FFO is computed in accordance with standards established by the National Association of Real Estate Investment Trusts ("NAREIT"). NAREIT defines FFO as net income (loss) excluding gains (losses) on sales of depreciable property, impairment charges related to depreciable real estate assets, and extraordinary items (computed in accordance with generally accepted accounting principles ("GAAP")); plus real estate related depreciation and amortization, and after similar adjustments for unconsolidated joint ventures. We believe FFO to be most directly comparable to net income as defined by GAAP. We believe that FFO should be examined in conjunction with net income (as defined by GAAP) as presented in the financial statements accompanying this release. FFO does not represent a measure of liquidity, nor is it indicative of funds available for our cash needs, including our ability to make cash distributions to shareholders.

Core Funds from Operations ("Core FFO"): Core FFO is computed as FFO adjusted for certain items that are generally non-cash in nature and that materially distort the comparative measurement of company performance over time. The adjustments include gains on sale of undeveloped land, impairment charges not related to depreciable real estate assets, tax expenses or benefit related to (i) changes in deferred tax asset valuation allowances, (ii) changes in tax exposure accruals that were established as the result of the previous adoption of new accounting principles, or (iii) taxable income (loss) related to other items excluded from FFO or Core FFO (collectively referred to as "other income tax items"), gains (losses) on debt transactions, adjustments on the repurchase or redemption of preferred stock, gains (losses) on and related costs of acquisitions, and severance charges related to major overhead restructuring activities. Although our calculation of Core FFO differs from NAREIT's definition of FFO and may not be comparable to that of other REITs and real estate companies, we believe it provides a meaningful supplemental measure of our operating performance.

Adjusted Funds from Operations ("AFFO"): AFFO is defined by the company as Core FFO (as defined above), less recurring building improvements and total second generation capital expenditures (the leasing of vacant space that had previously been under lease by the company is referred to as second generation lease activity) related to leases commencing during the reporting period, and adjusted for certain non-cash items including straight line rental income and expense, non-cash components of interest expense and stock compensation expense, and after similar adjustments for unconsolidated partnerships and joint ventures.

Exhibit II

Balance Sheets

(unaudited and in thousands)

	March 31, 2014	December 31, 2013	September 30, 2013	June 30, 2013	March 31, 2013
Assets:					
Rental property	$7,096,174	$7,031,660	$7,234,934	$7,094,986	$6,727,590
Accumulated depreciation	(1,422,986)	(1,382,757)	(1,406,849)	(1,364,439)	(1,346,961)
Construction in progress	277,400	256,911	198,988	266,388	303,383
Undeveloped land	570,718	590,052	580,052	621,143	607,283
Net real estate investments	6,521,306	6,495,866	6,607,125	6,618,078	6,291,295
Cash and cash equivalents	19,474	19,275	24,112	21,402	307,167
Accounts receivable	34,883	26,664	20,411	21,148	21,380
Straight-line rents receivable	126,387	120,497	127,311	124,951	123,108
Receivables on construction contracts, including retentions	27,833	19,209	28,706	30,205	27,465
Investments in and advances to unconsolidated companies	336,060	342,947	328,660	327,698	331,041
Deferred financing costs, net	33,764	36,250	38,029	40,837	41,097
Deferred leasing and other costs, net	462,176	473,413	502,714	523,100	489,621
Escrow deposits and other assets	205,480	218,493	209,771	176,483	169,925
Total assets	$7,767,363	$7,752,614	$7,886,839	$7,883,902	$7,802,099
Liabilities and Equity:					
Secured debt	$1,077,468	$1,100,124	$1,158,456	$1,241,527	$1,151,660
Unsecured debt	3,065,742	3,066,252	3,066,755	3,067,250	3,242,737
Unsecured line of credit	180,000	88,000	210,000	88,000	0
Construction payables and amounts due subcontractors	72,695	69,391	79,180	87,730	81,044
Accrued real estate taxes	77,301	75,396	105,263	86,968	78,985
Accrued interest	36,468	52,824	36,439	58,426	41,626
Other accrued expenses	52,118	68,276	40,983	45,078	33,586
Other liabilities	138,602	142,589	130,508	123,649	123,914
Tenant security deposits and prepaid rents	50,307	45,133	46,311	42,808	43,966
Total liabilities	4,750,701	4,707,985	4,873,895	4,841,436	4,797,518
Preferred stock	428,926	447,683	447,683	447,683	447,683
Common stock and additional paid-in capital	4,653,199	4,624,228	4,604,477	4,571,131	4,540,121
Accumulated other comprehensive income	3,832	4,119	3,780	3,950	3,228
Distributions in excess of net income	(2,100,245)	(2,062,787)	(2,076,299)	(2,014,399)	(2,020,455)
Total shareholders' equity	2,985,712	3,013,243	2,979,641	3,008,365	2,970,577
Noncontrolling interest	30,950	31,386	33,303	34,101	34,004
Total liabilities and equity	$7,767,363	$7,752,614	$7,886,839	$7,883,902	$7,802,099

Exhibit II

Statements of Operations

(unaudited and in thousands)

	Three Months Ended		
	March 31, 2014	March 31, 2013	% Change
Revenues:			
Rental and related revenue	**$237,350**	$209,879	13%
General contractor and service fee revenue	**55,820**	47,404	18%
	293,170	257,283	14%
Expenses:			
Rental expenses	**50,267**	38,861	29%
Real estate taxes	**32,467**	29,040	12%
General contractor and other services expenses	**47,271**	38,341	23%
Depreciation and amortization	**98,059**	92,993	5%
	228,064	199,235	14%
Other Operating Activities:			
Equity in earnings of unconsolidated companies	**2,321**	49,378	-95%
Gain on sale of properties	**15,853**	168	9336%
Gain on land sales	**152**	0	
Undeveloped land carrying costs	**(2,124)**	(2,198)	3%
Other operating expenses	**(92)**	(68)	-35%
General and administrative expenses	**(14,694)**	(13,145)	-12%
	1,416	34,135	-96%
Operating income	**66,522**	92,183	-28%
Other Income (Expenses):			
Interest and other income, net	**351**	153	129%
Interest expense	**(55,257)**	(57,181)	3%
Acquisition-related activity	**(14)**	643	-102%
Income tax expense (1)	**(2,674)**	0	
Income from continuing operations	**8,928**	35,798	-75%
Discontinued Operations:			
Loss before gain on sales	**(132)**	(629)	79%
Gain on sale of depreciable properties, net of tax	**16,775**	8,954	87%
Income from discontinued operations	**16,643**	8,325	100%
Net income	**25,571**	44,123	-42%
Dividends on preferred shares	**(7,037)**	(9,550)	26%
Adjustments for redemption/repurchase of preferred shares	**483**	(5,932)	0%
Net income attributable to noncontrolling interests	**(334)**	(598)	44%
Net income attributable to common shareholders	**$18,683**	$28,043	-33%
Basic net income per common share:			
Continuing operations attributable to common shareholders (2)	**$0.01**	$0.06	-83%
Discontinued operations attributable to common shareholders	**$0.05**	$0.03	67%
Total	**$0.06**	$0.09	-33%
Diluted net income per common share:			
Continuing operations attributable to common shareholders (2)	**$0.01**	$0.06	-83%
Discontinued operations attributable to common shareholders	**$0.05**	$0.03	67%
Total	**$0.06**	$0.09	-33%
Weighted average number of common shares outstanding	**327,106**	314,936	
Weighted average number of common shares and potential dilutive securities	**331,716**	319,571	

(1) The income tax expense included in continuing operations during the three months ended March 31, 2014 was triggered by the sale of one property during that time period, which was partially owned by our taxable REIT subsidiary, but due to continuing involvement in managing the property, was not classified as a discontinued operation.

(2) Dividends on preferred shares and adjustments for the redemption/repurchase of preferred shares are allocated entirely to continuing operations for basic and diluted net income (loss) per common share.

Exhibit II

Statements of FFO

(unaudited and in thousands)

	Three Months Ended	
	March 31, 2014	March 31, 2013
Rental Operations		
Revenues:		
Rental and related revenue from continuing operations	**$235,308**	$208,048
Lease buyouts	**2,042**	1,831
Revenues from continuing rental operations	**237,350**	209,879
Rental and related revenue from discontinued operations	**1,368**	16,404
	238,718	226,283
Operating expenses:		
Rental expenses	**50,267**	38,861
Real estate taxes	**32,467**	29,040
Operating expenses from discontinued operations	**913**	5,986
	83,647	73,887
FFO from rental operations	**155,071**	152,396
Unconsolidated Subsidiaries		
FFO from unconsolidated subsidiaries	**9,117**	8,497
Service Operations		
General contractor and service fee revenue	**55,820**	47,404
General contractor and other services expenses	**(47,271)**	(38,341)
FFO from fee based Service Operations	**8,549**	9,063
FFO from Operations	**172,737**	169,956
Gain on land sales	**152**	0
Undeveloped land carrying costs	**(2,124)**	(2,198)
Other operating expenses	**(92)**	(68)
General and administrative expenses	**(14,694)**	(13,145)
Interest and other income, net	**351**	153
Interest expense	**(55,257)**	(57,181)
Interest expense from discontinued operations	**(382)**	(4,260)
Dividends on preferred shares	**(7,037)**	(9,550)
Adjustments for redemption/repurchase of preferred shares	**483**	(5,932)
Acquisition-related activity	**(14)**	643
Noncontrolling interest share of FFO from consolidated subsidiaries	**(319)**	(510)
Diluted Funds from Operations - NAREIT	**$93,804**	$77,908
Less gain on land sales	**(152)**	0
Add back adjustments for redemption/repurchase of preferred shares	**(483)**	5,932
Add back acquisition-related activity	**14**	(643)
Diluted Core Funds from Operations	**$93,183**	$83,197
Weighted average number of common shares and potential dilutive securities	**334,380**	322,439
Diluted FFO per share	**$0.28**	$0.24
Diluted Core FFO per share	**$0.28**	$0.26

Exhibit II

Summary of EPS, FFO and AFFO

(unaudited and in thousands)

	Three Months Ended March 31 (Unaudited)					
	2014			2013		
	Amount	Wtd. Avg. Shares	Per Share	Amount	Wtd. Avg. Shares	Per Share
Net income attributable to common shareholders	$18,683			$28,043		
Less dividends on participating securities	(645)			(688)		
Net Income Per Common Share-Basic	18,038	327,106	$0.06	27,355	314,936	$0.09
Add back:						
Noncontrolling interest in earnings of unitholders	250	4,387		392	4,405	
Other potentially dilutive securities		223			230	
Net Income Attributable to Common Shareholders-Diluted	**$18,288**	**331,716**	**$0.06**	**$27,747**	**319,571**	**$0.09**
Reconciliation to Funds From Operations ("FFO")						
Net Income Attributable to Common Shareholders	$18,683	327,106		$28,043	314,936	
Adjustments:						
Depreciation and amortization	98,264			99,780		
Company share of joint venture depreciation, amortization and other	6,396			7,629		
Gains on depreciable property sales, net of tax-wholly owned, discontinued operations	(16,775)			(8,954)		
Gains on depreciable property sales, net of tax-wholly owned, continuing operations	(13,179)			(168)		
Gains/losses on depreciable property sales-JV	165			(48,814)		
Noncontrolling interest share of adjustments	(991)			(682)		
Funds From Operations-Basic	92,563	327,106	$0.28	76,834	314,936	$0.24
Noncontrolling interest in income of unitholders	250	4,387		392	4,405	
Noncontrolling interest share of adjustments	991			682		
Other potentially dilutive securities		2,887			3,098	
Funds From Operations-Diluted	**$93,804**	**334,380**	**$0.28**	**$77,908**	**322,439**	**$0.24**
Gain on land sales	(152)			-		
Adjustments for redemption/repurchase of preferred shares	(483)			5,932		
Acquisition-related activity	14			(643)		
Core Funds From Operations - Diluted	**$93,183**	**334,380**	**$0.28**	**$83,197**	**322,439**	**$0.26**
Adjusted Funds From Operations						
Core Funds From Operations - Diluted	$93,183	334,380	$0.28	$83,197	322,439	$0.26
Adjustments:						
Straight-line rental income and expense	(6,701)			(5,891)		
Amortization of above/below market rents and concessions	2,468			2,210		
Stock based compensation expense	8,277			6,854		
Noncash interest expense	1,602			2,310		
Second generation concessions	(76)			(68)		
Second generation tenant improvements	(7,461)			(7,859)		
Second generation leasing commissions	(6,902)			(5,636)		
Building improvements	(337)			(634)		
Adjusted Funds From Operations - Diluted	**$84,053**	**334,380**	**$0.25**	**$74,483**	**322,439**	**$0.23**
Dividends Declared Per Common Share			$0.170			$0.170
Payout Ratio of Core Funds From Operations - Diluted			60.71%			65.38%
Payout Ratio of Adjusted Funds From Operations - Diluted			68.00%			73.91%

Exhibit II

Discontinued Operations Disclosure

(unaudited and in thousands)

	Three Months Ended	
	March 31, 2014	March 31, 2013
Properties Comprising Discontinued Operations (1):		
Income Statement:		
Revenues	**$1,368**	$16,404
Operating expenses	**(913)**	(5,986)
Depreciation and amortization	**(205)**	(6,787)
Operating income	**250**	3,631
Interest expense	**(382)**	(4,260)
Gain on sale of depreciable properties	**19,752**	8,954
Income from discontinued operations before income taxes	**19,620**	8,325
Income tax expense (2)	**(2,977)**	0
Income from discontinued operations	**$16,643**	$8,325

(1) The amounts classified in discontinued operations for the periods ended March 31, 2014 and March 31, 2013 are comprised of three properties that are currently held for sale, ten properties sold in the three months ended March 31, 2014 and 25 properties sold during the year ended December 31, 2013.

Excluded from the above is one property that was sold during the three months ended March 31, 2014 and 13 properties that were sold during the year ended December 31, 2013 and, as a result of our maintaining varying forms of continuing involvement after the sale, did not meet the criteria to be classified in discontinued operations.

(2) The income tax expense included in discontinued operations during the three months ended March 31, 2014 was triggered by the sale of one property during that time period, which was partially owned by our taxable REIT subsidiary.

Exhibit II

Selected Financial Information

(unaudited and in thousands)

	Three Months Ended	
	March 31, 2014	March 31, 2013
Revenues from continuing operations	**$293,170**	$257,283
Revenues from discontinued operations	**1,368**	16,404
Total revenues	**$294,538**	$273,687
Calculation of Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA)		
Net income	**$25,571**	$44,123
Add depreciation and amortization - continuing operations	**98,059**	92,993
Add depreciation and amortization - discontinued operations	**205**	6,787
Add interest expense - continuing operations	**55,257**	57,181
Add interest expense - discontinued operations	**382**	4,260
Add income tax expense - continuing and discontinued operations (1)	**5,651**	0
EBITDA, prior to adjustments for joint ventures	**$185,125**	$205,344
Less pre-tax gains on depreciable property sales	**(35,605)**	(9,122)
Less gains/losses on depreciable property sales - Company's share of JV	**165**	(48,814)
Less gains on land sales	**(152)**	0
Add acquisition-related activity	**14**	(643)
Core EBITDA, prior to adjustments for joint ventures	**$149,547**	$146,765
Add back gains (losses) on depreciable property sales - Company's share of JV	**(165)**	48,814
Less equity in earnings	**(2,321)**	(49,378)
Company's share of JV EBITDA	**12,608**	13,144
Core EBITDA, including share of joint ventures	**$159,669**	$159,345
Components of Fixed Charges		
Interest expense, including discontinued operations	**$55,639**	$61,441
Company's share of JV interest expense	**3,084**	5,508
Capitalized interest	**4,170**	4,660
Company's share of JV capitalized interest	**54**	0
Interest costs for Fixed Charge reporting	**$62,947**	$71,609
Dividends on preferred shares	**7,037**	9,550
Total Fixed Charges	**$69,984**	$81,159
Common dividends paid	**$55,596**	$54,678
Unit distributions paid	**$746**	$751
Acquired lease-based intangible assets (included within deferred leasing and other costs)	**$394,497**	$398,717
Accumulated amortization on acquired lease-based intangible assets	**($159,762)**	($142,981)
Acquired lease based intangible assets, net	**$234,735**	$255,736
Common shares outstanding	**328,480**	321,667
Partnership units outstanding	**4,387**	4,388
Total common shares and units outstanding at end of period	**332,867**	326,055
Common Equity Market Capitalization (2)	**$5,618,795**	$5,536,414
Total Market Capitalization (3)	**$10,370,930**	$10,378,486

Note: Amounts shown represent continuing and discontinued operations except where noted.

(1) Income tax expense for the three months ended March 31, 2014 was the result of the sale of two properties partially owned by our taxable REIT subsidiary.

(2) Number of common shares and partnership units outstanding multiplied by the Company's closing share price at the end of each reporting period.

(3) Common Equity Market Capitalization plus face or redemption value of outstanding debt and preferred stock.

Exhibit II

Ratio Summary

(dollars in thousands)

	March 31, 2014	December 31, 2013	September 30, 2013	June 30, 2013	March 31, 2013
Effective Leverage (Debt + Company's Share of JV Debt) / (Total Assets + Accumulated Depreciation + Company's Share of JV Gross Assets)	**46%**	**46%**	**47%**	**47%**	**48%**
Debt to Total Market Capitalization (Debt / Total Market Capitalization as defined on page 11)	**42%**	**44%**	**44%**	**44%**	**42%**
Effective Leverage with Preferred Stock (Debt + Share of JV Debt + Preferred Stock) / (Total Assets + Accumulated Depreciation + Company's Share of JV Gross Assets)	**51%**	**50%**	**52%**	**52%**	**52%**
Debt plus Preferred to Total Market Capitalization ((Debt + Preferred Stock) / Total Market Capitalization as defined on page 11)	**46%**	**49%**	**49%**	**49%**	**47%**
Net Debt (Debt - Cash + Share of JV Debt) to Core EBITDA, Including Share of Joint Ventures:					
Trailing twelve months	**7.1**	**7.0**	**7.5**	**7.5**	**7.2**
Current quarter annualized	**7.2**	**6.8**	**7.4**	**7.3**	**6.9**
Proforma current quarter annualized (*)	**7.2**				
Net Debt (Debt - Cash + Share of JV Debt) + Preferred Equity to Core EBITDA, Including Share of Joint Ventures:					
Trailing twelve months	**7.8**	**7.7**	**8.2**	**8.2**	**7.9**
Current quarter annualized	**7.9**	**7.5**	**8.1**	**8.0**	**7.6**
Proforma current quarter annualized (*)	**7.8**				
Fixed Charge Coverage Ratio (Core EBITDA, Including Joint Ventures) / Total Fixed Charges					
Trailing twelve months	**2.2**	**2.1**	**2.0**	**1.9**	**1.9**
Most recent quarter	**2.3**	**2.3**	**2.2**	**2.1**	**2.0**

(*) Proforma Calculations - Core EBITDA and Net Debt	**Three Months Ended March 31, 2014**	
Core EBITDA, including share of joint ventures	$159,669	
Proforma EBITDA adjustment for current quarter acquisition	42	(1)
Proforma EBITDA adjustment for current quarter developments placed in service	1,275	(2)
Proforma EBITDA adjustment for properties in development pipeline	11,538	(3)
Remove EBITDA related to properties sold	(368)	(4)
Proforma Core EBITDA, including share of joint ventures	$172,156	
	x 4	
Annualized proforma Core EBITDA, including share of joint ventures	$688,624	
Total debt	$4,323,210	
Less cash	(19,474)	
Share of JV debt	307,484	
Net Debt	$4,611,220	
Plus remaining costs to spend for properties in development pipeline	331,004	(3)
Proforma Net Debt	$4,942,224	
Proforma Net Debt to EBITDA	**7.2**	
Proforma Net Debt	$4,942,224	
Preferred stock	428,926	
Proforma Net Debt plus Preferred	$5,371,150	
Proforma Net Debt plus Preferred to EBITDA	**7.8**	

Notes to Proforma Calculations:

(1) Current quarter acquisition consists of one industrial building that is 100% leased, totaling approximately 407,000 square feet. Adjustment is to reflect a full quarter of operations for this property.

(2) Current quarter developments placed in service consist of one office and three medical office buildings that are 100% leased, totaling more than 392,000 square feet. Adjustment is to reflect a full quarter of operations for such properties.

(3) There are 15 industrial, eight medical office and two office properties in our development pipeline as of March 31, 2014, totaling more than 7.5 million square feet (including two industrial properties, totaling approximately 1.8 million square feet, within one of our unconsolidated joint ventures). These properties have projected stabilized costs of more than $607.2 million (with the joint venture development costs reflected at our ownership percentage) and are 86% pre-leased in the aggregate. The proforma EBITDA is calculated based on the projected stabilized yield of 7.6% for these properties. The remaining costs to spend for these properties represent the total projected stabilized costs less the costs funded through March 31, 2014.

(4) Current quarter properties sold consist of nine industrial and two medical office buildings, totaling approximately 620,000 square feet. Adjustment is to remove the pre-sale operations of these properties from Core EBITDA for the quarter.

Exhibit II

Summary of Unsecured Public Debt Covenants

Covenant	Threshold	First Quarter '14	Fourth Quarter '13	Third Quarter '13	Second Quarter '13
Total Debt to Undepreciated Assets	<60%	48%	47%	49%	48%
Debt Service Coverage	>1.5x	2.5	2.5	2.4	2.3
Secured Debt to Undepreciated Assets	<40%	14%	14%	14%	15%
Undepreciated Unencumbered Assets to Unsecured Debt	>150%	217%	221%	215%	216%

Note: The ratios are based upon the results of Duke Realty Limited Partnership, the partnership through which Duke Realty conducts its operations, using calculations that are defined in the trust indenture.

	Three Months Ended		
Unencumbered Consolidated Assets	**March 31, 2014**		**March 31, 2013**
Number of properties	468	(1)	460
Total square feet (in thousands)	85,796	(1)	78,495
Gross book value (in thousands)	$6,091,021	(1)	$5,624,287
Annual stabilized NOI (in thousands)	$538,407	(1)	$517,895

(1) Excludes 23 wholly owned properties under development at March 31, 2014 which will be unencumbered upon completion. These properties totaled approximately 5.8 million square feet with total anticipated stabilized project costs of more than $568.3 million and anticipated stabilized NOI of more than $43.5 million.

Exhibit II

Owned Property Occupancy Analysis

(*SF in thousands*)

	March 31, 2013			June 30, 2013			September 30, 2013			December 31, 2013			March 31, 2014		
	# of Bldgs.	SF	% Leased	# of Bldgs.	SF	% Leased	# of Bldgs.	SF	% Leased	# of Bldgs.	SF	% Leased	# of Bldgs.	SF	% Leased
Stabilized or In Service Geater Than One Year:															
Bulk Distribution	481	110,458	94.0%	494	117,155	95.2%	495	118,909	95.4%	495	120,150	95.8%	487	120,539	95.2%
Suburban Office	176	20,131	84.5%	177	20,508	86.5%	177	20,507	87.2%	165	19,073	87.8%	165	19,172	88.1%
Medical Office	69	5,417	91.3%	72	5,563	93.0%	73	5,578	93.9%	63	5,298	93.7%	64	5,312	93.7%
Retail	6	1,327	85.4%	5	937	84.7%	5	937	87.1%	5	937	86.7%	5	937	87.6%
Total	732	137,334	92.4%	748	144,163	93.8%	750	145,931	94.2%	728	145,458	94.6%	721	145,959	94.2%
Unstabilized and In Service Less Than One Year: (1)															
Bulk Distribution	1	421	0.0%	2	1,021	0.0%	2	1,021	0.0%	2	1,021	33.6%	1	600	57.2%
Suburban Office	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Medical Office	1	52	52.0%	1	52	61.0%	1	52	58.1%	-	-	-	-	-	-
Retail	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Total	2	473	5.7%	3	1,073	3.0%	3	1,073	2.8%	2	1,021	33.6%	1	600	57.2%
Total In-Service Portfolio:															
Bulk Distribution	482	110,879	93.6%	496	118,176	94.4%	497	119,930	94.6%	497	121,171	95.3%	488	121,139	95.0%
Suburban Office	176	20,131	84.5%	177	20,508	86.5%	177	20,507	87.2%	165	19,073	87.8%	165	19,172	88.1%
Medical Office	70	5,469	90.9%	73	5,615	92.7%	74	5,630	93.6%	63	5,298	93.7%	64	5,312	93.7%
Retail	6	1,327	85.4%	5	937	84.7%	5	937	87.1%	5	937	86.7%	5	937	87.6%
Total	734	137,807	92.1%	751	145,237	93.2%	753	147,004	93.5%	730	146,479	94.2%	722	146,559	94.0%
Properties Under Development:															
Bulk Distribution	7	3,396	75.3%	3	1,936	87.6%	3	826	70.9%	10	4,854	89.8%	15	6,673	85.5%
Suburban Office	3	703	92.8%	2	406	75.8%	3	611	84.6%	3	652	81.5%	2	452	83.2%
Medical Office	13	1,021	100.0%	13	988	100.0%	12	817	100.0%	11	590	93.0%	8	397	89.6%
Retail	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Total	23	5,120	82.6%	18	3,331	89.8%	18	2,253	85.2%	24	6,095	89.2%	25	7,522	85.6%
Total Portfolio:															
Bulk Distribution	489	114,275	93.1%	499	120,112	94.3%	500	120,756	94.5%	507	126,025	95.0%	503	127,812	94.5%
Suburban Office	179	20,835	84.8%	179	20,915	86.3%	180	21,117	87.2%	168	19,724	87.6%	167	19,624	88.0%
Medical Office	83	6,491	92.4%	86	6,604	93.8%	86	6,447	94.4%	74	5,888	93.6%	72	5,709	93.4%
Retail	6	1,327	85.4%	5	937	84.7%	5	937	87.1%	5	937	86.7%	5	937	87.6%
Total	757	142,928	91.8%	769	148,567	93.1%	771	149,257	93.4%	754	152,574	94.0%	747	154,081	93.6%

Note: Percentage leased numbers are shown on a lease-up basis. Lease-up basis occupancy represents the percentage of total square feet based on executed leases without regard to whether the leases have commenced.

Note: Joint Ventures are included at 100%.

(1) Includes development projects placed in-service less than 1 year that have not reached 90% occupancy.

Exhibit II

Historical Occupancy Summary

(SF in thousands)

	Properties in Service (1)		Under Development		Total Portfolio	
	Total Square Feet	Percent Leased	Total Square Feet	Percent Leased	Total Square Feet	Percent Leased
December 31, 2002	105,196	87.1%	3,058	79.5%	108,254	86.8%
December 31, 2003	106,220	89.3%	2,813	72.6%	109,033	88.9%
December 31, 2004	109,987	90.9%	4,228	59.2%	114,215	89.7%
December 31, 2005	98,671	92.5%	9,005	41.7%	107,676	88.3%
December 31, 2006	110,629	92.9%	10,585	33.8%	121,214	87.7%
December 31, 2007	116,323	92.0%	16,578	50.7%	132,901	86.9%
December 31, 2008	131,049	88.8%	4,021	46.4%	135,070	87.6%
December 31, 2009	133,829	87.4%	1,620	70.0%	135,449	87.2%
December 31, 2010	136,735	89.1%	2,741	88.5%	139,476	89.1%
December 31, 2011	135,590	90.7%	913	89.1%	136,503	90.7%
December 31, 2012	141,196	93.0%	4,446	73.5%	145,642	92.4%
December 31, 2013	146,479	94.2%	6,095	89.2%	152,574	94.0%
March 31, 2014	146,559	94.0%	7,522	85.6%	154,081	93.6%

Note: Percentage leased numbers are shown on a lease-up basis. Lease-up basis occupancy represents the percentage of total square feet based on executed leases without regard to whether the leases have commenced.

Note: Joint Ventures are included at 100%.

(1) Includes unstabilized developments that have reached shell completion.

Exhibit II

FFO and NOI Reconciliation

(unaudited and in thousands)

	Three Months Ended	
	March 31, 2014	March 31, 2013
Core Funds from Operations - Diluted (page 9)	**$93,183**	$83,197
Add back: Interest expense, continuing operations	**55,257**	57,181
Add back: Interest expense, discontinued operations	**382**	4,260
Add back: Dividends on preferred shares	**7,037**	9,550
Less: Company share of joint venture depreciation, amortization and other	**(6,396)**	(7,629)
Add back: Noncontrolling interest in consolidated joint ventures	**84**	206
Core EBITDA, Prior to Adjustments for Joint Ventures (page 11)	**$149,547**	$146,765
Less: General contractor and service fee revenue, net of related expenses	**(8,549)**	(9,063)
Add back: General and administrative expenses	**14,694**	13,145
Add back: Undeveloped land carrying costs	**2,124**	2,198
Add back: Other operating expenses	**92**	68
Add back: Gains (losses) on depreciable property sales - Company's share of JV	**(165)**	48,814
Less: Equity in earnings	**(2,321)**	(49,378)
Less: Interest and other income	**(351)**	(153)
Less: Revenues not allocable to operating segments	**(979)**	(1,197)
Add back: Rental expenses and real estate taxes not allocable to operating segments	**1,671**	886
Wholly Owned Property Level NOI	**$155,763**	$152,085
Less: Revenues from discontinued operations	**(1,368)**	(16,404)
Add back: Rental expenses and real estate taxes from discontinued operations	**913**	5,986
Wholly Owned Property Level NOI from Continuing Operations	**$155,308**	$141,667
Adjustments to rental revenues (1)	**(5,549)**	(3,332)
Sold assets not in discontinued operations	**96**	(2,767)
Wholly Owned Property Level NOI - Cash Basis (page 17)	**$149,855**	$135,568
Proforma property level NOI adjustments - wholly owned properties (2)	**1,140**	388
Property level NOI - cash basis (share of JV properties)	**12,342**	11,256
Total Proforma Property Level NOI - Cash Basis (Page 17)	**$163,337**	$147,212

(1) Represents adjustments for straight line rental income and expense, amortization of above and below market rents, amortization of lease concessions, intercompany rents and termination fees.

(2) NOI is adjusted to reflect a full quarter of operations for properties that were placed in service or acquired during the quarter.

Exhibit II

Net Operating Income by Product Type

(dollars and SF in thousands)

	Bulk Distribution	Suburban Office	Medical Office	Retail	Total	
Total Wholly Owned and Joint Venture In-Service Portfolio						
Rental revenues from continuing operations	$134,002	$66,972	$33,310	$2,087	$236,371	(1)
Adjustments to rental revenues	(3,874)	(1,636)	97	(136)	(5,549)	(2)
Sold assets not in discontinued operations	-	10	86	-	96	(3)
Adjusted rental revenues	130,128	65,346	33,493	1,951	230,918	
Rental and real estate tax expenses from continuing operations	(38,219)	(29,082)	(12,916)	(846)	(81,063)	(4)
Wholly owned property level NOI-cash basis (PNOI)	91,909	36,264	20,577	1,105	149,855	
Proforma property level NOI adjustments- wholly owned properties	44	185	911	-	1,140	(5)
Wholly owned pro-forma property level NOI-cash basis	$91,953	$36,449	$21,488	$1,105	$150,995	
Property level NOI- cash basis (share of JV properties)	4,767	5,362	1,222	991	12,342	(6)
Total pro-forma property level NOI- cash basis	$96,720	$41,811	$22,710	$2,096	$163,337	
NOI % by product type	59%	26%	14%	1%		
Number of properties	486	165	63	5	719	(7)
Total square footage at 100%	120,576	19,172	5,255	937	145,939	(7)
Total square footage at economic ownership %	109,472	15,976	4,732	718	130,897	(7)
Average commencement occupancy for the three months ended 3/31/14	92.9%	86.4%	90.2%	84.9%	91.9%	(8)
Ending lease up occupancy at 3/31/14	95.0%	88.1%	93.6%	87.6%	94.0%	(9)

Note: **NOI information is for the three months ended March 31, 2014 and includes only wholly owned and joint venture in-service properties as of March 31,2014. Joint venture property NOI is shown at economic ownership percentage. Sold properties and projects designated as held for sale have been excluded.**

Note: **See page 19 for further detail regarding the composition of our in-service portfolio.**

Note: **Three properties are classified as held for sale, and treated as discontinued operations, at March 31, 2014 and, as such, are not included in the schedule above. These properties generated $729 of NOI during the three months ended March 31, 2014 and had a gross basis of $39,339 as of March 31, 2014.**

(1) Rental revenues from continuing operations as included in the segment reporting disclosures in the notes to our consolidated financial statements. Revenues not allocated to reportable segments, which are not included above, totaled $979 for the three months ended March 31, 2014.

(2) Represents adjustments for straight line rental income and expense, amortization of above and below market rents, amortization of lease concessions, intercompany rents and lease termination fees.

(3) Represents properties that were sold but not included in discontinued operations due primarily to ongoing property management agreements.

(4) Rental and real estate taxes as used in the computation of PNOI from the segment reporting disclosures in the notes to our consolidated financial statements.
Rental expenses and real estate taxes not allocated to reportable segments, which are not included above, totaled $1,671 for the three months ended March 31,2014.

(5) NOI is adjusted to reflect a full quarter of operations for properties that were placed in service or acquired during the quarter.

(6) NOI for joint venture properties is presented at Duke's effective ownership percentage.

(7) Number of properties, total square footage at 100% and total square footage at economic ownership % exclude two industrial buildings (563,000 SF) and one medical office building (57,000 SF) that are held for sale and included in discontinued operations.

(8) Commencement occupancy represents the percentage of total square feet where the leases have commenced.

(9) Lease up occupancy represents the percentage of total square feet based on executed leases without regard to whether the leases have commenced.

Exhibit II

Net Operating Income

(dollars and SF in thousands)

	Bulk Distribution	Suburban Office	Medical Office	Retail	Total
Stabilized Properties Generating Positive NOI (1)					
Total pro-forma property level NOI-cash basis, included in total from page 18	$ 97,928	$ 42,688	$ 22,710	$ 2,096	$ 165,421
Gross book value (4)	$4,868,181	$2,099,676	$ 1,233,091	$209,983	$8,410,931
Number of properties	465	154	63	5	687
Average age	11.8	14.9	6.1	8.0	11.9
Total square footage at 100%	116,096	18,110	5,254	937	140,396
Total square footage at economic ownership %	105,309	14,949	4,732	718	125,708
Average commencement occupancy for the three months ended 3/31/14	95.4%	88.3%	90.2%	84.9%	94.2%
Lease up occupancy at 3/31/14	96.6%	90.1%	93.6%	87.6%	95.6%
Stabilized Properties with Negative NOI (2)					
Total pro-forma property level NOI-cash basis, included in total from page 18	$ (1,185)	$ (877)	N/A	N/A	$ (2,063)
Gross book value (4)	$ 187,812	$ 113,590	N/A	N/A	$ 301,402
Number of properties	20	11	N/A	N/A	31
Average age	8.7	20.0	N/A	N/A	11.2
Total square footage at 100%	3,880	1,063	N/A	N/A	4,943
Total square footage at economic ownership %	3,863	1,026	N/A	N/A	4,890
Average commencement occupancy for the three months ended 3/31/14	23.8%	53.1%	N/A	N/A	30.1%
Lease up occupancy at 3/31/14	52.3%	54.0%	N/A	N/A	52.7%
Unstabilized Properties (3)					
Total pro-forma property level NOI-cash basis, included in total from page 18	$ (21)	N/A	N/A	N/A	$ (21)
Gross book value (4)	$ 9,543	N/A	N/A	N/A	$ 9,543
Number of properties	1	N/A	N/A	N/A	1
Average age	0.8	N/A	N/A	N/A	0.8
Total square footage at 100%	600	N/A	N/A	N/A	600
Total square footage at economic ownership %	300	N/A	N/A	N/A	300
Average commencement occupancy for the three months ended 3/31/14	57.2%	N/A	N/A	N/A	57.2%
Lease up occupancy at 3/31/14	57.2%	N/A	N/A	N/A	57.2%

Note: NOI information is for the three months ended March 31, 2014 and includes only wholly owned and joint venture in-service properties as of March 31, 2014. Joint venture property NOI is shown at economic ownership percentage. Sold properties and projects designated as held for sale have been excluded.

Note: This schedule provides supplemental information for the same population of properties presented on page 17 and 18.

Note: Three properties are classified as held for sale and treated as discontinued operations, at March 31, 2014 and, as such, are not included in the schedule above. These properties generated $729 of NOI during the three months ended March 31, 2014 and had a gross basis of $39,339 as of March 31, 2014.

(1) Represents buildings that have reached 90% occupancy and/or been in service for at least one year and that have positive NOI for the current reporting period.

(2) Represents buildings that have reached 90% lease-up occupancy and have negative NOI for the current reporting period.

(3) Represents buildings that have been in service for less than one year and have not reached 90% occupancy.

(4) Joint ventures are included at ownership percentage.

Exhibit II

Net Operating Income by Market

(dollars and SF in thousands)

Market	Net Operating Income: Bulk Distribution	Suburban Office	Medical Office	Retail	Total	Total Square Footage at Economic Ownership %: Bulk Distribution	Suburban Office	Medical Office	Retail	Total
Indianapolis	$ 11,174	$ 8,560	$ 2,165	$ 10	$ 21,909	14,917	2,812	402	38	18,170
Cincinnati	7,003	7,082	1,480	40	15,604	9,533	3,060	370	30	12,993
Dallas	8,873	539	4,184	-	13,596	10,663	200	816	-	11,678
Raleigh	3,612	7,285	1,578	52	12,527	2,801	2,297	357	20	5,475
Atlanta	6,078	1,937	4,104	-	12,119	8,370	724	891	-	9,986
South Florida	6,382	5,047	646	-	12,075	4,793	1,484	107	-	6,384
Chicago	10,528	98	976	-	11,602	10,773	20	161	-	10,954
Nashville	3,793	3,691	633	-	8,117	3,932	1,023	121	-	5,076
St. Louis	4,224	3,435	-	-	7,659	4,559	1,960	-	-	6,520
Central Florida	4,184	695	2,280	-	7,158	3,542	208	466	-	4,216
Columbus	6,684	97	-	-	6,781	8,332	51	-	-	8,383
Washington DC	612	3,626	576	-	4,814	272	728	101	-	1,101
Minneapolis	3,612	-	-	991	4,603	3,599	-	-	340	3,938
Houston	3,382	143	553	-	4,078	2,452	32	169	-	2,652
Pennsylvania	2,708	-	-	1,003	3,711	2,384	-	-	290	2,674
Savannah	3,606	-	-	-	3,606	5,318	-	-	-	5,318
Northern California	2,676	-	-	-	2,676	2,572	-	-	-	2,572
Southern California	2,557	-	-	-	2,557	1,796	-	-	-	1,796
Seattle	1,950	-	-	-	1,950	1,136	-	-	-	1,136
New Jersey	1,827	-	-	-	1,827	1,335	-	-	-	1,335
Phoenix	1,342	-	-	-	1,342	1,251	-	-	-	1,251
Baltimore	746	-	-	-	746	462	-	-	-	462
Other	375	452	3,534	-	4,362	517	350	772	-	1,638
Totals	$ 97,928	$ 42,688	$ 22,710	$ 2,096	$ 165,421	105,309	14,949	4,732	718	125,708

Note: NOI information is for the three months ended March 31, 2014 and includes only wholly owned and joint venture in-service properties as of March 31, 2014. Joint venture property NOI is shown at economic ownership percentage. Sold properties and projects designated as held for sale have been excluded.

Note: This schedule provides supplemental information for the stabilized properties generating positive NOI shown on page 18.

Exhibit II

Geographic Highlights

In Service Properties as of March 31, 2014

Primary Market	Square Feet (1) Bulk Distribution	Suburban Office	Medical Office	Retail	Overall	Percent of Overall	Average Annual Rental Revenue (2)	Percent of Annual Net Effective Rent
Indianapolis	19,524,342	2,918,233	539,157	38,366	23,020,098	15.7%	$ 92,195,992	12.8%
Cincinnati	9,626,505	3,311,264	370,180	206,315	13,514,264	9.2%	68,998,199	9.5%
Dallas	14,758,823	199,800	1,200,905	-	16,159,528	11.0%	56,664,699	7.8%
South Florida	4,915,895	1,794,523	107,000	-	6,817,418	4.7%	55,906,910	7.7%
Atlanta	8,938,350	1,249,036	890,892	-	11,078,278	7.6%	55,629,900	7.7%
Raleigh	2,800,680	2,394,831	356,836	20,061	5,572,408	3.8%	52,094,943	7.2%
Chicago	11,447,070	98,304	161,443	-	11,706,817	8.0%	48,240,791	6.7%
St. Louis	4,678,255	2,264,278	-	-	6,942,533	4.7%	39,932,968	5.5%
Nashville	3,932,110	1,167,531	120,660	-	5,220,301	3.6%	34,149,832	4.7%
Central Florida	4,268,901	415,373	465,727	-	5,150,001	3.5%	27,997,605	3.9%
Columbus	9,246,217	253,705	-	-	9,499,922	6.5%	25,403,374	3.5%
Minneapolis	3,720,250	-	-	381,922	4,102,172	2.8%	23,789,932	3.3%
Savannah	6,935,446	-	-	-	6,935,446	4.7%	19,640,725	2.7%
Houston	2,691,611	318,231	168,850	-	3,178,692	2.2%	19,331,482	2.7%
Washington DC	748,362	2,366,239	100,952	-	3,215,553	2.2%	18,265,052	2.5%
Pennsylvania	2,384,240	-	-	289,855	2,674,095	1.8%	15,899,000	2.2%
Northern California	2,571,630	-	-	-	2,571,630	1.8%	10,953,257	1.5%
Southern California	2,339,379	-	-	-	2,339,379	1.6%	10,914,228	1.5%
Seattle	1,136,109	-	-	-	1,136,109	0.8%	10,256,153	1.4%
New Jersey	1,335,464	-	-	-	1,335,464	0.9%	7,016,296	1.0%
Phoenix	2,058,316	-	-	-	2,058,316	1.4%	5,241,798	0.7%
Baltimore	462,070	-	-	-	462,070	0.3%	2,696,875	0.4%
Other	618,944	420,869	829,044	-	1,868,857	1.3%	21,667,161	3.0% (3)
Total	121,138,969	19,172,217	5,311,646	936,519	146,559,351	100.0%	$ 722,887,174	100.0%
% of Square Feet	82.7%	13.1%	3.6%	0.6%	100.0%			

Primary Market	Occupancy % Bulk Distribution	Suburban Office	Medical Office	Retail	Overall
Indianapolis	97.3%	93.4%	97.1%	92.1%	96.8%
Cincinnati	97.5%	84.8%	98.4%	100.0%	94.4%
Dallas	97.1%	100.0%	95.7%	-	97.1%
South Florida	91.4%	92.2%	100.0%	-	91.7%
Atlanta	89.3%	92.3%	95.7%	-	90.2%
Raleigh	95.8%	95.2%	97.2%	71.7%	95.5%
Chicago	98.0%	100.0%	98.9%	-	98.0%
St. Louis	95.5%	80.6%	-	-	90.7%
Nashville	81.0%	94.4%	100.0%	-	84.4%
Central Florida	93.6%	92.1%	81.3%	-	92.4%
Columbus	99.2%	75.4%	-	-	98.5%
Minneapolis	95.3%	-	-	82.5%	94.1%
Savannah	87.7%	-	-	-	87.7%
Houston	100.0%	100.0%	85.0%	-	99.2%
Washington DC	93.4%	80.3%	100.0%	-	84.0%
Pennsylvania	100.0%	-	-	85.9%	98.5%
Northern California	100.0%	-	-	-	100.0%
Southern California	76.8%	-	-	-	76.8%
Seattle	100.0%	-	-	-	100.0%
New Jersey	100.0%	-	-	-	100.0%
Phoenix	96.3%	-	-	-	96.3%
Baltimore	100.0%	-	-	-	100.0%
Other **(3)**	82.0%	58.6%	87.8%	-	79.3%
Total	95.0%	88.1%	93.7%	87.6%	94.0%

(1) Includes all wholly owned and joint venture projects shown at 100% as of report date.

(2) Annualized rental revenue represents average annual base rental payments, on a straight-line basis for the term of each lease, from space leased to tenants at the end of the most recent reporting period. Annualized rental revenue excludes additional amounts paid by tenants as reimbursement for operating expenses and real estate taxes, as well as percentage rents. Joint venture properties are included at the Company's economic ownership percentage.

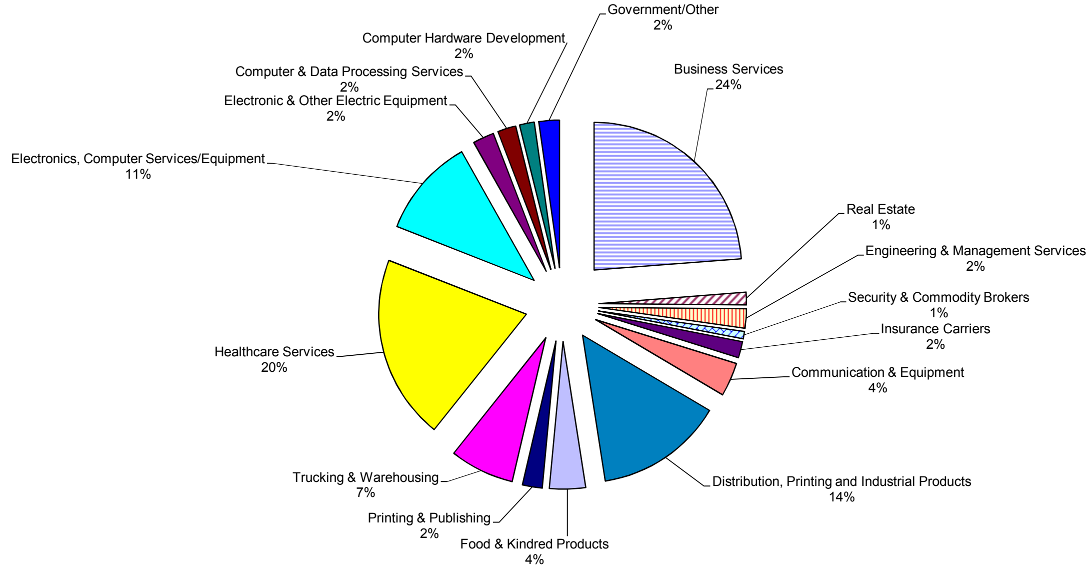
(3) Represents properties not located in the company's primary markets.

Exhibit II

Tenant Industry Profile and Largest Tenant Summary

March 31, 2014

Tenant Industry Profile as a Percentage of Annualized Gross Effective Rent (1)



Largest Tenants (In-Service Properties) Based Upon Annualized Gross Rent

Tenant	Primary Location	Primary Industry	Year of Lease Expiration	Average Annual Gross Effective Rent (1) (In Thousands)	Percentage of Annualized Gross Effective Rent
Baylor Scott & White Healthcare	Dallas	Healthcare Services	2014 - 2029	$20,201	2.5%
U.S. Government Agencies	South Florida	U.S. Government	2014 - 2034	17,126	2.2%
Amazon.com	Seattle	Retail	2017 - 2028	15,521	2.0%
Ascension Health	Other Midwest	Healthcare Services	2015 - 2029	10,226	1.3%
Lenovo Inc.	Raleigh	Computer Hardware Development	2020	9,558	1.2%
Crate and Barrel	New Jersey	Retail	2020 - 2022	8,236	1.0%
Mars, Incorporated	Columbus	Manufacturing/Agriculture	2014 - 2023	7,165	0.9%
Harbin Clinic	Atlanta	Healthcare Services	2027	7,093	0.9%
Home Depot	Northern California	Retail	2015 - 2024	6,377	0.8%
Interactive Intelligence	Indianapolis	Computer Software Services	2016 - 2019	6,194	0.8%
Northside Hospital Health Syst	Atlanta	Healthcare Services	2014 - 2023	6,169	0.8%
Tenet Healthcare Corp.	Dallas	Healthcare Services	2022 - 2030	5,846	0.7%
Schneider National	Savannah	Distribution/Warehousing	2014 - 2023	5,680	0.7%
Carolinas Healthcare System	Raleigh	Healthcare Services	2020	5,375	0.7%
Adventist Health	Central Florida	Healthcare Services	2014 - 2028	5,273	0.7%
Restoration Hardware	Columbus	Retail	2028	5,121	0.6%
Mercy	St. Louis	Healthcare Services	2014 - 2019	5,015	0.6%
Catholic Health Initiatives	Cincinnati	Healthcare Services	2021 - 2028	4,944	0.6%
Genco Distribution Systems	Indianapolis	Distribution/Warehousing	2014 - 2016	4,781	0.6%
CEVA Group PLC	Chicago	Distribution/Warehousing	2014 - 2020	4,728	0.6%
				$160,629	20.1%

(1) Represents average annual gross effective rents due from tenants in service as of March 31, 2014. Average annual gross effective rent equals the average annual rental property revenue over the terms of the respective leases including landlord operating expense allowance and excluding additional rent due as operating expense reimbursements and percentage rents.

Note: Joint ventures are included at the Company's economic ownership percentage.

Exhibit II

Same Property Performance

All Properties:	Three Months Ended March 31, 2014 and 2013 Bulk Distribution	Suburban Office	Medical Office	Retail	Total	Twelve Months Ended March 31, 2014 and 2013 Bulk Distribution	Suburban Office	Medical Office	Retail	Total
Number of properties (3)	446	156	25	4	631	446	156	25	4	631
Square feet	89,210,870	14,467,633	2,048,239	688,193	106,414,934	89,210,870	14,467,633	2,048,239	688,193	106,414,934
Percent of in-service properties	81.1%	90.6%	42.8%	95.9%	80.9%	81.1%	90.6%	42.8%	95.9%	80.9%
2014 Average Commencement Occupancy (1)	93.9%	85.6%	89.1%	80.8%	92.6%	93.8%	84.1%	88.6%	79.2%	92.3%
Period over period percent change	0.4%	3.7%	0.9%	3.6%	0.8%	1.0%	2.8%	1.0%	0.6%	1.2%

	Three Months Ended March 31 2014	2013	% Change		Twelve Months Ended March 31 2014	2013	% Change
				Bulk Distribution			
Total operating revenues	$ 112,037,791	$ 105,505,806	6.2%		$ 432,520,086	$ 416,584,839	3.8%
Total operating expenses	37,308,301	32,423,761	15.1%		130,431,514	122,735,346	6.3%
Net Operating Income (2)	$ 74,729,491	$ 73,082,045	2.3%		$ 302,088,572	$ 293,849,493	2.8%
				Suburban Office			
Total operating revenues	$ 67,757,406	$ 63,971,543	5.9%		$ 263,216,223	$ 252,794,131	4.1%
Total operating expenses	30,602,054	27,764,196	10.2%		114,777,650	110,523,242	3.8%
Net Operating Income (2)	$ 37,155,352	$ 36,207,347	2.6%		$ 148,438,573	$ 142,270,889	4.3%
				Medical Office			
Total operating revenues	$ 14,462,284	$ 13,435,853	7.6%		$ 55,758,912	$ 53,556,093	4.1%
Total operating expenses	6,298,683	5,580,943	12.9%		23,440,138	22,356,186	4.8%
Net Operating Income (2)	$ 8,163,601	$ 7,854,911	3.9%		$ 32,318,774	$ 31,199,907	3.6%
				Retail			
Total operating revenues	$ 4,492,438	$ 4,342,731	3.4%		$ 17,080,577	$ 16,987,728	0.5%
Total operating expenses	2,615,477	2,242,168	16.6%		9,036,786	7,897,900	14.4%
Net Operating Income (2)	$ 1,876,960	$ 2,100,563	-10.6%		$ 8,043,791	$ 9,089,828	-11.5%
				Total			
Total operating revenues	$ 198,749,919	$ 187,255,934	6.1%		$ 768,575,799	$ 739,922,791	3.9%
Total operating expenses	76,824,515	68,011,068	13.0%		277,686,088	263,512,674	5.4%
Net Operating Income (2)	**$ 121,925,405**	**$ 119,244,866**	**2.2%**		**$ 490,889,710**	**$ 476,410,116**	**3.0%**

Note: All information for joint venture properties is presented at Duke's effective ownership percentage.

(1) Commencement occupancy represents the percentage of total square feet where the leases have commenced.

(2) Net Operating Income (NOI) is equal to FFO excluding the effects of straight-line rent, concession amortization and market lease amortization.

(3) The population for determining same property performance includes both consolidated and joint venture properties. In order not to distort trends due to non-operating events, properties with termination fees over $250,000 have been excluded from both periods shown. The population, for both periods shown, consists of the 722 in-service properties that we own or jointly control, as of March 31, 2014, less (i) 47 in-service buildings that were acquired within the last 24 months, (ii) 26 in-service buildings we developed that were placed in service within the last 24 months, (iii) 15 in-service buildings that have recognized income from a lease termination fee of greater than $250,000 within the last 24 months and (iv) 3 in-service buildings that are under contract to sell at March 31, 2014 and are classified as held-for-sale for accounting purposes.

Exhibit II

Lease Expiration Comparison - Square Feet and Annualized Net Effective Rent

In-Service Properties as of March 31, 2014

(dollars and SF in thousands)

	Total Portfolio			Bulk Distribution Portfolio		Suburban Office Portfolio		Medical Office Portfolio		Retail Portfolio	
Year of Expiration	Square Feet	Average Annual Rental Revenue (1)	%	Square Feet	Average Annual Rental Revenue (1)	Square Feet	Average Annual Rental Revenue (1)	Square Feet	Average Annual Rental Revenue (1)	Square Feet	Average Annual Rental Revenue (1)
Wholly Owned Portfolio:											
2014	7,554	$ 37,520	6%	6,460	$ 24,478	985	$ 11,253	105	$ 1,669	4	$ 120
2015	12,713	63,955	10%	10,985	41,362	1,663	21,265	57	1,152	8	176
2016	14,667	74,647	11%	12,645	46,587	1,794	23,453	209	4,250	19	357
2017	14,326	74,653	11%	12,663	49,986	1,407	19,102	183	3,842	73	1,723
2018	12,525	75,548	11%	10,188	39,124	1,872	25,145	388	9,807	77	1,472
2019	11,660	65,132	10%	9,860	38,354	1,531	20,088	257	6,406	12	284
2020	10,807	61,512	9%	9,354	37,659	986	14,576	457	9,020	10	257
2021	7,443	42,451	6%	6,280	24,984	912	11,613	238	5,582	13	272
2022	5,920	29,731	4%	5,333	18,230	246	4,339	319	6,715	22	447
2023	2,883	24,489	4%	2,101	10,518	465	7,366	311	6,456	6	149
2024 and Therafter	16,183	117,592	18%	13,385	59,253	1,003	14,751	1,743	42,946	52	642
	116,681	$ 667,230	100%	99,254	$ 390,535	12,864	$ 172,951	4,267	$ 97,845	296	$ 5,899
Total Portfolio Square Feet	124,146			104,590		14,628		4,580		348	
Percent Leased - Lease up Basis (2)	94.0%			94.9%		87.9%		93.2%		85.7%	
Joint Venture Portfolio:											
2014	1,483	$ 3,280	6%	1,334	$ 2,239	146	$ 973	-	$ -	3	$ 68
2015	1,981	7,743	14%	967	1,570	1,014	6,173	-	-	-	-
2016	2,256	5,341	10%	1,867	2,912	373	2,126	1	3	15	300
2017	1,330	3,387	6%	1,007	1,749	316	1,638	-	-	7	-
2018	3,313	6,957	12%	2,296	2,126	800	4,332	-	-	217	499
2019	3,667	4,379	8%	3,350	2,359	309	1,750	-	-	8	270
2020	542	3,068	6%	417	846	50	326	-	-	75	1,896
2021	2,596	3,959	7%	2,449	2,572	120	805	6	27	21	555
2022	707	3,117	6%	414	601	284	2,238	-	-	9	278
2023	233	1,034	2%	121	67	102	880	-	-	10	87
2024 and Therafter	2,987	13,392	23%	1,621	2,441	508	2,207	702	4,708	156	4,036
	21,095	$ 55,657	100%	15,843	$ 19,482	4,022	$ 23,448	709	$ 4,738	521	$ 7,989
Total Portfolio Square Feet	22,413			16,549		4,544		732		588	
Percent Leased - Lease up Basis (2)	94.1%			95.7%		88.5%		96.8%		88.6%	
Total:											
2014	9,037	$ 40,800	6%	7,794	$ 26,717	1,131	$ 12,226	105	$ 1,669	7	$ 188
2015	14,694	71,698	10%	11,952	42,932	2,677	27,438	57	1,152	8	176
2016	16,923	79,988	11%	14,512	49,499	2,167	25,579	210	4,253	34	657
2017	15,656	78,040	11%	13,670	51,735	1,723	20,740	183	3,842	80	1,723
2018	15,838	82,505	11%	12,484	41,250	2,672	29,477	388	9,807	294	1,971
2019	15,327	69,511	10%	13,210	40,713	1,840	21,838	257	6,406	20	554
2020	11,349	64,580	9%	9,771	38,505	1,036	14,902	457	9,020	85	2,153
2021	10,039	46,410	6%	8,729	27,556	1,032	12,418	244	5,609	34	827
2022	6,627	32,848	5%	5,747	18,831	530	6,577	319	6,715	31	725
2023	3,116	25,523	4%	2,222	10,585	567	8,246	311	6,456	16	236
2024 and Therafter	19,170	130,984	17%	15,006	61,694	1,511	16,958	2,445	47,654	208	4,678
	137,776	$ 722,887	100%	115,097	$ 410,017	16,886	$ 196,399	4,976	$ 102,583	817	$ 13,888
Total Portfolio Square Feet	146,559			121,139		19,172		5,312		936	
Percent Leased - Lease up Basis (2)	94.0%			95.0%		88.1%		93.7%		87.6%	

(1) Annualized rental revenue represents average annual base rental payments, on a straight-line basis for the term of each lease, from space leased to tenants at the end of the most recent reporting period. Annualized rental revenue excludes additional amounts paid by tenants as reimbursement for operating expenses and real estate taxes, as well as percentage rents. Joint venture properties are included at the Company's economic ownership percentage.

(2) Lease up basis occupancy represents the percentage of total square feet based on executed leases without regard to whether the leases have commenced.

Exhibit II

New Lease Analysis

Second Generation Deals as of March 31, 2014

Product Type	Number of New Leases	Square Feet of Second Generation Spaces	2nd Generation Weighted Average Capital Expenditures: Per Sq. Ft.	2nd Generation Weighted Average Capital Expenditures: Per Sq. Ft. / Per Year of Lease Term	Average Term in Years	Average Net Effective Rent
Year Ended 2013						
Bulk Distribution	126	6,752,474	$ 4.00	$ 0.73	5.48	$ 3.63
Suburban Office	161	1,305,293	25.75	3.80	6.78	12.49
Medical Office	11	40,711	16.37	2.94	5.56	17.97
	298	8,098,478	$ 7.57	$ 1.33	5.69	$ 5.13
1st Quarter 2014						
Bulk Distribution	28	2,381,949	$ 4.98	$ 0.66	7.49	$ 3.58
Suburban Office	26	220,592	19.15	4.19	4.57	12.79
Medical Office	4	14,090	29.36	4.89	6.01	16.69
	58	2,616,631	$ 6.30	$ 0.87	7.23	$ 4.43
Year to Date 2014						
Bulk Distribution	28	2,381,949	$ 4.98	$ 0.66	7.49	$ 3.58
Suburban Office	26	220,592	19.15	4.19	4.57	12.79
Medical Office	4	14,090	29.36	4.89	6.01	16.69
	58	2,616,631	$ 6.30	$ 0.87	7.23	$ 4.43

Note: **Activity noted above does not include first generation lease-up of new development and acquisitions as these amounts are included in our initial return calculations. Activity is based on leases signed during the period and excludes temporary leases of space.**

Note: **Joint ventures are shown at 100%**

Exhibit II

Renewal Analysis

As of March 31, 2014

	Leases up for Renewal		Leases Renewed					Average Capital Expenditures		
Product Type	Number	Square Feet	Number	Square Feet	Percent Renewed (1)	Average Term in Years	Average Net Effective Rent	Per Sq. Ft.	Per Sq. Ft. / Per Year of Lease Term	Growth in Net Eff. Rent (2)
Year Ended 2013										
Bulk Distribution	240	16,446,780	159	11,286,276	68.6%	4.22	$ 4.00	$ 1.66	$ 0.39	4.31%
Suburban Office	269	2,703,532	179	2,214,216	81.9%	4.66	14.52	10.52	2.26	1.38%
Medical Office	39	138,984	22	53,433	38.4%	3.83	19.13	6.86	1.79	5.96%
	548	19,289,296	360	13,553,925	70.3%	4.29	$ 5.78	$ 3.13	$ 0.73	3.11%
1st Quarter 2014										
Bulk Distribution	50	2,694,499	36	1,784,591	66.2%	3.80	$ 4.56	$ 0.87	$ 0.23	8.29%
Suburban Office	43	295,701	22	158,011	53.4%	3.90	13.43	7.95	2.04	4.47%
Medical Office	10	32,751	4	18,153	55.4%	5.00	21.00	4.00	0.80	20.76%
	103	3,022,951	62	1,960,755	64.9%	3.82	$ 5.43	$ 1.47	$ 0.38	7.90%
Year to Date 2014										
Bulk Distribution	50	2,694,499	36	1,784,591	66.2%	3.80	$ 4.56	$ 0.87	$ 0.23	8.29%
Suburban Office	43	295,701	22	158,011	53.4%	3.90	13.43	7.95	2.04	4.47%
Medical Office	10	32,751	4	18,153	55.4%	5.00	21.00	4.00	0.80	20.76%
	103	3,022,951	62	1,960,755	64.9%	3.82	$ 5.43	$ 1.47	$ 0.38	7.90%

(1) The percentage renewed is calculated by dividing the square feet of leases renewed by the square feet of leases up for renewal. The square feet of leases up for renewal is defined as the square feet of leases renewed plus the square feet of space vacated due to lease expirations. Excludes temporary leases of space. Joint venture properties are included at 100%.

(2) Represents the percentage change in net effective rent between the original leases and the renewal leases. Net effective rent represents average annual base rental payments, on a straight-line basis for the term of each lease excluding operating expense reimbursements.

Exhibit II

Space Vacated Analysis

As of March 31, 2014

	Total	Terminations	Lease Expirations (1)		Default / Bankruptcy		Buyouts (2)		Relocations (3)		Contractions (4)	
			Space Vacated for the Following Reasons									
Year Ended 2013												
Bulk Distribution	130	8,106,662	81	5,160,504	22	1,293,566	9	800,704	6	491,805	12	360,083
Suburban Office	145	855,736	90	489,316	13	68,233	15	92,115	7	27,181	20	178,891
Medical Office	22	106,118	17	85,551	2	10,312	-	-	1	2,355	2	7,900
	297	9,068,516	188	5,735,371	37	1,372,111	24	892,819	14	521,341	34	546,874
1st Quarter 2014												
Bulk Distribution	25	2,036,855	14	909,908	2	37,102	7	860,339	1	77,281	1	152,225
Suburban Office	35	249,503	21	137,690	6	75,415	2	11,376	4	9,544	2	15,478
Medical Office	7	18,715	6	14,598	-	-	1	4,117	-	-	-	-
	67	2,305,073	41	1,062,196	8	112,517	10	875,832	5	86,825	3	167,703
Year to Date 2014												
Bulk Distribution	25	2,036,855	14	909,908	2	37,102	7	860,339	1	77,281	1	152,225
Suburban Office	35	249,503	21	137,690	6	75,415	2	11,376	4	9,544	2	15,478
Medical Office	7	18,715	6	14,598	-	-	1	4,117	-	-	-	-
	67	2,305,073	41	1,062,196	8	112,517	10	875,832	5	86,825	3	167,703

Note: Excludes temporary leases of space.

Note: Joint Ventures are shown at 100%.

(1) Represents tenants who did not renew their leases upon expiration due to the closing of their local operations, relocation to another property not owned or built by the Company, or the exercising of a termination option.

(2) Represents space with termination fees required to allow the tenants to vacate their space prior to the normal expiration of their lease term.

(3) Represents tenants who vacated their space and relocated to another property owned or built by the Company or moved out to accommodate another Duke tenant expansion.

(4) Represents tenants who have downsized prior to expiration of their lease term.

Exhibit II

Debt Maturity & Preferred Stock Analysis

March 31, 2014

(in thousands)

Year	Mortgages (1) Amortization	Mortgages (1) Maturities	Unsecured (1) Amortization	Unsecured (1) Maturities	Credit Facility (2)	Total (3)	Weighted Average Effective Interest Rates (3)
2014	$ 11,090	$ 49,406	$ 1,581	$ -	$ -	$ 62,077	6.23%
2015	12,432	193,346	2,226	250,000	180,000	638,004	5.07%
2016	9,937	368,132	2,370	150,000	-	530,439	6.14%
2017	7,616	108,129	2,523	450,000	-	568,268	5.89%
2018	5,252	-	2,685	550,000	-	557,937	4.03%
2019	4,077	268,438	2,859	250,000	-	525,374	7.97%
2020	3,883	-	1,498	250,000	-	255,381	6.73%
2021	3,416	9,047	-	250,000	-	262,463	3.99%
2022	3,611	-	-	600,000	-	603,611	4.20%
2023	3,817	-	-	250,000	-	253,817	3.75%
2024	4,036	-	-	-	-	4,036	5.62%
Thereafter	6,325	-	-	50,000	-	56,325	7.11%
	$ 75,492	$ 996,498	$ 15,742	$ 3,050,000	$ 180,000	$ 4,317,732	5.41%

(1) Scheduled amortizations and maturities represent only Duke's consolidated debt obligations.

(2) Comprised of the following:

Commitment	Balance O/S @ 3/31	Maturity	Rate @ 3/31	Type
$850,000	$180,000	December 2015	1.41%	DRLP line of credit

(3) Total debt balance and weighted average effective interest rates exclude fair value adjustments of $5,478 reflected on the balance sheet.

Fixed and Variable Rate Components of Debt	Balance	Weighted Average Interest Rate	Weighted Average Maturity (yrs)
Fixed Rate Secured Debt	$ 1,065,750	6.24%	2.81
Fixed Rate Unsecured Debt	2,815,741	5.70%	5.49
Variable Rate Debt and LOC	436,241	1.45%	2.77
Total	$ 4,317,732	5.41%	4.55

Preferred Stock Summary

Security	Dividend Rate	Liquidation Preference	Depositary Shares Outstanding	Optional Redemption Date
Series J preferred stock	6.63%	$ 96,133	3,845	Currently Redeemable
Series K preferred stock	6.50%	149,395	5,976	Currently Redeemable
Series L preferred stock	6.60%	183,399	7,336	Currently Redeemable
Weighted Average	6.57%	$ 428,926		

Exhibit II

Joint Venture Information

March 31, 2014

	Eaton/Vance	Duke Hulfish LLC	Dugan Texas	3630 Peachtree	Baylor Cancer Center	West End Retail (3)	All Points Industrial	Wishard	Linden Development (4)	Dugan Millenia	Other (5)	Total
In-service properties:												
Bulk distribution	11	7	35	-	-	-	1	-	-	-	13	67
Suburban office	20	10	-	1	-	-	-	-	-	3	1	35
Medical office	-	-	-	-	1	-	-	1	-	-	-	2
Retail	-	-	-	-	-	1	-	-	-	-	1	2
	31	17	35	1	1	1	1	1	-	3	15	106
Under development properties:												
Bulk distribution	-	-	-	-	-	-	2	-	-	-	-	2
	-	-	-	-	-	-	2	-	-	-	-	2
Total number of properties	31	17	35	1	1	1	3	1	-	3	15	108
Percent leased	86.0%	99.0%	95.3%	83.7%	94.9%	82.5%	89.1%	100.0%	N/A	92.1%	97.3%	94.5%
Square feet in-service (in thousands):												
Bulk distribution	670	6,120	6,876	-	-	-	600	-	-	-	2,283	16,549
Suburban office	2,147	1,201	-	436	-	-	-	-	-	415	345	4,544
Medical office	-	-	-	-	458	-	-	274	-	-	-	732
Retail	-	-	-	-	-	382	-	-	-	-	206	588
	2,817	7,321	6,876	436	458	382	600	274	-	415	2,834	22,413
Square feet under development (in thousands):												
Bulk distribution	-	-	-	-	-	-	1,758	-	-	-	-	1,758
	-	-	-	-	-	-	1,758	-	-	-	-	1,758
Total square feet (in thousands)	2,817	7,321	6,876	436	458	382	2,358	274	-	415	2,834	24,171
Company effective ownership percentage	30.0%	20.0%	50.0%	50.0%	16.0%	50.0%	50.0%	50.0%	50.0%	50.0%	10%-50%	
Balance sheet information (in thousands) (A)												
Real estate assets	$ 493,005	$ 384,404	$ 195,110	$ 103,327	$ 109,558	$ 113,502	$ 13,587	$ 74,422	$ -	$ 39,762	$ 96,930	$ 1,623,607
Construction in progress	151	63	508	1,075	-	43	21,558	-	148	31	895	24,472
Undeveloped land	-	-	1,657	-	-	-	43,183	-	59,920	6,204	15,608	126,572
Other assets	43,020	46,756	18,028	20,530	8,160	6,756	11,218	3,423	2,657	7,832	36,377	204,757
Total assets	$ 536,176	$ 431,223	$ 215,303	$ 124,932	$ 117,718	$ 120,301	$ 89,546	$ 77,845	$ 62,725	$ 53,829	$ 149,810	$ 1,979,408
Debt	$ 460,069	$ 79,408	$ -	$ 99,582	$ -	$ 99,400	$ 59,456	$ -	$ -	$ 35,000	$ 64,483	$ 897,398
Other liabilities	9,662	8,267	5,303	31,053	1,657	8,394	7,241	917	4,604	1,120	12,567	90,785
Equity	66,445	343,548	210,000	(5,703)	116,061	12,507	22,849	76,928	58,121	17,709	72,760	991,225
Total liabilities and equity	$ 536,176	$ 431,223	$ 215,303	$ 124,932	$ 117,718	$ 120,301	$ 89,546	$ 77,845	$ 62,725	$ 53,829	$ 149,810	$ 1,979,408
Selected QTD financial information (B)												
QTD share of rental revenue (in thousands)	$5,297	$2,954	$4,163	$1,459	$837	$2,769	$158	$1,199	-	$1,086	$560	$20,482
QTD share of in-service property unlevered NOI (in thousands)	$3,571	$2,175	$3,010	$414	$451	$945	($22)	$771	-	$675	$352	$12,342
QTD share of interest expense (in thousands)	$1,918	$208	-	$331	-	$390	$101	-	-	$105	$31	$3,084
QTD share of EBITDA (in thousands)	$3,451	$2,016	$2,941	$785	$507	$1,056	$71	$918	($93)	$644	$312	$12,608
Company share of JV gross assets (in thousands)	$194,528	$100,881	$145,228	$70,225	$20,887	$70,397	$47,036	$39,335	$31,363	$32,633	$35,223	$787,736
Interest rate (C)	(1)	(2)	N/A	L+2.5%	N/A	(3)	L+1.8%	N/A	N/A	L+1.7%	(5)	N/A
Company share of debt (in thousands)	$138,021	$15,882	N/A	$49,791	N/A	$49,700	$29,728	N/A	N/A	$17,500	$6,862	$307,484
Debt maturity date	(1)	(2)	N/A	7/15	N/A	(3)	12/14	N/A	N/A	7/16	(5)	N/A

(A) Balance sheet information is reported at 100% of joint venture. (B) Reported at Duke's share of joint venture. (C) Interest rate is fixed, except as noted.

Notes in (000's)

(1) The outstanding debt consists of nine separate loans: i) $22,587 at a fixed rate of 6.4% maturing August 2014, ii) $6,384 at a fixed rate of 8.2% maturing December of 2015, iii) $11,916 at a fixed rate of 6.0% maturing March 2016, iv) $27,765 at a fixed rate of 6.2% maturing June 2016, v) $131,250 at a fixed rate of 5.4% maturing March 2017, vi) $203,250 at a fixed rate of 5.4% maturing March 2017 , vii) $15,128 at a fixed rate of 5.6% maturing December 2019, viii) $33,879 at a fixed rate of 5.9% maturing January 2020 and ix) $6,782 at a fixed rate of 8.3% maturing November 2023.

(2) Debt consists of three separate loans: i) $13,653 at a fixed rate of 5.0% maturing September 2021, ii) $10,535 at a fixed rate of 4.4% maturing September 2021, and iii) $55,221 at a fixed rate of 5.2% maturing October 2021.

(3) Our share of in-service property revenue, unlevered NOI, EBITDA and interest expense for this joint venture is computed based on the operating cash flow distributions we would receive pursuant to our accumulated preferred return in this joint venture, which equates to our share being 89%. The debt consists of two separate loans: i) a variable rate land loan of LIBOR + 1.5% maturing September 2014, with a current amount outstanding of $14,400 and ii) a construction line of credit at LIBOR + 1.5% maturing September 2014, with a current amount outstanding of $85,000. Amounts charged by Duke to the joint venture are not included in share of interest expense above.

(4) This joint venture currently has 45.3 acres of land in Linden, New Jersey, anticipated for use to develop 450,000 square feet of retail buildings.

(5) Consists of 8 separate joint ventures that own and operate buildings and hold undeveloped land. Debt balance consists of three separate loans: i) $250 at a variable rate of LIBOR + 3.0% maturing June 2014, ii) $24,000 at a fixed rate of 8.0% maturing October 2015 and iii) $40,233 at a variable rate of LIBOR + 1.4% maturing December 2016.

Exhibit II

Joint Venture Debt Maturity Summary

March 31, 2014

(in thousands)

Year	Scheduled Amortization	Maturities	Total	Weighted Average Interest Rate
2014	$ 912	$ 86,191	$ 87,103	2.15%
2015	1,207	53,933	55,140	3.14%
2016	977	33,167	34,144	3.35%
2017	899	100,350	101,249	5.40%
2018	955	-	955	6.04%
2019	1,002	3,824	4,826	5.67%
2020	645	8,693	9,338	5.92%
2021	543	13,305	13,848	5.15%
2022	272	-	272	8.33%
2023	270	-	270	8.33%
2024	-	-	-	0.00%
Thereafter	-	-	-	0.00%
	$ 7,682	$ 299,463	$ 307,145	3.86%

	Balance	Weighted Average Interest Rate	Weighted Average Maturity (yrs)
Fixed Rate Secured Debt	$ 155,964	5.62%	3.33
Fixed Rate Unsecured Debt	-	-	0.00
Variable Rate Debt and LOC's	151,181	2.05%	0.62
Total	$ 307,145	3.86%	1.99

Note: Scheduled amortization and maturities reported at Duke's share.

Exhibit II

Development Projects Under Construction

March 31, 2014

(*in thousands*)

Project	Product Type	Market	Own %	Square Feet (000's)	Current Occ. %	Stabilized Costs (000's) (at Owner %)	Projected Costs Remaining (000's) (at Owner %)	Initial Stabilized Cash Yield	Stabilized GAAP Yield
Wholly Owned									
Grand Warehouse Expansion	Industrial	Chicago	100%	52	100%				
Centerre/Mercy	Medical Office	Other Midwest	100%	60	100%				
Perimeter Two	Office	Raleigh	100%	206	97%				
Baylor, Burleson	Medical Office	Dallas	100%	38	100%				
Projected In-Service Second Quarter 2014				356	98%				
10 Enterprise Parkway	Industrial	Columbus	100%	534	100%				
Baylor, Mansfield	Medical Office	Dallas	100%	38	100%				
Baylor, Colleyville	Medical Office	Dallas	100%	17	100%				
HH Gregg BTS	Industrial	Atlanta	100%	403	100%				
Linden Spec.	Industrial	New Jersey	100%	494	0%				
Lebanon Bldg. 2 Expansion	Industrial	Indianapolis	100%	218	100%				
Perimeter Three	Office	Raleigh	100%	245	71%				
Amazon BTS	Industrial	Baltimore	100%	1,018	100%				
Amazon BTS	Industrial	Baltimore	100%	346	100%				
Projected In-Service Third Quarter 2014				3,313	83%				
Centerre Baptist	Medical Office	Nashville	100%	53	100%				
FedEx BTS	Industrial	Atlanta	100%	77	100%				
West Chester Medical Off. Bldg	Medical Office	Cincinnati	100%	49	100%				
Gateway North 6	Industrial	Minneapolis	100%	300	100%				
Gateway Northwest One	Industrial	Houston	100%	358	0%				
Gateway Northwest Two	Industrial	Houston	100%	115	0%				
Palisades Ambulatory Care Ctr	Medical Office	New Jersey	100%	57	70%				
Projected In-Service Fourth Quarter 2014				1,009	51%				
Subtotal Projected In-Service 2014				4,678	77%				
20 Enterprise Parkway	Industrial	Columbus	100%	744	100%				
3909 North Commerce Expansion	Industrial	Atlanta	100%	257	100%				
St. Vincent Women's MOB	Medical Office	Indianapolis	100%	86	72%				
Projected In-Service First Quarter 2015				1,086	98%				
Wholly Owned Developments Under Construction				**5,764**	**81%**				
Joint Venture									
AllPoints Midwest Bldg 3	Industrial	Indianapolis	50%	1,144	100%				
AllPoints Midwest Bldg 5	Industrial	Indianapolis	50%	614	100%				
Projected In-Service Third Quarter 2014				1,758	100%				
Joint Venture Developments Under Construction				**1,758**	**100%**				
Total Company				**7,522**	**86%**	**$ 607,248**	**$ 331,004**	**7.6%**	**8.4%**

Exhibit II

Development Projects Placed In-Service

2012 - 2014

(*in thousands*)

	Wholly Owned					Joint Venture					Total				
			Initial Stabilized					Initial Stabilized					Initial Stabilized		
	Square Feet	Current Occ % (1)	Project Costs	Cash Yield	GAAP Yield	Square Feet	Current Occ % (1)	Project Costs	Cash Yield	GAAP Yield	Square Feet	Current Occ % (1)	Project Costs	Cash Yield	GAAP Yield
2012 Total	1,270	98%	$ 125,197	8.4%	8.7%	376	100%	$ 7,082	7.7%	7.9%	1,646	99%	$ 132,279	8.3%	8.7%
2013:															
1st Quarter	595	29%	40,764	6.4%	7.4%	-	-	-	-	-	595	29%	40,764	6.4%	7.4%
2nd Quarter	1,512	100%	181,920	7.7%	8.1%	600	57%	10,858	7.5%	7.9%	2,111	88%	192,778	7.7%	8.1%
3rd Quarter	1,917	100%	189,786	7.3%	7.7%	-	-	-	-	-	1,917	100%	189,786	7.3%	7.7%
4th Quarter	390	100%	63,430	7.8%	8.8%	273	100%	41,527	7.1%	8.5%	664	100%	104,957	7.5%	8.7%
2013 Total	4,414	90%	$ 475,900	7.4%	8.0%	873	71%	$ 52,385	7.2%	8.4%	5,287	87%	$ 528,285	7.4%	8.0%
2014:															
1st Quarter	392	100%	105,998	7.7%	8.7%	-	-	-	-	-	392	100%	105,998	7.7%	8.7%
2014 Total YTD	392	100%	$ 105,998	7.7%	8.7%	-	-	-	-	-	392	100%	$ 105,998	7.7%	8.7%

(1) Occupancy represents the percentage of total square feet based on executed leases without regard to whether the leases have commenced.

Note: Square feet for Joint Venture projects is shown at 100%; Project costs & returns included at Duke Realty ownership share.

Note: Excludes development projects completed which have subsequently been sold as of current quarter end.

Exhibit II

Dispositions and Acquisitions Summary

(in thousands)

	Dispositions				Acquisitions					
	Square Feet	Sales Proceeds	In-Place Cap Rate (1)	In-Place Occ % (2)	Square Feet	Stabilized Investment (3)	Acquisition Price (4)	In-Place Occ % (5)	In-Place Cash Yield (6)	
2013										
1st Quarter	4,099	$ 222,220	7.7%	98%	472	$ 29,980	$ 28,325	97%	6.9%	(7)
2nd Quarter	617	197,645	5.0%	76%	5,937	411,729	404,980	100%	6.3%	
3rd Quarter	232	45,565	4.4%	53%	453	39,398	38,765	100%	5.7%	
4th Quarter	2,606	411,731	7.4%	91%	1,191	74,034	73,414	100%	5.5%	
Total	7,554	$ 877,161	6.8%	92%	8,053	$ 555,141	$ 545,484	100%	6.1%	(7)
2014										
1st Quarter	725	$ 78,370	7.4%	93%	407	$ 17,753	$ 17,550	100%	6.3%	
Total YTD	725	$ 78,370	7.4%	93%	407	$ 17,753	$ 17,550	100%	6.3%	

Note: Sales of joint venture properties are included at ownership share.

(1) In-place cap rates of completed dispositions are calculated as current annualized net operating income, from space leased to tenants at the date of sale, divided by the sale price of the real estate. Annualized net operating income is comprised of base rental payments, excluding reimbursement of operating expenses, less current annualized operating expenses not recovered through tenant reimbursements.

(2) Occupancy represents the percentage of total square feet based on executed leases where the leases have commenced.

(3) Represents projected stabilized investment of real estate assets acquired after stabilization costs (such as applicable closing costs, lease up costs of any vacant space acquired, and deferred maintenance costs) are added to the acquisition price.

(4) Includes real estate assets and net acquired lease-related intangible assets but excludes other acquired working capital assets and liabilities.

(5) Occupancy represents the percentage of total square feet based on executed leases without regard to whether the leases have commenced.

(6) In-place yields of completed acquisitions are calculated as the current annualized net operating income, from space leased to tenants at the date of acquisition, divided by the acquisition price of the acquired real estate. Annualized net operating income is comprised of base rental payments, excluding reimbursement of operating expenses, less current annualized operating expenses not recovered through tenant reimbursements.

(7) Price, Investment, Yield, & Occ % includes one or more acquisitions in which Duke Realty purchased a partner's interest in a joint venture.

Exhibit III

REALpac
Real Property Association of Canada
Association des biens immobiliers du Canada

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March 17, 2014

International Financial Reporting Standards
Interpretations Committee
30 Cannon Street
London
EC4M 6XH

Subject: Tentative agenda decision – IAS 17 Leases – Meaning of incremental costs

Dear IFRS Interpretations Committee members,

This letter is submitted by the Real Property Association of Canada (REALpac) in response to the tentative agenda decision from the November 2013 discussion on IAS 17 Leases, Meaning of Incremental costs.

REALpac is Canada's senior national industry association for owners and managers of investment real estate. Our Members include publicly traded real estate companies, real estate investment trusts (REITs), private companies, pension funds, banks and life insurance companies. The association is further supported by large owner/occupiers and pension fund advisers as well as individually selected investment dealers and real estate brokerages. Members of REALpac currently own in excess of $180 Billion CAD in real estate assets located in the major centers across Canada

REALpac's Comments

The Interpretations Committee received a request for clarification about IAS 17 *Leases* related to the meaning of "incremental costs" within the context of IAS 17, and in particular, whether salary costs of permanent staff involved in negotiating and arranging new leases as a lessor qualify as "incremental costs".

We do not support the Interpretations Committee's tentative decision that internal salary costs do not qualify as incremental costs. In addition, we would assert that there is diversity in practice on this issue.

IAS 17 paragraph 38 states that "(I)nitial direct costs are often incurred by lessors and include amounts such as commissions, legal fees and internal costs that are incremental and directly attributable to negotiating and arranging a lease. They exclude general overheads such as those incurred by a sales and marketing team." In Canada, we consider certain internal costs as incremental and variable costs, not fixed. These costs are directly related to specific activities performed by the lessor that would not have occurred but for that successfully executed lease. Those activities may include: evaluating a prospective lessee's financial condition, evaluating and recording security arrangements, negotiating lease terms, preparing and processing lease documents and closing the lease transaction. These activities are initiated upon the prospective lessee's desire to enter into a lease, on behalf of the lessor and they relate directly to entering into the successfully executed lease. Therefore, they are integral to leasing. Among other examples, these companies typically have systems in place to track the number of successful leases completed by each internal leasing staff or time spent on successful deals in order to allocate costs (and time) to a specific lease arrangement and capitalize certain internal costs that relate to successful leases. Furthermore, these companies typically make reference to market-based rates for specific leasing activities which would establish an upper limit of what could be capitalized. Companies who make the rational business decision to minimize cost through employment of internal leasing personnel, opposed to hiring external leasing brokers should not be impacted by the accounting treatment. To make the issue even worse, some companies use both internal and external leasing. This will result in inconsistent accounting within the same company, which would make evaluating the results very difficult.

By our interpretation of paragraph 38, these internal costs meet the requirements of being both incremental and directly attributable to negotiating and arranging a lease.

In the Staff Paper (Agenda ref 7) from the November 2013 IFRIC meeting, points 21 – 26, reference is made to IAS 39, whereby an incremental cost is one that would not have been incurred if the entity had not acquired, issued or disposed of the financial instrument." While we agree that incremental costs should be interpreted as costs that would not have been incurred if the entity had not negotiated or initiated leases, we disagree with the conclusion in points 26 and 27 that salaried employees are "permanent" and that these salaries are "fixed" costs that are "unavoidable". Particularly where companies use time-tracking systems to allocate time and costs, our viewpoint is that these costs are variable, and do fluctuate with the volume of leases that are written. If the volume of leases written decreases, so do the number of employees employed for this work, and vice versa; therefore these costs are variable and are not "unavoidable".

Based on our discussions with our counterparts in the United States, it is our understanding that our accounting for similar costs is consistent with treatment under U.S. GAAP. ASC 840-20-25-18 states:

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"The costs directly related to those activities shall include only that portion of the employees' total compensation and payroll-related fringe benefits directly related to time spent performing those activities for that lease and other costs related to those activities that would not have been incurred but for that lease. Initial direct costs shall not include costs related to any of the following activities performed by the lessor:
a. Advertising
b. Soliciting potential lessees
c. Servicing existing leases
d. Other ancillary activities related to establishing and monitoring credit policies, supervision, and administration."

As active observers in the joint IASB/FASB Leases project, it is our understanding that the definition of initial direct costs under IFRS in IAS 17 and U.S. GAAP in ASC 840 is not intended to differ from current practice or from one another.

In Agenda paper 11A of the March 22-23, 2011 meeting of the IASB/FASB, the staff recommendation is "that *initial direct costs* should be defined as: Costs that are directly attributable to negotiating and arranging a lease that would not have been incurred had the lease transaction not been made." It was also noted that "(V)ery little feedback about the definition of initial direct costs was received. The staff thinks that the definition in the ED is appropriate and ***consistent with current lease guidance under Topic 840 and IAS 17. The staff notes that the proposed definition is not intended to change current practice for how initial direct costs are defined*** (emphasis added) (see Appendix A for current guidance)." Appendix A of that Agenda paper notes that:

"Under the guidance in Topic 840, initial directs costs include only those costs incurred by the lessor that are:
(a) Costs to originate a lease incurred in transactions with independent third parties that:
(i) Result directly from and are essential to acquire that lease.
(ii) Would not have been incurred had that leasing transaction not occurred.
(b) Directly related to only the following activities performed by the lessor for that lease:
(i) Evaluating the prospective lessee's financial condition
(ii) Evaluating and recording guarantees, collateral, and other security arrangements
(iii) Negotiating lease terms
(iv) Preparing and processing lease documents
(v) Closing the transaction"

Exhibit III

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It is our understanding that the capitalization of initial direct costs related to certain salaried employees engaged in arranging and negotiating leases for commercial real estate transactions is consistent across Canada and the U.S. We therefore do not agree with the Interpretation Committee's conclusion that predominant practice is to expense employee salary costs.

Overall, we believe that IAS 17 is clear that certain internal costs do qualify as incremental costs and are directly attributable to negotiating and arranging a lease. We further believe that this accounting treatment is consistent with both IFRS under IAS 17 and U.S. GAAP under ASC 840.

We thank the IFRIC for considering our comments on the tentative decision regarding the meaning of incremental costs within the context of IAS 17 Leases. Please contact Nancy Anderson, REALpac's Vice President Financial Reporting & Chief Financial Officer at nanderson@realpac.ca or at 1-416-642-2700 ext. 226 if you would like to discuss our comments.

Respectfully submitted,

NAnderson

Nancy Anderson
VP Financial Reporting & CFO
REALpac

Exhibit IV

Building a better working world

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INVESTOR IN PEOPLE

International Financial Reporting Standards
Interpretations Committee
30 Cannon Street
London
EC4M 6XH

20 January 2014

Dear IFRS Interpretations Committee members,

Tentative agenda decision – *IAS 17 Leases – Meaning of incremental costs*

Ernst & Young Global Limited, the central coordinating entity of the global EY organisation, welcomes the opportunity to offer its views on the above tentative agenda decision, as published in the November 2013 *IFRIC Update*.

The Interpretations Committee received a request for clarification of the meaning of 'incremental costs' within the context of IAS 17 *Leases*.

"The submitter asks whether the salary costs of permanent staff involved in negotiating and arranging new leases (and loans) qualify as 'incremental costs' within the context of IAS 17 and should therefore be included as initial direct costs in the initial measurement of a finance lease receivable."

We do not support the Interpretations Committee's tentative decision not to add this issue to its agenda, as we believe preparers would benefit from additional guidance related to capitalising certain internal costs as incremental costs. IAS 17.38 clearly indicates that some internal costs are incremental and directly attributable to negotiating and arranging a lease. Without additional clarification, preparers of financial statements may find it difficult to distinguish between certain internal costs that are incremental and internal costs that are not incremental.

The IASB and FASB staffs issued agenda paper 11A for the 21-23 March 2011 joint meeting addressing the definition of initial direct costs for the joint project on leasing. On page 4, paragraph 14 of this agenda paper, the staffs note that the definition proposed for the joint exposure draft *Leases* is not intended to change current practice for how initial direct costs are defined. ASC 840-20-25-18 permits "that portion of employees' total compensation and payroll-related fringe benefits directly related to time spent performing those activities for that lease…" to be included in initial direct costs of a lease. We believe the staffs' paper suggests there is no difference between IFRS and US GAAP currently, which is consistent with our observations in practice. Therefore, we believe the Interpretations Committee's tentative agenda decision as drafted would create an IFRS/US GAAP difference.

We believe the tentative agenda decision is inconsistent with the decision published in the September 2008 *IFRIC Update* on IAS 32 in which "… the IFRIC also noted that the terms 'incremental' and 'directly attributable' are used with similar but not identical meanings in many Standards and Interpretations. The IFRIC recommended that common definitions should be developed for both terms and added to the Glossary as part of the Board's annual improvements project." These definitions were not added to the Glossary and new standards are being developed that rely on these concepts, for example, the proposed new revenue and insurance standards. For standards developed jointly by the IASB and FASB, consistent definitions become more important. For example, the joint revenue standard, which is expected to be issued in Q1 2014, will not only create another standard that uses the term 'incremental costs', but also will provide a converged definition of incremental costs for the purpose of a single standard. A common definition of 'incremental costs' that would apply to all the standards that use the concept of 'incremental costs' would result in greater consistency in the application of its meaning among IFRS standards and among lessors reporting under IFRS and US GAAP.

Paragraph 38 of IAS 17 indicates that some internal costs are incremental and directly attributable to negotiating and arranging a lease: "Initial direct costs are often incurred by lessors and include amounts such as commissions, legal fees and *internal costs* (emphasis added) that are incremental and directly attributable to negotiating and arranging a lease. They exclude general overheads such as those incurred by a sales and marketing team." Some preparers consider certain internal costs as incremental or variable costs (not as fixed costs). These costs are directly related to specific activities performed by the lessor that would not have occurred but for that successfully executed lease. Those activities may include: evaluating a prospective lessee's financial condition, evaluating and recording security arrangements, negotiating lease terms, preparing and processing lease documents and closing the lease transaction. These activities are initiated upon the prospective lessee's desire to enter into a lease, on behalf of the lessor and they relate directly to entering into the successfully executed lease. Therefore, they are integral to leasing. These companies typically have a time-tracking system in place to allocate time (and costs) to a specific lease arrangement and capitalise certain internal costs that relate to successful leases.

In its tentative agenda decision, the Interpretations Committee noted that "… internal fixed costs do not qualify as 'incremental costs'. Only costs that would not have been incurred if the entity had not negotiated and arranged a lease should be included in the initial measurement of a finance lease receivable" and "… in the light of the existing IFRS requirements, neither an Interpretation nor an amendment to IFRSs was necessary." However, the Interpretations Committee does not indicate where in existing IFRS it is stated that internal fixed costs do not qualify as 'incremental costs' and, in turn, how this reconciles to the language in paragraph 38 of IAS 17, quoted above. Therefore, it is not clear why the Interpretations Committee concluded that the issue is clear in IFRS. It appears the Interpretations Committee may have reached such conclusion based, in part, on a perceived lack of diversity as indicating that it believes IFRS is clear on the issue when it noted that, "… there does not appear to be diversity in practice on this issue." However, we have observed diversity spanning multiple geographic areas (i.e., Australia, Europe and North America).

Without further explanation as to why certain internal fixed costs do not qualify as 'incremental costs', it would appear that the application of the agenda decision by these companies would be treated as a correction of an error in accordance with IAS 8.

In summary, we do not agree with the Interpretations Committee's tentative agenda decision. We do not believe IAS 17 is clear that certain internal fixed costs do not qualify as incremental costs as paragraph 38 clearly indicates that some internal costs are incremental and directly attributable to negotiating and arranging a lease. Clarification is needed to provide guidance on what costs the Board had in mind, as we believe a reasonable interpretation of paragraph 38 is that capitalising certain internal costs would be appropriate. In addition, the IASB has not acted upon the Interpretations Committee's September 2008 recommendation that common definitions of 'incremental' and 'directly attributable' be developed. Because the Interpretations Committee previously has been asked to clarify the definition of 'incremental', we recommend that the Interpretations Committee add the issue to its agenda. However, if the Interpretations Committee decides to uphold its November 2013 tentative agenda decision, we recommend that it clarify why it made its decision and how the application of that decision should be treated under IAS 8.

Should you wish to discuss the contents of this letter with us, please contact Leo van der Tas at the above address or on +44 (0)20 7951 3152.

Yours faithfully

Ernst & Young Global Limited

NATIONAL ASSOCIATION OF
REAL ESTATE INVESTMENT TRUSTS®

June 27, 2014

Chairman Russell Golden
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, Connecticut 06856-5116

Chairman Hans Hoogervorst
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Subject: Lease Accounting Project, Lessee Accounting

Dear Sirs:

The National Association of Real Estate Investment Trusts (NAREIT®) is submitting this unsolicited comment letter to provide the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB, and collectively, the Boards) its views on the relative financial reporting impacts of accounting for Type A and Type B leases. We recognize that there are a number of constituents that believe that the income statement impact of these two approaches to accounting for leases results in only minimal differences in charges to net income of lessees. We do not agree with this assessment and wish to provide the Boards our views with respect to broader considerations regarding the differences between Type A and Type B lease accounting and financial reporting. These considerations include conceptual differences between lease types and the usefulness to investors and other financial statement users of reported information.

Based on these broader considerations, as well as the quantitative differences between the proposed Type A and Type B accounting, NAREIT agrees with the FASB's view that a dual approach to accounting for leases is necessary in order to provide investors and other financial statement users with the most relevant information with respect to leases.

We support the Boards' decision to continue the reconsideration of accounting for leases, and we agree that lessees should reflect an asset and a liability for substantially all leases. We also continue to support the global convergence of a high quality set of financial reporting standards.

Conceptual Considerations

We agree with the FASB's decision to adopt Type B accounting for leases that do not transfer control over the asset to the lessee and that the criteria in International

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Accounting Standard (IAS) 17 *Leases* should be used in making that distinction. Because IAS 17 is well understood by financial statement preparers that currently report under IFRS, as well as auditors and regulators, we do not believe the dual model approach would increase complexity in applying the standard. Those leases that transfer control over substantially all of the future economic benefits of an asset to the lessee would be classified as a Type A lease and accounted for effectively as a purchase. Leases that do not transfer substantially all of the future economic benefits of the leased asset would be accounted for as Type B leases.

We also believe that the IASB's reference to the lessee model as a "single model" is a misnomer. The IASB has previously agreed to a scope exception for "short term" leases, as well as a practicability exception for "small ticket" leases. In our view, this amounts to a lessee accounting model that has three alternatives. In essence, the IASB is trading existing IFRS (*i.e.*, finance leases and operating leases) for a new model that will now have three types of leases: finance-type leases (*i.e.*, Type A leases), "short term" leases, and "small ticket" leases. We fail to see the simplification that the IASB's current decisions would provide over existing IFRS.

For Type B leases, there is clearly a linkage between the rights to use the asset and the lessee's obligation to make payments under the lease. Considering this linkage, we believe that the lessee should allocate the total cost of the lease over the term of the lease. We believe that the Type B accounting approach adopted by the FASB recognizes the linkage between the rights to use the asset and the lessee's obligation to make payments under the lease and more appropriately accounts for the economic differences between arrangements that simply provide a right to use an asset and those that are in-substance purchases of assets.

Quantitative Considerations

As indicated above, we understand that certain constituents are of the view that the income statement impacts of the two approaches to accounting for leases results in only minimal differences in charges to net income of lessees. Our experience indicates that this may generally not be the case. For example, a large global retailer developed pro forma financial impacts on the company's 2013 operating results that would result from applying the accelerated expense recognition patterns consistent with the proposed Type A accounting approach to all of the company's leases. The resulting pro forma net income was $46 million, $0.16 per share, less than net income reported for 2013. Applying the company's multiple to the $0.16 decrease in net income would negatively impact the company's stock price by $2-3 or about 10%.

Simply put, we do not consider this 10% negative impact to be "minimal."

In addition to the negative impact on earnings of applying the Type A approach to all leases, we agree with the analyses and conclusions reached with respect to the impacts on the balance sheets of a number of large global companies described in the June 25, 2014 unsolicited comment letter submitted to the Boards by the Equipment Leasing and Finance Association[1].

[1]http://www.fasb.org/cs/BlobServer?blobkey=id&blobnocache=true&blobwhere=1175828960081&blobheader=application%2Fpdf&blobheadername2=Content-Length&blobheadername1=Content Disposition&blobheadervalue2=831047&blobheadervalue1=filename%3DLEASES-14.UNS.0009.ELFA_WILLIAM_G._SUTTON.pdf&blobcol=urldata&blobtable=MungoBlobs

Usefulness of Reported Financial Information

The Boards have consistently indicated that financial standards should primarily serve the needs of investors and other financial statement users. NAREIT strongly agrees with this principle and believes that the presentation of financial information must provide relevant information to financial statement users. If information is not relevant, there is no need to debate the conceptual merits of the accounting.

An important standing committee of NAREIT is its Best Financial Practices Council. This Council reviews all financial reporting proposals that may impact the real estate industry's financial reporting, including proposals from the FASB, IASB and Securities and Exchange Commission (SEC). The Council currently includes 27 members representing a broad cross section of NAREIT's membership, including six investors/sell-side analysts. These financial statement users (and other investors and analysts who are NAREIT members) have been very clear in their position that, to be relevant, payments made by lessees pursuant to a lease of property should be reported as rent expense and not bifurcated as interest and amortization. Further, investors/sell-side analysts on the Council have consistently stated that, should the new Leases standard result in the elimination of rent expense, they would then ask companies to assist them in unwinding the proposed accounting. This would lead to analysts making capital allocation decisions based on unaudited/non-GAAP financial information, which in our view would not provide users with the most reliable decision-useful information.

If you would like to discuss our comments, please contact George Yungmann, NAREIT's Senior Vice President, Financial Standards, at 202-739-9432 or gyungmann@nareit.com, or Christopher Drula, NAREIT's Vice President, Financial Standards, at 202-739-9442 or cdrula@nareit.com.

Respectfully submitted,

George L. Yungmann
Senior Vice President, Financial Standards

Christopher T. Drula
Vice President, Financial Standards

Concurrent Session: Fixing a Hole Where the REIT Fell In

Thursday, March 31st
9:45am – 11am
Marriott Marquis, Washington DC

Moderator:
Craig Stern, EVP-Tax & Compliance, Vornado Realty Trust

Panelists:
Peter Genz, Partner-Tax, King & Spalding
Leslie Honig, Sr. Program Specialist, IRS (invited) David Silber, Deputy Associate Chief Counsel, Financial Institutions & Products , Internal Revenue Service
Dianne Umberger, Principal, EY

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March 30 - April 1

2016

Fixing a Hole Where the REIT Fell In

March 30-April 1, 2016

- **Moderator**
  - Craig Stern, Vornado Realty Trust

- **Panelists**
  - Peter Genz, King & Spalding
  - Leslie Honig, IRS
  - David Silber, IRS
  - Dianne Umberger, EY

Overview of Topics

- Statutory Relief Provisions — Dianne Umberger
- Reasonable Cause — Peter Genz
- IRS Comments — David Silber, Leslie Honig
- Tax Opinions — Peter Genz

Failure to meet gross income requirements — reasonable cause exception

- Relief under § 856(c)(6), if meet safe harbor:
  - Report violation-causing income (requirements in Treas. Reg. § 1.856-7(b))
  - Show reasonable cause and that violation not due to willful neglect
- Additional tax due under § 857(b)(5) in the amount of the product of:
  - the amount of income that caused the REIT to fail the 75% or 95% gross income test; and
  - a fraction meant to approximate the profitability of the REIT

Failure to meet gross asset requirements — 30-day cure

For any gross asset requirement violation (under § 856(c)(4)), 30-day cure period after the end of each quarter:

- Usually for 10% asset tests — stock or securities of an issuer
- Within 30 days of close of quarter, may cure violation caused by the acquired asset in such quarter
- No need to cure if failure merely due to valuation fluctuation of assets
- May cure by either disposing of asset that causes violation or by increasing gross asset base
- No need to show reasonable cause
- No penalty
- Generally believed to not be available for first quarter of REIT's first year

Failure to meet gross asset requirements — de minimis exception

Relief under § 856(c)(7)(B) for de minimis violation of 5% or 10% securities tests:*

- Applies when the excess asset that caused the violation of a 5% or 10% securities test is less than the *lesser* of:
  - $10,000,000; or
  - 1% of the REIT's gross asset value at the end of the tested quarter
- Usually for 10% asset test (small loans or stock interests)
- Must cure within six months of the end of the quarter in which the REIT *discovers* the violation (not the quarter in which the violation occurred)
- May cure either by disposing of assets that cause the violation or other means (e.g., making a TRS election, issuer modifying security (into mortgage or straight debt), REIT increasing gross asset value, contribute security to a TRS (which means paying corporate-level tax on income from security))
- No need to show reasonable cause
- No penalty

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* The PATH Act failed to update the cross reference to the 5% and 10% securities tests, which are now located at § 856(c)(4)(B)(iv).

Failure to meet gross asset requirements — other exceptions

Relief under § 856(c)(7)(A) for any violation of the gross asset requirements *other than* a de minimis violation of the 5% and 10% securities tests:

- Requirements to meet safe harbor:
  - Report violation-causing assets to IRS
  - Show reasonable cause and that violation not due to willful neglect
  - Cure within six months of the end of the quarter in which the REIT *discovers* the violation (not the quarter in which the violation occurred)
- Under § 856(c)(7)(C), additional tax imposed in the amount of the *greater* of:
  - $50,000; or
  - the product of (i) the net income generated by the “excess assets”; and (ii) the highest rate under § 11
- May cure either by disposing of assets that cause the violation or other means (e.g., making a TRS election, issuer modifying security, REIT increasing gross asset value)
- Query whether $50,000 must be paid for each year the violation occurred

Failure to meet requirements other than income and asset requirements — omnibus exception

Under § 856(g)(1) and (5), a REIT may be relieved from a failure to meet a requirement other than an income or asset requirement:

- The safe harbor relief applies if:
  - the failure was due to reasonable cause and not willful neglect; and
  - the REIT pays a $50,000 penalty per violation
- Helpful for issues such as “transferable shares,” “managed by directors,“ five or fewer, 100 shareholders, undistributed C corp. E&P
- Query whether $50,000 must be paid for each year the violation occurred

Failure to meet distribution requirements — deficiency dividend

- Under § 860, if, within 90 days of a "determination" that a REIT did not distribute sufficient dividends to meet the 90% dividend distribution requirement, the REIT may make such a dividend distribution with respect to the taxable year in which it failed to meet the requirement (and cure the failure)
- For relief, the REIT must also:
  - File a claim within 120 days of the determination
  - Pay an interest charge, calculated as if the amount of the deficiency dividend was additional tax due in the year with respect to which such distribution was paid
- A determination, for these purposes, means:
  - a judicial determination;
  - "a closing agreement made under section 7121"; or
  - "a statement by the taxpayer attached to its amendment or supplement to a return of tax for the relevant tax year" (Form 8927)

Reasonable Cause

- With respect to relief under § 856(c)(6) (for gross income requirements):
  - "Reasonable cause" if the REIT "exercised ordinary business care and prudence in attempting to satisfy the requirements" under Treas. Reg. § 1.856-7(c)(1)
  - Per Treas. Reg. § 1.856-7(c)(2)(i), "reasonable reliance on a reasoned, written opinion as to the characterization for purposes of section 856 of gross income to be derived (or being derived) from a transaction generally constitutes 'reasonable cause'"
  - Same principles apply for relief under § 856(g)(4) (the provision that permits a waiver of the four-year prohibition on re-electing REIT status after a termination year if reasonable cause can be shown, discussed later)
- With respect to other relief, not clear how a REIT shows reasonable cause; REIT's case is bolstered if REIT has a history of good compliance and due diligence policies

Reasonable Cause

- REIT tax advisors sometimes asked for tax opinions on reasonable cause when required for statutory relief, such as where a prior tax advisor provided an opinion or memorandum analyzing an issue and the REIT opinion giver is asked to opine that the REIT's reliance on the prior advisor's advice constituted reasonable cause
- Tax advisors are often unwilling to do this, particularly at the “will” level, as:
  - The REIT, the tax advisor, and the IRS may all have differing opinions on what constitutes reasonable cause
  - Difficult to opine on fact-specific issues
- Without a tax opinion, REIT may have to seek IRS ruling (if the failure is of recent origin) or a closing agreement
- It would be helpful if IRS were to issue rulings on reasonable cause under the REIT savings provisions, even if the returns in question have already been filed (as this system has worked well in the 9100 relief context)

Preferential Dividends

The PATH Act changes to preferential dividend rules:

- *For tax years beginning after Dec. 31, 2014*, the prohibition on "preferential" dividends (per § 562(c)(1)) now only applies to private REITs (that is, the prohibition no longer applies to public REITs)
- *For tax years beginning after Dec. 31, 2015*, new § 562(e)(2) permits the Secretary to "provide an appropriate remedy" for a REIT's distribution of a preferential dividend, where either:
  - "the Secretary determines that such failure is inadvertent or is due to reasonable cause and not due to willful neglect"; or
  - "such failure is of a type of failure which the Secretary has identified" as due to reasonable cause and not willful neglect
- Statutory language suggests PLR would be appropriate path to resolve preferential dividend issue for private REITs

Closing Agreements

- REIT may have concern regarding time-barred tax years, as years could still cause issues with respect to:
  - built-in gains tax exposure resulting from loss of REIT status; or
  - § 856(g)(3) four-year prohibition on re-election of REIT status
- Per Treas. Reg. § 301.7121-1(a), a closing agreement under § 7121 can "permanently and conclusively" resolve issues lurking from both time-barred and open tax years
- Closing agreements are handled by National Office or by the geographic LB&I Practice Area with exam authority. The Program Manager in the Practice Area is a contact.
- REIT should act swiftly after discovering issue and demonstrate prompt corrective actions
- REIT will typically have to pay a "toll charge" for the closing agreement, generally equal to the statutory relief provision penalty (toll charge will also apply to time-barred tax years)

9100 Relief (Late TRS Election)

- Often for overlooked securities that failed the 10% test
- TRS securities are not subject to 5% and 10% tests
- Private letter ruling under Treas. Reg. § 301.9100-3
- With permission from IRS, elect to treat certain securities as TRS securities, after the standard election period
- TRS securities not subject to 5% and 10% tests of § 856(c)(4)(A)(iv)
- *However*, TRS securities are subject to the general 75% asset test (§ 856(c)(4)(A)), as well as the 25% TRS securities test (§ 856(c)(4)(B)(i)*)
- Must show reasonable cause (although not technically required, some party accepts blame for failure)
- No penalty

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* As of Jan. 1, 2018, the 25% TRS securities test will be reduced to 20%

Protective TRS Elections

Elect TRS treatment in the case of:

- Subsidiary REIT (to mitigate concern the subsidiary may not qualify as a REIT)
- Interests in associations (e.g., property owners' association) organized as corporations (to mitigate concern that such interests are not real estate assets)
- Protects status of Parent REIT

Failsafe Asset Trusts

- As outlined in Rev. Proc. proposed by NAREIT in 2004:
  - Concept based on protective excess shares trust
  - Any assets that cause violation of asset requirements are automatically transferred to a trust in which a TRS or unrelated person is the beneficiary
- PLR 200234054 ruled favorably with respect to such an arrangement in the context of a 10% securities test violation
- In case of TRS beneficiary, violations may incur corporate-level tax (which may still be preferable to costs associated with curing violation)
- Can the REIT receive or rely on a tax opinion that the asset trust is valid?
  - Will the IRS respect?
- Query whether charitable trust must be named in advance of failure in order for transfer to be effective

Re-electing “REIT Status” after a violation

- Under § 856(g)(1), if an entity fails to meet the REIT requirements (and does not cure), its REIT status is terminated in the year the failure(s) occurred
- Under § 856(g)(3), if an entity terminates or has revoked its REIT status, neither that entity nor a successor entity may re-elect REIT status for the four taxable years subsequent to the year of failure
- However, § 856(g)(4) provides an exception to the four-year re-election rule (that is, the REIT is only busted with respect to the year of failure) if:
  - the entity did not “willfully fail to [timely] file” its return in the year of failure
  - the inclusion of any incorrect information was not fraudulent; and
  - the REIT establishes to the satisfaction of the Secretary that the failure was due to reasonable cause and not willful neglect (per Treas. Reg. § 1.856-8(d), made with reference to such standard in gross income requirements)
- This relief rarely if ever seen in PLRs since REIT status has been preserved through other means (e.g., relief provisions, closing agreements)

Successor Entities

- The four-year prohibition on re-electing REIT status applies to successor entities as well as to de-REITed entity
- Under Treas. Reg. § 1.856-8(c)(2), for these purposes, "successor" means an entity that meets the following requirements with respect to the de-REITed entity:
  - the "continuity of ownership requirement," meaning the same persons own directly or indirectly 50% or more of value of the potential successor and 50% or more of value of de-REITed entity at any time during the termination year; and
  - the "continuity of assets requirement," meaning that a "substantial portion" of the potential successor's assets were assets of the de-REITed entity or the successor acquired a substantial portion of the assets of the de-REITed entity

Successor Entities

- If Parent REIT acquires then liquidates Target REIT, and Target REIT has blown its REIT status, Parent REIT:
  - likely a successor;
  - inherits corporate tax liability; and
  - inherits built-in gain period for Target REIT's assets
- If de-REITed entity drops assets down to Target REIT in a § 351 transaction, then sells Target REIT, Target REIT may be successor

Tax Opinions

- Tax opinion is part of acquisition due diligence
- A REIT opinion for an open (or closed) tax year can be interpreted to subsume an opinion for the previous five tax years, even if time barred (that is, REIT cannot be a good REIT today if busted in the last five years)
- Although IRS cannot assert corporate tax for closed years, it may still question REIT status in time-barred years (as it may affect open years)
- Tax opinion needs to consider status of successor entities

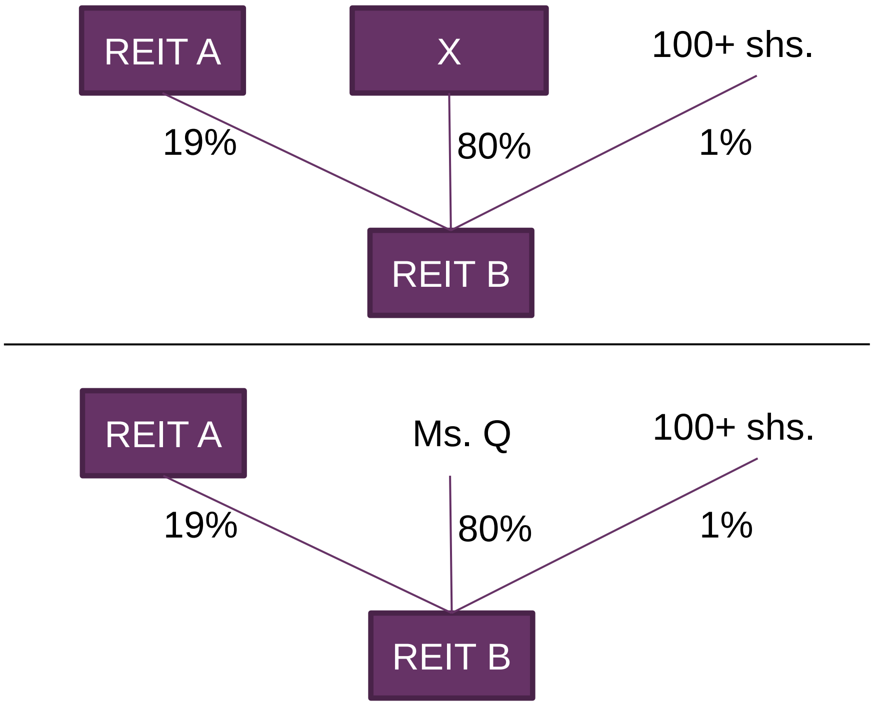
Relief for:	Requirements	Penalty Payment
De minimis asset test failure for 5% and 10% asset tests § 856(c)(7)(B)	• Failure is due to ownership of assets which have total value equal to or less than the lesser of (x) 1% of total value of REIT's assets that quarter and (y) $10 million. • Dispose of such assets (or otherwise pass asset tests) within six months after end of identification quarter • No requirement to show that failure to due reasonable cause and not willful neglect	• None
Asset test failure *other than* de minimis failure of 5% and 10% asset tests § 856(c)(7)(A)	• File schedule with description of each asset causing failure, following identification of failure by REIT. • Failure is due to reasonable cause and not to willful neglect. • Dispose of such assets (or otherwise pass asset tests) within 6 months.	• Pay tax equal to greater of (i) $50,000 or (ii) highest corporate tax rate times net income generated by assets that caused failure [for period beginning on first date of failure and ending on date REIT disposed of assets or otherwise passed asset test].

Relief for:	Requirements	Penalty Payment
Gross income test failure for 95% or 75% gross income tests § 856(c)(6)	• File schedule with description of each item of REIT's gross income for taxable year following identification of failure by REIT. • Failure is due to reasonable cause and not to willful neglect.	• Pay tax equal to the product of (x) the greater of (i) the amount by which 95% of the REIT's gross income exceeds the amount of items qualifying under the 95% income test, or (ii) the amount by which 75% of the REIT's gross income exceeded the amount of items qualifying under the 75% income test, multiplied by (y) a fraction, the numerator of which is generally the REIT's taxable income for the taxable year divided by the REIT's gross income for the taxable year. See section 857(b)(5).
Failure to meet 90% distribution requirement § 860	• Within 90 days of a "determination," pay a "deficiency dividend" • File a claim within 120 days of determination	• Pay interest computed on additional tax in the amount of the deficiency dividend as if such amount was tax in the year for which the deficiency dividend is paid
Any disqualification other than due to the gross income tests and asset tests § 856(g)(5)	• Failure is due to reasonable cause and not to willful neglect.	• REIT must pay $50,000 for each failure.

Example 1 — Asset Test Failure

- X [in violation of a shareholders' agreement] transfers its 80% interest in REIT B to Ms. Q, an individual, on December 1 of year 2. Although REIT B fulfills all other REIT requirements, as five or fewer individuals now own more than 50% of REIT B, REIT B is disqualified as a REIT for the entire year.

- REIT A owns 20% of REIT B, which is now a taxable C corp. REIT A discovers that it has an asset test issue:
  - Before it files its return
  - After it files its return



Example 2 — Income Test Failure

In violation of operating procedure guidelines, a property manager of REIT C enters into a lease that provides for rents based on net income. The rent from the lease causes REIT C to fail the 75% gross income test. REIT C discovers the issue:

- Before it files its return
- After it files its return

Example 3 — Other Requirements Failure

In its second year of existence, REIT D admits 100 shareholders on July 1 (prior, REIT D had fewer than 100 shareholders). REIT D discovers the issue:

- Before it files its second-year return
- After it files its second-year return

FIXING A HOLE WHERE THE REIT FELL IN[1]

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March 16, 2016

I. RELIEF PROVISIONS FOR ASSET TEST VIOLATIONS

A. 30-Day Cure Period Following Quarter-End

1. A REIT that meets the asset tests at the end of a calendar quarter will not fail them "because of a discrepancy during a subsequent quarter between the value of its various investments and the [asset test] requirements … unless such discrepancy exists immediately after the acquisition of any security or other property and is wholly or partly the result of such acquisition." Section 856(c)(4) (flush language). In other words, mere fluctuations in value that are beyond the REIT's control can't create an asset test violation. But acquisitions of securities or other property can, if they wholly or partly contribute to a violation at the end of the next quarter.

2. A REIT has 30 days (not a month) following the end of the calendar quarter to eliminate an asset test discrepancy at quarter-end, such as by disposing of assets or securities that caused the discrepancy. Section 856(c)(4) (flush language). This is a get-out-of-jail free card; no proof of reasonable cause required, no penalty. And the REIT can re-acquire the offending asset (at least after the 30-day cure period, and maybe even during the 30-day cure period) in the next quarter without causing a problem as long as the REIT meets the tests at the end of the next quarter.

a. Example. Investments in commercial paper may create a REIT bust if the REIT invests a substantial amount in the commercial paper of a single corporate issuer and thus violates the 5% asset test. Some bank accounts are set up to do overnight sweeps of the end-of-day account balance into commercial paper issued by a holding company affiliated with the bank. The IRS takes the position that commercial paper is a security and not a "cash-equivalent" (a cash-equivalent is a "good" asset, i.e., not a "security"). To avoid this problem, some REITs have instructed their bank not to sweep to commercial paper on the last day of the quarter. This should eliminate the tax issue, even if the sweep resumes the following day.

3. During the 30-day cure period the REIT can sell the offending securities or otherwise cure the asset test violation, such as by increasing its gross asset base so that a 5% securities test violation disappears.

4. What happens if the REIT disposes of the offending asset within the 30-day period and then reacquires it (or a similar asset) before the end of the 30-day period? Under a literal interpretation of the statute, this ought not affect the validity of the cure, but there is no authority on point and tax advisors generally prefer to see the cure last until the 30-day period is over.

5. Because of the introductory language of the 30-day cure provision ("A REIT that meets the asset tests at the end of a calendar quarter.."), it is generally thought that the 30-day cure cannot

[1] Sadly, no one will understand this title except another aging Beatles fan (Fixing a Hole from the Sgt. Pepper's album) or perhaps a really hip young person.

be relied on to cure a discrepancy relating to the end of the REIT's initial calendar quarter for its first REIT taxable year.

B. Protective TRS Elections and Failsafe Asset Trusts

1. Consider implementing self-help for a potential asset test violation. For example, a REIT might make a protective TRS election for a REIT subsidiary of a parent REIT, in the event that the IRS determines that the REIT subsidiary is not a qualified REIT. Another example might be a protective TRS election for a property owner's association that is organized as a corporation if there is a concern that such interest might be viewed as a "security" and not a "real estate asset." It does not appear that the IRS has ruled on the efficacy of such a protective election.

2. In 2004 NAREIT submitted to the IRS a proposed revenue procedure setting out the details for a protective or "failsafe" asset trust whose purpose would be to cure one or more identified types of asset test violations by automatically causing the offending asset to be placed in a trust whose beneficiary is a TRS of the REIT (or a person unrelated to the REIT). The concept was similar to the protective excess shares trust. The deemed transfer occurs on the day immediately prior to the last day of the calendar quarter on which the violation otherwise would have occurred. The IRS has not acted on this recommendation.

a. In PLR 200234054 (May 21, 2002), the IRS ruled that such a failsafe trust would be effective to prevent any future violation of the 10% securities test that might occur. The REIT represented that it had been advised by counsel that the trust would be enforceable under state law and that it would use its best efforts to give effect to all transfers required by the trust agreement. This concept is similar to the IRS rulings that have approved the so-called "excess shares" transfer restrictions that are widely used and are intended to preclude a REIT from violating the five-or-fewer stock ownership test due to subsequent transfers or non-transfer events. See, e.g., PLR 9552047 (Sept. 29, 1995) (IRS required the REIT to represent that the excess shares restriction was enforceable under state law).

b. Some REITs have adopted such protective asset trusts, but the REIT has to carefully consider (i) whether tax counsel will be willing to opine on the efficacy of the trust arrangement should an asset test violation occurs, and (ii) whether the REIT is prepared to accept the resulting corporate-level tax incurred by the TRS beneficiary on the income from the offending asset. Given the alternative of self-determining reasonable cause and paying the tax required by section 856(c)(7)(C) (discussed later in this outline) or a painful closing agreement process, such a trust may be a more appealing alternative, particularly if a ruling is obtained as to its efficacy.

c. What happens if a failsafe trust is put in place and later there is a potential asset test violation but not a crystal clear violation? The REIT might take the position that there is no deemed transfer to the trust until the IRS or a court determines that the asset test was violated, at which time a retroactive transfer to the trust is deemed to occur that automatically cures (if it works) the potential violation. The TRS's tax returns would have to be amended to report the additional income.

C. 9100 Relief for Late TRS Elections

1. One way to cure a 5% or 10% securities test bust with respect to securities of a subsidiary corporation (or non-corporate entity that has checked the box to be treated as a corporation) is to seek 9100 relief to make a late TRS election for such corporation so that the REIT's ownership of non-mortgage debt or stock of the corporation is exempt from the 5% and 10% securities tests by reason of the flush language of section 856(c)(4)(B)(iv) (but remains subject to the 75% asset test of section

856(c)(4)(A) and the mirror image 25% TRS securities test (which will shrink to a 20% TRS securities limit starting in 2018) of section 856(c)(4)(B)(ii)). See Treas. Reg. § 301.9100-1; Section 5.03, Rev. Proc. 2016-1, 2016-1 I.R.B. 1, 12 ("An Associate office will consider a request for an extension of time for making an election or other application for relief under § 301.9100-3 of the Treasury Regulations, even if submitted after the return covering the issue presented in the § 301.9100 request has been filed, an examination of the return has begun, or the issues in the return are being considered by Appeals or a Federal court").

2. A number of REITs have received private letter rulings permitting such a late election in order to cure a 10% securities test violation with respect to an overlooked corporate subsidiary. See, e.g., PLR 201452013 (Sept. 29, 2014) (a REIT-owned partnership acquired a hotel and leased it to a wholly owned LLC; the plan, as set out in the LLC's operating agreement, was to have the LLC make a check-the-box election to be taxed as a corporation and to make a TRS election for the LLC, but both were initially overlooked; then 9100 relief was sought and received to make a late check-the-box election but somehow the late TRS election was apparently overlooked a second time; despite what appears to have been a comedy of errors, the IRS permitted a late TRS election to be filed by the REIT and the LLC retroactive to the date the hotel lease was put in place); PLR 201144007 (Aug. 5, 2011) (IRS granted 9100 relief for a late TRS election for an LLC that had made a timely check-the-box election to be taxed as a corporation and that was organized to operate a cafeteria in an office building in which the REIT owned an interest; the REIT intended to make a TRS election for the LLC to insulate the REIT from impermissible tenant service income but screwed up); PLR 201002020 (Sept. 30, 2009) (permission granted to make late check-the-box and TRS elections for an LLC subsidiary of a REIT).

a. The regulations provide that the taxpayer, in order to get discretionary 9100 relief, must establish that it acted reasonably and in good faith, and that the grant of relief does not prejudice the government's interests. Treas. Reg. § 301.9100-3(b)(3)(iii). See PLR 200607016 (Feb. 17, 2006) (taxpayer transferred appreciated property to a foreign corporation with the intent of selling the property tax-free, unaware that section 367 rendered the initial contribution a fully taxable sale; when the taxpayer realized its mistake of law, it requested 9100 relief to file a late check-the-box election to treat the foreign entity as a disregarded entity; IRS refused, stating that the taxpayer failed to prove it had acted reasonably and in good faith). The IRS also wants to see that the taxpayer took prompt action when it discovered the failure to make the election.

3. It is always helpful to have an advisor fall on his or her sword and take the heat for the blown election deadline, which is typically documented with an affidavit submitted as part of the ruling request submission. Sometimes, though, the fault is the client's alone, or sometimes it is the fault of a third party. One 9100 ruling involved a REIT ("REIT A") that owned an interest in a joint venture. The other joint venture partner was also a REIT ("REIT B"). REIT B caused the joint venture to form a corporation and made a timely TRS election as to that corporation, but neglected to tell REIT A about the corporate subsidiary so that REIT A could also make a TRS election. It is understood that REIT B provided an affidavit taking the blame for failing to notify its partner.

4. In general, the IRS has been pretty forgiving in 9100 relief situations. One extreme example involved a REIT that was doing a public offering years ago and discovered at the last minute that a corporation that had been formed three years before to hold an interest in a limited partnership as part of a financing transaction was indirectly more than 10%-owned by the REIT, and yet no TRS election had been made. It is understood that the REIT got a 9100 relief private letter ruling one day after the 9100 ruling request was filed. An interesting aspect to this story is that tax counsel to the REIT reportedly gave an opinion, at the closing of the offering, that the IRS would grant the 9100 relief because (i) the REIT, in its view, met the IRS's announced requirements for the discretionary 9100 relief and (ii) the IRS had granted similar relief to other REITs. This opinion may have been rendered on the strength of oral assurances from the IRS that the relief would be forthcoming, but this obviously had to be white knuckle time for the REIT and its law firm.

5. As an aside, the IRS has also granted 9100 relief to file a corrected consent dividend election. In PLR 201045004 (Aug. 3, 2010), a private REIT whose sole shareholder was a listed property trust (presumably Australian) was granted 9100 relief to increase the amount of a consent dividend election. The REIT made an error in computing the section 163(j) earnings stripping limitation on its interest deduction and also failed to take into account a property dividend from a TRS of the REIT, thus resulting in an understatement of its REIT taxable income for year 1. This meant its original consent dividend was not sufficient to zero out REIT taxable income as adjusted.

a. Treas. Reg. § 1.565-1(b)(3) provides that a consent may be filed not later than the due date (including extensions) of the REIT's tax return for the taxable year for which the consent dividend deduction is claimed.

b. The IRS concluded that the taxpayer's failure to make a proper consent dividend election was due to inadvertent errors and communications failures on the part of employees of the REIT's shareholder, and that the REIT was not using hindsight to request relief and acted before the IRS discovered the failure. Thus, it determined that the REIT acted reasonably and in good faith under Treas. Reg. § 301.9100-3(b)(1)(i), and thus granted the taxpayer 45 days from the date of the ruling to file a consent dividend election with an amended return.

D. <u>De Minimis Failures of 5% or 10% Securities Tests</u>

1. Under a relief provision that is intended to be applicable to de minimis failures of the 5% and 10% securities tests set forth in section 856(c)(4)(B)(iv), a REIT that owns securities in excess of the 5% or 10% securities test limits at the end of a quarter is nevertheless considered to meet such test if:

a. The "failure is due to the ownership of assets the total value of which" does not exceed the <u>lesser of</u> 1% of the total value of the REIT's assets at the end of the quarter for which the failure occurred or $10 million, <u>and</u>

b. within six months after the last day of the quarter in which the REIT identifies the failure (not the quarter in which the failure occurred), the REIT either (i) "disposes of assets in order to meet the requirements" of the 5% or 10% securities tests, or (ii) otherwise meets such requirements within such time frame (such as by making a TRS election to cure a 10% violation as to an overlooked C corporation subsidiary). Section 856(c)(7)(B).

2. Note: section 317(a)(3) of the Protect Americans from Tax Hikes Act of 2015 ("PATH Act") added a new 25% securities asset test limitation relating to a REIT's holdings of "nonqualified publicly offered debt instruments" in subparagraph (iii) of section 856(c)(4)(B), which resulted in the 5% and 10% tests being redesignated as new subparagraph (iv). However, the asset test relief provisions in section 856(c)(7) continue to refer to subparagraph (iii) – so under a literal reading of the statute as it currently exists, there is no de minimis exception for the 5% and 10% securities test. This presumably will be fixed by a technical correction.

3. Unlike the other REIT savings provisions, the de minimis securities tests savings provision requires only identification of the failure and prompt corrective action following identification. <u>It does not require the REIT to prove reasonable cause and does not impose a monetary sanction</u>.

4. For REITs with $1 billion or more of gross asset value, the applicable de minimis cap is $10 million. For REITs with less than $1 billion of assets, the applicable cap is 1% of gross (e.g., a REIT with $100 million of gross assets has a $1 million cap).

5. The statute also provides that, in lieu of the six-month disposition period, the disposition can occur within "such other time period prescribed by the Secretary and in the manner prescribed by the Secretary." Section 856(c)(7)(B)(ii)(I).

6. The legislative history states that a REIT might "otherwise" meet such requirements (i.e., without a "disposition") in the case of the 5% test, by increasing its gross asset denominator, or in the case of the 10% test, by the issuer modifying the amount or value of its total securities. See H.R. Rep. (Conf.) No. 755, 108th Cong., 2d Sess. at 321, n. 147 (the "2004 Act Conference Report").

7. It seems logical that the de minimis threshold should be applied by reference to the amount by which the value of the security in question exceeds the 5% or 10% value limitations, as the case may be, and if the violation is a 10% voting power violation, by reference to the value of a portion of the shares corresponding to the excess voting power. On the other hand, the use of the word "total" in the phrase "failure is due to the ownership of assets the total value of which" might suggest that the entire value of the issuer's securities held by the REIT is taken into account. However, such an interpretation would mean that there is no de minimis relief for a 5% asset test violation caused by one security, because the offending security would by definition exceed 1% of the REIT's total assets. The 2004 Act Conference Report (p. 321) makes it clear that this relief was intended to apply for purposes of the 5% securities test.

8. The instructions to the 2015 Form 1120-REIT (p. 15) state as follows with respect to the de minimis savings provision:

> "**Note**. There is no tax imposed and you are not required to attach a schedule of assets to Form 1120-REIT for the de minimis relief provision under section 856(c)(7)(B)."

9. The de minimis securities test savings provision is not often helpful because of the size constraints. However, it may provide immunity for small loans that don't meet a safe harbor and might otherwise cause a 10% securities test violation, or for a REIT's ownership of stock of a largely dormant non-QRS corporation (e.g., a corporation owned by a partnership in which the REIT is a partner) for which no TRS election was made and the stock of which has little value because the TRS has little or no assets and operations.

E. Other Asset Test Failures

1. A second asset test relief provision is provided in section 856(c)(7)(A). It has a broader scope than the de minimis savings provision in that it applies to failures to satisfy any of the asset tests in section 856(c)(4) (not just the 5% and 10% securities tests). Unlike the de minimis exception, though, the subparagraph (A) exception requires proof of reasonable cause and imposes a tax sanction.

2. The subparagraph (A) exception applies if the failure to meet the asset tests for a particular quarter involves the "ownership of assets the total value of which" exceeds the 1%/$10 million de minimis threshold described above. Section 856(c)(7)(A). In that event, the failure is excused – that is, "is nevertheless considered to have satisfied the requirements of [section 856(c)(4)]" if all three of the following conditions are met:

a. The REIT, after identifying a failure for a particular quarter, files a schedule with the IRS in accordance with regulations prescribed by the Secretary that sets forth a description of each asset that caused the REIT to fail to satisfy the asset tests at the close of any quarter. Section 856(c)(7)(A)(i).

b. The failure to meet the asset test requirements at the end of a particular quarter is due to reasonable cause and not to willful neglect. Section 856(c)(7)(A)(ii). ("Reasonable cause" is discussed later in this outline.)

c. The REIT disposes of the assets set forth on the schedule within six months after the last day of the calendar quarter in which the REIT first identified the failure "or such other time period prescribed by the Secretary and in the manner prescribed by the Secretary," or otherwise meets such requirements during such time period. Section 856(c)(7)(A)(iii).

d. The instructions to the 2015 Form 1120-REIT (p. 15) describe the filing of the schedule as follows:

> "The REIT sets forth a description of each asset that causes the REIT to fail to satisfy the requirements of the asset test at the close of a quarter in a statement for the quarter attached to its timely filed Form 1120-REIT;"

e. Because of the reference to a "timely filed" return, it would appear that the schedule is attached to the Form 1120-REIT filed for the current taxable year in which the failure is identified, even if failures are identified for calendar quarters in prior taxable years for which returns have already been filed. Attaching the schedule to an amended return for a prior year in which the failure occurred should also be sufficient.

3. If the subparagraph (A) exception "applies [to a REIT] for any taxable year," it must pay an excise tax equal to the <u>greater of</u> (a) $50,000 or (b) an amount (determined under as-yet unissued regulations) equal to the product of (i) the net income generated by the assets described in the schedule for the period beginning on the first date that the failure occurred (i.e., the end of the calendar quarter for which the problem first arose) and ending on the earlier of the date the REIT disposed of the assets or the end of the first quarter when there is no longer an asset test failure, and (ii) the highest rate of tax specified in section 11 for corporations, currently 35%. Section 856(c)(7)(C).

a. Note that this tax (unlike the "penalty" imposed under section 856(g)(5)) is technically not a condition to obtaining the safe harbor relief. Thus, if there is a later dispute over the determination of the proper penalty, the fact that an incorrect amount was initially remitted by the REIT does not invalidate the safe harbor relief if the three requirements (filing of schedule, timely cure and reasonable cause) are otherwise met.

b. The section 856(c)(7)(C) tax is deductible in computing REIT taxable income. Section 857(b)(2)(E).

4. Because section 856(c)(7)(C)(i) refers to the subparagraph (A) exception applying "for any taxable year" instead of "any calendar quarter" (and the instructions to the 2015 Form 1120-REIT discussing the tax do the same thing), the tax should be determined without regard to the number or type of asset test failures that occur during the year -- that is, failures occurring at the end of one, two, three or four quarters, failures involving different asset tests or different assets, etc., should all be lumped together so that only one $50,000 tax applies (assuming that amount is less than a tax on the income from the problematic assets).

a. By contrast, the omnibus savings provision in section 856(g)(5) for other REIT failures imposes a $50,000 "penalty" -- not a "tax" -- "for each failure to satisfy a provision of this part."

b. It is unclear what happens if a particular asset test failure crosses over one taxable year and into the next. The tax-on-net-income component of the section 856(c)(7)(C) tax does not reference taxable years; it merely focuses on the period during which the failure persisted. Arguably the $50,000 tax should be imposed (if it is the lesser of the two amounts) only once, even if the asset test failure related to calendar quarters occurring in more than one taxable year. Under this view, the penalty presumably would be determined after the failure was cured and would be remitted with the tax return for the taxable year of the cure. The IRS may assert, however, that the penalty is determined on a year-by-year basis once a failure persists in successive taxable years, since subparagraph (C) begins with the language "If subparagraph (A) applies [to a REIT] for any taxable year,…"

c. Although the statutory language is not entirely clear, the "net income based" component of the tax should be imposed only on the portion of the asset that caused the failure -- e.g., if a REIT owns securities of a corporation that equal 7% of its gross assets and thus violates the 5% securities test, the tax should be imposed only on the net income attributable to the 2% excess portion.

II. SAVINGS PROVISION FOR GROSS INCOME TEST FAILURES

A. <u>Section 856(c)(6)</u>

1. Section 856(c)(6) provides that if a REIT fails the 95% or 75% gross income tests for any taxable year, it is nevertheless considered to have satisfied such tests if, following the identification of the failure by the REIT, the REIT files with the IRS a schedule setting forth "a description of each item of its gross income that is described in [sections 856(c)(2) or section 856(c)(3)]" for such taxable year. The schedule must be filed in accordance with regulations prescribed by the Secretary, which have not been issued. In addition, the failure must be due to reasonable cause and not to willful neglect.

a. Prior to amendment by the 2004 Jobs Act, section 856(c)(6) provided that the relief from disqualification applied if the REIT attached to its tax return for the taxable year a schedule setting forth "the nature and amount of each item of gross income described in [sections 856(c)(2) and (c)(3)]," and any error in the schedule was not due to fraud.

b. Note that section 856(c)(6) relief provision did not apply to the former 30% gross income test, which was repealed for taxable years beginning on or after August 5, 1997.

2. The regulations under such provision require disclosure of the totals of each type of gross income derived by the REIT from sources described in sections 856(c)(2) (95% test) and 856(c)(3) (75% test), but not separate lease-by-lease or loan-by-loan amounts. Treas. Reg. § 1.856-7(b). However, the REIT is required to maintain adequate records to substantiate the total amounts.

3. Under amended section 856(c)(6), the schedule is not filed with the IRS until a gross income test failure has been identified by the REIT. The instructions to the Form 1120-REIT say little about this schedule. Part III of Form 1120-REIT provides for the calculation of the section 857(b)(5) tax, but it is not clear that simply filling out Part III constitutes a sufficient disclosure of the sources and amounts of qualifying gross income. Therefore, a separate schedule should be attached to the return (or to an amended return if the failure relates to a prior taxable year).

B. Section 857(b)(5) Tax

1. The gross income test failure savings provision in section 856(c)(6) is tantalizing because it appears to have no sanction, but one must read on -- a special tax is imposed by section 857(b)(5).

2. In a nutshell, if the relief afforded by section 856(c)(6) applies to a REIT for any taxable year, section 857(b)(5) imposes a 100% "tax" equal to the product of the amount by which the nonqualifying gross income caused the REIT to fail the 95% or 75% gross income tests for such year, multiplied by a fraction intended to reflect the REIT's overall profitability (in effect, converting the tax base to which the 100% tax applies from gross excess bad income to net excess bad income).

3. Part III of the Form 1120-REIT lays out the complex mechanics for computing this tax. The fact that the form provides for self-assessment indicates that the IRS expects that taxpayers will make their own reasonable cause determination.

4. The section 857(b)(5) tax is deductible in computing REIT taxable income. Section 857(b)(2)(E).

III. OMNIBUS REASONABLE CAUSE EXCEPTION FOR FAILURES OTHER THAN INCOME TEST AND ASSET TEST FAILURES

A. Section 856(g)(5)

1. Section 243(f)(3) of the 2004 Jobs Act enacted section 856(g)(5), along with a corresponding amendment to section 856(g)(1).

2. If a REIT's election terminates for a taxable year due to one or more failures to comply with the provisions of sections 856-860 other than a failure to comply with the income tests in section 856(c)(2) and (c)(3) or the asset tests in section 856(c)(4), then sections 856(g)(1) and (5) collectively provide that the REIT's election does not terminate if:

a. The failures are due to reasonable cause and not willful neglect, and

b. The REIT pays a "penalty" of $50,000 "for each failure to satisfy a provision of this part" that is due to reasonable cause and not willful neglect. (Emphasis added.)

3. The penalty is paid in the manner prescribed by regulations and in the same manner as a tax. Section 856(g)(5)(C).

a. The section 856(g)(5) penalty is deductible in computing REIT taxable income. Section 857(b)(2)(E).

b. Unlike the taxes imposed by section 856(c)(7)(C) and 857(b)(5), the payment of the penalty is a condition precedent to obtaining the safe harbor relief.

c. Schedule J, line 2(f) of the Form 1120-REIT provides for the payment of this penalty (as well as the tax imposed as a result of non-de minimis asset test failures under section 856(c)(7)) and again contemplates self-assessment based on the taxpayer REIT's own determination that it had reasonable cause for the failure. The instructions to the 2015 Form 1120-REIT (p. 15) state as follows regarding the section 856(g)(5) relief:

> "Under section 856(g)(5), a REIT that fails to meet the REIT qualification requirements under sections 856–859, except for section 856(c)(2), 856(c)(3), and 856(c)(4), may avoid loss of its REIT status if the failure is due to reasonable cause and not due to willful neglect. In addition, the REIT must pay (as prescribed by regulations and in the same manner as tax) a penalty of $50,000 for each failure to satisfy a provision of sections 856-859. See section 856(g)(5)."

4. This relief provision potentially can help a REIT in remediating an organizational or structural failure, such as issues relating to "transferable shares," "managed by directors," the five or fewer test, 100-shareholder requirement, undistributed C earnings and profits, etc.

B. Application of Savings Provisions to Time-Barred Years

1. The effective date provisions of Section 243(g) of the 2004 Jobs Act relating to the savings provisions were amended by Section 403(d) of the Gulf Opportunity Zone Act of 2005 ("GO Zone Act") to provide that they apply with respect to failures that are satisfied after the date of enactment, and the legislative history of the Go Zone Act makes it clear that the two asset test savings provisions, the omnibus savings provision, and the amendment to the deficiency dividend procedures (discussed later in this outline) apply to "failures occurring in taxable years beginning on, before, or after the date of enactment" of the 2004 Jobs Act. The Joint Committee Explanation states as follows:

> "*REIT provisions (Act sec. 243).* -- The REIT may cure de minimis failures of asset requirements (other than the requirement that the REIT may not hold more than 10 percent (five percent for certain prior years) of the value of securities of a single issuer, for which failure-specific procedures are provided) by using the same procedures as the REIT may use for larger failures of asset tests.
>
> The provision clarifies that the new rules that permit the curing of certain REIT failures apply to failures with respect to which the requirements of the new rules are satisfied in taxable years of the REIT beginning after the date of enactment. Similarly, the provision clarifies that the new rules governing deficiency dividends that allow the taxpayer to make a determination by filing a statement with the IRS apply to statements filed in taxable years of the REIT beginning after the date of enactment.
>
> It is intended that the provisions of the Act that allow a REIT to correct failures of REIT qualification without losing its REIT status apply to corrections of failures for which the requirements for correction are satisfied after the date of enactment, <u>regardless of whether such failures occurred in taxable years beginning on, before, or after the date of enactment</u>. Similarly, it is intended that the provisions of the Act that allow deficiency dividends under section 860 to correct distribution failures, provided the deficiency is identified in a statement filed after the date of enactment in accordance with the provisions of the Act, <u>apply to failures occurring in taxable years beginning on, before, or after the date of enactment</u>." (Emphasis added.)

<u>See</u> Staff of Joint Committee on Taxation, <u>General Explanation of Tax Legislation Enacted in the 109th Congress</u>, p. 242 (Comm. Print. Jan. 17, 2007).

2. There is no specific guidance as to how the savings provisions discussed above for income test, asset test and other REIT failures apply to failures that occurred in taxable years that are, at the time of identification, time-barred.

3. It is often important to have finality if an issue is discovered in a time-barred year as well as open years because of the section 856(g)(3) four-year prohibition on re-election after a termination year and the 10-year BIG tax hangover that arises when a corporation goes from REIT status to C status and back to REIT status (provided the corporation meets the REIT requirements in the re-election year, such as no C earnings and profits). Further, no matter now theoretical or remote the risk of a barred-year REIT bust may be, it can still hold up a merger transaction or public offering until it is finally resolved.

4. A REIT could file an amended return for a barred year, attach the required schedules relating to the failure, explain the basis for reasonable cause, and pay the required tax or penalty. But without any assurance that the IRS will see reasonable cause through the same rose-colored glasses that the taxpayer and its advisors may be wearing may propel the REIT to seek a closing agreement. As will be discussed, in the closing agreement process the IRS generally seeks a penalty for barred year relief as well as open year relief, usually insisting on the same tax or penalty that applies to an open year.

C. <u>No Savings Provisions Apply to the Prohibited Transactions Tax</u>

1. There is no relief under the prohibited transaction tax provisions comparable to that provided by section 856(c)(6), section 857(b)(5) and Treas. Reg. § 1.856-7 (reasonable cause waiver of gross income test violation with a net income tax penalty on the excess bad income) where the taxpayer proceeds with a sale of property on the basis of a reasoned opinion of counsel, either to the effect that a sale was not a dealer sale or that the prohibited transactions tax safe harbor applied, and the IRS later prevails with a dealer challenge. Similarly, the section 856(g)(5) omnibus relief for REIT disqualification screw-ups also does not extend to the prohibited transactions tax.

2. T.D. 7767, 1981-1 C.B. 82, added Treas. Reg. § 1.857-5 (Net income and loss from prohibited transactions) and made major revisions and additions to the REIT regulations in 1981 to give effect to changes to the REIT laws made by the Tax Reform Act of 1976. In the preamble to the regulations, the IRS stated that commentators had requested a reasonable cause exception for REITs that sell foreclosure property without using an independent contractor in the belief that the foreclosure property was not held primarily for sale to customers in the ordinary course of a trade or business. The commentators asked for a reasonable cause exception to be provided if the REIT believed it was not holding the property primarily for such purpose (other than in the case of readily identifiable dealer activity such as condominium sales or sales of subdivided parcels). The IRS rejected this comment, stating that "to adopt a reasonable cause test would be tantamount to exempting property from the rules of section 856(e)(4)(C) if a favorable opinion had been received with respect to its character in the hands of the REIT." <u>See</u> T.D. 7767 (Information Supplementary), 1981-1 C.B. 82, 86.

3. Note that, because dealer gain is nonqualifying gross income and is excluded from the gross income test denominator (sections 856(c)(2) and (c)(3), flush language), characterizing real estate gains as dealer gain could indirectly create a gross income test failure by shrinking the 5% basket.

IV. PROHIBITION ON RE-ELECTION OF REIT STATUS AFTER TERMINATION OF STATUS

A. <u>Overview of Section 856(g)</u>

1. Section 856(g)(1), captioned "Failure to Qualify," provides as follows:

> "An election under subsection (c)(1) made by a corporation, trust, or association shall terminate if the corporation, trust, or association is not a [REIT] to which the provisions of this part apply for

the taxable year with respect to which the election is made, or for any succeeding taxable year unless paragraph (5) applies. Such termination shall be effective for the taxable year for which the corporation, trust, or association is not a [REIT] to which the provisions of this part apply, and for all succeeding taxable years."

2. This means that an entity that has elected to be taxed as a REIT loses its status automatically if it fails to qualify to be taxed as a REIT for a taxable year (and none of the savings provisions described above apply). The termination is effective for that taxable year and all subsequent taxable years, subject to the corporation's right to re-elect REIT status when permitted by section 856(g)(3). Section 856(g)(1).

3. Section 856(g)(3) provides that if the election to be treated as a REIT is revoked or terminated for a taxable year, the entity (and any "successor" to that entity within the meaning of Treas. Reg. § 1.856-8(c)(2)) generally may not again elect to be treated as a REIT until the fifth taxable year after the first taxable year for which the revocation or termination is effective.

4. It can be argued that a REIT election for the first REIT taxable year cannot "terminate" if the corporation had a REIT failure in that same taxable year, and therefore the initial election is simply a nullity and the corporation should not be prohibited from re-electing in the succeeding taxable year. However, the regulations seem to say otherwise. Treas. Reg. § 1.856-8(b) provides that an election of a corporation under section 856(c)(1) to be a REIT "shall terminate if the corporation … is not a qualified [REIT] for any taxable year (including the taxable year with respect to which the election is made)." Based on the parenthetical language, a corporation with a blown initial REIT election for year 1 apparently will not be permitted to elect REIT status again until year 6 unless either (i) the section 856(g)(3) reasonable cause exception applies, in which case the REIT is disqualified for year 1 but is not subject to the four-year wait on re-election, or (ii) the section 856(g)(5) omnibus exception for REIT failures (other than income and asset test failures) applies, in which case it appears the REIT election never terminates (not even for the first failure year).

5. An entity that has elected to be taxed as a REIT for a taxable year may revoke the election for any subsequent taxable year, provided that the revocation must be made within the first 90 days of the taxable year for which the revocation is to be effective. Section 856(g)(2).

6. The "successor" rules are potentially broad in scope and should be evaluated whenever a REIT acquires the assets of another REIT, by merger, liquidation or otherwise. Among other things, a REIT's status as a "successor" to another REIT can significantly expand the scope of an opinion-giver's due diligence when opining on the successor's REIT status -- in effect forcing the tax advisor to consider the qualified REIT status of the predecessor as well. This can happen even if the acquiring REIT immediately liquidates the target REIT and does not own the stock of the target REIT at the end of any calendar quarter.

B. <u>Reasonable Cause Exception in Section 856(g)(4)</u>

1. Section 856(g)(4) provides that if a REIT's election is terminated under paragraph (g)(1), "paragraph (3) shall not apply" -- meaning the four-year prohibition on re-election after the year of termination does not apply -- if (i) the REIT does not willfully fail to file a timely income tax return for the year in which the termination of the REIT election occurs, (ii) the inclusion of any incorrect information on the return is not due to fraud with intent to evade tax, and (iii) the REIT establishes "to the satisfaction of the Secretary" that its failure to qualify as a REIT is due to reasonable clause and not willful neglect.

2. The statement that "paragraph (3) shall not apply" means that establishing reasonable cause only prevents the four-year prohibition on re-election after a termination year from applying. By its terms, section 856(g)(4) does not prevent the termination of REIT status in the year of the REIT bust. (By contrast, the omnibus relief provision in paragraph (g)(5) for failures other than income test and asset test failures seems to apply to the initial REIT termination year as well as subsequent years.)

3. Unlike the savings provisions previously discussed, which merely require that the failure "be due to reasonable cause and not due to willful neglect," section 856(g)(4) requires that reasonable cause be established "to the satisfaction of the Secretary." This language has been interpreted by the courts in the context of other provisions of the Code to mean that "some amount of deference be given to the conclusion of the Commissioner … [t]o conclude otherwise would render the phrase superfluous." R.E. Deitz Corp. v. United States, 939 F.2d 1 (9th Cir. 1991). The Ninth Circuit also stated that "the appropriate amount of deference is embodied in the arbitrary and capricious standard, which allows for the exercise of discretion, although not unbounded discretion." See also Schoneberger v. Commissioner, 74 T.C. 1016 (1980) (establishing bona fide residency under section 911 to the satisfaction of the Secretary requires strong proof).

4. The regulations require that the REIT establish reasonable cause to the satisfaction of the District Director for the internal revenue district in which the REIT maintains its principal place of business or principal office or agency. Treas. Reg. § 1.856-8(d). Today, the reference to "District Director" should be construed to mean the Director of Field Operations for the Large Business & International Division ("LB&I").

5. Such regulation further provides that the principles of Treas. Reg. § 1.856-7(c) (including the principles relating to expert advice) will apply in determining reasonable cause for purposes of section 856(g)(4). Treas. Reg. § 1.856-7(c) sets forth the standards for determining reasonable cause for purposes of section 856(c)(6) (note that the regulation refers to former section 856(c)(7) and does not reflect changes to the Code since the regulation was issued.)

V. ESTABLISHING REASONABLE CAUSE

A. Failure Must be Due to Reasonable Cause and Not Willful Neglect

1. The most critical part of obtaining relief under the new savings provisions (other than the relief for de minimis asset test failures) is establishing reasonable cause.

2. The regulations that were issued under the pre-2004 Jobs Act version of section 856(c)(6) (and which are still in effect) state that a REIT meets the reasonable cause/no willful neglect standard by exercising ordinary business care and prudence in attempting to satisfy the requirements at the time the REIT enters into each transaction.

3. If the REIT enters into a transaction after exercising ordinary business care and prudence and then later determines that the transaction produces nonqualifying gross income that can reasonably be expected to violate the 95% or 75% gross income tests, the regulations state that the REIT must use ordinary business care and prudence to renegotiate or restructure the transaction or dispose of the offending property or lease. Treas. Reg. § 1.856-7(c)(1).

4. It is not clear how the taxpayer establishes reasonable cause for purposes of the savings provisions. Seeking a private letter ruling on reasonable cause for a prior REIT taxable year where the return has been filed generally is not a viable option. Section 2.01 of Revenue Procedure 2016-

1, 2016-1 I.R.B. 1, states that a "letter ruling" is a written determination "issued to a taxpayer by an Associate office in response to the taxpayer's written inquiry, filed prior to the filing of returns or reports that are required by the tax laws, about its status for tax purposes or the tax effects of its acts or transactions." Section 5.01 of Revenue Procedure 2016-1 also states that the IRS will not rule on transactions or issues relating to tax returns that have already been filed:

> "In income and gift tax matters, an Associate office generally issues a letter ruling on a proposed transaction or on a completed transaction if the letter ruling request is submitted before the return is filed for the year in which the transaction is completed. An Associate office will not ordinarily issue a letter ruling on a completed transaction if the letter ruling request is submitted after the return is filed for the year in which the transaction is completed. "Not ordinarily" means that unique and compelling reasons must be demonstrated to justify the issuance of a letter ruling submitted after the return is filed for the year in which the transaction is completed. The taxpayer must contact the Field office having audit jurisdiction over their return and obtain the Field's consent to the issuance of such a letter ruling."

5. In addition, while the issue of whether a REIT had reasonable cause for an income test, asset test or other REIT failure is not specifically identified as a "no rule" or "will not ordinarily rule" issue by the IRS (see Rev. Proc. 2016-3, 2016-1 I.R.B. 126), Section 3.02(5) of the Revenue Procedure states that a "general area" in which the IRS will not issue a ruling (as opposed to will not ordinarily issue a ruling) is "[w]hether under Subtitle F (Procedure and Administration) reasonable cause, due diligence, good faith, clear and convincing evidence, or other similar terms that require a factual determination exist." In addition, section 4.02(1) states that an area in which the IRS will not ordinarily issue a ruling is "[a]ny matter in which the determination requested is primarily one of fact, e.g., market value of property, or whether an interest in a corporation is to be treated as stock or indebtedness."

a. It appears that the only private letter ruling where the IRS ruled on reasonable cause for a REIT failure is PLR 9550019 (Sept. 15, 1995). There, the IRS ruled that certain gross income test failures were excused under the former section 856(c)(7) exception (now located in section 856(c)(6)).

b. The failures included (i) the failure to identify that the provision of meals, maid service and transportation service to the residents of two senior citizen projects raised a customary services problem and tainted the rents, and (ii) the failure to treat cost reimbursements received by certain management partnerships in which the REIT was an indirect partner as gross income for purposes of the gross income tests.

c. The facts of the ruling state that when the REIT went public in 1994, it obtained the opinion of a nationally recognized law firm with REIT experience that the REIT's "organization and proposed method of operation would enable it to meet the requirements for REIT qualification" and provided the law firm with "due diligence reports and other detailed accounts of its operations" that disclosed information pertaining to these two issues. An accounting firm later spotted the tax issues (tax lawyers and their opinions must often endure a post-opinion review from sharp-eyed due diligence teams from the major accounting firms) and the REIT voluntarily approached the IRS regarding the issues and sought the reasonable cause ruling. With respect to the senior citizens properties, the REIT represented that similar properties in the area provided the same services. The actual text of the ruling issued by the National Office is as follows:

> "Company's failure to satisfy the requirements of section 856(c)(2) of the Code for Period-A and Period-B is due to reasonable cause and not to willful neglect (within the meaning of section

856(c)(7)(C)) to the extent that such failure is caused by (i) the failure of the income from Project-A and Project-B to qualify as rents from real property due to the provision of meal, maid and transportation services, and/or (ii) the inclusion in gross income of the reimbursements paid by the unrelated owners under their agreements with the Managing Partnerships."

d. The ruling gives no analysis as to the facts on which the IRS based its reasonable cause determination. The IRS may have viewed the law firm's clean REIT opinion delivered at the time of the IPO as the grounds for reasonable cause. However, that opinion presumably was a standard short-form REIT opinion that did not specifically address the two issues subsequently identified. As such, it would not appear to be a "reasoned, written opinion" within the meaning of Treas. Reg. § 1.856-7(c)(2)(iii) (discussed further below). However, such regulation clearly leaves open the possibility that a lesser form of opinion and/or other facts showing reasonable cause could satisfy the statutory requirement.

e. The ruling states that the REIT agreed to restructure its operations to cure the two tax issues, to treat the rents derived from the two senior citizen projects as bad income until the problematic services were restructured, and to pay the tax imposed by section 857(b)(5) on such income. It agreed to take similar action on the reimbursements issue but reserved the right to seek a ruling to the effect that such reimbursements were not gross income.

6. REIT tax advisors are sometimes asked by their clients to opine on reasonable cause for a REIT failure where there is a reasonable-cause-based escape hatch. That may be wishful thinking in many cases because, as further discussed below, reasonable cause (as a REIT specialist at another law firm once said to me) is in the eye of the beholder, and while the client may be beholding one thing, the law firm may be beholding another, and the IRS might behold something else if it were to behold. The law firm may be opposed on principle to rendering an opinion on such a nebulous factual issue no matter what the facts may be, except perhaps where the REIT previously obtained and relied upon a written opinion from a tax advisor on the problematic position. As will be discussed, the regulations contain specific guidance as to when reliance on an advisor's opinion constitutes reasonable cause. If the tax advisor is unwilling to opine on reasonable cause, or will only do so at an unacceptably low comfort level, the only solution may be to seek an IRS ruling (if the failure is of very recent origin) or a closing agreement (discussed later in this outline).

7. It goes without saying that reasonable cause opinions are not something that lawyers typically do, especially at the "will" level of assurance that is customary for REIT qualification opinions. Everybody wants to transfer all risks to the lawyers and accountants, but there are limits. What REITs and their advisors desperately need is for the IRS to revise its policies and to entertain ruling requests on reasonable cause under the REIT savings provisions, even if the returns in question have already been filed. This would give REITs another way to achieve finality on issues that arise with greater speed without having to initiate a painful and possibly protracted closing agreement process. It would also ensure that the request is considered by persons in the National Office who have considerable experience with REIT issues. The IRS, after all, routinely grants 9100 relief to REITs in a variety of screw-up contexts, and does so fairly expeditiously; it would seem that giving reasonable cause rulings would not involve that much more administrative work and would be in keeping with its generally benign approach to REIT busts.

8. The REIT's reasonable cause defense will be bolstered if it can show that it had good REIT compliance and due diligence policies in place when the failure occurred.

9. The Instructions to the 2015 Form 1120-REIT (p. 14) require a statement to be attached to the REIT's return with respect to the REIT's reliance on the section 856(c)(6) gross income test savings provision and the two asset test savings provisions. This statement must explain why the REIT failed the particular REIT test and provide the reason why the failure was due to reasonable cause:

> "Taxes are imposed for the failure to meet the requirements of the asset test and/ or gross income test. To qualify for relief from the failure to meet these requirements, attach an explanation of why the REIT failed to meet the asset test and/ or gross income test. Attach supporting schedules and a statement showing the computation of the amount of tax. Also, include a reason why the failure was due to reasonable cause and not willful neglect. See sections 856(c)(2), 856(c)(3), and 856(c)(4).
>
> The statement for reasonable cause should be attached to Form 1120-REIT at the time it is filed."

B. Reliance on an Advisor's Written Opinion

1. Reasonable reliance on a "reasoned, written opinion" by a tax advisor (including in-house counsel) as to the favorable characterization of a particular gross income item that later turns out to be nonqualifying gross income "generally" constitutes reasonable cause. Treas. Reg. § 1.856-7(c)(2)(i). However, the absence of such an opinion, by itself, does not give rise to any inference that the gross income test failure was without reasonable cause. Id.

2. The opinion is a "reasoned" opinion, even if subsequently determined to be incorrect, provided it is based on a full disclosure of the facts by the REIT and addresses the facts and law that the opinion giver believes to be applicable.

3. An opinion that does nothing more than "recite the facts and express a conclusion" is not considered to be "reasoned." Treas. Reg. § 1.856-7(c)(2)(iii).

4. A written opinion is considered "reasoned" even if it reaches a conclusion which is subsequently determined be incorrect, so long as opinion is based on a full disclosure of the facts by the REIT and is addressed to the facts and law which the opinion-giver believes to be applicable. Treas. Reg. § 1.856-7(c)(2)(iii).

5. As an example where the REIT does not have reasonable cause, the regulations posit a situation where the REIT entered into a lease "knowing that it will produce nonqualified income which reasonably can be expected to cause a source-of-income requirement to be failed," even if the REIT had a legitimate business purpose for entering into the lease. Treas. Reg. § 1.856-7(c)(1).

6. Obtaining a reasoned opinion prior to sale from a tax advisor to the effect that a sale is not a prohibited transaction and that the gain is qualifying gross income will not avoid the prohibited transactions tax if the sale is later determined to be a dealer sale, but it should help to avoid a potential REIT disqualification issue if removing such tainted gain from the gross income denominator (as section 856 requires) causes the 5% basket to shrink and overflow with bad income.

7. Under this regulation, even a "should" or "more likely than not" comfort level should suffice, although a more-likely-than-not opinion might cause an IRS agent to question whether it was reasonable for the REIT to rely on the opinion. A disagreement between tax advisors over the merits of the position might also raise concerns on the reasonableness of the REIT's reliance.

8. If the REIT foul-up originated in a joint venture between the REIT and a third party, the IRS may want to see evidence that the REIT took measures to ensure that the third party manager/general partner was advised of the REIT's special tax status and the various REIT compliance tests. The REIT may want to consider expanding the typical joint venture REIT protection covenant so that it spells out more clearly the actions that might cause a REIT tax problem (such as acquiring a loan or other security or entering into a net profits lease) and ensure that management is informed of the issues. Another approach is to have the REIT's tax advisors document the venture's current business plan, operations and assets, have the venture partner acknowledge that it is accurate and complete, and prohibit the partner from deviating from that plan without the REIT's approval.

9. The extent to which the REIT can point the finger at its accountants and tax lawyers will also be relevant, of course. To be able to point the finger and establish reasonable reliance on an advisor, the REIT will need to bring tax advisors into the loop as transactions occur, leases are signed, and operations change. Formal written tax advice is increasingly being obtained by REITs, but some still take a penny-pinching approach and keep tax advisors at bay, or only involve an accounting firm on a sporadic basis and not the lawyer who will someday end up giving the REIT opinion.

10. Delivering a legal opinion after-the-fact to the effect that there was reasonable cause for a REIT bust, as part of a REIT qualification opinion, may be difficult because the issue is so fact-sensitive. However, some law firms have done so, most commonly where they (or another law or accounting firm tax advisor) previously provided the client with a contemporaneous memorandum or opinion on the issue and concluded (perhaps incorrectly in the eyes of the current opinion giver) that the REIT's position on the issue was sound.

C. Reasonable Cause In Other Contexts

1. Other than Treas. Reg. § 1.856-7, there is almost no guidance interpreting "reasonable cause and not willful neglect" in the context of a REIT failure.

2. In United States v. Boyle, 469 U.S. 241, 245 (1985), the Supreme Court, in interpreting the "due to reasonable cause and not willful neglect" language of the penalty provisions in sections 6651(a)(1) and (2) and 6656(a), stated that the taxpayer bears the "heavy burden of proving both (1) that the failure did not result from 'willful neglect' and (2) that the failure was 'due to reasonable cause.'" The Court stated that willful neglect is "conscious, intentional failure or reckless indifference." 469 U.S. at 245. "Reasonable cause" means the exercise of "ordinary business care and prudence." Treas. Reg. § 301.6651-1(c)(1); Boyle, 469 U.S. at 246.

3. There are countless provisions of the Code that employ a "reasonable cause and not willful neglect" standard, and there is a lot of interpretive authority under those provisions which is beyond the scope of this outline. (For example, TAM 200919032 (Jan. 29, 2009) contains an interesting discussion of reasonable cause under section 367, including Boyle and other authorities interpreting reasonable cause under other Code provisions.)

VI. PATH ACT RELIEF MEASURES RELATING TO PREFERENTIAL DIVIDEND RULE

A. Repeal of Section 562(c) for Public REITs

1. Section 314 of the PATH Act amends section 562(c) so that it no longer applies to a "publicly offered REIT," just as it previously did not apply to a publicly offered RIC. See Section 562(c)(1), as amended by the PATH Act.

2. New section 562(c)(2) defines a publicly offered REIT as a REIT which is required to file annual and periodic reports with the SEC under the Securities Exchange Act of 1934.

3. The repeal of the preferential dividend rule for publicly offered REITs is effective for distributions in taxable years beginning after December 31, 2014. Section 314(c) of the PATH Act.

4. This idiotic rule should have been repealed for private REITs also. For years, section 562(c) has accomplished absolutely nothing from a policy standpoint except to create yet another opportunity for well-meaning REITs to experience a go-to-pieces.

B. <u>IRS Authority to Provide Appropriate Remedy for Private REIT Section 562(c) Busts</u>

1. Section 315(a) of the PATH Act adds new section 562(e)(2), which provides that if a distribution by a REIT fails to comply with section 562(c), "the Secretary may provide an appropriate remedy to cure such failure in lieu of not considering the distribution to be a dividend for purposes of computing the dividends paid deduction."

2. One of two requirements must be met:

a. Either the Secretary determines that the failure is due to reasonable cause and not to willful neglect (section 562(e)(2)(A)), or

b. The failure is of a type which the Secretary has identified for purposes of section 562(e)(2) as being described in section 562(e)(2)(A) (i.e., reasonable cause failures). Section 562(e)(2)(B). This second criteria is interesting. The intent appears to be to permit the IRS to publicly identify preferential dividend "failures," or perhaps potential failures, where reasonableness is presumed to exist and, one would expect, an appropriate remedy is specified – perhaps paving the way for self-help if a taxpayer's facts clearly fall within an identified failure situation. <u>See</u> Staff of Joint Committee on Taxation, Technical Explanation of the Protecting Americans from Tax Hikes Act of 2015, House Amendment #2 to the Senate Amendment to H.R. 2029 (Rules Committee Print 114-40), p. 173, JCX-144-15 (December 17, 2015) (the "PATH Act JCT Explanation"); Joint Committee on Taxation, <u>General Explanation of Tax Legislation Enacted in 2015</u>, JCS-1-16, p. 267 (March 2016) (the "JCT 2015 Bluebook").

3. The new private REIT relief provision for section 562(c) busts is effective for distributions in taxable years beginning after December 31, 2015.

a. Thus, unlike the one-year retroactivity of the public REIT preferential dividend repeal, this relief provision is only effective starting in 2016.

b. Would it have killed Congress to make this relief fully retroactive for all REITs (public and private)?

4. Once again, we have a relief provision that is contingent on the IRS making a reasonable cause determination (unless it is a section 562(e)(2)(B) "identified failure"), and yet tax counsel will generally not opine on whether the IRS will or won't perceive a failure as due to reasonable cause. If the REIT is not under examination, there is currently no procedure in place for the REIT to seek such a reasonable cause determination other than by way of a closing agreement.

a. The IRS could decide to put out a revenue procedure with useful pre-determined reasonable cause situations that could allow REITs and their tax counsel to opine over the bust and avoid a closing agreement mess. But this could take years.

b. A prime candidate for intervention would be an issue that is plaguing the fund industry, which is when separate classes of REIT stock will be respected as such for purposes of applying section 562(c). A negative ruling recently issued by the IRS on a two-class stock structure has caused much turmoil. It is predicated on the idea that the IRS has the right to declare unilaterally that what corporate tax lawyers clearly perceive as separate classes of stock should be amalgamated and treated as one for purposes of applying section 562(c) in order to manufacture a preferential dividend problem.

c. Better yet, why not open up the ruling process for such reasonable cause determinations and process them rapidly like the IRS already does for busted REIT elections and TRS elections?

5. What sorts of "appropriate remedies" are contemplated?

a. The statutory language seems to preclude a remedy that would treat the dividend as nondeductible for purposes of determining a REIT's tax liability only, but not for purposes of determining whether the REIT met the 90% distribution requirement of section 857(a)(1) (which goes to REIT qualification). This is good news, since paying a corporate-level tax liability can be a catastrophic "remedy."

b. That seems to leave monetary fines or penalties as the logical remedy. How much? $50,000 per bust? How do you define each failure? What about section 562(c) failures that are of a recurring nature and potentially disqualify multiple distributions in multiple years?

VII. DEFICIENCY DIVIDEND RELIEF PROCEDURES

A. <u>Deficiency Dividends Defined</u>

1. Section 860(a) provides that if there is a "determination" with respect to any REIT that results in any "adjustment" for a taxable year, a deduction is allowed to the REIT for the amount of "deficiency dividends" for purposes of determining the deduction for dividends paid under section 857 for such taxable year.

2. The deficiency dividend procedures are important, for example, if the IRS audits a prior REIT taxable year and determines that the REIT had additional unreported income that, if not distributed through a deficiency dividend, would cause the REIT to pay tax on such income or possibly lose its REIT status by failing to meet the 90% dividend distribution requirement. More typically, deficiency dividend procedures are used to "replace" a prior dividend that the REIT thought was deductible but which is later determined to have been nondeductible because, for example, it was preferential under section 562(c).

3. The term "adjustment" means any increase in REIT taxable income (determined without regard to the dividends paid deduction and excluding capital gains), any increase in the excess of capital gains over the deduction for capital gains dividends, and any decrease in the deduction for dividends paid under section 561 (determined without regard to capital gain dividends).

4. A "determination" means a court decision, a section 7121 closing agreement, an agreement signed by the Secretary by or on behalf of the REIT relating to the liability of such entity for tax, or "a statement by the taxpayer attached to its amendment or supplement to a return of tax for the relevant tax year." Section 860(e)(4).

a. The quoted language was added by the 2004 Jobs Act to permit a REIT to make a unilateral determination of an "adjustment" and engage in self-help.

b. Under prior law, a deficiency dividend could only be paid after a determination resulting from a judicial decision, closing agreement or other IRS agreement relating to the REIT's tax liability.

5. The term "deficiency dividend" means a distribution of property made by the REIT on or within 90 days after the determination and as to which a claim for deduction thereof is filed within 120 days after the date of the determination, provided the distribution would have been deductible by the REIT if actually paid in the taxable year to which the determination relates. Section 860(f)(1).

a. Deficiency dividends are not deductible for the taxable year in which they are paid, but they are included in the income of the REIT's shareholders in the year actually paid under the normal dividend rules. Section 860(f)(3).

b. Because of the timing mismatch created by the shareholders picking up the income inclusion in the year of distribution while the REIT gets the deduction for the adjustment year, the REIT must pay an interest charge (and penalties) that is determined by treating the amount of the deficiency dividend deduction as an additional tax due for the adjustment year which is not treated as paid until the claim for the deficiency dividend deduction is filed.

6. Treating the entire deficiency dividend as a tax substantially overstates the interest charge that would apply to the shareholders' aggregate unpaid tax liability on the dividends, had the dividends been timely paid in the adjustment year. This punitive aspect is intended to encourage timely distribution.

B. <u>Relationship Between Section 860 and Section 856(g)(5)</u>

1. Section 856(g)(5) applies to a corporation "which is not a real estate investment trust to which the provisions of the part apply due to one or more failures to comply with the provisions of this part." The 90% distribution requirement in section 857(b)(1) is a provision of subpart M. Thus, a failure to meet the 90% distribution requirement due to, for example, an improperly executed consent dividend under section 565, or a nondeductible preferential dividend under section 562(c), would seem to be within the scope of section 856(g)(5). The issue is how this provision syncs up with the deficiency dividend procedures of section 860.

2. If reasonable cause exists for the failure to meet the distribution requirement (say, due to a preferential dividend issue) and the REIT pays the $50,000 penalty, section 856(g)(5) should apply to cure the failure to meet the 90% distribution requirement and allow REIT status to be preserved. However, it does not appear to eliminate the corporate-level tax liability associated with the disallowance of the deduction for the dividends originally paid.

3. Using the deficiency dividend procedures to solve the corporate-level tax problem entails two costs: an economic outlay in the form of a current year dividend that the REIT did not expect to pay and an interest charge on the amount of such dividends.

a. If a REIT preferential dividend issue is caught early and only affects say, one taxable year, deficiency dividends may be the answer.

b. If the failure is chronic and affects numerous prior taxable years, deficiency dividends often are not feasible or tolerable as a business matter -- the cash has to come from somewhere and the interest charge can be prohibitive. Thus, a closing agreement process may be the only practical solution. In such a case, the REIT's toll charge does not necessarily require the payment of the full deficiency dividend that might otherwise be required to zero out REIT taxable income. This is not only because the deficiency dividend solution might bankrupt the company, but also because such failures or potential failures are usually not cut-and-dried from a tax law perspective. There may be good arguments that a problematic distribution was not preferential, and even if it was, the extent to which other dividends were tainted thereby and therefore rendered nondeductible may be unclear.

VIII. CLOSING AGREEMENTS

A. <u>The Need for a Clean REIT Opinion (or an Auditor's FIN 48 Concerns) Typically Forces the Issue</u>

1. Public REITs generally require clean REIT tax opinions in order to do offerings of debt and equity securities and to engage in an M&A transaction in which it is the target REIT (or a transaction in which it is the acquirer and is issuing its own stock as consideration). Private REITs often need them as well, either because they are required as a condition to being acquired in a tax-free reorganization by another REIT (in which case the target REIT may also insist on getting a similar opinion as to the acquiror's REIT status) or the shares of the REIT are being sold to a buyer to avoid FIRPTA tax for non-US shareholders and the buyer wants assurance that it is not acquiring a C corporation in a REIT's clothing. Or, it may be needed because the REIT's sponsor or its investors require such an opinion at formation or in a subsequent capital raise.

2. REIT opinions for public REIT's are almost always provided by lawyers. The same is generally true for private REITs, although occasionally you will see an accounting firm step up and give an opinion if it has been the principal tax advisor, and the REIT doesn't want to incur the additional costs of bringing in a law firm with no prior history with the REIT's structure, assets, and tax compliance issues and positions.

3. The problem is that there are countless ways for a REIT to screw up, and REIT tax counsel is often asked to opine back to the REIT's initial REIT taxable year, even though most prior tax years are time-barred. Why are tax lawyers routinely asked to this? Mainly because there is nothing in the tax law to prevent the IRS from asserting that a REIT failed to qualify as a REIT in a time-barred year in order to assert either, or both, that (i) the 5-year (formerly 10-year) BIG tax applies to an asset sale in an open year where the REIT is concededly a good REIT (even though its REIT status terminated in an earlier year), or (ii) that the section 856(g)(3) four-year prohibition on re-election after a termination year applies, thereby permitting the IRS to assert that the REIT is taxable as a C corporation in an open year as a result of terminating in a barred year.

4. All opinion-givers hope and pray that the IRS would not take such a draconian approach on audit and confine its examination to open tax years, and they give soothing (unwritten) assurances to their client that this would be an extraordinary and highly unlikely scenario. However, there is nothing in the tax law that says the IRS can't look at a barred year in order to create a section 856(g)(3) problem or BIG tax issue in an open year. It is well established, for example, that the IRS can redetermine an NOL arising in a time-barred source year in order to assert an adjustment in an open year to which the NOL is carried. The same is true with respect to making adjustments to the tax basis of an asset in a barred year in order to reduce tax depreciation deductions in an open year.

5. The intermediate sanction provisions discussed above contemplate a black-and-white REIT failure that is discovered by the REIT or its tax advisors after the fact. But suppose that an analysis of the facts and the applicable law leads to an uncertain resolution -- the awful black hole of uncertainty into which many REIT issues fall. What happens if the REIT initially sees the problem but determines to live with it, then later becomes involved in a merger or securities offering, and the REIT's tax counsel (who may not have been involved in the original risk assessment) determines that it cannot provide a clean REIT opinion, or determines that it can but the acquiror's counsel or underwriter's counsel won't accept it? The absence of clear authority may put the REIT in a box from which it cannot escape -- a tax lawyer who cannot opine and a deal or offering where the other parties insist on a clean opinion to close. The REIT's auditors may then get nervous about having to book a FIN 48 reserve. In this situation, even though not involving a cut-and-dried REIT failure, a closing agreement may be the only practical way to get out of the box.

B. Nature of a Closing Agreement

1. Closing agreements are authorized by section 7121. They can be used to resolve the tax liability of a taxpayer for any taxable period ending prior to or subsequent to the date of the agreement, and may be entered into in any case in which "there appears to be an advantage in having the case permanently and conclusively closed, or if good and sufficient reasons are shown by the taxpayer for desiring a closing agreement and the Commissioner determined that the United States will not be disadvantaged as a result." Treas. Reg. § 301.7121-1(a).

2. Delegation Order No. 8-3, I.R.M. Section 1.2.47.4, states that the IRS can enter into and approve closing agreements only with respect to (i) a taxable period or periods ending before the date of the agreement, or (ii) related specific items affecting other taxable periods.

3. The Internal Revenue Manual contains detailed closing agreement procedures in I.R.M. Section 8.13.1, although none of these appear to be focused specifically on REITs.

4. Once signed by the Secretary, a closing agreement is "final and conclusive" and the case cannot be reopened or modified as to the matters agreed upon, by the IRS or the taxpayer. Section 7121(b).

5. The IRS doesn't have to adhere to the four corners of the law in arriving at the terms of a closing agreement. It typically subjects a closing agreement to fairly rigorous review.

C. Timeline for a Closing Agreement

1. There is no obligation on the part of the Service to undertake a closing agreement process just because a REIT wants it. The REIT wants the closing agreement yesterday and often believes it is not a bad actor and ought to get immediate and relatively painless relief. The IRS, however, has been through budget cuts and has limited resources to throw at this type of problem. The client must understand that the official who answers the initial phone call did not come into work that morning with a perfectly clean desk expecting to sit around until a REIT called in with an urgent, all-hands-on-deck tax problem.

a. Many tax advisors believe, rightly or wrongly, that a public REIT is likely to be more sympathetic case and more likely to get the IRS' attention, because the consequences of not being able to get a clean REIT opinion are highly visible and material, the potential harm to the company obvious, and the IRS official knows that there are innocent public stockholders who will suffer if the issue is not resolved expeditiously.

b. Private REITs, on the other hand, may have a tougher time getting the attention of the IRS because there are no public stockholders to garner sympathy and there may be a view, justified or not, that private REITs are to be viewed with a more jaundiced eye. Also, there may be tax planning or tax structuring aspects associated with the use of a private REIT that may color the IRS' view of its conduct, rightly or wrongly. But the IRS' official position, as one might expect, is that all REITs are treated equally.

c. In the vast majority of cases REIT closing agreements result from voluntary disclosures by REITs, which tends to put the REIT in a more sympathetic position from the IRS' perspective. The IRS might view the issue differently if it was picked up on audit.

2. The author is aware anecdotally of one REIT that got a closing agreement in less than three weeks, but that was many years ago. Today, however, a REIT cannot assume it can walk in and get a problem resolved in a matter of weeks or even months, although the IRS continues to be sensitive to the realities of taxpayer business transactions. If a major M&A transaction or securities offering is on hold because of the actual or potential REIT bust, the process may move more quickly. It is understood that some recent REIT closing agreements have taken a matter of months to obtain, but others have taken a year or two.

3. If it turns out that a REIT is facing that kind of extended time frame for a closing agreement, REIT tax counsel (along with the REIT's auditors) will be under increasing pressure to find a way to get comfortable and render a REIT opinion without a closing agreement. Counsel will need to consider whether it is willing to opine on reasonable cause in lieu of going for a closing agreement and have the client self-assess the prescribed statutory penalty. Also, other interested parties (e.g., M&A tax counsel on the other side, underwriter's counsel) will have to do their own review and determine if they are willing to rely on tax counsel's opinion, which might be at a lower comfort level than the customary "will" opinion.

D. <u>The Process</u>

1. As the discussion above indicates, there is no "Closing Agreement Division" or "Bureau of REIT Corrections" within the IRS.

2. If a REIT is under examination when the bust is discovered, it should notify the examination team. If not, the request is typically coordinated by the technical staff in the geographic examination area, so the request for relief should be made to the LB&I Practice Area Program Manager (formerly the LB&I Industry Executive Assistant, Technical) or one of the technical analysts in that group. A request for a closing agreement can come in through other channels, of course, such as by contacting an official in the Exam division or Financial Institutions and Products, and they will forward the request to the right place.

3. The large national accounting firms typically have on their staffs one or more former IRS personnel from the operating divisions who may have useful contacts in the Service. These firms usually have extensive closing agreement experience. Consequently, it is not uncommon for the accounting firm to take the lead and initiate the kick-off call. However, the REIT's law firm ordinarily works closely with the accounting firm in marshalling the facts, preparing the initial submission, and responding to requests for additional information.

a. This practitioner has found over the years that in the REIT world, the best product, and the best chance of a successful outcome (or maintaining a healthy REIT that doesn't have these harrowing problems) comes when the REIT's accounting firm and law firm work closely together with each other and with the client's in-house tax personnel. Law firms and accounting firms have different strengths and weaknesses. The best REIT tax advisors know this and strive to keep the other guy in the loop and their elbows tucked in. Each tax advisor should urge a fee-sensitive client to get both firms involved when material issues arise.

4. The initial written submission needs to be succinct, complete and compelling. It must lay out the nature of the failure or the potential failure (if the law is unclear), every fact that is relevant to the reasonable cause narrative, and the corrective action taken or proposed to be taken. The submission must walk the line between putting the client's best foot forward and making sure that all bad facts are laid on the table. The law firm usually takes primary responsibility for drafting the closing agreement, which is very much like a contract but isn't exactly.

5. The IRS likes to see that the client acted quickly once the error or potential error was discovered. Putting this process off too long may doom it.

6. All potential REIT failures need to be identified at the front end and included in the initial submission. You don't want to get well down the road in a closing agreement negotiation and then discover (or have the Examination Division discover in the course of its efforts to validate the facts) another potential opinion-blocking issue that was missed in the early stages. For all practical purposes you have one bite at the apple.

7. The IRS office that takes responsibility for the matter will refer it to the Examination Division for review, and Exam will investigate the facts and do a write-up on the issues. This can take a long time. A quality, comprehensive submission can speed up the examination process and ultimately lead to a quicker resolution.

8. The Exam write-up then goes to Division Counsel's Office for review. Division Counsel may have issues or questions and often seeks input from the people in in Financial Institutions and Products at the IRS National Office who have extensive knowledge and experience with REIT issues. That injects a further delay in the process, typically 90 days or more. If the issue relates to a return not yet filed, it is understood that the IRS National Office must sign off on any closing agreement.

9. Once an agreement in principle is reached, Division Counsel will then either take the first cut at drafting the closing agreement or ask the taxpayer's counsel to produce a draft and then edit that draft.

10. An important part of the narrative is prompt remedial corrective action. The IRS will want to understand what steps the client has taken, or intends to take, to eliminate the problematic asset or source of income (or other REIT failure) for the current and future taxable years, such as the disposition of an asset that caused an asset test failure.

11. If part of the REIT's reasonable-cause story involves pointing the finger at one of the REIT's external tax advisors, the REIT should consider retaining another tax advisor who can act independently on the matter. It usually is in the best interest of the firm that is on the hot seat to lay all the cards on the table fairly and openly -- after all, getting a closing agreement and eliminating a potential REIT bust is in everyone's best interest. Nonetheless, human nature being what it is, an independent advisor may lay out the story differently from the firm that is at fault or perceived by the client, fairly or unfairly, to be at fault. This can be somewhat delicate; no professional firm enjoys falling on its sword. But in the end, the facts are the facts, and the independent advisor must ensure that the story told is accurate and fair. It may be desirable to include affidavits from the advisors in the initial written submission, similar to the affidavits that routinely accompany requests for 9100 relief for a blown tax election deadline.

12. If the fault is largely internal, not external -- e.g., a key employee quit or was fired and a REIT ball was dropped in the transition or it was a total whiff and no outside advisor was consulted -- those facts also need to be laid out in unadorned fashion. In this process there seldom is any upside in putting lipstick on the pig -- the objective is not to invite the IRS to a barbeque.

E. <u>Closing Agreement Penalties</u>

1. Happily, the IRS has shown over the course of many years that it is not in the REIT-busting business, absent exceptional circumstances. This is particularly true where there are innocent public stockholders who will be harmed if the REIT is de-REITed. The IRS will, however, typically insist that the REIT pay a tax or penalty as part of the closing agreement. The client will be intensely, if not maniacally, focused on this tax/penalty and will want early front-end predictions of what it is going to cost.

2. The IRS does not have any formal "sentencing guidelines." However, sections 856 and 857 already prescribe a tax or penalty for certain REIT failures where reasonable cause is demonstrated: a "tax" on excess bad income imposed by section 857(b)(5); a "tax" equal to the greater of (a) $50,000 or (b) an amount equal to the highest corporate tax rate multiplied by the income derived from the problematic asset, in the case of a non-de minimis 5% or 10% securities test failure (section 856(c)(7)(C)); and a $50,000 "penalty" for other REIT failures (section 856(g)(5)(C)). The IRS generally views these statutory taxes/penalties as controlling if the actual or potential REIT bust falls in one of those failure categories, so the REIT should not assume that it can do better simply because of the intrinsic flexibility that the IRS has in the closing agreement process. Nor should it assume that it can do better simply because the REIT may be able to proffer legitimate arguments supporting the position that has caused the brouhaha.

a. In recent years, some closing agreements reportedly have been negotiated that involved a tax/penalty of $50,000 per year, plus interest from the due date of the return, at least where the failure did not implicate the section 857(b)(5) tax on excess nonqualifying gross income or the tax imposed by section 856(c)(7)(C) as a result of a non-de minimis 5% or 10% securities test failure.

b. It is understood that the IRS will also seek an appropriate penalty/tax (plus interest) for each time-barred year that is covered by the closing agreement.

c. One can always hold out hope that the IRS will exercise discretion on the penalty and consider a reduction from the statutory sanctions in appropriate cases, such as where the REIT has reasonable arguments that it complied with the law, where the good-faith and prompt-remedial-action facts are compelling, and/or where the statutory scheme would otherwise produce a tax/penalty that seems out of whack with the nature of the failure or potential failure and the REIT's conduct. But is it important to bear in mind that the IRS generally views the statutory penalties as controlling and Exam doesn't have settlement authority. If the manner in which the statutory sanctions apply to the particular facts is ambiguous, of course, that is something the parties can negotiate in the closing agreement context.

d. In FSA 1996-9 (Mar. 5, 1996), the IRS Office of Chief Counsel stated that it did not object to the District Director entering into a closing agreement with a REIT regarding a violation of the 75% asset test resulting from excess investments in repurchase agreements (which the IRS has ruled is a "security" for REIT asset test purposes). The FSA also invites the District Director to collect a penalty: "As the taxpayer's violation of the 75% asset test would, in all likelihood, result in a positive tax liability (computed as for a regular subchapter C corporation) for [redacted text], the District Director may require the taxpayer to remit some reasonable portion of the foregone tax as a condition of the closing agreement."

3. The REIT and its tax advisors need to consider possible settlement offers and creative structures and rationales in situations where the statutorily prescribed tax or penalty produces a number that seems way out of proportion to the failure or potential failure, such as a minor preferential dividend problem that would require a very large deficiency dividend (plus interest charge) to cure or where it is far from clear that a failure did, in fact, occur, but one which the REIT must resolve with finality in order to move forward with its business. The REIT typically does not address the penalty in its initial submission.

IX. SUCCESSOR RULES

A. __Overview__

1. Section 856(g)(3) and Treas. Reg. § 1.856-8(c)(1) provide that if a corporation's election to be treated as a REIT is revoked or terminated for a taxable year, such entity, and any "successor" to that entity within the meaning of Treas. Reg. § 1.856-8(c)(2), "is not eligible to make a new election" to be taxed as a REIT until the fifth taxable year after the first taxable year for which the revocation or termination is effective.

2. Counting the REIT termination year, this means there is a five-year wait before the terminated REIT or any "successor" can make a new REIT election.

3. In theory the IRS could assert that a REIT failed to qualify in a time-barred year (even though no deficiency can be asserted), in order to invoke the five-year wait for the terminated REIT or any successor to the REIT.

4. Depending on how far back the REIT bust occurred, this could theoretically create open C corporation years or open REIT years where the REIT has re-qualified but is now subject to the 5-year built-in gains tax recognition period. As discussed, this used to be a 10-year period, which Congress had previously shortened on several occasions. The permanent reduction of the recognition period to 5 years should take some of the pressure off of the "de-REITing in a barred year" concern and shorten the scope of REIT qualification tax opinions.

5. No matter how theoretical and remote this risk may seem, it may present problems for law firms that have to give REIT opinions. The inability to render a clean opinion that encompasses a "lookback period" sufficiently long to kill off any adverse consequences from a potential de-REITing in a barred year may be problematic.

6. Although the regulation refers to being ineligible to make a "new" REIT election, there is a risk that even a taxpayer that had already elected REIT status prior to becoming a successor to a terminated REIT may be precluded from filing as a REIT until the prescribed waiting period is over.

B. __Definition of "Successor__

1. Treas. Reg. 1.856-8(c)(2) defines a "successor" as any corporation that meets both a continuity of ownership requirement and a continuity of assets requirement with respect to the corporation whose REIT election was terminated.

2. The continuity of ownership test is met if, at any time "during the taxable year" the persons who own, directly or indirectly, 50% or more of the potential successor corporation also owned, at any time during the first taxable year for which the termination was effective, 50% or more of the terminated corporation's shares.

3. The continuity of assets test is met "only if" either:

a. A substantial portion of the potential successor corporation's assets were assets of the terminated REIT, or

b. The potential successor corporation acquired a substantial portion of the assets of the terminated REIT.

(1) The regulations don't define "substantial portion."

4. Note that this sets up a nasty two-way "gotcha," because "substantial" can be measured from the perspective of either the potential successor transferee or the terminated REIT transferor.

C. <u>Parent REIT Acquires Target REIT</u>

1. Assume parent REIT acquires all of the common stock of target REIT from an unrelated fund partnership.

2. Following the share purchase, parent REIT liquidates target REIT before a calendar quarter-end is crossed and is under the impression that its own REIT status is now shielded from any damage that a de-REITing of target for a prior year might cause.

3. Note that if parent REIT owned the stock of target REIT on a calendar quarter-end, a bust of the target's REIT status causes parent REIT to have a bust also (violation of the 10% securities test) unless timely cured or a relief provision applies. Many sellers of private REITs seek to negotiate a covenant that the buyer will not liquidate the target REIT until the following taxable year to minimize FIRPTA risks to their foreign shareholders, which necessarily means that the buyer will hold the REIT shares at the end of at least one calendar quarter.

4. If target REIT is found to have blown its REIT status for the liquidation year, parent REIT's own REIT status could be jeopardized because it is now a successor to a terminated REIT.

a. Parent REIT has acquired a substantial portion of target REIT's assets (all of them).

b. The continuity of ownership test is met because, at the time of the liquidation, the same persons directly or indirectly own both REITs.

5. Note that a termination of target's REIT status in a pre-acquisition year will not give rise to a "successor" issue as long as the owners of parent REIT did not directly or indirectly own 50% of more of target REIT at the time of the target REIT's termination.

D. <u>Other Tax Consequences of Termination of Target's REIT Status in Pre-Acquisition Year</u>

1. The termination of target's REIT status in a pre-acquisition year has other tax consequences. The inherited C corporation tax liability for busted REIT years that are still open under the statute of limitations is now the buyer's problem.

2. Even if the REIT re-qualified after the five-year waiting period under section 856(g), the built-in gains tax recognition period that commenced on January 1 of the initial re-qualification year may still be running. Thus, a section 331 liquidation of target REIT by a partnership subsidiary of parent REIT may trigger a current corporate tax liability on the portion of the recognized gain that constituted "built-in gain" at the beginning of the target REIT 's initial re-qualification year.

E. Target REIT Was Organized by Parent REIT

1. Assume target REIT was formed by way of a section 351 dropdown from a parent REIT, and subsequently the target's stock is purchased from parent REIT by a fund partnership which then does a section 331 liquidation of target REIT to step up basis.

2. Target REIT is a "successor" to the selling parent REIT. Thus, if the REIT election of the parent REIT was blown for some reason and the five-year section 856(g)(3) waiting period has not run by the time target REIT is formed, the ability of target to make a REIT election may be compromised.

3. Does this mean acquiror must also conduct tax due diligence on the selling parent REIT's status for the taxable year in which the target was formed, as well as prior taxable years? The buyer who asks to diligence the parent REIT may be told to take a hike, especially in a seller's market.

4. Note that parent's REIT status for taxable years subsequent to target's first REIT year can safely be ignored.

F. Observations on Successor Risks in the Acquisition Context

1. Buyer can argue that a REIT opinion as to the target REIT (assuming seller is willing to pay for one) effectively subsumes an opinion that the parent REIT qualified as such for the taxable year in which target REIT was formed and therefore did not cause a successor problem for target REIT, or it can try to get seller's tax counsel to expressly opine on the successor issue.

2. Buyer can consider getting insurance against this remote tax risk.

3. If the buyer intends to sell the REIT vehicle at some future point, that next buyer might also raise the successor issue when performing its own due diligence; they and their advisors might not see the risk the same way.

4. The reality is that these "successor" REIT issues emanating from a hypothetical de-REITing in a barred year are extremely unlikely to be raised in an actual IRS audit. REITs are rarely audited, and even when they are, successor issues are unlikely to be raised in closed years unless the predecessor REIT is already known to have been "busted." Nevertheless, this is the type of arcane REIT tax issue that smart, experienced due diligence teams are paid to identify, and rest assured they will (if for no other reason than to score points with their client or because they relish making opposing tax advisors squirm a little bit).

5. Ultimately, the biggest problem here is for the REIT opinion giver. In a compressed deal time frame, the opinion giver now must worry about two REITs, not just one, and the parent REIT may be big, complicated and long-lived.

6. In some deals, there may be no REIT opinion proffered or requested, and the buyer must rely solely on its own due diligence and possibly an indemnity or even tax risk insurance. An example might be where the target REIT is easy to diligence and low-risk (e.g., only one or two properties and recently formed).

X. SCOPE OF REIT OPINIONS -- BARRED YEAR REIT BUSTS

A. Built-In Gains Tax

1. Section 127(a) of the PATH Act amended section 1374(d)(7) to provide that the term "recognition period" means "the 5-year period beginning with the 1st day of the 1st taxable year for which the corporation was an S corporation." The amendment is effective for taxable years beginning after December 31, 2014. See PATH Act, Section 127(b). Thus, the five-year recognition period Congress had previously enacted on a temporary basis has thankfully been made permanent.

2. The 2015 JCT Bluebook makes it clear that this welcome change applies to REITs as well as S corporations. See 2015 JCT Bluebook at p. 149 (stating that "Under current Treasury regulations, these rules, including the five-year recognition period, also would apply to REITs and RICs that do not elect 'deemed sale' treatment").

a. For any taxable year beginning in 2009 and 2010, no tax was imposed on the net recognized built-in gain of an S corporation under section 1374 if the seventh taxable year in the corporation's recognition period preceded such taxable year. Thus, with respect to gain that arose prior to the conversion of a C corporation to an S corporation, no tax was imposed under section 1374 if the seventh taxable year for which the S corporation election was in effect preceded the taxable year beginning in 2009 or 2010.

b. For any taxable year beginning in 2011, no tax was imposed on the net recognized built-in gain of an S corporation if the fifth year of the recognition period preceded such taxable year.

c. For taxable years beginning in 2012 and thereafter, the term "recognition period" is applied by substituting a five-year period for the otherwise applicable 10-year period. Thus, if an S corporation with assets subject to the built-in gains tax disposed of such assets in a taxable year beginning in a post-2011 taxable year, and the disposition occurred more than five years after the first day of the recognition period, gain or loss on the disposition is not taken into account in determining the "net recognized built-in gain."

3. None of these amendments to section 1374(d)(7), including the PATH Act amendment, specifically address their application to REITs that are subject to the built-in gains tax by reason of Treas. Reg. § 1.337(d)-7. However, because that Treasury regulation applies the rules of section 1374 to a REIT "as if the … REIT were an S corporation," the section 1374 recognition period amendments should apply equally to a REIT subject to the built-in gains tax, as the JCT 2015 Bluebook confirms and the IRS has previously ruled. See PLR 201202014 (Oct. 13, 2011) (the IRS ruled that the section 1374 recognition period shortening provided in section 1374(d)(7)(B) for 2011 applied to a REIT that proposed to undergo a taxable liquidation in such year. Also, starting with 2009, the instructions to Form 1120-REIT have consistently stated that these amendments are applicable to REITs.

B. Effect of REIT Opinion Where Scope is Limited to All Open REIT Years

1. Because of the potential BIG tax exposure in an open year from de-REITing in a closed year, REIT opinion givers have often been asked to opine back to inception. With the BIG tax recognition period now shortened to five years, the rationale for rendering an opinion that delves into ancient REIT history is becoming weaker and weaker.

2. Suppose, for example, that counsel to a target REIT is only willing to opine for open REIT taxable years. Assume further that the opinion is being rendered in the first quarter of 2016. The open REIT years at that time will be 2012 - 2015 and the stub period in 2016. (The extended due date for filing the 2012 return was September 16, 2013, and three years from that date is September 16, 2016.)

a. A clean REIT opinion for 2012 arguably subsumes an opinion that the REIT also qualified back to 2008. This is because a REIT bust in 2008 (unless cured through a closing agreement or one of the statutory relief provisions) would, in theory, prevent the REIT from re-electing REIT status until 2013 -- even though the original bust year is barred by the statute of limitations -- unless the REIT can prove reasonable cause to the satisfaction of the Secretary under section 856(g)(4). Section 856(g)(3). Thus, an opinion that the REIT qualified in 2012 could be read to be an implied opinion that the REIT qualified back to 2008.

b. The IRS could not assert a corporate-level tax liability (whether due to tax liability arising from regular C corporation status or to REIT built-in gains tax liability) for the years 2008 through 2011 because those years are time-barred. However, the IRS could, in theory, assert a de-REITing issue in a barred year in order to collect a built-in gains tax on built-in gain asset sales that occur in an open year. The extent to which a REIT qualification opinion provides protection against the built-in gains tax being asserted in open taxable years depends on how far back the opinion goes.

(1) A REIT bust in 2007 would mean that the corporation would be eligible to re-qualify starting in 2012. Such REIT would have built-in gains tax exposure on asset sales occurring in the open taxable years 2012 – 2016, and thereafter could sell assets free of built-in gains tax (assuming the REIT continued to qualify as a REIT from 2008 onward).

(2) A REIT bust in 2006 would mean that the corporation would be eligible to re-qualify starting in 2011. Such REIT would have built-in gains tax exposure on asset sales occurring in the open taxable years 2012 – 2015, and thereafter could sell assets free of built-in gains tax (assuming the REIT continued to qualify as a REIT from 2008 onward).

3. In short, a REIT opinion for all open years does not necessarily provide protection with respect to potential built-in gains tax liability in such years from a REIT bust in a barred year. However, REIT opinion givers historically have not given specific opinions on the built-in gains tax.

Concurrent Session: General Counsel Perspectives

Friday, April 1st
11am – 12:15pm
Marriott Marquis, Washington DC

Moderator:
Jeffery Curry, CLO, CBL & Associates Properties, Inc.

Panelists:
Elizabeth Abdoo, EVP, General Counsel & Secretary, Host Hotels & Resorts, Inc.
James Hanks, Partner, Venable LLP
Pamela Roper, SVP-General Counsel & Corporate Secretary, Cousins Properties
George Schmidt, Member, Frost Brown Todd

Outline of Internal Controls Issues for General Counsel

1. **Cybersecurity**
    a. Disclosure Issues
        i. SEC CF Disclosure Guidance: Topic No. 2: *Cybersecurity* (October 13, 2011)[1]
        The SEC highlighted particular areas of disclosure in Form 10-K that may trigger cybersecurity risk or cyber incident disclosure depending on the facts and circumstances.
            1. *Risk Factors* – Disclose the risk of cyber incidents (Item 503(c) of Reg. S-K[2])
            2. *MD&A* – Address cybersecurity risks and cyber incidents if the costs of other consequences associated with one more or more known incidents or the risk of potential incidents represent a material event, trend, or uncertainty that is reasonably likely to have a material effect (Item 303(a)(3)(ii) of Reg. S-K)
            3. *Business* – Disclose to the extent a cyber incident materially affects the company's products, services, relationships with customers or suppliers, or competitive conditions (Item 101 of Reg. S-K)
            4. *Legal Proceedings* – Disclose a material pending legal proceeding that involves a cyber incident (Item 103 of Reg. S-K)
            5. *Financial Statements* – A number of situations involving cybersecurity risks and cyber incidents could impact financial statement disclosures
            6. *Disclosure Controls and Procedures* – Disclose the effect of a cyber incident on the company's conclusion about the effectiveness of its controls, including that ICFR may be ineffective following or as a result of cyber incident (Item 307 of Reg. S-K)
        ii. Heightened SEC Activity
            1. Initially over 50 SEC comment letters on cybersecurity disclosures
            2. Luis A. Aguilar, Comm'r, U.S. Sec. & Exch. Comm'n, *Cyber Risks and the Boardroom*, Conference, Boards of Directors, Corporate Governance and Cyber-Risks: Sharpening the Focus (June 10, 2014)[3]
    b. Risk Management Issues
        i. Development and implementation of cybersecurity program
        ii. Response to breach
        iii. Consequences of breach
2. **Internal Controls**
    a. Assist in establishing effective controls (SOX compliance)
    b. Educate board of directors, management and employees
    c. Attorney-client privilege issues

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[1] Exhibit A, also available at https://www.sec.gov/divisions/corpfin/guidance/cfguidance-topic2.htm
[2] Exhibit B: Selected Items from Regulation S-K
[3] Exhibit C

i. *Upjohn Co. v. United States*, 449 U.S. 383 (1981)[4]

ii. *In re Kellogg Brown & Root, Inc.*, 756 F.3d 754 (D.C. Circuit 2014)[5]

iii. *In re: Target Corporation Customer Data Security Breach Litigation*, MDL No. 14-2522 (D. Minn. October 23, 2015)[6]

3. Audit Committee

a. Enhanced disclosures for Audit Committees under consideration

i. SEC Concept Release No. 9862, *Possible Revisions to Audit Committee Disclosures* (July 1, 2015)[7]

ii. PCAOB Release No. 2015-004, *Supplemental Request for Comment: Rules to Require Disclosure of Certain Audit Participants on a New PCAOB Form* (June 30, 2015)[8]

iii. PCAOB Release No. 2015-005, *Concept Release on Audit Quality Indicators* (July 1, 2015)[9]

b. Annual evaluation of Audit Committee

c. GC as chief compliance officer

i. Internal management of communications for Audit Committee under ethics policy

ii. Procedures for review and investigation of concerns by and with Audit Committee

This outline was prepared at the request of Jeff Curry, Chief Legal Officer of CBL & Associates Properties, Inc., by Rebecca Taylor of Husch Blackwell LLP, 736 Georgia Avenue, Suite 300, Chattanooga, TN 37402; Phone: 423.755.2662; E-mail: Rebecca.taylor@huschblackwell.com.

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[4] Exhibit D
[5] Exhibit E
[6] Exhibit F
[7] Available at http://www.sec.gov/rules/concept/2015/33-9862.pdf
[8] Available at http://pcaobus.org/Rules/Rulemaking/Docket029/Release_2015_004.pdf
[9] Available at http://pcaobus.org/Rules/Rulemaking/Docket%20041/Release_2015_005.pdf

EXHIBIT A

Division of Corporation Finance
Securities and Exchange Commission

CF Disclosure Guidance: Topic No. 2

Cybersecurity

Date: October 13, 2011

Summary: This guidance provides the Division of Corporation Finance's views regarding disclosure obligations relating to cybersecurity risks and cyber incidents.

Supplementary Information: The statements in this CF Disclosure Guidance represent the views of the Division of Corporation Finance. This guidance is not a rule, regulation, or statement of the Securities and Exchange Commission. Further, the Commission has neither approved nor disapproved its content.

Introduction

For a number of years, registrants have migrated toward increasing dependence on digital technologies to conduct their operations. As this dependence has increased, the risks to registrants associated with cybersecurity[1] have also increased, resulting in more frequent and severe cyber incidents. Recently, there has been increased focus by registrants and members of the legal and accounting professions on how these risks and their related impact on the operations of a registrant should be described within the framework of the disclosure obligations imposed by the federal securities laws. As a result, we determined that it would be beneficial to provide guidance that assists registrants in assessing what, if any, disclosures should be provided about cybersecurity matters in light of each registrant’s specific facts and circumstances.

We prepared this guidance to be consistent with the relevant disclosure considerations that arise in connection with any business risk. We are mindful of potential concerns that detailed disclosures could compromise cybersecurity efforts -- for example, by providing a “roadmap” for those who seek to infiltrate a registrant’s network security -- and we emphasize that disclosures of that nature are not required under the federal securities laws.

In general, cyber incidents can result from deliberate attacks or unintentional events. We have observed an increased level of attention focused on cyber attacks that include, but are not limited to, gaining unauthorized access to digital systems for purposes of misappropriating assets or sensitive information, corrupting data, or causing operational disruption. Cyber attacks may also be carried out in a manner that does not require gaining unauthorized access, such as by causing denial-of-service attacks on websites. Cyber attacks may be carried out by third parties or insiders using techniques that range from highly sophisticated efforts to electronically circumvent network security or overwhelm websites to more traditional intelligence gathering and social engineering aimed at obtaining information necessary to gain access.

The objectives of cyber attacks vary widely and may include theft of financial assets, intellectual property, or other sensitive information belonging to registrants, their customers, or other business partners. Cyber attacks may also be directed at disrupting the operations of registrants or their business partners. Registrants that fall victim to successful cyber attacks may incur substantial costs and suffer other negative consequences, which may include, but are not limited to:

- Remediation costs that may include liability for stolen assets or information and repairing system damage that may have been caused. Remediation costs may also include incentives offered to customers or other business partners in an effort to maintain the business relationships after an attack;
- Increased cybersecurity protection costs that may include organizational changes, deploying additional personnel and protection technologies, training employees, and engaging third party experts and consultants;
- Lost revenues resulting from unauthorized use of proprietary information or the failure to retain or attract customers following an attack;
- Litigation; and
- Reputational damage adversely affecting customer or investor confidence.

Disclosure by Public Companies Regarding Cybersecurity Risks and Cyber Incidents

The federal securities laws, in part, are designed to elicit disclosure of timely, comprehensive, and accurate information about risks and events that a reasonable investor would consider important to an investment decision.[2] Although no existing disclosure requirement explicitly refers to cybersecurity risks and cyber incidents, a number of disclosure requirements may impose an obligation on registrants to disclose such risks and incidents. In addition, material information regarding cybersecurity risks and cyber incidents is required to be disclosed when necessary in order to make other required disclosures, in light of the circumstances under which they are made, not misleading.[3] Therefore, as with other operational and financial risks, registrants should review, on an ongoing basis, the adequacy of their disclosure relating to cybersecurity risks and cyber incidents.

The following sections provide an overview of specific disclosure obligations that may require a discussion of cybersecurity risks and cyber incidents.

Risk Factors

Registrants should disclose the risk of cyber incidents if these issues are among the most significant factors that make an investment in the company speculative or risky.[4] In determining whether risk factor disclosure is required, we expect registrants to evaluate their cybersecurity risks and take into account all available relevant information, including prior cyber incidents and the severity and frequency of those incidents. As part of this evaluation, registrants should consider the probability of cyber incidents occurring and the quantitative and qualitative magnitude of those risks, including the potential costs and other consequences resulting from misappropriation of assets or sensitive information, corruption of data or operational disruption. In evaluating whether risk factor disclosure should be provided, registrants should also consider the adequacy of preventative actions taken to reduce cybersecurity risks in the context of the industry in which they operate and risks to that security, including threatened attacks of which they are aware.

Consistent with the Regulation S-K Item 503(c) requirements for risk factor disclosures generally, cybersecurity risk disclosure provided must adequately describe the nature of the material risks and specify how each risk affects the registrant. Registrants should not present risks that could apply to any issuer or any offering and should avoid generic risk factor disclosure.[5] Depending on the registrant's particular facts and circumstances, and to the extent material, appropriate disclosures may include:

- Discussion of aspects of the registrant's business or operations that give rise to material cybersecurity risks and the potential costs and consequences;
- To the extent the registrant outsources functions that have material cybersecurity risks, description of those functions and how the registrant addresses those risks;
- Description of cyber incidents experienced by the registrant that are individually, or in the aggregate, material, including a description of the costs and other consequences;
- Risks related to cyber incidents that may remain undetected for an extended period; and
- Description of relevant insurance coverage.

A registrant may need to disclose known or threatened cyber incidents to place the discussion of cybersecurity risks in context. For example, if a registrant experienced a material cyber attack in which malware was embedded in its systems and customer data was compromised, it likely would not be sufficient for the registrant to disclose that there is a risk that such an attack may occur. Instead, as part of a broader discussion of malware or other similar attacks that pose a particular risk, the registrant may need to discuss the occurrence of the specific attack and its known and potential costs and other consequences.

While registrants should provide disclosure tailored to their particular circumstances and avoid generic "boilerplate" disclosure, we reiterate that the federal securities laws do not require disclosure that itself would compromise a registrant's cybersecurity. Instead, registrants should provide sufficient disclosure to allow investors to appreciate the nature of the risks faced by the particular registrant in a manner that would not have that consequence.

Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A)

Registrants should address cybersecurity risks and cyber incidents in their MD&A if the costs or other consequences associated with one or more known incidents or the risk of potential incidents represent a material event, trend, or uncertainty that is reasonably likely to have a material effect on the registrant's results of operations, liquidity, or financial condition or would cause reported financial information not to be necessarily indicative of future operating results or financial condition.[6] For example, if material intellectual property is stolen in a cyber attack, and the effects of the theft are reasonably likely to be material, the registrant should describe the property that was stolen and the effect of the attack on its results of operations, liquidity, and financial condition and whether the attack would cause reported financial information not to be indicative of future operating results or financial condition. If it is reasonably likely that the attack will lead to reduced revenues, an increase in cybersecurity protection costs, including related to litigation, the registrant should discuss these possible outcomes, including the amount and duration of the expected costs, if material. Alternatively, if the attack did not result in the loss of intellectual property, but it prompted the registrant to materially increase its cybersecurity protection expenditures, the registrant should note those increased expenditures.

Description of Business

If one or more cyber incidents materially affect a registrant's products, services, relationships with customers or suppliers, or competitive conditions, the registrant should provide disclosure in the registrant's "Description of Business."[7] In determining whether to include disclosure, registrants should consider the impact on each of their reportable segments. As an example, if a registrant has a new product in development and learns of a cyber incident that could materially impair its future viability, the registrant should discuss the incident and the potential impact to the extent material.

Legal Proceedings

If a material pending legal proceeding to which a registrant or any of its subsidiaries is a party involves a cyber incident, the registrant may need to disclose information regarding this litigation in its "Legal Proceedings" disclosure. For example, if a significant amount of customer information is stolen, resulting in material litigation, the registrant should disclose the name of the court in which the proceedings are pending, the date instituted, the principal parties thereto, a description of the factual basis alleged to underlie the litigation, and the relief sought.[8]

Financial Statement Disclosures

Cybersecurity risks and cyber incidents may have a broad impact on a registrant's financial statements, depending on the nature and severity of the potential or actual incident.

Prior to a Cyber Incident

Registrants may incur substantial costs to prevent cyber incidents. Accounting for the capitalization of these costs is addressed by Accounting Standards Codification (ASC) 350-40, *Internal-Use Software*, to the extent that such costs are related to internal use software.

During and After a Cyber Incident

Registrants may seek to mitigate damages from a cyber incident by providing customers with incentives to maintain the business relationship. Registrants should consider ASC 605-50, *Customer Payments and Incentives*, to ensure appropriate recognition, measurement, and classification of these incentives.

Cyber incidents may result in losses from asserted and unasserted claims, including those related to warranties, breach of contract, product recall and replacement, and indemnification of counterparty losses from their remediation efforts. Registrants should refer to ASC 450-20, *Loss Contingencies*, to determine when to recognize a liability if those losses are probable and reasonably estimable. In addition, registrants must provide certain disclosures of losses that are at least reasonably possible.

Cyber incidents may also result in diminished future cash flows, thereby requiring consideration of impairment of certain assets including goodwill, customer-related intangible assets, trademarks, patents, capitalized software or other long-lived assets associated with hardware or software, and inventory. Registrants may not immediately know the impact of a cyber incident and may be required to develop estimates to account for the various financial implications. Registrants should subsequently reassess the assumptions that underlie the estimates made in preparing the financial statements. A registrant must explain any risk or uncertainty of a reasonably possible change in its estimates in the near-term that would be material to the financial statements.[9] Examples of estimates that may be affected by cyber incidents include estimates of warranty liability, allowances for product returns, capitalized software costs, inventory, litigation, and deferred revenue.

To the extent a cyber incident is discovered after the balance sheet date but before the issuance of financial statements, registrants should consider whether disclosure of a recognized or nonrecognized subsequent event is necessary. If the incident constitutes a material nonrecognized subsequent event, the financial statements should disclose the nature of the incident and an estimate of its financial effect, or a statement that such an estimate cannot be made.[10]

Disclosure Controls and Procedures

Registrants are required to disclose conclusions on the effectiveness of disclosure controls and procedures. To the extent cyber incidents pose a risk to a registrant's ability to record, process, summarize, and report information that is required to be disclosed in Commission filings, management should also consider whether there are any deficiencies in its disclosure controls and procedures that would render them ineffective.[11] For example, if it is reasonably possible that information would not be recorded properly due to a cyber incident affecting a registrant's information systems, a registrant may conclude that its disclosure controls and procedures are ineffective.

Endnotes

[1]Cybersecurity is the body of technologies, processes and practices designed to protect networks, systems, computers, programs and data from attack, damage or unauthorized access. Whatis?com available at http://whatis.techtarget.com/definition/cybersecurity.html. See also Merriam-Webster.com available at http://www.merriam-webster.com/dictionary/cybersecurity.

[2] The information in this disclosure guidance is intended to assist registrants in preparing disclosure required in registration statements under the Securities Act of 1933 and periodic reports under the Securities Exchange Act of 1934. In order to maintain the accuracy and completeness of information in effective shelf registration statements, registrants may also need to consider whether it is necessary to file reports on Form 6-K or Form 8-K to disclose the costs and other consequences of material cyber incidents. See Item 5(a) of Form F-3 and Item 11(a) of Form S-3.

[3] Securities Act Rule 408, Exchange Act Rule 12b-20, and Exchange Act Rule 14a-9. Information is considered material if there is a substantial likelihood that a reasonable investor would consider it important in making an investment decision or if the information would significantly alter the total mix of information made available. See Basic Inc. v. Levinson, 485 U.S. 224 (1988); and TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438 (1976). Registrants also should consider the antifraud provisions of the federal securities laws, which apply to statements and omissions both inside and outside of Commission filings. See Securities Act Section 17(a); Exchange Act Section 10(b); and Exchange Act Rule 10b-5.

[4] See Item 503(c) of Regulation S-K; and Form 20-F, Item 3.D.

[5] Item 503(c) of Regulation S-K instructs registrants to "not present risks that could apply to any issuer or any offering" and further, to "[e]xplain how the risk affects the issuer or the securities being offered." Item 503(c) of Regulation S-K.

[6] See Item 303 of Regulation S-K; and Form 20-F, Item 5. A number of past Commission releases provide general interpretive guidance on these disclosure requirements. See, e.g., Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations, Release No. 33-8350 (Dec. 19, 2003) [68 FR 75056] Commission Statement About Management's Discussion and Analysis of Financial Condition and Results of Operations, Release No. 33-8056 (Jan. 22, 2002) [67 FR 3746]; Management's Discussion and Analysis of Financial Condition and Results of Operations; and Certain Investment Company Disclosures, Release No. 33-6835 (May 18, 1989) [54 FR 22427].

[7] See Item 101 of Regulation S-K; and Form 20-F, Item 4.B.

[8] See Item 103 of Regulation S-K.

[9] See FASB ASC 275-10, *Risks and Uncertainties.*

[10] See ASC 855-10, *Subsequent Events*.

[11] See Item 307 of Regulation S-K; and Form 20-F, Item 15(a).

http://www.sec.gov/divisions/corpfin/guidance/cfguidance-topic2.htm

EXHIBIT B

§ 229.101 (Item 101) Description of business.

(a) ***General development of business***. Describe the general development of the business of the registrant, its subsidiaries and any predecessor(s) during the past five years, or such shorter period as the registrant may have been engaged in business. Information shall be disclosed for earlier periods if material to an understanding of the general development of the business.

(1) In describing developments, information shall be given as to matters such as the following: the year in which the registrant was organized and its form of organization; the nature and results of any bankruptcy, receivership or similar proceedings with respect to the registrant or any of its significant subsidiaries; the nature and results of any other material reclassification, merger or consolidation of the registrant or any of its significant subsidiaries; the acquisition or disposition of any material amount of assets otherwise than in the ordinary course of business; and any material changes in the mode of conducting the business.

(2) ***Registrants***:

(i) Filing a registration statement on Form S-1 (§ 239.11 of this chapter) under the Securities Act or on Form 10 (§ 249.210 of this chapter) under the Exchange Act;

(ii) Not subject to the reporting requirements of section 13(a) or 15(d) of the Exchange Act immediately before the filing of such registration statement; and

(iii) That (including predecessors) have not received revenue from operations during each of the three fiscal years immediately before the filing of such registration statement, shall provide the following information:

(A) If the registration statement is filed prior to the end of the registrant's second fiscal quarter, a description of the registrant's plan of operation for the remainder of the fiscal year; or

(B) If the registration statement is filed subsequent to the end of the registrant's second fiscal quarter, a descripition of the registrant's plan of operation for the remainder of the fiscal year and for the first six months of the next fiscal year. If such information is not available, the reasons for its not being available shall be stated. Disclosure relating to any plan shall include such matters as:

(*1*) In the case of a registration statement on Form S-1, a statement in narrative form indicating the registrant's opinion as to the period of time that the proceeds from the offering will satisfy cash requirements and whether in the next six months it will be necessary to raise additional funds to meet the expenditures required for operating the business of the registrant; the specific reasons for such opinion shall be set forth and categories of expenditures and sources of cash resources shall be identified; however, amounts of expenditures and cash resources need not be provided; in addition, if the narrative statement is based on a cash budget, such budget shall be furnished to the Commission as supplemental information, but not as part of the registration statement;

(*2*) An explanation of material product research and development to be performed during the period covered in the plan;

(*3*) Any anticipated material acquisition of plant and equipment and the capacity thereof;

(*4*) Any anticipated material changes in number of employees in the various departments such as research and development, production, sales or administration; and

(*5*) Other material areas which may be peculiar to the registrant's business.

(b) ***Financial information about segments***. Report for each segment, as defined by generally accepted accounting principles, revenues from external customers, a measure of profit or loss and total assets. A registrant must report this information for each of the last three fiscal years or for as long as it has been in business, whichever period is shorter. If the information provided in response to this paragraph (b) conforms with generally accepted accounting principles, a registrant may include in its financial statements a cross reference to this data in lieu of presenting duplicative information in the financial statements; conversely, a registrant may cross reference to the financial statements.

(1) If a registrant changes the structure of its internal organization in a manner that causes the composition of its reportable segments to change, the registrant must restate the corresponding information for earlier periods, including interim periods, unless it is impracticable to do so. Following a change in the composition of its reportable segments, a registrant shall disclose whether it has restated the corresponding items of segment information for earlier periods. If it has not restated the items from earlier periods, the registrant shall disclose in the year in which the change occurs segment information for the current period under both the old basis and the new basis of segmentation, unless it is impracticable to do so.

(2) If the registrant includes, or is required by Article 3 of Regulation S-X (17 CFR 210) to include, interim financial statements, discuss any facts relating to the performance of any of the segments during the period which, in the opinion of management, indicate that the three year segment financial data may not be indicative of current or future operations of the segment. Comparative financial information shall be included to the extent necessary to the discussion.

(c) ***Narrative description of business***.

(1) Describe the business done and intended to be done by the registrant and its subsidiaries, focusing upon the registrant's dominant segment or each reportable segment about which financial information is presented in the financial statements. To the extent material to an understanding of the registrant's business taken as a whole, the description of each such segment shall include the information specified in paragraphs (c)(1) (i) through (x) of this section. The matters specified in paragraphs (c)(1) (xi) through (xiii) of this section shall be discussed with respect to the registrant's business in general; where material, the segments to which these matters are significant shall be identified.

(i) The principal products produced and services rendered by the registrant in the segment and the principal markets for, and methods of distribution of, the segment's principal products and services. In addition, state for each of the last three fiscal years the amount or percentage of total revenue contributed by any class of similar products or services which accounted for 10 percent or more of consolidated revenue in any of the last three fiscal years or 15 percent or more of consolidated revenue, if total revenue did not exceed $50,000,000 during any of such fiscal years.

(ii) A description of the status of a product or segment (e.g. whether in the planning stage, whether prototypes exist, the degree to which product design has progressed or whether further engineering is necessary), if there has been a public announcement of, or if the registrant otherwise has made public information about, a new product or segment that would require the investment of a material amount of the assets of the registrant or that otherwise is material. This paragraph is not intended to require disclosure of otherwise nonpublic corporate information the disclosure of which would affect adversely the registrant's competitive position.

(iii) ***The sources and availability of raw materials***.

(iv) The importance to the segment and the duration and effect of all patents, trademarks, licenses, franchises and concessions held.

(v) The extent to which the business of the segment is or may be seasonal.

(vi) The practices of the registrant and the industry (respective industries) relating to working capital items (e.g., where the registrant is required to carry significant amounts of inventory to meet rapid delivery requirements of customers or to assure itself of a continuous allotment of goods from suppliers; where the registrant provides rights to return merchandise; or where the registrant has provided extended payment terms to customers).

(vii) The dependence of the segment upon a single customer, or a few customers, the loss of any one or more of which would have a material adverse effect on the segment. The name of any customer and its relationship, if any, with the registrant or its subsidiaries shall be disclosed if sales to the customer by one or more segments are made in an aggregate amount equal to 10 percent or more of the registrant's consolidated revenues and the loss of such customer would have a material adverse effect on the registrant and its subsidiaries taken as a whole. The names of other customers may be included, unless in the particular case the effect of including the names would be misleading. For purposes of this paragraph, a group of customers under common control or customers that are affiliates of each other shall be regarded as a single customer.

(viii) The dollar amount of backlog orders believed to be firm, as of a recent date and as of a comparable date in the preceding fiscal year, together with an indication of the portion thereof not reasonably expected to be filled within the current fiscal year, and seasonal or other material aspects of the backlog. (There may be included as firm orders government orders that are firm but not yet funded and contracts awarded but not yet signed, provided an appropriate statement is added to explain the nature of such orders and the amount thereof. The portion of orders already included in sales or operating revenues on the basis of percentage of completion or program accounting shall be excluded.)

(ix) A description of any material portion of the business that may be subject to renegotiation of profits or termination of contracts or subcontracts at the election of the Government.

(x) Competitive conditions in the business involved including, where material, the identity of the particular markets in which the registrant competes, an estimate of the number of competitors and the registrant's competitive position, if known or reasonably available to the registrant. Separate consideration shall be given to the principal products or services or classes of products or services of the segment, if any. Generally, the names of competitors need not be disclosed. The registrant may include such names, unless in the particular case the effect of including the names would be misleading. Where, however, the registrant knows or has reason to know that one or a small number of competitors is dominant in the industry it shall be identified. The principal methods of competition (e.g., price, service, warranty or product performance) shall be identified, and positive and negative factors pertaining to the competitive position of the registrant, to the extent that they exist, shall be explained if known or reasonably available to the registrant.

(xi) If material, the estimated amount spent during each of the last three fiscal years on company-sponsored research and development activities determined in accordance with generally accepted accounting principles. In addition, state, if material, the estimated dollar amount spent during each of such years on customer-sponsored research activities relating to the development of new products, services or techniques or the improvement of existing products, services or techniques.

(xii) Appropriate disclosure also shall be made as to the material effects that compliance with Federal, State and local provisions which have been enacted or adopted regulating the discharge of materials into the environment, or otherwise relating to the protection of the environment, may have upon the capital expenditures, earnings and competitive position of the registrant and its subsidiaries. The registrant shall disclose any material estimated capital expenditures for environmental control facilities for the remainder of its current fiscal year and its succeeding fiscal year and for such further periods as the registrant may deem materials.

(xiii) ***The number of persons employed by the registrant***.

(d) ***Financial information about geographic areas****.*

(1) State for each of the registrant's last three fiscal years, or for each fiscal year the registrant has been engaged in business, whichever period is shorter:

(i) ***Revenues from external customers attributed to***:

(A) ***The registrant's country of domicile***;

(B) All foreign countries, in total, from which the registrant derives revenues; and

(C) ***Any individual foreign country, if material***. Disclose the basis for attributing revenues from external customers to individual countries.

(ii) Long-lived assets, other than financial instruments, long-term customer relationships of a financial institution, mortgage and other servicing rights, deferred policy acquisition costs, and deferred tax assets, located in:

(A) ***The registrant's country of domicile***;

(B) All foreign countries, in total, in which the registrant holds assets; and

(C) ***Any individual foreign country, if material***.

(2) A registrant shall report the amounts based on the financial information that it uses to produce the general-purpose financial statements. If providing the geographic information is impracticable, the registrant shall disclose that fact. A registrant may wish to provide, in addition to the information required by paragraph (d)(1) of this section, subtotals of geographic information about groups of countries. To the extent that the disclosed information conforms with generally accepted accounting principles, the registrant may include in its financial statements a cross reference to this data in lieu of presenting duplicative data in its financial statements; conversely, a registrant may cross-reference to the financial statements.

(3) A registrant shall describe any risks attendant to the foreign operations and any dependence on one or more of the registrant's segments upon such foreign operations, unless it would be more appropriate to discuss this information in connection with the description of one or more of the registrant's segments under paragraph (c) of this item.

(4) If the registrant includes, or is required by Article 3 of Regulation S-X (17 CFR 210), to include, interim financial statements, discuss any facts relating to the information furnished under this paragraph (d) that, in the opinion of management, indicate that the three year financial data for geographic areas may not be indicative of current or future operations. To the extent necessary to the discussion, include comparative information.

(e) ***Available information****.* Disclose the information in paragraphs (e)(1), (e)(2) and (e)(3) of this section in any registration statement you file under the Securities Act (15 U.S.C. 77a *et seq.*), and disclose the information in paragraphs (e)(3) and (e)(4) of this section if you are an accelerated filer or a large accelerated filer (as defined in § 240.12b-2 of this chapter) filing an annual report on Form 10-K (§ 249.310 of this chapter):

(1) Whether you file reports with the Securities and Exchange Commission. If you are a reporting company, identify the reports and other information you file with the SEC.

(2) That the public may read and copy any materials you file with the SEC at the SEC's Public Reference Room at 100 F Street, NE., Washington, DC 20549. State that the public may obtain information on the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330. If you are an electronic filer, state that the SEC maintains an Internet site that contains reports, proxy and information statements, and other information regarding issuers that file electronically with the SEC and state the address of that site (*http://www.sec.gov*).

(3) You are encouraged to give your Internet address, if available, except that if you are an accelerated filer or a large accelerated filer filing your annual report on Form 10-K, you must disclose your Internet address, if you have one.

(4)

(i) Whether you make available free of charge on or through your Internet website, if you have one, your annual report on Form 10-K, quarterly reports on Form 10-Q (§ 249.308a of this chapter), current reports on Form 8-K

(§ 249.308 of this chapter), and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Exchange Act (15 U.S.C. 78m(a) or 78o(d)) as soon as reasonably practicable after you electronically file such material with, or furnish it to, the SEC;

(ii) If you do not make your filings available in this manner, the reasons you do not do so (including, where applicable, that you do not have an Internet website); and

(iii) If you do not make your filings available in this manner, whether you voluntarily will provide electronic or paper copies of your filings free of charge upon request.

(f) ***Reports to security holders***. Disclose the following information in any registration statement you file under the Securities Act:

(1) If the SEC's proxy rules or regulations, or stock exchange requirements, do not require you to send an annual report to security holders or to holders of American depository receipts, describe briefly the nature and frequency of reports that you will give to security holders. Specify whether the reports that you give will contain financial information that has been examined and reported on, with an opinion expressed "by" an independent public or certified public accountant.

(2) For a foreign private issuer, if the report will not contain financial information prepared in accordance with U.S. generally accepted accounting principles, you must state whether the report will include a reconciliation of this information with U.S. generally accepted accounting principles.

(g) ***Enforceability of civil liabilities against foreign persons***. Disclose the following if you are a foreign private issuer filing a registration statement under the Securities Act:

(1) Whether or not investors may bring actions under the civil liability provisions of the U.S. Federal securities laws against the foreign private issuer, any of its officers and directors who are residents of a foreign country, any underwriters or experts named in the registration statement that are residents of a foreign country, and whether investors may enforce these civil liability provisions when the assets of the issuer or these other persons are located outside of the United States. The disclosure must address the following matters:

(i) The investor's ability to effect service of process within the United States on the foreign private issuer or any person;

(ii) The investor's ability to enforce judgments obtained in U.S. courts against foreign persons based upon the civil liability provisions of the U.S. Federal securities laws;

(iii) The investor's ability to enforce, in an appropriate foreign court, judgments of U.S. courts based upon the civil liability provisions of the U.S. Federal securities laws; and

(iv) The investor's ability to bring an original action in an appropriate foreign court to enforce liabilities against the foreign private issuer or any person based upon the U.S. Federal securities laws.

(2) If you provide this disclosure based on an opinion of counsel, name counsel in the prospectus and file as an exhibit to the registration statement a signed consent of counsel to the use of its name and opinion.

(h) ***Smaller reporting companies*** . A smaller reporting company, as defined by § 229.10(f)(1), may satisfy its obligations under this Item by describing the development of its business during the last three years. If the smaller reporting company has not been in business for three years, give the same information for predecessor(s) of the smaller reporting company if there are any. This business development description should include:

(1) ***Form and year of organization***;

(2) Any bankruptcy, receivership or similar proceeding; and

(3) Any material reclassification, merger, consolidation, or purchase or sale of a significant amount of assets not in the ordinary course of business.

(4) ***Business of the smaller reporting company*** . Briefly describe the business and include, to the extent material to an understanding of the smaller reporting company:

(i) Principal products or services and their markets;

(ii) Distribution methods of the products or services;

(iii) Status of any publicly announced new product or service;

(iv) Competitive business conditions and the smaller reporting company's competitive position in the industry and methods of competition;

(v) Sources and availability of raw materials and the names of principal suppliers;

(vi) Dependence on one or a few major customers;

(vii) Patents, trademarks, licenses, franchises, concessions, royalty agreements or labor contracts, including duration;

(viii) Need for any government approval of principal products or services. If government approval is necessary and the smaller reporting company has not yet received that approval, discuss the status of the approval within the government approval process;

(ix) Effect of existing or probable governmental regulations on the business;

(x) Estimate of the amount spent during each of the last two fiscal years on research and development activities, and if applicable, the extent to which the cost of such activities is borne directly by customers;

(xi) Costs and effects of compliance with environmental laws (federal, state and local); and

(xii) Number of total employees and number of full-time employees.

(5) ***Reports to security holders*** . Disclose the following in any registration statement you file under the Securities Act of 1933:

(i) If you are not required to deliver an annual report to security holders, whether you will voluntarily send an annual report and whether the report will include audited financial statements;

(ii) Whether you file reports with the Securities and Exchange Commission. If you are a reporting company, identify the reports and other information you file with the Commission; and

(iii) That the public may read and copy any materials you file with the Commission at the SEC's Public Reference Room at 100 F Street, NE., Washington, DC 20549, on official business days during the hours of 10 a.m. to 3 p.m. State that the public may obtain information on the operation of the Public Reference Room by calling the Commission at 1-800-SEC-0330. State that the Commission maintains an Internet site that contains reports, proxy and information statements, and other information regarding issuers that file electronically with the Commission and state the address of that site (*http://www.sec.gov*). You are encouraged to give your Internet address, if available.

(6) ***Foreign issuers*** . Provide the information required by Item 101(g) of Regulation S-K (§ 229.101(g)).

Instructions to Item 101*:*

1. In determining what information about the segments is material to an understanding of the registrant's business taken as a whole and therefore required to be disclosed, pursuant to paragraph (c) of this Item, the registrant should take into account both quantitative and qualitative factors such as the significance of the matter to the registrant (e.g., whether a matter with a relatively minor impact on the registrant's business is represented by management to be important to its future profitability), the pervasiveness of the matter (e.g., whether it affects or may affect numerous items in the segment information), and the impact of the matter (e.g., whether it distorts the trends reflected in the segment information). Situations may arise when information should be disclosed about a segment, although the information in quantitative terms may not appear significant to the registrant's business taken as a whole.

2. Base the determination of whether information about segments is required for a particular year upon an evaluation of interperiod comparability. For instance, interperiod comparability would require a registrant to report segment information in the current period even if not material under the criteria for reportability of FASB ASC Topic 280, *Segment Reporting,* if a segment has been significant in the immediately preceding period and the registrant expects it to be significant in the future.

3. The Commission, upon written request of the registrant and where consistent with the protection of investors, may permit the omission of any of the information required by this Item or the furnishing in substitution thereof of appropriate information of comparable character.

[47 FR 11401, Mar. 16, 1982, as amended at 63 FR 6381, Feb. 6, 1998; 64 FR 1734, Jan. 12, 1999; 67 FR 58504, Sept. 16, 2002; 70 FR 76641, Dec. 27, 2005; 73 FR 957, Jan. 4, 2008; 76 FR 50120, Aug. 12, 2011]

§ 229.103 (Item 103) Legal proceedings.

Describe briefly any material pending legal proceedings, other than ordinary routine litigation incidental to the business, to which the registrant or any of its subsidiaries is a party or of which any of their property is the subject. Include the name of the court or agency in which the proceedings are pending, the date instituted, the principal parties thereto, a description of the factual basis alleged to underlie the proceeding and the relief sought. Include similar information as to any such proceedings known to be contemplated by governmental authorities.

Instructions to Item 103:

1. If the business ordinarily results in actions for negligence or other claims, no such action or claim need be described unless it departs from the normal kind of such actions.

2. No information need be given with respect to any proceeding that involves primarily a claim for damages if the amount involved, exclusive of interest and costs, does not exceed 10 percent of the current assets of the registrant and its subsidiaries on a consolidated basis. However, if any proceeding presents in large degree the same legal and factual issues as other proceedings pending or known to be contemplated, the amount involved in such other proceedings shall be included in computing such percentage.

3. Notwithstanding Instructions 1 and 2, any material bankruptcy, receivership, or similar proceeding with respect to the registrant or any of its significant subsidiaries shall be described.

4. Any material proceedings to which any director, officer or affiliate of the registrant, any owner of record or beneficially of more than five percent of any class of voting securities of the registrant, or any associate of any such director, officer, affiliate of the registrant, or security holder is a party adverse to the registrant or any of its subsidiaries or has a material interest adverse to the registrant or any of its subsidiaries also shall be described.

5. Notwithstanding the foregoing, an administrative or judicial proceeding (including, for purposes of A and B of this Instruction, proceedings which present in large degree the same issues) arising under any Federal, State or local provisions that have been enacted or adopted regulating the discharge of materials into the environment or primary for the purpose of protecting the environment shall not be deemed "ordinary routine litigation incidental to the business" and shall be described if:

A. Such proceeding is material to the business or financial condition of the registrant;

B. Such proceeding involves primarily a claim for damages, or involves potential monetary sanctions, capital expenditures, deferred charges or charges to income and the amount involved, exclusive of interest and costs, exceeds 10 percent of the current assets of the registrant and its subsidiaries on a consolidated basis; or

C. A governmental authority is a party to such proceeding and such proceeding involves potential monetary sanctions, unless the registrant reasonably believes that such proceeding will result in no monetary sanctions, or in monetary sanctions, exclusive of interest and costs, of less than $100,000; provided, however, that such proceedings which are similar in nature may be grouped and described generically.

§ 229.303 (Item 303) Management's discussion and analysis of financial condition and results of operations.

(a) ***Full fiscal years***. Discuss registrant's financial condition, changes in financial condition and results of operations. The discussion shall provide information as specified in paragraphs (a)(1) through (5) of this Item and also shall provide such other information that the registrant believes to be necessary to an understanding of its financial condition, changes in financial condition and results of operations. Discussions of liquidity and capital resources may be combined whenever the two topics are interrelated. Where in the registrant's judgment a discussion of segment information or of other subdivisions of the registrant's business would be appropriate to an understanding of such business, the discussion shall focus on each relevant, reportable segment or other subdivision of the business and on the registrant as a whole.

(1) ***Liquidity***. Identify any known trends or any known demands, commitments, events or uncertainties that will result in or that are reasonably likely to result in the registrant's liquidity increasing or decreasing in any material way. If a material deficiency is identified, indicate the course of action that the registrant has taken or proposes to take to remedy the deficiency. Also identify and separately describe internal and external sources of liquidity, and briefly discuss any material unused sources of liquid assets.

(2) ***Capital resources***.

(i) Describe the registrant's material commitments for capital expenditures as of the end of the latest fiscal period, and indicate the general purpose of such commitments and the anticipated source of funds needed to fulfill such commitments.

(ii) Describe any known material trends, favorable or unfavorable, in the registrant's capital resources. Indicate any expected material changes in the mix and relative cost of such resources. The discussion shall consider changes between equity, debt and any off-balance sheet financing arrangements.

(3) ***Results of operations***.

(i) Describe any unusual or infrequent events or transactions or any significant economic changes that materially affected the amount of reported income from continuing operations and, in each case, indicate the extent to which income was so affected. In addition, describe any other significant components of revenues or expenses that, in the registrant's judgment, should be described in order to understand the registrant's results of operations.

(ii) Describe any known trends or uncertainties that have had or that the registrant reasonably expects will have a material favorable or unfavorable impact on net sales or revenues or income from continuing operations. If the registrant knows of events that will cause a material change in the relationship between costs and revenues (such as known future increases in costs of labor or materials or price increases or inventory adjustments), the change in the relationship shall be disclosed.

(iii) To the extent that the financial statements disclose material increases in net sales or revenues, provide a narrative discussion of the extent to which such increases are attributable to increases in prices or to increases in the volume or amount of goods or services being sold or to the introduction of new products or services.

(iv) For the three most recent fiscal years of the registrant or for those fiscal years in which the registrant has been engaged in business, whichever period is shortest, discuss the impact of inflation and changing prices on the registrant's net sales and revenues and on income from continuing operations.

(4) ***Off-balance sheet arrangements***.

(i) In a separately-captioned section, discuss the registrant's off-balance sheet arrangements that have or are reasonably likely to have a current or future effect on the registrant's financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources that is material to investors. The disclosure shall include the items specified in paragraphs (a)(4)(i)(A), (B), (C) and (D) of this Item to the extent necessary to an understanding of such arrangements and effect and shall also include such other information that the registrant believes is necessary for such an understanding.

(A) The nature and business purpose to the registrant of such off-balance sheet arrangements;

(B) The importance to the registrant of such off-balance sheet arrangements in respect of its liquidity, capital resources, market risk support, credit risk support or other benefits;

(C) The amounts of revenues, expenses and cash flows of the registrant arising from such arrangements; the nature and amounts of any interests retained, securities issued and other indebtedness incurred by the registrant in connection with such arrangements; and the nature and amounts of any other obligations or liabilities (including contingent obligations or liabilities) of the registrant arising from such arrangements that are or are reasonably likely to become material and the triggering events or circumstances that could cause them to arise; and

(D) Any known event, demand, commitment, trend or uncertainty that will result in or is reasonably likely to result in the termination, or material reduction in availability to the registrant, of its off-balance sheet arrangements that provide material benefits to it, and the course of action that the registrant has taken or proposes to take in response to any such circumstances.

(ii) ***As used in this paragraph (a)(4), the term*** *off-balance sheet arrangement* means any transaction, agreement or other contractual arrangement to which an entity unconsolidated with the registrant is a party, under which the registrant has:

(A) Any obligation under a guarantee contract that has any of the characteristics identified in FASB ASC paragraph 460-10-15-4 (Guarantees Topic), as may be modified or supplemented, and that is not excluded from the initial recognition and measurement provisions of FASB ASC paragraphs 460-10-15-7, 460-10-25-1, and 460-10-30-1.

(B) A retained or contingent interest in assets transferred to an unconsolidated entity or similar arrangement that serves as credit, liquidity or market risk support to such entity for such assets;

(C) Any obligation, including a contingent obligation, under a contract that would be accounted for as a derivative instrument, except that it is both indexed to the registrant's own stock and classified in stockholders' equity in the registrant's statement of financial position, and therefore excluded from the scope of FASB ASC Topic 815, *Derivatives and Hedging,* pursuant to FASB ASC subparagraph 815-10-15-74(a), as may be modified or supplemented; or

(D) Any obligation, including a contingent obligation, arising out of a variable interest (as defined in the FASB ASC Master Glossary), as may be modified or supplemented) in an unconsolidated entity that is held by, and material to, the registrant, where such entity provides financing, liquidity, market risk or credit risk support to, or engages in leasing, hedging or research and development services with, the registrant.

(5) ***Tabular disclosure of contractual obligations****.*

(i) In a tabular format, provide the information specified in this paragraph (a)(5) as of the latest fiscal year end balance sheet date with respect to the registrant's known contractual obligations specified in the table that follows this paragraph (a)(5)(i). The registrant shall provide amounts, aggregated by type of contractual obligation. The registrant may disaggregate the specified categories of contractual obligations using other categories suitable to its business, but the presentation must include all of the obligations of the registrant that fall within the specified categories. A presentation covering at least the periods specified shall be included. The tabular presentation may be accompanied by footnotes to describe provisions that create, increase or accelerate obligations, or other pertinent data to the extent necessary for an understanding of the timing and amount of the registrant's specified contractual obligations.

Contractual obligations	Payments due by period			3-5 years	More than 5 years
	Total	Less than 1 year	1-3 years		
[Long-Term Debt Obligations]					
[Capital Lease Obligations]					
[Operating Lease Obligations]					
[Purchase Obligations]					
[Other Long-Term Liabilities Reflected on the Registrant's Balance Sheet under GAAP]					
Total					

(ii) ***Definitions****:* The following definitions apply to this paragraph (a)(5):

(A) ***Long-term debt obligation*** means a payment obligation under long-term borrowings referenced in FASB ASC paragraph 470-10-50-1 (Debt Topic), as may be modified or supplemented.

(B) ***Capital lease obligation*** means a payment obligation under a lease classified as a capital lease pursuant to FASB ASC Topic 840, *Leases".* , as may be modified or supplemented.

(C) ***Operating lease obligation*** means a payment obligation under a lease classified as an operating lease and disclosed pursuant to FASB ASC Topic 840, as may be modified or supplemented.

(D) ***Purchase obligation*** means an agreement to purchase goods or services that is enforceable and legally binding on the registrant that specifies all significant terms, including: fixed or minimum quantities to be purchased; fixed, minimum or variable price provisions; and the approximate timing of the transaction.

Instructions to paragraph 303(a): 1. The registrant's discussion and analysis shall be of the financial statements and other statistical data that the registrant believes will enhance a reader's understanding of its financial condition, changes in financial condition and results of operations. Generally, the discussion shall cover the three-year period covered by the financial statements and shall use year-to-year comparisons or any other formats that in the registrant's judgment enhance a reader's understanding. However, where trend information is relevant, reference to the five-year selected financial data appearing pursuant to Item 301 of Regulation S-K (§ 229.301) may be necessary. A smaller reporting company's discussion shall cover the two-year period required in Article 8 of Regulation S-X and shall use year-to-year comparisons or any other formats that in the registrant's judgment enhance a reader's understanding.

2. The purpose of the discussion and analysis shall be to provide to investors and other users information relevant to an assessment of the financial condition and results of operations of the registrant as determined by evaluating the amounts and certainty of cash flows from operations and from outside sources.

3. The discussion and analysis shall focus specifically on material events and uncertainties known to management that would cause reported financial information not to be necessarily indicative of future operating results or of future financial condition. This would include descriptions and amounts of (A) matters that would have an impact on future operations and have not had an impact in the past, and (B) matters that have had an impact on reported operations and are not expected to have an impact upon future operations.

4. Where the consolidated financial statements reveal material changes from year to year in one or more line items, the causes for the changes shall be described to the extent necesary to an understanding of the registrant's businesses as a whole; *Provided, however,* That if the causes for a change in one line item also relate to other line items, no repetition is required and a line-by-line analysis of the financial statements as a whole is not required or generally appropriate. Registrants need not recite the amounts of changes from year to year which are readily computable from the financial statements. The discussion shall not merely repeat numerical data contained in the consolidated financial statements.

5. The term "liquidity" as used in this Item refers to the ability of an enterprise to generate adequate amounts of cash to meet the enterprise's needs for cash. Except where it is otherwise clear from the discussion, the registrant shall indicate those balance sheet conditions or income or cash flow items which the registrant believes may be indicators of its liquidity condition. Liquidity generally shall be discussed on both a long-term and short-term basis. The issue of liquidity shall be discussed in the context of the registrant's own business or businesses. For example a discussion of working capital may be appropriate for certain manufacturing, industrial or related operations but might be inappropriate for a bank or public utility.

6. Where financial statements presented or incorporated by reference in the registration statement are required by § 210.4-08(e)(3) of Regulation S-X [17 CFR part 210] to include disclosure of restrictions on the ability of both consolidated and unconsolidated subsidiaries to transfer funds to the registrant in the form of cash dividends, loans or advances, the discussion of liquidity shall include a discussion of the nature and extent of such restrictions and the impact such restrictions have had and are expected to have on the ability of the parent company to meet its cash obligations.

7. Any forward-looking information supplied is expressly covered by the safe harbor rule for projections. See Rule 175 under the Securities Act [17 CFR 230.175], Rule 3b-6 under the Exchange Act [17 CFR 240.3b-6] and Securities Act Release No. 6084 (June 25, 1979) (44 FR 38810).

8. Registrants are only required to discuss the effects of inflation and other changes in prices when considered material. This discussion may be made in whatever manner appears appropriate under the circumstances. All that is required is a brief textual presentation of management's views. No specific numerical financial data need be presented except as Rule 3-20(c) of Regulation S-X (§ 210.3-20(c) of this chapter) otherwise requires. However, registrants may elect to voluntarily disclose supplemental information on the effects of changing prices as provided for in FASB ASC Topic 255, *Changing Prices,* or through other supplemental disclosures. The Commission encourages experimentation with these disclosures in order to provide the most meaningful presentation of the impact of price changes on the registrant's financial statements.

9. Registrants that elect to disclose supplementary information on the effects of changing prices as specified by FASB ASC Topic 255 may combine such explanations with the discussion and analysis required pursuant to this Item or may supply such information separately with appropriate cross reference.

10. All references to the registrant in the discussion and in this Item shall mean the registrant and its subsidiaries consolidated.

11. Foreign private registrants also shall discuss briefly any pertinent governmental economic, fiscal, monetary, or political policies or factors that have materially affected or could materially affect, directly or indirectly, their operations or investments by United States nationals.

12. If the registrant is a foreign private issuer, the discussion shall focus on the primary financial statements presented in the registration statement or report. There shall be a reference to the reconciliation to United States generally accepted accounting principles, and a discussion of any aspects of the difference between foreign and United States generally accepted accounting principles, not discussed in the reconciliation, that the registrant believes is necessary for an understanding of the financial statements as a whole.

13. The attention of bank holding companies is directed to the information called for in Guide 3 (§ 229.801(c) and § 229.802(c)).

14. The attention of property-casualty insurance companies is directed to the information called for in Guide 6 (§ 229.801(f)).

Instructions to paragraph 303(a)(4): 1. No obligation to make disclosure under paragraph (a)(4) of this Item shall arise in respect of an off-balance sheet arrangement until a definitive agreement that is unconditionally binding or subject only to customary closing conditions exists or, if there is no such agreement, when settlement of the transaction occurs.

2. Registrants should aggregate off-balance sheet arrangements in groups or categories that provide material information in an efficient and understandable manner and should avoid repetition and disclosure of immaterial information. Effects that are common or similar with respect to a number of off-balance sheet arrangements must be analyzed in the aggregate to the extent the aggregation increases understanding. Distinctions in arrangements and their effects must be discussed to the extent the information is material, but the discussion should avoid repetition and disclosure of immaterial information.

3. For purposes of paragraph (a)(4) of this Item only, contingent liabilities arising out of litigation, arbitration or regulatory actions are not considered to be off-balance sheet arrangements.

4. Generally, the disclosure required by paragraph (a)(4) shall cover the most recent fiscal year. However, the discussion should address changes from the previous year where such discussion is necessary to an understanding of the disclosure.

5. In satisfying the requirements of paragraph (a)(4) of this Item, the discussion of off-balance sheet arrangements need not repeat information provided in the footnotes to the financial statements, provided that such discussion clearly cross-references to specific information in the relevant footnotes and integrates the substance of the footnotes into such discussion in a manner designed to inform readers of the significance of the information that is not included within the body of such discussion.

(b) ***Interim periods****.* If interim period financial statements are included or are required to be included by Article 3 of Regulation S-X (17 CFR 210), a management's discussion and analysis of the financial condition and results of operations shall be provided so as to enable the reader to assess material changes in financial condition and results of operations between the periods specified in paragraphs (b) (1) and (2) of this Item. The discussion and analysis shall include a discussion of material changes in those items specifically listed in paragraph (a) of this Item, except that the impact of inflation and changing prices on operations for interim periods need not be addressed.

(1) ***Material changes in financial condition****.* Discuss any material changes in financial condition from the end of the preceding fiscal year to the date of the most recent interim balance sheet provided. If the interim financial statements include an interim balance sheet as of the corresponding interim date of the preceding fiscal year, any material changes in financial condition from that date to the date of the most recent interim balance sheet provided also shall be discussed. If discussions of changes from both the end and the corresponding interim date of the preceding fiscal year are required, the discussions may be combined at the discretion of the registrant.

(2) ***Material changes in results of operations****.* Discuss any material changes in the registrant's results of operations with respect to the most recent fiscal year-to-date period for which an income statement is provided and the corresponding year-to-date period of the preceding fiscal year. If the registrant is required to or has elected to provide an income statement for the most recent fiscal quarter, such discussion also shall cover material changes with respect to that fiscal quarter and the corresponding fiscal quarter in the preceding fiscal year. In addition, if the registrant has elected to provide an income statement for the twelve-month period ended as of the date of the most recent interim balance sheet provided, the discussion also shall cover material changes with respect to that twelve-month period and the twelve-month period ended as of the corresponding interim balance sheet date of the preceding fiscal year. Notwithstanding the above, if for purposes of a registration statement a registrant subject to paragraph (b) of § 210.3-03 of Regulation S-X provides a statement of income for the twelve-month period ended as of the date of the most recent interim balance sheet provided in lieu of the interim income statements otherwise required, the discussion of material changes in that twelve-month period will be in respect to the preceding fiscal year rather than the corresponding preceding period.

Instructions to paragraph (b) of Item 303*:*

1. If interim financial statements are presented together with financial statements for full fiscal years, the discussion of the interim financial information shall be prepared pursuant to this paragraph (b) and the discussion of the full fiscal year's information shall be prepared pursuant to paragraph (a) of this Item. Such discussions may be combined.

2. In preparing the discussion and analysis required by this paragraph (b), the registrant may presume that users of the interim financial information have read or have access to the discussion and analysis required by paragraph (a) for the preceding fiscal year.

3. The discussion and analysis required by this paragraph (b) is required to focus only on material changes. Where the interim financial statements reveal material changes from period to period in one or more significant line items, the causes for the changes shall be described if they have not already been disclosed: *Provided, however,* That if the causes for a change in one line item also relate to other line items, no repetition is required. Registrants need not recite the amounts of changes from period to period which are readily computable from the financial statements. The discussion shall not merely repeat numerical data contained in the financial statements. The information provided shall include that which is available to the registrant without undue effort or expense and which does not clearly appear in the registrant's condensed interim financial statements.

4. The registrant's discussion of material changes in results of operations shall identify any significant elements of the registrant's income or loss from continuing operations which do not arise from or are not necessarily representative of the registrant's ongoing business.

5. The registrant shall discuss any seasonal aspects of its business which have had a material effect upon its financial condition or results of operation.

6. Any forward-looking information supplied is expressly covered by the safe harbor rule for projections. See Rule 175 under the Securities Act [17 CFR 230. 175], Rule 3b-6 under the Exchange Act [17 CFR 249.3b-6] and Securities Act Release No. 6084 (June 25, 1979) (44 FR 38810).

7. The registrant is not required to include the table required by paragraph (a)(5) of this Item for interim periods. Instead, the registrant should disclose material changes outside the ordinary course of the registrant's business in the specified contractual obligations during the interim period.

(c) ***Safe harbor***.

(1) The safe harbor provided in section 27A of the Securities Act of 1933 (15 U.S.C. 77z-2) and section 21E of the Securities Exchange Act of 1934 (15 U.S.C. 78u-5) ("statutory safe harbors") shall apply to forward-looking information provided pursuant to paragraphs (a)(4) and (5) of this Item, provided that the disclosure is made by: an issuer; a person acting on behalf of the issuer; an outside reviewer retained by the issuer making a statement on behalf of the issuer; or an underwriter, with respect to information provided by the issuer or information derived from information provided by the issuer.

(2) ***For purposes of paragraph (c) of this Item only***:

(i) All information required by paragraphs (a)(4) and (5) of this Item is deemed to be a *forward looking statement* as that term is defined in the statutory safe harbors, except for historical facts.

(ii) With respect to paragraph (a)(4) of this Item, the meaningful cautionary statements element of the statutory safe harbors will be satisfied if a registrant satisfies all requirements of that same paragraph (a)(4) of this Item.

(d) ***Smaller reporting companies*** . A smaller reporting company, as defined by § 229.10(f)(1), may provide the information required in paragraph (a)(3)(iv) of this Item for the last two most recent fiscal years of the registrant if it provides financial information on net sales and revenues and on income from continuing operations for only two years. A smaller reporting company is not required to provide the information required by paragraph (a)(5) of this Item.

[47 FR 11401, Mar. 16, 1982, as amended at 47 FR 29839, July 9, 1982; 47 FR 54768, Dec. 6, 1982; 52 FR 30919, Aug. 18, 1987; 68 FR 5999, Feb. 5, 2003; 73 FR 958, Jan. 4, 2008; 76 FR 50120, Aug. 12, 2011]

§ 229.307 (Item 307) Disclosure controls and procedures.

Disclose the conclusions of the registrant's principal executive and principal financial officers, or persons performing similar functions, regarding the effectiveness of the registrant's disclosure controls and procedures (as defined in § 240.13a-15(e) or § 240.15d-15(e) of this chapter) as of the end of the period covered by the report, based on the evaluation of these controls and procedures required by paragraph (b) of § 240.13a-15 or § 240.15d-15 of this chapter.

[68 FR 36663, June 18, 2003]

§ 229.503 (Item 503) Prospectus summary, risk factors, and ratio of earnings to fixed charges.

The registrant must furnish this information in plain English. See § 230.421(d) of Regulation C of this chapter.

(a) ***Prospectus summary.*** Provide a summary of the information in the prospectus where the length or complexity of the prospectus makes a summary useful. The summary should be brief. The summary should not contain, and is not required to contain, all of the detailed information in the prospectus. If you provide summary business or financial information, even if you do not caption it as a summary, you still must provide that information in plain English.

Instruction to paragraph 503(a): The summary should not merely repeat the text of the prospectus but should provide a brief overview of the key aspects of the offering. Carefully consider and identify those aspects of the offering that are the most significant and determine how best to highlight those points in clear, plain language.

(b) ***Address and telephone number.*** Include, either on the cover page or in the summary section of the prospectus, the complete mailing address and telephone number of your principal executive offices.

(c) ***Risk factors.*** Where appropriate, provide under the caption "Risk Factors" a discussion of the most significant factors that make the offering speculative or risky. This discussion must be concise and organized logically. Do not present risks that could apply to any issuer or any offering. Explain how the risk affects the issuer or the securities being offered. Set forth each risk factor under a subcaption that adequately describes the risk. The risk factor discussion must immediately follow the summary section. If you do not include a summary section, the risk factor section must immediately follow the cover page of the prospectus or the pricing information section that immediately follows the cover page. Pricing information means price and price-related information that you may omit from the prospectus in an effective registration statement based on § 230.430A(a) of this chapter. The risk factors may include, among other things, the following:

(1) ***Your lack of an operating history***;

(2) Your lack of profitable operations in recent periods;

(3) ***Your financial position***;

(4) ***Your business or proposed business; or***

(5) The lack of a market for your common equity securities or securities convertible into or exercisable for common equity securities.

(d) ***Ratio of earnings to fixed charges.*** If you register debt securities, show a ratio of earnings to fixed charges. If you register preference equity securities, show the ratio of combined fixed charges and preference dividends to earnings. Present the ratio for each of the last five fiscal years and the latest interim period for which financial statements are presented in the document. If you will use the proceeds from the sale of debt or preference securities to repay any of your outstanding debt or to retire other securities and the change in the ratio would be ten percent or greater, you must include a ratio showing the application of the proceeds, commonly referred to as the pro forma ratio.

Instructions to paragraph 503(d): 1. *Definitions.* In calculating the ratio of earnings to fixed charges, you must use the following definitions:

(A) ***Fixed charges.*** The term "fixed charges" means the sum of the following:

(a) interest expensed and capitalized, (b) amortized premiums, discounts and capitalized expenses related to indebtedness, (c) an estimate of the interest within rental expense, and (d) preference security dividend requirements of consolidated subsidiaries.

(B) ***Preference security dividend.*** The term "preference security dividend" is the amount of pre-tax earnings that is required to pay the dividends on outstanding preference securities. The dividend requirement must be computed as the amount of the dividend divided by (1 minus the effective income tax rate applicable to continuing operations).

(C) ***Earnings.*** The term "earnings" is the amount resulting from adding and subtracting the following items. Add the following:

(a) pre-tax income from continuing operations before adjustment for income or loss from equity investees; (b) fixed charges; (c) amortization of capitalized interest; (d) distributed income of equity investees; and (e) your share of pre-tax losses of equity investees for which charges arising from guarantees are included in fixed charges. From the total of the added items, subtract the following: (a) interest capitalized; (b) preference security dividend requirements of consolidated subsidiaries; and (c) the noncontrolling interest in pre-tax income of subsidiaries that have not incurred fixed charges. Equity investees are investments that you account for using the equity method of accounting. Public utilities following FASB ASC Topic 980, *Regulated Operations,* should not add amortization of capitalized interest in determining earnings, nor reduce fixed charges by any allowance for funds used during construction.

2. *Disclosure.* Disclose the following information when showing the ratio of earnings to fixed charges:

(A) ***Deficiency***. If a ratio indicates less than one-to-one coverage, disclose the dollar amount of the deficiency.

(B) ***Pro forma ratio***. You may show the pro forma ratio only for the most recent fiscal year and the latest interim period. Use the net change in interest or dividends from the refinancing to calculate the pro forma ratio.

(C) ***Foreign private issuers***. A foreign private issuer must show the ratio based on the figures in the primary financial statement. A foreign private issuer must show the ratio based on the figures resulting from the reconciliation to U.S. generally accepted accounting principles if this ratio is materially different.

(D) ***Summary Section***. If you provide a summary or similar section in the prospectus, show the ratios in that section.

3. *Exhibit*. File an exhibit to the registration statement to show the figures used to calculate the ratios. See paragraph (b)(12) of Item 601 of Regulation S-K (17 CFR 229.601(b)(12)).

(e) ***Smaller reporting companies***. A registrant that qualifies as a smaller reporting company, as defined by § 229.10(f), need not comply with paragraph (d) of this Item.

Instruction to Item 503: For asset-backed securities, see also Item 1103 of Regulation AB (§ 229.1103).

[63 FR 6383, Feb. 6, 1998, as amended at 70 FR 1594, Jan. 7, 2005; 73 FR 964, Jan. 4, 2008; 74 FR 18617, Apr. 23, 2009; 76 FR 50121, Aug. 12, 2011]

EXHIBIT C

Speech

Boards of Directors, Corporate Governance and Cyber-Risks: Sharpening the Focus

Commissioner Luis A. Aguilar

"Cyber Risks and the Boardroom" Conference
New York Stock Exchange
New York, NY

June 10, 2014

Good afternoon. Thank you for that kind introduction. I am glad to be back at the New York Stock Exchange. In anticipating today's conference, I thought back to an earlier trip to the NYSE where in April 2009, I had the opportunity to ring the closing bell. Before I begin my remarks, let me issue the standard disclaimer that the views I express today are my own, and do not necessarily reflect the views of the U.S. Securities and Exchange Commission ("SEC" or "Commission"), my fellow Commissioners, or members of the staff.

I am pleased to be here and to have the opportunity to speak about cyber-risks and the boardroom, a topic that is both timely and extremely important. Over just a relatively short period of time, cybersecurity has become a top concern of American companies, financial institutions, law enforcement, and many regulators.[1] I suspect that not too long ago, we would have been hard-pressed to find many individuals who had even heard of cybersecurity, let alone known what it meant. Yet, in the past few years, there can be no doubt that the focus on this issue has dramatically increased.[2]

Cybersecurity has become an important topic in both the private and public sectors, and for good reason. Law enforcement and financial regulators have stated publicly that cyber-attacks are becoming both more frequent and more sophisticated.[3] Indeed, according to one survey, U.S. companies experienced a 42% increase between 2011 and 2012 in the number of successful cyber-attacks they experienced per week.[4] As I am sure you have heard, recently there have also been a series of well-publicized cyber-attacks that have generated considerable media attention and raised public awareness of this issue. A few of the more well-known examples include:

- The October 2013 cyber-attack on the software company Adobe Systems, Inc., in which data from more than 38 million customer accounts was obtained improperly;[5]
- The December 2013 cyber-attack on Target Corporation, in which the payment card data of approximately 40 million Target customers and the personal data of up to 70 million Target customers was accessed without authorization;[6]
- The January 2014 cyber-attack on Snapchat, a mobile messaging service, in which a reported 4.6 million user names and phone numbers were exposed;[7]
- The sustained and repeated cyber-attacks against several large U.S. banks, in which their public websites have been knocked offline for hours at a time;[8] and
- The numerous cyber-attacks on the infrastructure underlying the capital markets, including quite a few on securities exchanges.[9]

In addition to becoming more frequent, there are reports indicating that cyber-attacks have become increasingly costly to companies that are attacked. According to one 2013 survey, the average annualized cost of cyber-crime to a sample of U.S. companies was $11.6 million per year, representing a 78% increase since 2009.[10] In addition, the aftermath of the 2013 Target data breach demonstrates that the impact of cyber-attacks may extend far beyond the direct costs associated with the immediate response to an attack.[11] Beyond the unacceptable damage to consumers, these secondary effects include reputational harm that significantly affects a company's bottom line. In sum, the capital markets and their critical participants, including public companies, are under a continuous and serious threat of cyber-attack, and this threat cannot be ignored.[12]

As an SEC Commissioner, the threats are a particular concern because of the widespread and severe impact that cyber-attacks could have on the integrity of the capital markets infrastructure and on public companies and investors.[13] The concern is not new. For example, in 2011, staff in the SEC's Division of Corporation Finance issued guidance to public companies regarding their disclosure obligations with respect to cybersecurity risks and cyber-incidents.[14] More recently, because of the escalation of cyber-attacks, I helped organize the Commission's March 26, 2014 roundtable to discuss the cyber-risks facing public companies and critical market participants like exchanges, broker-dealers, and transfer agents.[15]

Today, I would like to focus my remarks on what boards of directors can, and should, do to ensure that their organizations are appropriately considering and addressing cyber-risks. Effective board oversight of management's efforts to address these issues is critical to preventing and effectively responding to successful cyber-attacks and, ultimately, to protecting companies and their consumers, as well as protecting investors and the integrity of the capital markets.

The Role of the Boards of Directors in Overseeing Cyber-Risk Management

Background on the Role of Boards of Directors

When considering the board's role in addressing cybersecurity issues, it is useful to keep in mind the broad duties that the board owes to the corporation and, more specifically, the board's role in corporate governance and overseeing risk management. It has long been the accepted model, both here and around the world, that corporations are managed under the direction of their boards of directors.[16] This model arises from a central tenet of the modern corporation — the separation of ownership and control of the corporation. Under this structure, those who manage a corporation must answer to the true owners of the company — the shareholders.

It would be neither possible nor desirable, however, for the many, widely-dispersed shareholders of any public company to come together and manage, or direct the management of, that company's business and affairs. Clearly, effective full-time management is essential for public companies to function. But management without accountability can lead to self-interested decision-making that may not benefit the company or its shareholders. As a result, shareholders elect a board of directors to represent their interests, and, in turn, the board of directors, through effective corporate governance, makes sure that management effectively serves the corporation and its shareholders.[17]

Corporate Boards and Risk Management Generally

Although boards have long been responsible for overseeing multiple aspects of management's activities, since the financial crisis, there has been an increased focus on what boards of directors are doing to address risk management.[18] Indeed, many have noted that, leading up to the financial crisis, boards of directors may not have been doing enough to oversee risk management within their companies, and that this failure contributed to the unreasonably risky behavior that resulted in the destruction of untold billions in shareholder value and plunged the country and the global economy into recession.[19] Although primary responsibility for risk management has historically belonged to management, the boards are responsible for overseeing that the corporation has established appropriate risk management programs and for overseeing how management implements those programs.[20]

The importance of this oversight was highlighted when, in 2009, the Commission amended its rules to require disclosure about, among other things, the board's role in risk oversight, including a description of whether and how the board administers its oversight function, such as through the whole board, a separate risk committee, or the audit committee.[21] The Commission did not mandate any particular structure, but noted that "risk oversight is a key competence of the board" and that "disclosure about the board's involvement in the oversight of the risk management process should provide important information to investors about how a company perceives the role of its board and the relationship between the board and senior management in managing the material risks facing the company."[22]

The evidence suggests that boards of directors have begun to assume greater responsibility for overseeing the risk management efforts of their companies.[23] For example, according to a recent survey of 2013 proxy filings by companies comprising the S&P 200, the full boards of these companies are increasingly, and nearly universally, taking responsibility for the risk oversight of the company.[24]

Clearly, boards must take seriously their responsibility to ensure that management has implemented effective risk management protocols. Boards of directors are already responsible for overseeing the management of all types of risk, including credit risk, liquidity risk, and operational risk[25] — and there can be little doubt that cyber-risk also must be considered as part of board's overall risk oversight. The recent announcement that a prominent proxy advisory firm is urging the ouster of most of the Target Corporation directors because of the perceived "failure…to ensure appropriate management of [the] risks" as to Target's December 2013 cyber-attack is another driver that should put directors on notice to proactively address the risks associated with cyber-attacks.[26]

What Boards of Directors Can and Should Be Doing to Oversee Cyber-Risk

Given the significant cyber-attacks that are occurring with disturbing frequency, and the mounting evidence that companies of all shapes and sizes are increasingly under a constant threat of potentially disastrous cyber-attacks, ensuring the adequacy of a company's cybersecurity measures needs to be a critical part of a board of director's risk oversight responsibilities. [27]

In addition to the threat of significant business disruptions, substantial response costs, negative publicity, and lasting reputational harm, there is also the threat of litigation and potential liability for failing to implement adequate steps to protect the company from cyber-threats.[28] Perhaps unsurprisingly, there has recently been a series of derivative lawsuits brought against companies and their officers and directors relating to data breaches resulting from cyber-attacks.[29] Thus, boards that choose to ignore, or minimize, the importance of cybersecurity oversight responsibility, do so at their own peril.

Given the known risks posed by cyber-attacks, one would expect that corporate boards and senior management universally would be proactively taking steps to confront these cyber-risks. Yet, evidence suggests that there may be a gap that exists between the magnitude of the exposure presented by cyber-risks and the steps, or lack thereof, that many corporate boards have taken to address these risks. Some have noted that boards are not spending enough time or devoting sufficient corporate resources to addressing cybersecurity issues.[30] According to one survey, boards were not undertaking key oversight activities related to cyber-risks, such as reviewing annual budgets for privacy and IT security programs, assigning roles and responsibilities for privacy and security, and receiving regular reports on breaches and IT risks.[31] Even when boards do pay attention to these risks, some have questioned the extent to which boards rely too much on the very personnel who implement those measures.[32] In light of these observations, directors should be asking themselves what they can, and should, be doing to effectively oversee cyber-risk management.

NIST Cybersecurity Framework

In considering where to begin to assess a company's possible cybersecurity measures, one conceptual roadmap boards should consider is the Framework for Improving Critical Infrastructure Cybersecurity, released by the National Institute of Standards and Technology ("NIST") in February 2014. The NIST Cybersecurity Framework is intended to provide companies with a set of industry standards and best practices for managing their cybersecurity risks.[33] In essence, the Framework encourages companies to be proactive and to think about these difficult issues in advance of the occurrence of a possibly devastating cyber-event. While the Framework is voluntary guidance for any company, some commentators have already suggested that it will likely become a baseline for best practices by companies, including in assessing legal or regulatory exposure to these issues or for insurance purposes.[34] At a minimum, boards should work with management to assess their corporate policies to ensure how they match-up to the Framework's guidelines — and whether more may be needed.

Board Structural Changes to Focus on Appropriate Cyber-Risk Management

The NIST Cybersecurity Framework, however, is a bible without a preacher if there is no one at the company who is able to translate its concepts into action plans. Frequently, the board's risk oversight function lies either with the full board or is delegated to the board's audit committee. Unfortunately, many boards lack the technical expertise necessary to be able to evaluate whether management is taking appropriate steps to address cybersecurity issues. Moreover, the board's audit committee may not have the expertise, support, or skills necessary to add oversight of a company's cyber-risk management to their already full agenda.[35] As a result, some have recommended mandatory cyber-risk education for directors.[36] Others have suggested that boards be at least adequately represented by members with a good understanding of information technology issues that pose risks to the company.[37]

Another way that has been identified to help curtail the knowledge gap and focus director attention on known cyber-risks is to create a separate enterprise risk committee on the board. It is believed that such committees can foster a “big picture” approach to company-wide risk that not only may result in improved risk reporting and monitoring for both management and the board, but also can provide a greater focus — at the board level — on the adequacy of resources and overall support provided to company executives responsible for risk management.[38] The Dodd-Frank Act already requires large financial institutions to establish independent risk committees on their boards.[39] Beyond the financial institutions required to do so, some public companies have chosen to proactively create such risk committees on their boards.[40] Research suggests that 48% of corporations currently have board-level risk committees that are responsible for privacy and security risks, which represents a dramatic increase from the 8% that reported having such a committee in 2008.[41]

Clearly, there are various mechanisms that boards can employ to close the gap in addressing cybersecurity concerns — but it is equally clear that boards need to be proactive in doing so. Put simply, boards that lack an adequate understanding of cyber-risks are unlikely to be able to effectively oversee cyber-risk management.

I commend the boards that are proactively addressing these new risks of the 21st Century. However, while enhancing board knowledge and board involvement is a good business practice, it is not necessarily a panacea to comprehensive cybersecurity oversight.

Internal Roles and Responsibilities Focused on Cyber-Risk

In addition to proactive boards, a company must also have the appropriate personnel to carry out effective cyber-risk management and to provide regular reports to the board. One 2012 survey reported that less than two-thirds of responding companies had full-time personnel in key roles responsible for privacy and security, in a manner that was consistent with internationally accepted best practices and standards.[42] In addition, a 2013 survey found that the companies that detected more security incidents and reported lower average financial losses per incident shared key attributes, including that they employed a full-time chief information security officer (or equivalent) who reported directly to senior management.[43]

At a minimum, boards should have a clear understanding of who at the company has primary responsibility for cybersecurity risk oversight and for ensuring the adequacy of the company’s cyber-risk management practices.[44] In addition, as the evidence shows, devoting full-time personnel to cybersecurity issues may help prevent and mitigate the effects of cyber-attacks.

Board Preparedness

Although different companies may choose different paths, ultimately, the goal is the same: to prepare the company for the inevitable cyber-attack and the resulting fallout from such an event. As it has been noted, the primary distinction between a cyber-attack and other crises that a company may face is the speed with which the company must respond to contain the rapid spread of damage.[45] Companies need to be prepared to respond within hours, if not minutes, of a cyber-event to detect the cyber-event, analyze the event, prevent further damage from being done, and prepare a response to the event.[46]

While there is no “one-size-fits-all” way to properly prepare for the various ways a cyber-attack can unfold, and what responses may be appropriate, it can be just as damaging to have a poorly-implemented response to a cyber-event. As others have observed, an “ill-thought-out response can be far more damaging than the attack itself.”[47] Accordingly, boards should put time and resources into making sure that management has developed a well-constructed and deliberate response plan that is consistent with best practices for a company in the same industry.

These plans should include, among other things, whether, and how, the cyber-attack will need to be disclosed internally and externally (both to customers and to investors).[48] In deciding the nature and extent of the disclosures, I would encourage companies to go beyond the impact on the company and to also consider the impact on others. It is possible that a cyber-attack may not have a direct material adverse impact on the company itself, but that a loss of customers' personal and financial data could have devastating effects on the lives of the company's customers and many Americans. In such cases, the right thing to do is to give these victims a heads-up so that they can protect themselves.[49]

Conclusion

Let me conclude my remarks by reaffirming the significance of the role of good corporate governance. Corporate governance performed properly, results in the protection of shareholder assets. Fortunately, many boards take on this difficult and challenging role and perform it well. They do so by, among other things, being active, informed, independent, involved, and focused on the interests of shareholders.

Good boards also recognize the need to adapt to new circumstances — such as the increasing risks of cyber-attacks. To that end, board oversight of cyber-risk management is critical to ensuring that companies are taking adequate steps to prevent, and prepare for, the harms that can result from such attacks. There is no substitution for proper preparation, deliberation, and engagement on cybersecurity issues. Given the heightened awareness of these rapidly evolving risks, directors should take seriously their obligation to make sure that companies are appropriately addressing those risks.

Those of you who have taken the time and effort to be here today clearly recognize the risks, and I commend you for being proactive in dealing with the issue.

Thank you for inviting me to speak to you today.

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[1] For example, the Director of the Federal Bureau of Investigation (FBI), James Comey, said last November that "resources devoted to cyber-based threats will equal or even eclipse the resources devoted to non-cyber based terrorist threats." *See,* Testimony of James B. Comey, Jr., Director, FBI, U.S. Department of Justice, before the Senate Committee on Homeland Security and Governmental Affairs (Nov. 14, 2013), *available at* http://www.hsgac.senate.gov/hearings/threats-to-the-homeland. *See also,* Testimony of Jeh C. Johnson, Secretary, U.S. Department of Homeland Security, before the House Committee on Homeland Security (Feb. 26, 2014) ("DHS must continue efforts to address the growing cyber threat to the private sector and the '.gov' networks, illustrated by the real, pervasive, and ongoing series of attacks on public and private infrastructure."), *available at* http://docs.house.gov/meetings/HM/HM00/20140226/101722/HHRG-113-HM00-Wstate-JohnsonJ-20140226.pdf; Testimony of Ari Baranoff, Assistant Special Agent in Charge, United States Secret Service Criminal Investigative Division, before the House Committee on Homeland Security, Subcommittee on Cybersecurity, Infrastructure Protection, and Security Technologies (Apr. 16, 2014), *available at* http://docs.house.gov/meetings/HM/HM08/20140416/102141/HHRG-113-HM08-Wstate-BaranoffA-20140416.pdf ("Advances in computer technology and greater access to personally identifiable information (PII) via the Internet have created online marketplaces for transnational cyber criminals to share stolen information and criminal methodologies. As a result, the Secret Service has observed a marked increase in the quality, quantity, and complexity of cybercrimes

targeting private industry and critical infrastructure."); Remarks by Secretary of Defense Leon E. Panetta to the Business Executives for National Security (Oct. 11, 2012), *available at* http://www.defense.gov/transcripts/transcript.aspx?transcriptid=5136 ("As director of the CIA and now Secretary of Defense, I have understood that cyber attacks are every bit as real as the more well-known threats like terrorism, nuclear weapons proliferation and the turmoil that we see in the Middle East. And the cyber threats facing this country are growing.").

[2] *See, e.g.*, Martin Lipton, *et al.*, *Risk Management and the Board of Directors — An Update for 2014*, The Harvard Law School Forum on Corporate Governance and Financial Regulation (Apr. 22, 2014), *available at* http://blogs.law.harvard.edu/corpgov/2014/04/22/risk-management-and-the-board-of-directors-an-update-for-2014/ (noting that cybersecurity is a risk management issue that "merits special attention" from the board of directors in 2014); PwC 2012 Annual Corporate Directors Survey, *Insights from the Boardroom 2012: Board evolution: Progress made yet challenges persist*, *available at* http://www.pwc.com/en_US/us/corporate-governance/annual-corporate-directors-survey/assets/pdf/pwc-annual-corporate-directors-survey.pdf (finding that 72% of directors are engaged with overseeing and understanding data security issues and risks related to compromising customer data); Michael A. Gold, *Cyber Risk and the Board of Directors–Closing the Gap*, Bloomberg BNA (Oct. 18, 2013) *available at* http://www.bna.com/cyber-risk-and-the-board-of-directors-closing-the-gap// ("The responsibility of corporate directors to address cyber security is commanding more attention and is obviously a significant issue."); Deloitte Development LLC, *Hot Topics: Cybersecurity … Continued in the boardroom*, Corporate Governance Monthly (Aug. 2013), *available at* http://www.corpgov.deloitte.com/binary/com.epicentric.contentmanagement.servlet.ContentDeliveryServlet/USEng/Documents/Deloitte%20Periodicals/Hot%20Topics/Hot%20Topics%20-%20Cybersecurity%20%20%20Continued%20in%20the%20boardroom%20-August%202013%20-Final.pdf ("Not long ago, the term 'cybersecurity' was not frequently heard or addressed in the boardroom. Cybersecurity was often referred to as an information technology risk, and management and oversight were the responsibility of the chief information or technology officer, not the board. With the rapid advancement of technology, cybersecurity has become an increasingly challenging risk that boards may need to address."); Holly J. Gregory, *Board Oversight of Cybersecurity Risks*, Thomson Reuters Practical Law (Mar. 1, 2014), *available at* http://us.practicallaw.com/5-558-2825 ("The risk of cybersecurity breaches (and the harm that these breaches pose) is one of increasing significance for most companies and therefore an area for heightened board focus.").

[3] For example, on December 9, 2013, the Financial Stability Oversight Council held a meeting to discuss cybersecurity threats to the financial system. *See*, U.S. Department of the Treasury Press Release, "Financial Stability Oversight Council to Meet December 9," *available at* http://www.treasury.gov/press-center/press-releases/Pages/jl2228.aspx. During that meeting, Assistant Treasury Secretary Cyrus-Amir-Mokri said that "[o]ur experience over the last couple of years shows that cyber-threats to financial institutions and markets are growing in both frequency and sophistication." *See,* Remarks of Assistant Secretary Cyrus Amir-Mokri on Cybersecurity at a Meeting of the Financial Stability Oversight Council (Dec. 9, 2013), *available at* http://www.treasury.gov/press-center/press-releases/Pages/jl2234.aspx. In addition, in testimony before the House Financial Services Committee in 2011, the Assistant Director of the FBI's Cyber Division stated that the number and sophistication of malicious incidents involving financial institutions has increased dramatically over the past several years and offered numerous examples of such attacks, which included fraudulent monetary transfers, unauthorized financial transactions from compromised bank and brokerage accounts, denial of service attacks on U.S. stock exchanges, and hacking incidents in which confidential information was misappropriated. *See,* Testimony of Gordon M. Snow, Assistant Director, Cyber Division, FBI, U.S. Department of Justice, before the House Financial Services Committee,

Subcommittee on Financial Institutions and Consumer Credit (Sept. 14, 2011), *available at* http://financialservices.house.gov/uploadedfiles/091411snow.pdf.

[4] *2012 Cost of Cyber Crime Study: United States*, Ponemon Institute LLC and HP Enterprise Security (Oct. 2012), *available at* http://www.ponemon.org/local/upload/file/2012_US_Cost_of_Cyber_Crime_Study_FINAL6%20.pdf.

[5] *See, e.g.,* Jim Finkle, *Adobe says customer data, source code accessed in cyber attack*, Reuters (Oct. 3, 2013), *available at* http://www.reuters.com/article/2013/10/03/us-adobe-cyberattack-idUSBRE99212Y20131003; Jim Finkle, *Adobe data breach more extensive than previously disclosed*, Reuters (Oct. 29, 2013), *available at* http://www.reuters.com/article/2013/10/29/us-adobe-cyberattack-idUSBRE99S1DJ20131029; Danny Yadron, *Hacker Attack on Adobe Sends Ripples Across Web*, Wall Street Journal (Nov. 11, 2013), *available at* http://online.wsj.com/news/articles/SB10001424052702304644104579192393329283358.

[6] *See,* Testimony of John Mulligan, Executive Vice President and Chief Financial Officer of Target, before the Senate Judiciary Committee (Feb. 4, 2014), *available at* http://www.judiciary.senate.gov/imo/media/doc/02-04-14MulliganTestimony.pdf ; Target Press Release, "Target Confirms Unauthorized Access to Payment Card Data in U.S. Stores" (Dec. 19, 2013), *available at* http://pressroom.target.com/news/target-confirms-unauthorized-access-to-payment-card-data-in-u-s-stores.

[7] *See, e.g.,* Andrea Chang and Salvador Rodriguez, *Snapchat becomes target of widespread cyberattack*, L.A. Times (Jan. 2, 2014), *available at* http://articles.latimes.com/2014/jan/02/business/la-fi-snapchat-hack-20140103; Brian Fung, *A Snapchat security breach affects 4.6 million users. Did Snapchat drag its feet on a fix?* Washington Post (Jan. 1, 2014), *available at* http://www.washingtonpost.com/blogs/the-switch/wp/2014/01/01/a-snapchat-security-breach-affects-4-6-million-users-did-snapchat-drag-its-feet-on-a-fix/.

[8] *See, e.g.,* Joseph Menn, *Cyber attacks against banks more severe than most realize*, Reuters (May 18, 2013), *available at* http://www.reuters.com/article/2013/05/18/us-cyber-summit-banks-idUSBRE94G0ZP20130518; Bob Sullivan, *Bank Website Attacks Reach New Highs*, CNBC (Apr. 3, 2013), *available at* http://www.cnbc.com/id/100613270.

[9] For example, according to a 2012 global survey of securities exchanges, 53% reported experiencing a cyber-attack in the previous year. *See,* Rohini Tendulkar, *Cyber-crime, securities markets, and systemic risk*, Joint Staff Working Paper of the IOSCO Research Department and World Federation of Exchanges (July 16, 2013), *available at* http://www.iosco.org/research/pdf/swp/Cyber-Crime-Securities-Markets-and-Systemic-Risk.pdf. Forty-six securities exchanges responded to the survey.

[10] *See*, HP Press Release, *HP Reveals Cost of Cybercrime Escalates 70 Percent, Time to Resolve Attacks More Than Doubles* (Oct. 8, 2013), *available at* http://www8.hp.com/us/en/hp-news/press-release.html?id=1501128.

[11] *See*, Target Financial News Release, *Target Reports Fourth Quarter and Full-Year 2013 Earnings* (Feb. 26, 2014), *available at* http://investors.target.com/phoenix.zhtml?c=65828&p=irol-newsArticle&ID=1903678&highlight (including a statement from then-Chairman, President and CEO Gregg Steinhafel that Target's fourth quarter results "softened meaningfully following our December announcement of a data breach."); Elizabeth A. Harris, *Data Breach Hurts Profit at Target*, N.Y. Times (Feb. 26, 2014), *available at* http://www.nytimes.com/2014/02/27/business/target-reports-on-fourth-quarter-earnings.html?

_r=0 (noting that "[t]he widespread theft of Target customer data had a significant impact on the company's profit, which fell more than 40 percent in the fourth quarter" of 2013).

[12] I also want to note that at the Investment Company Institute's ("ICI") general membership meeting, held just last month, the issue of cybersecurity was front and center. Among the issues raised during the meeting was the "huge risk to brand" for a firm if they have a security failure in the event of a cyber-attack. A separate panel at the ICI conference devoted to cybersecurity also discussed the shift in focus from building "hard walls" to protect against risks from outside the company to cybersecurity focused on "inside" risks, such as ensuring that individuals with mobile applications or other types of flexible applications don't introduce, intentionally or unintentionally, malware or other kinds of security breaches that could lead to a cyber-attack on the company. *See, e.g.,* Jackie Noblett, *Cyber Breach a "Huge Risk to Brand,"* Ignites (May 29, 2014), *available at* http://ignites.com/c/897654/86334/cyber_breach_huge_risk_brand?referrer_module=emailMorningNews&module_order=7.

[13] *See,* Commissioner Luis A. Aguilar, *The Commission's Role in Addressing the Growing Cyber-Threat* (Mar. 26, 2014), *available at* http://www.sec.gov/News/PublicStmt/Detail/PublicStmt/1370541287184.

[14] On October 13, 2011, staff in the Commission's Division of Corporation Finance (Corp Fin) issued guidance on issuers' disclosure obligations relating to cyber security risks and cyber incidents. *See,* SEC's Division of Corporation Finance, *CF Disclosure Guidance: Topic No. 2—Cybersecurity* ("SEC Guidance") (Oct. 31, 2011), *available at* http://www.sec.gov/divisions/corpfin/guidance/cfguidance-topic2.htm. Among other things, this guidance notes that securities laws are designed to elicit disclosure of timely, comprehensive, and accurate information about risks and events that a reasonable investor would consider important to an investment decision, and cybersecurity risks and events are not exempt from these requirements. The guidance identifies six areas where cybersecurity disclosures may be necessary under Regulation S-K: (1) Risk Factors; (2) Management's Discussion and Analysis of Financial Condition and Results of Operation (MD&A); (3) Description of Business; (4) Legal Proceedings; (5) Financial Statement Disclosures; and (6) Disclosure Controls and Procedures. The SEC Guidance further recommends that material cybersecurity risks should be disclosed and adequately described as Risk Factors. Where cybersecurity risks and incidents that represent a material event, trend or uncertainty reasonably likely to have a material impact on the organization's operations, liquidity, or financial condition — it should be addressed in the MD&A. If cybersecurity risks materially affect the organization's products, services, relationships with customers or suppliers, or competitive conditions, the organization should disclose such risks in its description of business. Data breaches or other incidents can result in regulatory investigations or private actions that are material and should be discussed in the Legal Proceedings section. Cybersecurity risks and incidents that represent substantial costs in prevention or response should be included in Financial Statement Disclosures where the financial impact is material. Finally, where a cybersecurity risk or incident impairs the organization's ability to record or report information that must be disclosed, Disclosure Controls and Procedures that fail to address cybersecurity concerns may be ineffective and subject to disclosure. Some have suggested that such disclosures fail to fully inform investors about the true costs and benefits of companies' cybersecurity practices, and argue that the Commission (and not the staff) should issue further guidance regarding issuers' disclosure obligations. *See,* Letter from U.S. Senator John D. Rockefeller IV to Chair White (Apr. 9, 2013), *available at* http://www.commerce.senate.gov/public/?a=Files.Serve&File_id=49ac989b-bd16-4bbd-8d64-8c15ba0e4e51.

[15] *See* SEC Press Release, *SEC Announces Agenda, Panelists for Cybersecurity Roundtable* (Mar. 24, 2014), *available at*

http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370541253749; *Cybersecurity Roundtable Webcast* (Mar. 26, 2014), *available at* http://www.sec.gov/news/otherwebcasts/2014/cybersecurity-roundtable-032614.shtml. In addition, the SEC's National Exam Program has included cybersecurity among its areas of focus in its National Examination Priorities for 2014. *See,* SEC's National Exam Priorities for 2014, *available at* http://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2014.pdf. In addition, it was recently announced that SEC examiners will review whether asset managers have policies to prevent and detect cyber-attacks and are properly safeguarding against security risks that could arise from vendors having access to their systems. *See,* Sarah N. Lynch, *SEC examiners to review how asset managers fend off cyber attacks*, Reuters (Jan. 30, 2014), *available at* http://www.reuters.com/article/2014/01/30/us-sec-cyber-assetmanagers-idUSBREA0T1PJ20140130. FINRA has also identified cybersecurity as one of its examination priorities for 2014. *See,* FINRA's 2014 Regulatory and Examination Priorities Letter (Jan. 2, 2014), *available at* http://www.finra.org/web/groups/industry/@ip/@reg/@guide/documents/industry/p419710.pdf.

To continue the discussion and to allow the public to weigh in on this important topic, the SEC set up a public comment file associated with the Cybersecurity Roundtable. To date, we have received ten comment letters from academics, software companies, and other interested parties, *available at* http://www.sec.gov/comments/4-673/4-673.shtml. *See, e.g.*, Jodie Kelly, Senior Vice President and General Counsel, BSA| The Software Alliance comment letter (Apr. 30, 2014) (highlighting the importance of strong internal controls related to software assets as a first line of defense against cyber-attacks, and noting that verifying legal use of software is a critical first step in deterring cyber-attacks because the "existence and availability of pirated and counterfeit software exposes corporate information technology networks to significant risks in many ways."); Tom C.W. Lin, Associate Professor of Law, Temple University Beasley School of Law comment letter (Apr. 29, 2014) (expressing support for the roundtable and the Commission's attention to cybersecurity and highlighting four broad issues for the Commission's consideration: (1) cybersecurity threats to the high-speed, electronically connected modern capital markets can create systemic risks; (2) due to technological advances, financial choices are made by both people and machines, which does not comport congruently with many traditional modes of securities regulation; (3) incentives, in addition to penalties, should be designed to encourage firms to upgrade their cybersecurity capabilities; and (4) private regulation of cybersecurity should be vigorously enhanced and leveraged to better complement government regulation); Dave Parsonage, CEO, MitoSystems, Inc. comment letter (Apr. 3, 2014); Gail P. Ricketts, Senior IT Compliance and Risk Analyst, ON Semiconductor comment letter (Mar. 26, 2014) (suggesting future roundtables include speakers from outside the financial services industry, such as manufacturing); Michael Utzig, IT Director, Hefren Tillotson, Inc. comment letter (Mar. 26, 2014) (noting that readily available technologies that can protect email communications are not widely used despite universal understanding that cybersecurity is a high-priority); Cathy Santoro comment letter (Mar. 26, 2014) (raising questions about the interactions between banks and service providers and the measures being undertaken regarding mobile payment cybersecurity risks); Duane Kuroda, Senior Threat Researcher, NetCitadel comment letter (Mar. 25, 2014) (noting that the panel discussion should focus on the process and people involved in responding to breaches and not just their detection); William Pfister, Jr. comment letter (Mar. 25, 2014) (requesting that one of the panels address the potential conflicts between national security and required disclosure). Many of these letters are generally supportive of the Commission's efforts and focus in this area, and some identify issues and concerns that were not discussed in detail during the roundtable and warrant further attention. For example, one commenter highlighted the need for companies to adopt sound internal controls over the legal use of software, noting that pirated and counterfeit software can expose companies to heightened risk of cyber-attacks and recommending that registrants report on the status of such internal controls.[15] *See, e.g.*, Jodie Kelly, Senior Vice President and General Counsel, BSA| The Software Alliance comment letter (Apr. 30, 2014) (noting, among other things, that unlicensed software eliminates the opportunity for security updates and patches from legitimate vendors when security breaches are identified, and that malware and viruses may be contained within pirated software itself or reside on the networks from which it is downloaded. BSA recommends that registrants report on the status of their internal controls in the area of licensing and legal use of software, and that such controls should, at a minimum, ensure that software is only purchased from authorized vendors and that companies should have procedures to conduct periodic software inventories and limit exposure to malware and viruses brought into their systems by linkage of employees' personal devices to corporate systems). I encourage others to comment and provide valuable input on this critical issue.

[16] *See, e.g.*, Model Bus. Corp. Act § 8.01 (2002); Del. Gen. Corp. Law § 141(a).

[17] For additional thoughts on the importance of effective corporate governance, *see* Commissioner Luis A. Aguilar, *Looking at Corporate Governance from the Investor's Perspective*, *available at* http://www.sec.gov/News/Speech/Detail/Speech/1370541547078.

[18] *See, e.g.*, Committee of Sponsoring Organizations of the Treadway Commission, *Effective Enterprise Risk Oversight: The Role of the Board of Directors* (2009), *available at* http://www.coso.org/documents/COSOBoardsERM4pager-FINALRELEASEVERSION82409_001.pdf ("Clearly, one result of the financial crisis is an increased focus on the effectiveness of board risk oversight practices."); Committee of Sponsoring Organizations of the Treadway Commission, *Board Risk Oversight: A Progress Report — Where Boards of Directors Currently Stand in Executing Their Risk Oversight Responsibilities* (Dec. 2010), *available at* http://www.coso.org/documents/Board-Risk-Oversight-Survey-COSO-Protiviti_000.pdf ("Risk oversight is a high priority on the agenda of most boards of directors. Recently, the importance of this responsibility has become more evident in the wake of an historic global financial crisis, which disclosed perceived risk management weaknesses across financial services and other organizations worldwide. Based on numerous legislative and regulatory actions in the United States and other countries as well as initiatives in the private sector, it is clear that expectations for more effective risk oversight are being raised not just for financial services companies, but broadly across all types of businesses."); David A. Katz, *Boards Play A Leading Role in Risk Management Oversight*, The Harvard Law School Forum on Corporate Governance and Financial Regulation (Oct. 8, 2009), *available at* http://blogs.law.harvard.edu/corpgov/2009/10/08/boards-play-a-leading-role-in-risk-management-oversight/ ("Just as the Enron and other high-profile corporate scandals were seen as resulting from a lack of ethics and oversight, the credit market meltdown and resulting financial crisis have been blamed in large part on inadequate risk management by corporations and their boards of directors. As a result, along with the task of implementing corporate governance procedures and guidelines, a company's board of directors is expected to take a leading role in overseeing risk management structures and policies.").

[19] Nicola Faith Sharpe, *Informational Autonomy in the Boardroom*, 201 U. Ill. L. Rev. 1089 (2013) ("The financial crisis of 2007-2008 was one of the worst in U.S. history. In a single quarter, the blue chip company Lehman Brothers (who eventually went bankrupt) lost $2.8 billion. While commentators have identified multiple reasons why the crisis occurred, many posit that boards mismanaged risk and failed in their oversight duties, which directly contributed to their firms failing."); Lawrence J. Trautman and Kara Altenbaumer-Price, *The Board's Responsibility for Information Technology Governance*, 28 J. Marshall J. Computer & Info. L. 313 (Spring 2011) ("With accusations that boards of directors of financial institutions were asleep at the wheel while their companies engaged in risky behavior that erased millions of

dollars of shareholder value and plunged the country into recession, increasing pressure is now being placed on public company boards to shoulder the burden of risk oversight for the companies they serve."); William B. Asher, Jr., Michael T. Gass, Erik Skramstad, and Michele Edwards, *The Role of Board of Directors in Risk Oversight in a Post-Crisis Economy*, Bloomberg Law Reports-Corporate Law Vol. 4, No. 13, *available at* http://www.choate.com/uploads/113/doc/Asher,%20Gass%20-The%20Role%20of%20Board%20of%20Directors%20in%20Risk%20Oversight%20in%20a%20Post-Crisis%20Economy.pdf ("Senior management and corporate directors face renewed criticism surrounding risk management practices and apparent failures in oversight that are considered, at least in part, to be at the root of the recent crisis.").

[20] *See, e.g.,* Stephen M. Bainbridge, *Caremark and Enterprise Risk Management*, 34 Iowa J. Corp. L. 967 (2009) ("Although primary responsibility for risk management rests with the corporation's top management team, the board of directors is responsible for ensuring that the corporation has established appropriate risk management programs and for overseeing management's implementation of such programs."); Martin Lipton, *Risk Management and the Board of Directors–An Update for 2014*, The Harvard Law School Forum on Corporate Governance and Financial Regulation (Apr. 22, 2014), *available at* http://blogs.law.harvard.edu/corpgov/2014/04/22/risk-management-and-the-board-of-directors-an-update-for-2014/ (". . . the board cannot and should not be involved in actual day-to day risk *management*. Directors should instead, through their risk oversight role, satisfy themselves that the risk management policies and procedures designed and implemented by the company's senior executives and risk managers are consistent with the company's strategy and risk appetite, that these policies and procedures are functioning as directed, and that necessary steps are taken to foster a culture of risk-aware and risk-adjusted decision making throughout the organization. The board should establish that the CEO and the senior executives are fully engaged in risk management and should also be aware of the type and magnitude of the company's principal risks that underlie its risk oversight. Through its oversight role, the board can send a message to management and employees that comprehensive risk management is neither an impediment to the conduct of business nor a mere supplement to a firm's overall compliance program, but is instead an integral component of strategy, culture and business operations.").

[21] *Proxy Disclosure Enhancements*, SEC Rel. No. 33-9089 (Dec. 16, 2009), 74 Fed. Reg. 68334, *available at* http://www.sec.gov/rules/final/2009/33-9089.pdf.

[22] *Id.* That amendment also required disclosure of a company's compensation policies and practices as they relate to a company's risk management in order to help investors identify whether the company has established a system of incentives that could lead to excessive or inappropriate risk taking by its employees.

[23] *Supra* note 19, William B. Asher, Jr. *et al.*, *The Role of Board of Directors in Risk Oversight in a Post-Crisis Economy* ("We know today, however, that risk management has indeed forced its way into the boardroom and that there has been a substantial change in the relationship between the overseers of public companies and their shareholders.").

[24] *Risk Intelligent Proxy Disclosures — 2013: Trending upward*, Deloitte (2013), *available at* http://deloitte.wsj.com/riskandcompliance/files/2014/01/Risk_Intelligent_Proxy_Disclosures_2013.pdf (noting that 91% of the issuers of proxy disclosures noted that "the full board is responsible for risk.").

[25] See, *Proxy Disclosure Enhancements*, *supra* note 21.

[26] Paul Ziobro, *Target Shareholders Should Oust Directors, ISS Says*, Wall St. Journal (May

28, 2014), *available at* http://online.wsj.com/article/BT-CO-20140528-709863.html; Bruce Carton, *ISS Recommends Ouster of Seven Target Directors for Data Breach Failures*, ComplianceWeek (May 29, 2014), *available at* http://www.complianceweek.com/iss-recommends-ouster-of-seven-target-directors-for-data-breach-failures/article/348954/?DCMP=EMC-CW-WeekendEdition.

[27] *See, e.g.*, *Risk Management and the Board of Directors–An Update for* 2014, *supra* note 2 (noting that cybersecurity is a risk management issue that "merits special attention" from the board of directors in 2014); Alice Hsu, Tracy Crum, Francine E. Friedman, and Karol A. Kepchar, *Cybersecurity Update: Are Data Breach Disclosure Requirements On Target?*, The Metropolitan Corporate Counsel (Jan. 24, 2014), *available at* http://www.metrocorpcounsel.com/articles/27148/cybersecurity-update-are-data-breach-disclosure-requirements-target ("As part of a board's risk management oversight function, directors should assess the adequacy of their company's data security measures. Among other things, boards should have a clear understanding of the company's cybersecurity risk profile and who has primary responsibility for cybersecurity risk oversight and should ensure the adequacy of the company's cyber risk management practices, as well as the company's insurance coverage for losses and costs associate with data breaches.").

[28] Charles R. Ragan, *Information Governance: It's a Duty and It's Smart Business*, 19 Rich. J.L. & Tech. 12 (2013), *available at* http://jolt.richmond.edu/v19i4/article12.pdf. (indicating that "[t]he principles thus enunciated raise the specter of potential liability if officers and directors utterly fail to ensure the adequacy of information systems."); J. Wylie Donald and Jennifer Black Strutt, *Cybersecurity: Moving Toward a Standard of Care for the Board,* Bloomberg BNA (Nov. 4, 2013), *available at* http://www.bna.com/cybersecurity-moving-toward-a-standard-of-care-for-the-board/ (quoting from a Delaware Chancery Court decision stating that directors may be liable if "(a) the directors utterly failed to implement any reporting or information system or controls; *or* (b) having implemented such a system or controls, consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention.").

[29] *See, e.g., Collier v. Steinhafel et al.* (D.C. Minn. Jan. 2014), case number 0:14-cv-00266 (alleging that Target's board and top executives harmed the company financially by failing to take adequate steps to prevent the cyber-attack then by subsequently providing customers with misleading information about the extent of the data theft.); *Dennis Palkon et al. v. Stephen P. Holmes et al*. (D.C.N.J. May 2014), case number 2:14-cv-01234 (alleging that Wyndham's board and top executives harmed the company financially by failing to take adequate steps to safeguard customers' personal and financial information.).

[30] Steven P. Blonder, *How closely is the board paying attention to cyber risks?*, Inside Counsel (formerly Corporate Legal Times) (Apr. 9, 2014), *available at* http://www.insidecounsel.com/2014/04/09/how-closely-is-the-board-paying-attention-to-cyber. (Indicating that "[i]n all likelihood, absent an incident, it is likely that board members are not spending sufficient time evaluating or analyzing the risks inherent in new technologies, as well as their related cybersecurity risks.").

[31] Jody R. Westby, *Governance of Enterprise Security: CyLab 2012 Report — How Boards & Senior Executives Are Managing Cyber Risks*, Carnegie Mellon University CyLab (May 16, 2012), at 5. (Hereinafter "CyLab 2012 Report.").

[32] *Supra note 30,* Steven P. Blonder, *How Closely is the Board Paying Attention to Cyber Risks?* (stating that "[f]urther, even if a board has evaluated these risks, to what extent is such an evaluation dependent on a company's IT department — the same group implementing the existing technology protocols?").

[33] The National Institute of Standards and Technology Framework for Improving Critical Infrastructure Cybersecurity (Feb. 12, 2014) (the "NIST Cybersecurity Framework"), *available at* http://www.nist.gov/cyberframework/upload/cybersecurity-framework-021214.pdf, was released in response to President Obama's issued Executive Order 13636, titled "Improving Critical Infrastructure Cybersecuity," dated February 12, 2013. The NIST Cybersecurity Framework sets out five core functions and categories of activities for companies to implement that relate generally to cyber-risk management and oversight, which the NIST helpfully boiled down to five terms: Identify, Protect, Detect, Respond and Recover. This core fundamentally means the following: companies should (i) *identify* known cybersecurity risks to their infrastructure; (ii) develop safeguards to *protect* the delivery and maintenance of infrastructure services; (iii) implement methods to *detect* the occurrence of a cybersecurity event; (iv) develop methods to *respond* to a detected cybersecurity event; and (v) develop plans to *recover* and restore the companies' capabilities that were impaired as a result of a cybersecurity event. *See also,* Ariel Yehezkel and Thomas Michael, *Cybersecurity: Breaching the Boardroom*, The Metropolitan Corporate Counsel (Mar. 17, 2014), *available at* http://www.sheppardmullin.com/media/article/1280_MCC-Cybersecurity-Breaching%20The%20Boardroom.pdf.

[34] *Supra note* 2, Holly J. Gregory, *Board Oversight of Cybersecurity Risks; supra note* 33, Ariel Yehezkel and Thomas Michael, *Cybersecurity: Breaching the Boardroom* (stating that "[w]hile adoption of the Cybersecurity Framework is voluntary, it will likely become a key reference for regulators, insurance companies and the plaintiffs' bar in assessing whether a company took steps reasonably designed to reduce and manage cybersecurity risks.").

[35] Matteo Tonello, *Should Your Board Have a Separate Risk Committee?*, The Harvard Law School Forum on Corporate Governance and Financial Regulation (Feb. 12, 2012), *available at* https://blogs.law.harvard.edu/corpgov/2012/02/12/should-your-board-have-a-separate-risk-committee/ (asking "[d]oes the audit committee have the time, the skills, and the support to do the job, given everything else it is required to do?").

[36] *See, e.g.*, Katie W. Johnson, *Publicly Traded Companies Should Prepare To Disclose Cybersecurity Risks, Incidents*, Bloomberg BNA (Mar. 17, 2014), *available at* http://www.bna.com/publicly-traded-companies-n17179885721/ (citing Mary Ellen Callahan, Chair of the Privacy and Information Governance Practice at Jenner & Block, LLP at the International Association of Privacy Professionals Global Privacy Summit, held in March 2014); Michael A. Gold, *Cyber Risk and the Board of Directors — Closing the Gap*, Bloomberg BNA (Oct. 18, 2013), *available at* http://www.bna.com/cyber-risk-and-the-board-of-directors-closing-the-gap// (suggesting that companies would do well to have "[m]andatory cyber risk education for directors," among other things.); *see also, The Comprehensive National Cybersecurity Initiative*, initially launched by then-President George W. Bush in 2008, referencing "Initiative #8. Expand cyber education," and *available at* http://www.whitehouse.gov/issues/foreign-policy/cybersecurity/national-initiative.

[37] *Supra* note 19, Lawrence J. Trautman and Kara Altenbaumer-Price, *The Board's Responsibility for Information Technology Governance*.

[38] *Supra* note 35, Matteo Tonello, *Should Your Board Have a Separate Risk Committee?*; *supra* note 33, Ariel Yehezkel and Thomas Michael, *Cybersecurity: Breaching the Boardroom*.

[39] Dodd-Frank Act Section 165(h).

[40] *Supra* note 19, Lawrence J. Trautman and Kara Altenbaumer-Price, *The Board's Responsibility for Information Technology Governance*.

[41] Deloitte Audit Committee Brief, *Cybersecurity and the audit committee* (Aug. 2013), at 2, *available at* http://deloitte.wsj.com/cfo/files/2013/08/ACBrief_August2013.pdf.

[42] *See*, *supra* note 31, CyLab 2012 Report, at 27.

[43] PricewaterhouseCoopers LLP, *The Global State of Information Security Survey 2014*, at 4, *available at* http://www.pwc.com/gx/en/consulting-services/information-security-survey/download.jhtml (the "PwC IS Survey"). The PwC IS Survey also noted other shared attributes, such as having (i) an overall information security strategy; (ii) measured and reviewed the effectiveness of their security measures within the past year; and (iii) an understanding as to exactly what type of security events have occurred in the past year. *See also*, *supra* note 2, Holly Gregory, *Board Oversight of Cybersecurity Risks*.

[44] *Supra* note 27, Alice Hsu, *et al.*, *Cybersecurity Update: Are Data Breach Disclosure Requirements on Target?*.

[45] *See, e.g.,* Roland L. Trope and Stephen J. Humes, *Before Rolling Blackouts Begin: Briefing Boards on Cyber Attacks That Target and Degrade the Grid,* 40 Wm. Mitchell L. Rev. 647 (2014), at 656 (stating that "unlike other corporate crises, boards and management must be ready to address severe cyber incidents with response and recovery plans that activate upon discovery of an intrusion and with little or no time for deliberation.") Some observers have even suggested that companies conduct "cyberwar games" organized around hypothetical business scenarios in order to reenact how a company might respond in a real cybersecurity situation in order to fix what vulnerabilities are teased out from the simulated scenario. Tucker Bailey, James Kaplan, and Allen Weinberg, *Playing war games to prepare for a cyberattack*, McKinsey & Company Insights & Publications (July 2012). Other observers have suggested that companies implement a response plan that takes into consideration a number of factors, such as (i) how much risk the company can accept if systems or services have to shut down; (ii) for how long the company can sustain operations using limited or backup technology; and (iii) how quickly the company can restore full operations. *See, Former FBI Agent Mary Galligan on Preparing for a Cyber Attack,* CIO Journal, Deloitte Insights (Mar. 3, 2104), *available at* http://deloitte.wsj.com/cio/2014/03/03/former-fbi-agent-mary-galligan-on-preparing-for-a-cyber-attack/.

[46] *See, e.g., id.*, Roland L. Trope and Stephen J. Humes, *Before Rolling Blackouts Begin: Briefing Boards on Cyber Attacks That Target and Degrade the Grid*, at 656.

[47] *Supra* note 45, Tucker Bailey, James Kaplan, and Allen Weinberg, *Playing War Games to Prepare for a Cyberattack*.

[48] *Supra* note 33, Ariel Yehezkel and Thomas Michael, *Cybersecurity: Breaching the Boardroom*, Metropolitan Corporate Counsel (stating that "Boards should prepare for worst-case scenario cybersecurity breaches and help management develop immediate response plans, including public disclosure procedures and economic recovery strategies, to mitigate potential damages." In addition, "[b]oards should consider disclosing cybersecurity risks and protective measures on relevant SEC filings, as such disclosures can generate confidence in investors rather than fear.") The U.S. Department of Commerce also has suggested that a company's cybersecurity preparedness could include cybersecurity insurance, which is specifically designed to mitigate losses from a variety of cyber incidents, including data breaches, business interruption, and network damage. *Cybersecurity Insurance*, U.S. Department of Homeland Security, *available at* http://www.dhs.gov/publication/cybersecurity-insurance. Despite the increased threats of cyber-attacks, the cybersecurity insurance market has been slow to develop, and many companies have chosen to forego available policies, citing their perceived high cost, a lack of awareness about what they cover, and their confidence (or ignorance) about

their actual risk of a cyber-attack. *Id.* Moreover, despite the fact that cyber incidents are not covered by general liability policies, one survey noted that 57% of respondents indicated that their boards are not reviewing their existing policies for cyber-related risks. *See*, *supra* note 31, CyLab 2012 Report, at 15.

[49] The Department of Justice recently unsealed indictments against five Chinese military officials who allegedly conspired to steal information from U.S. companies across different industries. In connection with this indictment, it was recently reported that three U.S. public companies identified as victims of this conspiracy failed to report the theft of trade secrets and other data to their investors, despite the Commission's disclosure guidance on this topic. Two of the companies, Alcoa Inc. and Allegheny Technologies Inc., said that the thefts were not "material," and therefore did not have to be disclosed to investors. *See,* Chris Strohm, Dave Michaels and Sonja Elmquist, *U.S. Companies Hacked by Chinese Didn't Tell Investors*, Bloomberg (May 21, 2014), *available at* http://www.bloomberg.com/news/2014-05-21/u-s-companies-hacked-by-chinese-didn-t-tell-investors.html*; See also, supra note 14.*

Modified: June 10, 2014

EXHIBIT D

101 S.Ct. 677
Supreme Court of the United States

UPJOHN COMPANY et al., Petitioners,
v.
UNITED STATES et al.

No. 79–886.
|
Argued Nov. 5, 1980.
|
Decided Jan. 13, 1981.

Corporation and in–house general counsel appealed from order of the United States District Court for the Western District of Michigan, Noel P. Fox, Chief Judge, enforcing an Internal Revenue summons for documents. The Court of Appeals, Sixth Circuit, 600 F.2d 1223, affirmed in part, reversed in part and remanded. Certiorari was granted, and the Supreme Court, Justice Rehnquist, held that: (1) District Court's test, of availability of attorney–client privilege, was objectionable as it restricted availability of privilege to those corporate officers who played "substantial role" in deciding and directing corporation's legal response; (2) where communications at issue were made by corporate employees to counsel for corporation acting as such, at direction of corporate superiors in order to secure legal advice from counsel, and employees were aware that they were being questioned so that corporation could obtain advice, such communications were protected; and (3) where notes and memoranda sought by government were work products based on oral statements of witnesses, they were, if they revealed communications, protected by privilege, and to extent they did not reveal communications, they revealed attorney's mental processes in evaluating the communications and disclosure would not be required simply on showing of substantial need and inability to obtain equivalent without undue hardship.

Judgment of Court of Appeals reversed, and case remanded.

Chief Justice Burger filed an opinion concurring in part and concurring in the judgment.

****679** *Syllabus* [*]

***383** When the General Counsel for petitioner pharmaceutical manufacturing corporation (hereafter petitioner) was informed that one of its foreign subsidiaries had made questionable payments to foreign government officials in order to secure government business, an internal investigation of such payments was initiated. As part of this investigation, petitioner's attorneys sent a questionnaire to all foreign managers seeking detailed information concerning such payments, and the responses were returned to the General Counsel. The General Counsel and outside counsel also interviewed the recipients of the questionnaire and other company officers and employees. Subsequently, based on a report voluntarily submitted by petitioner disclosing the questionable payments, the Internal Revenue Service (IRS) began an investigation to determine the tax consequences of such payments and issued a summons pursuant to 26 U.S.C. § 7602 demanding production of, *inter alia*, the questionnaires and the memoranda and notes of the interviews. Petitioner refused to produce the documents on the grounds that they were protected from disclosure by the attorney–client privilege and constituted the work product of attorneys prepared in anticipation of litigation. The United States then filed a petition in Federal District Court seeking enforcement of the summons. That court adopted the Magistrate's recommendation that the summons should be enforced, the Magistrate having concluded, *inter alia*, that the attorney–client privilege had been waived and that the Government had made a sufficient showing of necessity to overcome the protection of the work–product doctrine. The Court of Appeals rejected the Magistrate's finding of a waiver of the attorney–client privilege, but held that under the so–called "control group test" the privilege did not apply "[t]o the extent that the communications were made by officers and agents not responsible for directing [petitioner's] actions in response to legal advice ... for the simple reason that the communications were not the 'client's.' " The court also held that the work–product doctrine did not apply to IRS summonses.

Held:

1. The communications by petitioner's employees to counsel are covered by the attorney–client privilege insofar as the responses to the ***384** questionnaires and any notes reflecting responses to interview questions are concerned. Pp. 682–686.

(a) The control group test overlooks the fact that such privilege exists to protect not only the giving of professional advice to ****680** those who can act on it but also the giving of information to the lawyer to enable him to give sound and informed advice. While in the case of the individual client the provider of information and the person who acts on the lawyer's advice are one and the same, in the corporate context it will frequently be employees beyond the control group (as defined by the Court of Appeals) who will possess the information needed by the corporation's lawyers. Middle–level—and indeed lower–level—employees can, by actions within the scope of their employment, embroil the corporation in serious legal difficulties, and it is only natural that these employees would have the relevant information needed by corporate counsel if he is adequately to advise the client with respect to such actual or potential difficulties. Pp. 683–684.

(b) The control group test thus frustrates the very purpose of the attorney–client privilege by discouraging the communication of relevant information by employees of the client corporation to attorneys seeking to render legal advice to the client. The attorney's advice will also frequently be more significant to noncontrol employees than to those who officially sanction the advice, and the control group test makes it more difficult to convey full and frank legal advice to the employees who will put into effect the client corporation's policy. P. 684.

(c) The narrow scope given the attorney–client privilege by the Court of Appeals not only makes it difficult for corporate attorneys to formulate sound advice when their client is faced with a specific legal problem but also threatens to limit the valuable efforts of corporate counsel to ensure their client's compliance with the law. P. 684.

(d) Here, the communications at issue were made by petitioner's employees to counsel for petitioner acting as such, at the direction of corporate superiors in order to secure legal advice from counsel. Information not available from upper–echelon management was needed to supply a basis for legal advice concerning compliance with securities and tax laws, foreign laws, currency regulations, duties to shareholders, and potential litigation in each of these areas. The communications concerned matters within the scope of the employees' corporate duties, and the employees themselves were sufficiently aware that they were being questioned in order that the corporation could obtain legal advice. P. 685.

2. The work–product doctrine applies to IRS summonses. Pp. 686–689.

(a) The obligation imposed by a tax summons remains subject to the traditional privileges and limitations, and nothing in the language ***385** or legislative history of the IRS summons provisions suggests an intent on the part of Congress to preclude application of the work–product doctrine. P. 687.

(b) The Magistrate applied the wrong standard when he concluded that the Government had made a sufficient showing of necessity to overcome the protections of the work–product doctrine. The notes and memoranda sought by the Government constitute work product based on oral statements. If they reveal communications, they are protected by the attorney–client privilege. To the extent they do not reveal communications they reveal attorneys' mental processes in evaluating the communications. As Federal Rule of Civil Procedure 26, which accords special protection from disclosure to work product revealing an attorney's mental processes, and *Hickman v. Taylor*, 329 U.S. 495, 67 S.Ct. 385, 91 L.Ed. 451, make clear, such work product cannot be disclosed simply on a showing of substantial need or inability to obtain the equivalent without undue hardship. P. 688.

600 F.2d 1223, 6 Cir., reversed and remanded.

Attorneys and Law Firms

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Lawrence G. Wallace, Washington, D. C., for respondents.

Opinion

***386** ****681** Justice REHNQUIST delivered the opinion of the Court.

We granted certiorari in this case to address important questions concerning the scope of the attorney–client privilege in the corporate context and the applicability of the work–product doctrine in proceedings to enforce tax summonses. 445 U.S. 925, 100 S.Ct. 1310, 63 L.Ed.2d 758. With respect to the privilege question the parties and various *amici* have described our task as one of choosing between two "tests" which have gained adherents in the courts of appeals. We are acutely aware, however, that we sit to decide concrete cases and not abstract propositions of law. We decline to lay down a broad rule or series of rules to govern all conceivable future questions in this area, even were we able to do so. We can and do, however, conclude that the attorney–client privilege protects the communications involved in this case from compelled disclosure and that the work–product doctrine does apply in tax summons enforcement proceedings.

I

Petitioner Upjohn Co. manufactures and sells pharmaceuticals here and abroad. In January 1976 independent accountants conducting an audit of one of Upjohn's foreign subsidiaries discovered that the subsidiary made payments to or for the benefit of foreign government officials in order to secure government business. The accountants, so informed petitioner, Mr. Gerard Thomas, Upjohn's Vice President, Secretary, and General Counsel. Thomas is a member of the Michigan and New York Bars, and has been Upjohn's General Counsel for 20 years. He consulted with outside counsel and R. T. Parfet, Jr., Upjohn's Chairman of the Board. It was decided that the company would conduct an internal investigation of what were termed “questionable payments.” As part of this investigation the attorneys prepared a letter containing a questionnaire which was sent to “All Foreign General and Area Managers” over the Chairman's signature. The letter ***387** began by noting recent disclosures that several American companies made “possibly illegal” payments to foreign government officials and emphasized that the management needed full information concerning any such payments made by Upjohn. The letter indicated that the Chairman had asked Thomas, identified as “the company's General Counsel,” “to conduct an investigation for the purpose of determining the nature and magnitude of any payments made by the Upjohn Company or any of its subsidiaries to any employee or official of a foreign government.” The questionnaire sought detailed information concerning such payments. Managers were instructed to treat the investigation as “highly confidential” and not to discuss it with anyone other than Upjohn employees who might be helpful in providing the requested information. Responses were to be sent directly to Thomas. Thomas and outside counsel also interviewed the recipients of the questionnaire and some 33 other Upjohn officers or employees as part of the investigation.

On March 26, 1976, the company voluntarily submitted a preliminary report to the Securities and Exchange Commission on Form 8–K disclosing certain questionable payments. [1] A copy of the report was simultaneously submitted to the Internal Revenue Service, which immediately began an investigation to determine the tax consequences of the payments. Special agents conducting the investigation were given lists by Upjohn of all those interviewed and all who had responded to the questionnaire. On November 23, 1976, the Service issued a summons pursuant to 26 U.S.C. § 7602 demanding production of:

> “All files relative to the investigation conducted under the supervision of Gerard Thomas to identify payments to employees of foreign governments and any ****682** political ***388** contributions made by the Upjohn Company or any of its affiliates since January 1, 1971 and to determine whether any funds of the Upjohn Company had been improperly accounted for on the corporate books during the same period.
>
>> “The records should include but not be limited to written questionnaires sent to managers of the Upjohn Company's foreign affiliates, and memorandums or notes of the interviews conducted in the United States and abroad with officers and employees of the Upjohn Company and its subsidiaries.” App. 17a–18a.

The company declined to produce the documents specified in the second paragraph on the grounds that they were protected from disclosure by the attorney–client privilege and constituted the work product of attorneys prepared in anticipation of litigation. On August 31, 1977, the United States filed a petition seeking enforcement of the summons under 26 U.S.C. §§ 7402(b) and 7604(a) in the United States District Court for the Western District of Michigan. That court adopted the recommendation of a Magistrate who concluded that the summons should be enforced. Petitioners appealed to the Court of Appeals for the Sixth Circuit which rejected the Magistrate's finding of a waiver of the attorney–client privilege, 600 F.2d 1223, 1227, n. 12, but agreed that the privilege did not apply “[t]o the extent that the communications were made by officers and agents not responsible for directing Upjohn's actions in response to legal advice ... for the simple reason that the communications were not the ‘client's.’ ” *Id.*, at 1225. The court reasoned that accepting petitioners' claim for a broader application of the privilege would encourage upper–echelon management to ignore unpleasant facts and create too broad a “zone of silence.” Noting that Upjohn's counsel had interviewed officials such as the Chairman and President, the Court of Appeals remanded to the District Court so that a determination of who was ***389** within the “control group” could be made. In a concluding footnote the court stated that the work–product doctrine “is not applicable to administrative summonses issued under 26 U.S.C. § 7602." *Id.*, at 1228, n. 13.

II

[1] **[2]** Federal Rule of Evidence 501 provides that "the privilege of a witness ... shall be governed by the principles of the common law as they may be interpreted by the courts of the United States in light of reason and experience." The attorney–client privilege is the oldest of the privileges for confidential communications known to the common law. 8 J. Wigmore, Evidence § 2290 (McNaughton rev. 1961). Its purpose is to encourage full and frank communication between attorneys and their clients and thereby promote broader public interests in the observance of law and administration of justice. The privilege recognizes that sound legal advice or advocacy serves public ends and that such advice or advocacy depends upon the lawyer's being fully informed by the client. As we stated last Term in *Trammel v. United States*, 445 U.S. 40, 51, 100 S.Ct. 906, 913, 63 L.Ed.2d 186 (1980): "The lawyer–client privilege rests on the need for the advocate and counselor to know all that relates to the client's reasons for seeking representation if the professional mission is to be carried out." And in *Fisher v. United States*, 425 U.S. 391, 403, 96 S.Ct. 1569, 1577, 48 L.Ed.2d 39 (1976), we recognized the purpose of the privilege to be "to encourage clients to make full disclosure to their attorneys." This rationale for the privilege has long been recognized by the Court, see *Hunt v. Blackburn*, 128 U.S. 464, 470, 9 S.Ct. 125, 127, 32 L.Ed. 488 (1888) (privilege "is founded upon the necessity, in the interest and administration of justice, of the aid of persons having knowledge of the law and skilled in its practice, which assistance can only be safely and readily availed of when free from the consequences or the apprehension of disclosure"). Admittedly complications in the application of the privilege arise when the client is a corporation, which in theory is an artificial creature of the ***390** ****683** law, and not an individual; but this Court has assumed that the privilege applies when the client is a corporation. *United States v. Louisville & Nashville R. Co.*, 236 U.S. 318, 336, 35 S.Ct. 363, 369, 59 L.Ed. 598 (1915), and the Government does not contest the general proposition.

[3] The Court of Appeals, however, considered the application of the privilege in the corporate context to present a "different problem," since the client was an inanimate entity and "only the senior management, guiding and integrating the several operations, ... can be said to possess an identity analogous to the corporation as a whole." 600 F.2d at 1226. The first case to articulate the so–called "control group test" adopted by the court below, *Philadelphia v. Westinghouse Electric Corp.*, 210 F.Supp. 483, 485 (ED Pa.), petition for mandamus and prohibition denied *sub nom. General Electric Co. v. Kirkpatrick*, 312 F.2d 742 (CA3 1962), cert. denied, 372 U.S. 943, 83 S.Ct. 937, 9 L.Ed.2d 969 (1963), reflected a similar conceptual approach:

> "Keeping in mind that the question is, Is it the corporation which is seeking the lawyer's advice when the asserted privileged communication is made?, the most satisfactory solution, I think, is that if the employee making the communication, of whatever rank he may be, is in a position to control or even to take a substantial part in a decision about any action which the corporation may take upon the advice of the attorney, ... then, in effect, *he is (or personifies) the corporation* when he makes his disclosure to the lawyer and the privilege would apply." (Emphasis supplied.)

Such a view, we think, overlooks the fact that the privilege exists to protect not only the giving of professional advice to those who can act on it but also the giving of information to the lawyer to enable him to give sound and informed advice. See *Trammel*, *supra*, at 51, 100 S.Ct., at 913; *Fisher*, *supra*, at 403, 96 S.Ct., at 1577. The first step in the resolution of any legal problem is ascertaining the factual background and sifting through the facts ***391** with an eye to the legally relevant. See ABA Code of Professional Responsibility, Ethical Consideration 4–1:

> "A lawyer should be fully informed of all the facts of the matter he is handling in order for his client to obtain the full advantage of our legal system. It is for the lawyer in the exercise of his independent professional judgment to separate the relevant and important from the irrelevant and unimportant. The observance of the ethical obligation of a lawyer to hold inviolate the confidences and secrets of his client not only facilitates the full development of facts essential to proper representation of the client but also encourages laymen to seek early legal assistance."

See also *Hickman v. Taylor*, 329 U.S. 495, 511, 67 S.Ct. 385, 393–394, 91 L.Ed. 451 (1947).

In the case of the individual client the provider of information and the person who acts on the lawyer's advice are one and the same. In the corporate context, however, it will frequently be employees beyond the control group as defined by the court below–"officers and agents ... responsible for directing [the company's] actions in response to legal advice"–who will possess the information needed by the corporation's lawyers. Middle–level—and indeed lower–level—employees can, by actions within the scope of their employment, embroil the corporation in serious legal difficulties, and it is only natural that these employees would have the relevant information needed by corporate counsel if he is adequately to advise the client with respect to such actual or potential difficulties. This fact was noted in *Diversified Industries, Inc. v. Meredith*, 572 F.2d 596 (CA8 1978) (en banc):

> "In a corporation, it may be necessary to glean information relevant to a legal problem from middle management or non–management personnel as well as from top executives. The attorney dealing with a complex legal problem 'is thus faced with a "Hobson's choice". If he ****684** interviews employees not having "the very highest authority", ***392** their communications to him will not be privileged. If, on the other hand, he interviews *only* those employees with the "very highest authority", he may find it extremely difficult, if not impossible, to determine what happened.' " *Id.*, at 608–609 (quoting Weinschel Corporate Employee Interviews and the Attorney–Client Privilege, 12 B.C.Ind. & Com. L.Rev. 873, 876 (1971)).

[4] The control group test adopted by the court below thus frustrates the very purpose of the privilege by discouraging the communication of relevant information by employees of the client to attorneys seeking to render legal advice to the client corporation. The attorney's advice will also frequently be more significant to noncontrol group members than to those who officially sanction the advice, and the control group test makes it more difficult to convey full and frank legal advice to the employees who will put into effect the client corporation's policy. See, *e. g., Duplan Corp. v. Deering Milliken, Inc.*, 397 F.Supp. 1146, 1164 (DSC 1974) ("After the lawyer forms his or her opinion, it is of no immediate benefit to the Chairman of the Board or the President. It must be given to the corporate personnel who will apply it").

The narrow scope given the attorney–client privilege by the court below not only makes it difficult for corporate attorneys to formulate sound advice when their client is faced with a specific legal problem but also threatens to limit the valuable efforts of corporate counsel to ensure their client's compliance with the law. In light of the vast and complicated array of regulatory legislation confronting the modern corporation, corporations, unlike most individuals, "constantly go to lawyers to find out how to obey the law," Burnham, The Attorney–Client Privilege in the Corporate Arena, 24 Bus.Law. 901, 913 (1969), particularly since compliance with the law in this area is hardly an instinctive matter, see, *e. g., United States v. United States Gypsum Co.*, 438 U.S. 422, 440–441, 98 S.Ct. 2864, 2875–2876, 57 L.Ed.2d 854 (1978) ("the behavior proscribed by the [Sherman] Act is ***393** often difficult to distinguish from the gray zone of socially acceptable and economically justifiable business conduct").[2] The test adopted by the court below is difficult to apply in practice, though no abstractly formulated and unvarying "test" will necessarily enable courts to decide questions such as this with mathematical precision. But if the purpose of the attorney–client privilege is to be served, the attorney and client must be able to predict with some degree of certainty whether particular discussions will be protected. An uncertain privilege, or one which purports to be certain but results in widely varying applications by the courts, is little better than no privilege at all. The very terms of the test adopted by the court below suggest the unpredictability of its application. The test restricts the availability of the privilege to those officers who play a "substantial role" in deciding and directing a corporation's legal response. Disparate decisions in cases applying this test illustrate its unpredictability. Compare, *e. g., Hogan v. Zletz*, 43 F.R.D. 308, 315–316 (ND Okl.1967), aff'd in part *sub nom. Natta v. Hogan*, 392 F.2d 686 (CA10 1968) (control group includes managers and assistant managers of patent division and research and development department), with *Congoleum Industries, Inc. v. GAF Corp.*, 49 F.R.D. 82, 83–85 (ED Pa.1969), aff'd, 478 F.2d 1398 (CA3 1973) (control group includes only division and corporate ****685** vice presidents, and not two directors of research and vice president for production and research).

***394** **[5]** The communications at issue were made by Upjohn employees[3] to counsel for Upjohn acting as such, at the direction of corporate superiors in order to secure legal advice from counsel. As the Magistrate found, "Mr. Thomas consulted with the Chairman of the Board and outside counsel and thereafter conducted a factual investigation to determine the nature and extent of the questionable payments *and to be* *in a position to give legal advice to the company with respect to the payments*." (Emphasis supplied.) 78–1 USTC ¶ 9277, pp. 83,598, 83,599. Information, not available from upper–echelon management, was needed to supply a basis for legal advice concerning compliance with securities and tax laws, foreign laws, currency regulations, duties to shareholders, and potential litigation in each of these areas.[4] The communications concerned matters within the scope of the employees' corporate duties, and the employees themselves were sufficiently aware that they were being questioned in order that the corporation could obtain legal advice. The questionnaire identified Thomas as "the company's General Counsel" and referred in its opening sentence to the possible illegality of payments such as the ones on which information was sought. App. 40a. A statement of policy accompanying the questionnaire clearly indicated the legal implications of the investigation. The policy statement was issued "in order that there be no uncertainty in the future as to the policy with respect to the practices which are the subject of this investigation." ***395** It began "Upjohn will comply with all laws and regulations," and stated that commissions or payments "will not be used as a subterfuge for bribes or illegal payments" and that all payments must be "proper and legal." Any future agreements with foreign distributors or agents were to be approved "by a company attorney" and any questions concerning the policy were to be referred "to the company's General Counsel." *Id.*, at 165a–166a. This statement was issued to Upjohn employees worldwide, so that even those interviewees not receiving a questionnaire were aware of the legal implications of the interviews. Pursuant to explicit instructions from the Chairman of the Board, the communications were considered "highly confidential" when made, *id.*, at 39a, 43a, and have been kept confidential by the company.[5] Consistent with the underlying purposes of the attorney–client privilege, these communications must be protected against compelled disclosure.

[6] The Court of Appeals declined to extend the attorney–client privilege beyond the limits of the control group test for fear that doing so would entail severe burdens on discovery and create a broad "zone of silence" over corporate affairs. Application of the attorney–client privilege to communications such as those involved here, however, puts the adversary in no worse position than if the communications had never taken place. The privilege only protects disclosure of communications; it does not protect disclosure of the underlying facts by those who communicated with the attorney:

> "[T]he protection of the privilege extends only to *communications* and not to facts. A fact is one thing and a communication concerning that fact is an entirely different ****686 *396** thing. The client cannot be compelled to answer the question, 'What did you say or write to the attorney?' but may not refuse to disclose any relevant fact within his knowledge merely because he incorporated a statement of such fact into his communication to his attorney." *Philadelphia v. Westinghouse Electric Corp.*, 205 F.Supp. 830, 831 (q2.7).

See also *Diversified Industries*, 572 F.2d., at 611; *State ex rel. Dudek v. Circuit Court*, 34 Wis.2d 559, 580, 150 N.W.2d 387, 399 (1967) ("the courts have noted that a party cannot conceal a fact merely by revealing it to his lawyer"). Here the Government was free to question the employees who communicated with Thomas and outside counsel. Upjohn has provided the IRS with a list of such employees, and the IRS has already interviewed some 25 of them. While it would probably be more convenient for the Government to secure the results of petitioner's internal investigation by simply subpoenaing the questionnaires and notes taken by petitioner's attorneys, such considerations of convenience do not overcome the policies served by the attorney–client privilege. As Justice Jackson noted in his concurring opinion in *Hickman v. Taylor*, 329 U.S., at 516, 67 S.Ct., at 396: "Discovery was hardly intended to enable a learned profession to perform its functions ... on wits borrowed from the adversary."

[7] Needless to say, we decide only the case before us, and do not undertake to draft a set of rules which should govern challenges to investigatory subpoenas. Any such approach would violate the spirit of Federal Rule of Evidence 501. See S.Rep. No. 93–1277, p. 13 (1974) ("the recognition of a privilege based on a confidential relationship ... should be determined on a case–by–case basis"); *Trammel*, 445 U.S., at 47, 100 S.Ct., at 910–911; *United States v. Gillock*, 445 U.S. 360, 367, 100 S.Ct. 1185, 1190, 63 L.Ed.2d 454 (1980). While such a "case–by–case" basis may to some slight extent undermine desirable certainty in the boundaries of the attorney–clientt ***397** privilege, it obeys the spirit of the Rules. At the same time we conclude that the narrow "control group test" sanctioned by the Court of Appeals, in this case cannot, consistent with "the principles of the common law as ... interpreted ... in the light of reason and experience," Fed. Rule Evid. 501, govern the development of the law in this area.

III

Our decision that the communications by Upjohn employees to counsel are covered by the attorney–client privilege disposes of the case so far as the responses to the questionnaires and any notes reflecting responses to interview questions are concerned. The summons reaches further, however, and Thomas has testified that his notes and memoranda of interviews go beyond recording responses to his questions. App. 27a–28a, 91a–93a. To the extent that the material subject to the summons is not protected by the attorney–client privilege as disclosing communications between an employee and counsel, we must reach the ruling by the Court of Appeals that the work–product doctrine does not apply to summonses issued under 26 U.S.C. § 7602. [6]

[8] [9] [10] The Government concedes, wisely, that the Court of Appeals erred and that the work–product doctrine does apply to IRS summonses. Brief for Respondents 16, 48. This doctrine was announced by the Court over 30 years ago in *Hickman v. Taylor*, 329 U.S. 495, 67 S.Ct. 385, 91 L.Ed. 451 (1947). In that case the Court rejected "an attempt, without purported necessity or justification, to secure written statements, private memoranda and personal recollections prepared or formed by an adverse party's counsel in the course of his legal duties." *Id.*, at 510, 67 S.Ct., at 393. The Court noted that "it is essential that a lawyer work with ***398** a certain degree of privacy" ****687** and reasoned that if discovery of the material sought were permitted

> "much of what is now put down in writing would remain unwritten. An attorney's thoughts, heretofore inviolate, would not be his own. Inefficiency, unfairness and sharp practices would inevitably develop in the giving of legal advice and in the preparation of cases for trial. The effect on the legal profession would be demoralizing. And the interests of the clients and the cause of justice would be poorly served." *Id.*, at 511, 67 S.Ct., at 393–394.

The "strong public policy" underlying the work–product doctrine was reaffirmed recently in *United States v. Nobles*, 422 U.S. 225, 236–240, 95 S.Ct. 2160, 2169–2171, 45 L.Ed.2d 141 (1975), and has been substantially incorporated in Federal Rule of Civil Procedure 26(b)(3). [7]

As we stated last Term, the obligation imposed by a tax summons remains "subject to the traditional privileges and limitations." *United States v. Euge*, 444 U.S. 707, 714, 100 S.Ct. 874, 879–880, 63 L.Ed.2d 741 (1980). Nothing in the language of the IRS summons provisions or their legislative history suggests an intent on the part of Congress to preclude application of the work–product doctrine. Rule 26(b)(3) codifies the work–product doctrine, and the Federal Rules of Civil Procedure are made applicable ***399** to summons enforcement proceedings by Rule 81(a)(3). See *Donaldson v. United States*, 400 U.S. 517, 528, 91 S.Ct. 534, 541, 27 L.Ed.2d 580 (1971). While conceding the applicability of the work–product doctrine, the Government asserts that it has made a sufficient showing of necessity to overcome its protections. The Magistrate apparently so found, 78–1 USTC ¶ 9277, p. 83,605. The Government relies on the following language in *Hickman*:

> "We do not mean to say that all written materials obtained or prepared by an adversary's counsel with an eye toward litigation are necessarily free from discovery in all cases. Where relevant and nonprivileged facts remain hidden in an attorney's file and where production of those facts is essential to the preparation of one's case, discovery may properly be had.... And production might be justified where the witnesses are no longer available or can be reached only with difficulty." 329 U.S., at 511, 67 S.Ct., at 394.

The Government stresses that interviewees are scattered across the globe and that Upjohn has forbidden its employees to answer questions it considers irrelevant. The above–quoted language from *Hickman*, however, did not apply to "oral statements made by witnesses ... whether presently in the form of [the attorney's] mental impressions or memoranda." *Id.*, at 512, 67 S.Ct., at 394. As to such material the Court did "not believe that any showing of necessity can be made under the circumstances of this case so as to justify production.... If there should be a rare situation justifying production of these matters petitioner's case is not of that type." *Id.*, at 512–513, 67 S.Ct., at 394–395. See also *Nobles*, *supra*, 422 U.S., at 252–253, 95 S.Ct., at 2177 (WHITE, J., concurring). Forcing an attorney to disclose notes and memoranda of witnesses' oral statements is particularly disfavored because it tends to reveal the attorney's mental processes, 329 U. S., at 513, 67 S.Ct., at 394–395 ("what he saw fit to write down regarding witnesses' remarks"); *id*, at 516–517, 67 S.Ct., at 396 ****688** ("the statement would be his [the ***400** attorney's] language, permeated with his inferences") (Jackson, J., concurring). [8]

Rule 26 accords special protection to work product revealing the attorney's mental processes. The Rule permits disclosure of documents and tangible things constituting attorney work product upon a showing of substantial need and inability to obtain the equivalent without undue hardship. This was the standard applied by the Magistrate, 78–1 USTC ¶ 9277, p. 83,604. Rule 26 goes on, however, to state that "[i]n ordering discovery of such materials when the required showing has been made, the court shall protect against disclosure of the mental impressions, conclusions, opinions or legal theories of an attorney or other representative of a party concerning the litigation." Although this language does not specifically refer to memoranda based on oral statements of witnesses, the *Hickman* court stressed the danger that compelled disclosure of such memoranda would reveal the attorney's mental processes. It is clear that this is the sort of material the draftsmen of the Rule had in mind as deserving special protection. See Notes of Advisory Committee on 1970 Amendment to Rules, 28 U.S.C.App., p. 442 ("The subdivision ... goes on to protect against disclosure the mental impressions, conclusions, opinions, or legal theories ... of an attorney or other representative of a party. The *Hickman* opinion drew special attention to the need for protecting an attorney against discovery of memoranda prepared from recollection of oral interviews. The courts have steadfastly safeguarded against disclosure of lawyers' mental impressions and legal theories ...").

***401** Based on the foregoing, some courts have concluded that *no* showing of necessity can overcome protection of work product which is based on oral statements from witnesses. See, *e. g., In re Grand Jury Proceedings,* 473 F.2d 840, 848 (CA8 1973) (personal recollections, notes, and memoranda pertaining to conversation with witnesses); *In re Grand Jury Investigation*, 412 F.Supp. 943, 949 (ED Pa.1976) (notes of conversation with witness "are so much a product of the lawyer's thinking and so little probative of the witness's actual words that they are absolutely protected from disclosure"). Those courts declining to adopt an absolute rule have nonetheless recognized that such material is entitled to special protection. See, *e. g., In re Grand Jury Investigation*, 599 F.2d 1224, 1231 (CA3 1979) ("special considerations ... must shape any ruling on the discoverability of interview memoranda ...; such documents will be discoverable only in a 'rare situation' "); Cf. *In re Grand Jury Subpoena*, 599 F.2d 504, 511–512 (CA2 1979).

We do not decide the issue at this time. It is clear that the Magistrate applied the wrong standard when he concluded that the Government had made a sufficient showing of necessity to overcome the protections of the work–product doctrine. The Magistrate applied the "substantial need" and "without undue hardship" standard articulated in the first part of Rule 26(b)(3). The notes and memoranda sought by the Government here, however, are work product based on oral statements. If they reveal communications, they are, in this case, protected by the attorney–client privilege. To the extent they do not reveal communications, they reveal the attorneys' mental processes in evaluating the communications. As Rule 26 and *Hickman* make clear, such work product cannot be disclosed simply on a showing of substantial need and inability to obtain the equivalent without undue hardship.

While we are not prepared at this juncture to say that such material is always protected by the work–product rule, we ***402 **689** think a far stronger showing of necessity and unavailability by other means than was made by the Government or applied by the Magistrate in this case would be necessary to compel disclosure. Since the Court of Appeals thought that the work–product protection was never applicable in an enforcement proceeding such as this, and since the Magistrate whose recommendations the District Court adopted applied too lenient a standard of protection, we think the best procedure with respect to this aspect of the case would be to reverse the judgment of the Court of Appeals for the Sixth Circuit and remand the case to it for such further proceedings in connection with the work–product claim as are consistent with this opinion.

Accordingly, the judgment of the Court of Appeals is reversed, and the case remanded for further proceedings.

It is so ordered.

Chief Justice BURGER, concurring in part and concurring in the judgment.

I join in Parts I and III of the opinion of the Court and in the judgment. As to Part II, I agree fully with the Court's rejection of the so–called "control group" test, its reasons for doing so, and its ultimate holding that the communications at issue are privileged. As the Court states, however, "if the purpose of the attorney–client privilege is to be served, the attorney and client must be able to predict with some degree of certainty whether particular discussions will be protected." *Ante*, at 684. For this very reason, I believe that we should articulate a standard that will govern similar cases and afford guidance to corporations, counsel advising them, and federal courts.

The Court properly relies on a variety of factors in concluding that the communications now before us are privileged. See *ante*, at 685. Because of the great importance of the issue, in my view the Court should make clear now that, as a ***403** general rule, a communication is privileged at least when, as here, an employee or former employee speaks at the direction of the management with an attorney regarding conduct or proposed conduct within the scope of employment. The attorney must be one authorized by the management to inquire into the subject and must be seeking information to assist counsel in performing any of the following functions: (a) evaluating whether the employee's conduct has bound or would bind the corporation; (b) assessing the legal consequences, if any, of that conduct; or (c) formulating appropriate legal responses to actions that have been or may be taken by others with regard to that conduct. See, *e. g., Diversified Industries, Inc. v. Meredith*, 572 F.2d 596, 609 (CA8 1978) (en banc); *Harper & Row Publishers, Inc. v. Decker*, 423 F.2d 487, 491–492 (CA7 1970), aff'd by an equally divided Court, 400 U.S. 348, 91 S.Ct. 479, 27 L.Ed.2d 433 (1971); *Duplan Corp v. Deering Milliken, Inc.*, 397 F.Supp. 1146, 1163–1165 (DSC 1974). Other communications between employees and corporate counsel may indeed be privileged—as the petitioners and several *amici* have suggested in their proposed formulations [*] —but the need for certainty does not compel us now to prescribe all the details of the privilege in this case.

Nevertheless, to say we should not reach all facets of the privilege does not mean that we should neglect our duty to provide guidance in a case that squarely presents the question in a traditional adversary context. Indeed, because Federal Rule of Evidence 501 provides that the law of privileges "shall be governed by the principles of the common law as they may be interpreted by the courts of the United States in the light of reason and experience," this Court has a special duty to clarify aspects of the law of privileges properly ***404** before us. Simply asserting that this failure "may to some slight extent undermine desirable certainty," *ante*, at 686, neither minimizes the consequences ****690** of continuing uncertainty and confusion nor harmonizes the inherent dissonance of acknowledging that uncertainty while declining to clarify it within the frame of issues presented.

All Citations

449 U.S. 383, 101 S.Ct. 677, 66 L.Ed.2d 584, 47 A.F.T.R.2d 81-523, 30 Fed.R.Serv.2d 1101, 81-1 USTC P 9138, Fed. Sec. L. Rep. P 97,817, 1980-81 Trade Cases P 63,797, 1981-1 C.B. 591, 7 Fed. R. Evid. Serv. 785

Footnotes

* The syllabus constitutes no part of the opinion of the Court but has been prepared by the Reporter of Decisions for the convenience of the reader. See *United States v. Detroit Lumber Co.*, 200 U.S. 321, 337, 26 S.Ct. 282, 288, 50 L.Ed. 499.

1 On July 28, 1976, the company filed an amendment to this report disclosing further payments.

2 The Government argues that the risk of civil or criminal liability suffices to ensure that corporations will seek legal advice in the absence of the protection of the privilege. This response ignores the fact that the depth and quality of any investigations, to ensure compliance with the law would suffer, even were they undertaken. The response also proves too much, since it applies to all communications covered by the privilege: an individual trying to comply with the law or faced with a legal problem also has strong incentive to disclose information to his lawyer, yet the common law has recognized the value of the privilege in further facilitating communications.

3 Seven of the eighty-six employees interviewed by counsel had terminated their employment with Upjohn at the time of the interview. App. 33a–38a. Petitioners argue that the privilege should nonetheless apply to communications by these former employees concerning activities during their period of employment. Neither the District Court nor the Court of Appeals had occasion to address this issue, and we decline to decide it without the benefit of treatment below.

4 See *id.*, at 26a–27a, 103a, 123a–124a. See also *In re Grand Jury Investigation*, 599 F.2d 1224, 1229 (CA3 1979); *In re Grand Jury Subpoena*, 599 F.2d 504, 511 (CA2 1979).

5 See Magistrate's opinion, 78–1 USTC ¶ 9277, p. 83,599: "The responses to the questionnaires and the notes of the interviews have been treated as confidential material and have not been disclosed to anyone except Mr. Thomas and outside counsel."

6 The following discussion will also be relevant to counsel's notes and memoranda of interviews with the seven former employees should it be determined that the attorney–client privilege does not apply to them. See n. 3, *supra.*

7 This provides, in pertinent part:

> "[A] party may obtain discovery of documents and tangible things otherwise discoverable under subdivision (b)(1) of this rule and prepared in anticipation of litigation or for trial by or for another party or by or for that other party's representative (including his attorney, consultant,

> surety, indemnitor, insurer, or agent) only upon a showing that the party seeking discovery has substantial need of the materials in the preparation of his case and that he is unable without undue hardship to obtain the substantial equivalent of the materials by other means. In ordering discovery of such materials when the required showing has been made, the court shall protect against disclosure of the mental impressions, conclusions, opinions, or legal theories of an attorney or other representative of a party concerning the litigation."

8 Thomas described his notes of the interviews as containing "what I considered to be the important questions, the substance of the responses to them, my beliefs as to the importance of these, my beliefs as to how they related to the inquiry, my thoughts as to how they related to other questions. In some instances they might even suggest other questions that I would have to ask or things that I needed to find elsewhere." 78–1 USTC ¶ 9277, p. 83,599.

* See Brief for Petitioners 21–23, and n. 25; Brief for American Bar Association as *Amicus Curiae* 5–6, and n. 2; Brief for American College of Trial Lawyers and 33 Law Firms as *Amici Curiae* 9–10, and n. 5.

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EXHIBIT E

756 F.3d 754
United States Court of Appeals,
District of Columbia Circuit.

In re KELLOGG BROWN & ROOT, INC., et al., Petitioners.

No. 14–5055.
|
Argued May 7, 2014.
|
Decided June 27, 2014.
|
Rehearing En Banc Denied Sept. 2, 2014.

Synopsis
Background: In a relator's qui tam action against a defense contractor under the False Claims Act (FCA), the United States District Court for the District of Columbia, James S. Gwin, J., 2014 WL 1016784, ordered the contractor to turn over the results of an internal investigation, and denied a stay pending appeal, 2014 WL 929430. The contractor petitioned for writ of mandamus.

Holdings: The Court of Appeals, Kavanaugh, Circuit Judge, held that:

[1] the internal investigation was protected by attorney-client privilege;

[2] the contractor had no adequate means to attain relief outside seeking a writ of mandamus;

[3] the District Court's error in denying attorney-client privilege was clear;

[4] the totality of the circumstances supported grant of a writ of mandamus; and

[5] the case did not warrant reassignment on remand.

Petition granted.

***755** On Petition for Writ of Mandamus (No. 1:05–cv–1276).

Attorneys and Law Firms

John P. Elwood argued the cause for petitioners. With him on the petition for writ of mandamus and the reply were John M. Faust, Craig D. Margolis, Jeremy C. Marwell, and Joshua S. Johnson.

Rachel L. Brand, Steven P. Lehotsky, Quentin Riegel, Carl Nichols, Elisebeth C. Cook, Adam I. Klein, Amar Sarwal, and Wendy E. Ackerman were on the brief for amicus curiae Chamber of Commerce of the United States of America, et al. in support of petitioners.

Stephen M. Kohn argued the cause for respondent. With him on the response to the petition for writ of mandamus were David K. Colapinto and Michael Kohn.

Before: GRIFFITH, KAVANAUGH, and SRINIVASAN, Circuit Judges.

Opinion

Opinion for the Court filed by Circuit Judge KAVANAUGH.

***756** KAVANAUGH, Circuit Judge:

****384** More than three decades ago, the Supreme Court held that the attorney-client privilege protects confidential employee communications made during a business's internal investigation led by company lawyers. *See Upjohn Co. v. United States,* 449 U.S. 383, 101 S.Ct. 677, 66 L.Ed.2d 584 (1981). In this case, the District Court denied the protection of the privilege to a company that had conducted just such an internal investigation. The District Court's decision has generated substantial uncertainty about the scope of the attorney-client privilege in the business setting. We conclude that the District Court's decision is irreconcilable with *Upjohn.* We therefore grant KBR's petition for a writ of mandamus and vacate the District Court's March 6 document production order.

I

Harry Barko worked for KBR, a defense contractor. In 2005, he filed a False Claims Act complaint against KBR and KBR-related corporate entities, whom we will collectively refer to as KBR. In essence, Barko alleged that KBR and certain subcontractors defrauded the U.S. Government by inflating costs and accepting kickbacks while administering military contracts in wartime Iraq. During discovery, Barko sought documents related to KBR's prior internal investigation into the alleged fraud. KBR had conducted that internal investigation pursuant to its Code of Business Conduct, which is overseen by the company's Law Department.

KBR argued that the internal investigation had been conducted for the purpose of obtaining legal advice and that the internal investigation documents therefore were protected by the attorney-client privilege. Barko responded that the internal investigation documents were unprivileged business records that he was entitled to discover. *See generally* Fed.R.Civ.P. 26(b)(1).

After reviewing the disputed documents *in camera,* the District Court determined that the attorney-client privilege protection did not apply because, among other reasons, KBR had not shown that "the communication would not have been made 'but for' the fact that legal advice was sought." *United States ex rel. Barko v. Halliburton Co.,* No. 1:05–cv–1276, ––– F.3d ––––, ––––, 2014 WL 1016784, at *2 (D.D.C. Mar. 6, 2014) (quoting *United States v. ISS Marine Services, Inc.,* 905 F.Supp.2d 121, 128 (D.D.C.2012)). KBR's internal investigation, the court concluded, was "undertaken pursuant to regulatory law and corporate policy rather than for the purpose of obtaining legal advice." *Id.* at ––––, 2014 WL 1016784, at *3.

KBR vehemently opposed the ruling. The company asked the District Court to certify the privilege question to this Court for interlocutory appeal and to stay its order pending a petition for mandamus in this Court. The District Court denied those requests and ordered KBR to produce the disputed documents to Barko within a matter of days. *See United States ex rel. Barko v. Halliburton Co.,* No. 1:05–cv–1276, 2014 WL 929430 (D.D.C. Mar. 11, 2014). KBR promptly filed a petition for a writ of mandamus in this Court. A number of business organizations and trade associations also objected to the District Court's decision and filed an amicus brief in support of KBR. We stayed the District Court's document production order and held oral argument on the mandamus petition.

The threshold question is whether the District Court's privilege ruling constituted legal error. If not, mandamus is of course inappropriate. If the District Court's ruling was erroneous, the remaining ****385 *757** question is whether that error is the kind that justifies mandamus. *See Cheney v. U.S. District Court for the District of Columbia,* 542 U.S. 367, 380–81, 124 S.Ct. 2576, 159 L.Ed.2d 459 (2004). We address those questions in turn.

II

[1] We first consider whether the District Court's privilege ruling was legally erroneous. We conclude that it was.

Federal Rule of Evidence 501 provides that claims of privilege in federal courts are governed by the "common law—as interpreted by United States courts in the light of reason and experience." Fed.R.Evid. 501. The attorney-client privilege is the "oldest of the privileges for confidential communications known to the common law." *Upjohn Co. v. United States,* 449 U.S. 383, 389, 101 S.Ct. 677, 66 L.Ed.2d 584 (1981). As relevant here, the privilege applies to a confidential communication between attorney and client if that communication was made for the purpose of obtaining or providing legal advice to the client. *See* 1 RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS §§ 68–72 (2000); *In re Grand Jury,* 475 F.3d 1299, 1304 (D.C.Cir.2007); *In re Lindsey,* 158 F.3d 1263, 1270 (D.C.Cir.1998); *In re Sealed Case,* 737 F.2d 94, 98–99 (D.C.Cir.1984); *see also Fisher v. United States,* 425 U.S. 391, 403, 96 S.Ct. 1569, 48 L.Ed.2d 39 (1976) ("Confidential disclosures by a client to an attorney made in order to obtain legal assistance are privileged.").

In *Upjohn,* the Supreme Court held that the attorney-client privilege applies to corporations. The Court explained that the attorney-client privilege for business organizations was essential in light of "the vast and complicated array of regulatory legislation confronting the modern corporation," which required corporations to "constantly go to lawyers to find out how to obey the law, ... particularly since compliance with the law in this area is hardly an instinctive matter." 449 U.S. at 392, 101 S.Ct. 677 (internal quotation marks and citation omitted). The Court stated, moreover, that the attorney-client privilege "exists to protect not only the giving of professional advice to those who can act on it but also the giving of information to the lawyer to enable him to give sound and informed advice." *Id.* at 390, 101 S.Ct. 677. That is so, the Court said, because the "first step in the resolution of any legal problem is ascertaining the factual background and sifting through the facts with an eye to the legally relevant." *Id.* at 390–91, 101 S.Ct. 677. In *Upjohn,* the communications were made by company employees to company attorneys during an attorney-led internal investigation that was undertaken to ensure the company's "compliance with the law." *Id.* at 392, 101 S.Ct. 677; *see id.* at 394, 101 S.Ct. 677. The Court ruled that the privilege applied to the internal investigation and covered the communications between company employees and company attorneys.

KBR's assertion of the privilege in this case is materially indistinguishable from Upjohn's assertion of the privilege in that case. As in *Upjohn,* KBR initiated an internal investigation to gather facts and ensure compliance with the law after being informed of potential misconduct. And as in *Upjohn,* KBR's investigation was conducted under the auspices of KBR's in-house legal department, acting in its legal capacity. The same considerations that led the Court in *Upjohn* to uphold the corporation's privilege claims apply here.

The District Court in this case initially distinguished *Upjohn* on a variety of grounds. But none of those purported distinctions takes this case out from under *Upjohn* 's umbrella.

***758 [2] **386** First, the District Court stated that in Upjohn the internal investigation began after in-house counsel conferred with outside counsel, whereas here the investigation was conducted in-house without consultation with outside lawyers. But Upjohn does not hold or imply that the involvement of outside counsel is a necessary predicate for the privilege to apply. On the contrary, the general rule, which this Court has adopted, is that a lawyer's status as in-house counsel "does not dilute the privilege." *In re Sealed Case,* 737 F.2d at 99. As the Restatement's commentary points out, "Inside legal counsel to a corporation or similar organization ... is fully empowered to engage in privileged communications." 1 RESTATEMENT § 72, cmt. c, at 551.

[3] Second, the District Court noted that in Upjohn the interviews were conducted by attorneys, whereas here many of the interviews in KBR's investigation were conducted by non-attorneys. But the investigation here was conducted at the direction of the attorneys in KBR's Law Department. And communications made by and to non-attorneys serving as agents of attorneys in internal investigations are routinely protected by the attorney-client privilege. *See FTC v. TRW, Inc.,* 628 F.2d 207, 212 (D.C.Cir.1980); *see also* 1 PAUL R. RICE, ATTORNEY–CLIENT PRIVILEGE IN THE UNITED STATES § 7:18, at 1230–31 (2013) ("If internal investigations are conducted by agents of the client at the behest of the attorney, they are protected by the attorney-client privilege to the same extent as they would be had they been conducted by the attorney who was consulted."). So that fact, too, is not a basis on which to distinguish *Upjohn.*

Third, the District Court pointed out that in *Upjohn* the interviewed employees were expressly informed that the purpose of the interview was to assist the company in obtaining legal advice, whereas here they were not. The District Court further stated that the confidentiality agreements signed by KBR employees did not mention that the purpose of KBR's investigation was to obtain legal advice. Yet nothing in *Upjohn* requires a company to use magic words to its employees in order to gain the benefit of the privilege for an internal investigation. And in any event, here as in *Upjohn* employees knew that the company's legal department was conducting an investigation of a sensitive nature and that the information they disclosed would be protected. *Cf. Upjohn,* 449 U.S. at 387, 101 S.Ct. 677 (Upjohn's managers were "instructed to treat the investigation as 'highly confidential' "). KBR employees were also told not to discuss their interviews "without the specific advance authorization of KBR General Counsel." *United States ex rel. Barko v. Halliburton Co.,* No. 1:05–cv–1276 ––– F.3d –––, ––– n. 33, 2014 WL 1016784, at *3 n. 33 (D.D.C. Mar. 6, 2014).

In short, none of those three distinctions of *Upjohn* holds water as a basis for denying KBR's privilege claim.

More broadly and more importantly, the District Court also distinguished *Upjohn* on the ground that KBR's internal investigation was undertaken to comply with Department of Defense regulations that require defense contractors such as KBR to maintain compliance programs and conduct internal investigations into allegations of potential wrongdoing. The District Court therefore concluded that the purpose of KBR's internal investigation was to comply with those regulatory requirements rather than to obtain or provide legal advice. In our view, the District Court's analysis rested on a false dichotomy. So long as obtaining or providing legal advice was one of the significant purposes of the internal investigation, the attorney ****387 *759** privilege applies, even if there were also other purposes for the investigation and even if the investigation was mandated by regulation rather than simply an exercise of company discretion.

The District Court began its analysis by reciting the "primary purpose" test, which many courts (including this one) have used to resolve privilege disputes when attorney-client communications may have had both legal and business purposes. *See id.* at *2; *see also In re Sealed Case,* 737 F.2d at 98–99. But in a key move, the District Court then said that the primary purpose of a communication is to obtain or provide legal advice only if the communication would not have been made "but for" the fact that legal advice was sought. 2014 WL 1016784, at *2. In other words, if there was any other purpose behind the communication, the attorney-client privilege apparently does not apply. The District Court went on to conclude that KBR's internal investigation was "undertaken pursuant to regulatory law and corporate policy rather than for the purpose of obtaining legal advice." *Id.* at *3; *see id.* at *3 n. 28 (citing federal contracting regulations). Therefore, in the District Court's view, "the primary purpose of" the internal investigation "was to comply with federal defense contractor regulations, not to secure legal advice." *United States ex rel. Barko v. Halliburton Co.,* No. 1:05–cv–1276, 4 F.Supp.3d 162, 166, 2014 WL 929430, at *2 (D.D.C. Mar. 11, 2014); *see id.* ("Nothing suggests the reports were prepared to obtain legal advice. Instead, the reports were prepared to try to comply with KBR's obligation to report improper conduct to the Department of Defense.").

The District Court erred because it employed the wrong legal test. The but-for test articulated by the District Court is not appropriate for attorney-client privilege analysis. Under the District Court's approach, the attorney-client privilege apparently would not apply unless the sole purpose of the communication was to obtain or provide legal advice. That is not the law. We are aware of no Supreme Court or court of appeals decision that has adopted a test of this kind in this context. The District Court's novel approach to the attorney-client privilege would eliminate the attorney-client privilege for numerous communications that are made for both legal and business purposes and that heretofore have been covered by the attorney-client privilege. And the District Court's novel approach would eradicate the attorney-client privilege for internal investigations conducted by businesses that are required by law to maintain compliance programs, which is now the case in a significant swath of American industry. In turn, businesses would be less likely to disclose facts to their attorneys and to seek legal advice, which would "limit the valuable efforts of corporate counsel to ensure their client's compliance with the law." *Upjohn,* 449 U.S. at 392, 101 S.Ct. 677. We reject the District Court's but-for test as inconsistent with the principle of *Upjohn* and longstanding attorney-client privilege law.

Given the evident confusion in some cases, we also think it important to underscore that the primary purpose test, sensibly and properly applied, cannot and does not draw a rigid distinction between a legal purpose on the one hand and a business purpose on the other. After all, trying to find *the* one primary purpose for a communication motivated by two sometimes overlapping purposes (one legal and one business, for example) can be an inherently impossible task. It is often not useful or even feasible to try to determine whether the purpose was A or B when the purpose was A and B. It is thus not correct for a court to presume that a communication can have only one primary purpose ****388** ***760** It is likewise not correct for a court to try to find *the* one primary purpose in cases where a given communication plainly has multiple purposes. Rather, it is clearer, more precise, and more predictable to articulate the test as follows: Was obtaining or providing legal advice *a* primary purpose of the communication, meaning one of the significant purposes of the communication? As the Reporter's Note to the Restatement says, "In general, American decisions agree that the privilege applies if one of the significant purposes of a client in communicating with a lawyer is that of obtaining legal assistance." 1 RESTATEMENT § 72, Reporter's Note, at 554. We agree with and adopt that formulation—"one of the significant purposes"—as an accurate and appropriate description of the primary purpose test. Sensibly and properly applied, the test boils down to whether obtaining or providing legal advice was one of the significant purposes of the attorney-client communication.

[4] In the context of an organization's internal investigation, if one of the significant purposes of the internal investigation was to obtain or provide legal advice, the privilege will apply. That is true regardless of whether an internal investigation was conducted pursuant to a company compliance program required by statute or regulation, or was otherwise conducted pursuant to company policy. *Cf.* Andy Liu et al., *How To Protect Internal Investigation Materials from Disclosure,* 56 GOVERNMENT CONTRACTOR ¶ 108 (Apr. 9, 2014) ("Helping a corporation comply with a statute or regulation—although required by law—does not transform quintessentially legal advice into business advice.").

In this case, there can be no serious dispute that one of the significant purposes of the KBR internal investigation was to obtain or provide legal advice. In denying KBR's privilege claim on the ground that the internal investigation was conducted in order to comply with regulatory requirements and corporate policy and not just to obtain or provide legal advice, the District Court applied the wrong legal test and clearly erred.

III

[5] Having concluded that the District Court's privilege ruling constituted error, we still must decide whether that error justifies a writ of mandamus. *See* 28 U.S.C. § 1651. Mandamus is a "drastic and extraordinary" remedy "reserved for really extraordinary causes." *Cheney v. U.S. District Court for the District of Columbia,* 542 U.S. 367, 380, 124 S.Ct. 2576, 159 L.Ed.2d 459 (2004) (quoting *Ex parte Fahey,* 332 U.S. 258, 259–60, 67 S.Ct. 1558, 91 L.Ed. 2041 (1947)). In keeping with that high standard, the Supreme Court in *Cheney* stated that three conditions must be satisfied before a court grants a writ of mandamus: (1) the mandamus petitioner must have "no other adequate means to attain the relief he desires," (2) the mandamus petitioner must show that his right to the issuance of the writ is "clear and indisputable," and (3) the court, "in the exercise of its discretion, must be satisfied that the writ is appropriate under the circumstances." *Id.* at 380–81, 124 S.Ct. 2576 (quoting and citing *Kerr v. United States District Court for the Northern District of California,* 426 U.S. 394, 403, 96 S.Ct. 2119, 48 L.Ed.2d 725 (1976)). We conclude that all three conditions are satisfied in this case.

A

[6] **[7]** First, a mandamus petitioner must have "no other adequate means to attain the relief he desires." *Cheney,* 542 U.S. at 380, 124 S.Ct. 2576. That initial requirement will often be met in cases where a petitioner claims that a district ****389** ***761** court erroneously ordered disclosure of attorney-client privileged documents. That is because (i) an interlocutory appeal is not available in attorney-client privilege cases (absent district court certification) and (ii) appeal after final judgment will come too late because the privileged communications will already have been disclosed pursuant to the district court's order.

The Supreme Court has ruled that an interlocutory appeal under the collateral order doctrine is not available in attorney-client privilege cases. *See Mohawk Industries, Inc. v. Carpenter,* 558 U.S. 100, 106–13, 130 S.Ct. 599, 175 L.Ed.2d 458 (2009); *see also* 28 U.S.C. § 1291. To be sure, a party in KBR's position may ask the district court to certify the privilege question for interlocutory appeal. *See* 28 U.S.C. § 1292(b). But that avenue is available only at the discretion of the district court. And here, the District Court denied KBR's request for certification. *See United States ex rel. Barko v. Halliburton Co.,* No. 1:05–cv–1276, 4 F.Supp.3d 162, 165–68, 2014 WL 929430, at *1–3 (D.D.C. Mar. 11, 2014). It is also true that a party in KBR's position may defy the district court's ruling and appeal if the district court imposes contempt sanctions for non-disclosure. But as this Court has explained, forcing a party to go into contempt is not an "adequate" means of relief in these circumstances. *See In re Sealed Case,* 151 F.3d 1059, 1064–65 (D.C.Cir.1998); *see also In re City of New York,* 607 F.3d 923, 934 (2d Cir.2010) (same).

On the other hand, appeal after final judgment will often come too late because the privileged materials will already have been released. In other words, "the cat is out of the bag." *In re Papandreou,* 139 F.3d 247, 251 (D.C.Cir.1998). As this Court and others have explained, post-release review of a ruling that documents are unprivileged is often inadequate to vindicate a privilege the very purpose of which is to prevent the release of those confidential documents. *See id.; see also In re Sims,* 534 F.3d 117, 129 (2d Cir.2008) ("a remedy after final judgment cannot unsay the confidential information that has been revealed") (quoting *In re von Bulow,* 828 F.2d 94, 99 (2d Cir.1987)).

For those reasons, the first condition for mandamus—no other adequate means to obtain relief—will often be satisfied in attorney-client privilege cases. Barko responds that the Supreme Court in *Mohawk,* although addressing only the availability of interlocutory appeal under the collateral order doctrine, in effect also barred the use of mandamus in attorney-client privilege cases. According to Barko, *Mohawk* means that the first prong of the mandamus test cannot be met in attorney-client privilege cases because of the availability of post-judgment appeal. That is incorrect. It is true that *Mohawk* held that attorney-client privilege rulings are not appealable under the collateral order doctrine because "postjudgment appeals generally suffice to protect the rights of litigants and ensure the vitality of the attorney-client privilege." 558 U.S. at 109, 130 S.Ct. 599. But at the same time, the Court repeatedly and expressly reaffirmed that *mandamus*—as opposed to the collateral order doctrine—remains a "useful safety valve" in some cases of clear error to correct "some of the more consequential attorney-client privilege rulings." *Id.* at 110–12, 130 S.Ct. 599 (internal quotation marks and alteration omitted). It would make little sense to read *Mohawk* to implicitly preclude mandamus review in all cases given that *Mohawk* explicitly preserved mandamus review in some cases. Other appellate courts that have considered this question have agreed. *See Hernandez v. Tanninen,* 604 F.3d 1095, 1101 (9th Cir.2010); *In re Whirlpool Corp.,* 597 F.3d 858, 860 (7th Cir.2010); *see also In* ****390** ***762** *re Perez,* 749 F.3d 849 (9th Cir.2014) (granting mandamus after *Mohawk* on informants privilege ruling); *City of New York,* 607 F.3d at 933 (same on law enforcement privilege ruling).

B

[8] **[9]** **[10]** Second, a mandamus petitioner must show that his right to the issuance of the writ is "clear and indisputable." *Cheney,* 542 U.S. at 381, 124 S.Ct. 2576. Although the first mandamus requirement is often met in attorney-client privilege cases, this second requirement is rarely met. An erroneous district court ruling on an attorney-client privilege issue by itself does not justify mandamus. The error has to be clear. As a result, appellate courts will often deny interlocutory mandamus petitions advancing claims of error by the district court on attorney-client privilege matters. In this case, for the reasons explained at length in Part II, we conclude that the District Court's privilege ruling constitutes a clear legal error. The second prong of the mandamus test is therefore satisfied in this case.

C

[11] **[12]** Third, before granting mandamus, we must be "satisfied that the writ is appropriate under the circumstances." *Cheney,* 542 U.S. at 381, 124 S.Ct. 2576. As its phrasing suggests, that is a relatively broad and amorphous totality of the circumstances consideration. The upshot of the third factor is this: Even in cases of clear district court error on an attorney-client privilege matter, the circumstances may not always justify mandamus.

In this case, considering all of the circumstances, we are convinced that mandamus is appropriate. The District Court's privilege ruling would have potentially far-reaching consequences. In distinguishing *Upjohn,* the District Court relied on a number of factors that threaten to vastly diminish the attorney-client privilege in the business setting. Perhaps most importantly, the District Court's distinction of *Upjohn* on the ground that the internal investigation here was conducted pursuant to a compliance program mandated by federal regulations would potentially upend certain settled understandings and practices. Because defense contractors are subject to regulatory requirements of the sort cited by the District Court, the logic of the ruling would seemingly prevent any defense contractor from invoking the attorney-client privilege to protect internal investigations undertaken as part of a mandatory compliance program. *See* 48 C.F.R. § 52.203–13 (2010). And because a variety of other federal laws require similar internal controls or compliance programs, many other companies likewise would not be able to assert the privilege to protect the records of their internal investigations. *See, e.g.,* 15 U.S.C. §§ 78m(b)(2), 7262; 41 U.S.C. § 8703. As KBR explained, the District Court's decision "would disable *most public companies* from undertaking confidential internal investigations." KBR Pet. 19. As amici added, the District Court's novel approach has the potential to "work a sea change in the well-settled rules governing internal corporate investigations." Br. of Chamber of Commerce et al. as Amici Curaie 1; *see* KBR Reply Br. 1 n. 1 (citing commentary to same effect); Andy Liu et al., *How To Protect Internal Investigation Materials from Disclosure,* 56 GOVERNMENT CONTRACTOR ¶ 108 (Apr. 9, 2014) (assessing broad impact of ruling on government contractors).

To be sure, there are limits to the impact of a single district court ruling because it is not binding on any other court or judge. But prudent counsel monitor court decisions closely and adapt their ****391** ***763** practices in response. The amicus brief in this case, which was joined by numerous business and trade associations, convincingly demonstrates that many organizations are well aware of and deeply concerned about the uncertainty generated by the novelty and breadth of the District Court's reasoning. That uncertainty matters in the privilege context, for the Supreme Court has told us that an "uncertain privilege, or one which purports to be certain but results in widely varying applications by the courts, is little better than no privilege at all." *Upjohn Co. v. United States,* 449 U.S. 383, 393, 101 S.Ct. 677, 66 L.Ed.2d 584 (1981). More generally, this Court has long recognized that mandamus can be appropriate to " forestall future error in trial courts" and "eliminate uncertainty" in important areas of law. *Colonial Times, Inc. v. Gasch,* 509 F.2d 517, 524 (D.C.Cir.1975). Other courts have granted mandamus based on similar considerations. *See In re Sims,* 534 F.3d 117, 129 (2d Cir.2008) (granting mandamus where "immediate resolution will avoid the development of discovery practices or doctrine undermining the privilege") (quotation omitted); *In re Seagate Technology, LLC,* 497 F.3d 1360, 1367 (Fed.Cir.2007) (en banc) (same). The novelty of the District Court's privilege ruling, combined with its potentially broad and destabilizing effects in an important area of law, convinces us that granting the writ is "appropriate under the circumstances." *Cheney,* 542 U.S. at 381, 124 S.Ct. 2576. In saying that, we do not mean to imply that all of the circumstances present in this case are necessary to meet the third prong of the mandamus test. But they are sufficient to do so here. We therefore grant KBR's petition for a writ of mandamus.

IV

[13] We have one final matter to address. At oral argument, KBR requested that if we grant mandamus, we also reassign this case to a different district court judge. *See* Tr. of Oral Arg. at 17–19; 28 U.S.C. § 2106. KBR grounds its request on the District Court's erroneous decisions on the privilege claim, as well as on a letter sent by the District Court to the Clerk of this Court in which the District Court arranged to transfer the record in the case and identified certain documents as particularly important for this Court's review. *See* KBR Reply Br.App. 142. KBR claims that the letter violated Federal Rule of Appellate Procedure 21(b)(4), which provides that in a mandamus proceeding the "trial-court judge may request permission to address the petition but may not do so unless invited or ordered to do so by the court of appeals."

[14] In its mandamus petition, KBR did not request reassignment. Nor did KBR do so in its reply brief, even though the company knew by that time of the District Court letter that it complains about. Ordinarily, we do not consider a request for relief that a party failed to clearly articulate in its briefs. To be sure, appellate courts on rare occasions will reassign a case sua sponte. *See Ligon v. City of New York,* 736 F.3d 118, 129 & n. 31 (2d Cir.2013) (collecting cases), *vacated in part,* 743 F.3d 362 (2d Cir.2014). But whether requested to do so or considering the matter sua sponte, we will reassign a case only in the exceedingly rare circumstance that a district judge's conduct is "so extreme as to display clear inability to render fair judgment." *Liteky v. United States,* 510 U.S. 540, 551, 114 S.Ct. 1147, 127 L.Ed.2d 474 (1994); *see also United States v. Microsoft Corp.,* 253 F.3d 34, 107 (D.C.Cir.2001) (en banc). Nothing in the District Court's decisions or subsequent letter reaches that very high standard. Based on the record before us, we have no reason to doubt that the District Court will ****392 *764** render fair judgment in further proceedings. We will not reassign the case.

* * *

In reaching our decision here, we stress, as the Supreme Court did in *Upjohn,* that the attorney-client privilege "only protects disclosure of communications; it does not protect disclosure of the underlying facts by those who communicated with the attorney." *Upjohn Co. v. United States,* 449 U.S. 383, 395, 101 S.Ct. 677, 66 L.Ed.2d 584 (1981). Barko was able to pursue the facts underlying KBR's investigation. But he was not entitled to KBR's own investigation files. As the *Upjohn* Court stated, quoting Justice Jackson, "Discovery was hardly intended to enable a learned profession to perform its functions ... on wits borrowed from the adversary." *Id.* at 396, 101 S.Ct. 677 (quoting *Hickman v. Taylor,* 329 U.S. 495, 515, 67 S.Ct. 385, 91 L.Ed. 451 (1947) (Jackson, J., concurring)).

Although the attorney-client privilege covers only communications and not facts, we acknowledge that the privilege carries costs. The privilege means that potentially critical evidence may be withheld from the factfinder. Indeed, as the District Court here noted, that may be the end result in this case. But our legal system tolerates those costs because the privilege "is intended to encourage 'full and frank communication between attorneys and their clients and thereby promote broader public interests in the observance of law and the administration of justice.' " *Swidler & Berlin v. United States,* 524 U.S. 399, 403, 118 S.Ct. 2081, 141 L.Ed.2d 379 (1998) (quoting *Upjohn,* 449 U.S. at 389, 101 S.Ct. 677).

We grant the petition for a writ of mandamus and vacate the District Court's March 6 document production order. To the extent that Barko has timely asserted other arguments for why these documents are not covered by either the attorney-client privilege or the work-product protection, the District Court may consider such arguments.

So ordered.

All Citations

756 F.3d 754, 410 U.S.App.D.C. 382, 38 IER Cases 1109, 94 Fed. R. Evid. Serv. 1078, 94 Fed. R. Evid. Serv. 1129

EXHIBIT F

UNITED STATES DISTRICT COURT
DISTRICT OF MINNESOTA

In re: Target Corporation Customer Data Security Breach Litigation.

This document relates to Financial Institution Actions.

MDL No. 14-2522 (PAM/JJK)

ORDER

This matter is before the Court on the Plaintiffs' request for the Court's intervention in compelling Target to produce certain documents that Target withheld from production and identified on its privilege log. Plaintiffs assert that Target improperly raised claims of attorney-client privilege and work-product protection for the items identified on the privilege log. (Doc. No. 593, Pls.' Letter Br.; *see also id.*, Appendix A, Pls.' Privilege Log Challenges (raising challenges to 370 entries on Target's initial privilege log).) Plaintiffs assert that Target improperly asserted privilege and work-product claims for items relating to a group called the Data Breach Task Force, which Target established in response to the data breach that precipitated this multi-district litigation. Plaintiffs also contend that Target improperly asserted privilege and work-product claims for communications with and documents prepared by Verizon. Target retained Verizon to investigate the data breach. Plaintiffs argue that these communications and documents at issue are not protected by the attorney-client privilege and the work-product doctrine because "Target would have had to investigate and fix the data breach regardless of any litigation, to appease its customers and ensure continued sales, discover its vulnerabilities, and protect itself against future breaches." (Pls.' Letter Br. 3–4.)

Target opposes the Plaintiffs' motion to compel production of these allegedly privileged and work-product protected communications and documents, and filed a letter brief (Doc. No. 599, Target's Letter Br.), along with several declarations and exhibits to substantiate Target's privilege and work-product claims (Doc. Nos. 600–04). Target asserts that the Data Breach Task Force was not involved in an ordinary-course-of-business investigation of the data breach. Rather, Target alleges that it established the Data Breach Task Force at the request of Target's in-house lawyers and its retained outside counsel so that the task force could educate Target's attorneys about aspects of the breach and counsel could provide Target with informed legal advice. (*See* Target's Letter Br. 1–2.) Target's Chief Legal Officer, Timothy Baer, Esq., explains that shortly after discovering the possibility that a data breach had occurred, Target retained outside counsel to obtain legal advice about the breach and its possible legal ramifications. (Doc. No. 600, Decl. of Timothy Baer, Esq. ("Baer Decl.") ¶¶ 4–5.) Once Target publicly announced the breach, consumers filed several class action lawsuits against Target (*id.* ¶ 8), and in early January 2014, Target established the Data Breach Task Force "to coordinate activities on behalf of [Target's in-house and outside] counsel to better position the Target Law Department and outside counsel to provide legal advice to Target personnel to defend the company" (*id.* ¶ 9).

With respect to Verizon, Target also explains that it has only claimed privilege and work-product protection for documents involving one team from Verizon Business

Network Services, which Target's outside counsel engaged to "'enable counsel to provide legal advice to Target, including legal advice in anticipation of litigation and regulatory inquiries.'" (Target's Letter Br. 4 (quoting Doc. No. 603, Decl. of Miriam Wugmeister, Esq. ("Wugmeister Decl.") ¶ 11; *see also* Doc. No. 604, Decl. of Michelle Visser, Esq. ("Visser Decl.") ¶ 3 n.1 (explaining that Ropes & Gray LLP was a party to an engagement letter entered into with a team from Verizon Business Network Services).) Meanwhile, another team from Verizon also conducted a separate investigation into the data breach on behalf of several credit card brands. (*See* Wugmeister Decl. ¶ 11; *see also* Doc. No. 602, Decl. of David Ostertag ¶ 10 (describing a separate investigation conducted by Verizon "on behalf of the payment card brands" and explaining that the Verizon teams did not communicate with each other about the substance of the attorney-directed investigation).)

In other words, Target asserts that following the data breach, there was a two-track investigation. On one track, it conducted its own ordinary-course investigation, and a team from Verizon conducted a non-privileged investigation on behalf of credit card companies. This track was set up so that Target and Verizon could learn how the breach happened and Target (and apparently the credit card brands) could respond to it appropriately. On the other track, Target's lawyers needed to be educated about the breach so that they could provide Target with legal advice and protect the company's interests in litigation that commenced almost immediately after the breach became publicly known. On this second track, Target established its own task force and engaged a separate team from Verizon to provide counsel with the necessary input, and it is for information generated along this track that Target has claimed attorney-client privilege and work-product protection.

Given the scope of the communications and documents at issue and so the Court would not be evaluating the parties' positions in a vacuum, on October 13, 2015, the Court ordered Target to provide certain documents for in camera inspection. (Doc. No. 618.) Specifically, the Court instructed Target to provide it with the documents identified in the bulleted list on pages 4 and 5 of the Plaintiffs' Letter Brief. Target provided the documents[1] in camera, and the Court has completed its in camera review. Based on that in camera review, the Court concludes that no hearing is required to decide the privilege and work-product issues raised as to the specific examples listed in Plaintiffs' Letter Brief. The Court limits its ruling in this Order to the specific privilege log entries that Target submitted for in camera review. The Court makes no ruling about any other entry on Target's privilege log. The parties may take guidance from this Order in their attempts to resolve their remaining disputes concerning Target's other claims of privilege and work-product protection.

Accordingly, **IT IS HEREBY ORDERED** that Plaintiffs' Motion to Compel (Doc. No. 593) is **GRANTED IN PART** and **DENIED IN PART** as follows:

1. The motion is **GRANTED IN PART** to the extent it seeks production of the redacted information corresponding to Target's privilege log entries 763–64, and

[1] Although the Court's October 13th Order mentioned 36 "documents" that were identified in Plaintiffs' Letter Brief, based on the in camera review, it is clear that the privilege log entries correspond to redactions, and some of these documents include multiple redactions, which correspond to multiple entries on Target's privilege log.

988–89. Target redacted information in these email communications that are updates to Target's Board of Directors in the aftermath of the data breach. These redacted communications from Target's Chief Executive Officer merely update the Board of Directors on what Target's business-related interests were in response to the breach. Nothing in the record supports a claim for attorney-client privilege for these communications as they do not involve any confidential communications between attorney and client, contain requests for or discussion necessary to obtain legal advice, nor include the provision of legal advice. Nor does anything in the record support a claim of work-product protection for this Board of Directors update. None of Target's declarations demonstrates that this Board of Directors update was provided because of any anticipation of litigation within the meaning of Fed. R. Civ. P. 26(b)(3). Target must provide unredacted versions of the emails corresponding to privilege log entries 763–64 and 988–89 within 3 days of this Order.

2. Otherwise, based on the Court's in camera review, and the declarations in support of Target's opposition, Plaintiffs' motion is **DENIED** with respect to the other privilege log entries that were included in Target's in camera submission:

a. The motion is moot with respect to entries 1360–65 on Target's privilege log. Target represented that the emails corresponding to those entries were produced without redactions on August 19, 2015, and the plaintiffs withdrew their motion as to those entries in a letter to the Court dated September 28, 2015.

b. The motion is moot with respect to entry 588 on Target's privilege log as Target has represented that it produced the corresponding email communication on October 19, 2014.

c. The motion is moot with respect to entries 744–45 on Target's privilege log as Target has represented that it produced the corresponding email communication on October 19, 2014.

d. The email communication corresponding to entry 89 on Target's privilege log is protected by the attorney-client privilege.

e. The email communications corresponding to entries 172–82 on Target's privilege log are protected by the attorney-client privilege and the work-product doctrine. In particular, Target has demonstrated, through the Declaration of Timothy Baer (Baer Decl. ¶¶ 8–9), that the work of the Data Breach Task Force was focused not on remediation of the breach, as Plaintiffs contend, but on informing Target's in-house and outside counsel about the breach so that Target's attorneys could provide the company with legal advice and prepare to defend the company in litigation that was already pending and was reasonably expected to follow. *See Rabushka v. Crane Co.*, 122 F.3d 559, 565 (8th Cir. 1997) (finding the non-movant on a motion to compel met its burden to establish work product and attorney-client privileges).

f. The email communications corresponding to entries 513–16 on Target's privilege log are protected by the attorney-client privilege. The communications are between a Target in-house attorney and his clients and were made for the purpose of obtaining legal advice.

g. The email communications corresponding to entries 589–90 on Target's privilege log are protected by the work-product doctrine. Plaintiffs have not carried their burden to demonstrate that they have a substantial need for these materials to prepare their case, nor that they cannot, without undue hardship, obtain the substantial equivalent by other means. Fed. R. Civ. P. 26(b)(3)(A)(ii); *St. Paul Reinsurance Co, Ltd. v. Commercial Fin. Corp.*, 197 F.R.D. 620, 628 (N.D. Iowa 2000) (providing that the party seeking disclosure of information protected by work-product doctrine bears the burden of proving substantial need and undue hardship to obtain the materials once proponent of the protection meets its initial burden). Plaintiffs have not demonstrated that without these work-product protected materials they have been deprived of any information about how the breach occurred or how Target conducted its non-privileged or work-product protected investigation. Target has produced documents and other tangible things, including forensic images, from which Plaintiffs can learn how the data breach occurred and about Target's response to the breach. (*See* Visser Decl. ¶ 11, Ex. 7 (report prepared by a separate team from Verizon Business Network Services that was not engaged by Target's counsel and that conducted an investigation on behalf of several credit card issuing companies).)

h. The email communications corresponding to entries 746–49 on Target's privilege log are protected by the attorney-client privilege and work-product doctrine. The communications are between a Target in-house attorney and his clients and were made for the purpose of obtaining legal advice and made in anticipation of litigation.

i. The email communications corresponding to entries 2004–05 on Target's privilege log are protected by the attorney-client privilege as Target has demonstrated the information in those communications was transmitted for the purpose of obtaining legal advice regarding the data breach investigation.

Date: October 23, 2015

s/ Jeffrey J. Keyes
JEFFREY J. KEYES
United States Magistrate Judge

To Do Items (Director Departure/Arrival)

Before Preliminary Proxy Statement is Filed

- D&O Questionnaires to new directors
- CSN&G Committee meeting or action by written consent:
  - Recommend new nominees to Board
  - Determine independence status of new nominees and recommend to Board
  - Recommend committees on which nominees will serve (if ready to make that decision at this stage; could wait until May meeting)
  - Recommend change to size of Board, effective as of the annual meeting
- Board meeting or action by written consent:
  - Update nominees to Board for annual meeting
  - Update agenda item (nine nominees for director)
  - Update who will act as proxy for the annual meeting (if it will change)
  - Determine independence status of new nominees
  - Make committees appointments for new nominees (if ready to make that decision at this stage; could wait until May meeting)
  - Approve change to size of Board, effective as of the annual meeting
- Prepare biographies and qualifications disclosure for new nominees to include in proxy statement
- Required to disclose source of nomination for new nominees for director (see S-K 407(c)(2)(vii)) in proxy statement (shareholder, non-management director, CEO, other executive officer, search firm)
- Analyze potential compensation committee interlock issues and address as necessary

Closer to time of the Annual Meeting

- Obtain power of attorney for new directors for Section 16 filings
- Form 3s due for new directors within 10 days after joining the Board
- Equity grants for new directors; Form 4 for grants
- D&O carrier notice about new directors/departing director
- D&O indemnity agreements for new directors
- No NYSE notice required since being elected by shareholders at annual meeting; new directors will be covered under annual affirmation prepared after the annual meeting

[date]

Via Federal Express

[Director Nominee]

RE: [Company Name] – Director Handbook

Dear [Director],

Welcome to the [Company Name] organization! I am writing to provide some materials in connection with your anticipated election to the Board.

Enclosed please find a Director Handbook, which we have created to help you become oriented to our history, structure, and governing documents. When we meet on the afternoon of [date], we will briefly walk through portions of this handbook. We have also scheduled time for you to meet one-on-one with [name], our CFO, and [name], our Chief Investment Officer. They will provide you with an overview of our financial information and details regarding our real estate portfolio. Of course, I am also more than happy to answer any questions regarding the materials in advance of (or after) that meeting.

I have also enclosed certain additional materials, listed below, that are necessary for the Company to be able to file certain required reports with the SEC. Forms that need to be returned are designated as such, but we can receive them in person on [date], if that is most convenient.

- SEC Insider Compliance Memo
- Reporting Person Certification (**PLEASE SIGN AND RETURN**)
- Power of Attorney – SEC Forms 3, 4 & 5 (**PLEASE SIGN AND RETURN**)
- Director Retainer Payment Election (**PLEASE SIGN AND RETURN**)
- D&O Questionnaire Update Certification (**PLEASE SIGN AND RETURN**)

I can be reached at [contact info] if you have any questions or concerns.

I look forward to working with you, and thank you for your efforts on behalf of our Company.

[General Counsel & Corporate Secretary]

Enclosures

DIRECTOR ORIENTATION AGENDA

[Date]

[Location]
[Date]
[Time]

Attendees:

New Director
Chief Executive Officer
Chief Financial Officer
Chief Investment Officer
General Counsel and Corporate Secretary

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1. **GENERAL BUSINESS OVERVIEW** – CEO

2. **INVESTMENT OVERVIEW** – CIO

3. **FINANCIAL INFORMATION** – CFO

4. **INVESTOR RELATIONS** – CFO

5. **GOVERNANCE MATTERS** – GC and Corp Sec.

<u>SELECTED PRINCIPAL ADVANTAGES OF BEING FORMED AS A CORPORATE OR TRUST REIT UNDER MARYLAND LAW</u>

James J. Hanks, Jr.
Partner, Venable LLP
Baltimore

March 9, 2016

Set forth below is a list some of the principal advantages of being formed as a corporate or trust REIT ("REIT") under Maryland law.

- Over 80% of the public REITs are formed under Maryland law.

- Charter may permit board to amend charter to increase or decrease authorized stock without a stockholder vote. (Maryland is first and perhaps only state with this provision.)

- Specific statutory validation of REIT share ownership and transfer limitations (including those designed to protect REIT tax status and "for any other purpose," *e.g.*, protection against hostile takeovers).

- Unlike Delaware, Maryland does not prohibit charter amendments related to share ownership and transfer provisions (including those designed to protect REIT tax status) from becoming effective against an existing stockholder who does not approve the amendment.

- <u>No franchise taxes in Maryland</u> (vs. Delaware, where the franchise tax for a publicly traded corporation can be as high as $180,000 per year).

- Broader statutory exculpation for directors and officers from personal liability for money damages than almost any other state, including Delaware, which (a) has more and broader exceptions (including "acts not in good faith," which was litigated for over ten years in the *Disney* case in Delaware) and (b) does not cover officers.

- Broader indemnification rights for directors and officers (vs. Delaware, which prohibits indemnification of derivative suit settlements).

- Clear statutory standard of conduct for directors (good faith, reasonable belief, ordinary prudence) vs. constantly shifting case-based standard in Delaware.

- Statutory presumption that any act of a director satisfies the standard of conduct for directors (vs. no such statute in Delaware).

- Broader takeover defense statutes than most other states (including Delaware):

    - Five-year moratorium on transactions with an unfriendly more-than-ten-percent holder (vs. three years in Delaware, a 15% threshold on holder's shares and an exception for a more-than-85% holder)

    - After the five-year moratorium, two supermajority votes (80% of outstanding shares and two-thirds of disinterested shares) required for transactions with an unfriendly more-than-ten-percent holder (vs. Delaware, which has no such statute)

    - "Just say no" validation statute (vs. Delaware, which has no such statute)

    - Poison pill validation statute, including 180-day "slow hand" provision (vs. Delaware, which prohibits slow hands)

    - Control share acquisition statute limiting voting rights of an unfriendly more-than-ten-percent holder (vs. Delaware, which has no such statute)

    - Single standard of judicial review (no *Unocal* enhanced scrutiny or *Weinberger* entire fairness).

- If a board of directors has at least three disinterested directors and a class of securities registered under the Securities Exchange Act of 1934, as amended (the "Exchange Act"), the board may elect, notwithstanding a contrary charter or bylaw provision, to (1) classify the board, (2) increase the vote required to remove a director to two-thirds of the outstanding shares, (3) increase the threshold required for stockholders to compel the company to call a special meeting of the stockholders to a majority of the outstanding shares, (4) vest in the board the exclusive power to set the number of directorships and fill vacancies and (5) provide that any director vacancy shall be filled for the entire remainder of the term in which the vacancy occurred. Delaware has no such statute.

- Statutory authorization for advance notice bylaws.

- No appraisal rights for shares not entitled to vote on the transaction (vs. Delaware, where this is not permitted).

- Charter may eliminate appraisal rights (vs. Delaware, where this is not permitted).

- "Market out" exception for appraisal rights applies to all stock listed on a national securities exchange (with limited exception for cash mergers in which directors and officers own five percent or more of the outstanding shares and any stock held by any of them is converted in the merger into stock of the acquirer) (vs. Delaware, where the market out does not apply to any cash merger).

- Board power, without stockholder approval, to reverse-split stock of a corporation with a class of equity securities registered under the Exchange Act so long as the split does not combine more than ten shares into one in any twelve-month period. (Delaware has no such statute.)

- Stockholders may act by less-than-unanimous written consent only if charter specifically permits it (vs. Delaware, which permits less-than-unanimous stockholder action by written consent unless charter prohibits it).

- Modern, flexible statute on dividends and other distributions (based on the Model Business Corporation Act).

- Statutory presumption that GAAP-based financial statements are *prima facie* proper and in accordance with Maryland General Corporation Law.

- More favorable case law re power of directors to dismiss derivative suits (vs. Delaware, where demand futility exception is still quite broad).

- Specific authority for REIT to issue stock to up to 100 holders for no consideration (no such statute in Delaware).

- No significant corporate plaintiffs' bar (vs. Delaware).

- Maryland courts are familiar with REITs and have decided numerous cases involving REIT issues.

- Charter may permit variation of rights of stockholders within the same class.

- No statutory restriction (as there is in Delaware) on deferring annual meeting past 13 months.

- Date for stockholders meeting may be as long as 90 days after the record date (vs. only 60 days in Delaware).

- More favorable abandoned property laws.

Please feel free to call if you have any questions or comments.

DUTIES OF DIRECTORS OF MARYLAND CORPORATIONS

James J. Hanks, Jr.
Partner, Venable LLP
Baltimore

March 9, 2016

I. STANDARD OF CONDUCT FOR DIRECTORS UNDER MARYLAND LAW

A. Generally

Under Maryland law, the business and affairs of a corporation are managed under the direction of a board of directors. Maryland General Corporation Law ("MGCL") § 2-401(a). Unlike Delaware, Maryland has a specific statutory standard of conduct for directors of a Maryland corporation that applies to all actions by directors. MGCL § 2-405.1(a). This standard applies individually, director by director, and not collectively to the board, and has three elements:

- A director of a Maryland corporation must act *in good faith*. This means the absence of any desire or reason to obtain a personal benefit, or a benefit for some person other than the corporation, that is not available *pro rata* to other stockholders.

- A director of a Maryland corporation must act with a *reasonable belief* that his or her action is in the *best interests of the corporation*. This means that a director must have some rational basis for believing that his or her actions are in the best interests of the *corporation*, as opposed to the interests of any stockholder or group of stockholders.

- A director of a Maryland corporation must act with the care of an *ordinarily prudent person* in a like position under similar circumstances. This means that a director should focus on the *process* by which he or she reaches decisions — asking questions, requesting information, deliberating carefully and the like. In short, the ordinary prudence requirement emphasizes the importance of process over substance. A director can be wrong, as determined retroactively, in a decision the director makes so long as he or she follows the right process in making it.[1]

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[1] Although Section 2-405.1(a) of the MGCL applies by its terms only to directors of Maryland corporations, it is generally believed that the same standards apply to trustees of Maryland Title 8 trust REITs ("Title 8 REITs"). A bill pending in the Maryland legislature would apply the standards of Section 2-405.1(a) of the MGCL to trustees of Title 8 REITs. Generally in this memo references to "the company" and intended to cover both "corporations" and "Title 8 REITs", references to "directors" are intended to cover "trustees" and references to the "charter" are intended to cover the "declaration of trust."

The MGCL also permits a director of a Maryland corporation to rely on an officer or employee whom he or she reasonably believes to be reliable and competent; a lawyer, certified public accountant or other person as to a matter that he or she believes to be within the person's professional or expert competence; or a committee of the board on which he or she does not serve, as to a matter within its designated authority, if he or she reasonably believes the committee to merit confidance. MGCL § 2-405.1(b).[2] For example, a director is entitled to rely on financial statements, legal opinions, fairness opinions, solvency opinions or officer's certificates relating to matters that the director reasonably believes to be within the expertise of the person preparing the material. However, information and opinions of officers or professional advisors should be just one element in the exercise of a director's business judgment. A director should never take an action solely because "the lawyers said it was OK" or "the bankers delivered a fairness opinion."

B. Consideration of Strategic Alternatives, including a Change of Control

The specific actions that may be required of the board of directors in connection with a possible transaction will depend upon the nature of the transaction, including whether the transaction involves a change of control. A sale of the business for all cash – whether through merger, sale of assets or otherwise – will always be a change of control. Conversely, an all stock-for-stock merger will not be a change of control so long as there is no single stockholder or affiliated group of stockholders who did not have effective voting control of the company *before* the transaction but will hold effective voting control of the surviving company *after* the transaction. In between these two paradigms are many less clear possibilities that may constitute a change of control depending on, among other things, (a) the amount of stock or other continuing equity that the shareholders of the selling company receive in the transaction and (b) the percentage of ownership in the combined company that constitutes effective control.

In considering strategic alternatives, including a possible change of control of the company, there will be two decisions for the board: First, the board must decide what is the best alternative available to the company. Second, if the board decides that the best alternative available is a transaction that would result in a change of control of the company and the board decides to pursue that transaction, then a director should assume that her or his duty to act in the best interests of the *company* shifts to a duty to seek the best value and other terms reasonably available for the *shareholders*, which is analogous to the so-called *Revlon* duty under Delaware law.

To that end, some stockholders of Laureate Education, Inc., a Maryland corporation, challenged a going-private transaction between Laureate and an entity formed and controlled by several private equity investors and two Laureate management directors (including the Chairman and CEO), on the usual grounds of directors' breach of duties, including negotiating an inadequate price. In its decision, the Court of Appeals of Maryland, the state's

[2] Although Section 2-405.1(b) of the MGCL applies by its terms only to directors of Maryland corporations, it is generally believed that the same standards apply to trustees of Title 8 REITs. A bill pending in the Maryland legislature would apply the standards of Section 2-405.1(b) of the MGCL to trustees of Title 8 REITs.

highest court, held that "in the context of a cash-out merger transaction, where the decision to sell the corporation has already been made, corporate directors owe their shareholders common law duties of candor and good faith efforts to maximize shareholder value." *Shenker v. Laureate Educ., Inc.*, 411 Md. 317, 351 (2009).

Conversely, if a transaction will *not* result in a change of control – for example, a stock-for-stock merger where there is no new controlling stockholder in the combined company – the board will *not* be required to get the best value for the stockholders but will be required to reasonably believe, acting in good faith and after the exercise of ordinary prudence, that the transaction is in the best interests of the company.

In a change of control transaction there is "no single blueprint" that a board must follow. Maryland law does *not* require an auction of the company. Any process chosen, however, should involve an opportunity for a market check, either before or after signing of an agreement and announcement of the transaction. Ordinarily, the greater the pre-signing market check, the less the need for a post-signing market check and *vice versa*. A pre-agreement market check may involve a survey of possible buyers and the advice and assistance of independent experts. A post-agreement market check may be advantageous to a company – and its shareholders – because it nails down one bidder while leaving the company open to pursuing higher offers, which may be attracted by announcement of the transaction. However, to be valid, a post-agreement market check must allow a fair opportunity for higher offers. *See* JAMES J. HANKS, JR., MARYLAND CORPORATION LAW, § 6.6(b) (Aspen Publishers, 2015 Supp.) ("HANKS"). That is, measures designed to protect a transaction from competing bidders, such as no-shop provisions, break-up fees and expense reimbursement, must be balanced against the costs of possibly precluding the opportunity for other bidders to make offers. Deal protection measures should be evaluated on a sliding scale: The greater the pre- or post-agreement market check, the more deference the courts will give to deal protection measures. On the flip side, the less expansive a market check, the less the deference will be given. The effect of deal protection measures can be offset to some degree by fiduciary outs and go-shop provisions.

If the company receives a proposal – solicited or unsolicited – that might result in a change of control, Maryland law specifically provides that the duties of directors do not require them to accept, recommend or respond to any proposal by a potential acquirer. Accordingly, the directors may "just say no." *See* MGCL § 2-405.1(d). In addition, Maryland law specifically provides that directors are *not* required to take any specific action with regard to takeover defenses or takeover statutes, directors are *not* required to act or fail to act because of the effect that your act or failure to act may have on the potential acquisition and directors are *not* required to act or fail to act solely because of the amount or type of consideration that may be offered. MGCL § 2-405.1(d) (also made applicable to Title 8 REITs by Maryland REIT Law § 8-601.1). Similarly, if directors decide to explore an offer to acquire control of the company but subsequently decide that the price and other terms that are being offered are not as favorable as continuing to own and run the business and remaining independent, they are free to change their minds and reverse their earlier decision that a change in control represents the best strategic alternative for the company.

C. Interested Director Transactions

In connection with the consideration of strategic alternatives available to the company, the board and each director individually must be mindful of interests that each director may have that may vary from those of the company. Under common law, a contract or other transaction between a corporation and a director (or a corporation or other entity in which the director is a director or has a material financial interest) was either void or voidable and could be rescinded in a stockholder's suit.

Section 2-419 of the MGCL, however, provides a safe harbor for interested director transactions, which removes the taint of the director's or directors' interests in a contract or transaction. Under Section 2-419, a contract or transaction in which one or more directors have an interest is not void or voidable solely because of the common directorship or interest, because of the presence of the director at the meeting of the board or board committee which authorizes, approves, or ratifies the contract or transaction or because of the counting of the vote of the director for the authorization, approval or ratification of the contract or transaction, if one of three conditions is satisfied:

- *First*, the fact of the common directorship or interest is disclosed or known to the board or board committee and the board or board committee approves the contract or transaction by the affirmative vote of a majority of disinterested directors, even if the disinterested directors constitute less than a quorum;

- *Second*, the fact of the common directorship or interest is disclosed or known to the stockholders entitled to vote and the contract or transaction is approved by a majority of the votes cast by the stockholders entitled to vote other than the votes of shares owned by the interested director or corporation or other entity; or

- *Third*, the contract or transaction is "fair and reasonable" to the corporation.[3]

A director is "disinterested" in a contract or transaction if neither the director nor any entity in which the director has a material financial interest is a party to or has a material financial interest in the contract or transaction. HANKS, § 6.22 (Supp. 2015). A material financial interest is one of such significance to the director that it would reasonably be expected to influence the director's judgment if he or she were called upon to vote on approving the transaction. *See* MODEL BUS. CORP. ACT § 8.60(1) (1999). A financial interest of other persons related economically or familially to the director could be a financial interest of the director. These persons could, depending upon the circumstances, include: (a) an entity (other than the corporation) of which the director is a shareholder, partner, director, officer or employee; (b) a spouse, parent, child, grandchild, sibling or co-resident of the director or a trust or the estate of

[3] Section 2-419 of the MGCL does not apply by its terms to Title 8 REITs. However, its provisions provide useful analogues.

any such individual; or (c) a trust or estate of which the director is a fiduciary or beneficiary. *See* MODEL BUS. CORP. ACT § 8.60(3) (1994). The Maryland courts have concluded that there should not be a *per se* rule that a director is deemed to be "interested" by virtue of the director's economic or familial relationships, but rather the test should be whether such a relationship would reasonably be expected to compromise the director's exercise of independent judgment. *See Shapiro v. Greenfield*, 136 Md. App. 1, 23-24, 764 A.2d 270, 282 (2000).

If either one of the two approval procedures – disinterested director or disinterested stockholder approval – is not followed because all the company's directors have an interest and it is not practical to obtain stockholder approval, then, as noted above, the contract or transaction will not be void or voidable if it is "fair and reasonable" to the corporation. This, however, is the least desirable safe harbor as the person (in this case, the corporation) asserting the validity of the transaction bears the burden of proving that it was fair and reasonable to the corporation; in the other two cases the burden of proof is shifted to the person challenging the transaction.

Several Maryland courts have examined whether a transaction was fair and reasonable and concluded that the word "fair" means that the material terms of the transaction are within the range that might have been agreed to by economically motivated disinterested persons negotiating at arm's length with knowledge of all material facts known to any party to the transaction. *See Independent Distrib., Inc. v. Katz*, 99 Md. App. 441, 457, 637 A.2d 886, 893, *cert. denied*, 335 Md. 697, 646 A.2d 363 (1994); *Tobacco Tech., Inc. v. Taiga Int'l N.V.*, 626 F. Supp. 2d 537 (D. Md. 2009). *See also Cummings v. United Artists Theatre Circuit, Inc.*, 237 Md. 1, 25–26, 204 A.2d 795, 808 (1964), which also held that "fairness is basically a factual determination and the lower court's findings will not be disturbed unless clearly erroneous." *Id*. at 26, 204 A.2d at 808. The word "reasonable" means that it makes sense for the corporation to enter into the transaction under the particular circumstances prevailing at the particular time that it was approved or authorized. *See Katz*, 99 Md. App. at 457, 637 A.2d at 893 (citing HANKS, § 6.22). *See also Tobacco Tech., Inc.*, 626 F. Supp. 2d at 550. The terms of a transaction may be "fair" but in the circumstances it may not be "reasonable" for the corporation to enter into the transaction.

II. POTENTIAL LIABILITY OF DIRECTORS UNDER MARYLAND LAW

Maryland law specifically provides that a director who performs her or his duties in accordance with the standard of conduct discussed above "has no liability by reason of being or having been a director of a corporation." MGCL § 2-405.1(c); MD. CODE ANN. CTS. & JUD. PROC. § 5-417. Boards of directors continuously make decisions involving a balancing of risks and benefits for the corporation. Although some decisions turn out to be mistaken or unwise, Maryland courts have recognized that it is unreasonable to re-examine these decisions with the benefit of hindsight. Indeed, the MGCL contains a presumption that an act of a director satisfies the statutory standard of conduct under Maryland law. MGCL § 2-405.1(e).

In order that directors may carry out their duties without undue fear of exposure to monetary liability, the MGCL and the Maryland REIT Law provide for several measures protecting directors against personal liability for money damages. Maryland law permits a Maryland company, by provision in its charter, to eliminate the liability of a director or officer for money damages in suits by or on behalf of the company or its shareholders except to the extent of the director's or officer's actual receipt of an improper benefit or profit in money, property or services or for liability resulting from the director's or officer's active and deliberate dishonesty that is material to the cause of action. MD. CODE ANN. CTS. & JUD. PROC. §§ 5-418, 5-419. This provision covers suits for money damages under state law, but not suits seeking to enjoin a particular transaction or suits under federal securities or other laws. The typical Maryland company charter contains a provision limiting the liability of its directors and officers for money damages in suits by the company or its shareholders to the maximum extent permitted by Maryland law.

In addition, a director of the company who fails to satisfy his or her duties may be entitled to indemnification or advance of expenses by the company, including in connection with direct or derivative claims brought by stockholders. Section 2-418 of the MGCL, which is made applicable to Title 8 REITs by Section 8-301(15) of the Maryland REIT Law, permits a Maryland corporation to indemnify its present and former directors and officers against judgments, penalties, fines, settlements and reasonable expenses actually incurred by them in connection with any proceeding to which they may be made, or threatened to be made, a party to, or witness in, by reason of their service in those or other capacities unless it is established that (a) the act or omission of the director or officer was material to the matter giving rise to the proceeding and (i) was committed in bad faith or (ii) was the result of active and deliberate dishonesty, (b) the director or officer actually received an improper personal benefit in money, property or services or (c) in the case of any criminal proceeding, the director or officer had reasonable cause to believe that the act or omission was unlawful. The MGCL also permits a Maryland corporation to advance the expenses of a director or officer, without requiring a determination of the director's or officer's ultimate entitlement to indemnification, upon receipt of (a) a written affirmation by the director or officer of his or her good faith belief that he or she has met the standard of conduct necessary for indemnification and (b) a written undertaking by him or her or on his or her behalf to repay the amount paid or reimbursed if it is ultimately determined that the standard of conduct was not met. MGCL § 2-418.

In addition, many companies provide additional protection for directors and officers through indemnification agreements and D&O liability insurance. Most directors' and officers' insurance policies are written in two parts: (a) reimbursement to the company for payments by it pursuant to its indemnification obligations and (b) reimbursement to the directors and officers directly if the company is unwilling (as sometimes happens following a change of control) or unable (as in the case of insolvency) to comply with its indemnification obligations.

III. BOARD PROCESS AND PROCEDURES

In any high-profile transaction, the possibility of litigation against the company and its directors is not insignificant. Although directors and officers have substantial protection against personal liability for money damages, if directors and officers do not satisfy their duties under Maryland law, any transaction may be enjoined or rescinded. Thus, a director should be prepared for the possibility of being deposed and testifying under oath. In a potential change of control of a company, a director should also be able to explain why his or her decision, whether to recommend or not recommend selling control of the company, is the best available alternative to the company and why, if the transaction is a change of control, it represents the best value and other terms reasonably available for the shareholders. In a non-change-of-control transaction, a director should be able to explain why he or she was reasonable in believing that his or her actions are in the best interests of the company.

This underscores the importance of each director doing some or all of the following:

- Obtaining as much information as possible, including the advice and opinions of experts, and weighing it carefully.

- Questioning information provided by management or advisors if the director feels, based on his or her individual knowledge and experience, that such information may be inaccurate or incomplete.

- Considering all reasonable alternatives.

- Deliberating carefully as a board, asking questions, expressing his or her views and listening to the views of others.

- Taking whatever time, including additional meetings, that the director feels he or she reasonably needs to deliberate and reach a decision.

- Generally satisfying himself or herself that the board's action is in the best interests of the company.

- If the company is insolvent, or is nearing insolvency, considering the contract rights and other legal rights of creditors.

A director should not hesitate to ask for more information or for more time if he or she feels the need for it.

Considering a range of strategic alternatives that may include the sale of the company or other change of control is obviously a very important decision. Each director should do whatever he or she reasonably feels needs to be done to reach an individual and collective decision on the best strategic alternative available to the company, and, if it is the sale of control of the company, then whether that alternative represents the best value and other terms reasonably available for the shareholders. A director must be able to ask the hard questions and, if necessary, to just say no to a proposal, even one endorsed by management, if the director disagrees.

In addition, as discussed above, if certain members of the board have an interest in a transaction that is different than the interests of shareholders generally, especially an interest that could create negative legal and public perception issues, it may be useful to establish a special committee of the board consisting of disinterested directors. A properly established and functioning special committee may minimize those issues and enhance the likelihood of a positive outcome.

Finally, we are often asked by directors about taking notes. Our advice is that a director should take whatever notes she or he feels would be necessary or helpful in performing her or his functions of oversight and decision-making. However, directors should remember that any notes taken by them may be discoverable in litigation. If a director discards or destroys notes, that fact may also be discoverable and a court may draw adverse inferences of fact against the director. Directors should also be reminded that even conversations, especially those outside the boardroom, except those clearly involving communications with counsel relating to legal advice, are discoverable. The attorney-client privilege varies from jurisdiction to jurisdiction and often turns out to be not as broad as some clients (and some lawyers too) think.

* * * *

If you have any questions or comments in connection with the foregoing information, please do not hesitate to call.

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Proxy Statements under Maryland Law – 2016

The 2016 proxy season is fast approaching. Based on our prior experience reviewing proxy statements for Maryland public companies, we would like to call your attention to certain matters of Maryland law about which we often receive questions. As in the past, we are available to review draft proxy statements for Maryland law compliance. Because the same principles generally apply to both corporations formed under the Maryland General Corporation Law (the "MGCL") and to real estate investment trusts formed under the Maryland REIT Law (the "MRL"), we generally refer hereafter only to corporations.

Virtual Stockholder Meetings. The MGCL expressly authorizes the board of directors, if it is otherwise authorized to determine the place of a meeting of stockholders, to determine that the meeting will be held solely by means of remote communication. A virtual meeting is subject to certain notice and procedural requirements set forth in the statute. The MGCL also requires that the board of directors provide a "place" for a meeting of the stockholders if requested by a stockholder, which means only that the corporation must provide a physical location for the requesting stockholders to access the meeting on the internet. It does not require the board of directors to transform the meeting into a traditional stockholders meeting held at a single location or to update the notice of the meeting. The MRL does not contain a counterpart to the MGCL provision on shareholder meetings by remote communication and simply requires that the declaration of trust provide for an annual meeting of shareholders "at a convenient location." We believe that a real estate investment trust could provide for a virtual shareholders meeting in the declaration of trust or bylaws and that it would be prudent to have those provisions generally mirror those in the MGCL.

Internet Availability of Proxy Materials. Pursuant to Regulation 14A (the "Proxy Rules") of the Securities and Exchange Commission ("SEC"), all filers are required to post their proxy materials on a publicly accessible internet website (other than EDGAR) and may choose to (a) utilize the "notice and access" model for furnishing proxy materials to shareholders by sending a notice of internet availability complying with the Proxy Rules (the "Proxy Rule Notice") or (b) deliver a full set of paper copies of the proxy materials, including the Proxy Rule Notice. A Maryland corporation may combine the notice of a meeting of stockholders that is required by the MGCL with the Proxy Rule Notice.

Householding. Proxy Rule 14a-3(e) provides that an annual report, proxy statement or Proxy Rule Notice will be considered to have been delivered to all shareholders of record who share an address so long as one annual report, proxy statement or Proxy Rule Notice, as applicable, is delivered to the shared address and is addressed (a) to the shareholders as a group, (b) to each of the shareholders individually or (c) to the shareholders in a form to which each of them has consented in writing. The Proxy Rules also require compliance with certain other conditions regarding express or implied consents by shareholders.

Although the MGCL does not address delivery of annual reports or proxy statements, it does address the manner in which a corporation may give notice of a meeting of stockholders by providing for four types of notice: personal delivery, leaving the notice at the stockholder's residence or place of business, mailing to the stockholder at the stockholder's address as shown on the records of the corporation and electronic transmission.

Under the MGCL, a single notice is effective as to all stockholders who share an address unless the corporation receives a written or electronic request from a stockholder at such address that a single notice not be given. In lieu of householding, we believe that the only means of delivery permissible under the MGCL is addressing the material to each stockholder "individually" at the shared physical or electronic address. The corporation may deliver these materials in one package if it lists the name of each stockholder-recipient on the label containing the shared address. Additionally, the corporation must include a separate proxy card for each individual stockholder at the shared address. The MRL does not state the permissible methods of delivery of notice to the shareholders and this is customarily addressed by provision in the declaration of trust or bylaws.

Proxy Access. Proxy Rule 14a-8 requires a company to include in its proxy materials, under certain circumstances, shareholder proposals recommending the adoption of a procedure in the company's governing documents for including shareholder nominees for director in the company's proxy materials ("proxy access").

Under the MGCL, the board may be given exclusive power over amendments to the bylaws and the bylaws of most of our Maryland public company clients so provide. Thus, stockholders of these companies are not able to amend the bylaws directly for any purpose and so any stockholder proposal to change the bylaws must be precatory. We continue to reiterate our advice of many years that Maryland law specifically recognizes the right of directors to refuse to take any action recommended by the stockholders, even if recommended by the holders of a substantial majority of the shares.

The New York City Comptroller, as part of his "Boardroom Accountability Project," has been writing to companies in the portfolios of the pension funds that he oversees to urge them to adopt proxy access and some companies have begun to do so. The Comptroller is promoting his Project as "a national campaign to give shareowners a true voice in how corporate boards are elected at every U.S. company. * * * The ability to nominate directors is a fundamental shareowner right and the starting point for this transformation." The Comptroller says that he selected the recipients of his letters on the basis of investor concerns over excessive CEO compensation, lack of board diversity or perceived failure to address climate change.

We have advised some companies in adopting proxy access. It is not clear whether proxy access will become mainstream. It is clear, however, that there are several variables to consider in adopting proxy access and that its machinery is not simple. We urge caution in the substantive decision and its implementation.

Advisory Vote on Executive Compensation. Pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") and rules adopted by the SEC, an issuer for which the SEC requires compensation disclosure under the Proxy Rules and Item 402 of Regulation S-K is generally required to include a shareholder advisory vote on executive compensation ("say-on-pay") in the annual meeting proxy statement at least every three years. Additionally, at least every six years, shareholders must be given the opportunity to hold an advisory vote on the frequency of the executive compensation advisory vote, selecting among choices of every one, two or three years or abstain. Almost all public companies submit say-on-pay votes to their shareholders annually. Companies that were first subject to the say-on-pay requirements when they became operative for shareholder meetings in 2011 will be required to include an advisory vote on the frequency of the say-on-pay vote for consideration at the 2017 annual meeting of shareholders.

Executive compensation advisory votes have no effect on a director's or trustee's duties under Maryland law with respect to compensation decisions. Section 14A of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), provides that shareholder advisory votes are not binding on the issuer and, among other things, may not be construed "[t]o create or imply any change to the fiduciary duties of such issuer or board of directors [or] . . . to create or imply any additional fiduciary duties for such issuer or board of directors."

Ratification of Auditors. Although quite common, ratification of the board's appointment of auditors is, of course, generally not required under federal or Maryland law. Importantly, as ratification of auditors is a routine matter under the New York Stock Exchange ("NYSE") rules, brokers are entitled to vote on it without instructions from their beneficial owners. Thus, if there is no other routine matter on the proxy card, inclusion of ratification of auditors on the card may assist in obtaining a quorum for the meeting.

Board Structure and Director Nominations. Item 7 of Schedule 14A of the Proxy Rules ("Schedule 14A") sets forth various requirements with respect to disclosure regarding the composition of the board and the director nomination process. Of particular note are the requirements that the proxy statement include (a) a discussion of the "specific experience, qualifications, attributes or skills" that led to the conclusion that the nominee or incumbent director should serve as a director; (b) a discussion of the leadership structure of the board, including, among other things, disclosure of why the board has determined that its leadership structure is appropriate and the role of the board in risk oversight; (c) the role of compensation consultants and any potential conflicts of interest; and (d) whether the board or nominating committee considers diversity in identifying board nominees, whether the board or nominating committee has a diversity policy and, if so, how it is implemented and its effectiveness assessed. Regarding the foregoing, there are three important issues under Maryland law:

First, (a) any policy and/or procedures relating to the consideration of shareholder-recommended candidates for director and (b) any specific minimum qualifications for recommendation by the nominating committee for election as a director should be drafted, adopted, disclosed and applied in full coordination with any existing provisions in the charter or bylaws relating to substantive qualifications for election (*e.g.*, minimum or maximum age or ownership of company stock) and procedures for nomination (*e.g.*, advance notice to the company) and with any corporate governance guidelines. With the proliferation of policies, processes, committee charters, guidelines and principles – in addition to already existing corporate charters and bylaws – it is important that the provisions of all these documents not conflict in either letter or spirit. This also applies to other requirements and duties such as those involving composition of the audit and compensation committees.

Second, the MGCL permits a director "to rely on any information, opinion, report, or statement . . . prepared or presented by" an officer, employee, lawyer, accountant, other expert or board committee on which the director does not serve if the director reasonably believes (a) the officer or employee to be reliable and competent, (b) the expert to be acting within her or his professional or expert competence or (c) the committee to merit confidence, as the case may be. This right to rely applies not only to determinations of independence and other matters relating to director nominations but also to any other determination that a director must make. Thus, the availability and presentation of information and advice can be an important element in a director's substantive performance and in protecting him or her from liability. However, directors should guard against over-reliance, especially in the current corporate governance environment. Appropriate reliance can be an important aid to – but is not a substitute for – the proper exercise of business judgment. The MGCL specifically provides that the board's delegation of authority to a committee does not relieve the directors who are not members of the committee of their duties under the MGCL.

Finally, the additional disclosure requirements, including the need to continuously evaluate the qualifications of all directors for service as directors, highlight the importance of an annual board self-evaluation (required by the NYSE) in which each director actively participates. Although NASDAQ does not have a similar requirement, many NASDAQ companies have adopted board evaluation processes as a matter of good corporate governance. We regularly assist clients in the design and conduct of board evaluations.

<u>Committees</u>. Item 7(d) of Schedule 14A and the rules enacted under the Sarbanes-Oxley Act of 2002 and by the stock exchanges require various disclosures in the proxy statement concerning the audit, compensation and nominating/corporate governance committees, their charters and their members. Item 7(d) currently requires a public company to include these committees' charters as appendices to its annual meeting proxy statement at least every three fiscal years, if the charters are not available to shareholders on the company's website. As a result, most public companies in our experience place these charters on their websites. In addition, Section 303A of the NYSE Listed Company Manual (the "Listed Company Manual") requires the charters of the audit, nominating and compensation committees, the corporate governance guidelines and the code of business conduct and ethics to be posted on the company's website.

All committee reports included in the proxy statement should have actually been reviewed and signed by each member of the committee and submitted to the board and made a part of the board and committee records. Although not required, a committee may want to consider dating these reports. Most importantly, each committee report should be carefully reviewed to confirm that the committee actually did what the report says was done.

Indemnification/Advance of Expenses in Derivative Suits. The MGCL requires any Maryland corporation to report in writing to its stockholders, prior to, or with the notice of, the next meeting of stockholders, any indemnification of or advance of expenses to a director or officer in a suit by or on behalf of the corporation.

Quorum and Presence at the Meeting. The MGCL provides that, unless the charter provides otherwise, the presence, in person or by proxy, of the holders of shares entitled to cast a majority of all the votes entitled to be cast is necessary to constitute a quorum at a meeting of stockholders. In the absence of a contrary charter provision, the MGCL permits the bylaws of a registered open-end investment company and a corporation having a class of equity securities registered under the Exchange Act and at least three independent directors to lower the quorum requirement to not less than one-third of the votes entitled to be cast at the meeting. A stockholder who is physically present at a meeting (including a stockholder who signs in and later leaves) should be counted as "present" for purposes of determining the existence of a quorum, whether or not the stockholder votes. The same rule applies to a stockholder who is "present . . . by proxy . . . ." That is, if a stockholder returns a properly executed proxy or otherwise authorizes a proxy (and the proxy holder attends the meeting or properly submits the proxy), he or she should be counted as present "by proxy," whether he or she votes on all matters, only some matters or no matters at all or affirmatively checks the box marked "withhold authority" as to directors or "abstain" as to one or more other matters.

Voting Requirements and Abstentions and Broker "Non-Votes". The MGCL addresses quorum and voting requirements at meetings of stockholders but, like most corporation statutes, does not deal specifically with the issue of abstentions and broker non-votes.

Voting Requirements. With three limited exceptions – special voting requirements for certain business combinations with "interested stockholders," approval of voting rights for control shares acquired in a control share acquisition and separate class voting – there are four different statutory levels of vote requirements in the MGCL, depending on the matter for which the vote is taken:

(a) Election of directors – Plurality of all the votes cast at a meeting at which a quorum is present. No counterpart in the MRL.

(b) Removal of a director – Majority of all the votes entitled to be cast for the election of directors (unless the corporation has elected to be subject to an alternative provision). The MRL contains a counterpart.

(c) Charter amendment; merger; transfer of all or substantially all of the assets; consolidation; share exchange; conversion; and dissolution – Two-thirds of all the votes entitled to be cast on the matter. The MRL contains a counterpart for amendment of declaration of trust, merger and conversion, but there are no MRL provisions governing the transfer of assets, consolidation, share exchange or dissolution.

(d) All other matters – Majority of all the votes cast at a meeting at which a quorum is present. No counterpart in the MRL.

In each of the foregoing situations, the vote required may be altered by provision in the charter or, in the case of the plurality vote requirement for the election of directors, in the bylaws as well. In the absence of a counterpart provision in the MRL, the provisions of the declaration of trust or the bylaws will determine the vote required. Furthermore, the board may choose to submit a proposal to the shareholders conditioned on approval (a) by a percentage greater than that required by the MGCL or the MRL or (b) by some group of shareholders, such as a "majority-of-the-minority provision" in connection with a merger with a controlling shareholder. In addition, other laws or rules may impose different vote requirements. For example, Section 312.03 and .07 and Section 303A.08 of the Listed Company Manual require shareholder approval by the vote described more fully below for equity compensation plans (subject to certain exceptions) and certain issuances of securities. Item 21(a) of Schedule 14A requires the proxy statement to disclose the votes required for the election of directors and for the approval of any other matter (except approval of auditors).

Abstentions. An abstention is always counted as present and entitled to vote because presence and entitlement to vote are necessary to the act of abstaining. With respect to the counting of votes, an abstention is not a vote cast. *Larkin v. Baltimore Bancorp*, 769 F.Supp. 919, 921 n.1 (D. Md.), *aff'd*, 948 F.2d 1281 (4th Cir. 1991). The NYSE, however, takes an unwritten position that abstentions are votes cast with respect to those matters for which shareholder approval is a prerequisite to the listing of shares under Section 312 of the Listed Company Manual.

If the vote required is either a plurality or majority or other percentage of the votes cast, an abstention will have no effect because it will not be a vote cast. If the vote required is a majority, two-thirds or other percentage of all the votes entitled to be cast, the effect of an abstention will be the same as a vote against the proposal because an absolute percentage of affirmative votes is required.

Broker Non-Votes. Many shares of public companies are held in "street" or nominee name in accounts with banks and broker-dealers. These banks and broker-dealers (holding the shares through The Depository Trust Company and its nominee partnership, Cede & Co., the ultimate record owner of the shares) are generally required under the Proxy Rules to provide proxy materials to the beneficial owners and to seek instructions with respect to the voting of those securities. Under Rule 452 of the NYSE, brokers are not permitted to vote without instructions in uncontested director elections.[1] Section 402.08(B) of the Listed Company Manual also lists various

[1] This rule has been in effect since 2009 but does not apply to director elections for investment companies registered under the Investment Company Act of 1940, as amended (the "1940 Act"). Closed-end investment companies that elect to be treated as business development companies under the 1940 Act are not included in this exception.

matters as to which a broker member may not vote or give any proxy without instructions from the beneficial owner. Pursuant to Dodd-Frank, this rule and section were amended to prohibit discretionary voting by brokers on any matter that relates to executive compensation, including the advisory say-on-pay votes mandated by Dodd-Frank. Additionally, in a 2012 memo to members and member organizations, the NYSE indicated that it would no longer treat certain corporate governance proposals, such as proposals to declassify the board, provide for majority voting in director elections or eliminate supermajority voting requirements, as routine matters. Accordingly, there are now very few proposals as to which a broker may exercise discretionary authority.

A broker non-vote is a vote that is not cast on a non-routine matter because the shares entitled to cast the vote are held in street name, the broker lacks discretionary authority to vote the shares and the broker has not received voting instructions from the beneficial owner.[2] If the broker votes on a routine matter but does not vote on a non-routine item on the proxy, then the shares held in street name are present for quorum purposes and the effect of not voting on the non-routine matter depends upon whether the vote requirement for that proposal is based upon a proportion of the votes cast (no effect) or a proportion of the votes entitled to be cast (effect of a vote against).[3] If the only matter at a meeting is non-routine, there should be no broker non-votes, because there is nothing on which the broker is permitted to vote, and shares held in street name for which voting instructions have not been received will be treated identically to shares held by a record holder who does not appear at the meeting in person or by proxy, *i.e.*, as unvoted shares.

Item 21(b) of Schedule 14A requires disclosure only of "the method by which votes will be counted, including the treatment and effect of abstentions and broker non-votes under applicable state law as well as registrant charter and by-law provisions." While Item 21(b) does not specifically require disclosure of the effect of abstentions and broker non-votes on determining a quorum, many companies make that disclosure anyway. It should also be noted that Item 5.07 of Form 8-K requires disclosure of the results of each matter voted upon by the shareholders, broken down into the number of votes cast for, against or withheld, as well as the numbers of abstentions and broker non-votes on each matter. If the company initially discloses preliminary voting results, it must file an amended Form 8-K within four business days after the final results are "known."

[2] Generally, the distribution and collection of voting instruction forms are handled by Broadridge Financial Solutions, Inc., acting on the brokers' behalf pursuant to contract.

[3] An SEC no-action letter issued to the American Bar Association in 1993 takes the position that for Rule 16b-3(d) purposes "broker non-votes should not be considered shares entitled to vote because the broker and proxy holder do not have the authority to vote the shares with regard to the plan." American Bar Ass'n, SEC No-Action Letter, 1993 SEC No-Act. LEXIS 782 (June 24, 1993). A different result might be reached under state corporation law. For example, similar language in the MGCL (*e.g.*, "votes entitled to be cast on the matter," see MGCL §2-604(e) (re charter amendments)) means the total votes to which the total outstanding shares are entitled. *Compare Berlin v. Emerald Partners*, 552 A.2d 482, 491-95 (Del. 1988). We disagree with the SEC's position because broker non-votes are not, to use the SEC's word, "shares" and do not implicate the underlying voting rights to which all shares of that class are entitled under applicable state law and the charter; rather, broker non-votes are the absence of the right of a particular person, the broker, to vote the shares on a particular matter without instruction from the beneficial owner. In other words, the shares remain entitled to vote but one particular holder, the broker, is not entitled to vote them.

Considering the requirements of the federal securities laws, Maryland law and the NYSE, we recommend for Maryland corporations and real estate investment trusts the forms of disclosure set forth on Appendix A hereto, which may be varied appropriately in accordance with the proposal and the applicable vote requirement. The bracketed language on quorums in Appendix A is not required by Item 21(b), but is often disclosed, as noted above.

Proxy Cards. The proxy card is the critical document under state law by which most votes of record are generally authorized to be cast. In this regard, it is important to note that "stockholder" is defined by the MGCL as "a person who is a record holder of shares of stock in a corporation . . . ."[4] Under the MGCL, the proxy must be written and must be signed by the stockholder of record or by the record stockholder's authorized agent. The MGCL provides that signing may be (a) by actual signature by the stockholder or the stockholder's authorized agent or (b) by the stockholder or the stockholder's authorized agent causing the stockholder's signature to be affixed to the writing by any reasonable means, including facsimile signatures. Note that the MGCL does not expressly apply to the voting instruction forms sent by or on behalf of brokers or other intermediaries to obtain voting instructions from beneficial owners holding in street name. A voting instruction is not a proxy under Maryland law and, if certain conditions are met, the solicitation by record holders of voting instructions from beneficial owners is generally exempt from the Proxy Rules pursuant to Rule 14a-2(a)(1).

Among the requirements of Proxy Rule 14a-4(a) and (b), the proxy card must state in boldface type who is soliciting the proxies, list the names of nominees for election as directors and provide an opportunity for the shareholder to withhold authority to vote for individual nominees. Proxy Rule 14a-4(b)(2) also provides that if the proxy card provides a means for the shareholder to vote for all nominees as a group, then it must also provide a means to withhold authority to vote for the group.

Electronic Voting. In recognition of the fact that corporations often hire proxy solicitors and other intermediaries to assist in soliciting proxies, the MGCL permits a stockholder not only to authorize another person to act as a proxy but also to authorize an intermediary, *e.g.*, a proxy solicitor, to authorize another person to act as a proxy. Either of these authorizations may be done "by telegram, cablegram, datagram, electronic mail, or any other electronic or telephonic means." In other words, a stockholder may effectively cast votes by telephone or internet, even though the MGCL does not expressly permit direct voting by telephone or other electronic means.

Deadlines for Shareholder Proposals for Next Annual Meeting. Proxy Rule 14a-5(e) requires the proxy statement to disclose, "under an appropriate caption," (a) the deadline for submitting shareholder proposals for inclusion in the proxy statement and proxy card for the next annual meeting, calculated as provided in Rule 14a-8(e) (Question 5), and (b) the deadline for submitting notice of a shareholder proposal for consideration at the meeting, calculated as provided

[4] There is no corresponding definition of "shareholder" under the MRL. In this memorandum, we have generally used "shareholder" to refer both to a stockholder of a Maryland corporation and a shareholder of a Maryland real estate investment trust, except when referring to a stockholder under a specific provision of the MGCL.

in Proxy Rule 14a-4(c)(1), or under an "advance notice provision, if any, authorized by applicable state law."

(a) *Inclusion in Proxy Statement and Proxy Card.* If the shareholder's proposal is submitted for inclusion in the proxy statement and proxy card for a regularly scheduled annual meeting, then under Proxy Rule 14a-8(e)(2) it must be received by the company at its principal executive office not less than 120 calendar days before the first anniversary of the date of the proxy statement released to shareholders for the prior year's annual meeting (which is interpreted by the SEC as the date that the proxy statement is first sent or given to shareholders).

(b) *Presentation at the Annual Meeting.* A shareholder may opt not to submit a proposal for inclusion in the proxy statement and proxy card but still want to present it at the meeting, or a shareholder may want to nominate an individual for election to the board. If so, the shareholder must comply with any advance notice provision in the charter or bylaws. The MGCL (which expressly applies in this regard to real estate investment trusts under the MRL) authorizes requiring advance notice for stockholder nominations or proposals.

In this regard, we have a well developed form of advance notice bylaw, used by many of our public company clients, containing detailed requirements of the information that must be submitted by a shareholder proponent of director nominees or other business. Advance notice requirements are important in providing the board the necessary time and information to properly consider shareholder nominations and proposals, especially in light of increased shareholder activism. If you have advance notice bylaws that have not been recently reviewed, you may want to consider doing so now so that any amendments may be incorporated in the bylaws (and possibly the 2016 proxy statement) for application to the 2017 annual meeting of shareholders.

<u>Postponement and Adjournment</u>. The MGCL expressly permits postponement of a meeting of stockholders before it is convened and adjournment of a convened meeting to a later date. Typically, a postponement is publicly disclosed not later than the day before the date of the meeting. The notice requirements for postponements and adjournments vary and also depend on the duration of the postponement or adjournment. We believe that the chair of the meeting has broad power to conduct the meeting of stockholders, including recessing and adjourning it, especially if this authority is specifically conferred by the bylaws, as is now customary.

* * * *

As discussed above, it is important that the various elements relating to the governance of the corporation – the charter, the bylaws, the board committee charters and corporate governance guidelines and policies – be consistent with one another. A comprehensive review of these documents should be a part of the preparation for each annual meeting. Additionally, in light of the current environment, the board should review the status of the company's defenses against an unsolicited takeover bid.

Other proxy solicitation issues involving Maryland law also frequently arise. We and our colleagues are available to discuss any questions you may have concerning Maryland law as it applies to your meeting notice, proxy statement and proxy card.

Jim Hanks
Michael Leber

This memorandum is provided for information purposes only and is not intended to provide legal advice. Such advice may be provided only after analysis of specific facts and circumstances and consideration of issues that may not be addressed in this document.

APPENDIX A

PROXY STATEMENTS UNDER MARYLAND LAW – 2016

N.B.: Be sure to check that the statutory vote requirements have not been altered by a provision in the charter, declaration of trust or bylaws.

Election of Directors by Plurality Vote

The vote of a plurality of all of the votes cast at a meeting at which a quorum is present is necessary for the election of a director. For purposes of the election of directors, abstentions and broker non-votes, if any, will not be counted as votes cast and will have no effect on the result of the vote[, although they will be considered present for the purpose of determining the presence of a quorum].

Election of Directors by "Majority Voting"

The vote of a majority of the total of votes cast for a nominee and [votes affirmatively withheld as to *or* votes against] a nominee at a meeting at which a quorum is present is necessary for the election of a director. For purposes of the election of directors, abstentions and broker non-votes, if any, will not be counted as votes cast and will have no effect on the result of the vote[, although they will be considered present for the purpose of determining the presence of a quorum]. [*N.B.: The foregoing disclosure is suggested for the increasingly common "majority voting" requirement in uncontested elections only.*]

Approval of Extraordinary Action

The affirmative vote of two-thirds of all of the votes entitled to be cast on the matter is required for approval of the proposed __[charter amendment, merger, etc.]__. For purposes of the vote on the proposed __[charter amendment, merger, etc.]__, abstentions and broker non-votes will have the same effect as votes against the proposal[, although they will be considered present for the purpose of determining the presence of a quorum].

Approval of Non-Extraordinary Action

The affirmative vote of a majority of all of the votes cast at a meeting at which a quorum is present is required for approval of __[specify proposal]__. For purposes of the vote on the __[specify proposal]__, abstentions [and broker non-votes – *N.B.: Include these words only if the vote is on a non-routine matter*] will not be counted as votes cast and will have no effect on the result of the vote[, although they will be considered present for the purpose of determining the presence of a quorum].

Approval of Advisory Vote on the Frequency
of an Advisory Vote on Executive Compensation

The option of one year, two years or three years that receives a majority of all the votes cast at a meeting at which a quorum is present will be the frequency for the advisory vote on executive compensation that has been recommended by shareholders. For purposes of this advisory vote, abstentions and broker non-votes will not be counted as votes cast and will have no effect on the result of the vote[, although they will be considered present for the purpose of determining the presence of a quorum]. In the event that no option receives a majority of the votes cast, we will consider the option that receives the most votes to be the option selected by shareholders. In either case, this vote is advisory and not binding on the Board or the Company in any way, and the Board or the Corporate Governance Committee may determine that it is in the best interests of the Company to hold an advisory vote on executive compensation more or less frequently than the option recommended by our shareholders.

Approval of Transaction under
Section 312.03 of the Listed Company Manual

The affirmative vote of a majority of the votes cast on the proposal at a meeting at which a quorum is present is required for approval of [specify proposal]. For purposes of the vote on [specify proposal], abstentions will have the same effect as votes against the proposal and broker non-votes will not have any effect on the result of the vote. [*N.B.*: *The treatment of abstentions as having the effect of a vote against the proposal is appropriate only if adhering to the unwritten NYSE policy that abstentions are votes cast; an abstention is not a vote cast for Maryland law purposes.*] [Both abstentions and broker non-votes will be considered present for the purpose of determining the presence of a quorum.]

Approval of SEC Rule 16b-3 Plan
(Other than a Discretionary Transaction)

The affirmative vote of the holders of a majority of the shares [or other securities] present (or represented) and entitled to vote at the meeting is required for approval of the proposed [specify name of employee benefit plan or describe specific transaction being submitted pursuant to Rule 16b-3(d)(2)]. For purposes of the vote on the proposed plan, abstentions will have the same effect as votes against the proposed [plan] [transaction] and broker non-votes will not be counted as shares entitled to vote[A] on the matter and will have no effect on

[A] See footnote 3, above.

the result of the vote. [Both abstentions and broker non-votes will be considered present for the purpose of determining the presence of a quorum.]

Approval by a 1940 Act Majority

The approval of the proposal requires the affirmative vote of the holders of a "majority of the outstanding voting securities" of the Fund as defined in [Section 2(a)(42) of] the Investment Company Act of 1940, which means the lesser of (i) 67% or more of the voting securities of the Fund present or represented at the meeting, if the holders of more than 50% of the Fund's outstanding voting securities are present or represented by proxy, or (ii) more than 50% of the outstanding voting securities of the Fund. For purposes of the vote on the proposal, abstentions and broker non-votes will have the effect of votes against the proposal[, although they will be considered present for purposes of determining the presence of a quorum].

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March 7, 2016

Supreme Court Looks to Citizenship of Shareholders of Maryland Title 8 REITs to Determine Diversity of Citizenship for Access to Federal Courts

The Supreme Court ruled today that the citizenship of a Maryland Title 8 real estate investment trust (a "trust REIT") that seeks access to the federal courts based on diversity-of-citizenship jurisdiction must be determined by looking to the citizenship of the shareholders. In an 8-0 decision, Justice Sotomayor writing for the Court held that the federal statute for diversity of citizenship as applied to a corporation, which looks to the state where the corporation's principal place of business is located and the state under the laws of which the corporation is incorporated, does not apply to unincorporated entities. *Americold Realty Trust v. Conagra Foods, Inc., et al.*

The effect of this decision will be to deny most widely-held trust REITs access to the federal courts on the grounds of diversity of citizenship of the parties to the litigation because it is likely that their shareholders will be citizens of many, perhaps all, states, including the states where the opposing party or parties are citizens. The right of a trust REIT to access federal courts based on a federal question arising under the Constitution, laws and treaties of the United States is not affected. For example, the jurisdiction of a suit by or against a trust REIT under the federal tax, securities, antitrust or environmental statutes would not be affected. It is only where a trust REIT seeks to assert or defend a non-federal claim in federal court that it will not be able to do so if even a single shareholder is a citizen of the same state as one of the opposing parties.

The National Association of Real Estate Investment Trusts filed an *amicus curiae* brief with the Court, in which we participated as co-counsel. Justice Sotomayor acknowledged NAREIT's brief but said: "We also decline an *amicus*' invitation to apply the same rule to an unincorporated entity that applies to a corporation – namely, to consider it a citizen only of its State of establishment and its principal place of business. See Brief for National Association of Real Estate Investment Trusts 11-21."

As the rules for the citizenship of unincorporated entities are not addressed by federal statute but are formulated by the courts, we believe that the rules that Congress has laid down for determining the citizenship of corporations – state of incorporation and principal place of business – are the closest analogue for widely-held trust REITs. The Court, however, concluded that "it is up to Congress if it wishes" to extend to trust REITs the same rule that it has long applied to corporations.

* * * *

As always, our colleagues and we are available at any time to discuss these or other matters.

Jim Hanks
Hirsh Ament
Jeb Cook

Concurrent Session: Governance

Thursday, March 31st
11:15am – 12:30pm
Marriott Marquis, Washington DC

Moderator:
Eric Kevorkian, SVP & Sr. Corporate Counsel, Boston Properties, Inc.

Panelists:
Donna Anderson, VP & Global Corporate Governance Analyst, T. Rowe Price Associates, Inc.
Margaret Foran, Chief Governance Officer, SVP & Corporate Secretary, Prudential Financial, Inc.
Zachary Oleksiuk, Head-Corporate Governance & Responsible Investment-Americas, Blackrock
Bruce Strohm, EVP & General Counsel, Equity Residential

BLACKROCK®

February 1, 2016

Dear ,

Over the past several years, I have written to the CEOs of leading companies urging resistance to the powerful forces of short-termism afflicting corporate behavior. Reducing these pressures and working instead to invest in long-term growth remains an issue of paramount importance for BlackRock's clients, most of whom are saving for retirement and other long-term goals, as well as for the entire global economy.

While we've heard strong support from corporate leaders for taking such a long-term view, many companies continue to engage in practices that may undermine their ability to invest for the future. Dividends paid out by S&P 500 companies in 2015 amounted to the highest proportion of their earnings since 2009. As of the end of the third quarter of 2015, buybacks were up 27% over 12 months. We certainly support returning excess cash to shareholders, but not at the expense of value-creating investment. We continue to urge companies to adopt balanced capital plans, appropriate for their respective industries, that support strategies for long-term growth.

We also believe that companies have an obligation to be open and transparent about their growth plans so that shareholders can evaluate them and companies' progress in executing on those plans.

We are asking that every CEO lay out for shareholders each year a strategic framework for long-term value creation. Additionally, because boards have a critical role to play in strategic planning, we believe CEOs should explicitly affirm that their boards have reviewed those plans. BlackRock's corporate governance team, in their engagement with companies, will be looking for this framework and board review.

Annual shareholder letters and other communications to shareholders are too often backwards-looking and don't do enough to articulate management's vision and plans for the future. This perspective on the future, however, is what investors and all stakeholders truly need, including, for example, how the company is navigating the competitive landscape, how it is innovating, how it is adapting to technological disruption or geopolitical events, where it is investing and how it is developing its talent. As part of this effort, companies should work to develop financial metrics, suitable for each company and industry, that support a framework for long-term growth. Components of long-term compensation should be linked to these metrics.

We recognize that companies operate in fluid environments and face a challenging mix of external dynamics. Given the right context, long-term shareholders will understand, and even expect, that you will need to pivot in response to the changing environments you are navigating. But one reason for investors' short-term horizons is that companies have not sufficiently educated them about the ecosystems they are operating in, what their competitive threats are and how technology and other innovations are impacting their businesses.

Without clearly articulated plans, companies risk losing the faith of long-term investors. Companies also expose themselves to the pressures of investors focused on maximizing near-term profit at the expense of long-term value. Indeed, some short-term investors (and analysts) offer more compelling visions for companies than the companies themselves, allowing these perspectives to fill the void and build support for potentially destabilizing actions.

Those activists who focus on long-term value creation sometimes *do* offer better strategies than management. In those cases, BlackRock's corporate governance team will support activist plans. During the 2015 proxy season, in the 18 largest U.S. proxy contests (as measured by market cap), BlackRock voted with activists 39% of the time.

Nonetheless, we believe that companies are usually better served when ideas for value creation are part of an overall framework developed and driven by the company, rather than forced upon them in a proxy fight. With a better understanding of your long-term strategy, the process by which it is determined, and the external factors affecting your business, shareholders can put your annual financial results in the proper context.

Over time, as companies do a better job laying out their long-term growth frameworks, the need diminishes for quarterly EPS guidance, and we would urge companies to move away from providing it. Today's culture of quarterly earnings hysteria is totally contrary to the long-term approach we need. To be clear, we do believe companies should still report quarterly results – "long-termism" should not be a substitute for transparency – but CEOs should be more focused in these reports on demonstrating progress against their strategic plans than a one-penny deviation from their EPS targets or analyst consensus estimates.

With clearly communicated and understood long-term plans in place, quarterly earnings reports would be transformed from an instrument of incessant short-termism into a building block of long-term behavior. They would serve as a useful "electrocardiogram" for companies, providing information on how companies are performing against the "baseline EKG" of their long-term plan for value creation.

We also are proposing that companies explicitly affirm to shareholders that their boards have reviewed their strategic plans. This review should be a rigorous process that provides the board the necessary context and allows for a robust debate. Boards have an obligation to review, understand, discuss and challenge a company's strategy.

Generating sustainable returns over time requires a sharper focus not only on governance, but also on environmental and social factors facing companies today. These issues offer both risks and opportunities, but for too long, companies have not considered them core to their business – even when the world’s political leaders are increasingly focused on them, as demonstrated by the Paris Climate Accord. Over the long-term, environmental, social and governance (ESG) issues – ranging from climate change to diversity to board effectiveness – have real and quantifiable financial impacts.

At companies where ESG issues are handled well, they are often a signal of operational excellence. BlackRock has been undertaking a multi-year effort to integrate ESG considerations into our investment processes, and we expect companies to have strategies to manage these issues. Recent action from the U.S. Department of Labor makes clear that pension fund fiduciaries can include ESG factors in their decision making as well.

We recognize that the culture of short-term results is not something that can be solved by CEOs and their boards alone. Investors, the media and public officials all have a role to play. In Washington (and other capitals), long-term is often defined as simply the next election cycle, an attitude that is eroding the economic foundations of our country.

Public officials must adopt policies that will support long-term value creation. Companies, for their part, must recognize that while advocating for more infrastructure or comprehensive tax reform may not bear fruit in the next quarter or two, the absence of effective long-term policies in these areas undermines the economic ecosystem in which companies function – and with it, their chances for long-term growth.

We note two areas, in particular, where policymakers taking a longer-term perspective could help support the growth of companies and the entire economy:

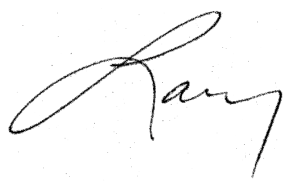
- First, tax policy too often lacks proper incentives for long-term behavior. With capital gains, for example, one year shouldn’t qualify as a long-term holding period. As I wrote last year, we need a capital gains regime that rewards long-term investment – with long-term treatment only after three years, and a decreasing tax rate for each year of ownership beyond that (potentially dropping to zero after 10 years).

- Second, chronic underinvestment in infrastructure in the U.S. – from roads to sewers to the power grid – will not only cost businesses and consumers $1.8 trillion over the next five years, but clearly represents a threat to the ability of companies to grow. At a time of massive global inequality, investment in infrastructure – and all its benefits, including job creation – is also critical for growth in most emerging markets around the world. Companies and investors must advocate for action to fill the gaping chasm between our massive infrastructure needs and squeezed government funding, including strategies for developing private-sector financing mechanisms.

Over the past few years, we've seen more and more discussion around how to foster a long-term mindset. While these discussions are encouraging, we will only achieve our goal by changing practices and policies, and CEOs of America's leading companies have a vital role to play in that debate.

Corporate leaders have historically been a source of optimism about the future of our economy. At a time when there is so much anxiety and uncertainty in the capital markets, in our political discourse and across our society more broadly, it is critical that investors in particular hear a forward-looking vision about your own company's prospects and the public policy you need to achieve consistent, sustainable growth. The solutions to these challenges are in our hands, and I ask that you join me in helping to answer them.

Sincerely,



Laurence D. Fink

Proxy voting guidelines for U.S. securities

February 2015

Proxy voting guidelines for U.S. securities

Contents

Proxy voting guidelines for U.S. securities

These guidelines should be read in conjunction with BlackRock's Global Corporate Governance and Engagement Principles, which are available on-line at www.blackrock.com

Introduction

BlackRock, Inc. and its subsidiaries (collectively, "BlackRock") seek to make proxy voting decisions in the manner most likely to protect and promote the economic value of the securities held in client accounts. The following issue-specific proxy voting guidelines (the "Guidelines") are intended to summarize BlackRock's general philosophy on corporate governance matters and approach to issues that may commonly arise in the proxy voting context for U.S. securities. These Guidelines are not intended to limit the analysis of individual issues at specific companies and are not intended to provide a guide to how BlackRock will vote in every instance. Rather, they share our view about corporate governance issues generally, and provide insight into how we typically approach issues that commonly arise on corporate ballots as well as our expectations of boards of directors. They are applied with discretion, taking into consideration the range of issues and facts specific to the company and the individual ballot item.

Voting guidelines

These guidelines are divided into six key themes which group together the issues that frequently appear on the agenda of annual and extraordinary meetings of shareholders.

The six key themes are:

- Boards and directors
- Auditors and audit-related issues
- Capital structure, mergers, asset sales and other special transactions
- Remuneration and benefits
- Social, ethical and environmental issues
- General corporate governance matters

Boards and directors

Director elections

BlackRock generally supports board nominees in most uncontested elections. BlackRock may withhold votes from certain directors on the board or members of particular board committees (or prior members, as the case may be) in certain situations, including, but not limited to:

- The independent chair or lead independent director and members of the governance committee, where a board fails to implement shareholder proposals that receive a majority of votes cast at a prior shareholder meeting, and the proposals, in our view, have a direct and substantial impact on shareholders' fundamental rights or long-term economic interests.

- The independent chair or lead independent director and members of the governance committee, where a board implements or renews a poison pill without seeking shareholder approval beforehand or within a reasonable period of time after implementation.

- The independent chair or lead independent director and members of the governance committee, where a board amends the charter/articles/by-laws such that the effect may be to entrench directors or to significantly reduce shareholder rights. In such cases, in determining whether to withhold support from directors, we will consider in part the company's publicly stated rationale for the changes and whether the board has determined to seek shareholder approval beforehand or within a reasonable period of time after implementation.

- The independent chair or lead independent director, members of the nominating committee, and/or the longest tenured director(s), where we observe a lack of board responsiveness to shareholders on board composition concerns, evidence of board entrenchment, insufficient attention to board diversity, and/or failure to promote adequate board succession planning over time in line with the company's stated strategic direction.

- An insider or affiliated outsider who sits on the board's audit, compensation, nominating or governance committees (the "key committees"), which we believe generally should be entirely independent. However, BlackRock will examine a board's complete profile when questions of independence arise prior to casting a withhold vote for any director. For controlled companies, as defined by the U.S. stock exchanges, we will only vote against insiders or affiliates who sit on the audit committee, but not other key committees.

- Members of the audit committee during a period when the board failed to facilitate quality, independent auditing, for example, if substantial accounting irregularities suggest insufficient oversight by that committee.

- Members of the audit committee during a period in which we believe the company has aggressively accounted for its equity compensation plans.

- Members of the compensation committee during a period in which executive compensation appears excessive relative to performance and peers, and where we believe the compensation committee has not already substantially addressed this issue.

- Members of the compensation committee where the company has repriced options without contemporaneous shareholder approval.

- The chair of the nominating committee, or where no chair exists, the nominating committee member with the longest tenure, where board member(s) at the most recent election of directors have received withhold votes from more than 30% of shares voting and the board has not taken appropriate action to respond to shareholder concerns. This may not apply in cases where BlackRock did not support the initial withhold vote.

- The chair of the nominating committee, or where no chair exists, the nominating committee member with the longest tenure, where the board is not composed of a majority of independent directors. However, this would not apply in the case of a controlled company.

- Where BlackRock obtains evidence that casts significant doubt on a director's qualifications or ability to represent shareholders.

- Where it appears the director has acted (at the company or at other companies) in a manner that compromises his or her reliability in representing the best long-term economic interests of shareholders.

- Where a director has a pattern of poor attendance at combined board and applicable key committee meetings. Excluding exigent circumstances, BlackRock generally considers attendance at less than 75% of the combined board and applicable key committee meetings by a board member to be poor attendance.

- Where a director has committed himself or herself to service on a large number of boards, such that we deem it unlikely that the director will be able to commit sufficient focus and time to a particular company (commonly referred to as “over-boarding”). While each situation will be reviewed on a case-by-case basis, BlackRock is most likely to withhold votes for over-boarding where a director is: 1) serving on more than four public company boards; or 2) is a chief executive officer at a public company and is serving on more than two public company boards in addition to the board of the company where they serve as chief executive officer.

If a board maintains a classified structure, it is possible that the director(s) with whom we have a particular concern may not be subject to election in the year that the concern arises. In such situations, if we have a concern regarding a committee or committee chair, we generally register our concern by withholding votes from all members of the relevant committee who are subject to election that year.

Director independence

We expect that a board should be majority independent. We believe that an independent board faces fewer conflicts and is best prepared to protect shareholder interests. Common impediments to independence in the U.S. may include, but are not limited to:

- Employment by the company or a subsidiary as a senior executive within the previous five years
- Status as a founder of the company
- Substantial business or personal relationships with the company or the company’s senior executives
- Family relationships with senior executives or founders of the company
- An equity ownership in the company in excess of 20%

Board composition and effectiveness

We encourage boards to routinely refresh their membership to ensure the relevance of the skills, experience and attributes of each director to the work of the board. To ensure that the board remains effective, regular reviews of board performance should be carried out and assessments made of gaps in skills or experience amongst the members. BlackRock believes it is beneficial for new directors to be brought onto the board periodically to refresh the group’s thinking and to ensure both continuity and adequate succession planning. We believe that the nominating committee of the board has the ability to implement such refreshment. In identifying potential candidates, boards should take into consideration the diversity of experience and expertise of the current directors and how that might be augmented by incoming directors. We encourage boards to disclose their views on: the mix of competencies, experience and other qualities required to effectively oversee and guide management; the process by which candidates are identified and selected, including whether professional firms or other sources outside of incumbent directors’ networks have been engaged to identify and/or assess candidates; the process by which boards evaluate themselves and any significant outcomes of the evaluation process, without divulging inappropriate and/or sensitive details; the consideration given towards board diversity, including, but not limited to, diversity of gender, race, age, experience, and skills; and other factors taken into account in the nomination process.

While we support regular board refreshment, we are not opposed in principle to long-tenured directors nor do we believe that long board tenure is necessarily an impediment to director independence. We believe that a variety of director tenures within the boardroom can be beneficial to ensure board quality and continuity of experience; our primary concern is that board members are able to contribute effectively as corporate strategy evolves and business conditions change over time, and that all directors, regardless of tenure, demonstrate appropriate responsiveness to shareholders over time. We acknowledge that each director brings their own unique skills and experiences and that no single person can be expected to bring all relevant skill sets to a board; at the same time, we generally do not believe it is necessary or appropriate to have any particular director on the board solely by virtue of a singular background or specific area of expertise.

As a result of the nominating committee's responsibility for board composition and refreshment over time, we typically oppose shareholder proposals imposing arbitrary limits on the pool of directors from which shareholders can choose their representatives. However, where boards find that age limits or term limits are the most efficient and objective mechanism for ensuring periodic board refreshment, we generally defer to the board's determination in setting such limits.

Board size

We generally defer to the board in setting the appropriate size. We believe directors are generally in the best position to assess what size is optimal to ensure a board's effectiveness. However, we may oppose boards that appear too small to allow for effective shareholder representation or too large to function efficiently.

CEO and management succession planning

There should be a robust CEO and management succession plan in place at the board level that is reviewed and updated on a regular basis. We expect succession planning to cover both long-term planning consistent with the strategic direction of the company and identified leadership needs over time as well as short-term planning in the event of an unanticipated executive departure. We acknowledge that both internal and external management candidates may be considered, as informed by required skill sets and cultural fit considerations and as appropriate to the company's circumstances. We encourage the company to explain its executive succession planning process, including where accountability lies within the boardroom for this task, without prematurely divulging sensitive information commonly associated with this exercise.

Classified board of directors/staggered terms

A classified board of directors is one that is divided into classes (generally three), each of which is elected on a staggered schedule (generally for three years). At each annual meeting, only a single class of directors is subject to reelection (generally one-third of the entire board).

We believe that classification of the board dilutes shareholders' right to evaluate promptly a board's performance and limits shareholder selection of their representatives. By not having the mechanism to immediately address concerns we may have with any specific director, we may be required to register our concerns through our vote on the directors who are subject to election that year (see "Director elections" for additional detail). Furthermore, where boards are classified, director entrenchment is more likely, because review of board service generally only occurs every three years. Therefore, we typically vote against classification and for proposals to eliminate board classification.

Contested director elections

Most director elections are not competitive, but shareholders are sometimes presented with competing slates of director candidates. Generally, such proxy contests are the result of a shareholder (or group of shareholders) seeking to change the company's strategy or address failures in the board's oversight of management. The details of proxy contests are assessed on a case-by-case basis. We evaluate a number of factors, which may include, but are not limited to: the qualifications of the dissident and management candidates; the validity of the concerns identified by the dissident; the viability of both the dissident's and management's plans; the likelihood that the dissident's solutions will produce the desired change; and whether the dissidents represent the best option for enhancing long-term shareholder value.

Cumulative voting for directors

Cumulative voting allocates one vote for each share of stock held, times the number of directors subject to election. A shareholder may cumulate his/her votes and cast all of them in favor of a single candidate, or split them among any combination of candidates. By making it possible to use their cumulated votes to elect at least one board member, cumulative voting is typically a mechanism through which minority shareholders attempt to secure board representation.

We typically oppose proposals that further the candidacy of minority shareholders whose interests do not coincide with our fiduciary responsibility. We may support cumulative voting proposals at companies where the board is not majority independent. We may support cumulative voting at companies that have a controlling shareholder. A cumulative voting structure is not consistent with a majority voting requirement, as it may interfere with the capacity of director candidates to achieve the required level of support. We may not support a cumulative voting proposal at a company that has adopted a majority voting standard.

Director compensation and equity programs

We believe that compensation for independent directors should be structured to align the interests of the directors with those of shareholders, whom the directors have been elected to represent. We believe that independent director compensation packages based on the company's long-term performance and that include some form of long-term equity compensation are more likely to meet this goal; therefore, we typically support proposals to provide such compensation packages. However, we will generally oppose shareholder proposals requiring directors to own a minimum amount of company stock, as we believe that companies should maintain flexibility in administering compensation and equity programs for independent directors, given each company's and director's unique circumstances. As discussed in further detail under the heading "Equity compensation plans" below, we believe that companies should prohibit directors from engaging in transactions with respect to their long-term compensation that might disrupt the intended economic alignment between equity plan beneficiaries and shareholders.

Indemnification of directors and officers

We generally support reasonable but balanced protection of directors and officers. We believe that failure to provide protection to directors and officers might severely limit a company's ability to attract and retain competent leadership. We generally support proposals to provide indemnification that is limited to coverage of legal expenses. However, we may oppose proposals that provide indemnity for: breaches of the duty of loyalty; transactions from which a director derives an improper personal benefit; and actions or omissions not in good faith or those that involve intentional misconduct.

Majority vote requirements

BlackRock generally supports proposals seeking to require director election by majority vote. Majority voting standards assist in ensuring that directors who are not broadly supported by shareholders are not elected to serve as their representatives. We note that majority voting is not appropriate in all circumstances, for example, in the context of a contested election. We also recognize that some companies with a plurality voting standard have adopted a resignation policy for directors who do not receive support from at least a majority of votes cast. Where we believe that the company already has a sufficiently robust majority voting process in place, we may not support a shareholder proposal seeking an alternative mechanism.

Risk oversight

Companies should have an established process for identifying, monitoring and managing key risks, and independent directors should have ready access to relevant management information and outside advice, as appropriate, to ensure they can properly oversee risk management. We encourage companies to provide transparency as to the optimal risk levels, how risk is measured and how risks are reported to the board. We are particularly interested to understand how risk oversight processes evolve in response to changes in corporate strategy and/or shifts in the business and related risk environment. Boards should clearly explain their approach to risk oversight, including where accountability lies within the boardroom for this activity, especially where there are multiple individuals or board committees tasked with oversight of various risks.

Separation of chairman and CEO positions

We believe that independent leadership is important in the board room. In the U.S. there are two commonly accepted structures for independent board leadership: 1) an independent chairman; or 2) a lead independent director. We assess the experience and governance track record of the independent chairman or lead independent director to understand capability and suitability to effectively and constructively lead a board. Our expectations of an individual in this role include, but are not limited to: being available to serve as an advisor to the CEO; contributing to the oversight of CEO and management succession planning; and being available to meet with shareholders when they have highly sensitive concerns about management or corporate governance issues. We generally consider the designation of a lead independent director as an acceptable alternative to an independent chair if the lead independent director has a term of at least one year and has powers to: 1) provide formal input into board meeting agendas; 2) call meetings of the independent directors; and 3) preside at meetings of independent directors. Where a company does not have a lead independent director that meets these criteria, we generally support the separation of chairman and CEO.

Shareholder access to the proxy

We believe that long-term shareholders should have the opportunity, when necessary and under reasonable conditions, to nominate individuals to stand for election to the boards of the companies they own and to have those nominees included on the company's proxy card. This right is commonly referred to as "proxy access". In our view, securing a right of shareholders to nominate directors without engaging in a control contest can enhance shareholders' ability to participate meaningfully in the director election process, stimulate board attention to shareholder interests, and provide shareholders an effective means of directing that attention where it is lacking. Given the complexity of structuring an appropriate proxy access mechanism and the brevity required of shareholder proposals, we generally expect that a shareholder proposal to adopt proxy access will describe general parameters for the mechanism, while providing the board with flexibility to design a process that is appropriate in light of the company's specific circumstances. Proxy access mechanisms should provide shareholders with a reasonable opportunity to use this right without stipulating overly restrictive or onerous parameters for use, and also provide assurances that the mechanism will not be subject to abuse by short-term investors, investors without a substantial investment in the company, or investors seeking to take control of the board. We will review proposals regarding the adoption of proxy access on a case-by-case basis.

Auditors and audit-related issues

BlackRock recognizes the critical importance of financial statements that provide a complete and accurate portrayal of a company's financial condition. Consistent with our approach to voting on boards of directors, we seek to hold the audit committee of the board responsible for overseeing the management of the audit function at a company, and may withhold votes from the audit committee's members where the board has failed to facilitate quality, independent auditing. We look to the audit committee report for insight into the scope of the audit committee's responsibilities, including an overview of audit committee processes, issues on the audit committee's agenda and key decisions taken by the audit committee. We take particular note of cases involving significant financial restatements or material weakness disclosures, and we expect timely disclosure and remediation of accounting irregularities.

The integrity of financial statements depends on the auditor effectively fulfilling its role. To that end, we favor an independent auditor. In addition, to the extent that an auditor fails to reasonably identify and address issues that eventually lead to a significant financial restatement, or the audit firm has violated standards of practice that protect the interests of shareholders, we may also vote against ratification.

From time to time, shareholder proposals may be presented to promote auditor independence or the rotation of audit firms. We may support these proposals when they are consistent with our views as described above.

Capital structure proposals

Blank check preferred

We frequently oppose proposals requesting authorization of a class of preferred stock with unspecified voting, conversion, dividend distribution and other rights ("blank check" preferred stock) because they may serve as a transfer of authority from shareholders to the board and a possible entrenchment device. We generally view the board's discretion to establish voting rights on a when-issued basis as a potential anti-takeover device, as it affords the board the ability to place a block of stock with an investor sympathetic to management, thereby foiling a takeover bid without a shareholder vote. Nonetheless, where the company appears to have a legitimate financing motive for requesting blank check authority, has committed publicly that blank check preferred shares will not be used for anti-takeover purposes, has a history of using blank check preferred stock for financings, or has blank check preferred stock previously outstanding such that an increase would not necessarily provide further anti-takeover protection but may provide greater financing flexibility, we may support the proposal.

Equal voting rights

BlackRock supports the concept of equal voting rights for all shareholders. Some management proposals request authorization to allow a class of common stock to have superior voting rights over the existing common or to allow a class of common to elect a majority of the board. We oppose such differential voting power as it may have the effect of denying shareholders the opportunity to vote on matters of critical economic importance to them.

When a management or shareholder proposal requests to eliminate an existing dual-class voting structure, we seek to determine whether the cost of restructuring will have a clear economic benefit to our clients' portfolio(s). We evaluate these proposals on a case-by-case basis, and we consider the level and nature of control associated with the dual-class voting structure as well as the company's history of responsiveness to shareholders in determining whether support of such a measure is appropriate.

Increase in authorized common shares

BlackRock considers industry specific norms in our analysis of these proposals, as well as a company's history with respect to the use of its common shares. Generally, we are predisposed to support a company if the board believes additional common shares are necessary to carry out the firm's business. The most substantial concern we might have with an increase is the possibility of use of common shares to fund a poison pill plan that is not in the economic interests of shareholders.

Increase or issuance of preferred stock

These proposals generally request either authorization of a class of preferred stock or an increase in previously authorized preferred stock. Preferred stock may be used to provide management with the flexibility to consummate beneficial acquisitions, combinations or financings on terms not necessarily available via other means of financing. We generally support these proposals in cases where the company specifies the voting, dividend, conversion and other rights of such stock where the terms of the preferred stock appear reasonable.

Stock splits and reverse stock splits

We generally support stock splits that are not likely to negatively affect the ability to trade shares or the economic value of a share. We generally support reverse splits that are designed to avoid delisting or to facilitate trading in the stock, where the reverse split will not have a negative impact on share value (*e.g.* one class is reduced while others remain at pre-split levels). In the event of a proposal to reverse split that would not also proportionately reduce the company's authorized stock, we apply the same analysis we would use for a proposal to increase authorized stock.

Mergers, asset sales, and other special transactions

In reviewing merger and asset sale proposals, BlackRock's primary concern is the best long-term economic interests of shareholders. While these proposals vary widely in scope and substance, we closely examine certain salient features in our analyses. The varied nature of these proposals ensures that the following list will be incomplete. However, the key factors that we typically evaluate in considering these proposals include:

- For mergers and asset sales, we assess the degree to which the proposed transaction represents a premium to the company's trading price. In order to filter out the effects of pre-merger news leaks on the parties' share prices, we consider a share price from multiple time periods prior to the date of the merger announcement. In most cases, business combinations should provide a premium. We may consider comparable transaction analyses provided by the parties' financial advisors and our own valuation assessments. For companies facing insolvency or bankruptcy, a premium may not apply.
- There should be a favorable business reason for the combination.
- Unanimous board approval and arm's-length negotiations are preferred. We will consider whether the transaction involves a dissenting board or does not appear to be the result of an arm's-length bidding process. We may also consider whether executive and/or board members' financial interests in a given transaction appear likely to affect their ability to place shareholders' interests before their own.
- We prefer transaction proposals that include the fairness opinion of a reputable financial advisor assessing the value of the transaction to shareholders in comparison to recent similar transactions.

Poison pill plans

Also known as Shareholder Rights Plans, these plans generally involve issuance of call options to purchase securities in a target firm on favorable terms. The options are exercisable only under certain circumstances, usually accumulation of a specified percentage of shares in a relevant company or launch of a hostile tender offer. These plans are often adopted by the board without being subject to shareholder vote.

Poison pill proposals generally appear on the proxy as shareholder proposals requesting that existing plans be put to a vote. This vote is typically advisory and therefore non-binding. We generally vote in favor of shareholder proposals to rescind poison pills.

Where a poison pill is put to a shareholder vote, our policy is to examine these plans individually. Although we oppose most plans, we may support plans that include a reasonable 'qualifying offer clause.' Such clauses typically require shareholder ratification of the pill, and stipulate a sunset provision whereby the pill expires unless it is renewed. These clauses also tend to specify that an all cash bid for all shares that includes a fairness opinion and evidence of financing does not trigger the pill, but forces either a special meeting at which the offer is put to a shareholder vote, or the board to seek the written consent of shareholders where shareholders could rescind the pill in their discretion. We may also support a pill where it is the only effective method for protecting tax or other economic benefits that may be associated with limiting the ownership changes of individual shareholders.

Reimbursement of expenses for successful shareholder campaigns

Proxy contests and other public campaigns can be valuable mechanisms for holding boards of underperforming companies accountable to their shareholders. However, these campaigns can also lead to unwarranted cost and distraction for boards and management teams, and may be imposed by investors whose interests are not aligned with other investors. Therefore, we generally do not support proposals seeking the reimbursement of proxy contest expenses, even in situations where we support the shareholder campaign, as we believe that introducing the possibility of such reimbursement may incentivize disruptive and unnecessary shareholder campaigns.

Remuneration and benefits

We note that there are both management and shareholder proposals related to executive compensation that appear on corporate ballots. We generally vote on these proposals as described below, except that we typically oppose shareholder proposals on issues where the company already has a reasonable policy in place that we believe is sufficient to address the issue. We may also oppose a shareholder proposal regarding executive compensation if the company's history suggests that the issue raised is not likely to present a problem for that company.

Advisory resolutions on executive compensation ("Say on Pay")

In cases where there is a Say on Pay vote, BlackRock will respond to the proposal as informed by our evaluation of compensation practices at that particular company, and in a manner that appropriately addresses the specific question posed to shareholders. We describe in the Appendix herein ("Our approach to Say on Pay") our beliefs and expectations related to executive compensation practices, our Say on Pay analysis framework, and our typical approach to engagement and voting on Say on Pay.

Advisory votes on the frequency of Say on Pay resolutions ("Say When on Pay")

BlackRock will generally opt for a triennial vote on Say on Pay. We believe that shareholders should undertake an annual review of executive compensation and express their concerns through their vote on the members of the compensation committee. As a result, it is generally not necessary to hold a Say on Pay vote on an annual basis, as the Say on Pay vote merely supplements the shareholder's vote on compensation committee members. However, we may support annual Say on Pay votes in some situations, for example, where we conclude that a company has failed to align pay with performance.

Claw back proposals

Claw back proposals are generally shareholder sponsored and seek recoupment of bonuses paid to senior executives if those bonuses were based on financial results that are later restated or were otherwise awarded as a result of deceptive business practices. We generally favor recoupment from any senior executive whose compensation was based on faulty financial reporting or deceptive business practices, regardless of that particular executive's role in the faulty reporting. We typically support these proposals unless the company already has a robust claw back policy that sufficiently addresses our concerns.

Employee stock purchase plans

An employee stock purchase plan ("ESPP") gives the issuer's employees the opportunity to purchase stock in the issuer, typically at a discount to market value. We believe these plans can provide performance incentives and help align employees' interests with those of shareholders. The most common form of ESPP qualifies for favorable tax treatment under Section 423 of the Internal Revenue Code. Section 423 plans must permit all full-time employees to participate, carry restrictions on the maximum number of shares that can be purchased, carry an exercise price of at least 85 percent of fair market value on grant date with offering periods of 27 months or less, and be approved by shareholders. We will typically support qualified ESPP proposals.

Equity compensation plans

BlackRock supports equity plans that align the economic interests of directors, managers and other employees with those of shareholders. We believe that boards should establish policies prohibiting use of equity awards in a manner that could disrupt the intended alignment with shareholder interests, for example: use of the stock as collateral for a loan; use of the stock in a margin account; use of the stock (or an unvested award) in hedging or derivative transactions. We may support shareholder proposals requesting the board to establish such policies.

Our evaluation of equity compensation plans is based on a company's executive pay and performance relative to peers and whether the plan plays a significant role in a pay-for-performance disconnect. We generally oppose plans that contain "evergreen" provisions allowing for the unlimited increase of shares reserved without requiring further shareholder approval after a reasonable time period. We also generally oppose plans that allow for repricing without shareholder approval. We may also oppose plans that provide for the acceleration of vesting of equity awards even in situations where an actual change of control may not occur. We encourage companies to structure their change of control provisions to require the termination of the covered employee before acceleration or special payments are triggered. Finally, we may oppose plans where we believe that the company is aggressively accounting for the equity delivered through their stock plans.

Golden parachutes

Golden parachutes provide for compensation to management in the event of a change in control. We generally view golden parachutes as encouragement to management to consider transactions that might be beneficial to shareholders. However, a large potential payout under a golden parachute arrangement also presents the risk of motivating a management team to support a sub-optimal sale price for a company.

We may support shareholder proposals requesting that implementation of such arrangements require shareholder approval. We generally support proposals requiring shareholder approval of plans that exceed 2.99 times an executive's current salary and bonus, including equity compensation.

When determining whether to support or oppose an advisory vote on a golden parachute plan ("Say on Golden Parachutes"), we normally support the plan unless it appears to result in payments that are excessive or detrimental to shareholders. In evaluating golden parachute plans, BlackRock may consider several factors, including:

- whether we believe that the triggering event is in the best interest of shareholders;
- an evaluation of whether management attempted to maximize shareholder value in the triggering event;

- the percentage of total transaction value that will be transferred to the management team, rather than shareholders, as a result of the golden parachute payment;
- whether excessively large excise tax gross up payments are part of the payout;
- whether the pay package that serves as the basis for calculating the golden parachute payment was reasonable in light of performance and peers; and/or
- whether the golden parachute payment will have the effect of rewarding a management team that has failed to effectively manage the company.

It may be difficult to anticipate the results of a plan until after it has been triggered; as a result, BlackRock may vote against a Say on Golden Parachute proposal even if the golden parachute plan under review was approved by shareholders when it was implemented.

Option exchanges

BlackRock may support a request to exchange underwater options under the following circumstances: the company has experienced significant stock price decline as a result of macroeconomic trends, not individual company performance; directors and executive officers are excluded; the exchange is value neutral or value creative to shareholders; and there is clear evidence that absent repricing the company will suffer serious employee incentive or retention and recruiting problems. BlackRock may also support a request to exchange underwater options in other circumstances, if we determine that the exchange is in the best interest of shareholders.

Pay-for-Performance plans

In order for executive compensation exceeding $1 million to qualify for federal tax deductions, the Omnibus Budget Reconciliation Act (OBRA) requires companies to link that compensation, for the company's top five executives, to disclosed performance goals and submit the plans for shareholder approval. The law further requires that a compensation committee comprised solely of outside directors administer these plans. Because the primary objective of these proposals is to preserve the deductibility of such compensation, we generally favor approval in order to preserve net income.

Pay-for-Superior-Performance

These are typically shareholder proposals requesting that compensation committees adopt policies under which a portion of equity compensation requires the achievement of performance goals as a prerequisite to vesting. We generally believe these matters are best left to the compensation committee of the board and that shareholders should not set executive compensation or dictate the terms thereof. We may support these proposals if we have a substantial concern regarding the company's compensation practices over a significant period of time, the proposals are not overly prescriptive, and we believe the proposed approach is likely to lead to substantial improvement.

Supplemental executive retirement plans

BlackRock may support shareholder proposals requesting to put extraordinary benefits contained in Supplemental Executive Retirement Plans ("SERP") agreements to a shareholder vote unless the company's executive pension plans do not contain excessive benefits beyond what is offered under employee-wide plans.

Social, ethical and environmental issues

Our fiduciary duty to clients is to protect and enhance their economic interest in the companies in which we invest on their behalf. It is within this context that we undertake our corporate governance activities. We believe that well-managed companies will deal effectively with the social, ethical and environmental ("SEE") aspects of their businesses.

BlackRock expects companies to identify and report on the material, business-specific SEE risks and opportunities and to explain how these are managed. This explanation should make clear how the approach taken by the company best serves the interests of shareholders and protects and enhances the long-term economic value of the company. The key performance indicators in relation to SEE matters should also be disclosed and performance against them discussed, along with any peer group benchmarking and verification processes in place. This helps shareholders assess how well management is dealing with the SEE aspects of the business. Any global standards adopted should also be disclosed and discussed in this context.

We may vote against the election of directors where we have concerns that a company might not be dealing with SEE issues appropriately. Sometimes we may reflect such concerns by supporting a shareholder proposal on the issue, where there seems to be either a significant potential threat or realized harm to shareholders' interests caused by poor management of SEE matters. In deciding our course of action, we will assess whether the company has already taken sufficient steps to address the concern and whether there is a clear and material economic disadvantage to the company if the issue is not addressed.

More commonly, given that these are often not voting issues, we will engage directly with the board or management. The trigger for engagement on a particular SEE concern is our assessment that there is potential for material economic ramifications for shareholders.

We do not see it as our role to make social, ethical or political judgments on behalf of clients. We expect investee companies to comply, at a minimum, with the laws and regulations of the jurisdictions in which they operate. They should explain how they manage situations where such laws or regulations are contradictory or ambiguous.

General corporate governance matters

We believe that shareholders should have the right to vote on key corporate governance matters, including on changes to governance mechanisms and amendments to the charter/articles/by-laws. We may vote against certain directors where changes to governing documents are not put to a shareholder vote within a reasonable period of time, in particular if those changes have the potential to impact shareholder rights (see "Director elections" herein). In cases where a board's unilateral adoption of changes to the charter/articles/by-laws promotes cost and operational efficiency benefits for the company and its shareholders, we may support such action if it does not have a negative effect on shareholder rights or the company's corporate governance structure.

When voting on a management or shareholder proposal to make changes to charter/articles/by-laws, we will consider in part the company's and/or proponent's publicly stated rationale for the changes, the company's governance profile and history, relevant jurisdictional laws, and situational or contextual circumstances which may have motivated the proposed changes, among other factors. We will typically support changes to the charter/articles/by-laws where the benefits to shareholders, including the costs of failing to make those changes, demonstrably outweigh the costs or risks of making such changes.

Adjourn meeting to solicit additional votes

We generally support such proposals unless the agenda contains items that we judge to be detrimental to shareholders' best long-term economic interests.

Bundled proposals

We believe that shareholders should have the opportunity to review substantial governance changes individually without having to accept bundled proposals. Where several measures are grouped into one proposal, BlackRock may reject certain positive changes when linked with proposals that generally contradict or impede the rights and economic interests of shareholders.

Corporate political activities

Companies may engage in certain political activities, within legal and regulatory limits, in order to influence public policy consistent with the companies' values and strategies, and thus serve shareholders' best long-term economic interests. These activities can create risks, including: the potential for allegations of corruption; the potential for reputational issues associated with a candidate, party or issue; and risks that arise from the complex legal, regulatory and compliance considerations associated with corporate political activity. We believe that companies which choose to engage in political activities should develop and maintain robust processes to guide these activities and to mitigate risks, including a level of board oversight.

When presented with shareholder proposals requesting increased disclosure on corporate political activities, we may consider the political activities of that company and its peers, the existing level of disclosure, and our view regarding the associated risks. We generally believe that it is the duty of boards and management to determine the appropriate level of disclosure of all types of corporate activity, and we are generally not supportive of proposals that are overly prescriptive in nature. We may determine to support a shareholder proposal requesting additional reporting of corporate political activities where there seems to be either a significant potential threat or actual harm to shareholders' interests and where we believe the company has not already provided shareholders with sufficient information to assess the company's management of the risk.

Finally, we believe that it is not the role of shareholders to suggest or approve corporate political activities; therefore we generally do not support proposals requesting a shareholder vote on political activities or expenditures.

Other business

We oppose giving companies our proxy to vote on matters where we are not given the opportunity to review and understand those measures and carry out an appropriate level of shareholder oversight.

Reincorporation

Proposals to reincorporate from one state or country to another are most frequently motivated by considerations of anti-takeover protections, legal advantages, and/or cost savings. We will evaluate, on a case-by-case basis, the economic and strategic rationale behind the company's proposal to reincorporate. In all instances, we will evaluate the changes to shareholder protection under the new charter/articles/by-laws to assess whether the move increases or decreases shareholder protections. Where we find that shareholder protections are diminished, we may support reincorporation if we determine that the overall benefits outweigh the diminished rights.

IPO governance

We expect boards to consider and disclose how the corporate governance structures adopted upon initial public offering ("IPO") are in shareholders' best long-term interests. We also expect boards to conduct a regular review of corporate governance and control structures, such that boards might evolve foundational corporate governance structures as company circumstances change, without undue costs and disruption to shareholders.

We will typically apply a one-year grace period for the application of certain director-related guidelines (including, but not limited to, director independence and over-boarding considerations), during which we expect boards to take steps to bring corporate governance standards in line with our expectations.

Further, if a company qualifies as an emerging growth company (an "EGC") under the Jumpstart Our Business Startups Act of 2012 (the "JOBS Act"), we will give consideration to the NYSE and NASDAQ governance exemptions granted under the JOBS Act for the duration such a company is categorized as an EGC. We expect an EGC to have a totally independent audit committee by the first anniversary of its IPO, with our standard approach to voting on auditors and audit-related issues applicable in full for an EGC on the first anniversary of its IPO.

Shareholders' right to act by written consent

In exceptional circumstances and with sufficiently broad support, shareholders should have the opportunity to raise issues of substantial importance without having to wait for management to schedule a meeting. We therefore believe that shareholders should have the right to solicit votes by written consent provided that: 1) there are reasonable requirements to initiate the consent solicitation process in order to avoid the waste of corporate resources in addressing narrowly supported interests; and 2) support from a minimum of 50% of outstanding shares is required to effectuate the action by written consent. We may oppose shareholder proposals requesting the right to act by written consent in cases where the proposal is structured for the benefit of a dominant shareholder to the exclusion of others, or if the proposal is written to discourage the board from incorporating appropriate mechanisms to avoid the waste of corporate resources when establishing a right to act by written consent. Additionally, we may oppose shareholder proposals requesting the right to act by written consent if the company already provides a shareholder right to call a special meeting that we believe offers shareholders a reasonable opportunity to raise issues of substantial importance without having to wait for management to schedule a meeting.

Shareholders' right to call a special meeting

In exceptional circumstances and with sufficiently broad support, shareholders should have the opportunity to raise issues of substantial importance without having to wait for management to schedule a meeting. We therefore believe that shareholders should have the right to call a special meeting in cases where a reasonably high proportion of shareholders (typically a minimum of 15% but no higher than 25%) are required to agree to such a meeting before it is called, in order to avoid the waste of corporate resources in addressing narrowly supported interests. However, we may oppose this right in cases where the proposal is structured for the benefit of a dominant shareholder to the exclusion of others. We generally believe that a right to act via written consent is not a sufficient alternative to the right to call a special meeting.

Simple majority voting

We generally favor a simple majority voting requirement to pass proposals. Therefore, we will support the reduction or the elimination of supermajority voting requirements to the extent that we determine shareholders' ability to protect their economic interests is improved. Nonetheless, in situations where there is a substantial or dominant shareholder, supermajority voting may be protective of public shareholder interests and we may support supermajority requirements in those situations.

Appendix: Our Approach to Say on Pay

We describe herein our beliefs and expectations related to executive compensation practices, our Say on Pay analysis framework, and our typical approach to engagement and voting on Say on Pay. We provide our views on this issue in somewhat more detail than other issues covered in these Guidelines because of the particular focus on executive compensation matters in the U.S. Although we expect proxy disclosures to be the primary mechanism for companies to explain their executive compensation practices, we may engage with members of management and/or the compensation committee of the board, where concerns are identified or where we seek to better understand a company's approach to executive compensation. We may also decline opportunities to engage with companies where we do not have any questions or concerns or believe that these Guidelines already cover the issues at hand.

Beliefs and Expectations Related to Executive Compensation Practices

- We believe that compensation committees are in the best position to make compensation decisions and should maintain significant flexibility in administering compensation programs, given their knowledge of the strategic plans for the company, the industry in which the company operates, the appropriate performance measures for the company, and other issues internal and/or unique to the company.
- Companies should explicitly disclose how incentive plans reflect strategy and incorporate long-term shareholder value drivers; this discussion should include the commensurate metrics and timeframes by which shareholders should assess performance.
- We support incentive plans that foster the sustainable achievement of results. Although we believe that companies should identify those performance measures most directly tied to shareholder value creation, we also believe that emphasis should be on those factors within management's control to create economic value over the long-term, which should ultimately lead to sustained shareholder returns over the long-term. Similarly, the vesting timeframes associated with incentive plans should facilitate a focus on long-term value creation, as appropriate to that particular company.
- While we do support the concept of compensation formulas that allow shareholders to clearly understand the rationale for compensation decisions, we do not believe that a solely formulaic approach to executive compensation necessarily drives shareholder value. BlackRock believes that compensation committees should use their discretion in designing incentive plans, establishing pay quanta, and finalizing compensation decisions, and should demonstrate how decisions are aligned with shareholder interests.
- BlackRock does not discourage compensation structures that differ from market practice. However, where compensation practices differ substantially from market practice, *e.g.* in the event of unconventional incentive plan design or extraordinary decisions made in the context of transformational corporate events or turnaround situations, we expect clear disclosure explaining how the decisions are in shareholders' best interests.
- We understand that compensation committees are undertaking their analysis in the context of a competitive marketplace for executive talent. We acknowledge that the use of peer group evaluation by compensation committees can help ensure competitive pay; however we are concerned about the potential ratchet effect of explicit benchmarking to peers. We therefore believe that companies should use peer groups to maintain an awareness of peer pay levels and practices so that pay is market competitive, while mitigating potential ratcheting of pay that is disconnected from actual performance.
- We expect companies to select peers that are broadly comparable to the company in question, based on objective criteria that are directly relevant to setting competitive compensation; we evaluate peer group selection based on factors including, but not limited to, business size, relevance, complexity, risk profile, and/or geography.

- We do not believe that arbitrary limits on potential compensation are necessarily in shareholders' best interests if those limits have the potential to cap performance. However, we expect compensation committees to ensure that incentive plans do not incentivize excessive risk taking beyond the company's determined risk appetite and that rewards are reasonable in light of returns to shareholders.

- We do not set forth a preference between cash, restricted stock, performance based equity awards, and stock options, amongst other compensation vehicles. We acknowledge that each may have an appropriate role in recruiting and retaining executives, in incentivizing behavior and performance, and in aligning shareholders' and executives' interests. Compensation committees should clearly disclose the rationale behind their selection of pay vehicles and how these fit with intended incentives. We also observe that different types of awards exhibit varying risk profiles, and the risks associated with pay plan design should be in line with the company's stated strategy and risk appetite.

- We expect compensation committees to consider and respond to the shareholder voting results of relevant proposals at previous years' annual meetings, and other feedback received from shareholders, as they evaluate compensation plans. At the same time, compensation committees should ultimately be focused on incentivizing long-term shareholder value creation and not necessarily on achieving a certain level of support on Say on Pay at any particular shareholder meeting.

Say on Pay Analysis Framework

- We analyze the compensation practices in the context of the company's stated strategy and identified value drivers and seek to understand the link between strategy, value drivers and incentive plan design.

- We examine both target and realizable compensation in order to understand the compensation committee's intended outcomes, to judge the appropriateness and rigor of performance measures and hurdles, and to assess the pay plan's sensitivity to the performance of the company.

- We review the pay and performance profiles of the company's disclosed peer companies, as applicable, to identify relative outliers for potential further analysis. We supplement our analysis of the company's stated peers with an independent review of peer companies as identified by third party vendors and our own analysis; part of this analysis includes an assessment of the relevance of the company's stated peers and the potential impact the company's peer selection may have on pay decisions.

- We conduct our analysis over various time horizons, with an emphasis on a sustained period, generally 3-5 years; however we consider company-specific factors, including the timeframe the company uses for performance evaluation, the nature of the industry, and the typical business cycle, in order to identify an appropriate timeframe for evaluation.

- We review key changes to pay components from previous years and consider the compensation committee's rationale for those changes.

- We examine extraordinary pay items (including but not limited to actual or contractual severance payments, inducement grants, one-time bonus and/or retention awards) to understand the compensation committee's rationale and alignment with shareholder interests.

- We may engage with members of management and/or the compensation committee of the board, where concerns are identified or where we seek to better understand a company's approach to executive compensation.

- We consider BlackRock's historical voting decisions (including whether a concern that led to a previous vote against management has been addressed, or whether we determined to support management at previous shareholder meetings with the expectation of future change), engagement activity, other corporate governance concerns at the company, and the views of our portfolio managers.

- We assess the board's responsiveness to shareholder voting results of relevant proposals at previous years' annual meetings, and other feedback received from shareholders.

Engagement and Voting on Say on Pay

- In many instances, we believe that direct discussion with issuers, in particular with the members of the compensation committee, can be an effective mechanism for building mutual understanding on executive compensation issues and for communicating any concerns we may have on executive compensation.
- In the event that we determine engagement is not expected to lead to resolution of our concerns about executive compensation, we may consider voting against members of the compensation committee, consistent with our preferred approach to hold members of the relevant key committee of the board accountable for governance concerns. As a result, our Say on Pay vote is likely to correspond with our vote on the directors who are compensation committee members responsible for making compensation decisions.
- We may determine to vote against the election of compensation committee members and/or Say on Pay proposals in certain instances, including but not limited to when:
    - We identify a misalignment over time between target pay and/or realizable compensation and company performance as reflected in financial and operational performance and/or shareholder returns;
    - We determine that a company has not persuasively demonstrated the connection between strategy, long-term shareholder value creation and incentive plan design;
    - We determine that compensation is excessive relative to peers without appropriate rationale or explanation, including the appropriateness of the company's selected peers;
    - We observe an overreliance on discretion or extraordinary pay decisions to reward executives, without clearly demonstrating how these decisions are aligned with shareholders' interests;
    - We determine that company disclosure is insufficient to undertake our pay analysis; and/or
    - We observe a lack of board responsiveness to significant investor concern on executive compensation issues.

BOARDROOM ACCOUNTABILITY PROJECT

Boardroom Accountability Project 2016 Company Focus List

Company	New/Refile	Largest Holdings	Diversity	Fossil Fuel	Pay	Other Governance*	Withdrawn
3M Company[1]	N	X					Yes
AbbVie Inc.	N	X	X				
Ameren Corporation	N			X			Yes
American Airlines Group Inc.	N		X				
American Tower Corporation	N				X		
Amgen Inc.	N	X					
Bed Bath & Beyond Inc.	N	X			X		
Boeing Company, The	N	X					Yes
Caterpillar Inc.	N	X			X		Yes
Cerner Corporation	N		X				
CMS Energy Corporation	N			X			
Colgate-Palmolive Company	N	X					
Dominion Resources, Inc.	N			X			Yes
Express Scripts Holding Company	N	X	X				
Home Depot, Inc., The	N	X					
Honeywell International Inc.	N	X			X		Yes
Intel Corporation	N	X					
Intercontinental Exchange, Inc.	N		X				
Johnson & Johnson	N	X					
Macerich Company, The	N				X		
NiSource Inc.	N			X			
NRG Energy, Inc.	N			X			
O'Reilly Automotive, Inc.	N		X				
PepsiCo, Inc.	N	X					
Pfizer Inc.	N	X					Yes
Praxair, Inc.	N				X		
salesforce.com, inc.	N	X			X		
SL Green Realty Corp.	N				X		
U.S. Bancorp	N	X					
Union Pacific Corporation[1]	N	X	X				Yes
Universal Health Services	N		X				
Unum Group	N				X		
WEC Energy Group, Inc.	N			X			
Wells Fargo & Company	N	X					Yes
Xcel Energy Inc.	N			X			
Zoetis Inc.	N		X				
AES Corporation, The	R			X			Yes
Alexion Pharmaceuticals, Inc.	R		X				
Alliance Data Systems Corporation	R		X				
Apartment Investment and Management Company	R				X		
Avon Products, Inc.	R				X		
Cabot Oil & Gas Corporation	R		X	X			
Chipotle Mexican Grill, Inc.	R				X		
CONSOL Energy Inc.	R			X			
Devon Energy Corporation	R			X			
Duke Energy Corporation	R			X			Yes
eBay Inc.	R		X				
Electronic Arts Inc.	R				X		
Exelon Corporation	R				X		
Exxon Mobil Corporation	R			X			
Fidelity National Financial, Inc.	R		X				
FirstEnergy Corp.	R			X			
FleetCor Technologies, Inc.	R		X		X		
Freeport-McMoRan Inc.	R			X	X		Yes
HCP, Inc.	R				X		
Monster Beverage Corporation	R		X				
Murphy Oil Corporation	R			X			
Nabors Industries Ltd.	R		X		X		
Netflix, Inc.	R					X	
New York Community Bancorp, Inc.	R				X		
Noble Energy, Inc.	R			X			
NVR, Inc.	R		X				
PACCAR Inc	R		X				
Peabody Energy Corporation	R			X			Yes
PPL Corporation	R			X			Yes
Precision Castparts Corp.	R		X				
Roper Technologies, Inc.	R		X				Yes
SBA Communications Corporation	R		X				
Southern Company, The	R			X			
Urban Outfitters, Inc.	R		X				
Vertex Pharmaceuticals Incorporated	R				X		
Visteon Corporation	R		X				

*Other governance includes companies that received proxy access or other governance proposals from NYC Funds in 2014

[1]Enactment already underway upon receipt of NYC Funds' proposal

Company information accurate as of January 9, 2016

REIT ALERT

February 4, 2015

Barbarians at the (REIT) Gates: REITs Should Be Prepared for a New World Order of Shareholder Activists, Hostile Overtures and Proxy Fights

SPEED READ

Publicly traded REITs today face an increased risk of potential shareholder activism, proxy fights and otherwise hostile overtures. In response to this growing trend, public REITs should examine their corporate governance profiles and evaluate their takeover preparedness. While substantive changes may not be in order, regular reviews of these important internal governance features can better prepare board members and management when a threat materializes and/or when the REIT otherwise receives shareholder proposals relating to governance matters.

For over 20 years from the dawn of the modern REIT era in the early 1990s, hostile takeovers, proxy fights and shareholder activists – the stuff of everyday business in many other sectors – were few and far between in the world of publicly traded REITs. While the REIT sector was an able and willing participant in M&A activity during this period, the overwhelming majority of deals were negotiated, friendly transactions. That is to say, with some notable exceptions,[1] suitors and concerned investors generally pressed their case through and with the participation of the target's board of directors, rather than by going over or around them directly to shareholders.

In thinking about why this has historically been the case for REITs, industry experts have offered a number of reasons:

- Public REITs tend to trade within a generally predictable band above and below their NAV (net asset value). As such, given the relative transparency of the asset class and of the REIT model, an acquiror or activist is less likely to be able to unlock sufficient value to justify the cost and effort of a hostile takeover or proxy fight.
- Many REITs are and were incorporated in Maryland, a jurisdiction where the actions of directors in the face of unwanted overtures may be given more deference by the courts and where the so-called Revlon duties requiring maximization of shareholder value may be less stringently applied.
- Virtually all public REITs have ownership limitation provisions in place that restrict, to greater and lesser degrees, the ability of any one person (or group of persons) to acquire a meaningful amount of the REIT's equity capital without prior board approval (for most REITs, the threshold is 9.8%).

The validity of these rationales has been a matter of academic debate from time to time[2] but activity in the marketplace in recent years demonstrates that the constraints to hostile overtures and activist campaigns in the public REIT sector, whatever they may have been, are no longer sufficient deterrents. To the contrary, REITs large and small have seen a flurry of hostile and activist activity over the past two years, which has served, and should continue to serve, as a wake-up call for the industry as a whole. A non-exhaustive list of hostile and activist activity that has appeared in the press or in public filings during this period includes:

- the disclosure by Lakewood Capital Management of a 5.8% state in Select Income REIT and its subsequent announcement of its intent to file a preliminary proxy statement to solicit votes for the election of a competing trustee (January 2015);
- the disclosure by Corvex Capital Management of a 7.1% stake in American Realty Capital (December 2014);
- issuance of public letters by Land and Buildings to the management of Pennsylvania REIT calling for the disposal of certain assets and other changes (October 2014);
- unsolicited offer letters from Land and Buildings to Associated Estates Realty Corp. (June 2014) and to BRE Properties (June 2013);
- the disclosure by each of Blue Mountain Capital and HG Vora Capital Management of respective 4.9% stakes in Chatham Lodging Trust and subsequent unsolicited offer letter from Blue Mountain to acquire the company (November 2013);
- the disclosure by Corvex Capital Management and Related Fund Management of a collective 9.8% stake in Commonwealth REIT and their subsequent successful campaign to remove and replace the entire board of trustees (February 2013); and
- letters received by dozens of public REITs in recent years from large institutional investors requesting corporate governance changes, such as destaggering of boards and adoption of a majority voting standard in uncontested elections.

In some of these instances, the REIT has been successful in rebuffing unsolicited overtures or activism, while in others the REIT ultimately underwent a change of control or adopted changes to its corporate structure and governance. The common denominator is that a sitting public REIT and its incumbent board came under direct public pressure from investors, competitors and/or other would-be suitors for matters ranging from changes in corporate governance (such as adoption of majority voting) all the way through to complete changes of control.

The merits of shareholder activism and unsolicited hostile overtures continue to be topics of extensive debate among market participants and commentators. The one thing that is clear, however, is that no public REIT should assume that it is immune from the forces at work in the current marketplace. Rather, REITs would be well served to undertake thorough reviews of their current corporate governance profiles to ensure that both the company and the board are optimally prepared to successfully navigate possible hostile activity for the benefit of all stockholders. Just as critically, if not more so, a public REIT must "know its stockholders" – that is, spend time understanding who the company's stockholders are and how they view the REIT's current business plan and prospects for growth.

REIT Anti-Takeover Protections

Takeover protections in the strictest sense have historically been identified with preventing, delaying or discouraging a party from acquiring a controlling interest in a company, unless the company's board of directors approves the acquisition. The array of takeover protections in use or available today also have the effect of preventing or delaying an array of corporate actions short of a change of control, such as charter and bylaw amendments, nominations and appointments to the board of directors.

The table below provides summary statistical data on a number of corporate governance provisions currently available and in use in the public REIT market, which may be useful under certain circumstances in the event of a hostile overture or threatened proxy fight. *Data is as of December 31, 2014 and based on a sample of over 50 NYSE-listed equity REITs of multiple enterprise values selected across multiple sectors, including both older and newer entrants to the market.*

PROVISION/STATUTE	PUBLICLY TRADED REITS*
Ownership limitation provision in charter [3]	100%
Blank check preferred	96%
No opt out of Maryland unsolicited takeover act (Subtitle 8)	85%**
Supermajority vote to remove directors	73%
Shareholders may not take action by (less than unanimous) written consent	73%
Majority of shareholders necessary to call special meeting	73%
Supermajority vote to amend certain provisions in the charter	72%
Only board permitted to fill vacant director positions	69%
Only board can amend bylaws [4]	69%
Directors may be removed only for cause	52%
Supermajority vote required to approve extraordinary transactions	24%
No opt out of business combination statute	24%
Classified board with staggered terms	12%
Exclusive forum selection bylaw	12%
No opt out of control share acquisition statute	12%
Active poison pill/shareholder rights plan	2%

** Percentages are rounded.*

*** Percentage shown is a percentage of only those REITs incorporated in Maryland.*

Opponents of takeover protections believe that their principal purpose is to enable a company's board and management to entrench themselves, or enable management to extract significant personal concessions, such as employment agreements or severance payments, as a condition to agreeing to a proposed change of control. Proponents believe that, when properly used by boards discharging their fiduciary duties to all stockholders, these types of takeover protections give a board the ability to maximize stockholder value. Proponents believe that these devices help in the following ways:

- they give a board time and flexibility to consider whether a proposed action or transaction is in the best interests of the company, which otherwise could be difficult to assess in a crisis situation created by a hostile proxy fight or unsolicited offer;
- they discourage the accumulation of stakes in the company or other activist initiatives designed to generate volatility in the stock price and trading profits for the activist(s);
- they deter potential acquirors from engaging in and benefiting from coercive tactics to the detriment of other stockholders; and
- they help protect stockholders from the costs associated with the distraction to management and employees, and the loss of valuable employees, caused by the hostile overture and/or other proposals.

As indicated by the data above, a majority of public REITs, both those organized in Maryland and otherwise, will typically have most of the takeover defenses listed in the table above available, either as embedded in charters and/or bylaws, or as adopted by the board of directors. Boards of directors, particularly in Maryland, may also have available more general defenses against unsolicited overtures, including (i) the "just say no" defense permitting the board of a company that is not "in play" to reject any acquisition offer involving a change of control regardless of the nature of the consideration offered, and (ii) a presumption that an act of a director of a corporation satisfies the director's standard of conduct under Maryland law. It is particularly worth noting that Maryland does not have a parallel to Delaware's *Unocal* standard under which defensive actions taken by the board of directors in response to a hostile threat can be subject to a stricter level of scrutiny than ordinary business actions.

Nevertheless, recent history has demonstrated that the availability of takeover defenses is in-and-of-itself not always going to be sufficient in the face of a determined activist or hostile actor.[5] For example, even a fully classified board can see a majority of incumbent directors voted off the board in the course of two consecutive annual elections. Moreover, in recent years a growing number of influential corporate governance advocates in the REIT sector, including several of the largest institutional stockholders sector-wide, have brought substantial pressure to bear on the boards of many REITs to irrevocably surrender important takeover defenses, such as permanently opting-out of

Maryland's statutory anti-takeover protections generally, or at least foregoing the ability to unilaterally classify the board.

Again, there is robust debate across the industry and beyond on the relative merits of these efforts and whether or not a company and its stockholders are ultimately helped or harmed by foreclosing the board's ability to deploy defensive measures in the face of a perceived threat – but it is clear that before voluntarily and permanently surrendering an otherwise available defense, a REIT's board should first fully consider the totality of defensive measures available to it and the relative efficacy of these measures in confronting a perceived threat to the company and its stockholders.[6]

Being prepared for a coercive bid or other hostile activity is not a one-size-fits-all proposition, and we do not recommend any particular set or subset of defenses as a blunderbuss approach for all public REITs. For example, a REIT that has the ability to unilaterally stagger its board at any time under the Maryland Unsolicited Takeover Act may feel less threatened by the specter of an activist campaign to take control of the board; a REIT whose ownership limitation provision is drafted so as to restrict accumulation of large blocks of stock by investors not approved by the board – even if the accumulation does not present a REIT qualification concern from a U.S. income tax perspective – may feel less of a need to have the ability to unilaterally adopt a shareholder rights plan. Conversely, REITs whose governing documents impose a mandatory sunset on duly adopted shareholder rights plan (e.g., after one year) may need to rely on other defenses once the rights plan expires.

We recommend that each public REIT take stock of its current corporate governance profile and state of its takeover preparedness (including the interconnectedness of takeover defenses and the way the efficacy of some may depend on the availability or structure of others). An evaluation of governance and takeover preparedness need not necessarily precipitate substantive changes, or any changes, and need not be undertaken with a particular threat in mind or on the horizon. Rather, periodic reviews of these important internal governance features can help the board and management be better prepared when a perceived threat does materialize and/or when the REIT otherwise receives shareholder proposals relating to governance matters. The review and evaluation process can help the board of directors determine whether the company's overall governance and preparedness profile is one that is responsive to the overarching duty of the board to be able to maximize stockholder value for the long term and in line with the corporate governance standards the board believes are appropriate for the company.

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[1] Some notable exceptions include the 1998 proxy battle waged by hedge funds led by Gotham Partners against the board of First Union Real Estate Investments; Simon/Westfield's hostile bid for Taubman in 2003; and Public Storage's hostile bid for Shurgard in 2005.
[2] For example, there have been pockets of time during which many REITs traded at relatively significant discounts to NAV. Likewise, the ability to take an initial ownership stake of nearly ten percent will often be more than sufficient for a determined hostile bidder or activist to gain the attention of a target and other shareholders.
[3] While beyond the scope of this article, note that ownership limitation provisions are not created equal and that the particular wording and definitions of each charter will generally determine the scope of the ownership limitation's perceived anti-takeover effect. For example, some charters impose the ownership limitation only on actual individuals as required to strictly comply with the relevant REIT qualification provisions under the Internal Revenue Code, while other charters impose the ownership limitation on entities and groups as well.
[4] Note that in some jurisdictions, such as Delaware, the board may not make substantive amendments to the bylaws without shareholder approval.
[5] In an extreme example, Commonwealth REIT in 2013 had in place essentially every possible takeover defense available, including a staggered board, a shareholder rights plan, draconian advance notice bylaw provisions, supermajority voting requirements and an affirmative "opt in" to Maryland's Unsolicited Takeover Act – yet determined activist investors were still able to remove the entire board of trustees without cause in 2014.
[6] See, e.g., "*Getting Nothing for Something*" by James J. Hanks, Jr., REIT Zone Publications, September 3, 2014 ("[W]hy give up, for no economic benefit to the REIT, an option that may provide some protection against an effort by investors or activists with goals other than those typically held by long-term shareholders to seize control of the company on a short-term basis in what may be temporarily unfavorable market conditions?")

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GOODWIN PROCTER

REIT ALERT

June 1, 2015

Why Green Street Should Rethink Its One-Size-Fits-All Position on Corporate Governance

SPEED READ

Research firm Green Street Advisors recently announced a revamping of its corporate governance scoring that penalizes all Maryland REITs that do not permanently opt out of the Maryland Unsolicited Takeover Act ("MUTA"). We are not certain that this "blunt instrument" approach to MUTA is appropriate. There may be scenarios where the protections available under MUTA — either alone or when used in conjunction with other available governance arrangements — can prove critical in enabling a board to act in good faith to maximize long-term shareholder value.

In our February 4, 2015 REIT Alert, "Barbarians at the (REIT) Gates: REITs Should Be Prepared for a New World Order of Shareholder Activists, Hostile Overtures and Proxy Fights," we addressed the increased risk faced by publicly-traded REITs today from potential shareholder activism, proxy fights and otherwise hostile overtures. We concluded that the boards of public REITs would be well served to regularly evaluate their companies' corporate governance profiles in an effort to help the board determine whether the company's overall governance and preparedness profile is one that provides the board of directors with the tools and flexibility to fulfill their overarching duty to maximize stockholder value for the long term. While our Alert discussed a variety of possible approaches to governance, we took care to point out that governance is not a "one-size-fits-all" proposition and that we do not recommend any particular set or subset of defenses as a blunderbuss approach for all public REITs. In particular, we did not recommend that every Maryland REIT rush to permanently opt out of the Maryland Unsolicited Takeover Act, or "MUTA",[1] since there may be scenarios in which the protections available under MUTA — either alone or when used in conjunction with other available governance arrangements — can prove critical in permitting a board acting in good faith to maximize long-term shareholder value.

In its recent "Heard on the Beach" column of May 28, 2015, entitled "Bush League Governance", Green Street Advisors announced a revamping of its corporate governance scoring that penalizes all Maryland REITs across the board if they do not permanently opt out of MUTA. Whereas under current scoring a REIT that had opted out of MUTA would earn 6 more points than a peer that had not done so, the revised scoring would increase this difference to 25 points.[2] All other things being equal, a Maryland REIT that has not permanently opted out of MUTA will receive a significantly lower corporate governance score relative to non-Maryland REITs and/or Maryland REITs that have permanently opted out of MUTA.

We are not certain that this "blunt instrument" approach to MUTA is appropriate for every Maryland REIT, without regard to the REIT's specific facts and circumstances. MUTA exists, indeed all corporate governance measures with possible anti-takeover effects exist, because legislatures and/or other actors in the investment community believe that the good faith exercise of protective measures in the face of a hostile bid may in many cases be the correct response by a target board seeking to fulfill its fiduciary duties to stockholders, as opposed to, say, promptly embracing a short-term premium that may undervalue the company's long-term business prospects. In particular, as stated in Goodwin Procter's February REIT Alert, the availability of one or more of the protections under MUTA can serve to:

- give the board time and flexibility to consider whether a proposed action or transaction is in the best interests of the company, which otherwise could be difficult to assess in a crisis situation created by a hostile proxy fight or unsolicited offer;
- discourage the accumulation of stakes (whether actual or through use of lower-cost derivatives) in the company or other activist initiatives designed to generate volatility in the stock price and trading profits for the activist(s);
- deter potential acquirors from engaging in and benefiting from coercive tactics to the detriment of other stockholders; and
- help protect stockholders from the costs associated with the distraction to management and employees, and the loss of valuable employees, caused by the hostile overture and/or other proposals.

Of course this is not to say that every REIT should arm itself with every takeover defense not prohibited by law or its governing documents. In the vast majority of cases, we believe the very best takeover defense is a management team that regularly and meaningfully engages with stockholders.

At a recent lunch panel hosted by Michael Bilerman, Head of Citi Research's Real Estate and Lodging team, at which corporate governance in the REIT Industry was discussed, one panelist noted that in hostile situations you need good actors, you need good rules and that it is important to keep in mind what are you solving for.[3] We think most parties would agree with this formulation. First and foremost, you need "good actors," a board of directors that is genuinely and in good faith seeking to maximize stockholder value in furtherance of its fiduciary duties to the company and is not seeking to entrench itself or management. Second, you need "good rules," a corporate governance structure that is both conducive to the board's exercising that duty in a deliberate and informed manner and that does not make necessary change unattainable by stockholders. Third, the board and stockholders need to keep in mind the ultimate goal, which is neither immediate capitulation nor indefinite entrenchment — it is identifying and implementing the solution that is ultimately the right one for stockholders, even if it takes a little longer until the right solution becomes clear.

So while the stated goal of activists and bidders generally is getting to a place where target boards are compelled to engage in a process instead of "just saying no," the thoughtful activist or bidder would also agree that it is not prudent for the board to be compelled to immediately throw all caution to the wind and immediately accept any bid that crosses the transom. Instead, during the Citi Research event, all of the panelists expressed support for a structure under which a target board would have the ability to impose a temporary "stay" on an activist or other hostile campaign, creating the critical space and time in which the board could work in good faith on formulating and executing on whatever plan is ultimately determined to be in the best interests of stockholders. If stockholders disagree with the board's approach, they will have their full say as soon as the "stay" expires but at least the board would have been given a realistic opportunity to demonstrate why its chosen plan was in the best interests of stockholders. The appropriate duration of a "stay" can and should be the topic of debate among interested parties in a given situation, but the essential notion that a board should be given time to fulfill its fiduciary duties appears to be accepted by all but those with the most short-term interests. Conversely, the one-size-fits-all approach now recommended by Green Street appears to be based on the assumption that not only can duly elected boards not be trusted to make the right decision in the face of a hostile bid, they shouldn't even be given the chance without being immediately forced to take the matter to the ballot box. This approach undervalues the benefits that boards can and do provide as fiduciaries for public company stockholders, irrespective of whether the board's actions are governed by Maryland, Delaware or another state's law.

The key to preserving the ability to carefully and deliberately go about getting to the right solution for stockholders is to ensure the right mix of available corporate governance provisions, paying particular attention to the interconnectedness of some provisions and the way the efficacy of some may depend on the availability or structure of others. For example, an effective takeover measure employed by many public companies in the face of an actual or threatened hostile bid is the adoption of a limited duration stockholder rights plan (a "poison pill").[4] In general, only the board of directors is given the power to redeem the rights or amend the plan so a rights plan, by its adoption, deters coercive takeover tactics by making them unreasonably expensive to the bidder and thus encourages prospective acquirors to negotiate rather than to attempt a hostile takeover.

More modern varieties of these plans typically have a hardwired sunset provision that causes the plan to automatically terminate in a year or less, unless otherwise approved by stockholders. In theory, this provides the temporary "stay" period in which the incumbent board can focus on the best course for maximizing stockholder value without a proverbial gun to its head. In practice, however, if a majority of the board can be replaced by stockholders at the next upcoming annual meeting or removed by stockholders without cause at a duly called special meeting to be held even earlier — then the incoming board can simply redeem the rights and/or amend or terminate the plan entirely and guarantee that the original's board's alternative business plan is never given an opportunity to succeed. This would bring us back to square one, a situation in which the board simply may not have the ability to properly evaluate a hostile bid versus its alternatives or the leverage to negotiate with a hostile bidder, which would be to the detriment of all stockholders.[5]

Indeed, this is when having the ability to stagger the board under MUTA for a limited duration would close the gap, working in tandem with the stockholder rights plan to impose the temporary "stay" that would benefit all stockholders. For example, if the board voted to adopt a limited duration stockholder rights plan, say for one year, and also to stagger its board under MUTA for that same one-year period,[6] then the two of these together effectively implement a one-year "stay" on the ability of an activist, raider or coercive bidder (or more likely a coalition of them), to either accumulate a significant amount of stock or to amend or eliminate the rights plan to permit an accumulation of stock. If, as urged by Green Street, the REIT had previously permanently opted out of the MUTA, then it would also knowingly have opted out of the ability to ensure its board had breathing room when evaluating strategic alternatives and the leverage to negotiate a better price for all stockholders. Some Maryland REITs in light of the total mix of facts and circumstances unique to that REIT may conclude that they do not want the benefits that MUTA provides, but we believe MUTA can be an important tool for boards to use to protect and enhance stockholder value in the face of a hostile bid when it is used responsibly.

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1 MUTA permits a Maryland corporation with a class of equity securities registered under the Securities Exchange Act of 1934 and at least three independent directors to elect to be subject, by provision in its charter or bylaws or a resolution of its board of directors and notwithstanding any contrary provision in the charter or bylaws, to any or all of five provisions:

(i) a classified board;

(ii) a two-thirds stockholder vote requirement for removing a director;

(iii) a requirement that the number of directors be fixed only by vote of the directors;

(iv) a requirement that a vacancy on the board be filled only by the remaining directors and for the remainder of the full term of the class of directors in which the vacancy occurred; and

(v) a majority requirement for the calling of a special meeting of stockholders.

2 Green Street will implement the new scoring by awarding only 5 out of 30 potential points to a Maryland REIT that does not have a staggered board but that has not opted out of MUTA. REITs organized in states other than Maryland will receive the full 30 points if they do not have a staggered board, presumably where applicable state law also does not permit staggering of the board without stockholder approval.

3 Citi Research, Weekly REIT and Lodging Strategy report, April 24, 2015.

4 A stockholder rights plan establishes a level of stock ownership (typically 10% or 15%) which a stockholder cannot exceed without incurring significant dilution to its holdings. A typical rights plan provides for a distribution to existing stockholders of rights that (a) in the event of an acquisition of more than a certain percentage (generally 10% to 25%) of the common stock, entitle the stockholder to purchase additional common stock at a significant discount (the "flip-in" feature) and (b) in the event of a squeeze-out transaction, entitle the stockholder to purchase the acquiring person's equity at a significant discount (the "flip-over" feature).

5 As noted during the Citi Research event, corporate governance rules in Canada are a useful reference point. Until only recently, Canadian public companies were generally significantly more vulnerable to hostile buyers and activist investors than their American peers, due primarily to blunderbuss statutory provisions that curbed use of corporate governance measures that could have an anti-takeover effect. Canadian law does not provide for staggered boards, any 5% shareholder may call a special meeting and investors can amass up to a 10% stake under the radar before public disclosure is required. Likewise, poison pills adopted by a target board were generally quickly done away with, often within two months. As a result, boards of target Canadian companies often had very little time to properly develop, let alone execute on, strategic alternatives to a hostile bid. Regulators and market participants alike did not view this state of affairs as necessarily positive for Canadian business as a whole. In an effort towards somewhat rebalancing the playing field, the Canadian Securities Administrators have proposed various new rules in recent years to give target company boards greater time to respond to hostile bids and flexibility. See, e.g., "Amendments Proposed to Significantly Change Take-Over Bid Rules" by Goodmans LLP, April 1, 2015.

6 While MUTA does not on its face provide for temporary staggering of the board, any opt in by the board can be accompanied by a formal commitment to de-stagger at the end of the year (or at the next annual meeting of stockholders).

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Brown, Waters Lead Call For SEC To Strengthen Disclosure Of Corporate Board Diversity

Coalition of Democratic Lawmakers Urge Faster Review of Board Diversity Proposal

Washington, DC, Mar 2
Leading Democratic lawmakers today urged the Securities and Exchange Commission to speed up its review of a proposal that would require companies to provide more specific details about the diversity of their corporate boards. The proposal, which nine public pension fund administrators submitted to the SEC almost a year ago, encourages the agency to require companies to disclose board nominees' gender, racial, and ethnic diversity.

In a letter to SEC Chair Mary Jo White, the lawmakers pressed the SEC to act on the proposal without any further delay. Sen. Sherrod Brown (D-OH) and Rep. Maxine Waters (D-CA), the senior

Democrats on the Senate Banking and House Financial Services Committees, respectively, led the letter, which was also signed by Sens. Robert Menendez (D-NJ), Jeff Merkley (D-OR), and Cory Booker (D-NJ), and Reps. Marcy Kaptur (D-OH), Carolyn Maloney (D-NY), Tim Ryan (D-OH), Marcia Fudge (D-OH), and Joyce Beatty (D-OH).

The Ohio Public Employees Retirement Systems (OPERS) and eight other public pension fund administrators – including the California Public Employees' Retirement System and the New York State Common Retirement Fund – submitted their rulemaking petition for more board diversity disclosure on March 31, 2015.

"While we applaud your decision to have SEC staff review OPERS' petition, we are disappointed with the amount of time the SEC is taking to examine and seek public comment on this important and widely supported proposal," the lawmakers wrote in their letter to White.

"Investment advisors, shareholders, policymakers, and other stakeholders have been telling the SEC and others for decades now that the diversity characteristics of board nominees and directors is information they need to make informed investment and voting decisions. Similarly, stakeholders have been explaining for decades that enhanced diversity disclosures may promote sociodemographic diversity on corporate boards, which in turn may promote better business strategy and corporate results," the lawmakers added.

The SEC adopted a rule change in 2009 that required publicly-traded companies to disclose more information on director selection and diversity. In their letter, the lawmakers outlined the new rule's limitations, noting that companies have taken a variety of different approaches to disclosing board nominees' qualifications and skills. And since the rule does not define diversity, the lack of a standard makes it difficult for shareholders and investors to make informed decisions when voting for directors.

To strengthen the quality of disclosures, the rulemaking petition encourages the SEC to require companies to indicate in a chart or matrix the qualifications, skills, and racial and gender composition of their board nominees.

"Such a requirement, with minimal burden and cost on companies, would aid in everyone's understanding, including the SEC's understanding, of each company's approach," the lawmakers wrote.

Women, who make up half the American workforce, hold just 16 percent of seats on corporate boards, and it could be decades before the gender gap in boardrooms closes, according to a recent **Government Accountability Office report**. The report, which Rep. Maloney requested in May 2014, found that it may take 40 years or more to reach a 50-50 gender balance on corporate boards.

The full text of the letter is below. A signed copy can be found online here.

March 2, 2016

The Honorable Mary Jo White
Chair
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

Dear Chair White:

We are writing to urge the Commission to seek public comment, without any further delay, on a proposed amendment submitted nearly a year ago by the Ohio Public Employees Retirement Systems (OPERS) and several leading public fund administrators on behalf of public fund fiduciaries.[1] While we applaud your decision to have SEC staff review OPERS' petition, we are disappointed with the amount of time the SEC is taking to examine and seek public comment on this important and widely supported proposal.

Investment advisors, shareholders, policymakers, and other stakeholders have been telling the SEC and others for decades now that the diversity characteristics of board nominees and directors is information they need to make informed investment and voting decisions. Similarly, stakeholders have been explaining for decades that enhanced diversity disclosures may promote sociodemographic diversity on corporate boards, which in turn may promote better business strategy and corporate results.[2] In 2009, the SEC partly acknowledged these stakeholders and their concerns when it required publicly-traded companies to disclose more information on director selection and diversity. Specifically, the SEC required reporting on **(1)** the companies' minimum qualifications, if any, for all directors, and any specific qualities or skills that at least one director must possess; and **(2)** whether and, if so, how the board considers diversity in identifying board nominees and if a diversity policy exists, how it is implemented and judged effective. The SEC did not define diversity.[3]

The 2009 rule change, however, fell short of providing stakeholders the information they need on board diversity. First, company disclosures now describe with varying levels of specificity the minimum qualifications and skills they use to identify directors. Yet many disclosures lack the clarity and detail needed for stakeholders to judge easily and accurately whether **(1)** the company's approach to and accurately whether **(1)** the company's approach to director qualifications and skills are appropriate in light of the company's overall business strategy and **(2)** the slate of board nominees is suitable. These disclosures could be improved, as OPERS explains, by also requiring a chart or matrix that visually depicts the company's approach to director qualifications and skills. Such a requirement, with minimal burden and cost on companies, would aid in everyone's understanding, including the SEC's understanding, of each company's approach.

Second, while companies now provide disclosure on the consideration of diversity in the board selection process, these disclosures often do not describe the concept of diversity with reference to sociodemographic characteristics such as gender, race, or ethnicity, or provide the sociodemographic characteristics of the board nominees.[4] These disclosures could be improved, yet again with minimal burden and cost on companies, by using a chart or matrix that lists whatever information each board nominee provides to the company about his or her gender, race, and ethnicity. Indeed, many companies already use charts or matrices to communicate biographical information about board nominees; for those companies, this change may be as simple as adding new columns to an existing chart.

In addition to being minimally burdensome, these types of improvements to board diversity disclosure are widely supported. Fifteen of 19 stakeholders told the U.S. Government Accountability Office last year that they support improving SEC rules to require more specific information from public companies on board diversity. Twelve stakeholders explicitly supported the SEC requiring companies to disclose the number of women on the board. [5] Moreover, the Council of Institutional Investors has endorsed the use of charts and matrices as "especially useful" disclosure tools for evaluating board candidates.[6]

Again, we strongly urge the Commission to avoid any further delay on seeking public comment on this straightforward proposal.

Thank you for considering our views on this important matter.

Sincerely,

Sen. Sherrod Brown, Ranking Member, Senate Committee on Banking, Housing, and Urban Affairs
Rep. Maxine Waters, Ranking Member, House Financial Services Committee
Sen. Robert Menendez
Sen. Jeff Merkley
Sen. Cory Booker

Sen. Cory Booker
Rep. Marcy Kaptur
Rep. Carolyn Maloney
Rep. Tim Ryan
Rep. Marcia Fudge
Rep. Joyce Beatty

Cc: The Honorable Michael Piwowar
The Honorable Kara Stein

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[1] Leaders from the following entities signed the Petition for Amendment of Proxy Rule Regarding Board Nominee Disclosure – Chart / Matrix Approach (File No. 4-682): the California Public Employees Retirement System; the California State Teacher's Retirement System; the Connecticut Retirement Plans and Trust Fund; the Illinois State Board of Investment; New York City; the New York State Common Retirement Fund; the North Carolina Department of State Treasurer; the Ohio Public Employees Retirement Systems; and the Washington State Investment Board.

[2] See U.S. Glass Ceiling Commission, A Solid Investment: Making Full Use of the Nation's Human Capital (Washington, D.C.: U.S. Government Printing Office, 1995), at 42-43.

[3] Item 407(c)(2)(v)-(vi) of Regulation S-K.

[4] Dhir, Aaron, Challenging Boardroom Homogeneity: Corporate Law, Governance, and Diversity (Cambridge University Press, 2015), at 175-76.

[5] Corporate Boards: Strategies to Address Representation of Women Include Federal Disclosure Requirements, GAO-16-30 (Dec. 2015), at 24-25.

[6] See, e.g., Council of Institutional Investors, Best Disclosure: Director Qualifications & Skills (Feb. 2014).

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Effective for Meetings on or after Feb. 1, 2016

Published Nov. 20, 2015

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UNITED STATES

BOARD OF DIRECTORS- VOTING ON DIRECTOR NOMINEES IN UNCONTESTED ELECTIONS

Unilateral Bylaw/Charter Amendments

Current General Recommendation: Generally vote against or withhold from directors individually, committee members, or the entire board (except new nominees, who should be considered case-by-case) if the board amends the company's bylaws or charter without shareholder approval in a manner that materially diminishes shareholders' rights or that could adversely impact shareholders, considering the following factors, as applicable:

- The board's rationale for adopting the bylaw/charter amendment without shareholder ratification;
- Disclosure by the company of any significant engagement with shareholders regarding the amendment;
- The level of impairment of shareholders' rights caused by the board's unilateral amendment to the bylaws/charter;
- The board's track record with regard to unilateral board action on bylaw/charter amendments or other entrenchment provisions;
- The company's ownership structure;
- The company's existing governance provisions;
- Whether the amendment was made prior to or in connection with the company's initial public offering;
- The timing of the board's amendment to the bylaws/charter in connection with a significant business development;
- Other factors, as deemed appropriate, that may be relevant to determine the impact of the amendment on shareholders.

Key Changes:

- Separate the methodology for evaluating adoptions of bylaw or charter provisions made prior to or in connection with a company's initial public offering from the methodology for evaluating unilateral board amendments to the bylaws or charter made following completion of a company's initial public offering, and
- Explicitly state that ISS will consider both such actions in determining vote recommendations for director nominees until such time as the actions are reversed or submitted to a binding vote of public shareholders.

New General Recommendation:

1.17. Generally vote against or withhold from directors individually, committee members, or the entire board (except new nominees, who should be considered case-by-case) if the board amends the company's bylaws or charter without shareholder approval in a manner that materially diminishes shareholders' rights or that could adversely impact shareholders, considering the following factors:

- The board's rationale for adopting the bylaw/charter amendment without shareholder ratification;
- Disclosure by the company of any significant engagement with shareholders regarding the amendment;
- The level of impairment of shareholders' rights caused by the board's unilateral amendment to the bylaws/charter;
- The board's track record with regard to unilateral board action on bylaw/charter amendments or other entrenchment provisions;
- The company's ownership structure;
- The company's existing governance provisions;
- The timing of the board's amendment to the bylaws/charter in connection with a significant business development; and,
- Other factors, as deemed appropriate, that may be relevant to determine the impact of the amendment on shareholders.

Unless the adverse amendment is reversed or submitted to a binding shareholder vote, in subsequent years vote case-by-case on director nominees. Generally vote against (except new nominees, who should be considered case-by-case) if the directors:

- Classified the board;
- Adopted supermajority vote requirements to amend the bylaws or charter; or
- Eliminated shareholders' ability to amend bylaws.

1.18. For newly public companies, generally vote against or withhold from directors individually, committee members, or the entire board (except new nominees, who should be considered case-by-case) if, prior to or in connection with the company's public offering, the company or its board adopts bylaw or charter provisions adverse to shareholders' rights, considering the following factors:

- The level of impairment of shareholders' rights caused by the provision;
- The company's or the board's rationale for adopting the provision;
- The provision's impact on the ability to change the governance structure in the future (e.g., limitations on shareholder right to amend the bylaws or charter, or supermajority vote requirements to amend the bylaws or charter);
- The ability of shareholders to hold directors accountable through annual director elections, or whether the company has a classified board structure; and,
- A public commitment to put the provision to a shareholder vote within three years of the date of the initial public offering.

Unless the adverse provision is reversed or submitted to a vote of public shareholders, vote case-by-case on director nominees in subsequent years.

Rationale for Update:

This update clarifies ISS policy and aligns ISS' approach to evaluating unilateral bylaw and charter amendments by pre-IPO companies and post-IPO company board members with feedback received from institutional investors. This update also establishes separate methodologies to evaluate adoptions of bylaw or charter provisions made prior to or in connection with a company's initial public offering and unilateral board amendments made to the bylaws or charter following completion of a company's initial public offering. This bifurcation reflects the differing expectations that investors may have for the governance structures of a newly-public company versus a company that has been public for some period of time.

At companies that are already public, investors have seen a marked increase in moves by boards to circumvent votes by unilaterally amending their companies' governing documents—usually the bylaws—to reduce shareholders' rights. While ISS tracked 10 such cases in 2013 (the historic norm in terms of volume), unilateral adoptions jumped to 64 in 2014, and there have been 62 thus far in 2015.

A majority of investor respondents to the ISS 2015–2016 policy survey favor adverse vote recommendations for director nominees when a board unilaterally adopts bylaw or charter amendments that "materially diminish" shareholders' rights until such time as the rights are restored. Both investor and non-investor respondents identify "classifying the board" and "establishing supermajority vote requirements for bylaw/charter amendments" as the unilateral actions for which continuing adverse vote recommendations would be most appropriate.

A significant percentage of recent IPOs have included provisions that limit board accountability to post-IPO investors and make it difficult for shareholders to amend the company's governing documents or take other corporate actions. While some pre-IPO boards argue that these governance structures will benefit investors over the long run, few of them provide opportunities for post-IPO shareholders to ratify these provisions. Notably, the lion's share of recent IPO firms have limited directors' accountability to shareholders by staggering board terms (via classified boards) and adopting supermajority vote provisions to amend the firms' governing documents. A law firm analysis of governance practices at more than 400 "emerging growth companies" that completed their IPOs in the period from Jan. 1, 2013, through Dec. 31, 2014, for example, found that 69 percent of these firms went public with classified boards and nearly three-quarters had supermajority vote requirements in place.[1] A separate law firm analysis of large IPOs at 46 non-controlled companies for the Sept. 1, 2001, to Oct. 31, 2013, period, found that 70 percent of the boards had staggered terms and 70 percent of the firms required supermajority votes to amend their bylaws.[2]

Overboarded Directors

Current General Recommendation: Vote against or withhold from individual directors who:

- Sit on more than six public company boards; or
- Are CEOs of public companies who sit on the boards of more than two public companies besides their own—withhold only at their outside boards[3].

Key Changes:

- In 2016, ISS will note in its analysis if a director is serving on more than five (5) public company boards.
- Starting in February of 2017, ISS will recommend against directors who sit on more than five (5) public company boards.

New General Recommendation: Vote against or withhold from individual directors who:

- Sit on more than six public company boards; for meetings on or after Feb. 1, 2017[4], sit on more than five public company boards; or
- Are CEOs of public companies who sit on the boards of more than two public companies besides their own—withhold only at their outside boards[3].

Rationale for Update:

More than a decade ago, in response to rising investor concerns about over-boarding and academic research questioning the performance of "busy" directors, ISS set limits of six directorships for most board members and three total board memberships (service on the home company board and two outside directorships) for sitting CEOs.

Since these limits were adopted, the average time commitment for board service has exploded. According to the National Association of Corporate Directors' (NACD) 2014-2015 Public Company Governance Survey, respondent directors of public companies now spend an average of 242 hours a year (or more than 30 eight-hour work days annually) on board service. This typical time commitment jumps up to 278 hours (or nearly five more eight-hour work days) when you add in the survey respondents' estimates of additional time spent in informal meetings/conversations with management. In contrast, the average annual director time commitment reported by NACD's survey respondents in 2005 was 190 hours (or fewer than 24 eight-hour work days).

[1] Morrison & Foerster, Getting the Measure of EGC Corporate Governance Practices: A survey and related resources, 2015.
[2] Davis Polk &Wardwell, Corporate Governance Practices in U.S. Initial Public Offerings (Excluding Controlled Companies, Jan, 2014.
[3] Although all of a CEO's subsidiary boards will be counted as separate boards, ISS will not recommend a withhold vote from the CEO of a parent company board or any of the controlled (>50 percent ownership) subsidiaries of that parent, but may do so at subsidiaries that are less than 50 percent controlled and boards outside the parent/subsidiary relationships.
[4] This policy change includes a 1-year transition period to allow time for affected directors to address necessary changes if they wish.

Recent academic research generally shows a negative association between board "busyness" and firm performance and director attendance at board meetings[5]. Notably, the authors of most of these studies define a "busy" director's workload as three or more boards.

Many boards have responded to concerns about overboarding by placing limits on the number of public company directorships that that their members may hold. Some boards appear to address time commitment concerns via their nominating panels. Spurred by these policies and common sense, most board members limit their board seats to four or fewer directorships.

ISS has periodically updated its overboarding policy since it was implemented in 2004, to incorporate the evolving market realities. The new policy aligns with feedback and research received from institutional investors as well as the issuer community (via our 2015-2016 policy survey and roundtable discussions) regarding the ability of a director to devote sufficient time to each board commitment. Based on that feedback as well as draft policy comments, ISS will continue evaluating the optimal level of directorships for individuals who are CEOs of public companies.

Proxy Contests/Proxy Access — Voting for Director Nominees in Contested Elections

Current General Recommendation: Vote case-by-case on the election of directors in contested elections, considering the following factors:

- Long-term financial performance of the target company relative to its industry;
- Management's track record;
- Background to the proxy contest;
- Nominee qualifications and any compensatory arrangements;
- Strategic plan of dissident slate and quality of critique against management;
- Likelihood that the proposed goals and objectives can be achieved (both slates);
- Stock ownership positions.

When the addition of shareholder nominees to the management card ("proxy access nominees") results in a number of nominees on the management card which exceeds the number of seats available for election, vote case-by-case considering the same factors listed above.

Key Changes:

- Clarifying a policy analysis framework to evaluate candidates nominated pursuant to proxy access as well as nominees in a proxy contest.
- While several factors may be similar in each evaluation, there may be factors that are unique to analyzing proxy access nominations.

New General Recommendation: Vote case-by-case on the election of directors in contested elections, considering the following factors:

[5] Cashman, George D. and Gillan, Stuart and Jun, Chulhee, Going Overboard? On Busy Directors and Firm Value (March 1, 2012). Available at SSRN: http://ssrn.com/abstract=2044798 or http://dx.doi.org/10.2139/ssrn.2044798; Falato, Antonio and Kadyrzhanova, Dalida and Lel, Ugur, Distracted Directors: Does Board Busyness Hurt Shareholder Value? (December 10, 2013). Available at SSRN: http://ssrn.com/abstract=2272478 or http://dx.doi.org/10.2139/ssrn.2272478; Jiraporn, Pornsit and Davidson, Wallace N. and Ning, Yixi and DaDalt, Peter J., Too Busy to Show Up? An Analysis of Directors' Absences (January 21, 2008). Available at SSRN: http://ssrn.com/abstract=1254642 or http://dx.doi.org/10.2139/ssrn.1254642

- Long-term financial performance of the target company relative to its industry;
- Management's track record;
- Background to the contested election;
- Nominee qualifications and any compensatory arrangements;
- Strategic plan of dissident slate and quality of critique against management;
- Likelihood that the proposed goals and objectives can be achieved (both slates); and
- Stock ownership positions.

In the case of candidates nominated pursuant to proxy access, vote case-by-case considering any applicable factors listed above or additional factors which may be relevant, including those that are specific to the company, to the nominee(s) and/or to the nature of the election (such as whether or not there are more candidates than board seats).

Rationale for Update:

This policy revision provides an analytical framework for evaluating candidates nominated pursuant to proxy access. ISS has a policy for evaluating director nominees in contested elections, which currently applies to proxy contests as well as proxy access nominations. However, the circumstances and motivations of a proxy contest and a proxy access nomination may differ significantly. Therefore, it is necessary to create adequate analytical latitude for evaluating candidates nominated through proxy access.

Proxy access rights have grown into a high-visibility corporate governance issue for US-listed companies. In 2014, ISS evaluated 18 shareholder proposals seeking proxy access rights. That number rose to more than 90 in 2015. Further, while five of the proposals received majority support in 2014, 52 have received majority support so far in 2015. Moreover, following the 2015 US proxy season, numerous companies have unilaterally adopted proxy access rights, even in the absence of majority-supported shareholder proposals.

While it is unlikely that many (or perhaps any) proxy access nominees will materialize in 2016, ISS believes it is prudent to update its framework for evaluating candidates nominated via proxy access right. In some cases, the nominating shareholder's views on the current leadership or company strategy may be opposed to the existing board's views. Alternatively, a shareholder nominator may generally agree with the company's strategy or have no specific critiques of incumbent directors, but may propose an alternative candidate to address a specific concern, such as board diversity or boardroom skills gaps.

COMPENSATION

Advisory Votes on Executive Compensation— Problematic Pay Practices

Insufficient Executive Compensation Disclosure by Externally Managed Issuers

Current General Recommendation: None.

Currently, insufficient disclosure regarding compensation arrangements for executives at an externally-managed issuer (EMI) is not considered a problematic pay practice under ISS policy. Absent any other significant concerns identified, ISS has generally not issued adverse say-on-pay recommendations on this basis. ISS does raise concerns, however, regarding the lack of transparency resulting when an EMI provides a say-on-pay proposal without information that enables investors to make an informed voting decision on the proposal.

Key Changes: Update the Problematic Pay Practice policy, add "Insufficient Executive Compensation Disclosure by Externally Managed Issuers (EMIs)" to the list of practices that may result in an adverse recommendation on the advisory vote on executive compensation. This refers to an EMI's failure to provide sufficient disclosure to enable shareholders to make a reasonable assessment of compensation arrangements for the EMI's named executive officers.

New General Recommendation: For externally-managed issuers (EMIs), generally vote against the say-on-pay proposal when insufficient compensation disclosure precludes a reasonable assessment of pay programs and practices applicable to the EMI's executives.

Rationale for Update:

Lack of Disclosure Precludes a Reasonable Assessment of Executive Compensation Arrangements

Like most U.S. public companies, EMIs are subject to periodic, advisory say-on-pay vote requirements. However, an EMI typically does not directly compensate its executives. Instead, executives are compensated by the external manager, which is reimbursed by the EMI through a management fee.

EMIs typically do not disclose any details about their compensation arrangements or payments made to executives by external managers. Many EMIs do not provide even basic disclosure regarding executive compensation arrangements and payments between the external manager and the EMI's executives. When "executive compensation information" is disclosed, it is usually limited to the aggregate management fee paid by the EMI to its manager. Without adequate information, shareholders are unable to conduct a reasonable assessment of executive compensation arrangements in order to identify potentially problematic aspects of those arrangements and to make an informed decision when voting on the EMI's say-on-pay proposal.

Some EMIs provide disclosure about the value and nature of NEOs' compensation arrangements in sufficient detail to enable shareholders to reasonably assess the arrangements and cast an informed vote on the EMI's say-on-pay proposal. Some EMIs, for example, disclose the aggregate portion of such fees that is allocable to executive compensation expenses. A small number of EMIs disclose detailed information on behalf of their external managers. This enhanced transparency demonstrates that such information can be made available within the constraints of company agreements with external managers.

As such, ISS will consider insufficient disclosure regarding compensation arrangements between executives and the external manager to be a problematic practice that warrants an AGAINST recommendation on the say-on-pay proposal.

2015-2016 Policy Survey

Based on 2015-2016 ISS Policy Survey results, 71% of investor respondents indicated that, in the event an EMI does not provide disclosure on the compensation paid to management by the eternal manager, ISS should recommend an AGAINST vote on the say-on-pay proposal, given that the level of disclosure does not meet shareholders' informational needs. Even a sizable minority (24%) of non-investor respondents (companies and advisors) responded that an AGAINST recommendation would be warranted.

U.S. Compensation Roundtables

At the 2015 ISS U.S. Compensation Roundtable held on Sept. 22, 2015, nearly all participants expressed their support for a policy update in which ISS would recommend AGAINST the say-on-pay proposals for EMIs that do not provide sufficient executive compensation disclosure. No participant expressed a preference for continuation of ISS' current approach of supporting the say-on-pay proposals in such cases. At the 2014 ISS U.S. Compensation Roundtable held on Sept. 16, 2014, participants similarly indicated that they considered an EMI's lack of compensation disclosure to inhibit shareholders' ability to fully assess the merits of the company's pay program and practices.

Hold Equity Past Retirement or for a Significant Period of Time

Current General Recommendation: Vote case-by-case on shareholder proposals asking companies to adopt policies requiring senior executive officers to retain all or a significant portion of the shares acquired through compensation plans, either:

- while employed and/or for two years following the termination of their employment ; or
- for a substantial period following the lapse of all other vesting requirements for the award ("lock-up period"), with ratable release of a portion of the shares annually during the lock-up period.

The following factors will be taken into account:

- Whether the company has any holding period, retention ratio, or officer ownership requirements in place. These should consist of:
  - Rigorous stock ownership guidelines;
  - A holding period requirement coupled with a significant long-term ownership requirement; or
  - A meaningful retention ratio;
- Actual officer stock ownership and the degree to which it meets or exceeds the proponent's suggested holding period/retention ratio or the company's own stock ownership or retention requirements;
- Post-termination holding requirement policies or any policies aimed at mitigating risk taking by senior executives;
- Problematic pay practices, current and past, which may promote a short-term versus a long-term focus.

A rigorous stock ownership guideline should be at least 10x base salary for the CEO, with the multiple declining for other executives. A meaningful retention ratio should constitute at least 50 percent of the stock received from equity awards (on a net proceeds basis) held on a long-term basis, such as the executive's tenure with the company or even a few years past the executive's termination with the company.

Vote case-by-case on shareholder proposals asking companies to adopt policies requiring Named Executive Officers to retain 75% of the shares acquired through compensation plans while employed and/or for two years following the termination of their employment, and to report to shareholders regarding this policy. The following factors will be taken into account:

- Whether the company has any holding period, retention ratio, or officer ownership requirements in place. These should consist of:
  - Rigorous stock ownership guidelines, or
  - A holding period requirement coupled with a significant long-term ownership requirement, or
  - A meaningful retention ratio,
- Actual officer stock ownership and the degree to which it meets or exceeds the proponent's suggested holding period/retention ratio or the company's own stock ownership or retention requirements.
- Problematic pay practices, current and past, which may promote a short-term versus a long-term focus.

A rigorous stock ownership guideline should be at least 10x base salary for the CEO, with the multiple declining for other executives. A meaningful retention ratio should constitute at least 50 percent of the stock received from equity awards (on a net proceeds basis) held on a long-term basis, such as the executive's tenure with the company or even a few years past the executive's termination with the company.

Generally vote against shareholder proposals that mandate a minimum amount of stock that directors must own in order to qualify as a director or to remain on the board. While ISS favors stock ownership on the part of directors, the company should determine the appropriate ownership requirement.

Key Changes:

- Broaden policy to encompass executive equity retention proposals more generally, eliminating the need for a separate policy covering proposals seeking retention of 75% of net shares.
- Clarify that the proposed retention ratio and the required duration of retention are some of the several factors that will be considered in ISS' case-by-case analysis.

New General Recommendation: Vote case-by-case on shareholder proposals asking companies to adopt policies requiring senior executive officers to retain a portion of net shares acquired through compensation plans. The following factors will be taken into account:

- The percentage/ratio of net shares required to be retained;
- The time period required to retain the shares;
- Whether the company has equity retention, holding period, and/or stock ownership requirements in place and the robustness of such requirements;
- Whether the company has any other policies aimed at mitigating risk taking by executives;
- Executives' actual stock ownership and the degree to which it meets or exceeds the proponent's suggested holding period/retention ratio or the company's existing requirements; and
- Problematic pay practices, current and past, which may demonstrate a short-term versus long-term focus.

Rationale for Update:

This policy update clarifies the factors considered in ISS' case-by-case analysis. It also broadens the policy to encompass equity retention proposals more generally, thereby eliminating the need for a separate policy tied to a specified retention ratio.

Specifically, the revised policy clarifies that the proponent's suggested retention percentage/ratio and the required retention duration are two of the several factors to be assessed under ISS' case-by-case approach. This change eliminates the need for separate policies tied to specified retention ratios (i.e. a separate policy for proposals requesting 75% net share retention), since the retention ratio is a factor to be considered for every proposal. In more clearly identifying the factors and eliminating repetitive language, the new policy is more streamlined and easier to understand.

ENVIRONMENTAL AND SOCIAL ISSUES

Animal Welfare

Current General Recommendation: Generally vote for proposals seeking a report on a company's animal welfare standards, unless:

- The company has already published a set of animal welfare standards and monitors compliance;
- The company's standards are comparable to industry peers; and
- There are no recent, significant fines or litigation related to the company's treatment of animals.

Key Changes:

- Add "or animal welfare-related risks" to introductory sentence;
- Add "controversies" to last bullet point; and
- Add "and/or its suppliers'" to the last bullet point.

New General Recommendation: Generally vote for proposals seeking a report on a company's animal welfare standards, or animal welfare-related risks, unless:

- The company has already published a set of animal welfare standards and monitors compliance;
- The company's standards are comparable to industry peers; and
- There are no recent significant fines, litigation, or controversies related to the company's and/or its suppliers' treatment of animals.

Rationale for Update:

In 2014, some proponents began submitting shareholder proposals requesting reports on the risks associated with the use of certain methods of animal housing (e.g. gestation crates and battery cages) and other animal welfare practices deemed inhumane in a company's supply chain. The updated policy clarifies that proposals requesting a report on animal welfare-related risks, including the aforementioned resolutions on supply chain risks, are analyzed under this policy. The inclusion of controversies, along with fines and litigation, provides for consistent language across the Environmental and Social Issues policies, and ensures consistent evaluation and incorporation of relevant information.

Pharmaceutical Pricing, Access to Medicines, and Prescription Drug Reimportation

Current General Recommendation: Vote case-by-case on proposals requesting that a company report on its product pricing or access to medicine policies, considering:

- The nature of the company's business and the potential for reputational and market risk exposure;
- Existing disclosure of relevant policies;
- Deviation from established industry norms;
- Relevant company initiatives to provide research and/or products to disadvantaged consumers;
- Whether the proposal focuses on specific products or geographic regions; and
- The potential burden and scope of the requested report.

Key Changes:

- Add "regulatory" to the risk exposure bullet point; and
  Add a bullet point for "recent signficiant controveries, litigation, or fines at the company."

New General Recommendation: Vote case-by-case on proposals requesting that a company report on its product pricing or access to medicine policies, considering:

- The potential for reputational, market, and regulatory risk exposure;
- Existing disclosure of relevant policies;
- Deviation from established industry norms;
- Relevant company initiatives to provide research and/or products to disadvantaged consumers;
- Whether the proposal focuses on specific products or geographic regions;
- The potential burden and scope of the requested report;
- Recent significant controversies, litigation, or fines at the company.

Rationale for Update:

This update codifies ISS' current practice. When evaluating resolutions that request a report on a company's policies related to product pricing and access to medicine, ISS considers the potential for regulatory risks and the company's exposure to controversies, litigation, or fines.

The addition of the controversies bullet point reflects the increased criticism regarding the pricing of pharmaceutical products, in particular specialty drugs. This criticism has not only resulted in media coverage, but also Senate and U.S. Department of Justice investigations at some companies. Additionally, a growing number of states have either passed or have presented legislation aiming to cap pricing for certain products or to require drug manufacturers to provide increased disclosure on the cost of drug research and production, resulting in additional regulatory risks for the pharmaceutical industry.

Climate Change/Greenhouse Gas (GHG) Emissions

Current General Recommendation: Generally vote for resolutions requesting that a company disclose information on the impact of climate change on its operations and investments, considering:

- Whether the company already provides current, publicly-available information on the impacts that climate change may have on the company as well as associated company policies and procedures to address related risks and/or opportunities;
- The company's level of disclosure is at least comparable to that of industry peers; and
- There are no significant controversies, fines, penalties, or litigation associated with the company's environmental performance.

Key Changes:

Add "such as financial, physical, or regulatory risks" to the introductory sentence.

New General Recommendation: Generally vote for resolutions requesting that a company disclose information on the risks related to climate change on its operations and investments, such as financial, physical, or regulatory risks, considering:

- Whether the company already provides current, publicly-available information on the impact that climate change may have on the company as well as associated company policies and procedures to address related risks and/or opportunities;
- The company's level of disclosure is at least comparable to that of industry peers; and
- There are no significant controversies, fines, penalties, or litigation associated with the company's environmental performance.

Rationale for Update:

During the 2015 proxy season, proponents filed new shareholder proposals addressing companies' capital expenditure strategies as they relate to investments in fossil fuel and stranded carbon asset risk (investment in high-cost, high-carbon assets could be stranded, as global demand for fossil fuels slows in the coming years and/or potential climate change regulations make them unburnable). These resolutions asked companies to either report on the consistency of their capital expenditure strategies with policymakers' goals to limit greenhouse gas emissions, or a company's strategy to address the risk of stranded assets presented by global climate change and associated demand reductions for oil and gas.

The revisions to the current policy clarify the types of risks related to climate change that can impact a company's operations and investments. It also clarifies that the capital expenditure strategy and stranded carbon asset resolutions are evaluated pursuant to this policy.

CANADA

BOARD OF DIRECTORS- VOTING ON DIRECTOR NOMINEES IN UNCONTESTED ELECTIONS

Overboarded Directors –TSX

Current General Recommendation: Generally vote withhold for individual director nominees if:

› Irrespective of whether the company has adopted a majority voting policy, the director is overboarded[6] AND the individual director has attended less than 75 percent of his/her respective board and committee meetings held within the past year without a valid reason for these absences.

Cautionary language will be included in ISS reports where directors are overboarded regardless of attendance.

Key Changes:

› Change the definition of "overboarded" from more than 2 outside public company boards to more than 1 in the case of CEOs, and from more than 6 total public company boards to more than 4 in the case of non-CEOs.
› Commencing as of February 2017 meeting dates, the new policy definition will be implemented under the ISS Canada TSX Overboarded Directors policy.

New General Recommendation: Generally vote withhold for individual director nominees if:

› Irrespective of whether the company has adopted a majority voting policy, the director is overboarded[6,7] AND the individual director has attended less than 75 percent of his/her respective board and committee meetings held within the past year without a valid reason for these absences.

Cautionary language will be included in ISS reports where directors are overboarded regardless of attendance.

Rationale for Update:

Directors need sufficient time and energy in order to be effective representatives of shareholders' interests. Directors' responsibilities are increasingly complex as board and key committee memberships demand greater time commitments.

In a 2014 study, 120 board chairs, directors and CEOs across Canada were surveyed regarding their annual time commitment per board on which they served. The survey found that the average annual time commitment per board for a Canadian director was 304 hours. This number was higher for directors of companies with assets of more than CA$5 billion (388 hours) and also higher for those with assets between CA$1 billion and CA$5 billion (335 hours). There

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[6] "Overboarded" is defined as: a CEO of a public company who sits on more than 2 outside public company boards in addition to the company of which he/she is CEO (withholds would only apply on outside boards these directors sit on), OR the director is not a CEO of a public company and sits on more than 6 public company boards in total.

[7] Starting February 1, 2017, "overboarded" will be defined as: a CEO of a public company who sits on more than 1 outside public company board in addition to the company of which he/she is CEO (withholds would only apply on outside boards these directors sit on), OR the director is not a CEO of a public company and sits on more than 4 public company boards in total.

was also a correlation between the role of a director and average annual time commitment. As expected, being a board chair is the most time consuming role; however, being a committee chair can be almost as time consuming.

While it appears that no comparable studies were conducted for previous years in Canada, according to a 2014-2015 US survey conducted by the National Association of Corporate Directors (NACD), directors of US public companies spent an annual average of 278 hours on board-related matters.

Based on the results of the 2015-16 ISS Global Policy Survey, a plurality of investor responses indicated that four total board seats is an appropriate limit for directors who are not active CEOs, and that a total of two board seats (a CEO's "home board" plus one outside board) is an appropriate limit for directors who are active CEOs.

ISS also obtained feedback in one-on-one discussions with institutional investors, the results of which indicate that a majority of those canvassed support maximum limits of four and two total board seats for non-CEO directors and CEO directors, respectively. These limits are reasonable in light of the "double-trigger" approach of jointly evaluating both number of board seats and attendance under Canadian policy.

Externally-Managed Issuers (EMIs) –TSX and TSXV

Current General Recommendation: None.

Key Changes:

Provide a framework for reviewing board accountability at EMIs, in cases where disclosure is limited or insufficient with respect to the management services agreement and how senior management is compensated.

New General Recommendation: Vote case-by-case on say-on-pay resolutions where provided, or on individual directors, committee members, or the entire board as appropriate, when an issuer is externally-managed and has provided minimal or no disclosure about their management services agreements and how senior management is compensated. Factors taken into consideration may include but are not limited to:

- The size and scope of the management services agreement;
- Executive compensation in comparison to issuer peers and/or similarly structured issuers;
- Overall performance;
- Related party transactions;
- Board and committee independence;
- Conflicts of interest and process for managing conflicts effectively;
- Disclosure and independence of the decision-making process involved in the selection of the management services provider;
- Risk mitigating factors included within the management services agreement such as fee recoupment mechanisms;
- Historical compensation concerns;
- Executives' responsibilities; and
- Other factors that may reasonably be deemed appropriate to assess an externally-managed issuer's governance framework.

Rationale for Update:

Externally-managed issuers (EMIs) typically pay fees to outside firms in exchange for management services. In most cases, some or all of the EMI's executives are directly employed and compensated by the external management firm.

EMIs typically do not disclose details of the management agreement in their proxy statements and only provide disclosure on the aggregate amount of fees paid to the manager, with minimal or incomplete compensation information.

Say-on-pay resolutions are voluntarily adopted in Canada, and none of the currently identified Canadian EMIs had a say-on-pay resolution on ballot this past year. Additionally, all non-controlled TSX-listed issuers are required to adopt majority voting director resignation policies which could result in a director being required to resign from a board if he or she receives more 'withhold' than 'for' votes at the shareholders' meeting. Some investor respondents to ISS' 2015-16 ISS Global Policy Survey indicated that in cases where an externally managed company does not have a say-on-pay proposal (i.e., 'withhold' votes may be recommended for individual directors), factors other than disclosure should be considered, such as performance, compensation and expenses paid in relation to peers, board and committee independence, conflicts of interest, and pay-related issues. Policy outreach sessions conducted with Canadian institutional investors resulted in identical feedback.

COMPENSATION

Equity Compensation Plans–TSX

Current General Recommendation: Vote case-by-case on equity-based compensation plans. Vote against the plan if any of the following factors applies:

- **Cost of Equity Plans:** The total cost of the company's equity plans is unreasonable;
- **Dilution and Burn Rate:** Dilution and burn rate are unreasonable, where the cost of the plan cannot be calculated due to lack of relevant historical data.
- **Plan Amendment Provisions:** The provisions do not meet ISS guidelines regarding those amendments that should require shareholder approval..
- **Non-Employee Director Participation:** Participation of directors is discretionary or unreasonable.
- **Pay for performance:** There is a disconnect between CEO pay and the company's performance.
- **Repricing Stock Options:** The plan expressly permits the repricing of stock options without shareholder approval and the company has repriced options within the past three years.
- **Problematic Pay Practices:** The plan is a vehicle for problematic pay practices.

Key Changes:

Similar to the model introduced in the United States for the 2015 proxy season, ISS is adopting a "scorecard" model (Equity Plan Scorecard – "EPSC") for Canadian TSX equity plans that considers a range of positive and negative factors to evaluate equity incentive plan proposals. In concert with ISS' longstanding Canadian policies for TSX equity plans (relating to non-employee director participation, amendment provisions, and repricing without shareholder approval), the total EPSC score will determine whether ISS recommends for or against the proposal.

EPSC factors will fall under three categories ("EPSC pillars"): Plan Cost, Plan Features, and Grant Practices.

As part of the new approach, the updated policy will:

- Utilize two index groups to determine certain thresholds and factor weightings: [8]
    - S&P/TSX Composite Index; and
    - Non-Composite TSX-listed Issuers.
- Utilize individual scorecards for both index groups, as well as Special Cases versions of these scorecards where certain historic data are unavailable;
- Measure plan cost (Shareholder Value Transfer or SVT) through both of the following:
    - The company's total new and previously reserved equity plan shares plus outstanding grants and awards ("A+B+C shares"); and
    - Only the new request plus previously reserved but ungranted shares ("A+B shares");
- Incorporate a wide range of new factors for consideration, both positive and negative, in determining how to recommend for a given equity plan.

New General Recommendation: Vote case-by-case on equity-based compensation plans using an "equity plan scorecard" (EPSC) approach. Under this approach, certain features and practices related to the plan[9] are assessed in combination, with positively-assessed factors potentially counterbalancing negatively-assessed factors and vice-versa. Factors are grouped into three pillars:

- **Plan Cost**: The total estimated cost of the company's equity plans relative to industry/market cap peers, measured by the company's estimated Shareholder Value Transfer (SVT) in relation to peers and considering both:
    - SVT based on new shares requested plus shares remaining for future grants, plus outstanding unvested/unexercised grants; and
    - SVT based only on new shares requested plus shares remaining for future grants.

- **Plan Features:**
    - Absence of problematic change-in-control (CIC) provisions, including:
        - Single-trigger acceleration of award vesting in connection with a CIC; and
        - Settlement of performance-based equity at target or above in the event of a CIC-related acceleration of vesting regardless of performance.
    - No financial assistance to plan participants for the exercise or settlement of awards;
    - Public disclosure of the full text of the plan document; and
    - Reasonable share dilution from equity plans relative to market best practices.

- **Grant Practices:**
    - Reasonable three-year average burn rate relative to market best practices;
    - Meaningful time vesting requirements for the CEO's most recent equity grants (three-year lookback);
    - The issuance of performance-based equity to the CEO;
    - A clawback provision applicable to equity awards; and
    - Post-exercise or post-settlement share-holding requirements (S&P/TSX Composite Index only).

Generally vote against the plan proposal if the combination of above factors, as determined by an overall score, indicates that the plan is not in shareholders' interests. In addition, vote against the plan if any of the following unacceptable factors have been identified:

- Discretionary or insufficiently limited non-employee director participation;

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[8] Additional Special Cases versions of both models will also be developed for companies that have recently IPO'd or emerged from bankruptcy and where the burn-rate factor would therefore not apply.
[9] In cases where certain historic grant data are unavailable (e.g. following an IPO or emergence from bankruptcy), Special Cases models will be applied which omit factors requiring these data.

- An amendment provision which fails to adequately restrict the company's ability to amend the plan without shareholder approval;
- A history of repricing stock options without shareholder approval (three-year look-back);
- The plan is a vehicle for problematic pay practices or a significant pay-for-performance disconnect under certain circumstances; or
- Any other plan features that are determined to have a significant negative impact on shareholder interests.

Rationale for Update:

As issues around cost transparency and best practices in equity-based compensation have evolved in recent years, ISS has determined to update its Canadian Equity Plans policy in order to provide for a more nuanced consideration of equity plan proposals.

Currently, the Canadian policy for equity plans comprises a series of pass/fail tests relating to plan cost and to three key concerns of Canadian investors:

- Non-employee director participation;
- Plan amendment provisions; and
- Repricing without shareholder approval.

While the three policy cornerstones above will continue to be overriding negative factors under the new policy, the pass/fail test for plan cost will be replaced with a scorecard approach designed to provide a robust overview of an equity plan's strengths and weaknesses.

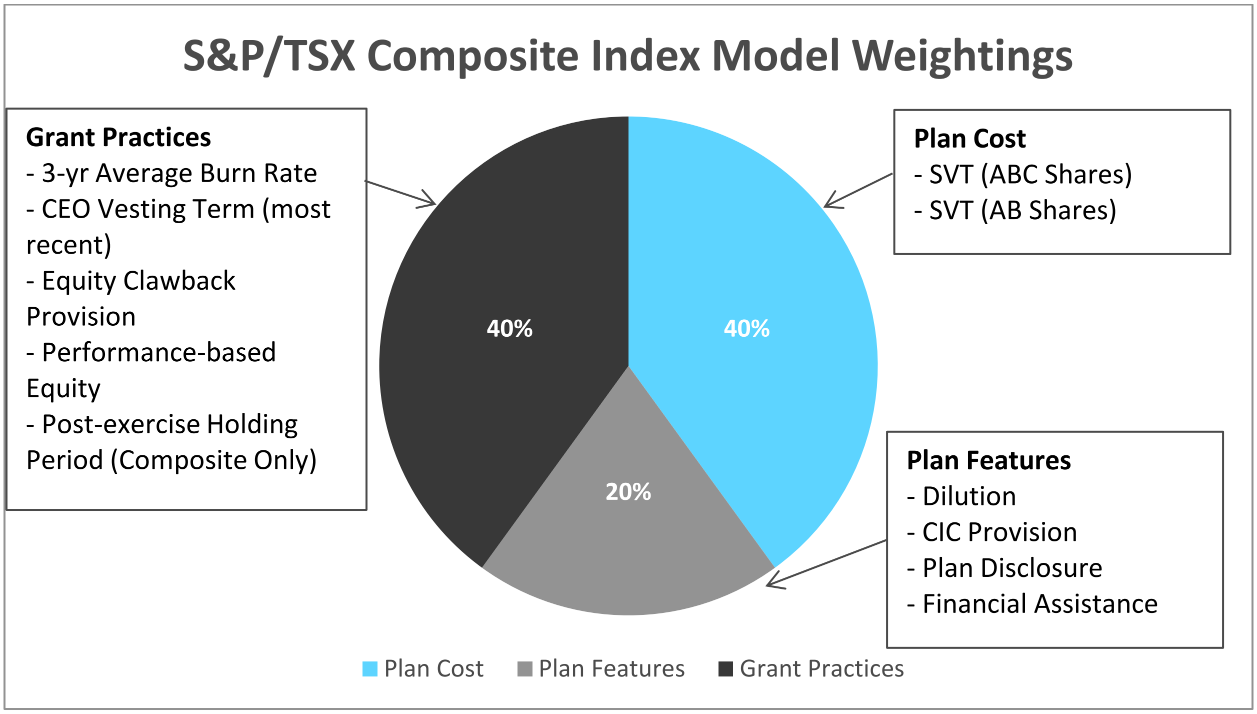
Feedback obtained through ongoing consultation with institutional investors since the 2013-2014 ISS policy cycle indicates strong support for the new approach, which incorporates the following key goals:

1. Consider a range of factors, both positive and negative, in determining vote recommendations;
2. Select factors based on institutional investors' concerns and preferences and on best practices within the Canadian market established through regulation, disclosure requirements, and best practice principles;
3. Establish factor thresholds and weightings which are cognizant of the Canadian governance landscape (separate scorecards for the S&P/TSX Composite Index and the broader TSX);
4. Ensure that key concerns addressed by policy continue to hold paramount importance (institution of overriding negative factors).

The EPSC policy for equity plan proposals significantly iterates ISS' current Canadian policy by providing a full-spectrum overview of plan cost, plan features, and historic grant practices. This allows shareholders greater insight into rising governance concerns, such as the implementation of risk-mitigating mechanisms, the strength of vesting provisions, and the use of performance-based equity, while also providing added assessments of longstanding concerns relating to equity plans such as burn rate and dilution.

By assessing these factors in combination, the EPSC is designed to facilitate a more holistic approach to vote recommendations. For example, a plan where cost is nominally higher than a company's allowable cap may receive a favourable recommendation if sufficient positive factors are present. Conversely, a plan where cost is nominally lower than the allowable cap may ultimately receive a negative recommendation if a preponderance of scorecard factors demonstrates adverse qualities. Plans will, however, continue to be subject to the scrutiny of overriding negative factors reflecting ISS' current policies regarding problematic non-employee director participation, insufficient plan amendment provisions, repricing without shareholder approval, and other egregious practices. Plans permitting these unacceptable practices will continue to receive an "against" recommendation.

A scorecard approach will enable the evaluation of equity plan proposals in consideration of a range of best practices. Weightings for the three scorecard pillars applicable to S&P/TSX Composite Index constituents and non-Composite TSX-listed issuers are shown below, along with the factors within each pillar. More information about the policy and weightings will be included in ISS' EPSC FAQ to be published in December.



BRAZIL

BOARD OF DIRECTORS - DIRECTOR ELECTIONS

Election of board and fiscal council nominees presented by minority ordinary and preferred holders under separate election items

Current General Recommendation: Vote against the election of directors nominated by non-controlling shareholders presented as a separate voting item if the nominee names are not disclosed in a timely manner prior to the meeting.

The policy is silent regarding the election of fiscal council members (statutory auditors) nominated by non-controlling shareholders, presented as separate voting items, as allowed by the Brazilian Corporate Law.

Key Changes:

- Recommend an abstain vote in the absence of timely disclosure regarding the names of the minority shareholders' director nominees (both ordinary minority nominee and/or preferred minority nominee, as applicable), when presented under a separate election; and
- Add the provision of an abstain vote recommendation in the absence of timely disclosure regarding the names of minority shareholders' fiscal council nominees and alternates (both ordinary and preferred minority nominees, as applicable), when presented under a separate election.

New General Recommendation: Vote abstain on the election of directors and fiscal council members nominated by non-controlling shareholders presented as a separate voting item if the nominee names are not disclosed in a timely manner prior to the meeting.

Rationale for Update:

The current recommendation to vote against the election of directors nominated by non-controlling shareholders presented as a separate voting item if the nominee names are not disclosed in a timely manner prior to the meeting is part of the Brazilian policy carved out from the Americas Regional policy mid-2013, effective as of Feb. 1, 2014, but was not fully implemented by the Latin America Research team due to the evolving processes in the voting operations chain regarding minority elections presented under separate items in the Brazilian market.

Minority nominees are generally considered independent and, as they can legally be presented up to the time of the meeting, a vote against would disenfranchise minority shareholders who could benefit from greater independent representation. Nonetheless, a vote for minority nominees in the absence of the disclosure of such names is inconsistent with ISS transparency principles and the overall policy framework for the Latin America region.

As such, an abstain vote is the most effective (and neutral) way to address minority shareholder election items when adequate disclosure is not provided in a timely manner. The policy update maintains the current practice of recommending a for vote if the names of the minority nominees are disclosed, and, in the absence of timely disclosure, to recommend an abstain vote for all minority election items, including directors and fiscal council nominees (ordinary and preferred shareholder meeting).

Combined Chairman/CEO

Current General Recommendation: None specific to the combination of Chair/CEO.

Key Changes:
Introduce policies for voting on directors at companies listed under the differentiated corporate governance segments in Brazil that maintain a combined Chair/CEO structure

New General Recommendation: Vote against the bundled election of directors of companies listed under the differentiated corporate governance segments of the Sao Paulo Stock Exchange (BM&FBovespa)--Novo Mercado, Nivel 2, and Nivel 1-- if the company maintains or proposes a combined chairman/CEO structure, after three (3) years from the date the company's shares began trading on the respective differentiated corporate governance segment.

Vote against the election of the company's chairman, if the nominee is also the company's CEO, when it is presented as a separate election at companies listed under the differentiated corporate governance segments of the Sao Paulo Stock Exchange (BM&FBovespa)–Novo Mercado, Nivel 2, and Nivel 1-- after three (3) years from the date the company's shares began trading on the respective differentiated corporate governance segment.

Rationale for Update:

The policy update is consistent with the current regulatory requirements of the Brazilian differentiated corporate governance listing segments (Novo Mercado, Nivel 2, and Nivel 1) adopted by the BM&FBovespa in 2010, which established the following:

No Accumulation of Positions. The offices of chairman of the board of directors and the chief executive officer or major executive officer of the Company shall not be accumulated in a single person, except in case of vacancy, in which event the circumstance will be disclosed to the market and action will be taken within the subsequent one hundred and eighty (180) days to fill in the positions.

However, accumulation of positions of chairman of the board of director and chief executive officer or major executive officer of the Company will be permitted on an exceptional and transitional basis for a maximum period of three (3) years starting from the date the Company shares begin to trade on the Novo Mercado, the Nivel 2 and Nivel 1.

Conflicts of Interest (Policy change applies to Americas Regional policy as well)

Current General Recommendation: Under extraordinary circumstances, vote against individual directors, members of a committee, or the entire board, due to:

- Material failures of governance, stewardship, risk oversight, or fiduciary responsibilities at the company;
- Failure to replace management as appropriate; or
- Egregious actions related to a director's service on other boards that raise substantial doubt about his or her ability to effectively oversee management and serve the best interests of shareholders at any company.

Key Changes:
Include the provision to recommend against an individual nominee, committee members, or the entire board in light of a conflict of interest that raises significant risk, which has not yet materialized (forward looking), in the absence of mitigating measures.

New General Recommendation: Under extraordinary circumstances, vote against individual directors, member(s) of a committee, or the entire board, due to:

- Material failures of governance, stewardship, risk oversight, or fiduciary responsibilities at the company;
- Failure to replace management as appropriate; or
- Egregious actions related to a director's service on other boards that raise substantial doubt about his or her ability to effectively oversee management and serve the best interests of shareholders at any company.

Vote against individual directors, members of a committee, or the entire board due to a conflict of interest that raises significant potential risk, in the absence of mitigating measures and/or procedures.

Rationale for Update:

The current policy framework refers to conflicts of interest that raise concern in specific transactions. The update addresses a conflict of interest that raises potential significant risk in terms of future possible actions or transactions that could be adverse to shareholders' interests, when the company does not disclose policies and procedures that would mitigate such risk.

COMPENSATION

Management Compensation

Current General Recommendation: Generally vote for management compensation proposals that are presented in a timely manner and include all disclosure elements required by the Brazilian Securities Regulator (CVM).

Vote against management compensation proposals when:

- The company fails to present a detailed remuneration proposal or the proposal lacks clarity; or
- The company does not disclose the total remuneration of its highest-paid executive; or
- The figure provided by the company for the total compensation of its highest-paid administrator is not inclusive of all elements of the executive's pay.

Key Changes:
Include a provision that a significant increase in the proposed remuneration cap on a year-over-year basis will trigger further scrutiny of the company's remuneration proposal, providing a framework for a more qualitative remuneration analysis.

New General Recommendation: Generally vote for management compensation proposals that are presented in a timely manner and include all disclosure elements required by the Brazilian Securities Regulator (CVM).

Vote against management compensation proposals when:

- The company fails to present a detailed remuneration proposal or the proposal lacks clarity; or
- The company does not disclose the total remuneration of its highest-paid executive; or
- The figure provided by the company for the total compensation of its highest-paid administrator is not inclusive of all elements of the executive's pay.

Vote case-by-case on global remuneration cap (or company's total remuneration estimate, as applicable) proposals that represent a significant increase of the amount approved at the previous AGM (year-over-year increase). When further scrutinizing year-over-year significant remuneration increases, jointly consider some or all of the following factors, as relevant:

- Whether there is a clearly stated and compelling rationale for the proposed increase;
- Whether the remuneration increase is aligned with the company's long-term performance and/or operational performance targets disclosed by the company;
- Whether the company has had positive TSR for the most recent one- and/or three-year periods;
- Whether the relation between fixed and variable executive pay adequately aligns compensation with the company's future performance.

Rationale for Update:

In Brazil, shareholders are asked to approve the aggregate remuneration of directors and executive officers annually through a binding resolution presented at a shareholder meeting. Regulatory changes implemented late 2009, effective as of January 2010 (Instructions 480 and 481), provided the framework of full disclosure of the proposed remuneration, including detailed information of executive remuneration (not individualized), which has now been in place for several years. While current policy has based recommendations solely on companies' compliance with the disclosure requirements, this update provides for a more qualitative analysis when a significant year-over-year increase signals that further scrutiny of remuneration practices is warranted.

Compensation Plans

Current General Recommendation: ISS will generally support reasonable equity pay plans that encourage long-term commitment and ownership by its recipients without posing significant risks to shareholder value.

Practically all of the plans presented since the implementation of the 2009 CVM guidelines have included reasonable dilution limits and adequate vesting conditions. Performance criteria, meanwhile, are rarely disclosed. ISS' assessments of these plans have generally hinged on the presence of discounted exercise prices (which are common in Brazil), particularly in the absence of specific performance criteria.

Vote against a stock option plan, or an amendment to the plan, if:

- The plan lacks a minimum vesting cycle of three years; and/or
- The plan permits options to be issued with an exercise price at a discount to the current market price, in the absence of explicitly stated, challenging performance hurdles related to the company's historical financial performance or the industry benchmarks; and/or
- The maximum dilution exceeds ISS guidelines of 5 percent of issued capital for a mature company and 10 percent for a growth company. However, ISS will support plans at mature companies with dilution levels up to 10 percent if the plan includes other positive features such as challenging performance criteria and meaningful vesting periods, as these features partially offset dilution concerns by reducing the likelihood that options will become exercisable unless there is a clear improvement in shareholder value; and/or
- Directors eligible to receive options under the scheme are involved in the administration of the plan.

Key Changes:
Reference restricted share plans to clarify that ISS will recommend against such plans based on the proposal of full-value shares (which essentially represent a 100-percent discount to market price) in the absence of publicly disclosed performance targets and hurdles.

New General Recommendation: ISS will generally support reasonable equity pay plans that encourage long-term commitment and ownership by its recipients without posing significant risks to shareholder value.

Practically all of the plans presented since the implementation of the 2009 CVM guidelines have included reasonable dilution limits and adequate vesting conditions. Performance criteria, meanwhile, are rarely disclosed. ISS' assessments of these plans have generally hinged on the presence of discounted exercise prices (which are common in Brazil), particularly in the absence of specific performance criteria.

Vote against a stock option plan and/or restricted share plan, or an amendment to the plan, if:

- The plan lacks a minimum vesting cycle of three years; and/or
- The plan permits options to be issued with an exercise price at a discount to the current market price, or permits restricted shares to be awarded (essentially shares with a 100 percent discount to market price), in the absence of explicitly stated, challenging performance hurdles related to the company's historical financial performance or the industry benchmarks; and/or
- The maximum dilution exceeds ISS guidelines of 5 percent of issued capital for a mature company and 10 percent for a growth company. However, ISS will support plans at mature companies with dilution levels up to 10 percent if the plan includes other positive features such as challenging performance criteria and meaningful vesting periods, as these features partially offset dilution concerns by reducing the likelihood that options will become exercisable unless there is a clear improvement in shareholder value; and/or
- Directors eligible to receive options under the scheme are involved in the administration of the plan.

Rationale for Update:

Currently, ISS Brazil policy does not address restricted share plans, only stock option plans, although the latter have been seen more frequently in the last couple of years. As such, this policy update includes specific reference to restricted share plans under the current policy framework already adopted for stock options plans.

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Speech

Keynote Address at the 2015 AICPA National Conference: "Maintaining High-Quality, Reliable Financial Reporting: A Shared and Weighty Responsibility"

Chair Mary Jo White

Washington, DC

Dec. 9, 2015

Good morning. Thank you, Bridgette [Hodges], for that kind introduction.

It is a pleasure to be here to speak to you about our shared and weighty responsibility to maintain high-quality, reliable financial reporting. This audience – preparers, auditors, audit committee members, and their advisors – is a very important one for the SEC. Investors, issuers, and the markets all depend on the work you do and the judgments you make – and how well you do both. You, together with the standard setters and the regulators, have a vital stake in ensuring that our capital markets remain the safest and strongest in the world – and we all share the responsibility.

Key to our mutual success is maintaining high-quality reporting of reliable and relevant financial information that investors can use to make informed investment decisions. If there is even one weak link in the financial reporting chain, investors and the integrity of our markets suffer. We must all work together in order to fulfill the high expectations investors rightly set for financial reporting.

This morning, I will talk about our respective responsibilities and some challenges I see for each of us. In the course of my remarks, I will touch on some of the current work we are doing at the SEC, including our disclosure effectiveness review, our concept release on audit committee disclosure, and the status of the Commission's consideration of the further use of International Financial Reporting Standards (IFRS). Over the next three days, our Chief Accountant Jim Schnurr, Director of Corporation Finance Keith Higgins, and Director of Enforcement Andrew Ceresney – and members of their staffs – will address each of the topics I cover in more detail.

The Responsibility of Preparers

Let me start with the role of preparers because you really are the lynchpin of high-quality, reliable financial reporting. You are the ones who make the often difficult and nuanced decisions and judgments required to meet the objectives and principles of U.S. Generally Accepted Accounting Principles (GAAP) or IFRS – from revenue recognition to impairments to fair value determinations. We rely on those of you in the trenches of finance and internal audit to press and challenge management on questions you have on transactions, judgments, and risk areas. It is not an easy job, and we all need to do whatever we can to support you – whether through strong external audits; through standard setters and Commission staff providing clarity in the implementation of new standards; or through our Whistleblower Office protecting you if you do find and report violations to us.

Preparers must recognize that management's ability to fulfill its financial reporting responsibilities significantly depends on the design and effectiveness of internal control over financial reporting (ICFR) – controls designed to provide reasonable assurance that the company's financial statements are prepared in accordance with GAAP.[1] While some initially questioned the value of such controls, we now generally hear from stakeholders – especially following new guidance and auditing standards issued in 2007[2] – that the ICFR requirements of the Sarbanes−Oxley Act have resulted in improved controls and financial reporting. And we see the improvement ourselves.

But, as you know, debate persists about whether companies and auditors are being required to perform documentation and testing of controls that is unnecessary – and, if so, the reasons why. There are useful, ongoing discussions about these issues among the Public Company Accounting Oversight Board (PCAOB), investors, the audit profession, and preparers, which the SEC staff has been keenly observing. I will not get ahead of those discussions, but I will say that it is hard to think of an area more important than ICFR to our shared mission of providing high-quality financial information that investors can rely on. We need to be frank about any challenges in the operation and assessments of ICFR and address them to the extent appropriate. But at the end of the day, ICFR must remain the strong bulwark of reliable financial reporting that it has become.

Another financial reporting topic of shared interest and current conversation is the use of non-GAAP measures. This area deserves close attention, both to make sure that our current rules are being followed and to ask whether they are sufficiently robust in light of current market practices. Non-GAAP measures are allowed in order to convey information to investors that the issuer believes is relevant and useful in understanding its performance. By some indications, such as analyst coverage and press commentary, non-GAAP measures are used extensively and, in some instances, may be a source of confusion.

Like every other issue of financial reporting, good practices in the use of non-GAAP measures begin with preparers. While your chief financial officer and investor relations team may be quite enamored of non-GAAP measures as useful market communication devices, your finance and legal teams, along with your audit committees, should carefully attend to the use of these measures and consider questions such as: Why are you using the non-GAAP measure, and how does it provide investors with useful information? Are you giving non-GAAP measures no greater prominence than the GAAP measures, as required under the rules? Are your explanations of how you are using the non-GAAP measures – and why they are useful for your investors – accurate and complete, drafted without boilerplate? Are there appropriate controls over the calculation of non-GAAP measures?

The Responsibility of Auditors

Preparers, of course, are not solely responsible for maintaining the strength of financial reporting. It also depends on thorough and objective audits performed by independent, knowledgeable, and skeptical public accountants. Indeed, while preparers are the lynchpin of high−quality financial reports, auditors are the key gatekeepers for those reports, protecting shareholders by ensuring that issues are promptly identified and addressed. As with other parts of the chain in financial reporting, there is both encouraging news and also some areas of concern.

In the encouraging column, investor confidence in audited financial statements and independent auditors is high.[3] We have also seen a general reduction in the number and severity of restatements of financial statements since the implementation of the Sarbanes-Oxley Act, although there are some specific areas that could benefit from a redoubling of efforts.[4] The positive signs are attributable, at least in part, to improvements in audit quality and the enhanced role that auditors generally now discharge in providing an essential check in the financial reporting process.

Significant credit for the increase in audit quality should be given to the PCAOB's inspection program and the enhancements it has made to some of the auditing standards. The PCAOB's inspection findings on individual audit engagements and firm quality controls have resulted in many audit firms making significant improvements, which in some cases included structural or systems changes beyond the specific remedial actions required.

In the worrisome column, we still observe too many instances where companies and their auditors have not discharged their responsibilities adequately under the securities laws and professional standards. Recent PCAOB inspections, for example, have found significant deficiencies in auditing the effectiveness of ICFR; assessing and responding to risks of material misstatement; auditing accounting estimates; and work performed by audit firms other than the signing firm in cross-border audits.[5] And as I will discuss later, we have also just recently brought two enforcement cases against national accounting firms and their partners for missing or ignoring red flags. Such failures are totally unacceptable.

The Responsibility of Audit Committees

The audit committee is another critical gatekeeper in the chain responsible for high-quality, reliable financial reporting. Listing requirements and SEC rules, as well as how companies address various enterprise risks, are placing heavy demands on audit committees. We must all ensure that they have the tools and the abilities to perform their important functions.

As I have said before, being a director of a public company is not "for the faint of heart." [6] Members of audit committees particularly need to be strong. Having served on the audit committee of a public company, I know first-hand how much work and responsibility the job requires. And, since my service, even more is being demanded, with many audit committees now being charged with overseeing additional risks, including incredibly important areas such as cybersecurity.

I have growing concerns about the amount of work required of some audit committees. The increasing workload may dilute an audit committee's ability to focus on its core responsibilities: selecting and overseeing the independent auditors; internal controls and auditing; setting up an appropriate system for the receipt and treatment of complaints about accounting; and reporting to shareholders.[7] And when directors serve on multiple boards, including multiple audit committees, we must question whether they can do the job effectively.

Companies and directors should carefully choose who serves on their audit committee, selecting only those who have the time, commitment, and experience to do the job well. Just meeting the technical requirements of financial literacy may not be enough to fully understand the financial reporting requirements or to challenge senior management on major, complex decisions. Nor is experience necessarily transferable. While independent directors should have diversified backgrounds, a director with financial reporting experience limited to manufacturing firms, for example, may not be able to adequately oversee the reporting of a large financial services firm.

Audit committees of every company must be entirely committed to their oversight of financial reporting. They must, for example, be able to adequately review how management is designing and implementing ICFR and how it is using non-GAAP measures. They must ask questions about their auditor's work and satisfy themselves of the job the auditors are doing, particularly when it is time to select the right auditor and recommend to shareholders that they ratify the company's choice.

Audit committees must also take seriously their reporting to shareholders, a critical responsibility on which the SEC is closely focused. Deputy Chief Accountant Brian Croteau will discuss the responses we have received on the concept release we issued in July on possible revisions to audit committee disclosure requirements. My only observation for now is that the audit committee report serves as a place for engaging with shareholders on important subjects, and the report must continue to meet the needs of investors as their interests and expectations evolve with the marketplace.

The Responsibility of Standard Setters

Let me now turn to the importance of standard setters to high-quality, reliable financial reporting. In a fundamental sense, good financial reporting cannot occur without strong, first-rate accounting standards established by independent standard setters. The quality and value of financial reporting would be seriously diminished if based on – and audited against – subpar accounting standards.

Confidence in financial reporting cannot exist without confidence in the underlying accounting standards and how and for what purpose they were developed. Accounting standards, with their potentially significant ramifications for companies, are often the subject of intense debates among policymakers, companies, investors, and other market participants. Setting a standard must be informed by all relevant viewpoints, but the standard must ultimately provide objective, accurate, and credible information about relevant economic activities useful for investor decisions, without regard to how it might change the behavior of market participants or regulators.

As you know, while the Commission retains the ultimate standard-setting authority for financial reporting in the United States, it has consistently looked to the private sector for leadership in establishing and improving high-quality accounting standards. Since the 1970s, the Financial Accounting Standards Board (FASB) has been the private sector standard setter for GAAP, and its structure and operations have been designed to preserve its independence and maintain a focus on strong standards.[8]

Since 2002, the FASB has also worked jointly with the International Accounting Standards Board (IASB) to develop converged, high-quality globally accepted accounting standards.[9] While several priority projects did not result in a common standard, the two boards have made significant progress in converging GAAP and IFRS in several major areas and are continuing to cooperate on other important projects. Too often, these successes are not sufficiently recognized, with the public discussion emphasizing instead the differences between GAAP and IFRS.

The new revenue recognition standard that Deputy Chief Accountant Wes Bricker will be talking about, for example, addresses one of the most fundamental financial statement metrics for investors. It is a prime example of how the cooperation between the two boards can produce high-quality standards that now will be globally consistent. Other success stories include reporting for business combinations and fair value measurements.

As both boards shift to agendas not dominated by joint projects, I urge them to continue, wherever possible, to build on these successes and maintain their commitment to collaboration in support of the objective of a single set of high-quality, globally accepted accounting standards.

I want to pause here to briefly mention the question of the use of IFRS by domestic issuers in the United States. As you know, since 2007, the Commission has permitted foreign private issuers to include financial statements prepared in accordance with IFRS, as issued by the IASB, in filings with the SEC without requiring reconciliation to U.S. GAAP.[10] And today, over 500 issuers representing trillions of dollars in aggregate market capitalization report to the Commission using IFRS. The Commission staff monitors and reviews the application of those standards in filings with the SEC in the same manner that it monitors and reviews the application of GAAP, making IFRS very much a focus in the SEC's work.

With respect to the issue of possible further use of IFRS in the United States, as I have said in the past, I believe it is important for the Commission, as a Commission, to make a further statement about its general views on the goal of a single set of high-quality global accounting standards – a topic that the Commission itself has not spoken on since 2010.[11]

At this conference last year, Jim Schnurr discussed the possibility of allowing domestic issuers to provide IFRS-based information as a supplement to GAAP financial statements without requiring reconciliation.[12] This proposal has the potential to be a useful next step, and the staff has now developed a recommendation for the Commission's consideration, which staff will be discussing with all of the Commissioners so that we can determine the path forward.

The Responsibility of Regulators

I will finish today with a brief discussion of the role of regulators. As with the other parties I have addressed, our vigilance and commitment too is essential for preserving high−quality, reliable financial reporting.

Let me first return briefly to the PCAOB. We work closely and collaboratively with the board to achieve our shared goals on behalf of investors and it is an extraordinarily important partnership.

One of my responsibilities since becoming Chair has been to attend board meetings of the International Organization of Securities Commissions (IOSCO), which oversees a number of important workstreams, including one dedicated to audit quality. Discussions around that workstream return again and again to how strong a contributor the PCAOB is in the United States to raising audit quality – through their inspections, standard setting, enforcement, and other initiatives. That is certainly my view, and I want to commend Chairman Doty and the PCAOB board and staff for the important work they have done – and continue to do – in raising the bar for auditors and audit quality.

For the Commission's part, our staff works closely with the PCAOB and all of the parties in the financial reporting chain to ensure that reports continue to serve to protect investors and build confidence in our markets. This work, of course, reflects the work of our Office of the Chief Accountant, expertly led by Jim Schnurr, who you will hear from shortly, and includes the extensive and very impressive work of the Division of Corporation Finance in reviewing and commenting on the financial reports of over 4,000 registrants each year. It also includes a strong enforcement program that prioritizes financial reporting cases.

One important area of mutual interest is the staff's work on its disclosure effectiveness initiative. As you know, at my direction, the Division of Corporation Finance is spearheading a comprehensive review of our disclosure regime, beginning with a review of Regulations S-K and S-X. In September, the Commission issued the first public product from that review – a request for comment on certain Regulation S-X requirements.[13] I anticipate further output in the coming year on Regulation S-K, as well as on various technical changes related primarily to financial statement disclosures and improvements to the presentation of information and tools on sec.gov.

There is also news from Congress on this front. Last week, a transportation bill was enacted that contained a number of SEC-related provisions, including one for disclosure modernization and simplification.[14] Among other provisions, the Commission is required to study the requirements in Regulation S-K, report the findings to Congress, and issue a proposed rule to implement the recommendations of the study.

Momentum on disclosure effectiveness is also occurring at companies. We have seen concrete progress by companies working to make disclosures clearer and more understandable, in particular by removing redundancies or unnecessary information.

But there is more work to do, both from our perspective and yours. The goal of the staff's initiative is to make disclosure more effective, which is not only about reducing volume and complexity, but also considering whether investors need more information in certain areas. While in some cases it may be beneficial to reduce volume and complexity to help investors better focus on important matters, you will hear from our staff in Corporation Finance that there are other areas – foreign tax disclosure is one – where the staff believes that more disclosure would help investors. The staff is considering all of these issues in its review, and I encourage companies to continue to undertake their own efforts to enhance disclosures for the benefit of their investors.

One of the ultimate tools to ensure high-quality, reliable financial reporting is strong enforcement when the rules are not followed. Since I became Chair in April 2013, the staff has reinvigorated its investigative and enforcement efforts in this area, with a focus on issuers and gatekeepers. The Commission has more than doubled the number of issuer reporting and disclosure actions it has brought – from 53 actions in fiscal year 2013 to 114 actions in fiscal year 2015, not counting cases based on delinquent filings and follow-on proceedings.

We have also been closely scrutinizing the gatekeepers of financial reporting, continuing to hold accountants, auditors, and audit committees accountable in appropriate circumstances. In the fiscal year that just ended, the Commission charged 76 respondents – 57 individuals and 19 firms – under Rule 102 (e) of the Commission's Rules of Practice. In September, we also charged a national audit firm for dismissing red flags and issuing false and misleading audit opinions about the financial statements of an audit client.[15] This was the Commission's first non-independence case against a national audit firm since 2009,[16] and the first case where we obtained admissions from a national audit firm.

Just last week, a second national audit firm admitted wrongdoing, and the firm and two of its partners agreed to settle charges that they ignored red flags and fraud risks while conducting deficient audits of two publicly-traded companies that wound up facing accounting-related enforcement actions.[17] In the past fiscal year, we also charged a former audit committee chair for substituting his incorrect interpretation of SEC rules requiring the disclosure of executive perks for the views of experts the company had hired, resulting in incomplete disclosures.[18]

The financial reporting area will continue to be a high priority for our enforcement program. Investors depend on comprehensive and accurate financial reporting, and so our fundamental objective is to raise the bar of compliance by issuers and their auditors and we will use all of our tools to do so.

Conclusion

Let me conclude on that note. In our time this morning, I have tried to give you an overview of how the SEC views our shared responsibility for strong financial reporting and to highlight some of the reporting issues that have our attention. Senior staff will talk more about these and other issues over the next three days.

As you listen to the discussion of specific financial reporting issues, it is important to keep in mind that regulators are not just preaching to you, although it may seem like that at times. What we are trying to do is engage proactively with you on our shared responsibility for high-quality, reliable financial reporting. It is a weighty responsibility that constantly requires the very best efforts of all of us. Investors and our capital markets deserve and demand no less.

Thank you.

[1] *See* Section 404 of the Sarbanes-Oxley Act of 2002, Securities Exchange Act Rules 13a-15 and 15d-15 and Item 308 of Regulation S-K.

[2] *See Commission Guidance Regarding Management's Report on Internal Control Over Financial Reporting Under Section 13(a) or 15(d) of the Securities Exchange Act of 1934,* Release No. 33-8810 (June 20, 2007), *available at* https://www.sec.gov/rules/interp/2007/33-8810.pdf and AS 2201: *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, *available at* http://pcaobus.org/Standards/Auditing/Pages/AS2201.aspx (originally adopted in June 2007 as Auditing Standard No. 5).

[3] *See* The Center for Audit Quality's Ninth Annual Main Street Investor Survey, Investor of the Future (September 2015), *available at* http://www.thecaq.org/docs/default-source/reports-and-publications/caq2015mainstreetinvestorsurvey.pdf?sfvrsn=4.

[4] *See* Center for Audit Quality, "Financial Restatement Trends in the United States: 2003-2012," *available at* http://www.thecaq.org/docs/reports-and-publications/financial-restatement-trends-in-the-united-states-2003-2012.pdf .

[5] *See* Audit Committee Dialogue, PCAOB Release No. 2015-003 (May 2015), *available at* http://pcaobus.org/sites/digitalpublications/Documents/AuditCommitteeDialogue.pdf.

[6] Mary Jo White, Chair, U.S. Securities and Exchange Commission, *A Few Things Directors Should Know About the SEC* (June 23, 2014), *available at* http://www.sec.gov/News/Speech/Detail/Speech/1370542148863.

[7] *See Standards Relating to Listed Company Audit Committees,* Release No. 33-8220 (April 9, 2003), *available at* https://www.sec.gov/rules/final/33-8220.htm.

[8] *See Policy Statement: Reaffirming the Status of the FASB as a Designated Private-Sector Standard Setter*, Release No. 33-8221 (April 25, 2003), *available at* https://www.sec.gov/rules/policy/33-8221.htm.

[9] The FASB's objective for participating is to increase the international comparability and the quality of standards used in the United States. *See* http://www.fasb.org/jsp/FASB/Page/SectionPage&cid=1218220079468.

[10] *See Acceptance From Foreign Private Issuers of Financial Statements Prepared in Accordance with International Financial Reporting Standards Without Reconciliation to U.S. GAAP,* Release No. 33-8879 (December 21, 2007), *available at* http://www.sec.gov/rules/final/2007/33-8879.pdf.

[11] Mary Jo White, Chair, U.S. Securities and Exchange Commission, Remarks at the Financial Accounting Foundation Trustees Dinner (May 20, 2014), *available at* http://www.sec.gov/News/Speech/Detail/Speech/1370541872065.

[12] James Schnurr, Chief Accountant, U.S. Securities and Exchange Commission, Remarks before the 2014 AICPA National Conference on Current SEC and PCAOB Developments (December 8, 2014), *available at,* http://www.sec.gov/News/Speech/Detail/Speech/1370543609306.

[13] *See Request for Comment on the Effectiveness of Financial Disclosures About Entities Other Than the Registrant,* Release No. 33-9929 (September 25, 2015), *available at*http://www.sec.gov/rules/other/2015/33-9929.pdf.

[14] *See* the "Fixing America's Surface Transportation Act", or "FAST Act," *available at* http://transportation.house.gov/uploadedfiles/fastact_xml.pdf.

[15] Press Release No. 2015-183, *SEC Charges BDO and Five Partners in Connection With False and Misleading Audit Opinions* (September 9, 2015), *available at* http://www.sec.gov/news/pressrelease/2015-184.html.

[16] Press Release No. 2009-271, *SEC Charges Ernst & Young and Six Partners for Roles in Accounting Violations at Bally Total Fitness* (December 17, 2009), *available at* http://www.sec.gov/news/press/2009/2009-271.htm.

[17] Press Release No. 2015-272, *SEC: Grant Thornton Ignored Red Flags in Audits* (December 2, 2015), *available at* http://www.sec.gov/news/pressrelease/2015-272.html.

[18] Press Release No. 2015-179, *SEC Charges Sports Nutrition Company With Failing to Properly Disclose Perks for Executives* (September 8, 2015), *available at* http://www.sec.gov/news/pressrelease/2015-179.html.

Modified: Dec. 9, 2015

U.S. Securities and Exchange Commission

Division of Corporation Finance
Securities and Exchange Commission

Shareholder Proposals

Staff Legal Bulletin No. 14H (CF)

Action: Publication of CF Staff Legal Bulletin

Date: October 22, 2015

Summary: This staff legal bulletin provides information for companies and shareholders regarding Rule 14a-8 under the Securities Exchange Act of 1934.

Supplementary Information: The statements in this bulletin represent the views of the Division of Corporation Finance (the "Division"). This bulletin is not a rule, regulation or statement of the Securities and Exchange Commission (the "Commission"). Further, the Commission has neither approved nor disapproved its content.

Contacts: For further information, please contact the Division's Office of Chief Counsel by submitting a web-based request form at https://tts.sec.gov/cgi-bin/corp_fin_interpretive.

A. The purpose of this bulletin

This bulletin is part of a continuing effort by the Division to provide guidance on important issues arising under Exchange Act Rule 14a-8. Specifically, this bulletin contains information about the Division's views on:

- the scope and application of Rule 14a-8(i)(9); and
- the scope and application of Rule 14a-8(i)(7) in light of *Trinity Wall Street v. Wal-Mart Stores, Inc.*[1]

You can find additional guidance about Rule 14a-8 in the following bulletins that are available on the Commission's website: SLB No. 14, SLB No. 14A, SLB No. 14B, SLB No. 14C, SLB No. 14D, SLB No. 14E, SLB No. 14F and SLB No. 14G.

B. Rule 14a-8(i)(9)

1. Background

Rule 14a-8(i)(9) is one of the substantive bases for exclusion of a shareholder proposal in Rule 14a-8. It permits a company to exclude a proposal "[i]f the proposal directly conflicts with one of the company's own proposals to be submitted to shareholders at the same meeting."

During the most recent proxy season, questions arose about the Division's interpretation of Rule 14a-8(i)(9). In light of these questions, Chair Mary Jo White directed the Division to review the proper scope and application of the rule.[2] As part of this review, we reviewed, among other things, Commission and Division statements and other materials, and considered approaches suggested by commenters.

2. History of Rule 14a-8(i)(9)

This exclusion was first adopted in 1967. At that time, the Commission amended Rule 14a-8(a), which already stated that Rule 14a-8 did not apply to elections to office, to codify the Commission's view that Rule 14a-8 "does not apply ... to counter proposals to matters to be submitted by the management."[3]

In 1976, the Commission renumbered and amended the exclusion. As adopted, Rule 14a-8(c)(9) provided that management could omit a proposal and any statement in support thereof from its proxy statement and form of proxy "[i]f the proposal is counter to a proposal to be submitted by the management at the meeting."[4] The Commission stated in the adopting release that "subparagraph (c)(9) of the revised rule merely restates a ground for omission already set forth in the existing rule. That is, a proposal that is counter to a proposal to be presented by the management may be omitted from an issuer's proxy materials."[5]

In 1982, the Commission characterized the exclusion as one of the substantive bases under Rule 14a-8 designed to permit omission of a shareholder proposal that "constitute[s] an abuse of the security holder proposal process."[6]

In 1998, the Commission revised Rule 14a-8 into its current Q&A, plain English format. In connection with these amendments, the Commission replaced the language in Rule 14a-8(c)(9) with Rule 14a-8(i)(9)'s current language, which allows the exclusion of a proposal that "directly conflicts with one of the company's own proposals to be submitted to shareholders at the same meeting."[7] The Commission also added a note to the rule stating that a "company's submission to the Commission under this section should specify the points of conflict with the company's proposal."[8] In proposing this revision, the Commission stated that the amended rule would "reflect the Division's long-standing interpretation permitting omission of a shareholder proposal if the company demonstrates that its subject matter directly conflicts with all or part of one of management's proposals."[9] At adoption, the Commission clarified that "by revising the rule we do not intend to imply that proposals must be identical in scope or focus for the exclusion to be available."[10]

3. The Division's application of Rule 14a-8(i)(9)

Based on our review of the history of the exclusion, we believe that it was intended to prevent shareholders from using Rule 14a-8 to circumvent the proxy rules governing solicitations. When a shareholder solicits in opposition to a management proposal, the Commission's proxy rules contain additional procedural and disclosure requirements that are not required by Rule 14a-8.[11] We do not believe the shareholder proposal process should be used as a means to conduct a solicitation in opposition without complying with these requirements. Several commenters agreed with this view.[12]

Many of the Division's response letters granting no-action relief under the exclusion have expressed the view that a shareholder proposal was excludable if including it, along with a management proposal, could present "alternative and conflicting decisions for the shareholders" and create the potential for "inconsistent and ambiguous results."[13] The response letters have used variations of this language for decades to articulate when a shareholder proposal may be excluded.[14] This language focused on the potential for shareholder confusion and inconsistent mandates, instead of more specifically on the nature of the conflict between a management and shareholder proposal.

After reviewing the history of Rule 14a-8(i)(9) and based on our understanding of the rule's intended purpose, we believe that any assessment of whether a proposal is excludable under this basis should focus on whether there is a direct conflict between the management and shareholder proposals. For this purpose, we believe that a direct conflict would exist if a reasonable shareholder could not logically vote in favor of both proposals, *i.e.*, a vote for one proposal is tantamount to a vote against the other proposal. While this articulation may be a higher burden for some companies seeking to exclude a proposal to meet than had been the case under our previous formulation, we believe it is most consistent with the history of the rule and more appropriately focuses on whether a reasonable shareholder could vote favorably on both proposals or whether they are, in essence, mutually exclusive proposals.[15]

In considering no-action requests under Rule 14a-8(i)(9) going forward, we will focus on whether a reasonable shareholder could logically vote for both proposals. For example, where a company seeks shareholder approval of a merger, and a shareholder proposal asks shareholders to vote against the merger, we would agree that the proposals directly conflict. Similarly, a shareholder proposal that asks for the separation of the company's chairman and CEO would directly conflict with a management proposal seeking approval of a bylaw provision requiring the CEO to be the chair at all times.

We will not, however, view a shareholder proposal as directly conflicting with a management proposal if a reasonable shareholder, although possibly preferring one proposal over the other, could logically vote for both. For example, if a company does not allow shareholder nominees to be included in the company's proxy statement, a shareholder proposal that would permit a shareholder or group of shareholders holding at least 3% of the company's outstanding stock for at least 3 years to nominate up to 20% of the directors would not be excludable if a management proposal would allow shareholders holding at least 5% of the company's stock for at least 5 years to nominate for inclusion in the company's proxy statement 10% of the directors. This is because both proposals generally seek a similar objective, to give shareholders the ability to include their nominees for director alongside management's nominees in the proxy statement, and the proposals do not present shareholders with conflicting decisions such that a reasonable shareholder could not logically vote in favor of both proposals.

Similarly, a shareholder proposal asking the compensation committee to implement a policy that equity awards would have no less than four-year annual vesting would not directly conflict with a management proposal to approve an incentive plan that gives the compensation committee discretion to set the vesting provisions for equity awards. This is because a reasonable shareholder could logically vote for a compensation plan that gives the compensation committee the discretion to determine the vesting of awards, as well as a proposal seeking implementation of a specific vesting policy that would apply to future awards granted under the plan.

In the preceding examples, the board of directors may have to consider the effects of both proposals if both the company and shareholder proposals are approved by shareholders. We do not believe, however, that such a decision represents the kind of "direct conflict" the rule was designed to address.[16]

Commenters generally agreed that Rule 14a-8(i)(9) is designed to ensure that Rule 14a-8 is not used as a means to circumvent the Commission's proxy rules governing solicitations,[17] and suggested several alternatives for administering the exclusion going forward. We agree that proponents should not be able to use Rule 14a-8 to circumvent the proxy rules governing solicitations and believe that focusing on whether a reasonable shareholder could logically vote for both proposals effectively addresses such concerns.

Some commenters suggested that the Division should take the view that precatory proposals do not directly conflict with management proposals because they are not binding.[18] We believe that a precatory shareholder proposal, while not binding, may nevertheless directly conflict with a management proposal on the same subject if a vote in favor is tantamount to a vote against management's proposal. Other commenters suggested that the exclusion should not apply when a shareholder submits his or her proposal before the company approves its proposal.[19] This approach would not necessarily prevent a shareholder from submitting a proposal opposing a management proposal, in contravention of the proxy rules governing solicitations. Finally, other commenters suggested that the Division either continue its historic application of the exclusion[20] or adopt a broader, subject matter exclusion.[21] We believe that these approaches do not take full account of the language of the exclusion because they may allow the exclusion of proposals that propose different means of accomplishing an objective, but do not directly conflict. In our view, granting no-action relief only if a reasonable shareholder could not logically vote in favor of both proposals is more appropriately rooted in the exclusion's intended purpose and language, and better helps companies, proponents and the staff determine when two proposals "directly conflict."[22]

C. Rule 14a-8(i)(7)

In *Trinity Wall Street v. Wal-Mart Stores, Inc.*, the U.S. Court of Appeals for the Third Circuit addressed the application of Rules 14a-8(i)(3) and 14a-8(i)(7).[23] Reversing a decision by the U.S. District Court for the District of Delaware which ruled that a shareholder proposal could not be excluded, a three-judge panel held that a shareholder proposal submitted to Wal-Mart Stores, Inc. ("Wal-Mart") was excludable under Rules 14a-8(i)(3)[24] and 14a-8(i)(7). The staff had previously agreed that Wal-Mart could exclude the proposal under Rule 14a-8(i)(7).[25]

In analyzing whether the proposal was excludable under Rule 14a-8(i)(7), the Third Circuit concluded that the proposal's subject matter related to Wal-Mart's ordinary business operations - specifically, "a potential change in the way Wal-Mart decides which products to sell." This conclusion was the same as our conclusion when responding to Wal-Mart's no-action request. We believe our analysis in this matter is consistent with the views the Commission has expressed on how to analyze proposals under the ordinary business exclusion, *i.e.*, the analysis should focus on the underlying subject matter of a proposal's request for board or committee review regardless of how the proposal is framed.[26]

The panel also considered whether the significant policy exception to the ordinary business exclusion applied. The majority opinion employed a new two-part test, concluding that "a shareholder must do more than focus its proposal on a significant policy issue; the subject matter of its proposal must 'transcend' the company's ordinary business."[27] The majority opinion found that to transcend a company's ordinary business, the significant policy issue must be "divorced from how a company approaches the nitty-gritty of its core business."[28] This two-part approach differs from the Commission's statements on the ordinary business exclusion and Division practice.

In contrast, the concurring judge analyzed Rule 14a-8(i)(7) in a manner consistent with the approach articulated by the Commission and applied by the Division, including in Wal-Mart's no-action request. Summarizing the Commission's history on this exclusion, the judge noted that "whether a proposal focuses on an issue of social policy that is sufficiently significant is not separate and distinct from whether the proposal transcends a company's ordinary business. Rather, a proposal is sufficiently significant 'because' it transcends day-to-day business matters."[29] The judge also explained that the Commission "treats the significance and transcendence concepts as interrelated, rather than independent."[30]

Although we had previously concluded that the significant policy exception does not apply to the proposal that was submitted to Wal-Mart, we are concerned that the new analytical approach introduced by the Third Circuit goes beyond the Commission's prior statements and may lead to the unwarranted exclusion of shareholder proposals. Whereas the majority opinion viewed a proposal's focus as separate and distinct from whether a proposal transcends a company's ordinary business, the Commission has not made a similar distinction. Instead, as the concurring judge explained, the Commission has stated that proposals focusing on a significant policy issue are not excludable under the ordinary business exception "*because* the proposals would transcend the day-to-day business matters and raise policy issues so significant that it would be appropriate for a shareholder vote."[31] Thus, a proposal may transcend a company's ordinary business operations even if the significant policy issue relates to the "nitty-gritty of its core business." Therefore, proposals that focus on a significant policy issue transcend a company's ordinary business operations and are not excludable under Rule 14a-8(i)(7).[32] The Division intends to continue to apply Rule 14a-8(i)(7) as articulated by the Commission and consistent with the Division's prior application of the exclusion, as endorsed by the concurring judge, when considering no-action requests that raise Rule 14a-8(i)(7) as a basis for exclusion.

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[1] 792 F.3d 323 (3d Cir. 2015).

[2] *See* Statement from Chair White Directing Staff to Review Commission Rule for Excluding Conflicting Proxy Proposals (Jan. 16, 2015), *available at* http://www.sec.gov/news/statement/statement-on-conflicting-proxy-proposals.html.

[3] Release No. 34-8206 (Dec. 14, 1967).

[4] Release No. 34-12999 (Nov. 22, 1976).

[5] *Id*.

[6] Release No. 34-19135 (Oct. 14, 1982).

[7] Release No. 34-40018 (May 21, 1998).

[8] *Id*.

[9] Release No. 34-39093 (Sept. 18, 1997).

[10] Release No. 34-40018.

[11] The Commission defined "solicitation in opposition" in Exchange Act Rule 14a-6. *See* Note 3 to Rule 14a-6(a). The discussion in this section is not intended to apply outside of the Division's application of Rule 14a-8(i)(9).

[12] *See* letters from (i) Faegre Baker Daniels LLP dated March 6, 2015 ("Faegre"); (ii) the Society of Corporate Secretaries & Governance Professionals dated March 25, 2015 (the "Society"); (iii) Gibson, Dunn & Crutcher LLP, Sidley Austin LLP, Wilmer Cutler Pickering Hale and Dorr LLP, Morrison & Foerster LLP and Skadden, Arps, Slate, Meagher & Flom LLP dated June 10, 2015 (the "Law Firms"); (iv) Business Roundtable dated June 10, 2015 ("Business Roundtable"); (v) Domini Social Investments LLC dated June 22, 2015 ("Domini"); (vi) US SIF: The Forum for Sustainable and Responsible Investment dated July 6, 2015 ("US SIF"); and (vii) Adrian Dominican Sisters, *et al.*, dated June 18, 2015 (the "Proponents").

[13] *See*, *e.g.*, *SBC Communications, Inc.* (Feb. 2, 1996). This articulation of the scope and application of the exclusion evolved over time. In the 1970s, some of the Division's response letters referenced the potential for inconsistent mandates if shareholders approved both proposals. *See*, *e.g.*, *General Mills, Inc.* (Jul. 6, 1979). Response letters in the early 1980s occasionally stated that inclusion of the proposal "may cause shareholder confusion," *see*, *e.g.*, *Ehrenreich Photo-Optical Industries, Inc.* (May 5, 1981), or "would be the source of shareholder confusion," *see*, *e.g.*, *Executive Industries, Inc.* (Jun. 26, 1981). By the 1990s, these concepts came together in the Division's most recent articulation of what constitutes a direct conflict, which references "alternative and conflicting decisions" and "inconsistent and ambiguous results." Two commenters highlighted the different language the staff has used over the years. *See* letters from

Domini dated June 22, 2015 and Professor J. Robert Brown, Jr. dated June 30, 2015.

[14] *See id.*

[15] We remind companies that the staff may need a complete copy of a company's proposal to evaluate a no-action request under Rule 14a-8(i)(9) and that the staff may not be able to agree that the company has met its burden of demonstrating that a shareholder proposal is excludable if those materials are not included with the company's no-action request. This same principle applies when the staff evaluates no-action requests under Rule 14a-8(i)(10).

[16] We recognize, however, that there may be instances in which a binding shareholder and management proposal would directly conflict. We do not believe that a reasonable shareholder would logically vote for two proposals, each of which has binding effect, that contain two mutually exclusive mandates. However, consistent with the Division's practice under Rule 14a-8(i)(1), our no-action response may allow proponents to revise a proposal's form from binding to nonbinding. If revised within a specified time, and a reasonable shareholder could otherwise logically vote for both proposals, the shareholder proposal would not be excludable under Rule 14a-8(i)(9). In addition, a binding shareholder proposal on the same subject as a binding management proposal may be excludable under Rules 14a-8(i)(1) or 14a-8(i)(2) to the extent a company demonstrates that it is excludable under one of those bases.

[17] *See supra*, note 12.

[18] *See* letters from (i) The Marco Consulting Group dated January 9, 2015; (ii) the Council of Institutional Investors dated January 9, 2015 and March 25, 2015; (iii) the New York City Comptroller dated January 15, 2015 and June 17, 2015; (iv) the California Public Employees Retirement System and the California State Teachers' Retirement Systems dated May 21, 2015; (v) James McRitchie dated June 8, 2015 ("McRitchie"); (vi) Domini; (vii) US SIF; (viii) the Proponents; (ix) the New York State Comptroller dated July 7, 2015; (x) John Chevedden dated July 14, 2015 ("Chevedden"); (xi) Steve Nieman dated July 14, 2015 ("Nieman"); and (xii) the State Board of Administration of Florida dated August 7, 2015.

[19] *See* letters from (i) McRitchie; (ii) Domini; (iii) the Proponents; (iv) US SIF; (v) Chevedden; and (vi) Nieman.

[20] *See* letters from (i) American Bankers Association, *et al*., dated February 24, 2015;(ii) the Law Firms; and (iii) Business Roundtable.

[21] *See* letters from Faegre and the Society.

[22] Where a shareholder proposal is not excluded and companies are concerned that including proposals on the same topic could potentially be confusing, we note that companies can, consistent with Rule 14a-9, explain in the proxy materials the differences between the two proposals and how they would expect to consider the voting results. As always, we expect companies and proponents to respect the Rule 14a-8 process and encourage them to find ways to constructively resolve their differences.

[23] Rule 14a-8(i)(3) permits a company to exclude a shareholder proposal "[i]f the proposal or supporting statement is contrary to ... [Rule] 14a-9, which prohibits materially false or misleading statements in proxy soliciting materials" and Rule 14a-8(i)(7) permits a company to exclude a shareholder proposal "[i]f the proposal deals with a matter relating to the company's ordinary business operations."

[24] Two judges concluded that the proposal could be excluded under Rule 14a-8(i)(3). The Division was not asked to express a view on the application of Rule 14a-8(i)(3) to this proposal in the no-action process and therefore we do not express a view in this bulletin.

[25] *Wal-Mart Stores, Inc.* (Mar. 20, 2014). In our view, the proposal was excludable because it related to the company's ordinary business operations and did not focus on a significant policy issue.

[26] Release No. 34-20091 (Aug. 16, 1983).

[27] *Trinity*, 792 F.3d at 346-347.

[28] *Id*. at 347.

[29] *Id*. at 353 (Schwartz, J., concurring).

[30] *Id*.

[31] Release No. 34-40018 (emphasis added).

[32] Whether the significant policy exception applies depends, in part, on the connection between the significant policy issue and the company's business operations. *See* Staff Legal Bulletin No. 14E (Oct. 27, 2009) (stating that a proposal generally will not be excludable "as long as a sufficient nexus exists between the nature of the proposal and the company").

http://www.sec.gov/interps/legal/cfslb14h.htm

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A Report by UNITE HERE
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Improving corporate governance at hospitality REITs:

Year 3 Progress Report

UNITE HERE has recently concluded the third season of a focused program to improve corporate governance at lodging and hospitality REITs. Working together with a range of institutional investors, we are seeing a new, higher standard of corporate governance emerging in the sector.

Why Hospitality REITs?

We believe that transparent, accountable, stable and well-run companies are in the interest of shareholders and stakeholders alike. Our contribution to efforts to improve corporate governance has focused on a segment of the hospitality industry – the industry we best understand.

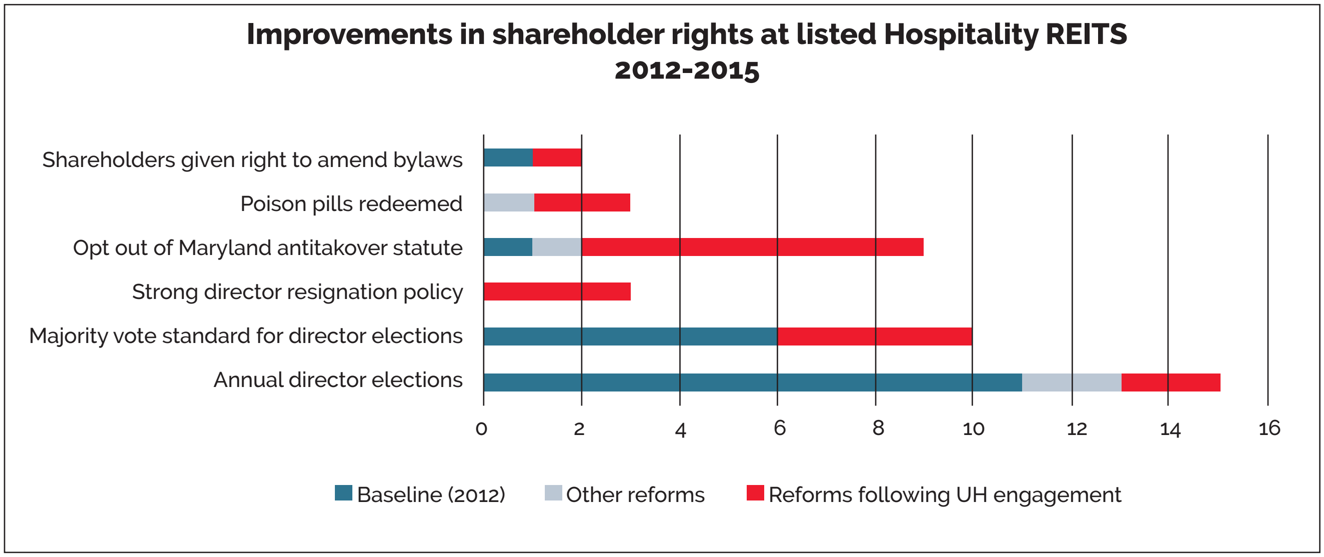
The small- and mid-cap companies in the lodging REIT sector have not typically benefited from the shareholder activism that has transformed corporate governance practices in S&P 500 companies. When we started our program, several companies had classified boards, and almost every company remained subject to potent state anti-takeover statutes.

UNITE HERE's program seeks to give hospitality REIT shareholders a voice in the use of statutory anti-takeover devices, as well as the myriad defenses put in place by companies themselves: staggered board terms, supermajority voting requirements, plurality vote standards in director elections and poison pills. Strengthening shareholder rights at lodging REITs, moreover, should help shareholders preserve strategic opportunities in a highly cyclical industry.

Tangible progress for lodging REIT shareholders since 2012

Working with a range of institutional investors, we've seen concrete improvements to shareholder rights at listed lodging REITs, with **18 separate reforms adopted at 11 of 17 listed lodging REITs.**

Our progress at a glance:



Classified boards

Between 2013 and 2015, the number of hospitality REITs with classified boards sank from 6 to 2. Two companies initiated board declassification following the submission of shareholder proposals by UNITE HERE (Felcor Lodging Trust and Lasalle Hotel Properties), while a majority of shareholders voted in support of our proposal to declassify the board of Gaming and Leisure Properties, the first US gaming REIT. Hospitality Properties Trust began declassifying its Board after a five year campaign led by an institutional investor.

Requiring majority support for director elections

Four REITs adopted majority vote thresholds for uncontested director elections upon receiving our shareholder proposals, bringing the total of hospitality REITs adhering to this standard to ten.

In the course of engagement with UNITE HERE, three REITs (Strategic Hotels, Chesapeake Lodging Trust, RLJ Lodging Trust) took the additional step of adopting strong director resignation policies, which stipulate that no director can be reappointed after receiving less than majority support in two consecutive uncontested elections.

Giving shareholders a say in the use of antitakeover statutes

Maryland's Unsolicited Takeovers Act (MUTA) allows REIT boards to unilaterally adopt numerous takeover defenses, such as a classified board, without shareholder approval.

In 2012, only one lodging REIT had opted out of the statute's provisions. Today, nine lodging REITs opt out of provisions of MUTA, seven of which opted out in response to shareholder proposals by UNITE HERE.

Only those companies opting out as a result of our engagement have agreed to require prior shareholder approval before opting back into MUTA – an essential step in truly opting out.

Five of six shareholder proposals to opt out of MUTA received the support of a majority of votes cast. The average level of support was 70%.

Strengthening right to amend bylaws

Shareholders of most listed lodging C-Corps have the right to initiate bylaw amendments, but this right is not common at lodging REITs. Without it, corporate governance reform can take years, and can be unilaterally reversed by the Board. Shareholders at one REIT (Sunstone Hotel Investors) gained the right to initiate bylaw amendments after the board unanimously recommended adopting UNITE HERE's proposal. Shareholders at three additional REITs receiving the same proposal (Host Hotels, Diamondrock Hotels and RLJ Lodging Trust) voted to recommend extending to shareholders the right to initiate bylaw amendments (49% of votes at Chesapeake Lodging Trust were cast in support of this proposal).

Shareholder approval of poison pills

Strategic Hotels decided to redeem its poison pill, and require shareholder approval of future poison pills (within 12 months of adoption), as recommended by UNITE HERE's shareholder proposal.

Continued engagement

The majority (14/18) of reforms we've seen put in place to date have been accomplished through engagement – shareholder proposals were withdrawn before a vote.

Fourteen of our proposals pursuant to SEC Rule 14a-8 have proceeded to a shareholder vote. Twelve of the fourteen (86%) received the support of a majority of votes cast, with an average of 67% of votes cast in favor. To date, four of the majority-supported proposals (33%) have been implemented. A more complete report of voting results can be found on our website, www.hotelcorpgov.org.

Next steps

While we have achieved tangible improvements in shareholder rights at lodging and hospitality REITs, much work remains to be done. At several REITs, proposals supported by majority votes have not been implemented; many companies still have potent takeover defenses, limits to shareholders' ability to hold directors accountable and/or limits to shareholder rights.

UNITE HERE represents hospitality workers and is a member of the Council of Institutional Investors. Its members are beneficiaries of pension funds with over $60 billion in assets. Since 2012, UNITE HERE has pursued a program of improving shareholder rights at hospitality REITs (see www.hotelcorpgov.org.

UNITE HERE

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Stock buybacks by lodging REITs:

Do they work in the down cycle?

In 2015, lodging REIT stock prices lost more than a quarter of their value after six consecutive years of steady gains. The NAREIT lodging REIT index plummeting -27.3% over the course of the year.[1] At the same time, the private market value of hotel assets continued to climb, leading to steeply discounted company valuations.

Lodging REITs have taken divergent responses to these developments. Strategic Hotels initiated a search for strategic alternatives in the summer and announced a sale to Blackstone in September, at a 13% premium to its pre-offer price. Another REIT recently announced it would distribute the proceeds from an asset sale to shareholders via a special dividend. However, seven other lodging REITs have authorized share repurchases worth just over $2 billion, a range of 4% to 22% of company stock.[2]

Company	Share repurchases authorized ($000s)	Estimated Market Cap (1/22/16, 000s)	Approximate % of market cap repurchased
CHSP	$ 100,000	$ 1,400,000	7.1%
DRH	$ 150,000	$ 1,630,000	9.2%
HT	$ 200,000	$ 916,590	21.8%
HST	$ 1,000,000	$ 10,380,000	9.6%
RLJ	$ 400,000	$ 2,290,000	17.5%
RHP	$ 100,000	$ 2,330,000	4.3%
XHR	$ 100,000	$ 1,530,000	6.5%

Are share buybacks by lodging REITs a good use of capital at this point in the cycle? Because IRS regulations limit REITs' ability to retain earnings, buybacks tend to be funded by debt or asset sales – and to a limited degree, cash reserves. But lodging REITs play in a more volatile space, and are subject to liquidity challenges during cyclical downturns – to an extent not shared by other REITs.

Using an analysis of stock buybacks during the previous lodging cycle, we argue that lodging REIT shareholders may be better served at this point in the cycle by other strategies, such as special dividends financed by asset sales or an outright business sale. We argue that in the previous downturn, buybacks were not effective in stabilizing share prices or protecting dividends:

> *In the last downturn, modest stock buybacks were wiped out by large share issuances in short order as the end of the upcycle turned quickly into the downcycle.* In 2008, several lodging REITs who were not sold to private equity bought back stock as prices began to decline. However, stock prices continued their descent until the second quarter of 2009. Most lodging REITs were forced to issue large volumes of shares at declining prices to raise cash, wiping out the impact of the 2008 buybacks. On average, REITs issuing buybacks subsequently issued greater volumes of stock.
>
> *In the last downturn, stock buybacks may have accelerated lodging REITs' cash crunch.* To the extent that buybacks were financed by drawing down cash reserves and increasing debt, they pushed REITs into a more precarious position at the worst possible time. Most lodging REITs halted distributions entirely; some also requested permission from the IRS to issue distributions in stock rather than cash.
>
> *Could stock buybacks act as M&A deterrents?* Investors should carefully evaluate the impact of proposed stock buyback plans on the REIT's ability to pursue other strategic alternatives. Would a change in EPS or price/FFO impact executive compensation? Would buybacks be offset by stock issued to executives? Would a leverage-funded buyback discourage potential takeover offers by increasing the cost of an acquisition?

Management teams are appropriately considering how to exploit the gap between high real estate values on the one hand, and depressed share prices on the other. But investors should urge management teams to consider other ways to make this gap work for shareholders. By distributing the proceeds of asset sales to shareholders as special dividends, for example, management teams allow shareholders to choose whether to plough their funds back into the company.

Further, past cycles suggest that lodging REITs take a beating in terms of share prices and dividends for years, suggesting lodging REITs should consider an outright sale of the company. Roughly half of lodging REITs successfully executed business sales at or around the peak of the last cycle, achieving on average a 20% premium for shareholders.

Is the timing right for share repurchases?

After reaching a cyclical high on or around the end of 2014, lodging REIT shares lost over a quarter of their value, on average, in 2015. Some management teams have begun using capital to repurchase their own shares at these lower prices.

In fact, the price of lodging REIT stocks indicates some skepticism in the market about a rebound in the near term. On average, the lodging up-cycle lasts 7 years.[3] Lodging REIT stock prices have been steadily increasing since Q2 2009. One analyst sees the hotel industry entering the final third of the current cycle.[4]

While industry fundamentals remain decent, analysts and investors see storm clouds on the horizon. U.S. supply growth is picking up, particularly in key markets, approaching the 2% long term average growth level.[5] Interest rates have begun to increase after being frozen at historic lows. Events such as Paris and San Bernadino attacks may impact travel plans and intentions. Indeed, the market strongly punished lodging REITs for missing revenue and EBITDA projections even slightly in the second half of 2015.

A Merrill Lynch analyst told *The Wall Street Journal* in August 2007: "And there's always the possibility that the bottom of this REIT bear market hasn't been reached, Mr. Sakwa [Merrill Lynch] said. If the credit panic spreads, stocks could tumble further, making buybacks poor investments."[6]

How will REITs finance share repurchases?

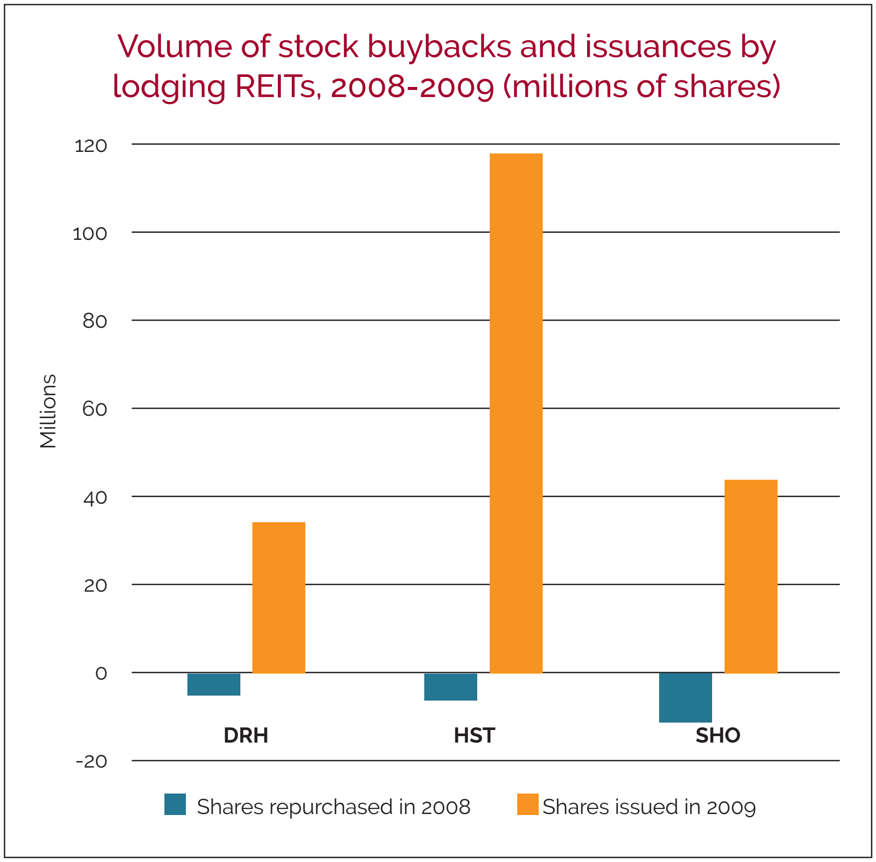
REITs typically have less free cash flow than corporations, as they must distribute most of their income to shareholders via dividends. Funds for buybacks can also be raised by selling assets or levering up.[7]

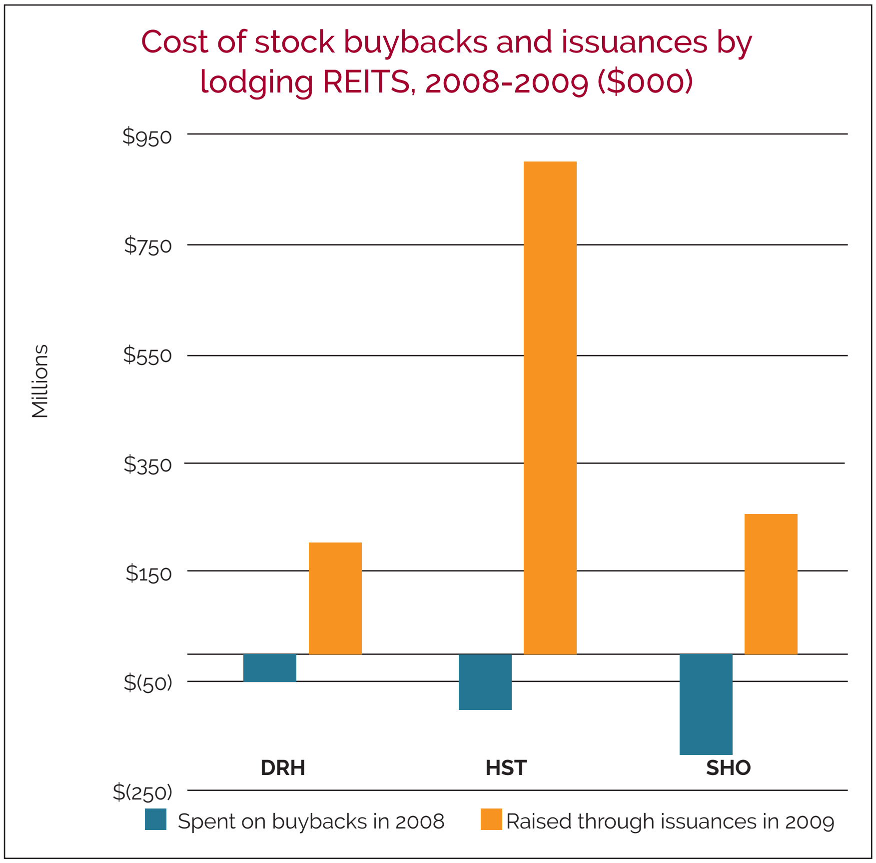
'Share repurchases may be a plus for REIT net asset values in the short-term, but over time the resultant increase in leverage could impair credit quality,' according to Fitch Director Reinor Bazarewski. 'It is important to note that current REIT leverage is above levels seen at the end of 2006, just before share buybacks spiked sharply during the last credit cycle.'[8] As we will see, in 2009, many lodging REITs had to reduce or suspend dividends due to a cash crunch.

Of the seven REITs announcing share repurchase programs in 2015, four have provided information about how these buybacks may be funded. Of these four, three include cash and financing as possible funding sources, while one (Host) announced plans to fund repurchases through asset sales.

Lessons from the Past, 1: Buybacks were followed swiftly by share issuances

Diamondrock (DRH), Host (HST) and Sunstone (SHO), three of the four veteran lodging REITs pursuing share repurchase programs in 2008, completed share issuances the very next year that were 3 to 18 times the volume of shares repurchased the previous year.[9]


Volume of stock buybacks and issuances by lodging REITs, 2008-2009 (millions of shares)
Millions
120
100
80
60
40
20
0
-20
DRH
HST
SHO
Shares repurchased in 2008
Shares issued in 2009


Cost of stock buybacks and issuances by lodging REITS, 2008-2009 ($000)
Millions
$950
$750
$550
$350
$150
$(50)
$(250)
DRH
HST
SHO
Spent on buybacks in 2008
Raised through issuances in 2009

Moreover, REITs that had executed share buybacks in 2008 increased their share volumes by an average of 26% by the end of 2009, while lodging REITs with no repurchase programs in 2008 increased their share volumes by an average of 13%.

Lessons from the Past, 2: Buybacks did not save dividends

In the last downturn, lodging REITs not only saw share prices lose upwards of 80% of their value; they also saw dividends dry up, or, in most cases, cease. On average, lodging REITs suspended periodic dividends for an average of 2.7 years.[10]

Company	Per share dividend mid-2008	Per share dividend mid-2009	Dividends stopped	Regular dividends resumed	Years without dividends
AHT	0.13	0	26-Sep-08	27-Mar-11	2.50
BEE	0.24	0	26-Sep-08	12/11/2015	7.21
DRH	0.25	0	3-Sep-08	23-Mar-11	2.55
FCH	0.35	0	10-Oct-08	13-Jan-14	5.26
HPT	0.77	0	16-Jan-09	21-Jan-10	1.01
HST	0.196	0	29-Dec-08	4-Nov-09	0.85
HT	0.72	0.2			0.00
LHO	0.175	0.01			0.00
SHO	0.35	0	17-Dec-08	26-Sep-13	4.78

At the time, the IRS attempted to ease the cash crunch REITs were experiencing by allowing them to issue up to 90% of their dividends in stock.[11] At least three lodging REITs elected to distribute stock in place of dividends pursuant to this ruling during the downturn; all had repurchased stock in 2008.[12] Strategic Hotels was not able to resume paying dividends after the last downturn at all.

Who benefits?

Critics of stock buybacks note they do not actually create value — by, for instance, repositioning or renovating assets — but instead may be a way to engineer improved performance metrics, at least in the short term. Investors should evaluate:

- How the volume of stock repurchased compares to the volume of stock issued for executive compensation. Is the share buyback a means of moving capital from shareholders to executives?

- Whether share repurchases have an impact on executive compensation. Some shareholders have filed shareholder proposals asking boards to factor out the impact of share repurchases when calculating per-share operating metrics for the purposes of determining executive compensation.

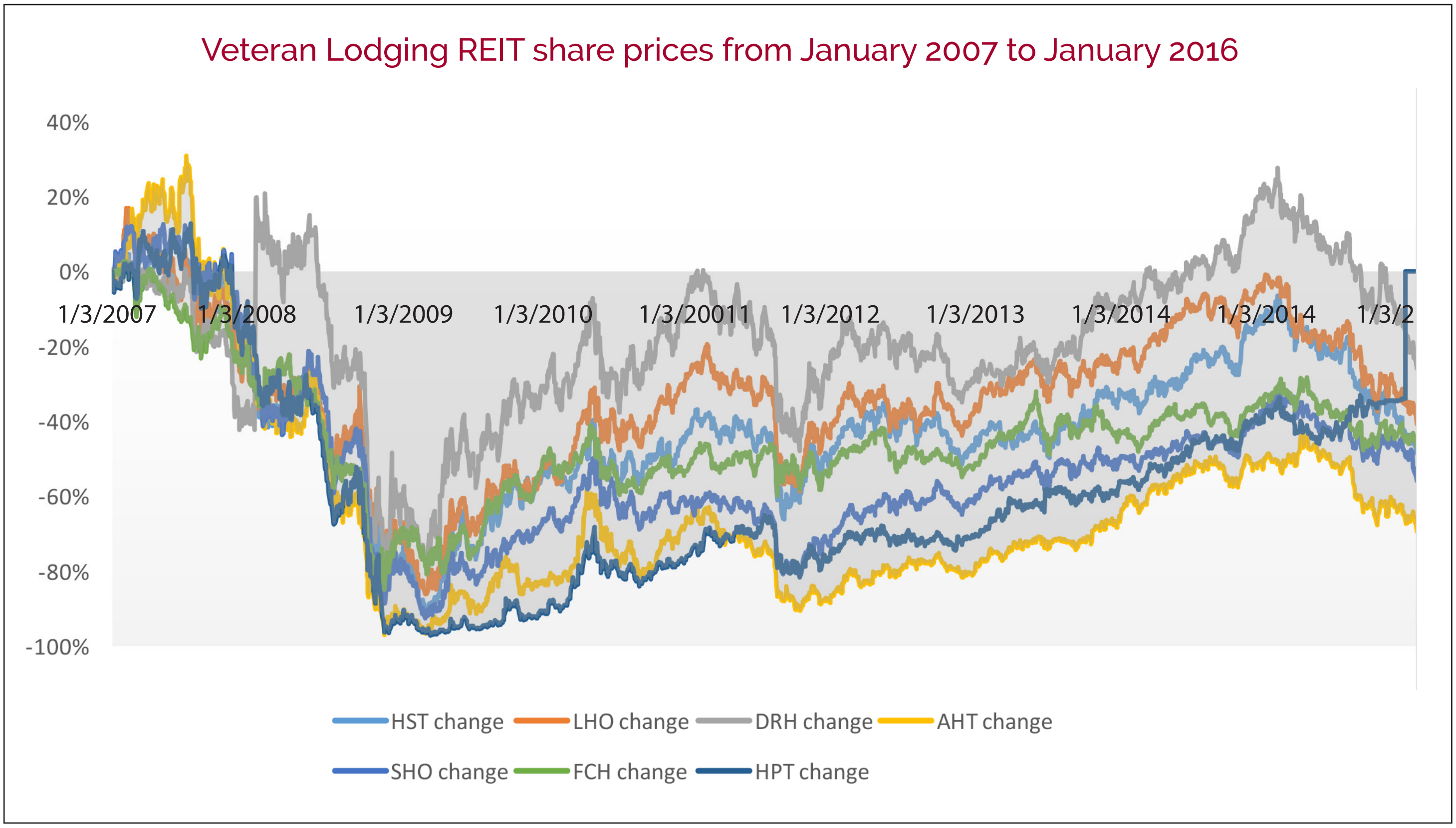
Alternative to Buybacks: #1 Issue dividends

Proceeds from asset sales and excess cash can be distributed to shareholders as dividends, rather than being ploughed back into share repurchases. Special dividends preserve investor choice – if investors have confidence that lodging stocks will recover quickly, they can reinvest these dividends into company stock. But if they are skeptical about the near-term fortunes of lodging stocks – and share prices suggest that many are – they can reinvest elsewhere.

If the three lodging REITs that completed share repurchase programs in 2008 had instead distributed funds of the same value to shareholders, shareholders would have realized between $0.189 and $2.88 per share in special distributions.[13]

Alternative to Buybacks: #2 Sell company

Near the peak of the last lodging cycle, approximately half of listed lodging REITs were taken private through a company sale. At least one additional lodging REIT reports that a planned sale was interrupted by the tightening of the credit markets in the second half of 2007.[14] The average pre-announcement premium received by shareholders was approximately 20%.[15] One prominent lodging REIT, Strategic Hotels & Resorts, agreed to be acquired on September 8, 2015 to Blackstone; the offer price represented a 13% premium to the stock's trading price the day before Strategic announced its intention to pursue a sale on July 23, 2015.[16] Strategic, which announced an exploration of strategic alternatives in the summer of 2015, is the only listed lodging REIT whose shares showed a gain in 2015.


Veteran Lodging REIT share prices from January 2007 to January 2016
40%
20%
0%
-20%
-40%
-60%
-80%
-100%
1/3/2007
1/3/2008
1/3/2009
1/3/2010
1/3/20011
1/3/2012
1/3/2013
1/3/2014
1/3/2014
1/3/2
HST change
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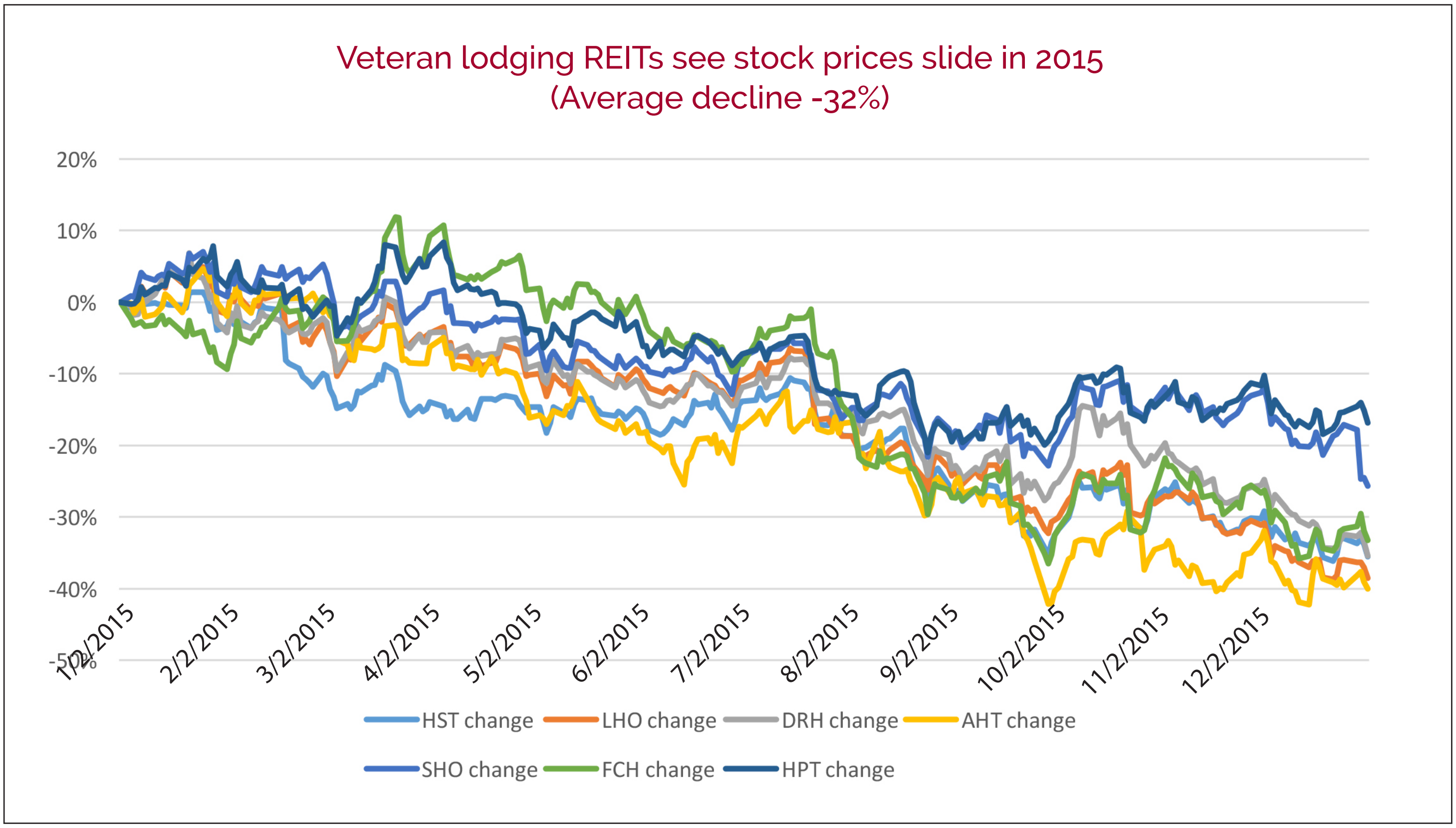
AHT change
SHO change
FCH change
HPT change


Veteran lodging REITs see stock prices slide in 2015
(Average decline -32%)
20%
10%
0%
-10%
-20%
-30%
-40%
-50%
1/2/2015
2/2/2015
3/2/2015
4/2/2015
5/2/2015
6/2/2015
7/2/2015
8/2/2015
9/2/2015
10/2/2015
11/2/2015
12/2/2015
HST change
LHO change
DRH change
AHT change
SHO change
FCH change
HPT change

Endnotes

1 Dow Jones US Hotel & Lodging REIT Index, https://www.google.com/finance?cid=15591941 1-year returns, accessed January 26, 2016
2 Third quarter market cap estimates obtained from Google Finance profiles for listed companies, accessed January 25, 2016. Share repurchase authorizations: Q3 10-Q reports for CHSP, DRH, RLJ; Press releases for HT (October 5, 2015), Host (November 16, 2015), RHP (August 20, 2015) and Xenia (December 10, 2015).
3 http://www.hotel-online.com/News/PR2007_1st/Feb07_AverageMarket.html
4 Lodging, 2016 Outlook, JP Morgan, January 6, 2016, p. 3
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8 http://www.reuters.com/article/fitch-more-share-buybacks-and-risk-may-b-idUSFit69718020140429#74OiSQ6ARbqjX0xT.97
9 Ashford Hospitality Trust completed a stock-financed merger towards the end of 2007, leading to pronouncedly different stock dynamics in the following years, and has therefore been excluded from this analysis. Shares repurchased and issued do not include equity awards; the shares issued total for Host includes shares issued as dividends in 2009. Source: Diamondrock 10-K, "Consolidated Statements of Stockholders' Equity, Years Ended December 31, 2009, 2008 and 2007," p. F-7, filed with the SEC on February 26, 2010; Host 2010 10-K "Consolidated Statements of Equity and comprehensive Income (Loss), Years Ended December 31, 2009, 2008 and 2007," p. 92, filed with the SEC on March 1, 2010; Sunstone Hotel Investors, Inc. 10-K "Consolidated Statements of Stockholders' Equity, 2009, 2008 and 2007," F-5 to F-7, filed with the SEC on February 23, 2010;
10 Yahoo Finance historical dividend reports for listed stocks, accessed 1/26/2016
11 http://www.forbes.com/2009/04/15/reits-stock-dividend-markets-real-estate.html
12 Diamondrock and Sunstone: See http://www.forbes.com/2009/04/15/reits-stock-dividend-markets-real-estate.html ; Host: See 2010 10-K "Consolidated Statements of Equity and comprehensive Income (Loss), Years Ended December 31, 2009, 2008 and 2007," p. 92, filed with the SEC on March 1, 2010.
13 Value of 2008 share repurchases as reported in company 10-ks, divided by shares outstanding as of 12/31/2008: Host: See 2010 10-K "Consolidated Statements of Equity and comprehensive Income (Loss), Years Ended December 31, 2009, 2008 and 2007," p. 92, filed with the SEC on March 1, 2010; Sunstone Hotel Investors, Inc. 10-K "Consolidated Statements of Stockholders' Equity, 2009, 2008 and 2007," F-5 to F-7, filed with the SEC on February 23, 2010; Diamondrock 10-K, "Consolidated Statements of Stockholders' Equity, Years Ended December 31, 2009, 2008 and 2007," p. F-7, filed with the SEC on February 26, 2010
14 See Diamondrock 2008 Proxy Statement, p. 12: http://www.sec.gov/Archives/edgar/data/1298946/000104746908003255/a2183487zdef14a.htm
15 See discussion in the DEFC14A, filed by UNITE HERE for Chesapeake Lodging Trust on 4/21/15: http://www.sec.gov/Archives/edgar/data/1034426/000103442615000046/chspdefc14aedgar042115.htm
16 http://www.streetinsider.com/Corporate+News/Blackstone+to+Acquire+Strategic+Hotels+%26+Resorts+(BEE)+in+~$6B+Deal/10872768.html

Concurrent Session: Housing Finance Potpourri

Thursday, March 31st
9:45am – 11am
Marriott Marquis, Washington DC

Moderator:
Daniel Grattan, VP, Annaly Capital Management, Inc.

Panelists:
Christopher Brown, Staff to Representative Blaine Luetkemeyer, U.S. House of Representatives
Anne Canfield, President, Canfield & Associates, Inc.
Laurie Goodman, Director-Housing Finance Policy Center, Urban Institute
John von Seggern, President & CEO, Council of Federal Home Loan Banks

REIT Wise®

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March 30 - April 1

2016

Housing Finance Potpourri

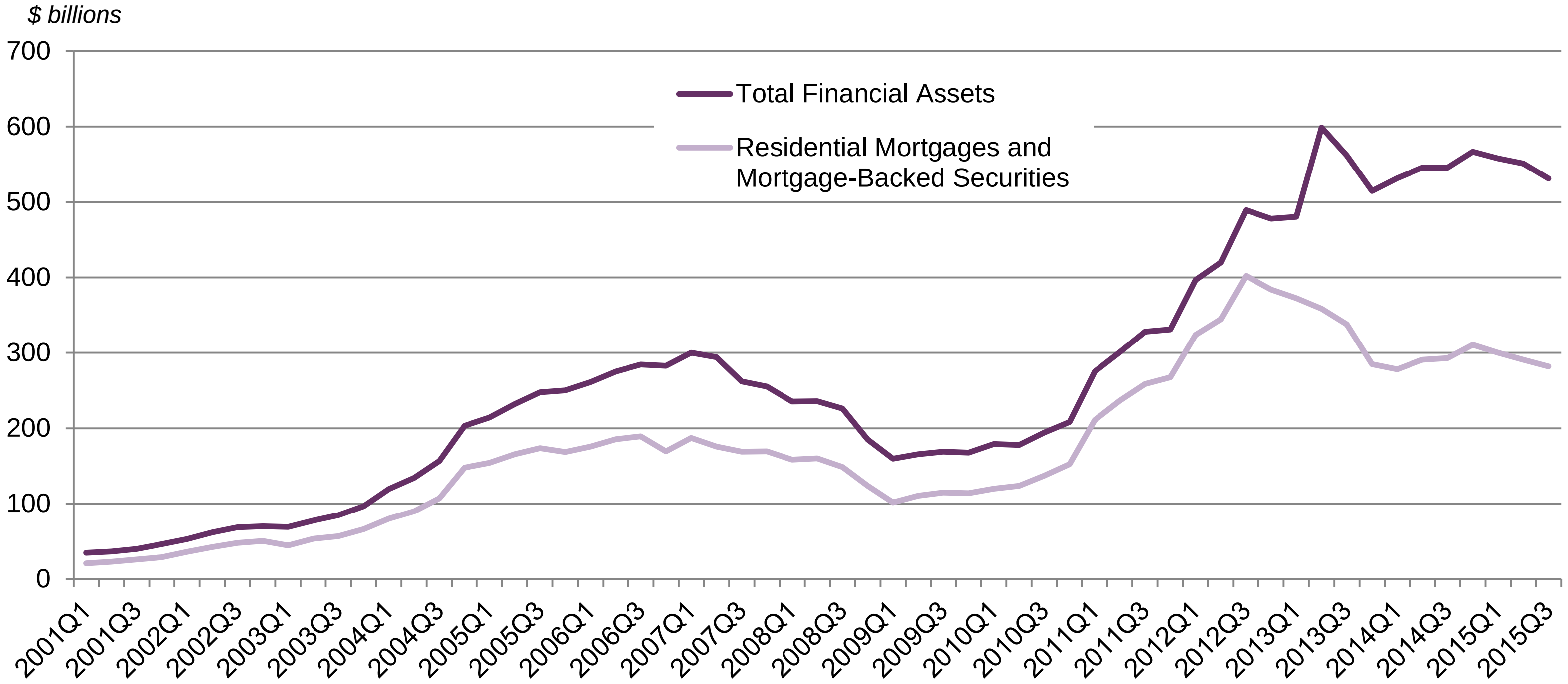
March 30-April 1, 2016

Laurie Goodman
Director, Housing Finance Policy Center
Urban Institute

FHLB Membership

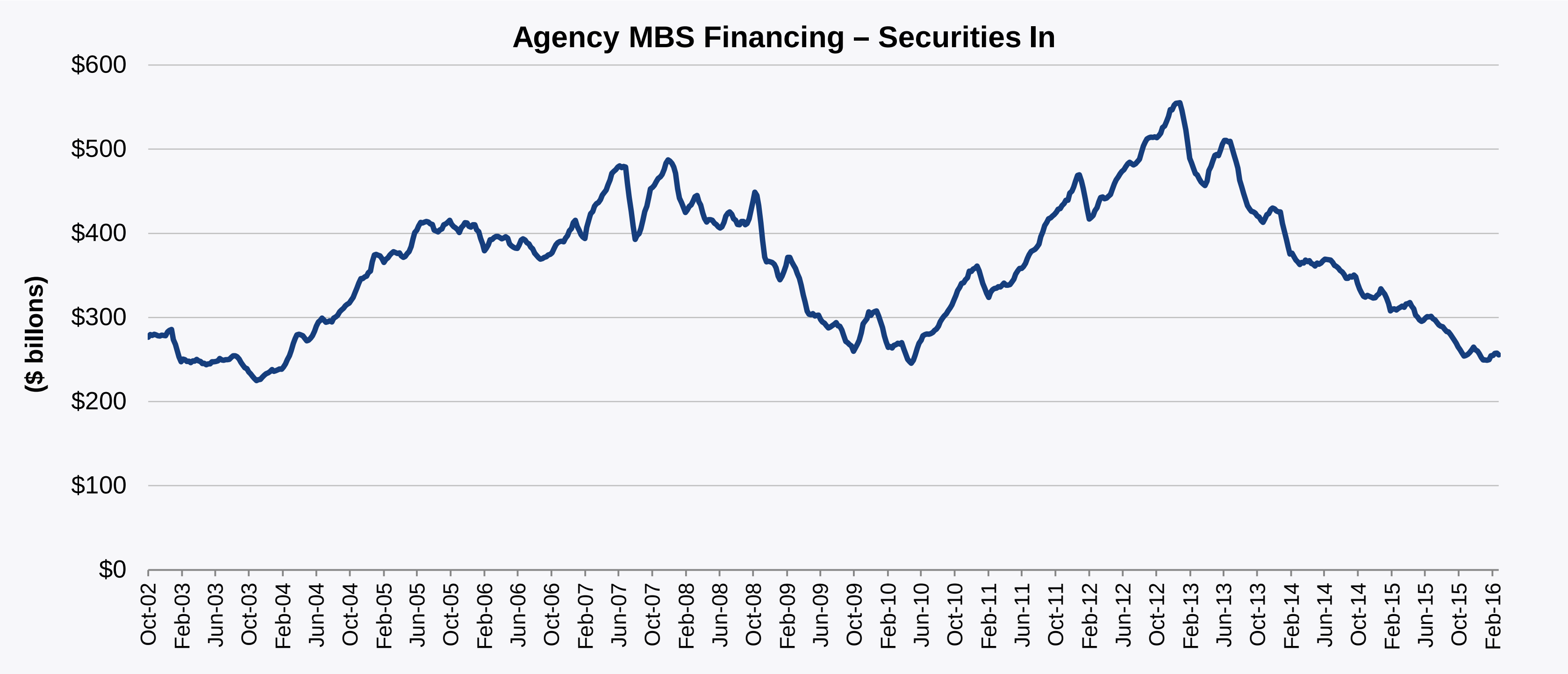
- REITS support the mission of the FHLBs and benefit the larger mortgage market.
  - Deep mortgage focus, provides liquidity and funding to the mortgage market
  - Could help build the non-QM market
  - Diversifies REIT funding sources and provides valuable long term financing
- Risks posed by captives are low, and can be managed without a ban.
  - Overall exposure is small
  - Can manage current and future risks using existing tools (overcollateralization, credit limit)
  - Strengthening the membership approval process for insurers can address safety concerns
- Why did the FHFA say no?
  - They felt congress should decide which institutions should be in or out.
  - They did not believe they had a good way to draw the line (REITs, Public hedge funds, private hedge funds, not mortgage related entities).

Mortgage REITs, Assets



Source: Federal Reserve Flow of Funds

Access to Repo is contracting



Source: Federal Reserve Bank of New York

Tax Code as applied to REITS and the Securities Act of 1940 needs to be amended to accommodate CRT Securities

REIT Tax Legislation (enacted in 1960)

- Intended to permit retail investors to invest in real estate through a tax-efficient vehicle (REITS generally don't pay corporate taxes).
- REITS must pass:
  - 75% asset test: 75% of the value of their total assets are represented by real property, mortgages on real property, other real estate assets, cash and cash equivalents, and government securities.
  - 75% income test: 75% of their gross income needs to be from interest on mortgages, rents from real property, gains from real property or mortgage sales, and other real estate income.
- GSE Risk Sharing Securities (CAS and STACR) are debt obligations of the GSEs.
- They do not represent interest in mortgages or other interests in real estate: the principal repayment on the securities contains an embedded derivative which references the performance of a group of mortgage loans.
- CAS and STACR are good REIT assets (as they are government securities), but are not good REIT income.
- Other securities can be problematic as well.
- Securities backed by non-performing loans (NPLs) or re-performing loans (RPLs) are generally not REMICS and are not good REIT assets or income. REMICs require that there be no active management of the assets. This makes them unsuitable for NPL/RPL deals.
- NPL/RPL deals have been the largest single category of non-agency issuance in 2014, 2015 and thus far in 2016.

Tax Code as applied to REITS and the Securities Act of 1940 needs to be amended to accommodate CRT Securities (Cont.)

Securities Act of 1940

- Mortgage REITS are investment companies because they are engaged primarily in the business of investing, reinvesting, or trading in securities.
- However, there is an exemption to SEC registration 5(c)3(c) for entities who are engaged in "purchasing or otherwise acquiring mortgages and other liens on and interest in real estate."
- To meet the exemption criteria, the entity must hold:
  - At least 55% of the assets in "qualifying mortgages," which includes real estate, loans fully secured by real estate, assets that are the functional equivalent of the above, such as whole-pool agency MBS, and certain commercial real estate B-notes.
  - At least 80% of the assets must be "qualifying mortgages" or real estate related assets.
- Agency CMOs and non-agency private label securities do not qualify for the purpose of the 55% rule, as they are not whole pools. They do qualify under the 80% rule.
- GSE Risk Sharing Securities (CAS and STACR) do not qualify under the 55% rule because they are debt obligations of the GSEs and do not represent interest in mortgages or other interests in real estate. They may qualify under the 80% rule.
- NPL/RPL loan deals do not count toward either requirement.

A More Promising Road to GSE Reform

MARCH 2016

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A More Promising Road to GSE Reform

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We are nearly seven years into recovery from a once-in-a-lifetime financial crisis, triggered by widespread failure across virtually every aspect of our housing finance system.[1] While much work has been done to address the flaws of this critical part of the nation's economy, a major step remains: reforming Fannie Mae and Freddie Mac. These two enormously important yet flawed institutions endure in conservatorship while their regulator, the Federal Housing Finance Agency, admirably helps them tread water while pleading for direction from a paralyzed Congress.[2]

The situation is not healthy. Lenders and investors alike hold back in the face of the deep uncertainty, leading to a less liquid, less robust and less functional mortgage market. Nor is it sustainable, as the strains of an arrangement that was intended as temporary will likely eventually require the government-sponsored enterprises to turn back to the Treasury for help, making investors and Congress alike increasingly uneasy.

Over and over, efforts to advance reform have foundered, due in part to a range of concerns raised by policymakers and stakeholders.[3] Here, we offer an approach that attempts to address these concerns, easing the path for reform and, we hope, restarts the conversation about how to move forward. Like any approach, it solves some problems but leaves others that need further work.[4] But we believe that a fresh approach like this is needed to move the conversation forward, because the system can tread water only so long.

A national highway system for the mortgage market

The principal objective of our proposal is to migrate those components of today's system that work well into a system that is no longer impaired by the components that do not, with as little disruption as possible. To do this, our proposal would merge Fannie and Freddie to form a single government corporation, which would handle all of the operations that those two institutions perform today, providing an explicit federal guarantee on mortgage-backed securities while syndicating all noncatastrophic credit risk into the private market.[5] This would facilitate a deep, broad and competitive primary and secondary mortgage market; limit the taxpayer's risk to where it is absolutely necessary; ensure broad access to the system for borrowers in all communities; and ensure a level playing field for lenders of all sizes.

The government corporation, which here we will call the National Mortgage Reinsurance Corporation, or NMRC[6], would perform the same functions as do Fannie and Freddie today. The NMRC would purchase conforming single-family and multifamily mortgage loans from originating lenders or aggregators, and issue securities backed by these loans through a single issuing platform that the NMRC owns and operates. It would guarantee the timely payment of principal and interest on the securities and perform master servicing responsibilities on the underlying loans, including setting and enforcing servicing and loan modification policies and practices. It would ensure access to credit in historically underserved communities through compliance with existing affordable-housing goals and duty-to-serve requirements. And it would provide equal footing to all lenders, large and small, by maintaining a "cash window" for mortgage purchases.

The NMRC would differ from Fannie and Freddie, however, in several important respects. It would be ***required*** to transfer all noncatastrophic credit risk on the securities that it issues to a broad range of private entities. Its mortgage-backed securities would be backed by the full faith and credit of the U.S. government, for which it would charge an explicit guarantee fee, or g-fee, sufficient to cover any risk that the government takes. And while the NMRC would maintain a modest portfolio with which to manage distressed loans and aggregate single- and multifamily loans for securitization, it cannot use that portfolio for investment purposes. Most importantly, as a government corporation, the NMRC would be motivated neither by profit nor market share, but by a mandate to balance broad access to credit with the safety and soundness of the mortgage market.

A corporation, not an agency

Why a government corporation rather than a government agency or a privately owned mutual or utility? A government corporation can have considerably more flexibility than a government agency. It need not face the same constraints in rule-making or employee compensation, for instance, nor depend on Congress for funding.[7] This flexibility will allow the NMRC to function with more of the flexibility of a private entity, which will be critical in managing an infrastructure as complex and fluid as we have in the housing finance system.[8]

Yet the costs of taking the next step and making the NMRC a privately owned mutual or utility would outweigh the benefits. The pressure to increase profits and market share that drives the typical private company to be more innovative and efficient would be largely absent with the NMRC; it would be a heavily regulated monopoly whose range of business activities, rate of return, and market share would be closely prescribed by policymakers. Whatever marginal flexibility a privately owned institution would have relative to a government corporation would not be worth the significant costs of depending so completely, yet again, on a too-big-to-fail institution, or, in the case of a mutual, the enormous challenges of setting up and operating a company owned by hundreds of institutions of vastly different sizes and interests.

It is also uncertain whether a de novo privately owned institution would be able to raise the considerable capital necessary to fully support the system. Equity investors could be reluctant to commit up front to a system that is untested and deeply entangled with the government. This is not an issue when the NMRC is a government corporation, as the private capital needed will be brought into the system gradually through the credit risk transfer process that FHFA has overseen for the last several years.

FHFA retains its functions

Under the proposed system, the FHFA would retain the functions it has today, providing broad regulatory oversight over the NMRC and the Federal Home Loan Bank system and their counterparties. In addition, it would set the g-fee for the catastrophic risk and maintain a mortgage insurance fund, or MIF, funded by those g-fees sufficient to cover the costs of a catastrophic downturn. If the MIF is depleted during a crisis, the FHFA would have the authority to make up any shortfalls in the fund by increasing g-fees to a level greater than that needed to cover the prevailing credit risk when economic conditions normalize.[9] The FHFA's role in the housing finance system would thus be analogous to the FDIC's role in the banking system, similarly protecting taxpayers from any losses accrued from backstopping the system.

We propose having both a government corporation and a regulator, rather than combining them, for several reasons. First is the quite distinct functions involved—managing the core infrastructure of the conforming market and providing its oversight—which lend themselves to different skill sets and internal controls. Second, the division allows a single regulator, the FHFA, to oversee more than one channel of government-backed lending, the NMRC and the FHLB system, and to coordinate policies with the government's other mortgage credit supports like Ginnie Mae, the Federal Housing Administration, the Veterans Administration, and the USDA. Finally, separate entities would allow the FHFA to act as an ombudsman for mediating stakeholder concerns about NMRC's activities. The importance of this role was recently illustrated when mortgage lenders took up their concerns about Fannie and Freddie's representation and warranty policies with the FHFA. It took longer to resolve this dispute than most would have preferred, but the agency was ultimately successful, to the benefit of borrowers and the mortgage market.

The key function of the secondary mortgage market, namely the taking of interest rate and noncatastrophic credit risk, would be handled by the private sector. A large number and broad range of financial institutions would compete to take credit risk. Like the national highway system, in which a wider range of commerce is able to move freely across the country because of the government's stewardship of the infrastructure, here institutions of all sizes and forms will be better able to compete because they have the same access to the basic functions of the conforming mortgage market on which they rely.

The advantages of the system

Replaces too big to fail with genuine competition

Putting the infrastructure that mortgage market participants depend on into a government corporation accomplishes two key things. First, no private institutions become indispensable to a healthy, functioning secondary market simply by controlling its infrastructure or taking a significant share of the system's credit risk. *No* private institutions will be backstopped by the government, either explicitly or implicitly: None will have an incentive to take on risk that it knows it cannot and will not have to bear. Second, by putting the market's core infrastructure where lenders of all sizes will have equal access, we reduce barriers to entry and thus increase competition in the primary market. Competition among the sources of private capital in the secondary market will also be enhanced by the larger and deeper market for the NMRC's credit risk syndication.

Broad access for underserved communities and small lenders

The creation of the NMRC will also make it much easier to ensure broad access for underserved communities. Rather than rely on the effectiveness of legislative measures to incentivize private guarantors to provide secondary market access for lending in underserved communities, we simply impose the current regime for accomplishing this on the NMRC. The NMRC will be required to meet duty-to-serve and affordability goals defined by the FHFA, the same as Fannie and Freddie must do today. And like the GSEs, to help meet these obligations, the NMRC will price its g-fees in a manner that subsidizes lower wealth borrowers who are creditworthy but may not be able to afford a mortgage loan otherwise. In addition to this subsidy, the NMRC will charge an explicit 10 bps affordability fee that will be used to fund initiatives to support access and affordability for homeownership and rental housing.[10]

Community banks and small lenders will also have access to the system in the way they have it today, by using the cash window through the NMRC. Moreover, they will no longer be vulnerable to the historical practice at Fannie and Freddie of providing larger lenders with better pricing given their volume and market power, as this would run directly contrary to the NMRC's mandate to provide broad, competitive access to the secondary market. This mandate would also ensure that the NMRC uses risk syndication practices that maintain a level playing field for all lenders.[11]

Lower borrower cost

Mortgage rates in the proposed system would be no higher on average through the business cycle than those in the current system (see Box 1). While the fee for the government's explicit reinsurance is a new cost that would be passed on to the borrower, it would be offset by lower yields on the NMRC mortgage securities. Unlike Fannie and Freddie's MBS, the NMRC's MBS would be explicitly backed by the full faith and credit of the U.S. government, and would thus trade more like Ginnie Mae's explicitly guaranteed MBS, which have historically traded 20 basis points lower in yield than Fannie and Freddie MBS.

While there would be some variation in mortgage rates across borrowers with different credit profiles in the system proposed, as there was in the current system prior to conservatorship and is today, it would be moderated by the need for the NMRC to comply with its duty-to-serve and affordable-housing goals, much as it is with Fannie and Freddie today. Rates may be more cyclical than in the current system given the additional reliance on private capital. While Fannie and Freddie's current g-fee rarely changes in response to market conditions, NMRC's g-fee will vary depending on the cost of private capital, which in turn will fluctuate with the perceived risk in the market. G-fees will thus be lower in the new system than in the current system in low-risk environments, when private entities are willing to provide capital more cheaply, and higher in high-risk environments than they would be in the current system, when these entities will require higher returns. The impact on mortgage rates will depend on other factors that will also change with the business cycle, including the yields on MBS and lenders' margins. The cyclicality of g-fees and mortgage rates in the proposed system could also be meaningfully mitigated in a number of ways such as the adoption of countercyclical capital standards, which is described later.

Flexibility in a stressed secondary market

Under our proposed system, the NMRC will have the authority and flexibility needed to manage a crisis in the secondary market. In times of stress, private investors in the risk being syndicated by the NMRC would demand higher returns to justify taking on the higher risk. In a time of acute stress, these investors will either be unwilling to provide capital at all or require such a high return that it would cause guarantee fees and mortgage rates to spike, exacerbating the financial stress. To ensure that this does not happen in the new system, the NMRC would have the flexibility to scale back its risk transfers when private capital's required return rises above a predefined crisis threshold.

To illustrate how this could work, at least at a very high level, suppose the threshold for defining a crisis is when private capital requires an extraordinary return of more than 25%. This is consistent with what investors required in the recent financial crisis, and compares to the roughly 10% return required by investors currently.[12] When this crisis threshold is breached, the NMRC would have the authority to scale back the volume of credit risk it syndicates as it deems appropriate. With this threshold, there would be an effective cap on the g-fee and mortgage rates borrowers face in a crisis, thus serving to mitigate it.

Less disruptive transition

Rather than winding the current system down and starting largely from scratch[13], we merely accelerate the steps that FHFA already has under way to transfer the GSEs' risk to the private market and synchronize their activities, and then use their merged infrastructure to form the structure for the government corporation that replaces them. Fannie and Freddie would continue to build the common securitization platform; the current effort to synchronize *some* of the processes at the enterprises would be extended to *all* of them, from purchasing mortgages to securitizing them and overseeing their servicing; and their current risk-sharing efforts would be expanded so that all of the noncatastrophic risk on their new business would be sold into the market. Importantly, Fannie and Freddie, and ultimately the NMRC, will gradually shift their risk-syndication efforts to the mix of structures that prove most effective in maintaining broad access to affordable credit, a level playing field for lenders of all sizes, and resiliency against market downturns.

Once Fannie and Freddie are issuing a single security off of a single platform, operating under a single set of processes and syndicating all of their noncatastrophic credit risk, their operational assets will be put into the newly formed government corporation, the NMRC. The GSEs' legacy financial assets and liabilities would remain with them and would be steadily wound down; the infrastructure required to manage the wind down and the Treasury's current $258 billion line of credit to backstop their liabilities would also remain with them until they were extinguished.

Only as large as it needs to be

The NMRC will purchase, pool and securitize only those loans that meet the product features of the Consumer Financial Protection Bureau's definition of a "Qualified Mortgage" and have a dollar amount no greater than a limit to be determined by the FHFA.[14]

The system proposed could accommodate either a large or a small government footprint, with the size controlled by adjusting these loan limits.[15] This will allow policymakers to significantly reduce the government's share of the market when purely private lending channels are healthy enough to serve much of the country's borrowers adequately, and scale it up if and when they struggle. While it is important that policymakers do not overuse this flexibility, as that would create unhelpful uncertainty for private-label security investors and portfolio lenders, having some flexibility will give policymakers comfort to pull the government's share back in normal economic times, knowing that they can expand its share when the private channels dry up. The proposed FHFA regulatory structure also should encourage coordination with the loan limits and priorities of the FHA, VA and USDA to create a more unified federal approach to supporting homeownership and rental housing, even if these entities are not incorporated into the NMRC system as suggested below.

Potential costs

While our proposed housing finance system offers significant advantages, it does come with two potential costs worth noting.

Competition

By putting the purchasing, pooling, master servicing, securitizing and risk syndication functions into a government corporation, we give up some competition across these dimensions. How much is difficult to tell, as regulators would inevitably impose significant limitations on the discretion that they would allow private companies providing these functions, given the benefits of standardization and the importance of managing risk and consumer protection in the system. However, they would no doubt give private institutions at least some discretion, which would lead to differentiation and competition, resulting in a system that is in some respects more nimble and efficient than the one we propose, with more innovation in developing new mortgage products, servicing loans, and sharing credit risk. As we learned in the crisis, not all of that competition and innovation would be beneficial to consumers or the stability of the market, but surely much of it would.

We believe that the system proposed is nonetheless worth this trade-off. This is in part because we believe it is important to solve for the shortcomings in systems in which these functions are in the private sector, but also because the competitive advantages of the system proposed offset at least some of the competitive loss described here. By putting the key infrastructure into a government corporation, we level the playing field for lenders of all sizes to compete rather than become beholden to larger institutions that have gained an advantage in times past by taking control over access to the secondary market. Our system also promotes competition in the secondary market across a wider range of sources of private capital, including capital markets, reinsurers, private mortgage insurers, lenders, and other private entities.

Budgetary implications

It is also important to note that transitioning to this system would move the role of the federal government in backstopping the market onto the federal budget. The impact would be modest, however, since the NMRC will set its g-fee based on returns consistent with those charged by private capital. It would thus be operating consistently with how the Congressional Budget Office evaluates the risk associated with Fannie Mae and Freddie Mac's activities today.[16] The debt issued by NMRC to support its portfolio is unlikely to be added to the Treasury's debt load or count toward the U.S. Treasury's statutory debt limit, but the impact if it did would be inconsequential.[17] The legacy obligations of the GSEs would remain with them as they are wound down in conservatorship, so their accounting should remain unchanged.[18]

Additional concerns

In addition to these two potential costs, we would also expect two concerns with our proposed system to be raised, running, incidentally, in opposite directions: that we are relying too heavily on the government in this new system and that we are relying too heavily on private capital to bear the credit risk.

Too much government

As described above, the share of the market that the NMRC would support will be limited to plain vanilla, low-risk loans only up to the size the regulator deems necessary to ensure broad access to credit. In normal times, we would expect lending backed by portfolio lenders and private-label securities investors to serve the majority of the nation's mortgage needs, allowing the government-backed channel to retreat to a more conservative role. It will only take on a larger role in the market if and as the purely private lending channels dry up.

Moreover, even *within* the government-backed channel, the government corporation's role will be limited and targeted to increase private capital within that channel. By giving the NMRC the role of gatekeeper to the secondary market within this channel, the system will create more competition in both the primary lending market and the market for credit risk being absorbed in the secondary market. And in bearing the catastrophic credit risk, the NMRC will create greater demand for their mortgage-backed securities, attracting investors who are only interested in taking interest-rate risk. The government's role in the system we propose is thus not only constrained in its share of the market, but also in its presence within that share, and targeted in a way that maximizes competition and private capital.

Too much private capital

On the other hand, the significant volume of credit risk in the market will no doubt give some pause that there is sufficient private capital willing to take on the primary role allotted to it in this system. Of course, unless one proposes having the government take on a larger role in assuming credit risk in the market than we see today, this is a challenge inherent to *any* proposal to reform the current system. In the system we propose, this challenge is handled by taking on credit risk gradually, allowing the market to develop over time and providing regulators and policymakers time to adjust the course of their risk sharing as it becomes clearer which risk syndication structures are most promising. While we are confident that there is sufficient private capital to take on all of the noncatastrophic credit risk in the system, taking this gradual approach ensures the smoothest possible path to building the broad and deep market needed.

Possible additions to the base system

One of our primary objectives in offering this proposal is to chart a path for reform with as little transition cost and disruption as possible. That has led us to focus simply on migrating the parts of the current system that have worked well over the years into a new system stripped of the flaws that got the current one into trouble. To further improve upon the new system, however, several additional steps could be taken.

Countercyclical capital

To limit the expected cyclicality in mortgage rates in the NMRC system, policymakers should consider the adoption of countercyclical capital standards for both private sources of capital and the MIF. For example, they could be tied to house prices, so that as the market heats up more capital is required and as it cools off, less, thus easing bubbles and accelerating recoveries. Countercyclical capital regimes are already under consideration at the FHFA and consistent with the direction state insurance regulators are headed.[19]

Skin in the game

Policymakers should also consider requiring the NMRC to follow current risk-retention rules for private-label MBS and hold onto 5% of the credit risk that it transfers into the private market. This give the NMRC an added incentive to be careful about the risk that it allows to flow into the secondary market, but, perhaps more importantly, it would provide helpful market feedback, ensuring that the NMRC is not caught off guard when the market is sufficiently distressed as to trigger the deeper catastrophic risk coverage.

Integrating government-backed mortgage lending

Finally, the system we have proposed would allow policymakers to better integrate FHA and other mission-oriented government housing finance agencies into the mainstream system. Once the NMRC is established, it could also purchase, pool and securitize loans insured by the FHA, Veterans Administration and USDA as Ginnie Mae does today. For these loans it would be unnecessary to share the credit risk, as those agencies bear the noncatastrophic credit risk already.

Bringing all government-backed lending into a single, coherent system would make it easier for regulators and policymakers to ensure that historically underserved communities are not only being served, but being served as well as everyone else in the mainstream mortgage market.

The longer it takes, the riskier it gets

It is all too easy to take false comfort in the current status quo in the mortgage market. Home sales and house prices continue to trend upward in most of the country, and lenders have a market into which to sell their loans. But the housing finance system we have today is unhealthy and unsustainable; mortgage credit remains overly tight, taxpayers remain at risk, and the system lingers in a dysfunctional limbo. If we do not take seriously the need for reform until there is a crisis, we will be forced to undertake a remarkably complex and important effort when we are least equipped to handle it.

Our nation deserves a housing finance system that ensures broad access to lenders and borrowers alike, insulates taxpayers behind deep and competitive private capital, and is no longer compromised by the toxic incentives that come with dependence on too-big-to-fail institutions. We offer up this proposal because we believe that it does just that, but also, and perhaps more importantly, to restart the discussion. Let's not wait until the next crisis.

Box 1: Mortgage rates under different housing finance systems

Mortgage rates under our proposed housing finance system would be no higher on average than current rates, and meaningfully lower than under other proposed systems.

Current system

In the current system the mortgage rate on a Fannie or Freddie loan equals the sum of the yield required by investors in Fannie and Freddie mortgage-backed securities, the cost of servicing the loan, what lenders charge for originating the loan, and Fannie and Freddie's g-fee. Their g-fee in turn is equal to the sum of their administrative costs, their expected loan losses, the cost of capital they need to hold for unexpected losses, and what they are required to charge borrowers to pay for the 2013 payroll tax holiday.

The rate on a 30-year fixed-rate mortgage loan to a typical borrower in the current system in a well-functioning economy (characterized by full employment, low and stable inflation, and a normalized monetary policy) should be 6.1% (see Table 1).[20] This equals the sum of the 4.9% expected yield on Fannie and Freddie's MBS, the 50-basis point cost of loan origination and servicing, and the 70-basis point g-fee.

Fannie and Freddie's MBS yield is in turn equal to the 4% Treasury yield, plus the 90-basis point typical spread on Fannie and Freddie MBS over Treasuries. This yield spread compensates investors for prepayment risk, and the risk that the GSEs are unable to make good on their guarantee for credit risk. Even though Fannie and Freddie are operating under government conservatorship, investors are still unsure of the government's commitment to fully backstop their MBS and thus require a higher yield to compensate. Fannie and Freddie's 70-basis point g-fee is largely composed of the cost of capital the GSEs implicitly hold for unexpected losses.[21]

NMRC system

The private market in the NMRC system provides capital covering the first 3.5% of losses, and the after-tax return on this capital is 10%. The sources of private capital in the NMRC system are not too big to fail, and thus will not be required to hold additional capital to remain going concerns in a crisis, as would be required of a systemically important financial institution.

The NMRC will provide the going-concern capital needed in a crisis through the MIF. The MIF will be equal to 2.5% of the total insurance-in-force, and funded by a catastrophic reinsurance fee of 10 basis points.[22] When combined with the 3.5% capitalization rate for the private capital, this would bring the system's total capitalization to 6%, which is approximately double the realized losses experienced by Fannie and Freddie as a result of the crisis.

The fee charged in the NMRC system to fund the subsidy to ensure that the affordable-housing goals and duty-to-serve requirements are met is also assumed to be 10 basis points.[23] Offsetting these added costs is the lower yield expected on NMRC MBS. Given the government's full backing of the securities, they would have yields similar to Ginnie MBS, which are approximately 20 basis points lower than Fannie and Freddie MBS.

While mortgage rates in the NMRC system would be similar to the current system on average through the business cycle, they may also be more cyclical, depending on changes in g-fees, yields on MBS and lenders' margins. They would be capped, however, so that in a crisis they would not rise so high that the housing market would be undermined, further weakening the economy and exacerbating the crisis. To illustrate, consider that a crisis is defined to occur when private sources of capital require a 25% return of equity. In this case, the maximum increase in g-fees charged by NMRC and private capital together in a crisis would be an estimated 53 basis points, or about 33 basis points higher than what we have in today's market after accounting for the 20-basis point benefit of the explicit government backstop on NMRC's MBS.[24]

Other housing finance systems

Mortgage rates would be higher in the other significant housing finance proposals than in the NMRC system. This includes the system envisaged under the Senate legislation sponsored by Senators Johnson and Crapo in 2014 (Johnson-Crapo), the system that would be created through the recapitalization and privatization of Fannie and Freddie (Recap and Release), and the fully privatized system envisaged under the so-called PATH Act introduced by Republicans in the House Financial Services Committee in 2014.

This is our conclusion even under the most favorable assumptions regarding how these other proposals would ultimately be implemented. Rates would be higher under Johnson-Crapo given the likelihood that the private guarantors at the center of that system would be deemed too big to fail and thus required to hold much more capital, a cost that would be passed on to mortgage borrowers.[25] This would also be a problem under Recap and Release, as Fannie and Freddie would certainly be deemed too big to fail.[26] And rates would go up most dramatically under the PATH Act, because of the significant capital required for private institutions to bear the entirety of the credit risk in the absence of a government backstop.[27]

Table 1: Comparing Mortgage Rates Under Different Housing Finance Systems

	Current system		NMRC		Johnson-Crapo		Recap and Release		PATH Act	
Mortgage rate		6.10%		6.10%		6.26%		6.55%		7.16%
Difference with current system				*0.00%*		*0.17%*		*0.46%*		*1.06%*
Mortgage-backed securities yield		4.90%		4.70%		4.70%		4.90%		5.30%
Spread on mortgage securities		90 bps		70 bps		70 bps		90 bps		130 bps
Treasury rate (duration matched)		400 bps		400 bps		400 bps		400 bps		400 bps
Servicing and origination compensation		50 bps		50 bps		50 bps		50 bps		50 bps
Guarantee fee		70 bps		90 bps		106 bps		115 bps		136 bps
Expected credit losses		4 bps		4 bps		4 bps		4 bps		4 bps
Administrative costs		7 bps		7 bps		7 bps		7 bps		7 bps
Govt catastrophic reinsurance fee		0 bps		10 bps		10 bps		0 bps		0 bps
Affordability fee		0 bps		10 bps		10 bps		10 bps		0 bps
Payroll tax surcharge		10 bps		10 bps		10 bps		10 bps		10 bps
Dividend on Treasury capital		0 bps		0 bps		0 bps		0 bps		0 bps
	Capitalization	**Cost of capital**	**Capitalization**	**Cost of capital**	**Capitalization**	**Cost of capital**	**Capitalization**	**Cost of capital**	**Capitalization**	**Cost of capital**
Total capitalization and cost of capital	3.5%	49 bps	3.5%	49 bps	10.0%	65 bps	10.0%	84 bps	5.0%	115 bps
Common equity	3.5%	56 bps	3.5%	56 bps	3.5%	56 bps	5.0%	79 bps	5.0%	125 bps
Preferred equity	0.0%	0 bps	0.0%	0 bps	1.0%	11 bps	0.0%	0 bps	0.0%	0 bps
Subordinated debt	0.0%	0 bps	0.0%	0 bps	2.5%	8 bps	0.0%	0 bps	0.0%	0 bps
Government credit line	0.0%	0 bps	0.0%	0 bps	0.0%	0 bps	5.0%	15 bps	0.0%	0 bps
Present value of future g-fees	0.0%	0 bps	0.0%	0 bps	3.0%	0 bps	0.0%	0 bps	0.0%	0 bps
Less: Return on cash reserves to pay for losses		-7 bps		-7 bps		-9 bps		-10 bps		-10 bps
Assumptions:										
Before-tax cost of common equity		16%		16%		16%		16%		25%
After-tax cost of common equity		10%		10%		10%		10%		16%
After-tax cost of preferred equity		7%		7%		7%		7%		7%
Cost of subordinated debt (bps spread over Treasury)		300		300		300		300		300
Cost of government credit line (bps)		0		0				300		
Pre-tax return on unlevered capital		2%		2%		2%		2%		2%
Treasury draw ($ bil)		187		187		187		187		187
Tax rate		37%		37%		37%		37%		37%

Note: This analysis is for 30-year fixed-rate mortgage borrowers with loan-to-value ratios and credit scores consistent with the current distribution of Fannie Mae and Freddie Mac loans. It also assumes that the economy is in equilibrium, meaning that it is at full employment and inflation is consistent with the Federal Reserve's 2% target.

Source: Moody's Analytics

Endnotes

1 For a useful discussion of the wide range of issues that led to the collapse of the housing finance sector, see the "Financial Crisis Inquiry Report: Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States," January 2011.

2 FHFA Director Melvin L. Watt's most explicit call on Congress to act came in a recent speech at the Bipartisan Policy Center, found here.

3 The bill passed out of the Senate Banking Committee in 2014 sponsored by Chairman Johnson (D-SD) and Ranking Member Crapo (R- ID) was the most promising legislative attempt to date to design a system to provide broad access to credit at manageable risk to the taxpayer. An analysis of the legislation is provided in Housing Finance Reform Steps Forward, Mark Zandi and Cristian deRitis, Moody's Analytics whitepaper, March 2014.

4 There are quite a few issues that we have not addressed here that would need to be in converting this general model into legislation: the details of the charter creating the NMRC, how to address Fannie and Freddie's shareholders, and details on how this model would function in the multifamily market, to name but a few.

5 We refer to catastrophic credit risk throughout the paper to mean credit losses comparable to those experienced during the recent housing crash and Great Recession.

6 The authors apologize for adding yet another indecipherable abbreviation to the GSE discussion and hope that policymakers can come up with something more memorable.

7 The applicability of statutes regarding rule-making, employee compensation and so forth would be set out in its congressional charter. For an explanation of government corporations generally see "Federal Government Corporations: An Overview," Kevin R. Kosar, Congressional Research Service, July 2011.

8 One area where this flexibility will be important is employee compensation. While there is no limitation on compensation in government corporations per se, in developing the NMRC's charter Congress will face pressure to limit the pay in the institution. While pay at taxpayer-backed institution should indeed be kept in check, it will be extremely important to give the NMRC the flexibility to attract and retain a level of talent and experience sufficient to handle the considerable responsibility here.

9 This is analogous to what the FHA has been doing in recent years by charging historically high insurance premiums in order to rebuild the Mutual Mortgage Insurance Fund.

10 We assume that the funds generated will be allocated to the Housing Trust Fund, the Capital Magnet Fund and initiatives to support innovations to expand access to credit in harder to serve populations.

11 It is worth noting that the authors take no position, ex ante, about what mix of risk sharing structures the NMRC should use. It will be up to the FHFA, the GSEs and ultimately the NMRC to determine what mix best serves borrowers, maintains a level playing field for lenders of all sizes and maintains stable liquidity through the business cycle.

12 A 25% return on equity is also consistent with the return required by unsecured consumer lenders such as credit card lenders. Note that fleshing this concept out would take some work: Policymakers would need to develop a mechanism for determining when the ROE threshold has been reached, a way to discern regional stresses from national ones, and so forth.

13 One of the most compelling concerns with the legislative proposals offered thus far has been the significant but uncertain cost of transition. For a sense of this concern, see "Millstein: Here's How to Revamp Fannie, Freddie," in the Wall Street Journal, October 22, 2012.

14 For a summary of the product features that would not be allowed to run through the NMRC (interest only loans, negatively amortizing loans, and loans with balloon payments), see "What is a Qualified Mortgage," by the Consumer Financial Protection Bureau, updated February 8, 2016.

15 While there is an argument for setting the size of the loan limits in statute to insulate the decision-making from political pressure, we believe that it is better to leave it to the discretion of the regulator, perhaps with explicit guidance regarding the conditions under which they should raise or lower it.

16 This is not an endorsement of the use of fair value accounting rules for the government's credit-related activities, but simply to say that our proposal is consistent with the way the CBO evaluates the GSEs today.

17 Whether NMRC debt is counted toward the Treasury's debt load or debt limit depends on the NMRC's charter. If the charter explicitly states that the NMRC debt securities are guaranteed by the U.S. government, then the securities would count against the debt limit. However, if the NMRC charter act is silent and the marketing of the NMRC securities instead relies on the decades-long line of Attorney General and DOJ Office of Legal Counsel published opinions that state that all obligations of all federal agencies (including government corporations) are equally backed by the full faith and credit of the United States, unless explicitly disclaimed in the respective charter act (as Congress did in the case of the TVA and USPS charter acts), then the NMRC securities would not count against the statutory debt limit.

18 Most importantly, the GSEs' current obligations would not be counted towards the Treasury's debt or debt limit.

19 The FHFA's work on countercyclical capital is described in "Countercyclical Capital Regime: A Proposed Design and Empirical Evaluation," Scott Smith and Jesse Weiher, FHFA working paper, April 2012. The National Association of Insurance Commissioners has established a working group to develop new capital standards for private mortgage insurers that will include countercyclical standards.

20 The current mortgage rate is much lower, at below 4%, since the economy has yet to achieve full employment, inflation is below target, and monetary policy remains far from normal. All of which is keeping Treasury yields and thus yields on Fannie and Freddie's MBS atypically low.

21 See "A General Theory of G-Fees," Mark Zandi and Cristian deRitis, Moody's Analytics White Paper, October 2014 for a more detailed explanation of this analysis.

22 The 10 basis point fee to fund the MIF is the same as in the Johnson-Crapo legislation. Many cost is based on a number of assumptions, including the assumption that it will be based on Fair Credit Reporting Act accounting.

23 There will be some costs associated with the operation of the NMRC, but they are assumed to be offset by the lower costs associated through the merger of Fannie and Freddie's operations.

24 This is equal to the product of the 15-percentage point increase in private capital's required rate of return (25% crisis threshold ROE minus 10% current ROE) and the system's 3.5% private capitalization.

25 An analysis of the Johnson-Crapo legislation is provided in "Housing Finance Reform Steps Forward," Mark Zandi and Cristian deRitis, Moody's Analytics white paper, May 2014.

26 For more on how re-privatizing Fannie and Freddie would increase mortgage rates, see "Privatizing Fannie and Freddie: Be Careful What You Ask For," Jim Parrott and Mark Zandi, May 2015.

27 For more on how the PATH Act would impact mortgage rates see "Evaluating PATH," Mark Zandi and Cristian deRitis, Moody's Analytics White Paper, July 2013.

About the Authors

Jim Parrott is a senior fellow at the Urban Institute and owner of Falling Creek Advisors, which provides financial institutions with strategic advice on housing finance issues. Jim spent several years in the White House as a senior advisor on the National Economic Council, where he led the team of advisors charged with counseling the cabinet and president on housing issues. He was on point for developing the administration's major housing policy positions; articulating and defending those positions with Congress, the press and public; and counseling White House leadership on related communications and legislative strategy. Prior to his time with the NEC, Jim was counsel to Secretary Shaun Donovan at the Department of Housing and Urban Development. He has a JD from Columbia University School of Law, an MA from the University of Washington, and a BA from the University of North Carolina.

Lewis S. Ranieri is Founder and Chairman of Ranieri Strategies LLC which is focused on financial services and the use of cognitive technologies. Mr. Ranieri had been Vice Chairman of Salomon Brothers, Inc. ("Salomon"). He is generally considered to be the "father" of the securitized mortgage market. Mr. Ranieri helped develop the capital markets as a source of funds for housing and commercial real estate, established Salomon's leadership position in the mortgage-backed securities area, and also led the effort to obtain federal legislation to support and build the market. Mr. Ranieri was inducted into the National Housing Hall of Fame. In November 2004, BusinessWeek magazine named him one of "the greatest innovators of the past 75 years," and in 2005, he received the Distinguished Industry Service Award from the American Securitization Forum.

Gene Sperling was National Economic Advisor and Director of the National Economic Council for President Obama (2011-2014) and President Clinton (1996-2001). He was also formerly Counselor to Secretary of Treasury Tim Geithner (2009-2010), Deputy National Economic Advisor (1993-1996) and Economic Advisor to Governor Mario Cuomo (1990-1992). He currently heads Sperling Economic Strategies, which provides advice to several companies, start-ups as well as foundations and philanthropies. The ideas expressed in this paper are purely his own. Sperling is also the Founder, former Executive Director (2002-2008) and Advisor Board Chair of the Center of Universal Education (Brookings Institution), which focuses on policies for education in low-income nations, with a special focus on girls education and children in conflict. He as also formerly Senior Fellow at Center for American Progress and Council on Foreign Relations. He is the author of two books: The Pro-Growth Progressive (2006), and What Works in Girls Education: Evidence on the World's Best Investment (2004, 2015), and was a consultant and part-time writer for the television show West Wing (Season 3-6).

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Barry Zigas is Director of Housing Policy at Consumer Federation of America. He also advises nonprofits on strategy and policy through his firm Zigas and Associates LLC. He was President of the National Low Income Housing Coalition from 1984-1993 where he led the efforts to create the Low Income Housing Tax Credit and HOME programs, as well as community lending goals for Fannie Mae and Freddie Mac. He joined Fannie Mae in 1993 and served as Senior Vice President for Community Lending from 1995-2006. He serves as board chair for Mercy Housing, Inc. and as board Vice Chair of the Low Income Investment Fund, as well as consumer advisory councils for Bank of America, Ocwen, JP Morgan Chase and Freddie Mac. He was a member of the Bipartisan Policy Center's housing commission 2011-13, and served on the Rouse Maxwell Housing Task Force in 1988-89. He is a Phi Beta Kappa graduate of Grinnell College, from which he also received an alumni award in 2012, and a 1997 graduate of the Advanced Management Program at the Wharton School, University of Pennsylvania.

114TH CONGRESS
1ST SESSION

H. R. 3808

To require the withdrawal and study of the Federal Housing Finance Agency's proposed rule on Federal Home Loan Bank membership, and for other purposes.

IN THE HOUSE OF REPRESENTATIVES

OCTOBER 22, 2015

Mr. LUETKEMEYER (for himself, Mr. MCHENRY, Mr. HECK of Washington, and Mr. CARNEY) introduced the following bill; which was referred to the Committee on Financial Services

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A BILL

To require the withdrawal and study of the Federal Housing Finance Agency's proposed rule on Federal Home Loan Bank membership, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. FHLB MEMBERSHIP PROPOSED RULE.

(a) DEFINITIONS.—In this section:

(1) COMMUNITY DEVELOPMENT FINANCIAL INSTITUTION.—The term "community development financial institution" has the meaning given that term in section 103 of the Community Development

Banking and Financial Institutions Act of 1994 (12 U.S.C. 4702).

(2) COVERED PROPOSED RULE.—The term "covered proposed rule" means the proposed rule of the Federal Housing Finance Agency entitled "Members of Federal Home Loan Banks" (79 Fed. Reg. 54848 (September 12, 2014)).

(3) OTHER TERMS FROM THE FEDERAL HOME LOAN BANK ACT.—The terms "community financial institution", "Federal Home Loan Bank", and "Federal Home Loan Bank System" have the meanings given those terms in section 2 of the Federal Home Loan Bank Act (12 U.S.C. 1422).

(b) WITHDRAWAL OF PROPOSED RULE.—Not later than 30 days after the date of enactment of this Act, the Federal Housing Finance Agency shall withdraw the covered proposed rule.

(c) GAO STUDY AND REPORT ON PROPOSED RULE.—

(1) STUDY.—

(A) IN GENERAL.—The Comptroller General of the United States shall conduct a study on the impact that the covered proposed rule would have, if adopted as proposed, on—

(i) the ability of the Federal Home Loan Banks to fulfill the mandate to provide liquidity to support housing finance and economic and community development;

(ii) the safety and soundness of the Federal Home Loan Bank System;

(iii) the liquidity needs of financial intermediaries;

(iv) the stability of the Federal Home Loan Bank System;

(v) the benefits of a diverse membership base for Federal Home Loan Banks; and

(vi) the ability of member institutions to rely on access to Federal Home Loan Bank advances.

(B) CONSIDERATIONS.—In conducting the study under subparagraph (A), the Comptroller General of the United States shall consider—

(i) the comment letters submitted in response to the notice of proposed rulemaking for the covered proposed rule;

(ii) the legislative and administrative history of the Federal Home Loan Bank membership rules;

(iii) the burden placed on community financial institutions and community development financial institutions; and

(iv) the legal authority of the Federal Housing Finance Agency to exclude from membership any class or category of insurance companies.

(2) REPORT.—Not later than 1 year after the date of enactment of this Act, the Comptroller General of the United States shall submit to the Committee on Banking, Housing, and Urban Affairs of the Senate and the Committee on Financial Services of the House of Representatives a report on the findings of the study conducted under paragraph (1)(A).

○

FINAL RULE
FEDERAL HOME LOAN BANK MEMBERSHIP

FREQUENTLY ASKED QUESTIONS

1. WHAT IS FHFA'S REGULATION ON FEDERAL HOME LOAN BANK MEMBERSHIP?

FHFA's regulation on Federal Home Loan Bank (FHLBank) membership implements provisions of the Federal Home Loan Bank Act (Bank Act) that establish the requirements an institution must meet to become and remain a member of a FHLBank. The regulation specifies how and when an institution must demonstrate compliance with the statutory membership eligibility requirements and otherwise implements those requirements. The regulation also establishes requirements relating to the membership application process and determination of the appropriate FHLBank district for membership, members' purchase and redemption of FHLBank capital stock, and voluntary or involuntary termination and reacquisition of membership.

2. WHY IS FHFA PUBLISHING THIS FINAL RULE?

As regulator of the FHLBanks, FHFA is responsible for ensuring the effective implementation of the provisions and purposes of the Bank Act, including those provisions relating to FHLBank membership. In recent years, changes in the financial services industry have raised a number of issues that the existing membership regulation did not sufficiently address. In 2010, FHFA began an extensive review of its membership regulation to determine whether and how the regulation should be revised to address any of those issues. This final rule, as well as the Advance Notice of Proposed Rulemaking, published in December 2010, and the proposed rule published in September 2014, are the result of that review.

3. HOW IS THE FINAL RULE DIFFERENT FROM THE PROPOSED RULE?

The final rule does not include two provisions from the proposed rule that would have required FHLBank members to maintain ongoing minimum levels of investment in specified residential mortgage assets as a condition of remaining eligible for membership. Also, while the proposed rule would have required FHLBanks to immediately terminate the membership of any captive insurance company that became a member on or after the date the proposed rule was published, the final rule provides for a one-year transition period before the required termination.

4. WHY DID FHFA DECIDE NOT TO INCLUDE THE ONGOING INVESTMENT REQUIREMENTS IN THE FINAL RULE?

Based on comments received in response to the proposed rule and on research indicating that over 98 percent of current members already comply with both proposed requirements, FHFA determined that the benefit of forcing the remaining two percent of current members to comply with these proposals would be outweighed by the burden the proposed rule would have imposed. While members' ongoing commitment to housing finance is important to ensuring fidelity to the Bank Act, FHFA believes that the statutory requirement for members to continue their commitment to housing finance can be addressed, for the time being, by monitoring the levels of residential mortgage assets they hold.

5. WHY DID FHFA DEFINE "INSURANCE COMPANY" TO EFFECTIVELY EXCLUDE CAPTIVE INSURERS FROM MEMBERSHIP?

The final rule's definition of "insurance company" is designed to prevent circumvention of the Bank Act. The primary business of a captive insurer is underwriting insurance for its parent company or for other affiliates, rather than for the public at large, and captives are generally easier and less expensive to charter, capitalize and operate. The number of entities that are otherwise ineligible for membership in a FHLBank establishing captive insurance subsidiaries as conduits to get low-cost FHLBank funding for the ineligible entity has increased considerably in recent years. Since mid-2012, 27 new captive insurers have been admitted as members, 25 of which are owned by entities that are not themselves eligible for membership. FHFA is concerned that this practice will continue to grow and there is no reason to believe it will not grow to include entities other than REITs, such as hedge funds, investment banks and finance companies, some of which have already inquired about establishing captives to gain access to the FHLBank System.

6. WHAT WILL HAPPEN TO ALL THE CAPTIVE INSURERS THAT ARE ALREADY MEMBERS OF AN FHLBANK?

Consistent with the proposed rule, under the final rule captive insurers that became members prior to publication of FHFA's proposed rule in 2014 will be allowed to remain members for up to 5 years after the effective date of the final rule. For these institutions, the final rule limits outstanding advances during the five-year transition period to 40 percent of the assets of the captive and prohibits new advances or renewals that mature beyond the five-year transition period. Existing advances that mature beyond this transition period will be permitted to remain in place.

Captive insurers that became members after publication of the proposed rule must terminate their memberships within one year following the effective date of the final rule. The final rule allows such captives until the end of that one-year period (or until the date of termination, if earlier) to repay their existing advances, but prohibits them from taking new advances or renewing existing advances that expire during that transition period.

7. HOW MANY CAPTIVE INSURERS WILL BE IMPACTED BY THIS RULE? WHAT IS THEIR CURRENT VOLUME OF ADVANCES?

As of September 30, 2015 there were 40 captive insurers in the FHLBank System.[1] As of November 13, 2015 the total dollar volume of outstanding advances to captive insurers was just over $35 billion.

8. WHAT IS FHFA'S LEGAL AUTHORITY FOR EXCLUDING CAPTIVES?

Through the Bank Act and the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (Safety and Soundness Act), Congress gave FHFA regulatory authority over the FHLBanks and gave the Director of FHFA the duty to ensure that each FHLBank complies with the regulations issued under each statute. FHFA has the authority to adopt regulations the Director deems necessary to implement the specific membership provisions of the Bank Act, as well as those the Director deems necessary to ensure that the intent of the statutory membership provisions is accomplished. The authority to ensure that the provisions and purposes of the Bank Act are carried out includes the authority to adopt regulations necessary to ensure that the FHLBanks, their members, or any other parties do not frustrate or subvert the provisions or purposes of the Bank Act.

[1] Since September 30, 2015, one captive insurer was dissolved and acquired by a non-member, thus terminating its membership.

9. WHY DOES FHFA EXCLUDE CAPTIVE INSURERS FROM MEMBERSHIP EVEN THOUGH REITs THAT SERVE AS PARENT COMPANIES TO MANY CAPTIVES ACTUALLY SUPPORT HOUSING FINANCE?

FHFA agrees that mortgage real estate investment trusts (REITs) play an important role in the residential mortgage market. However, concluding that channeling of low-cost FHLBank funding to REITs and other ineligible entities through captive members is not authorized by or consistent with the Bank Act, FHFA is compelled to put an end to that practice until such time as Congress authorizes that access.

10. WILL FHFA'S FINAL RULE PROHIBIT INSURANCE COMPANIES THAT WRITE POLICIES FOR THE PUBLIC FROM OBTAINING MEMBERSHIP?

FHFA has taken special care to define "insurance company" so that captives having the characteristics that give rise to the Agency's concerns will be excluded, while those institutions that do not give rise to such concerns and that would be regarded as carrying out the business of insurance as traditionally understood will continue to be considered insurance companies for purposes of determining eligibility for FHLBank membership.

11. WHY DOES THE FINAL RULE REQUIRE INSURANCE COMPANIES TO SUBMIT AUDITED FINANCIALS TO THEIR FHLBANK?

The Bank Act requires an institution to be in a "financial condition" such that advances can be safely made to it in order to be eligible for membership and the existing regulation already requires the FHLBanks to review the audited financial statements of depository institution applicants. The final rule revises the regulation to require the FHLBanks to obtain and review the audited financial statements of insurance company applicants when assessing the financial condition of the applicant. There are significant benefits to relying on financial statements that have been audited by a third party, particularly when assessing an institution's financial condition prior to admitting it to membership, the only time at which this requirement will apply.

12. WHY DOES THE PLACE OF BUSINESS MATTER FOR AN INSURANCE COMPANY?

The Bank Act provides generally that an eligible institution may become a member only of the FHLBank in the district in which the institution's "principal place of business" is located, but does not define that term. FHFA's existing membership regulation deemed an institution's "principal place of business" in most cases to be the state in which it maintains its "home office," but allowed for limited exceptions. Recently, some insurance companies and non-depository community development financial institutions have attempted to apply for membership in the FHLBank whose district included the state under whose laws those entities had been domiciled or incorporated, even though they conducted all of their business activities elsewhere. The final rule therefore retains the "home office" approach and adds a provision requiring the FHLBank to confirm that the institution also conducts business operations from that location. The "principal place of business" provisions will be applied only prospectively and will therefore not affect current FHLBank members.

13. WHEN IS THE NEW RULE EFFECTIVE?

The final rule will be effective 30 days after publication in the Federal Register.

FEDERAL REGISTER

Vol. 81 Wednesday,
No. 12 January 20, 2016

Part II

Federal Housing Finance Agency

12 CFR Part 1263
Members of Federal Home Loan Banks; Final Rule

FEDERAL HOUSING FINANCE AGENCY

12 CFR Part 1263

RIN 2590–AA39

Members of Federal Home Loan Banks

AGENCY: Federal Housing Finance Agency.

ACTION: Final rule.

SUMMARY: The Federal Housing Finance Agency (FHFA) has adopted a final rule revising its regulations governing Federal Home Loan Bank (Bank) membership. The final rule adopts several key revisions included in the Notice of Proposed Rulemaking. These revisions will prevent the circumvention of the statute's membership restrictions by ineligible entities using captive insurers as conduits for Bank membership by defining the term "insurance company" to exclude captive insurers, thereby making them ineligible for Bank membership; permit any Bank that has admitted captives to membership a transition period within which to wind down its affairs with those entities; require a Bank to obtain and review an insurance company's audited financial statements when considering its application for membership; clarify the standards by which a Bank is to determine the "principal place of business" for its members, including specific standards for insurance companies and community development financial institutions; and remove obsolete provisions and make numerous non-substantive textual revisions so as to provide greater clarity. The final rule does not implement the proposed rule's provisions with respect to continuing eligibility requirements, in order, as explained below, to avoid compliance burdens that may outweigh the benefits. The specific revisions made, and the rationale for making them, are set forth in the **SUPPLEMENTARY INFORMATION** below.

DATES: *Effective Date:* February 19, 2016.

FOR FURTHER INFORMATION CONTACT: Eric M. Raudenbush, Assistant General Counsel, Office of General Counsel, *Eric.Raudenbush@fhfa.gov,* (202) 649–3084; or Julie Paller, Senior Financial Analyst, Supervisory and Regulatory Policy, Division of Bank Regulation, *Julie.Paller@fhfa.gov,* (202) 649–3201 (not toll-free numbers), Federal Housing Finance Agency, 400 Seventh Street SW., Washington, DC 20219. The telephone number for the Telecommunications Device for the Hearing Impaired is (800) 877–8339.

SUPPLEMENTARY INFORMATION:

I. Background

A. Overview of the Existing Bank Membership Requirements

1. Statutory Requirements

The Federal Home Loan Bank System (Bank System) consists of eleven district Banks and the Office of Finance. The Banks are wholesale financial institutions, organized under authority of the Federal Home Loan Bank Act (Bank Act) to serve the public interest by enhancing the availability of residential housing finance and community lending credit through their member institutions and, to a very limited extent, through certain eligible nonmembers.[1] Each Bank is structured as a regional cooperative in that it is owned and controlled by member institutions located within its district, which are its primary customers.[2]

The Banks carry out their public policy function primarily by providing low cost loans, known as advances, to their members. These must be fully secured by one or more specific types of collateral, including residential mortgage loans and residential mortgage-backed securities, but also government securities, cash, other real estate related collateral, and, in some cases, secured small business, agriculture, or community development loans, or securities backed by such loans.[3] In most cases, Bank members must use the proceeds of long-term advances (that is, advances with an original term to maturity of more than five years) to fund residential housing finance, although, since 1999, smaller bank and thrift members have also been permitted to obtain long-term advances to fund small business and community development activities.[4] Bank members may use the proceeds of shorter-term advances for any business purpose. The Banks also may provide members with a limited range of other products and services, such as they provide through the "acquired member asset" (AMA) programs, under which they may purchase qualifying residential mortgage loans from their members or facilitate the sale of such loans to third-party investors.[5]

The Banks fund their operations principally through the issuance of consolidated obligations (COs), which are debt instruments issued on their behalf by the Office of Finance (a joint office of the Banks) and on which all of the Banks are jointly and severally liable.[6] Congress has vested in the Banks market advantages designed to enable them to raise funds in the capital markets at interest rates only slightly higher than those on comparable Treasury instruments. These government-sponsored entities have various advantages, which include, among other things: The exemption of the Banks' corporate earnings and the earnings on their COs from state and federal income taxes;[7] the classification of the Banks' COs as "exempted securities" under the Securities Act of 1933 and as "government securities" under the Securities Exchange Act of 1934;[8] and the authority of the U.S. Department of the Treasury (Treasury Department) to purchase up to $4 billion in COs under certain circumstances and the fact that Congress has occasionally granted it authority to purchase higher amounts during periods of financial crisis.[9] These market advantages were designed to enable the Banks to provide low-cost wholesale funding to their member institutions so that, in turn, those members could provide long-term home mortgage loans to consumers at a reasonable cost. These advantages accrue not only to consumers, but also to the members themselves, which benefit from a lower cost of funds that makes those institutions more competitive in their markets as compared with non-members who do not have access to such low-cost wholesale funding.

In line with the public policy goals underlying the creation of the Banks

[1] *See* 12 U.S.C. 1423, 1431(e), 1432(a). *See also Fahey* v. *O'Melveny & Myers,* 200 F.2d 420, 446 (9th Cir. 1952) (stating that a Bank is "a federal instrumentality organized to carry out public policy"); *ADAPSO* v. *FHLBB,* 568 F.2d 478, 480 (6th Cir. 1977) (stating that the Banks remain federal instrumentalities although their stock is now held entirely by private entities). In addition to advances to members, the Bank Act also authorizes the Banks to make advances to nonmember mortgagees, including state housing finance agencies, that have been approved under title II of the National Housing Act, 12 U.S.C. 1707, *et seq.,* and that meet certain additional requirements. *See* 12 U.S.C. 1430b. These entities are referred to as "housing associates" in FHFA's regulations. *See* 12 CFR 1201.1, 1264.1–.6, 1266.16–.17.

[2] Specifically, only members may own the capital stock of a Bank, 12 U.S.C. 1426(a)(4)(B), all members are required to maintain a minimum investment in Bank stock, 12 U.S.C. 1426(c)(1), each Bank is managed by a board of directors that is elected by its members, *see* 12 U.S.C. 1427(a), (b), (c), and (with limited exceptions noted in footnote 1 above) only members may obtain advances and access other products and services provided by a Bank, *see* 12 U.S.C. 1429, 1430(a)(1), 1430b.

[3] 12 U.S.C. 1430(a)(3).

[4] *See* 12 U.S.C. 1430(a)(2).

[5] *See* 12 CFR part 955.

[6] *See* 12 U.S.C. 1431; 12 CFR part 1270.

[7] *See* 12 U.S.C. 1433.

[8] *See* 12 U.S.C. 1426a(c)(2).

[9] *See* 12 U.S.C. 1431(i), (*l*).

and in conjunction with its decision to provide the Banks, and consequently their members, with the market advantages described above, Congress made a decision to limit eligibility for Bank membership to the types of financial institutions listed in section 4(a) of the Bank Act. When the statute was originally enacted in 1932, these included thrift institutions of various types that existed at the time (*i.e.*, building and loan associations, savings and loan associations, cooperative banks, homestead associations, and savings banks), as well as insurance companies. Since 1932, Congress has amended section 4(a) to expand the list of institutions that may be eligible for Bank membership only three times, adding federally insured depository institutions in 1989,[10] non-depository Community Development Financial Institutions (CDFIs) in 2008,[11] and non-federally insured credit unions in 2015.[12] Today, because most depository institutions (including the types of thrifts listed in section 4(a)) are now federally insured, essentially four types of institutions may be eligible for membership: (1) Federally insured depository institutions (including banks and thrifts whose deposits are insured by the Federal Deposit Insurance Corporation (FDIC) and credit unions whose deposits are insured by the National Credit Union Administration (NCUA)); (2) insurance companies; (3) CDFIs that are certified by the Community Development Financial Institutions Fund of the Treasury Department; and (4) non-federally insured credit unions meeting certain statutory criteria. Entities that do not fall within one of those categories are ineligible for Bank membership.

While qualifying as one of those enumerated types of institutions is one prerequisite for membership eligibility, an institution must meet several other requirements set forth in section 4 of the Bank Act in order to obtain membership. Section 4(a)(1) of the Bank Act requires that an institution, regardless of type: (A) Be duly organized under the laws of any state or the United States; (B) be subject to inspection and regulation under banking, or similar, laws of a state or the United States; and (C) "makes such home mortgage loans as, in the judgment of the Director [of FHFA], are long-term loans." [13] An institution that fails to satisfy any of those requirements is not eligible for Bank membership. (Hereinafter, those requirements are referred to as the "duly organized," "subject to inspection and regulation," and "makes long-term home mortgage loans" requirements, respectively).

Section 4(a)(2) of the Bank Act imposes additional eligibility requirements on insured depository institutions that were not members of a Bank as of January 1, 1989. These require that any such institution: (A) Have at least 10 percent of its total assets in "residential mortgage loans"; (B) be in a financial condition such that advances may be safely made to it; and (C) show that the character of its management and its home-financing policy are consistent with sound and economical home financing.[14] (Hereinafter, those requirements are referred to as the "10 percent," "financial condition," "character of management," and "home financing policy" requirements, respectively). However, section 4(a)(4) exempts from the "10 percent" requirement any "community financial institution" (CFI),[15] which the statute defines as an FDIC-insured depository institution with less than $1 billion in average total assets (adjusted annually for inflation) over the preceding three years.[16]

2. FHFA's Existing Bank Membership Regulation

FHFA's regulation on Bank membership, located at 12 CFR part 1263, specifies how and when an institution must demonstrate compliance with each of the statutory membership eligibility requirements and otherwise implements those requirements. The regulation also establishes requirements relating to the membership application process, determination of the appropriate Bank district for membership, members' purchase and redemption of Bank capital stock, and voluntary or involuntary termination and reacquisition of membership.

The regulation requires all insured depository institutions, insurance companies, and CDFIs to meet six requirements in order to be considered eligible for membership: The "duly organized," "subject to inspection and regulation," [17] and "makes long-term home mortgage loans" requirements, which by statute apply to all types of institutions; and the "financial condition," "character of management," and "home financing policy" requirements, which FHFA and its predecessor agency, the Federal Housing Finance Board (Finance Board), have applied by regulation to all institutions as a matter of safety and soundness.[18] Paralleling the statute, the membership regulation requires that non-CFI depository institutions also meet the "10 percent" requirement in order to be eligible for membership, but does not extend that requirement to CFIs, CDFIs or insurance companies.[19] However, the regulation does require institutions that are not insured depository institutions (*i.e.*, insurance companies and CDFIs) to have "mortgage-related assets" that "reflect a commitment to housing finance" in order to be considered eligible.[20]

For each of the six general eligibility requirements and for the "10 percent" requirement, part 1263 includes at least one separate section specifying in more detail how a Bank that is considering an institution's application for membership is to determine whether the applicant satisfies the requirement.[21] An applicant that meets the criteria of any of those more detailed provisions is deemed to be in compliance with the corresponding statutory eligibility requirement, although that presumption

[10] *See Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA)*, Public Law 101–73, § 704, 103 Stat. 183, 415 (1989).

[11] *See Housing and Economic Recovery Act of 2008*, Public Law 110–289, § 1206, 122 Stat. 2654, 2787 (2008). CDFI credit unions were eligible for Bank membership prior to 2008 due to their status as insured depository institutions.

[12] On December 4, 2015, the President signed into law an amendment to section 4(a) of the Bank Act that allows any non-federally insured credit union meeting certain specified criteria to be treated as an "insured depository institution" for purposes of determining its eligibility for Bank membership. *See Fixing America's Surface Transportation Act*, Public Law 114–94, § 82001 (2015). This final rule does not implement or otherwise address that recent statutory amendment. To the extent that regulatory revisions are necessary or appropriate to implement the amendment, they must be the subject of a separate rulemaking.

[13] 12 U.S.C. 1424(a)(1). In lieu of being subject to inspection and regulation by a state or federal regulator, a CDFI applicant must be certified as a CDFI by the Treasury Department. *See* 12 U.S.C. 1424(a)(1)(B).

[14] 12 U.S.C. 1424(a)(2).

[15] 12 U.S.C. 1424(a)(4).

[16] 12 U.S.C. 1422(10)(A). By statute, FHFA must annually adjust the $1 billion CFI asset limit for inflation. 12 U.S.C. 1422(10)(B). The inflation-adjusted CFI limit for 2015 was $1.123 billion. *See* 80 FR 6712 (Feb. 6, 2015).

[17] As provided in the statute, an institution certified as a CDFI by the Treasury Department's CDFI Fund is deemed to have met the "subject to inspection and regulation" requirement by virtue of that certification. *See* 12 CFR 1263.6(a)(2), 1263.8.

[18] 12 CFR 1263.6(a).

[19] 12 CFR 1263.6(b).

[20] 12 CFR 1263.6(c). The regulation does not define the term "mortgage-related assets."

[21] *See* 12 CFR 1263.7–1263.18. In the case of the "financial condition" requirement, there are two such sections—one (§ 1263.11) setting forth the specific criteria for insured depository institutions and another (§ 1263.16) setting forth the specific criteria for insurance companies and CDFIs. There are also separate sections setting forth specific criteria for determining all of the eligibility requirements for recently chartered insured depository institutions (§ 1263.14) and for determining some of the eligibility requirements for recently consolidated institutions of any type (§ 1263.15).

may be rebutted if the Bank obtains substantial evidence to the contrary.[22] Conversely, an applicant that does not meet the criteria of the more detailed provisions is presumed to be out of compliance with the corresponding statutory eligibility requirements. With respect to several of the requirements, the presumption of non-compliance can be rebutted if certain additional criteria are met.[23] However, the presumption of non-compliance arising from failure to meet the criteria for the "makes long-term home mortgage loans," and "10 percent" requirements (as well as the "duly organized" requirement) is conclusive and may not be rebutted.

In the case of the "10 percent" requirement, the regulation deems any insured depository institution to which that statutory requirement applies to have satisfied that requirement if, at the time of its application for Bank membership, its most recently filed regulatory financial report indicates that it has at least 10 percent of its total assets in "residential mortgage loans."[24] In contrast to the "10 percent" requirement, neither the Bank Act nor the regulation establishes a quantitative standard for determining compliance with the "makes long-term home mortgage loans" requirement. The regulation deems an institution to have satisfied that statutory requirement if, at the time of its application for Bank membership, its most recently filed regulatory financial report demonstrates that it originates or purchases long-term home mortgage loans.[25] The regulation does not specify the level of activity that is needed to meet the requirement. The membership regulation does not require a Bank to determine an institution's compliance with either the "10 percent" or "makes long-term home mortgage loans" requirement once that institution has become a Bank member.

B. FHFA's Review of the Membership Regulation

This final rule is one of the results of a continuing review of FHFA's Bank membership regulation that the Agency began in 2010. Most of the fundamental aspects of the existing membership regulation were adopted as part of two rulemakings undertaken by the Finance Board in the mid-1990s.[26] Although the membership regulation was subsequently amended several times (in some cases to make important substantive changes[27]), until 2010 there had been no comprehensive review of the regulation as a whole since it was amended to grant the Banks the authority to approve or deny membership applications in 1996. FHFA's decision to undertake such a review was prompted in part by the evolution of the financial services industry in the intervening years, which had given rise to a number of issues that the existing regulation either did not address or addressed inadequately. The goal of this review, which is ongoing, has been to determine whether the existing regulatory provisions continue to effectively implement the requirements of the Bank Act and the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (Safety and Soundness Act) and to fulfill the purposes underlying those requirements. FHFA has also sought to determine whether certain provisions that do not need substantive revision should nonetheless be revised to address questions that have arisen about their application, or simply to read more clearly or conform more closely to the style, structure and nomenclature FHFA now uses in its other regulations.

In December 2010, after FHFA had completed an initial review of the membership regulation, the Agency published an Advance Notice of Proposed Rulemaking (ANPR) in which it requested comments on a number of issues.[28] Primary among those issues was whether the existing regulation was effectively implementing the statutory "10 percent," "makes long-term home mortgage loans," and "home financing policy" eligibility requirements. The ANPR asked whether it would be appropriate to establish more objective and quantifiable standards for either of the latter two requirements and whether any or all of those requirements should be revised to explicitly apply on a continuing basis, rather than only at the time of admission to membership. The ANPR also requested comment on other issues, including whether, in light of FHFA's supervisory concerns about the acceptance of so-called "captive" insurers as members by several Banks, the Agency should amend the regulation to exclude such entities from Bank membership. FHFA received 137 comment letters in response to the ANPR, almost all of which opposed revising the membership regulation in any of the ways discussed in the notice. However, because very few of those letters provided detailed responses to the questions FHFA asked, the Agency continued to study the issues and ultimately decided to proceed with a Notice of Proposed Rulemaking (proposed rule).

C. The Proposed Rule

FHFA published a proposed rule in the **Federal Register** on September 12, 2014.[29] It proposed to make two fundamental changes to the Bank membership regulation, as well as several other substantive, but less fundamental, changes, and numerous non-substantive revisions to clarify various existing regulatory provisions.

First, the proposed rule would have revised the regulation to require that an institution hold at least one percent of its assets in home mortgage loans in order to be deemed to satisfy the statutory "makes long-term home mortgage loans" requirement and to require that each Bank member comply

[22] 12 CFR 1263.17(a).

[23] *See* 12 CFR 1263.17(b) through (f).

[24] The regulation defines the term "residential mortgage loan," which the statute does not define, to include generally all assets that qualify as home mortgage loans (*see* definition in footnote 25 below), regardless of whether the underlying loans are "long-term" or not, plus loans secured by junior liens on one-to-four family property or multifamily property, loans secured by manufactured housing, funded residential construction loans, and mortgage pass-through securities representing an ownership interest in, or mortgage debt securities secured by, any of those types of assets. 12 CFR 1263.1.

[25] 12 CFR 1263.9. The Bank Act defines the term "home mortgage loan" to mean "a loan made by a member upon the security of a home mortgage." 12 U.S.C. 1422(4). In turn, the statute defines the term "home mortgage" to mean a first mortgage, or its equivalent, upon real estate on which one or more homes or dwelling units are located. 12 U.S.C. 1422(5). The existing regulation supplements the statutory definition of "home mortgage loan" by defining the term generally to include any loan or interest in a loan that is secured by a first lien mortgage or any mortgage pass-through security that represents an undivided ownership interest in such loans or in another security that represents an undivided ownership interest in such loans. 12 CFR 1263.1. The regulation also defines the term "long-term," which the statute does not define, to mean "a term to maturity of five years or greater." *See id.*

[26] In 1993, the Finance Board adopted a new membership regulation in order to implement the revisions to the statutory membership requirements made by FIRREA in 1989. *See* 58 FR 43522 (Aug. 17, 1993). Most of the existing material addressing the general eligibility requirements (now located in § 1263.6), the stock requirements (§§ 1263.19–1263.23), and membership withdrawal, termination, and readmission requirements (§§ 1263.24–1263.30) was adopted at that time. A 1996 rulemaking made significant revisions and additions to the regulation in order to authorize the Banks to approve or deny all membership applications. *See* 61 FR 42531 (Aug. 16, 1996). Prior to that time, the Finance Board had the ultimate authority to approve or deny membership applications, although it had delegated some of that decision-making authority to the Banks in the case of institutions meeting certain "safe harbor" criteria. Most of the existing material regarding the application process (§§ 1263.2–1263.5) and the rebuttable presumptions that apply to the various eligibility requirements (§§ 1263.7–1263.18) were adopted as part of the 1996 rulemaking.

[27] For example, the regulation was amended in 2000 to implement the new statutory exemption of CFIs from the "10 percent" requirement, *see* 65 FR 13866 (Mar. 15, 2000), and in 2010 to implement the statutory amendments making non-depository CDFIs eligible for membership, *see* 75 FR 678 (Jan. 5, 2010).

[28] *See* 75 FR 81145 (Dec. 27, 2010).

[29] *See* 79 FR 54848 (Sept. 12, 2014).

with that "one percent" requirement and, where applicable, with the "10 percent" requirement on an ongoing basis as a condition of remaining a member. The proposed rule would have required each Bank to determine member compliance with those ongoing requirements annually, using data from members' regulatory financial reports where possible, to calculate the relevant ratios based on a three-year rolling average. Members found to be out of compliance with either requirement would have been given one year to return to compliance. As proposed, the rule would have required a Bank to terminate the membership of any institution that remained out of compliance for two consecutive years.

Second, the proposed rule sought to address the growing use of captive insurers as vehicles through which parent companies not meeting the membership eligibility requirements of the Bank Act could circumvent those requirements and gain access to low-cost Bank advances to fund their own operations and investments.[30] Several real estate investment trusts (REITs), which are not eligible for Bank membership, had established captive subsidiaries that became Bank members and then obtained advances that were disproportionately large in comparison with the investments and operations of the captives themselves, and additional REITs and other ineligible entities were seeking to do the same. This, combined with the facts that many of the parents were guaranteeing repayment of the advances made to their captive subsidiaries and providing the collateral for those advances, led FHFA to the conclusion that the real purpose of those arrangements was to provide the non-member REITs with access to Bank funding to which they were not legally entitled.

The proposed rule would have addressed this supervisory concern by defining the term "insurance company"—which is not defined in either the Bank Act or the existing regulation—to exclude captives, thereby rendering those types of entities ineligible for Bank membership. Specifically, the proposed rule would have defined "insurance company" to mean "a company whose primary business is the underwriting of insurance for nonaffiliated persons or entities." A typical captive, whose primary business is the underwriting of insurance for its parent company or for other affiliates, would not be included within the scope of the proposed definition of "insurance company." Because, as discussed above, the Bank Act and the membership regulation limit eligibility for Bank membership to institutions that qualify as an insured depository institution, a CDFI, or an insurance company, defining "insurance company" to exclude captives effectively removes such entities from among the types of institutions that may be eligible for membership.

Although the proposed rule would have made all captives ineligible for membership, it would have permitted any captive that had been admitted to membership prior to the publication date of the proposed rule to remain a member of its current Bank for five years following the effective date of the final rule. However, the rule would have capped the amount of advances that a Bank could have outstanding to such a member at 40 percent of the member's total assets and prohibited a Bank from making a new advance, or renewing an existing advance, with a maturity date beyond the five-year grace period. As proposed, the regulatory text would not have explicitly addressed the treatment of any captives that a Bank may have admitted to membership on or after the date on which the proposed rule was published. FHFA stated in the **SUPPLEMENTARY INFORMATION** to the proposed rule, however, that it would interpret the regulation to require the immediate termination of such captives' membership and the prompt liquidation of any outstanding advances.

The proposed rule also would have made several other substantive, but less fundamental, changes: (1) To expand the list of assets that qualify as "home mortgage loans" to include all types of mortgage-backed securities (MBS) (as opposed to only mortgage pass-through securities) that are fully backed by qualifying whole loans; (2) to require that a Bank examine an insurance company applicant's most recent audited financial statements in determining whether it meets the "financial condition" eligibility requirement; and (3) to revise the existing regulation and add a new provision addressing how a Bank should determine the "principal place of business" (and, therefore, the appropriate Bank district for membership) for insurance companies or CDFIs. In addition to those primary revisions, FHFA also proposed to make a number of conforming changes necessary to integrate the new requirements into the regulation and to make numerous non-substantive revisions to clarify various regulatory provisions.

D. Overview of Comments on the Proposed Rule

The proposed rule initially provided for a comment period of 60 days, but, in response to numerous requests, FHFA extended the comment period to 120 days.[31] The extended comment period closed on January 12, 2015, and FHFA received over 1,300 comment letters in response to the proposed rule. Nearly 60 percent of the comment letters came from bank and thrift institutions and related trade associations; about 12 percent came from credit unions and related trade associations. The remainder of the letters were from the Banks (all of which sent more than one letter), insurance companies, CDFIs, affordable housing agencies and organizations, various types of community support organizations, home builders, REITs, public officials, and others. About two-thirds of all letters were versions of one form letter template or another.

Few of the comment letters expressed support for any aspect of the proposed rule, and the vast majority expressed opposition to, or requested that FHFA withdraw, the entire rule. The most commonly expressed concerns arose from a belief that the rule, if implemented, would result in the Banks having fewer members on average and that this, in turn, would result in a reduction in their income. This, commenters contended, would compromise the Banks' ability to act as reliable sources of liquidity, inhibit their ability to carry out their housing

[30] A captive is a special-purpose insurer formed primarily to underwrite the risks of its parent company or affiliated companies. A typical captive resembles a traditional commercial insurance company in that it is licensed under state law, sets premiums and writes policies for the risks it underwrites, collects premiums, and pays out claims. The biggest difference between a captive insurer and a commercial insurance company is that a captive does not sell insurance to the general public. In 1972, Colorado became the first state in the U.S. to enact legislation recognizing and governing captives as a class of entity distinct from commercial insurance companies. To date, over 30 states and the District of Columbia have enacted such captives-specific statutes. Primarily because captives do not sell insurance to the general public, these state statutes establish standards for the formation, licensing, operation, and supervision of captives that are generally less onerous than either the state statutory regimes that apply to commercial insurance companies or the state and federal laws under which depository institutions are chartered, operated, and supervised. *See* Frank Seneco, Wesley Sierk & Evan Jehle, *Do-It-Yourself Insurance,* Private Wealth Magazine, July/Aug. 2014, at 21–22, *http://www.fa-mag.com/news/do-it-yourself-insurance-18548.html?issue=230* (last visited Dec. 8, 2015); *see also* National Association of Insurance Commissioners, Captive and Special Purpose Vehicle Use Subgroup of the Financial Condition Committee, *Captives and Special Purpose Vehicles—An NAIC White Paper* (June 6, 2013), *http://www.naic.org/store/free/SPV-OP-13-ELS.pdf* (last visited Dec. 8, 2015).

[31] *See* 79 FR 60384 (Oct. 7, 2014).

finance and community development mission, and reduce the amount of funds available for their Affordable Housing Programs and Community Investment Cash Advance programs. However, few of the commenters expressing these views provided factual support for their opinions or attempted to quantify the effects they believed the rule would have on the Banks' operations.

FHFA reviewed every comment letter and considered all of the comments in developing the final rule. The primary comments regarding each of the substantive aspects of the proposed rule, as well as FHFA's responses to some of those comments, are discussed immediately below. Comments addressing specific rule provisions are discussed in part III of this **SUPPLEMENTARY INFORMATION**, which describes the final rule in detail and the ways in which it differs from the proposed rule.

1. Comments on the Proposed Ongoing Asset Ratio Requirements

Over 800 of the comment letters addressed FHFA's proposal to measure compliance with the "makes long-term home mortgage loans" requirement based on a quantitative standard and to apply that quantitative requirement to members on an ongoing basis. Over 600 of the letters addressed the proposal to apply the "10 percent" requirement to members on an ongoing basis. Almost all of the commenters addressing those proposals were opposed to the proposed revisions. Approximately 66 percent of those opposed to the ongoing quantitative "makes long-term home mortgage loans" requirement and approximately 51 percent of those opposed to the ongoing "10 percent" requirement stated that managing their balance sheets for compliance would hinder members' business by putting them in the position of choosing between optimal balance sheet management and continued access to their Banks as a source of liquidity. About half of the commenters opposed to the proposed revisions stated that members would be harmed by losing membership in the Bank System and about half also cited concerns regarding the additional regulatory burden on members.

As further objections to the proposal, commenters also stated, among other things, that the proposal would create a significant operational burden on the Banks because the member financial information required to determine compliance with the ongoing requirements is not perfectly aligned with specific call report line items; the proposal would provide little or no benefit to the Bank System; members could never be certain that FHFA would not increase the quantitative requirements in the future; the proposed ongoing requirements would reduce membership levels at the Banks; the current regulations and collateral requirements already ensure that members maintain a nexus to the Banks' housing finance mission; the proposed ongoing requirements have no foundation in the Bank Act or its legislative history; and the requirements do not take into account that financial services organizations are often structured such that they hold mortgages and mortgage securities in various entities within their corporate organization for a range of business reasons.

Commenters also expressed concerns specific to the proposal to make the "10 percent" requirement ongoing, including that CFIs with total assets approaching the CFI threshold amount might forego acquiring another institution or reduce other activities that could grow their business solely because doing so would push their asset size above the CFI threshold and thus make them immediately subject to the "10 percent" requirement. In addition, some commenters expressed concern that, because the Bank Act does not exempt smaller credit unions from the "10 percent" requirement as it does for small banks and thrifts, the proposed changes would impose a disproportionately greater compliance burden on small credit unions than they would on small banks and thrifts.

Having reviewed all of the comment letters addressing the proposed ongoing asset ratio requirements, FHFA has decided not to include those revised requirements in the final rule. The Agency's research indicates that over 98 percent of current members likely would be in compliance with both proposed requirements (as applicable). This suggests that, for the time being, FHFA can address its supervisory concerns about members abandoning their commitment to housing finance by continuing to monitor the levels of residential mortgage assets held by members.

FHFA also recognizes that establishing a system to monitor members' compliance with the proposed ongoing asset ratio requirements could pose an additional incremental burden on the Banks and their members, particularly on members whose asset ratios are close to the required minimums. FHFA also carefully considered the comments received from the credit union industry, which contended that the proposed ongoing "10 percent" requirement would impose a disproportionate burden on small credit unions because they cannot qualify as CFIs. That view is consistent with the Agency's recent research, which indicates that, of the current members that would not meet an ongoing "10 percent" requirement, about 68 percent of them would be small credit unions.

Although FHFA has determined not to adopt the ongoing asset ratio requirements as part of the final rule, the Agency believes that members' ongoing commitment to housing finance is important to ensuring fidelity to the Bank Act and the purposes for which the Bank System was established and that the issue warrants continued monitoring going forward. FHFA therefore will continue to monitor this issue carefully and may revisit the issue in the future should its monitoring reveal a need for further action. Any such action would be undertaken through a separate rulemaking, with prior notice to, and an opportunity for comments from, all interested parties.

2. Comments on the Proposed Exclusion of Captives From Membership

About 400 of the comment letters addressed FHFA's proposal to exclude captives from Bank membership to some degree, with about 60 of those letters treating the issue in some depth. Almost all of the letters expressed opposition to all aspects of the captives proposal and none expressed support for the overall proposal. Almost all of the commenters' specific arguments in opposition to the captives proposal fell into two general categories: (1) That FHFA does not have the legal authority to implement the proposal; and (2) that the proposal is flawed from a policy perspective. Many commenters included arguments falling into both categories in their letters.

A few of the comment letters expressed no opposition to the proposal, but suggested some clarifying textual revisions. One commenter explicitly supported the idea of excluding REIT-controlled captives from membership, stating that, because REITs are uninsured, they pose "unnecessary risks" to the Bank system and, because REITs already benefit from tax preferences, it is questionable public policy to allow them access to the lower cost funding the Banks provide. However, that commenter was opposed to the exclusion of captives controlled by other types of entities.

a. Comments on FHFA's Legal Authority To Implement the Captives Proposal

Commenters who expressed legally based objections to the captives proposal made three types of arguments in support of those objections: (1) FHFA lacks the legal authority to define the term "insurance company" to exclude captives; (2) irrespective of its general authority, FHFA cannot legally exclude all captives from membership as proposed because the proposal lacks a factual basis, arbitrarily singles out captives, or is overly broad; and (3) in any event, FHFA lacks the legal authority to terminate or require termination of a captive member. These three general categories, including most of the specific legal arguments offered within those categories, are addressed in turn below.

The general legal argument expressed most frequently in the comment letters was that FHFA lacks the legal authority to define the term "insurance company" to exclude captives. Many commenters stated that, because "insurance company" is not defined in the statute, the term must be given what they believe to be its plain meaning—*i.e.*, that a captive must be considered to be an "insurance company" under the Bank Act, apparently because it is chartered or licensed under state insurance laws. Because a captive is considered to be an "insurance company" under the laws of the states that have captive insurance statutes, these commenters argued, FHFA has no authority to interpret the term any differently for purposes of the Bank Act, and thus cannot exclude captives from the category of "insurance company" as used in the Bank Act. In support of this argument, several commenters specifically cited the federal McCarran-Ferguson Act,[32] which reserves to the states the authority to regulate and tax the business of insurance, except in cases where Congress has adopted a statutory provision that explicitly provides otherwise.

Numerous commenters argued that FHFA's proposal to define "insurance company" to exclude captives from membership is outside the Agency's authority because it runs contrary to Congress's clear intent regarding the meaning of the term and the scope of Bank membership. In this vein, many cited the fact that the Bank Act provides that "any" insurance company may be eligible for membership as evidence of Congress's unambiguous intent to prohibit the Bank System regulator from narrowing the scope of the term to exclude any entity chartered as any type of insurance company. Others disputed FHFA's assertion in the proposed rule that in 1932 Congress could not have contemplated that the term "insurance company" would include captives because they did not exist at that time. These commenters contended that the concept of "self-insurance" has existed for hundreds of years and that other types of self-insurance vehicles did exist in 1932, although they were not at that time referred to as "captives." Several commenters also noted that Congress has never acted to exclude captives from membership, despite the fact that an increasing number of states have adopted captive insurance statutes since the first such statutes were enacted domestically in the 1970s. Finally, many commenters cited Congress's decision to extend eligibility for Bank membership to commercial banks and credit unions in 1989 and to CDFIs in 2008 as evidence of its intent to effect "an inclusive and expansive approach" to membership and characterized FHFA's attempt to exclude captives from membership as running counter to that intent.

In addition to the broader assertions that FHFA lacks any authority to interpret the scope of the term "insurance company" as not including captives, numerous commenters argued, more narrowly, that the Agency cannot legally implement the specific approach set forth in the proposed rule because it lacks any factual basis to justify that approach. Many of the commenters advancing such arguments mischaracterized the Agency's proposal to exclude captives as being based primarily on either safety and soundness concerns or a view that captives (or their parents) do not support housing finance. Those making such mischaracterizations asserted, and in some cases cited specific evidence, that the assumptions underlying those purported bases are erroneous. Others, who correctly characterized FHFA's primary goal as being to prevent the circumvention of the statute by ineligible entities, such as REITs, that have formed captives for the express purpose of gaining access to Bank funding to which they are not legally entitled, argued that the proposed rule provided no evidence to show a factual basis for those concerns.

Some commenters argued that, even if FHFA has a legitimate factual basis for its concerns regarding the ability of ineligible entities to obtain indirect access to Bank funding through eligible subsidiaries, the Agency's decision to focus only on the exclusion of captives in the proposed rule is arbitrary because it disregards the possibility that other types of members could be utilized for a similar purpose.

While commenters advancing the foregoing argument asserted that the proposed prohibition would be too narrow, others asserted that it would be overly broad. Commenters taking the latter view contended that, if FHFA wishes to prevent entities that are not eligible for Bank membership from using captives to access Bank funding, then it should exclude from membership only captives that are owned by ineligible entities or, even more narrowly, only captives that FHFA has determined are actually being used as a funding conduit for an ineligible parent.

Finally, a number of commenters, while not conceding that FHFA has the authority to prevent the Banks from accepting captives as new members going forward, argued specifically that the Agency may not terminate, or require the Banks to terminate, captives that have already been approved for membership under the existing regulations. In support of this contention, several commenters noted that, while the Bank Act at one time explicitly authorized the Bank System regulator to require a Bank to terminate a member in certain circumstances, Congress removed this explicit authorization in 1999.

Another commenter who focused on FHFA's comments in the proposed rule **SUPPLEMENTARY INFORMATION** regarding the possibility that captive membership may pose unique safety and soundness issues asserted that those concerns could not serve as a basis for requiring the termination of captive members until the Agency had taken the steps required by section 8 of the Bank Act.[33] Specifically, the commenter asserted that section 8 of the Bank Act requires FHFA, if it believes that any of the state laws under which captives are regulated give rise to safety and soundness concerns, to undertake a study of those laws and that only after concluding that a state's laws fail to provide adequate protection to the Banks may FHFA restrict the membership of otherwise eligible members in that state.

One commenter asserted that termination of existing captive members would give rise to a "takings" claim against the United States in that it would deprive former captive members of their right to a pro rata share of the retained earnings of their former Banks and of access to Bank advances and other products and services without adequate compensation. The commenter

[32] 15 U.S.C. 1011–1015.

[33] 12 U.S.C. 1428.

argued that, therefore, such termination is prohibited under a ruling by the U.S. Court of Appeals for the D.C. Circuit that no federal agency may adopt a rule that would give rise to a "takings" claim against the United States unless it is expressly authorized it to do so by statute.[34]

b. Comments Asserting That the Proposal Is Flawed From a Policy Perspective

While many of the commenters did not address FHFA's legal authority to implement the proposed exclusion of captives from membership, almost all of the commenters asserted that doing so would represent a poor policy choice. The arguments made in support of commenters' policy-based objections focused primarily on issues of (1) safety and soundness, (2) mission achievement, and (3) the financial health of the Banks, their members, and the overall residential mortgage market.

Again focusing on FHFA's comments regarding the possibility that captive membership may pose unique safety and soundness issues, numerous commenters argued that captives do not pose safety and soundness risks that are materially greater than or different from those posed by other types of members. These commenters offered a number of contentions in support of this argument, including that captives are subject to regulatory regimes that are generally the same as those that apply to traditional insurers and are supervised in a similar fashion; captives have a lower rate of insolvency and default than traditional insurers because they tend to be over-capitalized and operated conservatively so as to ensure that they will be able to pay the claims of their owners; and Banks have been admitting captives as members for over 20 years and have experienced no losses on advances to captive members. Other commenters asserted that to the extent that captives may present unique safety and soundness concerns, those concerns can be addressed with more targeted requirements, such as requiring captive members to meet special seasoning requirements, minimum capital levels, or maximum leverage ratios. Still others contended that the Banks already have sufficient processes and procedures to manage any additional risk that captives may pose.

Many commenters urged FHFA to continue to allow captives—particularly those controlled by REIT parents—to be admitted to Bank membership, stressing that mortgage REITs' substantial commitment to the residential mortgage market in the U.S. is consistent with the mission of the Banks. Going further, many argued that, contrary to the approach taken in the proposed rule, FHFA should actually encourage membership approval for REIT-controlled captives as a means of increasing the level of private capital in the residential mortgage market. Several of these commenters asserted that the collateral requirements applying to Bank advances would tend to dissuade entities whose business practices are not consistent with the housing finance mission of the Banks from forming captives in order to gain access to Bank advances.

A number of commenters argued that FHFA offered no analysis of the financial impact the proposed exclusion of captives would have on the Banks and their members. Many commenters noted that the Bank System benefits from a diverse and robust membership and asserted that eliminating one class of existing and potential members would result in lost income for the Banks now and in the future. At least one commenter asserted that, for certain Banks, the financial impact of the proposal could be so significant as to jeopardize their independent status, thereby forcing them to consolidate with other Banks. Many commenters pointed out that any action that might reduce the income of any Bank to any extent would necessarily reduce the amount of funds available for those Banks' Affordable Housing Programs (AHP) because the statute requires 10 percent of a Bank's earnings to be dedicated to its AHP.

In addition to the predictions of negative consequences for the Banks and their members, a number of commenters asserted that preventing mortgage REITs and similar companies from accessing Bank funding through captive subsidiaries would have negative consequences for the overall residential mortgage market. Noting that the long-term and reliable nature of Bank funding assists in reducing the likelihood that mortgage market crises will occur and in mitigating such crises when they do occur, several of these commenters argued that preventing captive parents from accessing that funding could increase instability in the residential mortgage market by reducing liquidity and curtailing the availability of long-term funding.

c. Comment Letters Suggesting Alternative Approaches

A number of commenters suggested alternative approaches to address what they perceived to be FHFA's concerns regarding captives that would be less severe than the outright exclusion of all captives from Bank membership.

Several commenters that believed FHFA's concerns to be primarily related to safety-and-soundness or mission achievement issues suggested that the Agency could address these concerns by adopting borrowing, financial condition, or mission standards to apply specifically to captives (or, in some cases, to insurance companies generally). For example, one commenter suggested that FHFA could require ongoing periodic reporting to the Bank of information that would allow it to adequately assess the financial health and investment strategies of, and other risk metrics pertaining to, both the captive and its parent; apply a more stringent mission test to potential captive members and their parents using asset or income tests; or require that all collateral pledged by captives or their parents to secure advances be real estate related.

Commenters that more appropriately focused on FHFA's primary concern—the misuse of the captive vehicle by non-eligible entities—stated that FHFA should prevent those practices specifically, without excluding all captives from membership. For example, some suggested that the final rule allow captives with a parent or affiliate that is itself eligible for Bank membership to remain eligible. One such commenter favored the use of captives to allow parent companies that are themselves eligible for membership ("particularly . . . institutions that now have substantially higher liquidity requirements than in the past") essentially to become members of more than one Bank, which the commenter asserted "would not only help to serve the industry's liquidity needs, but would reduce the concentration risk posed by large institutions belonging to only one or two [Banks]."

Other commenters suggested that the final rule exclude from membership only captives that FHFA or the Banks have determined are owned by non-eligible entities that are using or have used those captives as conduits to receive Bank funding for their own use. Those commenters did not provide much detail as to how that would be accomplished, although one suggested that FHFA itself should review captives' applications for Bank membership in order to determine the purpose behind each application. Finally, one commenter, who asserted that FHFA "is not well informed about captives," suggested that the Agency should "increase its knowledge in this area and find ways to address issues raised in the

[34] *See Bell Atlantic Tel. Cos.* v. *FCC*, 24 F.3d 1441, 1445–46 (D.C. Cir. 1994).

[proposed rule] by participating in a task force with insurance regulators and others in the captive insurance industry."

d. Results of FHFA's Review of Comments on the Captives Proposal

FHFA has reviewed all of the comments regarding its proposal to exclude captives from Bank membership and has studied especially closely the considered opinions of those commenters that addressed the issue in depth. After giving careful consideration to all of the viewpoints expressed, the Agency has decided to finalize the captives provisions essentially as proposed, albeit with some minor modifications to the transition provisions. The final provisions, the reasons FHFA has decided to adopt them, the bases for FHFA's conclusion that it possesses the authority to adopt those provisions, and the Agency's responses to the points raised in the comment letters are all discussed in detail in parts II and III of this **SUPPLEMENTARY INFORMATION**.

3. Comments on the Other Substantive Proposed Revisions

About 80 commenters addressed the proposal to require a Bank to obtain and review an insurance company applicant's most recent audited financial statements in determining whether it meets the "financial condition" eligibility requirement. Nearly all of the commenters opposed the inclusion of that requirement in the final rule. Most of those commenters based their objections on the assertion that the requirement would be burdensome for insurance companies—especially those that are not required by law to have their financial statements reviewed by an outside auditor. FHFA has considered these concerns, but has decided to include the requirement, as proposed, in the final rule.

The Agency recognizes that there are costs associated with obtaining audited financial statements. It also believes, however, that there are significant benefits to the Banks from being able to rely on financial statements that have been audited by a third party, particularly when assessing an insurance company's financial condition prior to admitting it to membership, which is the only time at which this requirement will apply. Even with this additional requirement, the financial information that insurance company applicants will be required to provide to the Banks will be far less than the financial information that insured depository institution applicants must provide.

About 80 of the comment letters addressed the parts of the proposed rule that would have amended the regulations governing how an institution's principal place of business is to be determined which, in turn, dictates the Bank it may join. The proposal included one provision specific to insurance companies and CDFIs, which would have required a Bank to use objective factors to identify the geographic location from which an insurance company or CDFI conducts the predominant portion of its business operations. The proposal also would have revised the general provision, which presumes the location of an institution's "home office" to be its principal place of business, by adding a requirement that the institution actually conduct business from its home office in order to benefit from that presumption. The effect of that revision would have been to prevent a Bank from relying solely on an institution's state of domicile or incorporation as the principal place of business for Bank membership purposes.

Most of the comments focused specifically on the effect the proposed revisions would have on insurance companies.[35] Almost all of those commenters (with the exception of a few of the Banks, as discussed below) opposed the proposed revisions and stated their preference that the final rule should instead provide that an insurance company's principal place of business shall in all cases be its state of domicile (*i.e.*, the state in which it is chartered). The commenters preferred the latter approach to the standard set forth in the proposed rule because they believed that it would be simpler to apply and would ultimately impose less burden on both the Banks and state insurance regulators. In other words, under a state of domicile standard each Bank would then need to deal only with the insurance regulators and insurance laws of the states within its district, and each insurance regulator would then need to establish a working relationship only with its local Bank.[36]

[35] One comment letter addressed the issue specifically as it relates to CDFIs and expressed support for the approach taken in the proposed rule.

[36] FHFA expects each Bank to communicate regularly with the regulator for each of its insurance company members and to be thoroughly familiar with the state insurance laws that apply to each of those members. *See* FHFA Advisory Bulletin AB 2013–09, *Collateralization of Advances and Other Credit Products to Insurance Company Members* (Dec. 23, 2013). Regardless of where an insurance company may be licensed to do business or where it carries out its back office operations, it is regulated and supervised by the insurance regulator of its state of domicile under the laws of that state.

Although there may be some practical benefits to using the state of domicile as a proxy for an institution's principal place of business, the core question is whether such an approach would be consistent with the requirements of the Bank Act. FHFA has previously determined that the term "principal place of business" contemplates a physical location at which a company conducts the predominant portion of its business activities, and that a "presence" that is legal only, without any actual business activity, falls short of what the Bank Act requires. While the state laws under which insurance companies and CDFIs are chartered typically require companies to provide an in-state address for service of legal notices or for other purposes, those laws do not necessarily require a company to maintain any kind of business presence in the state. It is possible, then, that an insurance company or a CDFI may not conduct *any* of its business in its state of domicile. To amend the regulation, as the commenters suggest, to provide that the principal place of business of an insurance company or CDFI is in all cases to be its state of domicile would allow for the possibility that a Bank member's principal place of business could be a location at which it actually has *no* place of business. Such a result would not comport with FHFA's view of the term "principal place of business" and thus would not be consistent with the requirements of the Bank Act.

II. Treatment of Captive Insurers Under the Final Rule

FHFA has carefully considered the thoughts and opinions expressed in the comment letters and thoroughly analyzed possible alternative means of addressing its concerns about the use of captive insurers by entities not eligible for Bank membership to gain access to Bank advances. Having done so, the Agency has decided to include in the final rule, with some modifications, the provisions excluding captives from Bank membership and requiring the Banks, after a transition period, to terminate the membership of all captives that were admitted under the existing regulations. As proposed, the final rule defines "insurance company" to exclude captives, thereby making them ineligible for Bank membership.

These provisions of the final rule address FHFA's supervisory concerns about the ability of entities ineligible for Bank membership (including mortgage REITs and other entities) to circumvent the Bank Act and obtain *de facto* Bank membership through captive subsidiaries that become members and then act as conduits to low-cost Bank funding for the ineligible entity. The use of captives for this purpose under the existing regulation has grown dramatically in recent years, and has continued since the publication of the proposed rule. FHFA has well-founded concerns that this use of captive subsidiaries is open to multiple types of ineligible entities such as equity REITs, hedge funds, investment banks, and finance companies and that the practice may spread to those and other types of ineligible entities once they become aware of the advantages of gaining *de facto* Bank membership through such arrangements. As regulator of the Bank System, FHFA is responsible for ensuring the effective implementation of the provisions and purposes of the Bank Act. That responsibility includes ensuring that only entities eligible for Bank membership obtain the benefits of membership. FHFA is fulfilling that responsibility by including in this final rule provisions intended to prevent further use of captives to circumvent the membership eligibility requirements of the Bank Act.

Like the proposed rule, the final rule also sets forth a transition provision permitting captives that became members prior to the publication date of the proposed rule to remain members for five years after the effective date of the final rule, but limiting their outstanding advances to 40 percent of their assets and, while permitting new advances below the 40 percent threshold, prohibiting new advances or renewals that mature beyond the five-year transition period. The final rule also contains an additional transition provision, not included in the proposed rule, to address the treatment of captives admitted to membership on or after the date of publication of the proposed rule. This provision permits any Bank that has admitted such captives one year following the effective date of the final rule within which to terminate the membership of those captives. The rule allows such captives until the end of that one-year period (or until the date of termination, if earlier) to repay their existing advances, but prohibits them from taking new advances or renewing existing advances that expire during that grace period.

In reaching its decision to include these provisions in the final rule, FHFA gave due consideration to the fact that the vast majority of commenters addressing the proposed exclusion of captives from membership objected to that aspect of the proposed rule. Ultimately, however, the volume of adverse comments does not drive FHFA's policy determinations, particularly in this case, where FHFA has found significant evidence that REITs and other entities have been forming captives solely for the purpose of providing ineligible institutions access to Bank advances.

FHFA carefully considered the merits of the opinions expressed and assertions made by commenters, including from those commenters that provided verifiable information that the Agency could assess as part of the rulemaking process. The arguments taken as a whole did not persuade the Agency that the existing statute should be applied to allow admission of captives to membership. The policy reasons behind FHFA's decision to include the captives provisions in the final rule, the legal bases for including those provisions, and the Agency's responses to a number of specific comments are set forth in detail below.

A. Policy Reasons for Excluding Captives From Bank Membership

1. Until Recently, Only a Few Captives Had Become Bank Members, and Most of Those Had Parents or Other Affiliated Entities That Were Eligible To Be Bank Members Themselves

As mentioned above, the Bank Act provides that, in addition to insured depository institutions and CDFIs, "any . . . insurance company" shall be eligible to become a member of a Bank if it meets the applicable requirements. The Bank Act does not define "insurance company," and neither FHFA nor its predecessor agencies had previously adopted a regulatory definition of that term. Consequently, as a practical matter, any entity chartered or licensed as an "insurance company" under state law and that has met the other applicable requirements historically has been permitted to become a Bank member. Because captive insurers are chartered or licensed as insurance companies under the laws of states that have enacted captive insurance statutes, a number of those types of entities have been permitted to become Bank members under the existing membership regulation.

Although a Bank first admitted a captive to membership over twenty years ago, until recently Banks had accepted very few captives. The first captive to be admitted became a member in 1994. In the ensuing years, up until mid-2012, no more than eleven additional captives joined the Bank System. Most of the captive members that were admitted during that time period have parent companies that either are themselves eligible to be Bank members or are holding companies that own another eligible entity.

2. Recently, There Has Been a Dramatic Increase in Captive Members and Applicants, Almost All of Which Are Controlled by Ineligible Entities Seeking Access to Bank Funding

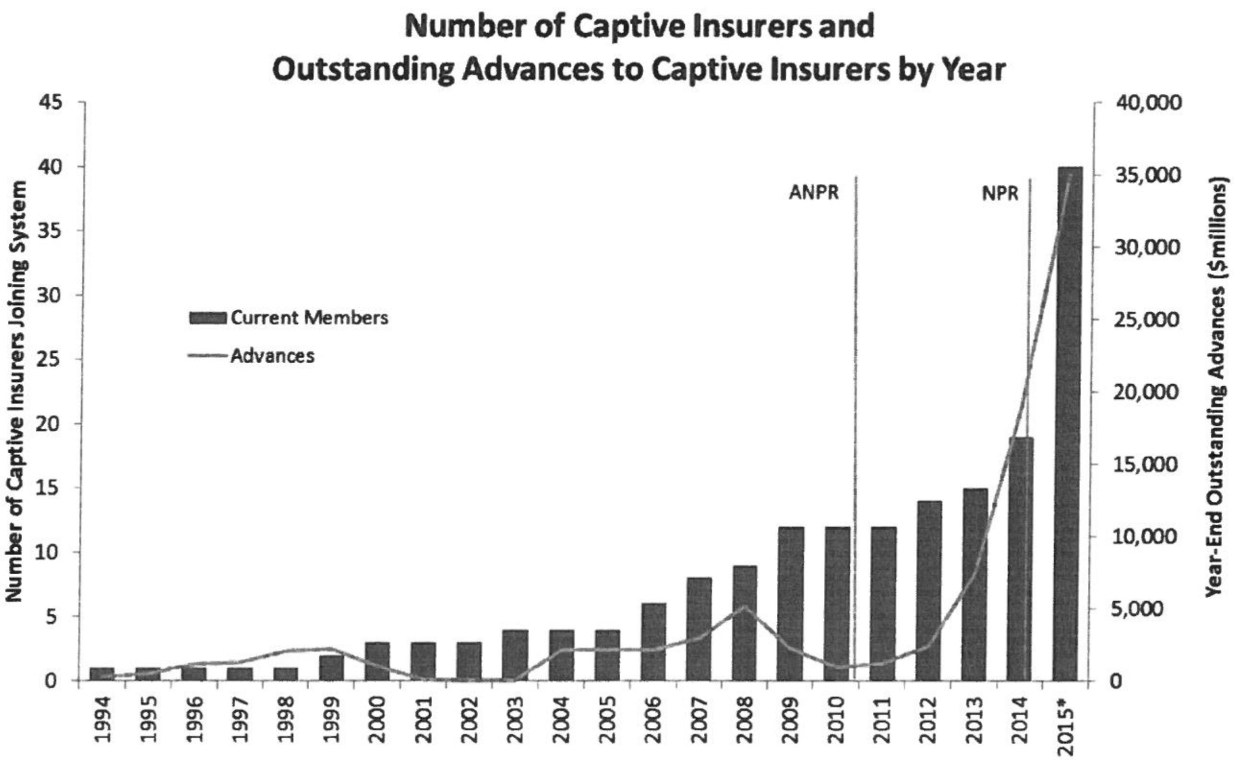
Over the last several years, however, new captive members and membership applications by captives have shown a significant and accelerating increase. Since mid-2012, the Banks have admitted 27 new captive members, 25 of which are owned by mortgage REITs, finance companies, and other types of entities that are not themselves eligible for membership. Twenty of those 25 have become members since the publication of the proposed rule in September of 2014. This trend has become a matter of growing concern to FHFA, as it has become increasingly clear that captives are being promoted and used as vehicles to provide access to Bank funding and to other benefits of membership for institutions that are legally ineligible for membership. The Banks that have accepted these captive members have based their approvals on the financial strength of the parent and not the captive itself and have projected a level of advances activity that is disproportionately large in relation to the captives own business operations and related investment needs. In many cases (although, to date, not all), captive members have fulfilled the projections reflected in the membership digests by maintaining disproportionately large levels of outstanding advances, almost all of which have been secured by collateral provided by the parent. As a result of these developments, FHFA sees a current need to define "insurance company" in a manner that will prevent the creation of such *de facto* membership arrangements.

The information contained in the membership application digests prepared by the Banks in connection with the admission of most of those captive subsidiaries supports a conclusion that they applied for membership—and, in fact, were established—for the primary purpose of accessing Bank funding for their parents' business needs; they did not seek membership to obtain support for their own operations or investments.[37]

[37] The regulations require that a Bank "prepare a written digest for each applicant stating whether or not the applicant meets each of the [applicable membership eligibility requirements], the Bank's findings, and the reasons therefor." *See* 12 CFR 1263.2(b). Since September 2012, FHFA has had a special data request in place pursuant to which it has received from the Banks the membership digests for each new insurance company and CDFI

As an initial matter, those digests indicate that all but one of the 25 captive members owned by a REIT or similar ineligible entity were *de novo* entities at the time they applied for membership; at least 20 of the 25 had been chartered within the preceding six months and all but one of the remaining five had been chartered within the preceding 12 months. The digests also show that the dollar amounts of anticipated advances to be made to most of those captives are grossly disproportionate to the amount of insurance business underwritten by the captive, contemplate that the parents will provide both the collateral and a guaranty for the captives' debt, and, in some cases, acknowledge that the captives will use the advance proceeds to make loans to their parents. The Banks themselves recognized the conduit nature of these captives by basing their assessment of the financial condition of their new captive members, and the amount of advances they may obtain, on the financial resources of their parents, rather than on the captives themselves.

The chart below illustrates the recent dramatic increases in the number of captive members and in the amount of advances outstanding to captive members.



* For 2015, number of captive insurers is as of September 30, and amount of outstanding advances to captive members is as of November 13.

member approved during that time period. *See* FHFA Special Data Request SDR 2012–02, "Membership Decision Documentation for New Insurance Company and CDFI Members" (Sept. 17, 2012).

3. There Are Currently Ongoing Efforts To Encourage Ineligible Entities To Use Captive Subsidiaries as a Means of Accessing Low-Cost Bank Funding

Numerous public statements made by captive management companies and consultants, insurance regulators, and the parent companies themselves tend to confirm that almost all of the captives in the recent wave of new members and applicants were established and applied for membership for the purpose of providing their ineligible parents with access to Bank funding and other benefits of membership. For example, Marsh & McLennan (Marsh), a firm that characterizes itself as "the world's leading captive manager," published an article in its quarterly newsletter in early 2014 stating that it had been working with REIT clients since the summer of 2013 "to create captives for the purpose of accessing funding with the Federal Home Loan Bank system" and advertising that "low-cost funding" obtained from a Bank through a captive subsidiary can allow a REIT parent to "increase leverage and improve liquidity at attractive rates." [38] After noting that captives were being formed in two particular states to permit access to the two Banks in whose respective districts those states lie, Marsh concluded by stating that its captive advisory team "is likely to begin forming captives in other domiciles to access additional branches of the [Bank System]." It is clear from that article, as well as from a contemporaneous Marsh report containing similar statements,[39] that the firm is not encouraging existing captives to become Bank members to obtain funding for their own investments and operations, but is instead encouraging REITs and possibly other ineligible entities to create new captives to use as conduits to low-cost Bank funding for their own operations.

At around the same time that Marsh published those materials, another firm, Willis Group Holdings PLC (which describes itself as "a leading global risk advisor, insurance and reinsurance broker") published a brochure on its Web site entitled "Joining the Federal Home Loan Bank Offers Significant Advantages for Captive Owners, Including Low Interest Loans and Letters of Credits [sic]." [40] After describing how the firm had "experienced a significant increase in existing and prospective captive owners looking to join [a Bank] via a captive subsidiary" and summarizing the benefits of Bank membership, the brochure concludes by encouraging "[p]rospective members [to] contact Willis or the regional [Bank] to discuss the prospect of their captive joining the [Bank]."

Even state insurance regulators have been publicly extolling the advantages a company can enjoy by having a captive subsidiary become a Bank member. For example, a recent article that focused on the formation of so-called "831(b) captives" quoted one state's regulator as remarking that such captive entities can be "a portal for membership" in the Bank System.[41] In the same vein, several of the mortgage REITs that commented on the proposed rule revealed their intentions regarding their captive subsidiaries by advocating "access by mortgage REITs" to the Bank System, describing the proposed rule as "[d]enying access to [Bank] funding for a mortgage REIT," or making similar statements.

4. Captives Are Uniquely Suited To Act as Conduits for Accessing the Bank System

Among the types of institutions that, to date, have been considered eligible for Bank membership, captive insurers are uniquely suited to act as conduit vehicles for business entities that wish to gain access to the Bank System, but that are ineligible to become members in their own right. Because captives are self-insurance mechanisms and typically do not sell insurance policies to the public at large, it is generally far easier and less expensive to charter, capitalize, and operate a captive than to establish and operate a traditional life or casualty company that sells policies to the public.[42] This was cogently explained by the captive regulator of one of the leading domestic captive domiciles in a response to a "Frequently Asked Question" (FAQ) appearing on its official Web site. There, the regulator noted that, while "[c]ommercial insurance companies sell insurance to the general public and are licensed in all states in which they do business," captives by contrast "directly insure only their owners," are "licensed in only one state, and operate[] under the captive insurance law of that domicile." Because of those differences, the regulator explained, "the degree of regulatory oversight required for captives is less than that which is required for commercial insurers."

Despite the fact that captives are already easier to establish and more lightly regulated than commercial insurance companies, the competition among states to attract businesses to organize captive subsidiaries in their respective borders is leading some states to amend, or modify the manner in which they apply, their captive laws to further reduce the regulatory burdens in relation to those imposed by other states. In a recent report prepared by a state insurance regulator that was required by statute to study the advisability of establishing a captive insurer industry in that state, that regulator recommended that the state's legislature "forgo captive legislation at this time" in part because "the industry has developed in ways that have caused considerable regulatory concern at the federal and state levels." The report explained, "To become a thriving captive domicile today, a state must be willing to relax important regulatory

[38] *See* Marsh & McLennan Companies, *Using Captives to Access Federal Home Loan Banking System Funding*, Marsh Insights: Captives (Mar. 2014) at 5, *http://usa.marsh.com/Portals/9/Documents/6454MA14-12785CAPNewsletter03-2014.pdf* (last visited Dec. 8, 2015).

[39] *See* Marsh & McLennan Companies, *The Evolution of Captives: 50 Years Later (Annual Captive Benchmarking Report)* (May 2014) at 2, 5.

[40] Willis Group Holdings, *Joining the Federal Home Loan Bank Offers Significant Advantages for Captive Owners, Including Low Interest Loans and Letters of Credits*, Willis Global Captive Management Alert (Apr. 2014), *http://www.willis.com/documents/publications/services/captives/20140426_50294_PUBLICATION_Global_Captive_Management_Alert_FINAL.pdf* (last visited Dec. 8, 2015).

[41] *See* Caroline McDonald, *Steady As She Goes: 2014 Domicile Captive Review*, Risk Management (Aug. 1, 2014), *http://www.rmmagazine.com/2014/08/01/steady-as-she-goes-2014-captive-domicile-review/* (last visited Dec. 8, 2015). An "831(b) captive," sometimes referred to as a "microcaptive," is a captive that does not underwrite life insurance and that generates annual premiums of $1.2 million or less. Under section 831(b) of the Internal Revenue Code, such an entity can elect to pay federal income tax based only on its investment income instead of on its taxable income as a corporation. 26 U.S.C. 831(b). The use of 831(b) captives by individuals and businesses has drawn close scrutiny from the Internal Revenue Service in recent years.

[42] *See* Daniel Schwarcz, *A Critical Take on Group Regulation of Insurers in the United States*, 5 U.C. Irvine L. Rev. 537, 555 (Aug. 2015) (stating that captives have typically been viewed "as presenting limited regulatory concerns" due to their status as self-insurance mechanisms and that "[a]s a result, captives are subject to very limited regulatory restrictions: Their financial statements are not publicly available, they do not have to comply with statutory accounting rules and the associated reserve requirements, and they generally are not subject to standard risk-based capital requirements"). One state insurance regulator, in reporting to the state legislature on the desirability of enacting insurance legislation specific to captives, stated that a captive "is not regulated like an admitted insurance carrier, but operates under relaxed rules governing the captive's formation, capitalization, and solvency." In noting in this Supplementary Information the differences between the regulation of captives and the other types of institutions that have, to date, been considered eligible for Bank membership, FHFA is not expressing any judgment as to the adequacy of captive regulation generally or in any particular state with a captive statute, for purposes of the limited businesses for which captives are organized.

safeguards. Attractive new domiciles are those that have a high risk appetite, demand few hurdles to formation, have low premium taxes and fees, have minimal solvency and capital requirements, and require little in the way of reporting." [43]

The competition between states is further evidenced by a proliferation of press releases from state insurance regulators touting their selection as, or nomination for, a "U.S. captive domicile of the year" award that is bestowed annually by a major captive industry magazine. For example, one state regulator noted in a press release regarding its selection as a finalist for the 2015 award that, after having twice amended its captive laws in recent years, the state had "positioned itself to become a preferred domicile to companies seeking a sophisticated regulatory infrastructure." An article in the sponsoring magazine announcing the winner of the 2015 award (which, ultimately, was not the state regulator that issued the above-quoted press release) stated that its judges selected the announced winner in part because, "despite being an established jurisdiction, [the victorious domicile] continues to review its statute on an annual basis to ensure it continues delivering efficiency and value." [44]

The same characteristics that make captives far more viable than traditional insurance companies to use as vehicles for achieving *de facto* Bank membership also set them apart from insured depository institutions in that respect. Given the many obstacles to obtaining a commercial bank, savings and loan, or credit union charter,[45] as well as the comprehensive systems of prudential regulation and supervision to which those types of institutions are subject, FHFA must regard as highly improbable the prospect of an ineligible entity chartering a depository institution for the primary purpose of providing itself with *de facto* Bank membership. FHFA is unaware of a single instance of such an occurrence in the history of the Bank System. The additional layer of supervision and examination to which a company would become subject under either the Bank Holding Company Act [46] or the Savings and Loan Holding Company Act [47] if it were to acquire control of a commercial bank or savings and loan association makes those types of institutions even more unlikely to be used as mere conduits to Bank funding. In contrast, the lack of any such requirements applying to the parent of a captive makes captives an especially attractive membership channel for REITs and other ineligible entities that are not subject to the type of inspection and regulation that applies to institutions that are eligible for Bank membership. The requirements for certification of CDFIs similarly make them unsuitable vehicles to serve as conduits for Bank funding to ineligible parents.[48]

5. FHFA Has a Well-Founded Concern That the Use of Captives as Conduits to Bank Funding Will Grow Beyond Mortgage REITs To Include Additional Entities That Have Little or No Connection to Housing Finance

As is evidenced by the recent surge in captive applications and membership approvals, an increasing number of mortgage REITs and similar ineligible entities have decided that the amount of effort and expense associated with forming and operating a captive is low enough to make it feasible to use this method to gain access to the Bank System. In light of the example set by those that appear to have successfully circumvented the statutory membership requirements through the use of captive subsidiaries, as well as the previously described efforts by some in the captives industry to promote this practice, FHFA expects that the prevalence of this practice will continue to grow unabated if the Agency does not take action now to end it. Having seen increasing numbers of mortgage REITs use the captive vehicle to gain access to the Bank System, the Agency is concerned that other types of entities, which may have no connection to housing finance, will begin to form captives for the same purpose.

Indeed, some connected with the insurance industry have advocated the use of captives to provide access to the Bank System regardless of whether the parent company has any connection with residential mortgage lending. For example, an article re-published on the Web site of one state's department of insurance in 2011 reported that a "budding concept is for captive owners, nonbank companies included, to use their captive insurers as portals to cheap bank credit under a federal banking law [*i.e.*, the Bank Act] enacted decades before the first captive appeared." The article revealed that the concept is one that the state's captive regulator wants "companies like manufacturers that have nothing to do with home financing" to consider and that he is "promoting the concept with captive managers," in part as "an engine of captive growth" in his state. The same article also quoted a number of risk management consultants as stating that the use of captives as conduits to access Bank funding "could grow" and "sounds like a wonderful arbitrage opportunity," that "[r]esidential builders could benefit, as well as healthcare institutions" from the strategy, and that it would be a "prudent thing" for a captive owner to take advantage of the opportunity to access such low-cost capital even if the owner

[43] In addition, a 2011 New York Times article entitled "Seeking Business, States Loosen Insurance Rules," came to conclusions that were similar to those reached by the state insurance regulator quoted above. The article, which appeared on the newspaper's front page, cited numerous examples of states competing among themselves to relax their regulatory requirements in order to attract captives to their respective domiciles. It reported that one state, after observing the success of another in attracting captives, responded by amending its laws governing the tax rates captives must pay on premium revenues to make its rates lower than those of the other state; this prompted the other state to reconsider its own rates. The article also noted that the number of captives domiciled in a particular state had doubled in the preceding calendar year, after its insurance commissioner was given the power to exempt captives from various provisions of the state's captive insurer laws. The bulk of the article was devoted to investigating the growing trend of commercial insurance companies forming captives to reinsure blocks of outstanding policies in order to take advantage of the lower reserve requirements that apply to captives under the laws of some states. *See* Mary Williams Walsh and Louise Story, *Seeking Business, States Loosen Insurance Rules*, New York Times (New York ed.) (May 8, 2011) at A1, *http://www.nytimes.com/2011/05/09/business/economy/09insure.html?pagewanted=all&_r=0* (last visited on Dec. 8, 2015).

[44] *See* Richard Cutcher, *2015 US Captive Services Awards: Winners Announced*, Captive Review (Aug. 11, 2015), *http://captivereview.com/news/2015-us-captive-services-awards-winners-announced/* (last visited on Dec. 8, 2015).

[45] *See, e.g.*, Patricia A. McCoy, *Banking Law Manual: Federal Regulation of Financial Holding Companies, Banks and Thrifts* § 3.02[2] (Matthew Bender, 2nd ed. 2015) (explaining that, because depository institution charters "can be (and often are) denied for a variety of reasons, including unacceptable management, poor prospects for financial success, no perceived need for the institution's services or a competitive threat to existing institutions in the same market," they serve as "powerful if erratic controls on entry into commercial banking and the thrift industry").

[46] *See* 12 U.S.C. 1844; *see also* 12 CFR part 225 (implementing regulations).

[47] *See* 12 U.S.C. 1467a; *see also* 12 CFR parts 238, 239 (implementing regulations).

[48] To be eligible for CDFI certification, an organization must have a primary mission of promoting community development; provide both financial and educational services; serve and maintain accountability to one or more defined target markets; maintain accountability to a defined market; and be a legal, non-governmental entity at the time of application (with the exception of Tribal governmental entities). 12 CFR 1805.201. An entity must meet quantitative mission requirements in order to obtain and maintain certification as a CDFI.

is "building cars or running hotels."[49] As noted above, Bank advances need not be collateralized with residential mortgage assets and need not be used for residential housing finance if they are of less than five years maturity.

The Agency's concerns about the prospect of wider use of the captive vehicle also arise from a number of other factors. Recently, for example, the first captive member owned by an equity REIT (as opposed to a mortgage REIT) joined the Bank System and, for the first time, a captive owned by an investment bank (in this case through a number of intermediating subsidiaries) was approved for Bank membership. In addition, at least one mortgage bank recently inquired about the possibility of a Bank admitting to membership a captive subsidiary that it proposed to establish for that purpose. While the use of captive subsidiaries to access the Bank System by entities that are not involved with housing finance is nascent, recent history with traditional insurance companies and, more recently, with REITs has shown that once one portion of an industry realizes the benefits of obtaining access to Bank advances, others in that industry will follow.[50]

6. The Bank Act Specifies the Types of Institutions That May Be Eligible To Be Bank Members, and FHFA Must Act To Prevent the Continued Circumvention of Those Eligibility Requirements by Entities That Are Not Eligible

Abundant evidence exists of a prevalent and growing practice by entities that are themselves ineligible for Bank membership using captive subsidiaries to achieve a *de facto* membership status that effectively provides them with the same access to advances that is available to the types of institutions that are eligible to become members under the Bank Act. In light of the evidence, FHFA has concluded that it must take action to prohibit that practice in order to ensure the fulfillment of one of the key elements of the statutory scheme established by Congress—limiting Bank membership to the types of institutions specified in the Bank Act.

As discussed above, section 4(a) of the Bank Act specifically enumerates the types of institutions that may be eligible for membership. By necessary implication, the statute must be read as a clear statement by Congress that entities of a type not included on that list of eligible institutions are not authorized to become members or otherwise to obtain the benefits of Bank membership, regardless of the extent to which those entities may be engaged in some part of the residential mortgage market. FHFA believes that in order to give effect to this congressional intent it must look to the substance of these transactions, and cannot ignore that the economic reality behind the growing trend of captive memberships is that the captives are being used to create a *de facto* membership for entities that are not among the types of entities that may become Bank members directly.

Many commenters asserted that Congress's failure thus far to exclude captives from membership despite their increasing prevalence in the U.S. since the 1970s must necessarily lead to the conclusion that it has no concerns about the manner in which they are currently being used. Therefore, those commenters argue, FHFA must continue to consider captives to be a type of insurance company that is eligible for Bank membership. Congress's intent concerning the meaning of the term "insurance company," as used in the Bank Act, as well as FHFA's authority to interpret that term in the current context, are discussed in detail below. However, on the specific point raised by commenters, the phenomenon of ineligible companies using captives as a conduit to obtain access the Bank System is a very recent development. FHFA does not regard the lack of congressional action on the issue of Bank membership for captive insurers to be indicative of any particular congressional intent. FHFA will not attempt to interpret the views of a current Congress that has not acted to amend a statute enacted by a prior Congress decades earlier.

Other commenters cited Congress's decision to extend eligibility for Bank membership to commercial banks and credit unions in 1989 and to CDFIs in 2008 as evidence of its intent to effect "an inclusive and expansive approach" to membership and characterized FHFA's attempt to exclude captives from membership as running counter to that intent. To the contrary, FHFA views those actions as an indication that when Congress determines that it is appropriate to permit a particular type of institution to have access to the Bank System, it will amend the Bank Act to expressly authorize that access. For example, at the time Congress enacted the Bank Act in 1932, the primary institutional holders of non-farm residential mortgage debt were savings and loan associations,[51] which held 21.4 percent, followed by savings banks at 17.1 percent, life insurance companies at 11.1 percent, and commercial banks at 10.4 percent.[52] Despite the fact that commercial banks were significant participants in originating and investing in residential mortgage loans at that time, Congress declined to include them in the list of entities eligible for Bank membership. That remained the case until 1989, when Congress made federally insured commercial banks and credit unions eligible for membership. Moreover, although representatives of the mortgage banking industry have lobbied Congress to amend the Bank Act to allow mortgage bankers to become Bank members based on their active role in supporting residential housing finance, Congress has not done so.[53]

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[49] *See* Dave Lenckus, *Cashing In On Captives*, Risk & Insurance Newsletter (Mar. 1, 2011).

[50] Although insurance companies have been eligible for membership since 1932, until recently only a very few insurance companies actually have become members. While only 31 insurance companies and captives were Bank members in 1996, 304 were members at the end of 2014.

[51] These were then also referred to by various other names, such as those used in section 4(a) of the Bank Act—building and loan associations, cooperative banks, and homestead associations. *See* Leo Grebler, David M. Blank & Louis Winnick, *Capital Formation in Residential Real Estate: Trends and Prospects* 203, n.14 (1956).

[52] *See* Grebler, *supra* at 473. The percentages shown are as of December 31, 1931. In 1932, as well as for decades before and up through the early 1970s, many life insurance companies were heavily involved in the origination of home mortgage loans through extensive mortgage lending networks. *See* Kenneth A. Snowden, *The Anatomy of a Residential Mortgage Crisis: A Look Back to the 1930s* 5–8 (Nat'l Bureau of Econ. Research, Working Paper No. 16244, 2010). At some points during those years, life insurance companies held more than 20 percent of all domestic non-farm residential mortgage debt. *See* Grebler, *supra* at 472–74; Snowden, *supra* at 5. *See also* Raymond J. Saulnier, *Urban Mortgage Lending by Life Insurance Companies* 1–9 (1950).

[53] For example, at a November 2013 hearing of the Senate Committee on Banking, Housing, and Urban Affairs on a bill to reform the secondary mortgage markets, the Chairman-elect of the Mortgage Bankers Association testified that "Congress should give serious consideration to expanding Federal Home Loan Bank membership eligibility to include access for non-depository mortgage lenders" and to "community lenders of a variety of business models, including independent mortgage bankers." *Housing Finance Reform: Protecting Small Lender Access to the Secondary Mortgage Market: Hearing on S. 1217 Before the S. Comm. on Banking, Housing, and Urban Affairs*, 113th Cong. 65–66 (Nov. 5, 2013) (statement of Bill Cosgrove, Chief Executive Officer, Union Home Mortgage Corp., and Chairman-Elect, Mortgage Bankers Association). Earlier, the Housing and Community Development Act of 1992 required that the Finance Board and the Department of Housing and Urban Development, among other agencies, each study a multitude of issues related to the Bank System, including possible measures to increase membership in the System, and report to Congress on their recommendations with respect to those issues. *See* Public Law 102–550, § 1393, 106 Stat. 3672, 4009–11 (1992). For reasons relating to mission, safety and soundness, and competitive balance, the reports produced by both agencies recommended against expanding the list of institutions that may be eligible for Bank membership to include mortgage banks. *See* Federal Housing Finance Board, *Report on the Structure and Role of the Federal Home Loan Bank System* 119 (Apr. 1993);

Similarly, Congress has not authorized REITs to become members. If Congress believed that REITs' involvement in the residential mortgage markets warranted them having access to Bank advances, it could have authorized them to become members, just as it did for certain CDFIs in 2008 [54] and for certain non-federally insured credit unions in 2015,[55] when it amended the Bank Act to make those types of entities eligible for membership. The fact that it has not done so for REITs, or for other types of entities that are not enumerated in section 4(a) of the Bank Act, leads FHFA to conclude that Congress has not intended to permit those entities access to Bank funding.

Whether entities that are currently ineligible for membership should be permitted to have access to Bank advances is the type of public policy issue that is for Congress to address. By precluding ineligible institutions from gaining *de facto* membership through captive insurers, the final rule has the effect of preserving the decision of whether to allow REITs access to the Bank System for Congress to address, should it choose to do so. The transition periods, both the five-year transition for pre-NPR captives and the one-year transition for the post-NPR captives, will provide Congress sufficient time to consider whether Bank membership should be extended to additional categories of members before the Banks are required to begin terminating the membership of existing captive members. If Congress determines that permitting REITs, or any other entities that are not currently eligible, to have such access is the appropriate policy, then it will amend the Bank Act to make them explicitly eligible for membership as it has done in the past for commercial banks, credit unions, and CDFIs. If it decides to do so, it may also wish to consider whether special statutory provisions should be enacted with respect to REITs or other entities not subject to inspection and regulation to address their unregulated status, which would set them apart from other types of entities that are currently eligible, and whether and how to except them from the current statutory requirement that members be "subject to inspection and regulation." [56]

B. Legal Authority of FHFA To Exclude Captives From Membership and To Require the Banks To Terminate the Membership of Captives Previously Admitted

FHFA possesses ample legal authority to adopt a regulation defining the term "insurance company" to exclude captives, thereby rendering them ineligible for membership, and to require the Banks to terminate the membership of all captives that they had admitted to membership before FHFA adopted this final rule making captives ineligible.

1. Congress Granted FHFA Broad Regulatory Authority To Ensure That the Purposes of the Bank Act Are Carried Out

Congress has given FHFA, through its Director, broad authority to administer the Bank Act. Specifically, Congress granted the Director of FHFA general regulatory authority over the Banks and specified that he is to exercise that authority to ensure that the purposes of the Bank Act and the Safety and Soundness Act (under which the Agency is established) are carried out.[57] Congress also enumerated a number of principal duties for the Director of FHFA, which include the duty to ensure that each Bank complies with the regulations issued under the Bank Act and Safety and Soundness Act, and granted the Director the authority to exercise such incidental powers as he deems necessary to fulfill his duties and responsibilities in the supervision and regulation of the Banks.[58] Congress also provided the Director of FHFA with specific authority to issue any regulations and take other regulatory actions that he deems necessary not only to implement and enforce the specific requirements of the Bank Act, but also to ensure that the Banks operate in a safe and sound manner and that the purposes of the statutes are accomplished.[59] Thus, FHFA has the authority to adopt regulations that the Director deems necessary to implement the specific membership provisions of the Bank Act, as well as those that the Director deems necessary to ensure that the purposes behind the statutory membership provisions are accomplished. By necessary implication, the grant of authority to ensure that the provisions and purposes of the Bank Act are carried out includes with it the authority to adopt regulations necessary to ensure that neither the Banks, their members, nor any other parties take any actions to circumvent, frustrate, or subvert the provisions or purposes of the Bank Act.

2. Congress Clearly Delineated the Types of Institutions That May Be Eligible for Bank Membership

It is clear from the language of section 4(a)(1) of the Bank Act that Congress intended to permit only the types of institutions listed in that section to become Bank members and that it did not intend to permit any institutions not listed therein to become members. It also is reasonable to infer from the statutory language that Congress intended that entities not explicitly deemed eligible for membership should not be able to obtain indirectly any of the principal benefits of Bank membership—including the access to low-cost advances that the Banks are able to provide because of their statutory market advantages—that they are not permitted to obtain directly.[60] Although Congress did include insurance companies among the types of institutions that may be eligible to become members, it manifestly did not include REITs, hedge funds, investment banks, finance companies, or other types of general business entities.[61]

3. Captives are Being Used To Circumvent the Membership Eligibility Provisions of the Bank Act and Are Uniquely Suited To Be Used for That Purpose

As described in detail above, FHFA has determined that ineligible entities have been circumventing the statutory provisions limiting the types of entities that may become Bank members by

U.S. Department of Housing and Urban Development, Office of Policy Development and Research, *Report to Congress on the Federal Home Loan Bank System, Vol. II* 6–12 (Apr. 1994). In addition, at a 1994 hearing, Under Secretary of the Treasury for Domestic Finance Frank N. Newman testified that, as recommended in the reports, the Treasury Department did not believe that membership eligibility should be expanded beyond then-currently eligible group of depository institutions and insurance companies. *See The Future of the Federal Home Loan Bank System: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs on the Need for a Comprehensive Legislative Package to Update and to Strengthen the Federal Home Loan Bank System's Mission, Structure, Capital Requirements, and Regulatory Oversight*, 103rd Cong., 4, 25 (June 15, 1994).

[54] *See Housing and Economic Recovery Act of 2008*, Public Law 110–289, § 1206, 122 Stat. 2654, 2787 (2008).

[55] *See Fixing America's Surface Transportation Act*, Public Law 114–94, § 82001 (2015).

[56] For example, when Congress added CDFIs to the list of eligible member types, Congress exempted them from the requirement that they be subject to inspection and regulation (because they are not) and instead provided that they must be certified as CDFIs by the Treasury Department. *See* 12 U.S.C. 1424(a)(1)(B).

[57] 12 U.S.C. 4511.

[58] 12 U.S.C. 4513(a)(1), (2).

[59] 12 U.S.C. 4526(a).

[60] To enable the Banks to better fulfill their public policy mission, Congress vested in them market advantages that some might view as depriving government treasuries of revenue and exposing taxpayers to risk. This supports the conclusion that Congress intended to strictly limit access to the Bank System.

[61] *See* 12 U.S.C. 1424(a)(1).

using captive subsidiaries as vehicles to access the benefits of membership to which they are not legally entitled. As also detailed above, captives as a class are uniquely suited to being used for that purpose due to the limited scope of their business activities, which makes them easier and less expensive to establish and operate, and because they are more lightly regulated than commercial insurance companies or insured depository institutions. There is also a relative absence of restrictions on the activities and investments of a captive's parent, as compared to those that apply to an entity that establishes a federally insured bank or savings association subsidiary. These unique characteristics, as among the types of institutions that are permitted to become Bank members under the existing membership regulation, have led captive promoters, insurance regulators, and others with vested interests in expanding the ubiquity of captives to promote them as vehicles through which REITs and other ineligible entities—including those having no connection to housing finance—may obtain access to low-cost Bank advances. This, along with the examples set by those whose attempts to use captives to obtain access to the Bank System have so far met with apparent success, makes it likely that the practice of using of captives for that purpose will continue to grow in the absence of any action by FHFA to halt the practice.

4. FHFA Has the Authority To Take Action To Prevent the Circumvention of the Provisions and Purposes of the Bank Act

The authorities conferred upon FHFA by the Bank Act and the Safety and Soundness Act, described above, empower the Agency to adopt a regulation to prevent this circumvention of the provisions and purposes of the Bank Act. Given that the vast majority of captive members are being used by ineligible entities to circumvent the statutory membership eligibility requirements and, aside from this illegitimate use, have little or no reason to be Bank members, FHFA is not required to treat those types of captives as "insurance companies" for membership purposes simply because they are chartered or licensed under state insurance statutes. The Agency has sufficient legal authority, through its mandate to ensure that the purposes of the statute are carried out, to consider the economic realities of these arrangements—*i.e.*, that the parent companies are the true parties in interest, while the captives act merely as conduits—and to take appropriate regulatory action.

FHFA has determined that the most effective and appropriate way to prevent the use of captives as vehicles to provide *de facto* membership for ineligible entities is to adopt a regulation defining the heretofore undefined term "insurance company" to exclude from membership all captives that may feasibly be used for that purpose. As discussed in part III of this **SUPPLEMENTARY INFORMATION**, FHFA has taken special care to define "insurance company" so that captives having the characteristics that give rise to the Agency's concerns will be excluded, while those institutions that do not engender such concerns and that would be regarded as carrying out the business of insurance as traditionally understood (even if they are denominated as "captives" under their states' insurance laws) will continue to be considered as insurance companies for purposes of determining eligibility for Bank membership.

5. Viewed in the Context of Today's Marketplace, in Contrast to That of 1932, the Meaning of "Insurance Company" Is Ambiguous and, Therefore, FHFA May Adopt a Reasonable Interpretation of That Term To Effect the Purposes of the Bank Act

An administrative agency has authority to interpret and define the terms of the statutes that it administers, especially terms that are undefined.[62] Among the specific types of entities that are eligible for Bank membership, Congress has defined only "insured depository institution." [63] Congress did not define the term "insurance company" or provide any other guidance about its meaning. This leaves the term open to FHFA to define, provided that the definition is reasonable given the provisions and purposes of the Bank Act.

Many commenters expressed the opinion that defining "insurance company" to exclude captives would be in contradiction to the unambiguously expressed intent of Congress as embodied in the plain language of the Bank Act, which provides that "any . . . insurance company" may be eligible for membership. By basing their assertions as to the plain meaning of section 4(a)(1) on the fact that the term "insurance company" is preceded by the word "any" in that paragraph (as are all the other terms used to describe the types of institutions that may be eligible for membership), many commenters begged the essential question of what constitutes an "insurance company" for purposes of the Bank Act in the first place. A few commenters asserted or implied that the statutory membership provisions must be read as including captives because captives are "organized, licensed and regulated" under state insurance statutes or "meet[] the definition of an insurance company under state law." [64] FHFA does not believe that such a reading is required, particularly where, as here, it would result in an interpretation that allows circumvention of specific provisions of the Bank Act and subverts the scheme of the statute as a whole. In other contexts, the Supreme Court has held that a federal regulator may reasonably define an activity or a transaction as not insurance under federal law even if state law would treat it as such.[65]

Sometimes a statutory term that appears on its face to have a commonly understood meaning may be shown to

[62] *See Astrue* v. *Capato*, 132 S.Ct. 2021, 2026 (2012); *Chevron U.S.A., Inc.* v. *Natural Resources Defense Council*, 467 U.S. 837, 843–44 (1984); *Securities Industry Association* v. *Clarke*, 885 F.2d 1034 (2d Cir. 1989), *cert. denied*, 493 U.S. 1070 (1990).

[63] *See* 12 U.S.C. 1422(9) (defining "insured depository institution" to include banks and savings associations the deposits of which are insured by the FDIC and credit unions the share accounts of which are insured by the NCUA). In addition, although Congress did not define the term "community development financial institution," it did provide that only those CDFIs that have been certified by the Treasury Department are eligible for membership. *See* 12 U.S.C. 1424(a)(1)(B).

[64] In support of this argument, several commenters specifically cited the federal McCarran-Ferguson Act, which provides, in pertinent part, that "[n]o Act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any State for the purpose of regulating the business of insurance, or which imposes a fee or tax upon such business, unless such Act specifically relates to the business of insurance." *See* 15 U.S.C. 1012(b). However, nothing in this final rule relates in any way to the regulation of the business of insurance or to the taxation or imposition of fees on any captive or commercial insurance company.

[65] In *Nationsbank* v. *Variable Annuity Life Ins. Co.*, 513 U.S. 251 (1995) ("VALIC"), the U.S. Supreme Court declined to apply a state law-based definition of "insurance" to a federal banking statute. There, the Court upheld the Comptroller of the Currency's classification of annuities as investments, rather than as insurance, under the National Bank Act (NBA), despite respondent's assertions that Congress intended to define "insurance" under the NBA by reference to state law, under which annuities are typically regulated as insurance. In upholding the Comptroller's classification, the Court stated, among other things, "the federal banking law does not plainly require automatic reference to state law here. The Comptroller has concluded that the federal regime is best served by classifying annuities according to their functional characteristics. Congress has not ruled out that course . . .; courts, therefore, have no cause to dictate to the Comptroller the state-law constraint VALIC espouses." 513 U.S. at 261–262. *See also Helvering* v. *LeGierse*, 312 U.S. 531 (1941) (holding that a transaction was not an insurance transaction for federal tax purposes despite its comprising a set of insurance policies under state law).

be ambiguous when it is considered in light of the statute's overall structure, purpose, and history.[66] Construing the term "insurance company" to include any type of entity organized under a state's insurance statutes would allow companies that are not eligible for Bank membership to continue to use captives—or any entities having similar characteristics that might be developed under a different moniker—as a means of providing them with *de facto* membership. In this case, an ambiguity arises because an unconstrained reading of "insurance company" would result in a situation that is contrary to Congress's clear intent to limit the benefits of Bank membership to the several types of institutions listed in section 4(a)(1) of the Bank Act. In contrast, a reading of the term that encompasses insurance companies as they were understood when the Bank Act was enacted, not including captives, would be fully consistent with that provision and with the statutory scheme as a whole.

The ambiguity also arises because it is highly unlikely that Congress considered in 1932 whether captives, which did not then exist, or any class of entity having similar characteristics that would allow the entities to be readily used to circumvent the statutory requirements, should be deemed to be included within the term "insurance company." It is most likely that the term "insurance company" would have been understood by Congress and others in 1932 to refer to a company that was in the business of insurance as it was then understood—that is, the shifting of risk by the insured to a larger class of policyholders through the intermediation of the insurance company—and not to a mechanism for the administration of self-insurance.[67] The current phenomenon of captives as a legal vehicle for managing the parent company's self-insurance did not exist in 1932 and cannot have been within the contemplation of Congress. Captives in the modern sense began to appear only in the late 1950s and early 1960s. Even for many years after U.S. companies first began to form captive subsidiaries, those captives had to be domiciled off-shore, because the state insurance laws that existed at the time made it prohibitively expensive to form and operate a captive in the United States.[68] Colorado became the first U.S. jurisdiction to adopt legislation authorizing the chartering and licensing of captives in 1972,[69] and the captive trend did not begin to gain any real momentum until the mid-1980s.

Although some commenters asserted that early forms of captives existed in 1932 and that Congress must therefore have intended to include them as eligible for membership, those commenters did not identify any example of a captive as it is defined in FHFA's final regulation,[70] nor did they cite anything in the legislative history of the Bank Act that addresses self-insurance by any name. There is scant mention of insurance companies in the legislative history of the Bank Act, although it is logical to infer that Congress specifically included insurance companies among the types of institutions eligible for membership because life insurance companies were actively involved in originating and investing in residential mortgage loans at that time. Life insurance companies, among other classes of insurance companies, would have fit within the traditional view of an insurance company as being an institution that underwrites insurance for entities that are not its affiliates.

Because the types of captives that are now, and recently have been, seeking Bank membership did not come into existence until well after Congress enacted the Bank Act, FHFA does not believe that it is possible to conclude, as some commenters have asserted, that Congress would have intended to include such entities among those eligible for Bank membership. Reasonably assuming that Congress viewed the term "insurance company" in its traditional sense, it would not have had any reason to consider the possibility that another type of business entity could have organized an insurance company and then used it as a vehicle for obtaining advances from a Bank to fund its own investments or business operations.

Thus, changing factual circumstances have generated an ambiguity in the term "insurance company." The definition of that term contained in the final rule is consistent with its historical use in the statute and with the purposes of the statute, but necessarily results in a definition that would exclude some modern entities licensed or chartered under a state's insurance statutes. Because Congress has not defined the term and because it is ambiguous for the reasons discussed, FHFA has the legal authority to define "insurance company" in a manner that is reasonable in light of the provisions and purposes of the Bank Act.

6. It Is Reasonable To Define "Insurance Company" To Exclude Captives

Defining "insurance company" to exclude captives is reasonable for three fundamental reasons, all of which have been thoroughly addressed above. First, doing so is consistent with section 4(a)(1) of the Bank Act, which is reflective of a congressionally created statutory scheme to limit the benefits of Bank membership to the types of institutions specifically listed therein. Second, captives are uniquely suited to serve as vehicles for the circumvention of that statutory provision and its underlying purposes and are being actively promoted for that use, and there is no countervailing public policy reason for them to be Bank members on the basis of their own functions, separate from their parents'. Third, defining "insurance company" in this manner is consistent with the likely intent of Congress, which would have viewed an insurance company as being a company in the business of "risk-shifting and risk-distributing," as the Supreme Court described insurance less than a decade after the enactment of the Bank Act.[71] In addition, it is highly unlikely that Congress contemplated the existence of any class of eligible

[66] *See King* v. *Burwell*, 135 S. Ct. 2480 (2015); *FDA* v. *Brown & Williamson Tobacco Corp.*, 529 U.S. 120, 132–133 (2000).

[67] *See Helvering* v. *LeGierse*, 312 U.S. 531, 539–40 (1941) (stating that "[h]istorically and commonly insurance involves risk-shifting and risk-distributing" and finding that the transaction at issue did not involve those features and therefore was not insurance under the federal income tax laws); *Spring Canyon Coal Co.* v. *Commissioner of Internal Revenue*, 43 F.2d 78, 80 (10th Cir. 1930) (holding that a company's contribution to a self-insurance reserve was not deductible as an insurance premium under the federal income tax laws because there was no shifting of risk). In 1932, life insurance companies originated and invested in large numbers of residential mortgage loans; these longer-term assets were well matched in duration to their life insurance liabilities. Captives do not share that business model.

[68] *See* Shanique Hall, *Recent Developments in the Captive Insurance Industry*, NAIC Center for Insurance Policy and Research Newsletter (Jan. 2012), *http://www.naic.org/cipr_newsletter_archive/vol2_captive.htm* (last visited Dec. 8, 2015).

[69] Maureen A. Sanders, *Risk Retention Groups: Who's Sorry Now?*, 17 S. Ill. U.L.J. 531, 542, n. 76 (1993).

[70] Some commenters referred to the Church Properties Fire Insurance Corporation, which was formed by lay leaders of the Episcopal Church in 1929 in order to "reduce costs by selling direct to churches and their affiliated organizations." *See Episcopalians Form Fire Insurance Concern To Reduce the Cost of Policies on Churches*, New York Times (May 23, 1929) at 1. To the extent that this entity could be characterized as an equivalent of a modern captive, it appears to have been most similar to either an association captive or a group captive, most of which would likely qualify as an "insurance company" under the final rule definition. Although the terms used vary from state to state, an "association captive" is generally understood to be a captive that it is sponsored or owned by a group of entities within a particular trade, industry, or service organization and that insures only the risks of its owners or their affiliates. *See* Hall, *supra*.

[71] *Helvering* v. *LeGierse*, 312 U.S. at 539.

financial institution having the characteristics of modern captives (which, as discussed, did not then exist) that make captives feasible to use as funding conduits for entities Congress did not deem eligible for Bank membership, and even less likely that Congress would have approved of such use, which effectively circumvents the very membership restrictions it imposed.

Several commenters asserted that the Agency's proposal to address that concern by focusing only on captives was "arbitrary" (and therefore not within the Agency's authority to adopt) because it disregarded the possibility that other types of members had passed advance proceeds on to non-members through intercompany transfers and could continue to do so in the future. The majority of members that are not captives are owned by holding companies that are not themselves eligible for membership and there is little question that advance proceeds may flow through to the parent companies in many cases. Given the fungibility of money and the typically complex structures of modern financial institutions, it would be extremely difficult for FHFA, or any agency, to develop a workable means of preventing all such transfers. However, even assuming that a small number of non-captive members could be acting effectively as conduits for their parent companies, no evidence suggests that any type of member institution other than captives is, as a class, being used to any material degree for such purposes. In contrast, there is abundant evidence, detailed above, that almost all members that are captives as defined in the final rule were established and sought to become Bank members for the primary purpose of acting as conduits for their ineligible parents. Given this, as well as their unique suitability for such purposes and the general absence of any other compelling rationale for them to be members, FHFA's exclusion of captives in this final rule is reasonable.

7. FHFA Has the Authority To Require the Termination of Captives That Were Previously Admitted to Bank Membership

Section 6(d)(2)(A) of the Bank Act provides that the board of directors of a Bank "may terminate" the membership of any member institution if, "subject to the regulations of the Director" of FHFA, it determines that any of the statutory grounds for termination exist. Those grounds include a failure to comply with any provision of the Bank Act or FHFA regulations.[72] A number of commenters asserted that this provision vests discretionary termination authority in each Bank and that, consequently, FHFA does not have the authority to require a Bank to terminate the membership of captives that were admitted under the regulations in force at the time of admission. In support of that assertion, several of those commenters also noted that the Bank Act had previously contained a provision explicitly authorizing the Bank System regulator to remove a member for cause (including failure to comply with statutory or regulatory provision) after a hearing, but that Congress removed that explicit authorization in 1999 when it adopted the current termination provision.[73]

Although the 1999 amendments did transfer the mechanism of termination from the Bank System regulator to the Banks themselves, it is not plausible to suggest, as do the commenters, that Congress thereby stripped the regulator of its authority to require the removal of a member when doing so is necessary to halt a violation of the statute or regulations. The use of the words "may terminate" indicates that Congress intended to permit a Bank's board of directors some degree of discretion in deciding whether and when to terminate an institution's membership, but that discretion is limited by the statutory language subjecting the exercise of that termination authority to the regulations of the Director.[74] In this case, the Director has adopted regulatory amendments implementing a provision of the Bank Act in a way that makes captives—including those that were previously admitted—ineligible for membership. When effective, the amended regulation will be binding on the Banks, which will be obliged to comply with its provisions to the same extent that they are obliged to comply with any other statutory or regulatory requirement.

Section 6(d)(2)(A) may permit a Bank to exercise its discretion, for example, in deciding whether and when to terminate the membership of an institution that has committed a statutory or regulatory violation for which no particular sanction is specified. The express caveat in section 6(d)(2)(A) making a Bank's termination authority subject to FHFA regulations, as well as FHFA's broad powers as supervisor and regulator of the Banks and its statutory duty to administer the Bank Act in a manner that promotes the Act's purposes and protects the public interest, provide the Agency with sufficient authority to adopt a regulation that, as the final rule does, specifies the circumstances in which a violation of the law requires a Bank to exercise its termination authority. The exercise of this regulatory authority is appropriate where, as here, the violation is not one of technical noncompliance with a minor requirement, but of the fundamental principles defining eligibility for membership and access to the Bank System, the purposes of which would be undermined if membership were allowed to continue. For these reasons, when a member is in violation of a lawfully adopted regulation for which the required sanction is termination of membership, a Bank does not have the discretion to refuse to terminate the member when and as required by the regulation.

Apart from questioning FHFA's power to regulate the Banks' termination authority under section 6(d)(2)(A), a few commenters offered other reasons that they believed the Agency cannot require a Bank to terminate the membership of its existing captive members. One asserted that requiring the termination of existing captive members would give rise to a "takings" claim against the United States in that it would deprive former captive members of their right to a pro rata share of the retained earnings of their former Banks and of access to Bank advances and other products and services, without adequate compensation. Citing a ruling by the U.S. Court of Appeals for the D.C. Circuit that no federal agency may adopt a regulation that would give rise to a "takings" claim unless it is expressly authorized it to do so by statute,[75] the commenter further argued that FHFA may not adopt a regulation requiring termination because such an express statutory authorization does not exist.

Bank members—even those that are in compliance with all statutory and regulatory eligibility requirements—have no constitutionally protected property interest in continuing Bank membership. Although the Bank Act specifies that the holders of a Bank's the

[72] 12 U.S.C. 1426(d)(2)(A).

[73] *See Financial Services Modernization Act of 1999*, Pub. L. 106–102, sec. 608, 113 Stat. 1338, 1461 (1999).

[74] In addition, as the Court of Appeals for the D.C. Circuit has explained, " 'May' ordinarily connotes discretion, but neither in lay nor legal understanding is the result inexorable. Rather, the conclusion to be reached 'depends on the context of the statute, and on whether it is fairly to be presumed that it was the intention of the legislature to confer a discretionary power or to impose an imperative duty.' " *Thompson* v. *Clifford*, 408 F.2d 154, 158 (D.C. Cir. 1968) (*citations omitted*); *see also Halverson* v. *Slater*, 129 F.3d 180, 188–189 (D.C. Cir. 1997).

[75] *See Bell Atlantic Tel. Cos.* v. *FCC*, 24 F.3d 1441, 1445–46 (D.C. Cir 1994).

Class B stock "shall own the retained earnings, surplus, undivided profits, and equity reserves, if any, of the [Bank]," it also makes clear that, "[e]xcept as specifically provided in [section 6 of the Bank Act] or through the declaration of a dividend or a capital distribution by a [Bank], or in the event of liquidation of the [Bank], a member shall have no right to withdraw or otherwise receive distribution of any portion of the retained earnings of the [Bank]." [76] But even if members did have a constitutionally protected property interest in Bank membership, FHFA's regulation effects neither a *per se* taking nor a regulatory taking as courts have developed those concepts.

A *per se* taking occurs when the government physically appropriates real or personal property for its own use without just compensation.[77] A captive terminated as required under the final rule will be fully compensated when the Bank redeems its Bank stock for par value (the same amount paid by the captive when it acquired the stock) in the manner provided under the Bank's capital plan. Regardless of compensation, the captive's Bank stock will not have been physically appropriated by the government for its own use. Thus, there will have been no *per se* taking.

Neither will there be a regulatory taking, which occurs when the government imposes a restriction on the use of property that results a severe and unwarranted diminution in the property's value.[78] The terminated member will not only receive the par value of its Bank stock when the stock is redeemed, but will also continue to receive any dividends declared up to the time its stock is redeemed. Thus, there can be no claim that the economic value of the stock will have been destroyed. In addition, because the Banks have independent power to terminate membership, members have a reasonable expectation that their membership may be terminated at some point. Because dividend payments are at all times subject to the approval of the Bank's board of directors, there is no reasonable investment expectation that dividends will continue to be paid. Finally, because the captives became Bank members with full knowledge that all Bank activities are heavily regulated, they cannot claim to have had a reasonable investment-backed expectation that the regulatory regime would remain forever static. This is especially true in the case of entities that became members for the purpose of circumventing the statutory membership requirements.

Another commenter, who focused on FHFA's comments in the proposed rule **SUPPLEMENTARY INFORMATION** regarding the possibility that captive membership may pose unique safety and soundness issues, asserted that those concerns could not serve as a basis for requiring the termination of captive members until the Agency had taken the steps required by section 8 of the Bank Act. Section 8 requires that FHFA keep abreast of the state laws under which Bank members are chartered and regulated, and states that if FHFA concludes that the laws of any state provide inadequate protection to a Bank in making or collecting advances, the Agency may "withhold or limit the operation" of any Bank in that state until satisfactory conditions are established.[79] The commenter asserted that this statutory provision prohibits FHFA from taking any action with respect to captive members until it has first undertaken a study of all of the state laws under which they operate, and only after concluding that a particular state's laws fail to provide adequate protection to a Bank.

FHFA rejects the assertion that section 8 may be read to limit in any way the steps the Agency may take in fulfilling its statutory duty to ensure the safe and sound operation of the Banks. Even if section 8 could be so construed, it would not limit the Agency's ability to require the termination of captive members. Although the proposed rule discussed some safety and soundness concerns to which captive membership gives rise, the Agency's proposal and its ultimate decision to exclude captives from Bank membership and to require the termination of existing captives stems from its conclusion that they are being used to circumvent the statutory requirements governing the types of institutions that may become Bank members, and not primarily from safety and soundness concerns regarding captive insurers.[80] FHFA re-emphasizes that point in this final rule.

C. Discussion of Other Arguments Raised by Commenters

Most of the arguments made by commenters in opposition to the proposed captives provisions have been addressed in the discussion above regarding the legal and policy bases for FHFA's adoption of the final captives provisions. However, some commenters made other arguments that are not addressed above and that warrant discussion.

Many commenters stressed that mortgage REITs' substantial commitment to the residential mortgage market in the U.S. is consistent with the mission of the Banks, and argued that allowing them to access the low-cost funding that the Banks are able to provide will increase the level of private capital in the residential mortgage market, benefiting existing and potential homeowners and the public. Others similarly argued that preventing REITs from accessing Bank funding through their captive subsidiaries could increase instability in the residential mortgage market by reducing liquidity and curtailing the availability of long-term funding. FHFA acknowledges that mortgage REITs play a large role in the residential mortgage market and does not question the legitimacy of their activities. However, while FHFA has the duty to ensure that the operations and activities of the Banks "foster liquid, efficient, competitive, and resilient national housing finance markets," it also has a duty to ensure that the Banks carry out that mission "only through activities that are authorized under and consistent with" the Bank Act and the Safety and Soundness Act.[81] Having concluded that the channeling of low-cost Bank funding to REITs and other ineligible entities through captive members is not authorized by or consistent with the Bank Act, the Agency is compelled to take action to put an end to that practice until such time, and on such terms, as Congress authorizes that access. Similarly, it is not appropriate for FHFA to expand Bank membership beyond the framework established by Congress in order to provide greater macroeconomic stability in times of financial stress, as urged by some commenters.

A number of other commenters argued that FHFA offered no analysis of the financial impact the proposed exclusion of captives would have on the Banks and their members, and asserted that excluding captives from membership would result in reduced

[76] 12 U.S.C. 1426(h). *See also Fahey* v. *O'Melveny & Myers*, 200 F.2d 420, 467 (9th Cir. 1952) (holding that the "purchase of [Bank] stock is a condition of [Bank] membership and does not confer proprietary interest or a property right of any kind in any [Bank] itself").

[77] *See Horne* v. *Dep't of Agriculture*, 135 S. Ct. 2419, 2426–27 (2015).

[78] *See Horne*, 135 S. Ct. at 2427.

[79] *See* 12 U.S.C. 1428.

[80] After describing the proposed captives provisions in the **SUPPLEMENTARY INFORMATION** to the proposed rule, FHFA stated that it was proposing to take those actions "to address supervisory concerns about certain institutions that are ineligible for Bank membership, but that are using captives as vehicles through which they can obtain Bank advances to fund their business operations." *See* 79 FR 54848, 54853 (Sept. 12, 2014).

[81] 12 U.S.C. 4513(a)(1)(B).

income for the Banks in the short run and lost opportunities for income growth in the future. Any projection the Agency might attempt to make regarding the exclusion of captives would be speculative. Despite the fact that the number of captive members has increased dramatically since 2012, they still constitute a very small percentage of the Banks' membership base, and the number that would have been approved for membership in future years cannot be estimated. Similarly, while the amount of advances currently outstanding to captives is known, it is not possible to project what future levels would have been because of the difficulty of estimating not only the number of potential captive members forgone, but also what their level of demand for advances would have been.

Regardless of the financial impact, which is unknown, FHFA cannot allow the Banks to continue to engage in activities that it has concluded are not authorized under the law. Congress mandated the establishment of the Banks in order to advance public policy goals and, in order to ensure that they could fulfill those goals, provided them with initial funding from the Treasury Department and granted them tax and other advantages not generally enjoyed by ordinary for-profit corporations. Accordingly, unlike ordinary corporations, the Banks are not free to undertake any and all activities that they judge to be profitable from a business perspective without regard to the limitations imposed by their authorizing statute. Against the uncertain financial impact on the Banks of this regulation must be counterbalanced the equally uncertain financial effects of expanded government exposure and possible economic distortions from supporting expanded categories of businesses.

Many commenters pointed out that any action that might reduce the income of any Bank to any extent would necessarily reduce the amount of funds available for those Banks' Affordable Housing Programs (AHP), because the statute requires 10 percent of a Bank's earnings to be dedicated to its AHP. But increasing AHP contributions is not a legitimate reason to enhance Banks' earnings by allowing access to Bank advances by ineligible entities. In any event, expanding Banks' income through the admission of members who should be regarded as ineligible under the Bank Act is a very low-leverage way of increasing the availability of AHP funds, because the statute requires only 10 percent of Bank earnings to be dedicated to the AHP.

Finally, some commenters questioned why FHFA cannot address its concerns regarding the use of captives as funding conduits by adopting more narrowly tailored restrictions, such as by excluding from membership only captives that are owned by ineligible entities or, even more narrowly, only those that FHFA has determined are actually being used as a funding conduit for an ineligible parent. In developing the final rule, FHFA fully considered a number of narrower options, but ultimately concluded that each those options either raised legal concerns, would not adequately address the Agency's policy concerns, or were not workable from a practical perspective.

For example, the Agency considered whether it would be possible to adopt a final rule allowing captives to be members, but including provisions restricting the extent to which the captive could pass advance proceeds on to an ineligible parent such as by establishing a specified percentage of a captive's assets that may be funded by advances or by requiring that all collateral be kept on the books of the captive. FHFA concluded that, while either of these options could be justified from a legal perspective, neither would be likely to be effective, given the fungibility of advance proceeds and the legal and other expert resources available to the captive's parent companies that would enable them to develop methods of effectively circumventing any such restrictions.[82]

FHFA also considered adopting a final rule that would have continued to allow membership for captives owned by entities eligible to become members. This option raises a legal question whether the statutory membership framework contemplates conditioning eligibility for membership on the activities or investments of a particular institution's parent company. Apart from that, however, this option would still allow institutions that are themselves eligible for membership to use captive subsidiaries to enable inexpensive access to multiple Banks. Like the use of captives by ineligible parents, this potential use by eligible parents raises substantial questions of policy and legitimacy under the Bank Act, in light of the statute's provision that a member may join only the Bank in the district in which its principal place of business is located.[83]

III. Section-by-Section Analysis of the Final Rule

A. Definitions—§ 1263.1

The final rule adds several new definitions to § 1263.1, as well as revises or deletes the definitions of a number of terms that appear in the existing regulation. Although most of these changes are non-substantive, newly added definitions for the terms "insurance company" and "captive" are intended to implement the main policy goal of the final rule—preventing circumvention of the Bank Act's membership categories by excluding captive insurers from Bank membership. The final rule defines "insurance company" as "an entity that holds an insurance license or charter under the laws of a State and whose primary business is the underwriting of insurance for persons or entities that are not its affiliates." The rule defines "captive" as "an entity that holds an insurance license or charter under the laws of a State, but that does not meet the definition of 'insurance company' set forth in this section or fall within any other category of institution that may be eligible for membership." The purpose of defining those terms is to distinguish, as among entities that are deemed to be an insurance company under state law, between those that may be eligible for Bank membership as an "insurance company" and those that are not eligible. An entity that is chartered or licensed under a state's insurance statutes but that neither meets the definition of "insurance company" nor falls within any of the other categories of institutions that may be eligible for membership under the statute or regulations, is ineligible for membership.

Both the terms "insurance company" and "captive" were defined in the proposed rule and the final definitions are similar to those that were proposed. The proposed rule would have defined "insurance company" to mean "a company whose primary business is the underwriting of insurance for nonaffiliated persons or entities." It

[82] Some representatives of captive members represented to FHFA that their captive subsidiaries directly support residential housing finance and do not act as conduits to ineligible parents. However, as stated above, FHFA has been unable to develop an administratively feasible way to assure that this is the case or remains so, and in the great majority of instances that FHFA has reviewed, it is not. Also, in these cases, the captive is not engaged primarily in the business of insurance, meaning the business of shifting and spreading risk to unaffiliated parties, and, therefore, would not be an insurance company as Congress would have understood that concept in 1932.

[83] *See* 12 U.S.C. 1424(b). If a depository institution were to establish a captive insurer in a state in another Bank district, structured so that its books, records, and personnel were located there, the regulation, as revised by the final rule, would recognize that other state as the principal place of business of the captive for Bank membership purposes.

would have defined "captive" to mean "a company that is authorized under state law to conduct an insurance business, but that does not meet the definition of 'insurance company' . . . or fall within any other category of institution eligible for membership." In the final rule, the latter part of the definition of "captive" remains as proposed, while the initial phrase has been revised to refer more precisely to "an entity that holds an insurance license or charter under the laws of a State." The final rule adds that same initial phrase to the definition of "insurance company," substituting it for the generic term "a company" that was used in the proposed definition. This was done to make clearer that these two definitions are meant to be read in conjunction with each other. In addition, in the final rule, the definition of "insurance company" now refers to an entity "whose primary business is the underwriting of insurance for persons or entities that are not its affiliates," instead of one "whose primary business is the underwriting of insurance for nonaffiliated persons or entities." The sole reason for this change in nomenclature is because, in response to the requests of a number of commenters, FHFA has added a definition of the word "affiliate" to the final rule.

Several commenters asserted that the term "nonaffiliated persons or entities" was too vague and could be read in a way that would exclude from the definition of "insurance company" (and therefore from eligibility for Bank membership) entities that, because of diffuse ownership or other factors, cannot be easily used as financing conduits. The types of entities identified were: Mutual insurance companies, which are owned by their policyholders; "association captives," which may be incorporated as a mutual insurer under state captive statutes to insure a group of policyholders engaged in a related trade; and risk retention groups (RRGs), which are liability insurance companies that may be chartered as either captives or as traditional insurers under state law and that are authorized as RRGs under federal law.[84] FHFA has concluded that these types of insurance companies would in almost all cases be within the definition of "insurance company" adopted in the final rule and therefore would remain eligible for membership.

Two commenters provided specific recommendations as to how the term "nonaffiliated persons or entities" could be clarified so as to preclude the possibility that the definition of "insurance company" could be read to exclude entities that are not the intended targets of the proposal. One commenter, a Bank, suggested that FHFA define the term "nonaffiliated persons or entities" in the final rule to mean "one or more persons or entities holding less than 50% equity ownership or voting control of the insurance company."

Another commenter suggested that FHFA take an approach similar to that reflected in the Bank Holding Company Act ("BHCA"), which defines "affiliate" to mean "any company that controls, is controlled by, or is under common control with another company." [85] In turn, the BHCA states that one company is considered to have "control" over another thereunder if it: (A) "directly or indirectly or acting through one or more other persons owns, controls, or has power to vote 25 per centum or more of any class of voting securities of the bank or company"; (B) "controls in any manner the election of a majority of the directors or trustees of the bank or company"; or (C) the Board of Governors of the Federal Reserve System (FRB) "determines, after notice and opportunity for hearing, that the company directly or indirectly exercises a controlling influence over the management or policies of the bank or company." [86] The commenter suggested that FHFA also adopt a "safe harbor" provision similar to one that applies to determinations made by the FRB under clause (C) of the foregoing which establishes a presumption that "any company which directly or indirectly owns, controls, or has power to vote less than 5 per centum of any class of voting securities of a given . . . company does not have control over that . . . company." [87]

FHFA has decided to follow that commenter's basic suggestion by adopting the concepts of "affiliate" and "control" that are reflected in the BHCA because those terms have well established meanings, as illustrated by their being used also in the Safety and Soundness Act with respect to affiliates of Fannie Mae and Freddie Mac.[88] While the final definition of "affiliate" is taken from the BHCA, the text defining the scope of the word "control" (which in the final rule appears within the definition of "affiliate") is based not on the language of the BHCA itself, but on the somewhat more specific definition of that word that the FRB used in its implementing regulations.[89]

The final rule defines "affiliate" to mean "any entity that controls, is controlled by, or is under common control with another entity." The new definition of "affiliate" also specifies that, for purposes of that definition, one entity "controls" another if it: (1) Owns or controls 25 percent or more of the outstanding voting stock, limited partnership shares, or similar interests of the other entity; (2) controls in any manner the election of a majority of the directors, trustees, or general partners of the other entity; or (3) has the power to exercise a controlling influence over the management or policies of the other entity through a management agreement, common directors or management officials, or by any other means.

The final rule definition of "control" does not include an equivalent of clause (C) in the BHCA definition of that term, which contemplates the possibility that the FRB may be required to hold hearings to determine whether one company exercises a controlling influence over another company. In other words, the rule does not contemplate that FHFA will under any circumstances hold a hearing to determine whether one entity "controls" another or to determine whether an entity falls within the definition of "insurance company." Instead, a Bank may need to inquire into the facts of a particular case and apply its reasoned judgment in some circumstances. In applying the definition of "control," a Bank should first make the relatively straightforward determination as to whether one entity exerts a controlling influence over another in the manner described in paragraphs (1) or (2) of the definition. If the answer to that question is "yes," then the inquiry need go no further—one entity "controls" the other, and they are thus considered to be affiliates under the rule. If the answer to that question is "no," then the Bank must consider, under paragraph (3), whether one entity has the power to exercise a controlling influence over the management or policies of the other entity by any other means, such as through a management agreement, common directors, or common management officials.

FHFA has also declined to include in the definition of "control" an equivalent to the BHCA provision establishing a presumption of non-control in cases where one company controls less than 5 percent of the voting stock of another.

[84] *See Federal Liability Risk Retention Act*, 15 U.S.C. 3901, *et seq.*

[85] 12 U.S.C. 1841(k).

[86] 12 U.S.C. 1841(a)(2).

[87] 12 U.S.C. 1841(a)(3).

[88] *See* 12 U.S.C. 4502(1).

[89] *See* 12 CFR 225.2(e).

FHFA believes that including such a provision will only further complicate the definition by appearing to require extensive inquiry into arrangements where one entity may control more than 5 percent, but less than 25 percent of the voting stock of another entity. To be clear, if a Bank determines that control does not exist in the manner described in paragraphs (1) or (2) and determines after reasonable inquiry that no alternative means of control exist as provided in paragraph (3), then it may presume that one entity does not control the other and, therefore, that they need not be considered affiliates under the rule.

Several commenters argued that the proposed rule also left unclear how a Bank would determine whether the "underwriting of insurance for nonaffiliated persons or entities" constitutes a company's "primary business," in determining whether a particular entity fell within the definition of "insurance company." One Bank suggested that FHFA define "primary business" to mean "a business line (such as selling policies, including reinsurance policies or contracts of reinsurance) that constitutes more than half of the insurance company's business." However, the concept of half of a company's business invokes measurement questions more complex and protean than are easily susceptible of being addressed in regulation language of general applicability. FHFA believes that close interpretive questions are unlikely to arise with any frequency, but is prepared to provide interpretive guidance as needed in any appropriate cases.

Determinations regarding whether an institution meets the definition of "insurance company," including determinations about what constitutes an "affiliate" and "control," as well as the manner in which Banks should memorialize their conclusions with respect to those determinations in an applicant's membership application file, are addressed further in the discussion of final § 1263.2(b) below.

The one other substantive definitional change is to finalize the proposed expansion of the definition of "home mortgage loan" to include all types of MBS backed by qualifying loans and securities. Existing § 1263.1 generally defines "home mortgage loan" to include a loan that is secured by a first lien mortgage on one-to-four- or multi-family property, as well as a mortgage pass-through security that represents an undivided ownership interest in the underlying pool of mortgage loans. As proposed, the final rule replaces the existing reference to a pass-through security with a more general reference to a security representing either: (i) A right to receive a portion of the cash flows from a pool of qualifying loans; or (ii) an interest in other securities representing such a right. The reference to a right to receive a portion of the cash flows is intended to encompass both the rights of a holder of a mortgage pass-through security to an undivided ownership interest in the underlying loans and their principal and interest payments, as well as the rights of a holder "debt-type" instruments that grant the holder the right to a specified portion of the cash flows from the pooled mortgage loans. Thus, the revision is intended to bring within the definition of "home mortgage loan" all types of MBS—including pass-through securities, CMOs, REMICs, and principal-only and interest-only strips—that are fully backed by whole loans that meet the definition of "home mortgage loan" or by other MBS that are fully backed by such loans. The revised definition is not intended to include a bond or other debt security that is a general obligation of the issuer, even if it is collateralized by qualifying mortgage loans.

FHFA is making this revision in recognition of the fact that the capital markets do not distinguish between MBS structured as pass-through vehicles and those structured as debt instruments. In adopting the existing definition in 1993, the Finance Board codified the approach of its predecessor agency, the Federal Home Loan Bank Board (FHLBB), which had held that a mortgage-backed security must provide its holder with a *pro rata* ownership interest in each of the loans in the underlying pool of mortgage loans in order for the purchase of that MBS to constitute the equivalent of making or purchasing those underlying loans. Thus, while the Finance Board permitted mortgage pass-through securities, which are structured to give the holder a theoretical undivided ownership interest in each of the underlying loans, to be counted toward satisfaction of the "makes long-term home mortgage loans" requirement, it did not permit other types of MBS to be used for that purpose.

However, as explained in the **SUPPLEMENTARY INFORMATION** to the proposed rule, investors in today's financial markets recognize that the economic interest in the loans underlying such instruments is essentially the same for all types of MBS, regardless of their legal structure. Indeed, the availability of the many types of MBS with different characteristics that have evolved to meet investors' needs over the past several decades has made the secondary mortgage market much more liquid. In recognition of this, FHFA believes that it is appropriate to expand the definition of "home mortgage loan" to include all types of MBS backed by qualifying whole loans and eliminate the distinction that the regulations have historically drawn between pass-through securities and other types of MBS.

This revision was originally proposed in connection with FHFA's proposal to require an institution to hold at least one percent of its total assets in home mortgage loans in order to be deemed to comply with the "makes long-term home mortgage loans" eligibility requirement. The change was intended in part to ease the burden on members that would have been imposed by that new quantitative requirement by allowing them to satisfy the requirement with a wider range of first lien mortgage-related assets than would have been the case if the existing definition were retained. It was also intended in part to make it easier for the Banks to obtain the information necessary to confirm members' compliance with the one percent requirement from their regulatory financial reports. Notwithstanding that FHFA will not be finalizing the one percent requirement at this time, the Agency has decided to include the revised definition in the final rule for the reasons stated above.

In conjunction with the revision of the definition of "home mortgage loan," the final rule also revises the definition of "residential mortgage loan" by replacing paragraph (5) (referring to "mortgage pass-through securities") and paragraph (6) (referring to "mortgage debt securities") with a new paragraph (5), which is intended to include both types of securities. The new provision is similar to paragraph (2) of the definition of "home mortgage loan," referring generally to a security representing either: (i) A right to receive a portion of the cash flows from a pool of whole "residential mortgage loans"; or (ii) an interest in other securities representing such a right. This revision is not intended to effect any substantive change, but merely to streamline the definition in light of the fact that the revisions to the definition of "home mortgage loan" make it unnecessary to distinguish between pass-through securities and other types of MBS in the definition of "residential mortgage loan."

Each of the remaining revisions to the definitions within § 1263.1 is intended either to remove a duplicative definition or to shorten or otherwise clarify the definition itself or the regulatory text in which the defined term appears. Each of these revisions appeared in the proposed rule and each is being finalized essentially as proposed. None of the revisions is intended to alter the meaning of any defined term or substantive provision.

B. Membership Application Process—§§ 1263.2–1263.5

The final rule makes several revisions to subpart B of part 1263, which governs the membership application process.

As proposed, the final rule relocates to § 1263.2(a) from § 1263.6(a) language prohibiting any institution from becoming a member of a Bank unless it has submitted to that Bank a membership application that satisfies the requirements of part 1263, except as otherwise specified in part 1263 (such as in the case of transfers or certain consolidations). While existing § 1263.2(a) requires that an applicant submit an application that complies with the requirements of part 1263, it does not state explicitly that an institution may not become a member unless it has done so. FHFA believes that this statement is more appropriately situated in its new location, which addresses the membership application process, rather than its current location, which addresses the substantive membership eligibility requirements.

Existing § 1263.2(b) requires a Bank to prepare a written digest for each applicant stating whether or not the applicant meets each of the applicable membership eligibility requirements and providing support for its conclusions with respect to each requirement. The final rule revises this subsection to add a specific requirement that, in any digest prepared for an applicant whose eligibility for membership is contingent upon its meeting the new definition of "insurance company," the Bank must state whether the applicant meets that definition and summarize the facts and identify the sources on which it relied in reaching that conclusion. In such cases, the digest should support the Bank's determination that an applicant qualifies as an "insurance company" by summarizing the bases for the Bank's conclusion that the applicant's primary business is the underwriting of insurance for persons or entities that are not its affiliates. In the case of a traditional life or casualty insurance company, for example, it may be sufficient to indicate that a majority of the company's premium income is derived from policies sold to unaffiliated parties. In the case of a mutual insurance company, for example, it may be sufficient to indicate that the company is organized in mutual form and that none of its policyholders has the power to control the election of persons to its board of directors. For a risk retention group, a Bank may be required to obtain additional information establishing that none of the owners control more than 25 percent of its voting shares. In a very few cases, a Bank may be required to conduct a more detailed analysis about whether any one or more policy holders can be said to have "control" over the applicant or related companies that may cause it to be considered an "affiliate," as defined in § 1263.1.

Section 1263.2(c) of the existing regulation requires that a Bank create and maintain a membership file for each applicant. Paragraph (2) of that subsection requires that the Bank include in that file, as an attachment to the application digest, all materials required to document the applicant's eligibility for membership. Paragraph (2) further provides that the Bank "may retain in the file only the relevant portions of the regulatory financial reports required by [part 1263]." This provision is intended merely to allow a Bank the option of omitting from an applicant's file the portions of the applicant's regulatory financial report that are not relevant to its eligibility for membership. However, as currently phrased, the provision could be read as *prohibiting* the Bank from including the non-relevant portions. To eliminate the possibility of such a misreading, the final rule revises this provision to state, instead, that the Bank "is not required to retain in the file" portions of the reports "that are not relevant to its decision on the membership application."

Section 1263.3(c) of the existing regulation also addresses the timing and notice requirements applicable to a Bank's decision on an institution's application for membership. As proposed, the final rule makes a number of non-substantive revisions to that provision to state the requirements as to the timing of the Bank's decision more precisely. No change in meaning is intended.

Section 1263.4 of the existing regulation addresses the circumstances under which an institution may be admitted to membership in a Bank "automatically"—that is, without the need to apply for membership. As proposed, the rule makes two minor wording changes to § 1263.4(a), which governs automatic membership for certain charter conversions, to make the provision read more clearly. No change in meaning is intended.

Existing § 1263.4(b) provides that any member whose membership is transferred pursuant to § 1263.18(d) shall automatically become a member of the Bank to which it transfers. However, while the cross-referenced provision—existing § 1263.18(d)—requires that the Banks involved agree on a "method of orderly transfer" before a "transfer of membership" takes effect, neither that provision nor § 1263.4(b) specifies the types of events that constitute a "transfer" of membership. As a result, FHFA has occasionally received questions about how § 1263.4(b) is to be applied.

FHFA proposed to revise § 1263.4(b) to remove the reference to a "transfer" and, instead, specify that a new membership application is not required when a member either physically relocates its principal place of business to another Bank district (such as through a consolidation) or redesignates its principal place of business to another Bank district as provided under § 1263.18(c). FHFA believes that both of these situations should be treated in the same manner because they are simply different means of bringing about the same result—*i.e.*, a change in the location of a member's principal place of business from one Bank district to another. No commenters objected to the proposed revisions, and FHFA is adopting them as proposed. FHFA has also added language to clarify that the automatic membership at the new Bank commences upon the purchase of the minimum amount of stock needed under the new Bank's capital structure plan.

Section 1263.5 of the existing regulation gives an institution whose membership application has been denied by a Bank the right to appeal the denial to FHFA. FHFA did not propose any substantive revisions to this section, but requested comments on whether the regulations needed to continue to afford applicants this right of appeal, given that no applicants have ever requested an appeal. The Agency received relatively few comments in response to this request, but those that did respond—mostly CDFIs and credit unions, but also a few of the Banks—were uniformly opposed to removal of the appeal provision. One representative letter from a CDFI cited the right of a CDFI applicant under existing § 1263.16(b)(1)(iii) to present to a Bank as part of its application any information it believes demonstrates that is satisfies the "financial condition" eligibility requirement. The commenter stated that the adoption of that provision, as well as FHFA's discussion of the provision in the **SUPPLEMENTARY**

INFORMATION to the final rule in which it was included, demonstrates that the Agency understands that Banks "make judgments in their assessment of CDFI eligibility that could require additional review." The commenter concluded that, in light of "the inconsistent experience with CDFI membership across the System . . . the option for an appeal process should be maintained." Because of the concerns expressed by commenters, FHFA has decided to retain the appeal provision in the regulation.

C. Membership Eligibility Requirements—§§ 1263.6–1263.18

Subpart C of the existing regulation, which includes §§ 1263.6 through 1263.18, addresses the requirements that an institution must meet in order to be eligible for Bank membership. Section 1263.6 sets forth all of the eligibility requirements, while the remaining sections of subpart C address more specifically the manner in which a Bank is to determine compliance with those requirements for the different types of institutions that may be eligible for membership.

The proposed rule would have revised §§ 1263.6, 1263.9 and 1263.10, and would have added a new § 1263.11 (thereby requiring the re-numbering of existing §§ 1263.11–1263.18), to require that an institution hold at least one percent of its assets in "home mortgage loans" to be deemed to satisfy the statutory eligibility requirement that it make long-term home mortgage loans, and that each member comply on an ongoing basis with that one percent requirement and, where applicable, with the statutory eligibility requirement that it have at least 10 percent of its total assets in "residential mortgage loans" as a condition of remaining a Bank member. Because, as discussed above, FHFA has decided not to implement those proposed ongoing asset ratio requirements at this time, the proposed revisions to subpart C that were meant to implement the new requirements are not included in the final rule. Nonetheless, the final rule makes some fairly extensive changes to subpart C in that it: Adds to § 1263.6 a provision addressing the treatment of captive insurers that were admitted to Bank membership prior to the effective date of the rule; finalizes a proposed new provision in § 1263.16 requiring insurance companies to provide audited financial statements as part of the membership application process; finalizes a proposed new provision in § 1263.18 addressing the manner in which a Bank is to determine the "principal place of business" for insurance companies and CDFIs; and makes non-substantive clarifying revisions to the texts of §§ 1263.14, 1263.15, 1263.17 and 1263.18.

1. General Eligibility Requirements—§ 1263.6

Section 1263.6 sets forth the general eligibility requirements for Bank membership and provides that entities that do not meet the requirements of part 1263 shall be ineligible for Bank membership. With respect to the manner in which this section is to be applied, the most significant change the final rule makes is in defining "insurance company," as discussed in detail above. The introductory paragraph to § 1263.6(a) enumerates the types of institutions that are eligible under the Bank Act for membership. Entities of a type not listed in § 1263.6(a) and those, regardless of type, that do not meet the applicable requirements of part 1263, are not eligible for Bank membership. By defining the term "insurance company" in § 1263.1 to include only those entities "whose primary business is the underwriting of insurance for persons or entities that are not its affiliates," the final rule makes clear that a captive, as defined in the regulation, is not an "insurance company" for purposes of section 4(a) of the Bank Act and § 1263.6(a) of the membership regulation. Thus, captives are not eligible for Bank membership, and those that the Bank had previously admitted to membership must wind down their relationships with the Banks in accordance with this final rule.

With respect to the text of § 1263.6(a) itself, the rule finalizes one proposed revision to the introductory paragraph. As discussed above, the final rule removes from this section and relocates to § 1263.2(a) language requiring all applicants to submit an application meeting all of the requirements of the Bank Act and FHFA regulations before it may become a member. FHFA believes that it is more appropriate for that requirement to be included with other material addressing the membership application process than in § 1263.6, which addresses the substantive membership eligibility requirements.

In conjunction with the implementation of the ongoing asset ratio requirements, the proposed rule also would have revised the introductory paragraph, which currently states that an institution meeting the requirements of paragraphs (a)(1) through (a)(6) of that subsection shall be "eligible to *become* a member" of a Bank, to provide that an institution shall be "eligible to *be* a member" if it meets those requirements. The final rule makes a slightly different change, by revising that paragraph to provide that an institution shall be "eligible for Bank membership" if it meets the listed requirements. Despite the fact that the final rule does not require the Banks to determine members' compliance with the "makes long-term home mortgage loans" and "10 percent" requirements on an ongoing periodic basis as would have been required under the proposed rule, FHFA is nonetheless making this revision to dispel any notion that the eligibility requirements of § 1263.6(a) are no longer of any relevance to a member once it has been approved for membership.[90]

The final rule makes one additional change to § 1263.6(a) that was not reflected in the proposed rule by adding a new paragraph (7) providing that, in addition to meeting the requirements listed in paragraphs (1) through (6), an institution must have complied with any applicable requirement of § 1263.6(b) or § 1263.6(c) to be eligible for membership. This revision is not meant to effect any substantive change, but is intended merely to provide clarity by ensuring that § 1263.6(a) contains a comprehensive list of all of the requirements an institution is, or may be, required to meet to be eligible for membership. Section 1263.6(b) refers to the "10 percent" requirement that applies to insured depository institutions that are not CFIs, while § 1263.6(c) refers to the requirement that an applicant that is not an insured depository institution have a level of mortgage-related assets that reflect a commitment to housing finance. The

[90] As explained in the proposed rule, the existing regulations already reflect the necessarily ongoing nature of several of the eligibility requirements, although they employ various enforcement mechanisms short of the ultimate sanction of termination to ensure continuing compliance with those requirements. For example, under the existing membership regulation, an applicant for Bank membership must in most cases satisfy the "home financing policy" requirement by demonstrating that it has achieved a rating of "Satisfactory" or better on its most recent CRA evaluation. While the regulations do not require a member to maintain a "Satisfactory" or better CRA rating in order to retain its Bank membership, they do mandate restrictions on access to advances for failure to maintain such a rating. *See* 12 CFR 1290.5(b). FHFA's advances regulation effectively enforces the "financial condition" requirement by permitting a Bank to limit a member's access to advances if its credit underwriting indicates that it is advisable to do so and requires a Bank to limit or restrict access to advances in the case of a member that lacks positive tangible capital, but that has not yet reached the point of insolvency. *See* 12 CFR 1266.4. The "duly organized" and "subject to inspection and regulation" eligibility requirements are essentially self-enforcing in that any member that fell out of compliance with either of those requirements could not continue to operate as a financial institution.

final rule makes no changes to subsections (b) or (c), which both refer to what an "applicant" must do to "become" a member. To make clear that compliance with those requirements will continue to be assessed only at the time of application, new § 1263.6(a)(7) states that an institution to which either of those requirements apply shall be eligible for Bank membership if it "has complied" with the applicable requirement.

Existing § 1263.6(d) states that "[e]xcept as otherwise provided in this part, if an applicant does not satisfy the requirements of this part, the applicant is ineligible for membership." The proposed rule would have redesignated this provision as § 1263.6(c)(1) and revised it to read, "Except as provided in paragraph (c)(2) of this section, an institution that does not satisfy the requirements of this part shall be ineligible to be a member of a Bank." In the final rule, the provision remains as § 1263.6(d), but is revised to read, "Except as provided in paragraph (e) of this section, an institution that does not satisfy the requirements of this part shall be ineligible for membership." This revised language is similar to that which was proposed. As proposed, the final rule removes the initial qualifier "[e]xcept as otherwise provided in this part," which is redundant in that the reference to satisfying the "requirements of this part" is most logically read to take into account any exceptions to the general requirements. At the same time, the final rule adds a new qualifier—"[e]xcept as provided in paragraph (e)"—which is a new provision, described immediately below, that specifies the manner in which the Banks are to wind down their business with existing captive members before terminating the membership of those captives.

Because FHFA has amended the regulation to make captives ineligible for membership, the final rule adds a new provision, § 1263.6(e), to govern the treatment of captives that were admitted to membership prior to the effective date of the final rule. Like the proposed rule, the final rule treats captives that had been admitted to membership before the date of publication of the proposed rule (September 12, 2014) (hereinafter referred to as "pre-NPR captives") differently from those that were admitted to membership on or after that date (hereinafter referred to as "post-NPR captives").

The final rule treats pre-NPR captives in essentially the same manner as would have been the case under the proposed rule. Section 1263.6(e)(1)(i) of the final rule permits a Bank five years from the effective date of the final rule to wind down its relationship with a pre-NPR captive. As proposed, the final rule also permits a Bank to continue to make or renew advances to such captives during that five year transition period, but only if: (A) After making or renewing an advance, the Bank's total outstanding advances to that captive would not exceed 40 percent of the captive's total assets; and (B) the maturity date of any new or renewed advance does not extend beyond the end of the five-year transition period. In the case of a captive that already has advances that exceed 40 percent of its assets, the final rule does not require a Bank to call those advances prior to their maturity date, but it does prevent the Bank from making or renewing any further advances to that captive until total outstanding advances have been reduced to below 40 percent of the captive's assets. Similarly, a Bank that already has made advances to captives that mature beyond five years from the effective date of the final rule may allow those to roll off in accordance with their terms, but may not renew them.

Section 1263.6(e)(1)(ii) of the final rule requires a Bank to terminate the membership of any pre-NPR captive no later than five years after the effective date of the rule. The Bank is to carry out the terminations as provided under § 1263.27, which is not amended by this final rule and which provides each Bank's board with the necessary authority to terminate the membership of any captive for failing to comply with a requirement of the Bank Act, as implemented by a regulation adopted by FHFA. The requirements of § 1263.27(b), regarding stock redemption periods, and § 1263.27(c), regarding post-termination membership rights, shall apply without exception to any terminated captive.

Final § 1263.6(e)(1)(ii) further requires a Bank, after terminating the membership of a pre-NPR captive, to liquidate outstanding advances to, settle other business transactions with, and repurchase or redeem Bank stock held by that captive in accordance with § 1263.29, which also is not revised by the final rule. This provision also makes clear that in terminating a pre-NPR captive's membership a Bank may nonetheless allow the captive to repay any existing advances in accordance with their contractual terms, regardless of whether their maturity dates occur after the date of the termination of membership, so long as the advances had been made in conformity with the regulations in effect at the time the advance was made. In such cases, the Bank would also delay the repurchase of Bank stock held by the captive in support of any such advance until after the advance has been repaid, in accordance with the Bank's capital plan. The five-year transition period for these pre-NPR captives is intended to mitigate to a reasonable extent the burden that the termination of membership might otherwise have on any such captive that became a Bank member in reliance on the previous membership regulations. The limitations on advances that may be made during this period are intended to permit a pre-NPR captive to continue to borrow at its existing levels for a reasonable period of time, while also limiting its ability to provide increased financing to affiliates that are ineligible for Bank membership.

The text of the proposed rule did not explicitly address the treatment of post-NPR captives, but, in the **SUPPLEMENTARY INFORMATION**, FHFA stated that it would interpret the rule to require the immediate termination of such captives' membership and the prompt liquidation of any outstanding advances, and that it would consider making those requirements explicit in the final rule if any Bank were to admit a captive to membership subsequent to the date of publication of the proposed rule. Notwithstanding that notice of the proposed consequences to captives admitted to membership after the date of the proposed rule, several Banks have continued to admit captives to membership, although at least some have obtained from such captives written acknowledgements of the possible immediate termination of their memberships. Because of those developments, FHFA has decided that it should address the treatment of those post-NPR captives explicitly in the final rule. In order to avoid the disruption to the Banks and those captives that could result from an immediate termination of membership and repayment of all advances, FHFA has reconsidered the position it took in the proposed rule and has decided to provide the Banks with a one-year transition period within which to wind down their affairs with any post-NPR captives they have admitted.

Accordingly, § 1263.6(e)(2)(i) of the final rule provides the Banks with a one-year transition period from the effective date of the final rule within which to wind down its relationships with any captives that had been admitted to membership on or after September 12, 2014. The final rule prohibits a Bank from making or renewing an advance to a post-NPR captive during that transition period, but does not require the immediate liquidation of any advances that may already be outstanding on the effective date of the rule.

Section 1263.6(e)(2)(ii) of the final rule requires a Bank to terminate the membership of any post-NPR captive as provided under § 1263.27 no later than one year from the effective date of the final rule. It also requires generally that upon the termination of membership the Bank must liquidate all outstanding advances to the post-NPR captives, settle all other business transactions, and repurchase or redeem all Bank stock held by the terminated captive in accordance with § 1263.29. Thus, in contrast to pre-NPR captives, post-NPR captives must completely wind down all business relationships with the Banks, including the full repayment of all outstanding advances, prior to or simultaneously with the termination of membership.

2. Treatment of De Novo Insured Depository Institution Applicants—§ 1263.14

Section 1263.14 of the existing membership regulation sets forth special standards by which a Bank is to assess the compliance of a "de novo applicant"—*i.e.*, an insured depository institution chartered less than three years prior to the date it applies for Bank membership—with the membership eligibility requirements. It deems each de novo applicant to be in compliance with the "duly organized," "subject to inspection and regulation," "financial condition," and "character of management" eligibility requirements and provides an alternative means for such an applicant to meet the "makes long-term home mortgage loans requirement" if it cannot meet the general standard set forth in § 1263.9. With respect to both the "10 percent" and "home financing policy" requirements, it provides standards pursuant to which an applicant may be "conditionally approved" for membership at the time of application and then achieve full membership if additional criteria are met within a certain timeframe.

Although the proposed rule would have made no substantive changes to the existing standards, it would have significantly revised the text of this section (which would have been redesignated at § 1263.15) to provide greater clarity, primarily with respect to the standards for conditional approval and subsequent full membership. The proposed rule would, however, have added two new paragraphs to provide alternative standards by which a member that had been admitted as a de novo applicant could be deemed to comply with the proposed ongoing asset ratio requirements for a period of time before being required to meet the standards that would have applied to all other members.

Like the proposed rule, the final rule significantly revises the text of this section (which remains as § 1263.14 in the final rule), but organizes the material differently than was proposed. Again, these changes are intended primarily to state the requirements regarding conditional approval and subsequent full membership more clearly and are not meant to implement any substantive change. Because FHFA is not implementing the proposed ongoing asset ratio requirements at this time, the proposed provisions relating to those requirements are not included in final § 1263.14.

In the existing regulation, the term "de novo applicant" is defined in § 1263.14(a) and is used throughout the remainder of § 1263.14 to refer to an insured depository institution that was chartered less than three years prior to the date it applies for Bank membership. As proposed, the final rule substitutes "de novo insured depository institution" for "de novo applicant" to make clear that the time-limited exceptions for entities formed within the preceding three years apply only to insured depository institutions and not to insurance companies or non-depository CDFIs. In addition, the rule moves that definition from § 1263.14(a) to § 1263.1, where the definitions of other terms that are used in part 1263 are located. As is the case with the existing membership regulation, the final rule does not provide any special standards for measuring the compliance of recently formed insurance company or non-depository CDFI applicants with the membership eligibility requirements.

While the final rule also revises the text of § 1263.14(a) to reflect the new nomenclature, it retains the substance of the existing subsection by deeming each de novo insured depository institution applicant to be in compliance with the "duly organized," "subject to inspection and regulation," "financial condition," and "character of management" eligibility requirements. This reflects the fact that the chartering entity and the federal deposit insurer would have evaluated those areas in connection with granting the charter and approving the institution for deposit insurance.[91]

Existing § 1263.14(b) allows a de novo insured depository institution to satisfy the "makes long-term home mortgage loans" requirement by providing a written justification acceptable to the Bank of how its home financing credit policy and lending practices will include originating or purchasing long-term home mortgage loans. The final rule makes minor revisions to the text of this subsection, but retains the substance of the existing provision.

Existing § 1263.14(c) deems a de novo insured depository institution to which the "10 percent" requirement applies and that has been in operation for less than one year to be "conditionally . . . in compliance" with that requirement at the time of application, and grants the institution "conditional membership approval" until the institution reaches the one-year anniversary of its commencement of operations. At that point, if the institution provides evidence acceptable to the Bank that it holds at least 10 percent of its assets in residential mortgage loans, it is deemed to be "in compliance" with the "10 percent" requirement. If the institution is unable to provide such evidence within that time frame, it is deemed to be "in noncompliance" with the "10 percent" requirement, its "conditional membership approval is deemed null and void," is terminated, and its membership stock must be redeemed in accordance with § 1263.29.

The final rule revises the structure of § 1263.14(c) (condensing it from five paragraphs to three) and to its nomenclature, but makes only one minor change to the substance of that subsection. That substantive change is reflected in final § 1263.14(c)(1). As currently written, that paragraph appears to deem any de novo insured depository institution applicant to which it applies to be in mere conditional compliance with the "10 percent" requirement, without allowing for the possibility (perhaps slight) that the applicant may be able to demonstrate that it is already in full compliance with that requirement as provided in § 1263.10. The final rule remedies this oversight by specifying, in § 1263.14(c)(1), that the subsection applies to "a de novo insured depository institution applicant that commenced its initial business operations less than one year before applying for Bank membership [that] is subject to, but cannot yet meet, the 10 percent requirement . . . as provided in § 1263.10." If an institution already complies with § 1263.10 at the time it applies for membership, it is not subject to the procedures set forth in § 1263.14(c) under the final rule. With respect to applicants to which § 1263.14(c) does apply, final

[91] *See* 61 FR 42531, 42538 (Aug. 16, 1996) (discussing reasoning behind adoption of streamlined requirements for de novo insured depository institutions).

§ 1263.14(c)(1) provides that a Bank shall conditionally approve such an applicant for membership if it meets all other applicable requirements (which include the other membership eligibility requirements as modified for de novo insured depository institutions under this section).

Final § 1263.14(c)(2) provides that if an institution that was conditionally approved for membership demonstrates to the satisfaction of its Bank that it satisfies the "10 percent" requirement as provided under § 1263.10 within one year after it begins its business operations, its membership approval shall become final—*i.e.,* it shall be considered to be fully approved for membership (unless it also remains subject to conditional approval under § 1263.14(d)). Conversely, final § 1263.14(c)(3) provides that if such an institution fails to demonstrate its full compliance with the "10 percent" requirement within one year after it begins its business operations, its conditional membership approval shall become void.

Existing § 1263.14(d) deems any de novo insured depository institution that has not yet received its first CRA performance evaluation to be in conditional compliance with the "home financing policy" requirement if it provides a written justification acceptable to the Bank of how and why its home financing credit policy and lending practices will meet the credit needs of its community. The existing regulation allows a Bank to conditionally approve an applicant for membership on this basis until it receives its first CRA evaluation. If the institution receives a "Satisfactory" or better rating on its first CRA evaluation, it is deemed to be in full compliance with the "home financing policy" requirement and its membership approval shall become final (unless it also remains subject to conditional approval under § 1263.14(c)). If it fails to achieve a "Satisfactory" rating on that evaluation, it is considered to be out of compliance (unless that presumption is rebutted as specified in the regulation) and its conditional membership approval becomes void. The final rule revises the structure and nomenclature of § 1263.14(d) that parallel the revisions made to § 1263.14(c), but makes no substantive changes to that subsection.

The final rule adds a new subsection (e) to § 1263.14 to consolidate existing requirements that apply to conditional membership approvals under subsections (c) and (d). Final § 1263.14(e) provides that a de novo insured depository institution that has been conditionally approved for membership under § 1263.14(c)(1) or § 1263.14(d)(1) is subject to all regulations applicable to members generally, including those relating to stock purchase requirements and advances or collateral, notwithstanding that its membership may be merely conditional for some period of time. Final § 1263.14(e) also provides that if an institution's conditional membership approval becomes void as provided in § 1263.14(c)(3) or § 1263.14(d)(3), then the Bank must liquidate any outstanding indebtedness and redeem or repurchase its capital stock as it would for any other terminated member under § 1263.29.

3. Recently Consolidated Applicants—§ 1263.15

Section 1263.15 provides guidance to the Banks about how to assess a membership application submitted by an institution that recently has undergone a merger or other business combination with another institution. The existing provision specifies the manner in which the Banks must apply the "financial condition," "home financing policy," "makes long-term home mortgage loans," and "10 percent" requirements to such applicants. The final rule makes numerous non-substantive revisions to that section so as to provide greater clarity, but makes no substantive changes.

With respect to the "financial condition" requirement, final § 1263.15(a) requires a recently consolidated applicant that has not filed consolidated financial reports with its regulator for at least six quarters or three calendar years to provide the Bank with whatever regulatory reports it has filed as a consolidated institution, plus *pro forma* financial statements for any quarters for which actual combined financial reports are not available. With respect to the "home financing policy" requirement, final § 1263.15(b) requires a recently consolidated applicant that has not yet received its first CRA performance evaluation as a consolidated entity to provide a written justification acceptable to the Bank of how and why its home financing credit policy and lending practices will meet the credit needs of its community. With respect to the "makes long-term home mortgage loans" and "10 percent" requirements, final § 1263.15(c) allows a recently consolidated applicant that has not yet filed a regulatory financial report as a consolidated entity to provide the Bank instead with the *pro forma* financial statements that it had provided to the regulator that approved the consolidation.

4. Financial Condition of CDFIs and Insurance Companies—§ 1263.16

Existing § 1263.16 governs the application of the "financial condition" requirement to insurance company and certain CDFI applicants. By regulation, in order for such an institution to be eligible for membership its financial condition must be "such that advances may be safely made to it." [92] The Bank Act applies this "financial condition" requirement only to certain insured depository institutions,[93] but both FHFA and the Finance Board have applied this requirement by regulation to all institutions, including insurance companies, as a matter of safety and soundness.[94] The final rule does not alter this approach.

Under existing § 1263.16(a), an insurance company applicant is deemed to meet the "financial condition" requirement if the Bank determines, based on the information contained in the applicant's most recent regulatory financial report, that it meets all of its minimum statutory and regulatory capital requirements and, in addition, meets all applicable capital standards established by the NAIC, regardless of whether those NAIC standards have been adopted by the state in which the company is subject to regulation. As proposed, the final rule carries forward those requirements, but also adds a new provision that requires a Bank to review an insurance company applicant's most recent audited financial statements and to determine that its financial condition is such that the Bank can safely make advances to it before that applicant may be deemed to meet the "financial condition" requirement. The final rule requires that the Bank make the latter determination based upon audited financial statements prepared in accordance with generally accepted accounting principles (GAAP), if they are available, but allows the use of financial statements prepared in accordance with statutory accounting principles if GAAP statements are not available.

[92] 12 CFR 1263.6(a)(4).

[93] *See* 12 U.S.C. 1424(a)(2)(B).

[94] *See* 58 FR 43522, 43531–34 (1993) (discussion in **SUPPLEMENTARY INFORMATION** to Finance Board's first post-FIRREA final rule on Bank Membership of the agency's decision to apply the requirements of section 4(a)(2)(B) of the Bank Act to insurance companies, as well as insured depository institutions).

5. Determination of Appropriate District for Bank Membership—§ 1263.18

The Bank Act provides that an eligible institution may become a member only of the Bank of the district in which the institution's "principal place of business" (PPOB) is located, but does not define that term.[95] The existing membership regulation includes both a general provision for determining the location of an institution's PPOB, as well as an alternative provision that allows an institution to request that the Bank designate a different state for the PPOB if certain requirements are met. Under the general provision, the PPOB is deemed to be the state in which an institution "maintains its home office established as such in conformity with the laws under which the institution is organized." [96] The alternative provision allows an institution to designate a different state as its PPOB if it meets a three-part test for establishing that it has a sufficient connection to that other state.[97]

a. Proposed PPOB Provisions

The proposed rule would have redesignated § 1263.18 as § 1263.19, but retained the basic structure of that section (while adding additional paragraphs, as noted below). That section remains as § 1263.18 under the final rule. In the discussion of the substantive revisions to that section below, the existing, proposed, and final provisions are all referred to as being located in § 1263.18 in order to avoid confusion.

The proposed rule would have made three substantive revisions to § 1263.18 that were intended to address how the Banks designate the PPOB for certain insurance company and community development financial institution (CDFI) members. As more insurance companies and CDFIs have become Bank members, they have revealed shortcomings in the current regulation's application to some situations that these institutions can present that do not arise with depository institutions, such as being domiciled in one state but conducting all business operations from a different state. As noted in the **SUPPLEMENTARY INFORMATION** to the proposed rule, FHFA had previously declined a request to allow the Banks to look solely to the state of domicile for an insurance company or the state of incorporation for a CDFI to identify the PPOB, because that approach would allow for the possibility of an institution having its "principal" place of business for membership purposes at a location from which it actually conducts no business activities. Such an arrangement is not consistent with the statute.

To address these issues, FHFA first proposed to amend the general PPOB provision by adding a requirement that an institution also must actually conduct business activities from its home office location in order for the home office to be designated as the PPOB. The intent was to make clear that a mere legal presence, such as a statutory home office or a registered agent's office at which no business is conducted, is not sufficient by itself to constitute a company's PPOB. FHFA was prompted to make this revision by learning of instances in which insurance companies and CDFIs had sought to become members of the Bank whose district included the state under whose laws those entities had been domiciled or incorporated, even though they conducted all of their business activities elsewhere.

FHFA also proposed to add a new section that would be specific to insurance companies and CDFIs, which would apply only in those cases in which an institution could not satisfy the general requirements for determining its PPOB. Thus, the new provision would apply only to an institution that did not have an actual "home office" established under the laws of its chartering statute, or that had such a "home office" but did not conduct business operations from that location, and that could not satisfy the existing three-part test for designating an alternative location for its PPOB. Under the proposed provision, a Bank would be required to designate as the institution's PPOB "the geographic location from which the institution actually conducts the predominant portion of its business activities." The proposed rule further required that a Bank make these PPOB determinations based on the totality of the circumstances related to a particular institution and using "objective factors" for making the decision. The proposal included three examples of such objective factors, which were the location of the institution's senior executives, the locations of the offices from which it conducts business, and the locations from which its non-executive officers and employees carry out the institution's business activities.

Lastly, the proposed rule included a separate provision for designating the PPOB for those insurance companies that maintain no physical business presence in any state. As more insurance companies have become Bank members, FHFA has learned that certain insurance companies, such as those that are part of a holding company, may not maintain any physical office premises of their own that might be designated as their PPOB. Moreover, such companies may not have their own dedicated officers or employees, but instead may have joint employees or officers who are primarily employed by a separate affiliated insurance company. Those persons also may be situated at different geographic locations, *i.e.*, the locations of the business offices of the affiliated companies, rather than at one central location. Such companies also may contract with unaffiliated service providers to perform the services that ordinarily would be performed by a company's employees. For such companies, where it is not possible to identify a single physical location from which the insurance company can be said to actually conduct the predominant portion of its business activities, the proposed rule would have allowed the Banks to designate the insurance company's state of domicile as its PPOB.

b. Comment Letters on Proposed PPOB Provisions

Approximately 80 comment letters addressed some aspect of these proposed PPOB amendments. Many of the comment letters were substantively identical and contended that using the state of domicile or incorporation would be the most logical way to determine the PPOB for CDFI and insurance company members. They also noted that the existing three-part test for redesignating a member's PPOB already provided an adequate alternative means for members to designate a place other than the state of domicile or incorporation. These commenters also criticized creating a separate PPOB provision for insurance company and CDFI members, saying that it would promote district shopping by such members and would create an unfair advantage for insurance companies over depository institution members.

Many other comment letters also urged FHFA to look solely to the state of domicile as the PPOB for insurance companies. Their principal reasons

[95] 12 U.S.C. 1424(b). An institution may, in the alternative, become a member of the Bank of an adjoining district, if that is demanded by convenience and the Director of FHFA approves that arrangement. There is no record of this statutory alternative ever having been used.

[96] *See* 12 CFR 1263.18(b).

[97] The regulation allows an institution to have a state other than the one in which it maintains its home office designated as its PPOB, provided that: (i) at least 80 percent of the institution's accounting books, records, and ledgers are maintained in that state; (ii) a majority of the institution's board of director and board committee meetings are held in that state; and (iii) a majority of the institution's five highest paid officers have their places of employment located in that state. *See* 12 CFR 1263.18(c).

included: the simplicity of the approach; it would allow Banks to focus only on the insurance laws of the states in their districts; it would defer to state regulators on what constitutes a "home office"; it would avoid the inconsistent results that would likely occur if each Bank made its own decisions about what constituted the "predominant portion" of an institution's business; and it would recognize the realities of the marketplace, in which the concept of large institutions having a single physical location from which they conduct their business is no longer the norm.

Nine Banks submitted separate letters that were nearly identical in substance and generally opposed the revisions to the PPOB regulation. These letters also suggested certain revisions, one of which FHFA has decided to incorporate into the final rule, as described below. The Banks also favored using the state of domicile as the PPOB for insurance companies, urging FHFA to recognize the central importance of the domicile to the operation and regulation of any insurance company, and to defer to state insurance regulators' determination of what constitutes an insurance company's "home office." The Banks further contended that principles of safety and soundness favor using the state of domicile, as that would avoid requiring each Bank to become familiar with the insurance regulators and laws for states outside of its district. A number of commenters other than the Banks also raised these same points in favor of using the state of domicile as the PPOB.

The Banks recommended substantive revisions to the proposed rule. For the general PPOB provision—which would allow the home office to be designated as the PPOB only if the institution also conducted some "business operations" from that office—the Banks recommended that FHFA specify what activities would constitute "business operations." Specifically, the Banks asked that FHFA define the term "business operations" to include an institution having any business, operations, or sales office in the domiciliary state, having any officer's place of employment located in the domiciliary state, or conducting any business in the domiciliary state, including the sale of insurance policies. The Banks contended that the addition of such requirements would ensure that an institution had more than a "mere legal presence" in its domiciliary state.

The Banks recommended similar revisions to the provision that would have applied solely to certain insurance companies and CDFI members, and which would have required a Bank to identify "the geographic location from which the institution actually conducts the predominant portion of its business activities." The Banks recommended that FHFA add specific metrics to that provision that would provide clear guidance about what factors would constitute "the predominant portion" of a company's business activities. Specifically, the Banks recommended that the final rule allow the PPOB to be determined based on any two of the following factors: (1) The location of a plurality of the institution's employees; (2) the location of the places of employment of a plurality of certain specified senior executives; or (3) the location of the company's largest office (as measured by number of employees). Each of the Banks' proposed metrics is similar to the more generally phrased "objective factors" that FHFA had included as examples in the proposed rule, *i.e.,* "the location from which the institution's senior officers direct, control, and coordinate" an institution's activities, the "locations of the offices from which the institution conducts its business," and "the location from which its other officers and employees carry out the business activities." As discussed below, FHFA is persuaded that the final rule would be improved by the addition of the specific metrics suggested by the Banks and has incorporated them into the final rule.

All of the Banks that submitted similar comment letters also supported the third substantive revision in the proposed rule, which would have allowed the Banks to designate the state of domicile as the PPOB for any insurance company that maintains no physical offices of its own and has no employees of its own (*i.e.,* they are shared with other affiliates or the employee functions are performed by contractors), or whose executives may be situated at multiple locations. In addition to the matters discussed above, all of the Banks submitted supplemental comment letters in July 2015 that expressed their views on how to determine the PPOB for a captive insurance company. Certain Banks favored using the state of domicile for captives, while others favored other approaches, such as the location of the parent company or the location of any affiliated company that is already a member of a Bank. Several of the Banks expressed concerns that allowing captives to use the state of domicile as their PPOB would encourage "district shopping" among the Banks by the parent companies of prospective captive members, which could undermine the cooperative nature of the Bank System. Because FHFA has defined the term "insurance company" to exclude captives and has required the termination of membership for existing captives members, FHFA has not addressed this issue in the final rule.

c. Overview of Final PPOB Provisions

In the final rule, FHFA has decided to adopt certain of the substantive amendments largely as they were proposed, and to modify the other provisions by incorporating the revisions recommended by the Banks. All of these provisions are to be applied prospectively, and thus will not affect current members. In addition, FHFA is adopting as proposed clarifying amendments to the "transfer of membership" provisions of § 1263.18(d)(1), which deals with transfers of membership from one Bank to another. The proposed rule would have revised this provision to make clear that it applies to instances where a member of one Bank either redesignates or relocates its PPOB to a state located in another Bank district. A "redesignation" of a PPOB can occur if a member satisfies the three-part test set out in § 1263.18(c), which remains unchanged in the final rule. A "relocation" of a member's PPOB would occur if it were to physically relocate its home office, as identified in its charter, to another state, such as in connection with a corporate reorganization, merger, or acquisition, and continued to conduct business from that new location. This revision is intended to reflect the two methods by which transfers of membership can occur—which had previously not been described by the regulation—and is related to revisions made to § 1263.4(b), regarding "automatic membership" that can occur as a result of such changes in a member's principal place of business. No commenters opposed these revisions to § 1263.18(d)(1).

d. General PPOB/Home Office Test

The final rule adopts the amendment to the general PPOB provision, § 1263.18(b), as it was proposed. Thus, the general approach for designating the PPOB for any member is to identify the state within which the institution maintains its home office, as the home office is established in accordance with the laws under which the institution is organized, and to confirm that the institution also conducts business operations from that office. As noted previously, as increasing numbers of insurance companies and CDFIs have become members, FHFA has learned that it is possible for them to conduct all of their business activities in states other than those under whose laws they are domiciled or incorporated. Moreover, although the law of most states may require an insurance company to maintain a "home office" within the domicile state, FHFA is also aware of instances in which the statutory "home office" claimed to be the PPOB for membership purposes has been nothing more than the address of an in-state registered agent, such as a law firm, whose sole function may be to accept service of process on behalf of the insurance company. FHFA has received inquiries from the Banks about how to determine the PPOB for such institutions, and is aware of instances in which Banks have agreed between themselves that in such cases the appropriate Bank for membership purposes is the Bank from whose district the insurance company or CDFI actually conducts its business operations, not the state of domicile.

As noted in the proposed rule, FHFA believes that the term "principal place of business" must be read to require that some material amount of business activities be conducted at that location, and that a mere legal presence—such as being domiciled or incorporated under the laws of a particular state, without more—is not sufficient to establish an institution's PPOB. Accordingly, in order to be consistent with Section 4(b) of the Bank Act, FHFA believes that it must amend the existing "home office" provision to address the above-described situations by requiring that the institution also conduct some business operations from its home office in order for that home office to be designated as its PPOB. The final rule retains the requirement of the existing rule, which requires that the "home office" be established as such under state law. FHFA has not accepted the Banks' suggested revisions to this paragraph—which would specify certain activities that could constitute conducting business operations from the home office—principally because the examples provided were too attenuated to be consistent with FHFA's concept of a "principal" place of business. The amendment made by the final rule should have no effect on depository institution applicants. The charters for depository institutions typically designate a location within a state as the institution's "home office," which location also will be a branch office at which the institution conducts some portion of its lending and deposit taking business, which is sufficient to meet the new standard. The amendment also should not adversely affect insurance company applicants because, as was pointed out by some commenters, most insurance companies in fact conduct some or all of their business operations from offices located within their state of domicile, and because the final rule includes a new provision, § 1263.18(f), that specifically addresses insurance companies and CDFIs that cannot satisfy the general PPOB provision.

A significant number of commenters urged FHFA not to amend § 1263.18(b) and to "retain" what they believed to be its current regulatory approach, which they characterized as a "state of domicile" test for insurance companies. Neither FHFA nor any of its predecessor agencies has ever adopted a regulation that established a state of domicile approach for insurance companies or that otherwise specifically addressed insurance companies. The most likely reason is that the Bank System regulators had not previously seen any need to address those issues because insurance companies have, until relatively recently, been a very small portion of the membership base. Although the Bank Act has authorized insurance companies to become members since 1932, only in recent years has the number of insurance companies grown significantly. For example, as recently as 1996, the Bank System had no more than 31 insurance company members, out of a total membership base of 6,146.[98] By the end of 2014, the number of insurance company members had grown to 304, out of 7,367 total members.[99] Also, FHFA has become aware of the need to provide more specific guidance for identifying the PPOB for insurance companies and to first consider whether the state of domicile, by itself, is sufficient under the statute to constitute an insurance company's PPOB.

Moreover, although the language of the current regulation, which refers to the "home office established as such in conformity with the laws under which the institution is organized," could arguably be read as tantamount to a "state of domicile" test, neither FHFA nor its predecessors has ever adopted that interpretation. Indeed, the history of this regulation indicates that it is unlikely that the predecessor agencies ever considered the concept of an insurance company's domicile when they adopted this language. The current language appears to date to 1958, when the FHLBB adopted a definition of "principal office" as part of its regulations that applied to savings associations that were insured by the Federal Savings and Loan Insurance Corporation (FSLIC). The 1981 regulations of the FSLIC defined "principal office" in much the same way as FHFA currently defines "principal place of business," [100] but the context makes clear that the term could not have applied to insurance companies because it appeared within the regulations of the FSLIC, which applied only to federally insured savings and loan associations.[101] Through the more recent revisions to the membership regulations, neither FHFA nor the Finance Board has ever addressed whether it intended the term to be synonymous with an insurance company's state of domicile or a CDFI's state of incorporation. Moreover, although certain commenters contended that the Agency has used a "state of domicile" test for insurance companies, the fact is that some Banks currently have as members insurance companies that are domiciled outside of the Bank's district. That suggests that even the Banks have not viewed FHFA's regulations as mandating the use of the state of domicile for making PPOB determinations.

[98] *See* Federal Home Loan Bank System, *1996 Financial Report* at 10–11.

[99] *See* Federal Home Loan Banks, *2014 Combined Financial Report* at 32. The same was true in the early years of the Bank System, as the annual reports for the Federal Home Loan Bank Board indicate that: as of June 30, 1935, there were three insurance companies among 3,324 total members; as of June 30, 1937, there were twelve insurance companies among 3,886 total members; and as of December 31, 1952 there were five insurance companies among 4,056 total members.

[100] *See* 12 CFR 561.7 (1981). That provision defined "principal office" to mean "the home office of an institution established as such in conformity with the laws under which the insured institution is organized." The term "insured institution" was defined to mean a savings and loan association the deposits of which were insured by the FSLIC. 12 CFR 561.1 (1981). The 1981 Code of Federal Regulation citation indicates that that definition of "principal office" was adopted as part of the FSLIC regulations in 1958 and had not subsequently been amended.

[101] The definition of "principal office" at 12 CFR 561.7 (1981) was located within definitional sections of the regulations of the FSLIC, which applied only to federally insured savings and loan associations. Thus, there would have been no reason for the FSLIC to have considered anything having to do with insurance companies because they were not eligible for FSLIC insurance. The FHLBB did have separate regulations in 1981 governing the Bank System, but those regulations did not define "principal office" or "principal place of business." It was not until 1987 that the FHLBB incorporated this long-standing FSLIC definition of "principal office" into its membership regulations, which it did by cross-referencing the FSLIC definition. *See* 12 CFR 523.3–2 (1988) (PPOB for membership purposes is the state in which an institution maintains its "principal office" as defined in 12 CFR 561.7). In 1993, the Finance Board eliminated the cross-reference and provided that for membership purposes an institution's PPOB is the state in which it maintains its home office, established as such under the laws under which the institution is organized. *See* 12 CFR 933.5(b) (1994).

The comment letters also raised other reasons for using a state of domicile approach, which include: (1) The belief that a separate PPOB provision for insurance companies would be unfair to depository institution members; (2) the need to recognize the primacy of state law with regard to matters of insurance company regulation; and (3) the belief that Banks should not be required to become familiar with the insurance laws for states outside of their districts. FHFA does not believe that any of those arguments are sufficient to overcome the Bank Act's requirement of more than a mere legal presence to constitute an institution's "principal" place of business. As to the unfairness issue, FHFA reiterates that it has adopted the amendments to address a specific concern—*i.e.*, the possibility that insurance companies and CDFIs can conduct business entirely outside of the state in which they are domiciled or incorporated, that is not presented by depository institutions. Adopting a regulation that addresses specific situations that are unique to insurance companies and CDFIs is a proper exercise of FHFA's regulatory authority and does not confer any advantage on insurance company or CDFI members.

As to the concern about not recognizing the primacy of state law on matters relating to the regulation of insurance companies, FHFA notes that the final rule does not purport to regulate in any way the operation of insurance companies. Rather, it implements a provision of the Bank Act, the interpretation of which Congress has vested solely in FHFA. The fact that a state insurance regulator may deem a simple legal presence to be sufficient to constitute an institution's "home office" for purposes of the state insurance code does not mean that FHFA must construe the Bank Act in the same manner or that FHFA must defer to the interpretations of fifty different state insurance commissioners on that point. At its core, the final rule simply indicates the Bank to which an insurance company may apply for membership; it does not in any way interfere with the ability of a state insurance regulator to oversee the operations of the insurance companies domiciled in its state.

A number of the comment letters noted that FHFA has issued guidance stressing the importance of the Banks understanding the laws under which their insurance company members are chartered and developing relationships with the state insurance regulators. These commenters also have reasoned that it would be most consistent with that guidance for FHFA to adopt a state of domicile PPOB standard because doing so would allow the Banks to concentrate their resources on the insurance laws and insurance regulators for the states in their own districts. They have also contended that requiring them to develop such knowledge and relationships with the insurance regulators of other states would impose a significant burden. While FHFA acknowledges that developing a level of expertise about the insurance laws of any state and developing a relationship with the state insurance commissioners does require a commitment of time and resources, it does not believe that doing so would constitute an undue burden for any Bank. As noted previously, some Banks already have insurance company members that are domiciled in states outside of their districts. FHFA is not aware of any difficulties arising at those Banks from the fact that the state of domicile is outside of the Banks' districts. Indeed, FHFA has been told in at least one instance that Bank staff was fully committed to developing the same level of expertise and communication regarding insurance company members domiciled outside of their district as they had done for those domiciled within the district.

e. PPOB for Certain Insurance Companies and CDFIs

As proposed, § 1263.18(f) included two separate components—one dealing with certain CDFIs and insurance companies, and one dealing with insurance companies lacking any distinct physical presence. The first provision would have established a separate PPOB standard for insurance companies and CDFIs for which the Banks could not determine the PPOB under either the general provision of § 1263.18(b) (either because they lack a home office designated as such under state law or did not conduct business from their home office) or the alternative three-part test provision of § 1263.18(c). For those institutions, the proposed rule would have required the Banks to determine the geographic location from which the institutions actually conduct the predominant portion of their business activities, using "objective factors" to make that determination. The proposal included three examples of such objective factors. The second provision would have required the Banks to designate the state of domicile as the PPOB for an insurance company that did not have a physical presence in any state.

The Banks and others criticized the first provision, contending that the term "predominant portion of its business activities" was too vague and would result in different Banks reaching different conclusions as to what facts constitute the predominant portion of a company's business activities. As noted previously, the Banks recommended adding specific metrics to this provision, which FHFA agrees would make the final rule clearer and easier to administer. Accordingly, FHFA has incorporated the Banks' suggested revisions into the final rule.

In the final rule, FHFA has modified proposed § 1263.18(f) in two respects, by adding language based on the comment letters from the Banks, and by replacing the proposed language that had dealt with insurance companies that maintain no physical offices of their own. Subsection (f) addresses only those insurance companies and CDFIs for which a Bank cannot designate the PPOB under the general provision of § 1263.18(b) or the existing three-part test of § 1263.18(c). The final rule retains the core concept of the proposed rule, which requires the Banks to designate as the PPOB for these institutions the geographic location from which the institutions actually conduct the predominant portion of their business activities.

To address the concerns of the commenters, FHFA has deleted the language of the proposal that would have required the Banks to make these determinations based on the totality of the circumstances and objective factors. In place of that language FHFA has added new language that closely follows the language recommended by the Banks. FHFA agrees that the three factors recommended by the Banks will provide a reasonable proxy for ascertaining the location from which an institution can be said to conduct the predominant portion of its business. Thus, the final rule will allow the Banks to deem an institution to conduct the predominant portion of its business in the state in which any two of three specified factors are present. The three factors are: (i) The state in which the institution's largest office (as measured by the number of employees) is located; (ii) the state in which a plurality of the institution's employees are located; and (iii) the state in which a plurality of the institution's senior executives are located. In the event that there is an institution for which this test does not work because each of the three factors would identify a different state, then the Bank would be required to analyze the matter under the general standard of paragraph (f)(1), meaning that it should look to these and other factors of the Bank's choosing to determine from which of those three possible states the institution actually conducts the predominant portion of its business activities.

FHFA expects that there will be very few instances in which an institution would be unable to use this test, but because it is possible that each of these factors may point to a different state FHFA has decided to retain the general "predominant portion of its business activities" standard in the final rule to address such possibilities. The final rule adds new language, located in paragraph (f)(3) providing that if a Bank determines that it is unable to determine from which of those geographic locations the institution actually conducts the predominant portion of its business, then it shall designate the state of domicile as the PPOB. In considering the number of employees and senior executives for a particular insurance company or CDFI subject to this paragraph, the Banks should consider all such persons, regardless of whether those persons may also serve as joint employees or senior executives for affiliated companies. For purposes of this provision, the term "senior executives" is defined to include all officers at or above the level of senior vice president, and the final rule includes a non-exclusive list of examples of titles of the positions that would qualify as senior executives for this purpose.

f. PPOB for Insurance Companies With No Physical Offices

The proposed rule included one provision that dealt with insurance companies that have no physical offices of their own—*i.e.,* they neither own nor rent any office space. That provision would have permitted a Bank to designate the state of domicile as the PPOB for such insurance companies, provided that the insurance company also had no employees of its own or whose senior officers are situated at multiple locations. The intent of this provision was to address situations that some Banks have brought to FHFA's attention in the case of insurance company applicants that are part of a holding company structure and that use employees and executives of their affiliated insurance companies as joint employees, or that use third party service providers to perform the services that otherwise would be performed by an institution's own employees. Most of the Banks supported this amendment and no commenters affirmatively opposed it, except to the extent that it was thought that it could be used by captives to "district shop" among the Banks.

In the final rule, however, FHFA has removed this provision because the situation that it was designed to address is now adequately covered under the revised provisions of the final rule, as described immediately above, which allow for the state of domicile to be designated as the PPOB if the Bank cannot use the two-factor test or otherwise identify a particular geographic location from which the predominant portion of the business is conducted. Thus, under this provision an insurance company that neither owns nor rents office space in its own name can use its state of domicile as its PPOB so long as a plurality of its employees and a plurality of its senior executives are not located in the same state.

The final rule also has relocated into a new § 1263.18(g) language from the proposed rule pertaining to the Banks' recordkeeping obligations with respect to their designation of their members' PPOBs. The substance of this provision is unchanged from the proposed rule. The final rule also carries over without substantive change the amendments to § 1263.18(d), pertaining to transfers of Bank membership resulting from the relocation or redesignation of an institution's PPOB.

D. Bank Stock Requirements—§§ 1263.20–1263.23

Subpart D of part 1263 currently sets forth certain requirements regarding the purchase and disposition of Bank stock. As proposed, the final rule repeals several provisions within this subpart that relate to the purchase and disposition of Bank stock in accordance with the law in effect prior to the enactment of the Financial Services Modernization Act of 1999 [102] (hereinafter, the "GLB Act"). Among other things, the GLB Act amended the Bank Act to require each Bank to establish and operate under its own capital structure plan.[103] The provisions being repealed no longer have any effect because all of the Banks are now operating under GLB Act capital plans. The provisions being repealed are: (1) § 1263.19, which generally requires Bank capital stock to be sold at par (because this requirement is now addressed in FHFA's regulations governing Bank capital); (2) portions of § 1263.20 that relate to the pre-GLB Act subscription capital requirements; (3) § 1263.21, pertaining to the issuance and form of Bank stock, primarily under the pre-GLB Act regime; and (4) portions of § 1261.22 relating to the redemption of excess shares of pre-GLB Act capital stock. The final rule retains the substance of the remaining provisions of existing subpart D, although those provisions have been reorganized to reflect the GLB Act capital provisions more explicitly.

[102] Pub. L. 106–102, sec. 608, 113 Stat. 1338, 1458–61 (Nov. 12, 1999).

[103] *See* 12 U.S.C. 1426.

As proposed, § 1263.20(a) of the final rule provides that an institution becomes a member only upon the purchase of the amount of membership stock required under the Bank's capital plan. This further requires an approved applicant to purchase the required stock within 60 days, or else its membership approval becomes void. This carries over much of the substance of existing provisions that now appear, respectively, in paragraphs (a)(2) and (d) of existing § 1263.20.

Final § 1263.20(b) requires a Bank to issue its capital stock to a new member only after it has approved the institution for membership and received payment in full for the par value of the Bank stock. This replaces a similar provision, which had appeared in § 1263.21(a) of the existing regulation. Section 1263.20(c) of the final rule carries over the substance of existing § 1263.20(e), and requires that each Bank report to FHFA information regarding each new member's minimum investment in Bank capital stock, in accordance with the instructions provided in FHFA's Data Reporting Manual.

The final rule also retains the substance of existing § 1263.22(b)(1), which requires each Bank to calculate annually each member's required minimum stock holdings for purposes of determining the number of votes that the member may cast in that year's election of directors, and sets forth the procedures and timing that each Bank must follow with regard to that calculation. That material is carried over with some minor textual edits to provide greater clarity, as the sole provision of proposed § 1263.22. Existing § 1263.23, which governs excess Bank stock, is retained without change.

E. Withdrawal, Termination, and Readmission—§§ 1263.24–1263.30

As proposed, the final rule implements a non-substantive structural change to part 1263 by consolidating sections that are currently dispersed among subparts E through H into subpart E.

Existing § 1263.24 governs the effects that a merger or other consolidation of members has on their membership status. The final rule would retain nearly all of the existing text of that section without change, but would revise § 1263.24(b)(5) to remove references to Banks that have not yet converted to a GLB Act capital structure. The final rule also deletes existing § 1263.24(d), which addresses FHFA approval for transfers of Bank stock that occur in a merger of members, because it too implements a provision of the Bank Act that was repealed by the GLB Act.

Section 1263.26 of the existing regulation governs voluntary withdrawal from Bank membership. Paragraph (d) of that section conditioned the ability of a member to withdraw on FHFA having certified that the withdrawal will not cause the Bank system to fail to contribute the amounts required to fund the interest payments owed on obligations issued by the Resolution Funding Corporation (REFCorp).[104] Because the Banks satisfied their obligation to contribute to the debt service on the REFCorp bonds as of July 2011, this provision has become moot. The final rule deletes that provision but leaves the remainder of § 1263.26 unchanged.

Section 1263.27 of the existing regulation establishes the grounds and procedures for the involuntary termination of an institution's Bank membership, as well as the rights of an institution whose membership is terminated. The final rule retains that section without change.

F. Other Membership Provisions—§§ 1263.31–1263.32

As proposed, the final rule consolidates sections of part 1263 that are currently contained in subparts I and J—§§ 1263.31 and 1263.32—into subpart F. The final rule retains these remaining provisions of the existing membership regulation without change, except that the cross-reference to § 1263.22(b)(1) found in § 1263.31(d) (which requires each member to provide its Bank annually with the data necessary to calculate its minimum required holdings of Bank stock) would be revised to reflect its redesignation as § 1263.22.

IV. Consideration of Differences Between the Banks and the Enterprises

Section 1313(f) of the Safety and Soundness Act requires the Director of FHFA, when promulgating regulations relating to the Banks, to consider the differences between the Banks and the Enterprises (Fannie Mae and Freddie Mac) as they relate to: The Banks' cooperative ownership structure; the mission of providing liquidity to members; the affordable housing and community development mission; their capital structure; and their joint and several liability on consolidated obligations.[105] The Director also may consider any other differences that are deemed appropriate. In preparing this final rule, the Director considered the differences between the Banks and the Enterprises as they relate to the above factors, and determined that the rule is appropriate.

V. Paperwork Reduction Act

The Paperwork Reduction Act of 1995 (PRA) requires that FHFA consider the impact of paperwork and other information collection burdens imposed on the public.[106] Under the PRA and the implementing regulations of the Office of Management and Budget (OMB), an agency may not collect or sponsor the collection of information, nor may it impose an information collection requirement unless it displays a currently valid control number assigned by OMB.[107] FHFA's regulation "Members of the Federal Home Loan Banks," located at 12 CFR part 1263, contains several collections of information that OMB has approved under control number 2590–0003, which is due to expire on December 31, 2016.

The proposed rule would have added a new collection of information to part 1263 related to the proposal to require an institution to hold at least one percent of its assets in "home mortgage loans" in order to satisfy the statutory "makes long-term home mortgage loans" and to require members to meet both that one percent requirement and the statutory "10 percent" requirement (where applicable) on an ongoing basis as a condition of remaining a Bank member. Because these changes are not being implemented in the final rule, there will be no new collection of information under part 1263; in addition, the existing collections under part 1263 will remain the same as those that have been approved by OMB under the existing clearance. Therefore, FHFA has withdrawn its request to OMB to approve a revision to control number 2590–0003.

VI. Regulatory Flexibility Act

The Regulatory Flexibility Act[108] (RFA) requires that a regulation that has a significant economic impact on a substantial number of small entities, small businesses, or small organizations must include an initial regulatory flexibility analysis describing the regulation's impact on small entities. Such an analysis need not be undertaken if the agency has certified that the regulation will not have a significant economic impact on a substantial number of small entities.[109] FHFA has considered the impact of the final rule under the RFA. The General Counsel of FHFA certifies that the final rule is not likely to have a significant economic impact on a substantial number of small entities because the regulation applies only to the Banks, which are not small entities for purposes of the RFA.

List of Subjects in 12 CFR Part 1263

Federal home loan banks, Reporting and recordkeeping requirements.

Authority and Issuance

For the reasons stated in the SUPPLEMENTARY INFORMATION, FHFA revises 12 CFR part 1263 to read as follows:

PART 1263—MEMBERS OF THE BANKS

Subpart A—Definitions

Subpart B—Membership Application Process

Subpart C—Eligibility Requirements

Subpart D—Stock Requirements

[104] *See* 12 U.S.C. 1441b(f)(2)(C).

[105] 12 U.S.C. 4513(f).

[106] *See* 44 U.S.C. 3507(a) and (d).

[107] *See* 44 U.S.C. 3512(a); 5 CFR 1320.8(b)(3)(vi).

[108] 5 U.S.C. 601, *et seq.*

[109] *See* 5 U.S.C. 605(b).

Authority: 12 U.S.C. 1422, 1423, 1424, 1426, 1430, 1442, 4511, 4513.

Subpart A—Definitions

§ 1263.1 Definitions.

For purposes of this part:

Adjusted net income means net income, excluding extraordinary items such as income received from, or expense incurred in, sales of securities or fixed assets, reported on a regulatory financial report.

Affiliate means any entity that controls, is controlled by, or is under common control with another entity. For purposes of this definition, one entity controls another if it:

(1) Directly or indirectly, or acting through one or more other persons, owns, controls, or has the power to vote twenty-five (25) percent or more of the outstanding shares of any class of voting securities of the other entity, including shares of common or preferred stock, general or limited partnership shares or interests, or similar interests that entitle the holder:

(i) To vote for or to select directors, trustees, or partners (or individuals exercising similar functions) of that entity; or

(ii) To vote on or to direct the conduct of the operations or other significant policies of that entity;

(2) Controls in any manner the election of a majority of the directors, trustees, or general partners (or individuals exercising similar functions) of the other entity; or

(3) Otherwise has the power to exercise, directly or indirectly, a controlling influence over the management or policies of the other entity through a management agreement, common directors or management officials, or by any other means.

Aggregate unpaid loan principal means the aggregate unpaid principal of a subscriber's or member's home mortgage loans, home-purchase contracts and similar obligations.

Allowance for loan and lease losses means a specified balance-sheet account held to fund potential losses on loans or leases, which is reported on a regulatory financial report.

Appropriate regulator means:

(1) In the case of an insured depository institution or a CDFI credit union, an appropriate Federal banking agency or appropriate State regulator, as applicable; or

(2) In the case of an insurance company, an appropriate State regulator accredited by the NAIC.

Captive means an entity that holds an insurance license or charter under the laws of a State, but that does not meet the definition of "insurance company" set forth in this section or fall within any other category of institution that may be eligible for membership.

CDFI credit union means a State-chartered credit union that has been certified as a CDFI by the CDFI Fund and that does not have federal share insurance.

CDFI Fund means the Community Development Financial Institutions Fund established under section 104(a) of the Community Development Banking and Financial Institutions Act of 1994 (12 U.S.C. 4703(a)).

CFI asset cap means $1 billion, as adjusted annually by FHFA, beginning in 2009, to reflect any percentage increase in the preceding year's Consumer Price Index (CPI) for all urban consumers, as published by the U.S. Department of Labor.

Class A stock means capital stock issued by a Bank, including subclasses, that has the characteristics specified in section 6(a)(4)(A)(i) of the Bank Act (12 U.S.C. 1426(a)(4)(A)(i)) and applicable FHFA regulations.

Class B stock means capital stock issued by a Bank, including subclasses, that has the characteristics specified in section 6(a)(4)(A)(ii) of the Bank Act (12 U.S.C. 1426(a)(4)(A)(ii)) and applicable FHFA regulations.

Combination business or farm property means real property for which the total appraised value is attributable to residential, and business or farm uses.

Community development financial institution or CDFI means an institution that is certified as a community development financial institution by the CDFI Fund under the Community Development Banking and Financial Institutions Act of 1994 (12 U.S.C. 4701 *et seq.*), other than a bank or savings association insured under the Federal Deposit Insurance Act (12 U.S.C. 1811 *et seq.*), a holding company for such a bank or savings association, or a credit union insured under the Federal Credit Union Act (12 U.S.C. 1751 *et seq.*).

Community financial institution or CFI means an institution:

(1) The deposits of which are insured under the Federal Deposit Insurance Act (12 U.S.C. 1811 *et seq.*); and

(2) The total assets of which, as of the date of a particular transaction, are less than the CFI asset cap, with total assets being calculated as an average of total assets over three years, with such average being based on the institution's regulatory financial reports filed with its appropriate regulator for the most recent calendar quarter and the immediately preceding 11 calendar quarters.

Composite regulatory examination rating means a composite rating assigned to an institution following the guidelines of the Uniform Financial Institutions Rating System (issued by the Federal Financial Institutions Examination Council), including a CAMELS rating or other similar rating, contained in a written regulatory examination report.

Consolidation means a combination of two or more business entities, and includes a consolidation of two or more entities into a new entity, a merger of one or more entities into another entity, or a purchase of substantially all of the assets and assumption of substantially all of the liabilities of an entity by another entity.

CRA means the Community Reinvestment Act of 1977 (12 U.S.C. 2901 *et seq.*).

CRA performance evaluation means, unless otherwise specified, a formal performance evaluation of an institution prepared by its appropriate regulator as required by the CRA or, if such a formal evaluation is unavailable for a particular institution, an informal or preliminary evaluation.

De novo insured depository institution means an insured depository institution with a charter approved by its appropriate regulator within the three years prior to the date the institution applies for Bank membership.

Dwelling unit means a single room or a unified combination of rooms designed for residential use.

Enforcement action means any written notice, directive, order, or agreement initiated by an applicant for Bank membership or by its appropriate regulator to address any operational, financial, managerial, or other deficiencies of the applicant identified by such regulator. An "enforcement action" does not include a board of directors' resolution adopted by the applicant in response to examination weaknesses identified by such regulator.

Funded residential construction loan means the portion of a loan secured by real property made to finance the on-site construction of dwelling units on one-to-four family property or multifamily property disbursed to the borrower.

Gross revenues means, in the case of a CDFI applicant, total revenues received from all sources, including grants and other donor contributions and earnings from operations.

Home mortgage loan means:

(1) A loan, whether or not fully amortizing, or an interest in such a loan, which is secured by a mortgage, deed of trust, or other security agreement that creates a first lien on one of the following interests in property:

(i) One-to-four family property or multifamily property, in fee simple;

(ii) A leasehold on one-to-four family property or multifamily property under a lease of not less than 99 years that is renewable, or under a lease having a period of not less than 50 years to run from the date the mortgage was executed; or

(iii) Combination business or farm property where at least fifty (50) percent of the total appraised value of the combined property is attributable to the residential portion of the property, or in the case of any community financial institution, combination business or farm property, on which is located a permanent structure actually used as a residence (other than for temporary or seasonal housing), where the residence constitutes an integral part of the property; or

(2) A security representing:

(i) A right to receive a portion of the cash flows from a pool of long-term loans, provided that, at the time of issuance of the security, all of the loans meet the requirements of paragraph (1) of this definition; or

(ii) An interest in other securities, all of which meet the requirements of paragraph (2)(i) of this definition.

Insurance company means an entity that holds an insurance license or charter under the laws of a State and whose primary business is the underwriting of insurance for persons or entities that are not its affiliates.

Insured depository institution means an insured depository institution as defined in section 2(9) of the Bank Act, as amended (12 U.S.C. 1422(9)).

Long-term means a term to maturity of five years or greater at the time of origination.

Manufactured housing means a manufactured home as defined in section 603(6) of the National Manufactured Housing Construction and Safety Standards Act of 1974, as amended (42 U.S.C. 5402(6)).

Multifamily property means:

(1) Real property that is solely residential and includes five or more dwelling units;

(2) Real property that includes five or more dwelling units combined with commercial units, provided that the property is primarily residential; or

(3) Nursing homes, dormitories, or homes for the elderly.

NAIC means the National Association of Insurance Commissioners.

Nonperforming loans and leases means the sum of the following, reported on a regulatory financial report:

(1) Loans and leases that have been past due for 90 days (60 days, in the case of credit union applicants) or longer but are still accruing;

(2) Loans and leases on a nonaccrual basis; and

(3) Restructured loans and leases (not already reported as nonperforming).

Nonresidential real property means real property that is not used for residential purposes, including business or industrial property, hotels, motels, churches, hospitals, educational and charitable institution buildings or facilities, clubs, lodges, association buildings, golf courses, recreational facilities, farm property not containing a dwelling unit, or similar types of property.

One-to-four family property means:

(1) Real property that is solely residential, including one-to-four family dwelling units or more than four family dwelling units if each dwelling unit is separated from the other dwelling units by dividing walls that extend from ground to roof, such as row houses, townhouses, or similar types of property;

(2) Manufactured housing if applicable State law defines the purchase or holding of manufactured housing as the purchase or holding of real property;

(3) Individual condominium dwelling units or interests in individual cooperative housing dwelling units that are part of a condominium or cooperative building without regard to the number of total dwelling units therein; or

(4) Real property which includes one-to-four family dwelling units combined with commercial units, provided the property is primarily residential.

Operating expenses means, in the case of a CDFI applicant, expenses for business operations, including, but not limited to, staff salaries and benefits, professional fees, interest, loan loss provision, and depreciation, contained in the applicant's audited financial statements.

Other real estate owned means all other real estate owned (*i.e.*, foreclosed and repossessed real estate), reported on a regulatory financial report, and does not include direct and indirect investments in real estate ventures.

Regulatory examination report means a written report of examination prepared by the applicant's appropriate regulator, containing, in the case of insured depository institution applicants, a composite rating assigned to the institution following the guidelines of the Uniform Financial Institutions Rating System, including a CAMELS rating or other similar rating.

Regulatory financial report means a financial report that an applicant is required to file with its appropriate regulator on a specific periodic basis, including the quarterly call report for commercial banks and savings associations, quarterly or semi-annual call report for credit unions, NAIC's annual or quarterly statement for insurance companies, or other similar report, including such report maintained by the appropriate regulator in an electronic database.

Residential mortgage loan means any one of the following types of loans, whether or not fully amortizing:

(1) A home mortgage loan;

(2) A funded residential construction loan;

(3) A loan secured by manufactured housing whether or not defined by State law as secured by an interest in real property;

(4) A loan secured by a junior lien on one-to-four family property or multifamily property;

(5) A security representing:

(i) A right to receive a portion of the cash flows from a pool of loans, provided that, at the time of issuance of the security, all of the loans meet the requirements of one of paragraphs (1) through (4) of this definition; or

(ii) An interest in other securities that meet the requirements of paragraph (5)(i) of this definition;

(6) A home mortgage loan secured by a leasehold interest, as defined in paragraph (1)(ii) of the definition of "home mortgage loan," except that the period of the lease term may be for any duration; or

(7) A loan that finances one or more properties or activities that, if made by a member, would satisfy the statutory requirements for the Community Investment Program established under section 10(i) of the Bank Act (12 U.S.C. 1430(i)), or the regulatory requirements established for any Community Investment Cash Advance program.

Restricted assets means both permanently restricted assets and temporarily restricted assets, as those terms are used in Financial Accounting Standard No. 117, or any successor publication.

Total assets means the total assets reported on a regulatory financial report or, in the case of a CDFI applicant, the total assets contained in the applicant's audited financial statements.

Unrestricted cash and cash equivalents means, in the case of a CDFI applicant, cash and highly liquid assets that can be easily converted into cash that are not restricted in a manner that prevents their use in paying expenses, as contained in the applicant's audited financial statements.

Subpart B—Membership Application Process

§ 1263.2 Membership application requirements.

(a) *Application.* Except as otherwise specified in this part, no institution may become a member of a Bank unless it has submitted to that Bank an application that satisfies the requirements of this part. The application shall include a written resolution or certification duly adopted by the applicant's board of directors, or by an individual with authority to act on behalf of the applicant's board of directors, of the following:

(1) *Applicant review.* The applicant has reviewed the requirements of this part and, as required by this part, has provided to the best of its knowledge the most recent, accurate, and complete information available; and

(2) *Duty to supplement.* The applicant will promptly supplement the application with any relevant information that comes to its attention prior to the Bank's decision on whether to approve or deny the application, and if the Bank's decision is appealed pursuant to § 1263.5, prior to resolution of any appeal by FHFA.

(b) *Digest.* The Bank shall prepare a written digest for each applicant stating whether or not the applicant meets each of the requirements in §§ 1263.6 to 1263.18, the Bank's findings, and the reasons therefor. In preparing a digest for an applicant whose satisfaction of the membership eligibility requirements of § 1263.6(a) is contingent upon its meeting the definition of "insurance company" set forth in § 1263.1, the Bank shall state its conclusion as to whether the applicant meets that definition and summarize the bases for that conclusion.

(c) *File.* The Bank shall maintain a membership file for each applicant for at least three years after the Bank decides whether to approve or deny membership or, in the case of an appeal to FHFA, for three years after the resolution of the appeal. The membership file shall contain at a minimum:

(1) *Digest.* The digest required by paragraph (b) of this section.

(2) *Required documents.* All documents required by §§ 1263.6 to 1263.18, including documents required to establish or rebut a presumption under this part, shall be described in and attached to the digest. The Bank is not required to retain in the file portions of regulatory financial reports that are not relevant to its decision on the membership application. If an applicant's appropriate regulator requires return or destruction of a regulatory examination report, the date that the report is returned or destroyed shall be noted in the file.

(3) *Additional documents.* Any additional document submitted by the applicant, or otherwise obtained or generated by the Bank, concerning the applicant.

(4) *Decision resolution.* The decision resolution described in § 1263.3(b).

§ 1263.3 Decision on application.

(a) *Authority.* FHFA hereby authorizes the Banks to approve or deny all applications for membership, subject to the requirements of this part. The authority to approve membership applications may be exercised only by a committee of the Bank's board of directors, the Bank president, or a senior officer who reports directly to the Bank president, other than an officer with responsibility for business development.

(b) *Decision resolution.* For each applicant, the Bank shall prepare a written resolution duly adopted by the Bank's board of directors, by a committee of the board of directors, or by an officer with delegated authority to approve membership applications. The decision resolution shall state:

(1) That the statements in the digest are accurate to the best of the Bank's knowledge, and are based on a diligent and comprehensive review of all available information identified in the digest; and

(2) The Bank's decision and the reasons therefor. Decisions to approve an application should state specifically that:

(i) The applicant is authorized under the laws of the United States and the laws of the appropriate State to become a member of, purchase stock in, do business with, and maintain deposits in, the Bank to which the applicant has applied; and

(ii) The applicant meets all of the membership eligibility criteria of the Bank Act and this part.

(c) *Action on applications.* The Bank shall act on an application within 60 calendar days of the date the Bank deems the application to be complete. An application is "complete" when a Bank has obtained all the information required by this part, and any other information the Bank deems necessary, to process the application. If an application that was deemed complete subsequently is deemed incomplete because the Bank determines during the review process that additional information is necessary to process the application, the Bank may suspend the 60-day processing period until the Bank again deems the application to be complete, at which time the processing period shall resume. The Bank shall notify an applicant in writing when it deems the applicant's application to be complete, and shall maintain a copy of the notice in the applicant's membership file. The Bank shall notify an applicant whenever it suspends or resumes the 60-day processing period, and shall maintain a written record of those notifications in the applicant's membership file. Within three business days of a Bank's decision on an application, the Bank shall provide the applicant and FHFA with a copy of the Bank's decision resolution.

§ 1263.4 Automatic membership.

(a) *Automatic membership for certain charter conversions.* An insured depository institution member that converts from one charter type to another automatically shall become a member of the Bank of which the converting institution was a member on the effective date of the conversion, provided that the converted institution continues to be an insured depository institution and the assets of the institution immediately before and immediately after the conversion are not materially different. In such case, all relationships existing between the member and the Bank at the time of such conversion may continue.

(b) *Automatic membership for transfers.* Any member that relocates its principal place of business to another Bank district or that redesignates its principal place of business to another Bank district pursuant to § 1263.18(c) automatically shall become a member of the Bank of that district upon the purchase of the minimum amount of Bank stock required for membership in that Bank, as required by § 1263.20.

(c) *Automatic membership, in the Bank's discretion, for certain consolidations.* (1) If a member institution (or institutions) and a nonmember institution are consolidated, and the consolidated institution has its principal place of business in a State in the same Bank district as the disappearing institution (or institutions), and the consolidated institution will operate under the charter of the nonmember institution, on the effective date of the consolidation, the consolidated institution may, in the discretion of the Bank of which the disappearing institution (or institutions) was a member immediately prior to the effective date of the consolidation, automatically become a member of such Bank upon the purchase of the minimum amount of Bank stock required for membership in that Bank, as required by § 1263.20, provided that:

(i) 90 percent or more of the consolidated institution's total assets are derived from the total assets of the disappearing member institution (or institutions); and

(ii) The consolidated institution provides written notice to such Bank, within 60 calendar days after the effective date of the consolidation, that it desires to be a member of the Bank.

(2) The provisions of § 1263.24(b)(4)(i) shall apply, and upon approval of automatic membership by the Bank, the provisions of § 1263.24(c) shall apply.

§ 1263.5 Appeals.

(a) *Appeals by applicants.*—(1) *Filing procedure.* Within 90 calendar days of the date of a Bank's decision to deny an application for membership, the applicant may file a written appeal of the decision with FHFA.

(2) *Documents.* The applicant's appeal shall be addressed to the Deputy Director for Federal Home Loan Bank Regulation, Federal Housing Finance Agency, 400 Seventh Street SW., Washington, DC 20219, with a copy to the Bank, and shall include the following documents:

(i) *Bank's decision resolution.* A copy of the Bank's decision resolution; and

(ii) *Basis for appeal.* An applicant must provide a statement of the basis for the appeal with sufficient facts, information, analysis, and explanation to rebut any applicable presumptions, or otherwise to support the applicant's position.

(b) *Record for appeal.*—(1) *Copy of membership file.* Upon receiving a copy of an appeal, the Bank whose action has been appealed (appellee Bank) shall provide FHFA with a copy of the applicant's complete membership file. Until FHFA resolves the appeal, the appellee Bank shall supplement the materials provided to FHFA as any new materials are received.

(2) *Additional information.* FHFA may request additional information or further supporting arguments from the appellant, the appellee Bank, or any other party that FHFA deems appropriate.

(c) *Deciding appeals.* FHFA shall consider the record for appeal described in paragraph (b) of this section and shall resolve the appeal based on the requirements of the Bank Act and this part within 90 calendar days of the date the appeal is filed with FHFA. In deciding the appeal, FHFA shall apply the presumptions in this part, unless the appellant or appellee Bank presents evidence to rebut a presumption as provided in § 1263.17.

Subpart C—Eligibility Requirements

§ 1263.6 General eligibility requirements.

(a) *Requirements.* Any building and loan association, savings and loan association, cooperative bank, homestead association, insurance company, savings bank, community development financial institution (including a CDFI credit union), or insured depository institution shall be eligible for Bank membership if:

(1) It is duly organized under tribal law, or under the laws of any State or of the United States;

(2) It is subject to inspection and regulation under the banking laws, or under similar laws, of any State or of the United States or, in the case of a CDFI, is certified by the CDFI Fund;

(3) It makes long-term home mortgage loans;

(4) Its financial condition is such that advances may be safely made to it;

(5) The character of its management is consistent with sound and economical home financing;

(6) Its home financing policy is consistent with sound and economical home financing; and

(7) It has complied with any applicable requirement of paragraphs (b) and (c) of this section.

(b) *Additional eligibility requirement for insured depository institutions other than community financial institutions.* In order to be eligible to become a member of a Bank, an insured depository institution applicant other than a community financial institution also must have at least 10 percent of its total assets in residential mortgage loans.

(c) *Additional eligibility requirement for applicants that are not insured depository institutions.* In order to be eligible to become a member of a Bank, an applicant that is not an insured depository institution also must have mortgage-related assets that reflect a commitment to housing finance, as determined by the Bank in its discretion.

(d) *Ineligibility.* Except as provided in paragraph (e) of this section, an institution that does not satisfy the requirements of this part shall be ineligible for membership.

(e) *Treatment of captives previously admitted to membership.* A Bank that admitted one or more captives to membership prior to February 19, 2016 shall wind down its relationship with, and terminate the membership of, each of those captives as provided in this paragraph (e).

(1) *Captives admitted prior to September 12, 2014.*—(i) A Bank shall have until February 19, 2021 to wind down its business transactions with any captive that it had admitted to membership prior to September 12, 2014, notwithstanding the captive's ineligibility for Bank membership. The Bank may make or renew an advance to such a captive only if:

(A) After making or renewing the advance, its total outstanding advances to that captive would not exceed 40 percent of the captive's total assets; and

(B) The new or renewed advance has a maturity date no later than February 19, 2021.

(ii) A Bank shall terminate the membership of any captive described in paragraph (e)(1)(i) of this section no later than February 19, 2021, as provided under § 1263.27. After termination, the Bank shall require the liquidation of any outstanding indebtedness owed by, and the settlement of all other outstanding business transactions with, such terminated captive, and shall redeem or repurchase the Bank stock owned by the captive in accordance with § 1263.29; provided that the Bank may allow the captive to repay any outstanding advance made or last renewed in accordance with the applicable requirements then in effect and having a maturity date later than its date of termination in accordance with its terms and delay the repurchase of any Bank stock held in support of that advance until after the advance has been repaid, in accordance with the Bank's capital plan.

(2) *Captives admitted on or after September 12, 2014.*—(i) A Bank shall have until February 19, 2017 to wind down its business transactions with any captive that it had admitted to membership on or after September 12, 2014, notwithstanding the captive's ineligibility for Bank membership. The

Bank shall not make or renew any advance to such a captive.

(ii) A Bank shall terminate the membership of any captive described in paragraph (e)(2)(i) of this section no later than February 19, 2017, as provided under § 1263.27. Upon termination, the Bank shall require the liquidation of any outstanding indebtedness owed by, and the settlement of all other outstanding business transactions with, such terminated captive, and shall redeem or repurchase the Bank stock owned by the captive in accordance with § 1263.29; provided that all advances outstanding to that member must be repaid in full by the termination date.

§ 1263.7 Duly organized requirement.

An applicant shall be deemed to be duly organized, as required by section 4(a)(1)(A) of the Bank Act (12 U.S.C. 1424(a)(1)(A)) and § 1263.6(a)(1), if it is chartered by a State or federal agency as a building and loan association, savings and loan association, cooperative bank, homestead association, insurance company, savings bank, or insured depository institution or, in the case of a CDFI applicant, is incorporated under State or tribal law.

§ 1263.8 Subject to inspection and regulation requirement.

An applicant shall be deemed to be subject to inspection and regulation, as required by section 4(a)(1)(B) of the Bank Act (12 U.S.C. 1424 (a)(1)(B)) and § 1263.6(a)(2) if, in the case of an insured depository institution or insurance company applicant, it is subject to inspection and regulation by its appropriate regulator. A CDFI applicant that is certified by the CDFI Fund is not subject to this requirement.

§ 1263.9 Makes long-term home mortgage loans requirement.

An applicant shall be deemed to make long-term home mortgage loans, as required by section 4(a)(1)(C) of the Bank Act (12 U.S.C. 1424(a)(1)(C)) and § 1263.6(a)(3), if, based on the applicant's most recent regulatory financial report filed with its appropriate regulator, or other documentation provided to the Bank, in the case of a CDFI applicant that does not file such reports, the applicant originates or purchases long-term home mortgage loans.

§ 1263.10 Ten percent requirement for certain insured depository institution applicants.

An insured depository institution applicant that is subject to the 10 percent requirement of section 4(a)(2)(A) of the Bank Act (12 U.S.C. 1424(a)(2)(A)) and § 1263.6(b) shall be deemed to comply with that requirement if, based on the applicant's most recent regulatory financial report filed with its appropriate regulator, the applicant has at least 10 percent of its total assets in residential mortgage loans, except that any assets used to secure mortgage-backed securities as described in paragraph (5) of the definition of "residential mortgage loan" set forth in § 1263.1 shall not be used to meet this requirement.

§ 1263.11 Financial condition requirement for depository institutions and CDFI credit unions.

(a) *Review requirement.* In determining whether a building and loan association, savings and loan association, cooperative bank, homestead association, savings bank, insured depository institution, or CDFI credit union has complied with the financial condition requirements of section 4(a)(2)(B) of the Bank Act (12 U.S.C. 1424(a)(2)(B)) and § 1263.6(a)(4), the Bank shall obtain as a part of the membership application and review each of the following documents:

(1) *Regulatory financial reports.* The regulatory financial reports filed by the applicant with its appropriate regulator for the last six calendar quarters and three year-ends preceding the date the Bank receives the application;

(2) *Financial statement.* In order of preference—

(i) The most recent independent audit of the applicant conducted in accordance with generally accepted auditing standards by a certified public accounting firm which submits a report on the applicant;

(ii) The most recent independent audit of the applicant's parent holding company conducted in accordance with generally accepted auditing standards by a certified public accounting firm which submits a report on the consolidated holding company but not on the applicant separately;

(iii) The most recent directors' examination of the applicant conducted in accordance with generally accepted auditing standards by a certified public accounting firm;

(iv) The most recent directors' examination of the applicant performed by other external auditors;

(v) The most recent review of the applicant's financial statements by external auditors;

(vi) The most recent compilation of the applicant's financial statements by external auditors; or

(vii) The most recent audit of other procedures of the applicant.

(3) *Regulatory examination report.* The applicant's most recent available regulatory examination report prepared by its appropriate regulator, a summary prepared by the Bank of the applicant's strengths and weaknesses as cited in the regulatory examination report, and a summary prepared by the Bank or applicant of actions taken by the applicant to respond to examination weaknesses;

(4) *Enforcement actions.* A description prepared by the Bank or applicant of any outstanding enforcement actions against the applicant, responses by the applicant, reports as required by the enforcement action, and verbal or written indications, if available, from the appropriate regulator of how the applicant is complying with the terms of the enforcement action; and

(5) *Additional information.* Any other relevant document or information concerning the applicant that comes to the Bank's attention in reviewing the applicant's financial condition.

(b) *Standards.* An applicant of the type described in paragraph (a) of this section shall be deemed to be in compliance with the financial condition requirement of section 4(a)(2)(B) of the Bank Act (12 U.S.C. 1424(a)(2)(B)) and § 1263.6(a)(4), if:

(1) *Recent composite regulatory examination rating.* The applicant has received a composite regulatory examination rating from its appropriate regulator within two years preceding the date the Bank receives the application;

(2) *Capital requirement.* The applicant meets all of its minimum statutory and regulatory capital requirements as reported in its most recent quarter-end regulatory financial report filed with its appropriate regulator; and

(3) *Minimum performance standard*—

(i) Except as provided in paragraph (b)(3)(iii) of this section, the applicant's most recent composite regulatory examination rating from its appropriate regulator within the past two years was "1", or the most recent rating was "2" or "3" and, based on the applicant's most recent regulatory financial report filed with its appropriate regulator, the applicant satisfied all of the following performance trend criteria—

(A) *Earnings.* The applicant's adjusted net income was positive in four of the six most recent calendar quarters;

(B) *Nonperforming assets.* The applicant's nonperforming loans and leases plus other real estate owned, did not exceed 10 percent of its total loans and leases plus other real estate owned, in the most recent calendar quarter; and

(C) *Allowance for loan and lease losses.* The applicant's ratio of its allowance for loan and lease losses plus the allocated transfer risk reserve to nonperforming loans and leases was 60 percent or greater during four of the six most recent calendar quarters.

(ii) For applicants that are not required to report financial data to their appropriate regulator on a quarterly basis, the information required in paragraph (b)(3)(i) of this section may be reported on a semi-annual basis.

(iii) A CDFI credit union applicant must meet the performance trend criteria in paragraph (b)(3)(i) of this section irrespective of its composite regulatory examination rating.

(c) *Eligible collateral not considered.* The availability of sufficient eligible collateral to secure advances to the applicant is presumed and shall not be considered in determining whether an applicant is in the financial condition required by section 4(a)(2)(B) of the Bank Act (12 U.S.C. 1424(a)(2)(B)) and § 1263.6(a)(4).

§ 1263.12 Character of management requirement.

(a) *General.* A building and loan association, savings and loan association, cooperative bank, homestead association, savings bank, insured depository institution, insurance company, and CDFI credit union shall be deemed to be in compliance with the character of management requirements of section 4(a)(2)(C) of the Bank Act (12 U.S.C. 1424(a)(2)(C)) and § 1263.6(a)(5) if the applicant provides to the Bank an unqualified written certification duly adopted by the applicant's board of directors, or by an individual with authority to act on behalf of the applicant's board of directors, that:

(1) *Enforcement actions.* Neither the applicant nor any of its directors or senior officers is subject to, or operating under, any enforcement action instituted by its appropriate regulator;

(2) *Criminal, civil or administrative proceedings.* Neither the applicant nor any of its directors or senior officers has been the subject of any criminal, civil or administrative proceedings reflecting upon creditworthiness, business judgment, or moral turpitude since the most recent regulatory examination report; and

(3) *Criminal, civil or administrative monetary liabilities, lawsuits or judgments.* There are no known potential criminal, civil or administrative monetary liabilities, material pending lawsuits, or unsatisfied judgments against the applicant or any of its directors or senior officers since the most recent regulatory examination report, that are significant to the applicant's operations.

(b) *CDFIs other than CDFI credit unions.* A CDFI applicant, other than a CDFI credit union, shall be deemed to be in compliance with the character of management requirement of § 1263.6(a)(5), if the applicant provides an unqualified written certification duly adopted by the applicant's board of directors, or by an individual with authority to act on behalf of the applicant's board of directors, that:

(1) *Criminal, civil or administrative proceedings.* Neither the applicant nor any of its directors or senior officers has been the subject of any criminal, civil or administrative proceedings reflecting upon creditworthiness, business judgment, or moral turpitude in the past three years; and

(2) *Criminal, civil or administrative monetary liabilities, lawsuits or judgments.* There are no known potential criminal, civil or administrative monetary liabilities, material pending lawsuits, or unsatisfied judgments against the applicant or any of its directors or senior officers arising within the past three years that are significant to the applicant's operations.

§ 1263.13 Home financing policy requirement.

(a) *Standard.* An applicant shall be deemed to be in compliance with the home financing policy requirements of section 4(a)(2)(C) of the Bank Act (12 U.S.C. 1424(a)(2)(C)) and § 1263.6(a)(6), if the applicant has received a CRA rating of "Satisfactory" or better on its most recent CRA performance evaluation.

(b) *Written justification required.* An applicant that is not subject to the CRA shall file, as part of its application for membership, a written justification acceptable to the Bank of how and why the applicant's home financing policy is consistent with the Bank System's housing finance mission.

§ 1263.14 De novo insured depository institution applicants.

(a) *Presumptive compliance.* A de novo insured depository institution applicant shall be deemed to meet the duly organized, subject to inspection and regulation, financial condition, and character of management requirements of §§ 1263.7, 1263.8, 1263.11 and 1263.12, respectively.

(b) *Makes long-term home mortgage loans requirement.* A de novo insured depository institution applicant shall be deemed to make long-term home mortgage loans, as required by section 4(a)(1)(C) of the Bank Act (12 U.S.C. 1424(a)(1)(C)) and § 1263.6(a)(3), if it has filed as part of its application for membership a written justification acceptable to the Bank of how its home financing credit policy and lending practices will include originating or purchasing long-term home mortgage loans.

(c) *10 percent requirement.*—(1) *Conditional approval.* If a de novo insured depository institution applicant that commenced its initial business operations less than one year before applying for Bank membership is subject to, but cannot yet meet, the 10 percent requirement of section 4(a)(2)(A) of the Bank Act (12 U.S.C. 1424(a)(2)(A)) and § 1263.6(b) as provided in § 1263.10, a Bank may conditionally approve that applicant for membership if it meets all other applicable requirements.

(2) *Approval may become final.* If, within one year after commencement of its initial business operations, an institution that was conditionally approved for membership under paragraph (c)(1) of this section supplies evidence acceptable to the Bank that it satisfies the 10 percent requirement as provided under § 1263.10, its membership approval shall become final.

(3) *Approval may become void.* If an institution that was conditionally approved for membership under paragraph (c)(1) does not satisfy the requirements of paragraph (c)(2) of this section, it shall be deemed to be out of compliance with the 10 percent requirement, and its conditional membership approval shall become void.

(d) *Home financing policy requirement.*—(1) *Conditional approval.* If a de novo insured depository institution applicant cannot meet the home financing policy requirement of section 4(a)(2)(C) of the Bank Act (12 U.S.C. 1424(a)(2)(C)) and § 1263.6(a)(6) as provided under § 1263.13 because it has not received its first CRA performance evaluation, a Bank may conditionally approve that applicant for membership if it meets all other applicable requirements and has included in its application a written justification acceptable to the Bank of how and why its home financing credit policy and lending practices will meet the credit needs of its community.

(2) *Approval may become final.* If an institution that was conditionally approved for membership under paragraph (d)(1) of this section supplies evidence acceptable to the Bank that it has satisfied the home financing policy requirement as provided under § 1263.13 by receiving a CRA rating of "Satisfactory" or better on its first CRA

performance evaluation, its membership approval shall cease to be conditional.

(3) *Approval may become void.* If an institution that was conditionally approved for membership under paragraph (d)(1) of this section receives a rating of "Needs to Improve" or "Substantial Non-Compliance" on its first CRA performance evaluation, and fails to rebut the presumption of non-compliance with the home financing policy requirement as provided under § 1263.17(f), it shall be deemed to be out of compliance with that requirement and its conditional membership approval shall become void.

(e) *Other rules.* An institution that has been conditionally approved for membership under paragraph (c)(1) or (d)(1) of this section shall be subject to all regulations applicable to members generally, including those relating to stock purchase requirements and or collateral, notwithstanding that its membership may be conditional for some period of time. If an institution's conditional membership approval becomes void as provided in paragraphs (c)(3) or (d)(3) of this section, then the Bank shall liquidate any outstanding indebtedness owed by the institution to the Bank and redeem or repurchase its capital stock in accordance with § 1263.29.

§ 1263.15 Recently consolidated applicants.

An applicant that has recently consolidated with another institution is subject to the requirements of §§ 1263.7 to 1263.13 except as provided in this section.

(a) *Financial condition requirement.* For purposes of § 1263.11(a)(1) and 1263.11(b)(3)(i)(A), a recently consolidated applicant that has not yet filed regulatory financial reports as a consolidated entity for six quarters or three calendar year-ends shall provide to the Bank:

(1) All regulatory financial reports that the applicant has filed as a consolidated entity; and

(2) *Pro forma* combined financial statements for those quarters for which actual combined regulatory financial reports are unavailable.

(b) *Home financing policy requirement.* For purposes of § 1263.13, a recently consolidated applicant that has not yet received its first CRA performance evaluation as a consolidated entity shall file as part of its application a written justification acceptable to the Bank of how and why the applicant's home financing credit policy and lending practices will meet the credit needs of its community.

(c) *Makes long-term home mortgage loans requirement; 10 percent requirement.* For purposes of determining compliance with §§ 1263.9 and 1263.10, a Bank may, in its discretion, permit a recently consolidated applicant that has not yet filed a regulatory financial report as a consolidated entity to provide the *pro forma* financial statement for the consolidated entity that the consolidating entities filed with the regulator that approved the consolidation.

§ 1263.16 Financial condition requirement for insurance company and certain CDFI applicants.

(a) *Insurance companies.*—(1) An insurance company applicant shall be deemed to meet the financial condition requirement of § 1263.6(a)(4) if the Bank determines:

(i) Based on the information contained in the applicant's most recent regulatory financial report filed with its appropriate regulator, that the applicant meets all of its minimum statutory and regulatory capital requirements and the capital standards established by the NAIC; and

(ii) Based on the applicant's most recent audited financial statements, that the applicant's financial condition is such that the Bank can safely make advances to it.

(2) In making the determination required under paragraph (a)(1)(ii) of this section, the Bank shall use audited financial statements that have been prepared in accordance with generally accepted accounting principles, if they are available. If they are not available, the Bank may use audited financial statements prepared in accordance with statutory accounting principles.

(b) *CDFIs other than CDFI credit unions.*—(1) *Review requirement.* In order for a Bank to determine whether a CDFI applicant, other than a CDFI credit union, has complied with the financial condition requirement of § 1263.6(a)(4), the applicant shall submit, as a part of its membership application, each of the following documents, and the Bank shall consider all such information prior to acting on the application for membership:

(i) *Financial statements.* An independent audit conducted within the prior year in accordance with generally accepted auditing standards by a certified public accounting firm, plus more recent quarterly statements, if available, and financial statements for the two years prior to the most recent audited financial statement. At a minimum, all such financial statements must include income and expense statements, statements of activities, statements of financial position, and statements of cash flows. The financial statement for the most recent year must include separate schedules or disclosures of the financial position of each of the applicant's affiliates, descriptions of their lines of business, detailed financial disclosures of the relationship between the applicant and its affiliates (such as indebtedness or subordinate debt obligations), disclosures of interlocking directorships with each affiliate, and identification of temporary and permanently restricted funds and the requirements of these restrictions;

(ii) *CDFI Fund certification.* The certification that the applicant has received from the CDFI Fund. If the certification is more than three years old, the applicant must also submit a written statement attesting that there have been no material events or occurrences since the date of certification that would adversely affect its strategic direction, mission, or business operations; and

(iii) *Additional information.* Any other relevant document or information a Bank requests concerning the applicant's financial condition that is not contained in the applicant's financial statements, as well as any other information that the applicant believes demonstrates that it satisfies the financial condition requirement of § 1263.6(a)(4), notwithstanding its failure to meet any of the financial condition standards of paragraph (b)(2) of this section.

(2) *Standards.* A CDFI applicant, other than a CDFI credit union, shall be deemed to be in compliance with the financial condition requirement of § 1263.6(a)(4) if it meets all of the following minimum financial standards—

(i) *Net asset ratio.* The applicant's ratio of net assets to total assets is at least 20 percent, with net and total assets including restricted assets, where net assets is calculated as the residual value of assets over liabilities and is based on information derived from the applicant's most recent financial statements;

(ii) *Earnings.* The applicant has shown positive net income, where net income is calculated as gross revenues less total expenses, is based on information derived from the applicant's most recent financial statements, and is measured as a rolling three-year average;

(iii) *Loan loss reserves.* The applicant's ratio of loan loss reserves to loans and leases 90 days or more delinquent (including loans sold with full recourse) is at least 30 percent, where loan loss reserves are a specified balance sheet account that reflects the amount reserved for loans expected to be uncollectible and are based on information derived from the applicant's most recent financial statements;

(iv) *Liquidity.* The applicant has an operating liquidity ratio of at least 1.0 for the four most recent quarters, and for one or both of the two preceding years, where the numerator of the ratio includes unrestricted cash and cash equivalents and the denominator of the ratio is the average quarterly operating expense.

§ 1263.17 Rebuttable presumptions.

(a) *Rebutting presumptive compliance.* The presumption that an applicant meeting the requirements of §§ 1263.7 to 1263.16 is in compliance with the corresponding eligibility requirements of section 4(a) of the Bank Act (12 U.S.C. 1424(a)) and § 1263.6(a) and (b), may be rebutted, and the Bank may deny membership to an applicant, if the Bank obtains substantial evidence to overcome the presumption of compliance.

(b) *Rebutting presumptive noncompliance.* The presumption that an applicant not meeting a particular requirement of §§ 1263.8, 1263.11, 1263.12, 1263.13, or 1263.16, is not in compliance with the corresponding eligibility requirement of section 4(a) of the Bank Act (12 U.S.C. 1424(a)) and § 1263.6(a) may be rebutted and the applicant shall be deemed to be in compliance with an eligibility requirement, if it satisfies the applicable requirements in this section.

(c) *Presumptive noncompliance by insurance company applicant with "subject to inspection and regulation" requirement of § 1263.8.* If an insurance company applicant is not subject to inspection and regulation by an appropriate State regulator accredited by the NAIC, as required by § 1263.8, the applicant or the Bank shall prepare a written justification that provides substantial evidence acceptable to the Bank that the applicant is subject to inspection and regulation as required by § 1263.6(a)(2), notwithstanding the regulator's lack of NAIC accreditation.

(d) *Presumptive noncompliance with financial condition requirements of §§ 1263.11 and 1263.16*—(1) *Applicants subject to § 1263.11.* For applicants subject to § 1263.11, in the case of an applicant's lack of a composite regulatory examination rating within the two-year period required by § 1263.11(b)(1), a variance from the rating required by § 1263.11(b)(3)(i), or a variance from a performance trend criterion required by § 1263.11(b)(3)(i), the applicant or the Bank shall prepare a written justification pertaining to such requirement that provides substantial evidence acceptable to the Bank that the applicant is in the financial condition required by § 1263.6(a)(4), notwithstanding the lack of rating or variance.

(2) *Applicants subject to § 1263.16.* For applicants subject to § 1263.16, in the case of an insurance company applicant's variance from a capital requirement or standard of § 1263.16(a) or, in the case of a CDFI applicant's variance from the standards of § 1263.16(b), the applicant or the Bank shall prepare a written justification pertaining to such requirement or standard that provides substantial evidence acceptable to the Bank that the applicant is in the financial condition required by § 1263.6(a)(4), notwithstanding the variance.

(e) *Presumptive noncompliance with character of management requirement of § 1263.12*—(1) *Enforcement actions.* If an applicant or any of its directors or senior officers is subject to, or operating under, any enforcement action instituted by its appropriate regulator, the applicant shall provide or the Bank shall obtain:

(i) *Regulator confirmation.* Written or verbal confirmation from the applicant's appropriate regulator that the applicant or its directors or senior officers are in substantial compliance with all aspects of the enforcement action; or

(ii) *Written analysis.* A written analysis acceptable to the Bank indicating that the applicant or its directors or senior officers are in substantial compliance with all aspects of the enforcement action. The written analysis shall state each action the applicant or its directors or senior officers are required to take by the enforcement action, the actions actually taken by the applicant or its directors or senior officers, and whether the applicant regards this as substantial compliance with all aspects of the enforcement action.

(2) *Criminal, civil or administrative proceedings.* If an applicant or any of its directors or senior officers has been the subject of any criminal, civil or administrative proceedings reflecting upon creditworthiness, business judgment, or moral turpitude since the most recent regulatory examination report or, in the case of a CDFI applicant, during the past three years, the applicant shall provide or the Bank shall obtain—

(i) *Regulator confirmation.* Written or verbal confirmation from the applicant's appropriate regulator that the proceedings will not likely result in an enforcement action; or

(ii) *Written analysis.* A written analysis acceptable to the Bank indicating that the proceedings will not likely result in an enforcement action or, in the case of a CDFI applicant, that the proceedings will not likely have a significantly deleterious effect on the applicant's operations. The written analysis shall state the severity of the charges, and any mitigating action taken by the applicant or its directors or senior officers.

(3) *Criminal, civil or administrative monetary liabilities, lawsuits or judgments.* If there are any known potential criminal, civil or administrative monetary liabilities, material pending lawsuits, or unsatisfied judgments against the applicant or any of its directors or senior officers since the most recent regulatory examination report or, in the case of a CDFI applicant, occurring within the past three years, that are significant to the applicant's operations, the applicant shall provide or the Bank shall obtain—

(i) *Regulator confirmation.* Written or verbal confirmation from the applicant's appropriate regulator that the liabilities, lawsuits or judgments will not likely cause the applicant to fall below its applicable capital requirements set forth in §§ 1263.11(b)(2) and 1263.16(a); or

(ii) *Written analysis.* A written analysis acceptable to the Bank indicating that the liabilities, lawsuits or judgments will not likely cause the applicant to fall below its applicable capital requirements set forth in § 1263.11(b)(2) or § 1263.16(a), or the net asset ratio set forth in § 1263.16(b)(2)(i). The written analysis shall state the likelihood of the applicant or its directors or senior officers prevailing, and the financial consequences if the applicant or its directors or senior officers do not prevail.

(f) *Presumptive noncompliance with home financing policy requirements of §§ 1263.13 and 1263.14(d).* If an applicant received a "Substantial Non-Compliance" rating on its most recent CRA performance evaluation, or a "Needs to Improve" CRA rating on its most recent CRA performance evaluation and a CRA rating of "Needs to Improve" or better on any immediately preceding formal CRA performance evaluation, the applicant shall provide or the Bank shall obtain:

(1) *Regulator confirmation.* Written or verbal confirmation from the applicant's appropriate regulator of the applicant's recent satisfactory CRA performance,

including any corrective action that substantially improved upon the deficiencies cited in the most recent CRA performance evaluation(s); or

(2) *Written analysis.* A written analysis acceptable to the Bank demonstrating that the CRA rating is unrelated to home financing, and providing substantial evidence of how and why the applicant's home financing credit policy and lending practices meet the credit needs of its community.

§ 1263.18 Determination of appropriate Bank district for membership.

(a) *Eligibility.* (1) An institution eligible to be a member of a Bank under the Bank Act and this part may be a member only of the Bank of the district in which the institution's principal place of business is located, except as provided in paragraph (a)(2) of this section. A member shall promptly notify its Bank in writing whenever it relocates its principal place of business to another State and the Bank shall inform FHFA in writing of any such relocation.

(2) An institution eligible to become a member of a Bank under the Bank Act and this part may be a member of the Bank of a district adjoining the district in which the institution's principal place of business is located, if demanded by convenience and then only with the approval of FHFA.

(b) *Principal place of business.* Except as otherwise designated in accordance with this section, the principal place of business of an institution is the State in which the institution maintains its home office established as such in conformity with the laws under which the institution is organized and from which the institution conducts business operations.

(c) *Designation of principal place of business*—(1) A member or an applicant for membership may request in writing to the Bank in the district where the institution maintains its home office that a State other than the State in which it maintains its home office be designated as its principal place of business. Within 90 calendar days of receipt of such written request, the board of directors of the Bank in the district where the institution maintains its home office shall designate a State other than the State where the institution maintains its home office as the institution's principal place of business, provided that, all of the following criteria are satisfied:

(i) At least 80 percent of the institution's accounting books, records, and ledgers are maintained, located or held in such designated State;

(ii) A majority of meetings of the institution's board of directors and constituent committees are conducted in such designated State; and

(iii) A majority of the institution's five highest paid officers have their place of employment located in such designated State.

(2) Written notice of a designation made pursuant to paragraph (c)(1) of this section shall be sent to the Bank in the district containing the designated State, FHFA, and the institution.

(3) The notice of designation made pursuant to paragraph (c)(1) of this section shall include the State designated as the principal place of business and the Bank of which the subject institution is eligible to be a member.

(4) If the board of directors of the Bank in the district where the institution maintains its home office fails to make the designation requested by the member or applicant pursuant to paragraph (c)(1) of this section, then the member or applicant may request in writing that FHFA make the designation.

(d) *Transfer of membership.* (1) In the case of a member whose principal place of business has been designated as a State located in another Bank district in accordance with paragraph (c) of this section, or in the case of a member that has relocated its principal place of business to a State in another Bank district, the transfer of membership from one Bank to another Bank shall not take effect until the Banks involved reach an agreement on a method of orderly transfer.

(2) In the event that the Banks involved fail to agree on a method of orderly transfer, FHFA shall determine the conditions under which the transfer shall take place.

(e) *Effect of transfer.* A transfer of membership pursuant to this section shall be effective for all purposes, but shall not affect voting rights in the year of the transfer and shall not be subject to the provisions on termination of membership set forth in section 6 of the Bank Act (12 U.S.C. 1426) or §§ 1263.26 and 1263.27, nor the restriction on reacquiring Bank membership set forth in § 1263.30.

(f) *Insurance companies and CDFIs.* (1) For an insurance company or CDFI that cannot satisfy the requirements of paragraphs (b) or (c) of this section for designating its principal place of business, a Bank shall designate as the principal place of business the geographic location from which the institution actually conducts the predominant portion of its business activities.

(2) A Bank may deem an institution to conduct the predominant portion of its business activities in a particular State if any two of the following three factors are present:

(i) The institution's largest office, as measured by the number of employees, is located in that State;

(ii) A plurality of the institution's employees are located in that State; or

(iii) The places of employment for a plurality of the institution's senior executives are located in that State.

(3) If a Bank cannot designate a State as the principal place of business under paragraph (f)(1) of this section, and cannot otherwise identify a geographic location from which the institution actually conducts the predominant portion of its business activities, it shall designate the State of domicile or incorporation as the principal place of business for that institution.

(4) For purposes of paragraph (f)(2) of this section, the term "senior executive" means all officers at or above the level of "senior vice president" and includes the positions of president, executive vice president, chief executive officer, chief financial officer, chief operating officer, general counsel, as well as any individuals who perform functions similar to those positions whether or not the individual has an official title.

(g) *Records.* A Bank designating the principal place of business for a member under this section shall document the bases for its determination in writing and shall include that documentation in the membership digest and application file for the institution that are required under § 1263.2.

Subpart D—Stock Requirements

§ 1263.19 [Reserved]

§ 1263.20 Stock purchase.

(a) *Minimum purchase requirement.* An institution that has been approved for membership in a Bank as provided in this part shall become a member of that Bank upon purchasing the amount of stock required under the membership stock purchase provisions of that Bank's capital structure plan. If an institution fails to purchase the minimum amount of stock required for membership within 60 calendar days after the date on which it is approved for membership, the membership approval shall become void and that institution may not become a member of that Bank until after it has filed a new application and the Bank has approved that application pursuant to the requirements of this part.

(b) *Issuance of stock.* After approving an institution for membership, and in return for payment in full of the par value, a Bank shall issue to that institution the amount of capital stock required to be purchased under the Bank's capital structure plan.

(c) *Reports.* Each Bank shall report to FHFA information regarding the minimum investment in Bank capital stock made by each new member referred to in paragraph (a) of this section, in accordance with the instructions provided in the Data Reporting Manual.

§ 1263.21 [Reserved]

§ 1263.22 Annual calculation of stock holdings.

A Bank shall calculate annually each member's required minimum holdings of Bank stock using calendar year-end financial data provided by the member to the Bank, pursuant to § 1263.31(d), and shall notify each member of the result. The notice shall clearly state that the Bank's calculation of each member's minimum stock holdings is to be used to determine the number of votes that the member may cast in that year's election of directors and shall identify the State within the district in which the member will vote. A member that does not agree with the Bank's calculation of the minimum stock purchase requirement or with the identification of its voting State may request FHFA to review the Bank's determination. FHFA shall promptly determine the member's minimum required holdings and its proper voting State, which determination shall be final.

§ 1263.23 Excess stock.

(a) *Sale of excess stock.* Subject to the restriction in paragraph (b) of this section, a member may purchase excess stock as long as the purchase is approved by the member's Bank and is permitted by the laws under which the member operates.

(b) *Restriction.* Any Bank with excess stock greater than one percent of its total assets shall not declare or pay any dividends in the form of additional shares of Bank stock or otherwise issue any excess stock. A Bank shall not issue excess stock, as a dividend or otherwise, if after the issuance, the outstanding excess stock at the Bank would be greater than one percent of its total assets.

Subpart E—Withdrawal, Termination and Readmission

§ 1263.24 Consolidations involving members.

(a) *Consolidation of members.* Upon the consolidation of two or more institutions that are members of the same Bank into one institution operating under the charter of one of the consolidating institutions, the membership of the surviving institution shall continue and the membership of each disappearing institution shall terminate on the cancellation of its charter. Upon the consolidation of two or more institutions, at least two of which are members of different Banks, into one institution operating under the charter of one of the consolidating institutions, the membership of the surviving institution shall continue and the membership of each disappearing institution shall terminate upon cancellation of its charter, provided, however, that if more than 80 percent of the assets of the consolidated institution are derived from the assets of a disappearing institution, then the consolidated institution shall continue to be a member of the Bank of which that disappearing institution was a member prior to the consolidation, and the membership of the other institutions shall terminate upon the effective date of the consolidation.

(b) *Consolidation into nonmember*—(1) *In general.* Upon the consolidation of a member into an institution that is not a member of a Bank, where the consolidated institution operates under the charter of the nonmember institution, the membership of the disappearing institution shall terminate upon the cancellation of its charter.

(2) *Notification.* If a member has consolidated into a nonmember that has its principal place of business in a State in the same Bank district as the former member, the consolidated institution shall have 60 calendar days after the cancellation of the charter of the former member within which to notify the Bank of the former member that the consolidated institution intends to apply for membership in such Bank. If the consolidated institution does not so notify the Bank by the end of the period, the Bank shall require the liquidation of any outstanding indebtedness owed by the former member, shall settle all outstanding business transactions with the former member, and shall redeem or repurchase the Bank stock owned by the former member in accordance with § 1263.29.

(3) *Application.* If such a consolidated institution has notified the appropriate Bank of its intent to apply for membership, the consolidated institution shall submit an application for membership within 60 calendar days of so notifying the Bank. If the consolidated institution does not submit an application for membership by the end of the period, the Bank shall require the liquidation of any outstanding indebtedness owed by the former member, shall settle all outstanding business transactions with the former member, and shall redeem or repurchase the Bank stock owned by the former member in accordance with § 1263.29.

(4) *Outstanding indebtedness.* If a member has consolidated into a nonmember institution, the Bank need not require the former member or its successor to liquidate any outstanding indebtedness owed to the Bank or to redeem its Bank stock, as otherwise may be required under § 1263.29, during:

(i) The initial 60 calendar-day notification period;

(ii) The 60 calendar-day period following receipt of a notification that the consolidated institution intends to apply for membership; and

(iii) The period of time during which the Bank processes the application for membership.

(5) *Approval of membership.* If the application of such a consolidated institution is approved, the consolidated institution shall become a member of that Bank upon the purchase of the amount of Bank stock necessary, when combined with any Bank stock acquired from the disappearing member, to satisfy the minimum stock purchase requirements established by the Bank's capital structure plan.

(6) *Disapproval of membership.* If the Bank disapproves the application for membership of the consolidated institution, the Bank shall require the liquidation of any outstanding indebtedness owed by, and the settlement of all other outstanding business transactions with, the former member, and shall redeem or repurchase the Bank stock owned by the former member in accordance with § 1263.29.

(c) *Dividends on acquired Bank stock.* A consolidated institution shall be entitled to receive dividends on the Bank stock that it acquires as a result of a consolidation with a member in accordance with applicable FHFA regulations.

§ 1263.25 [Reserved]

§ 1263.26 Voluntary withdrawal from membership.

(a) *In general*—(1) Any institution may withdraw from membership by providing to the Bank written notice of its intent to withdraw from membership. A member that has so notified its Bank shall be entitled to have continued access to the benefits of membership until the effective date of its withdrawal. The Bank need not commit to providing any further services, including advances, to a withdrawing member that would mature or otherwise terminate subsequent to the effective date of the withdrawal. A member may cancel its notice of withdrawal at any time prior to its effective date by providing a written cancellation notice to the Bank. A Bank may impose a fee on a member that cancels a notice of withdrawal, provided that the fee or the manner of its calculation is specified in the Bank's capital plan.

(2) A Bank shall notify FHFA within 10 calendar days of receipt of any notice of withdrawal or notice of cancellation of withdrawal from membership.

(b) *Effective date of withdrawal.* The membership of an institution that has submitted a notice of withdrawal shall terminate as of the date on which the last of the applicable stock redemption periods ends for the stock that the member is required to hold, as of the date that the notice of withdrawal is submitted, under the terms of a Bank's capital plan as a condition of membership, unless the institution has cancelled its notice of withdrawal prior to the effective date of the termination of its membership.

(c) *Stock redemption periods.* The receipt by a Bank of a notice of withdrawal shall commence the applicable 6-month and 5-year stock redemption periods, respectively, for all of the Class A and Class B stock held by that member that is not already subject to a pending request for redemption. In the case of an institution, the membership of which has been terminated as a result of a merger or other consolidation into a nonmember or into a member of another Bank, the applicable stock redemption periods for any stock that is not subject to a pending notice of redemption shall be deemed to commence on the date on which the charter of the former member is cancelled.

§ 1263.27 Involuntary termination of membership.

(a) *Grounds.* The board of directors of a Bank may terminate the membership of any institution that:

(1) Fails to comply with any requirement of the Bank Act, any regulation adopted by FHFA, or any requirement of the Bank's capital plan;

(2) Becomes insolvent or otherwise subject to the appointment of a conservator, receiver, or other legal custodian under federal or State law; or

(3) Would jeopardize the safety or soundness of the Bank if it were to remain a member.

(b) *Stock redemption periods.* The applicable 6-month and 5-year stock redemption periods, respectively, for all of the Class A and Class B stock owned by a member and not already subject to a pending request for redemption, shall commence on the date that the Bank terminates the institution's membership.

(c) *Membership rights.* An institution whose membership is terminated involuntarily under this section shall cease being a member as of the date on which the board of directors of the Bank acts to terminate the membership, and the institution shall have no right to obtain any of the benefits of membership after that date, but shall be entitled to receive any dividends declared on its stock until the stock is redeemed or repurchased by the Bank.

§ 1263.28 [Reserved]

§ 1263.29 Disposition of claims.

(a) *In general.* If an institution withdraws from membership or its membership is otherwise terminated, the Bank shall determine an orderly manner for liquidating all outstanding indebtedness owed by that member to the Bank and for settling all other claims against the member. After all such obligations and claims have been extinguished or settled, the Bank shall return to the member all collateral pledged by the member to the Bank to secure its obligations to the Bank.

(b) *Bank stock.* If an institution that has withdrawn from membership or that otherwise has had its membership terminated remains indebted to the Bank or has outstanding any business transactions with the Bank after the effective date of its termination of membership, the Bank shall not redeem or repurchase any Bank stock that is required to support the indebtedness or the business transactions until after all such indebtedness and business transactions have been extinguished or settled.

§ 1263.30 Readmission to membership.

(a) *In general.* An institution that has withdrawn from membership or otherwise has had its membership terminated and which has divested all of its shares of Bank stock, may not be readmitted to membership in any Bank, or acquire any capital stock of any Bank, for a period of five years from the date on which its membership terminated and it divested all of its shares of Bank stock.

(b) *Exceptions.* An institution that transfers membership between two Banks without interruption shall not be deemed to have withdrawn from Bank membership or had its membership terminated.

Subpart F—Other Membership Provisions

§ 1263.31 Reports and examinations.

As a condition precedent to Bank membership, each member:

(a) Consents to such examinations as the Bank or FHFA may require for purposes of the Bank Act;

(b) Agrees that reports of examination by local, State or federal agencies or institutions may be furnished by such authorities to the Bank or FHFA upon request;

(c) Agrees to give the Bank or the appropriate Federal banking agency, upon request, such information as the Bank or the appropriate Federal banking agency may need to compile and publish cost of funds indices and to publish other reports or statistical summaries pertaining to the activities of Bank members;

(d) Agrees to provide the Bank with calendar year-end financial data each year, for purposes of making the calculation described in § 1263.22; and

(e) Agrees to provide the Bank with copies of reports of condition and operations required to be filed with the member's appropriate Federal banking agency, if applicable, within 20 calendar days of filing, as well as copies of any annual report of condition and operations required to be filed.

§ 1263.32 Official membership insignia.

Members may display the approved insignia of membership on their documents, advertising and quarters, and likewise use the words "Member Federal Home Loan Bank System."

Dated: January 11, 2016.

Melvin L. Watt,

Director, Federal Housing Finance Agency.

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Remarks as Prepared for Delivery
Melvin L. Watt, Director
Federal Housing Finance Agency
Bipartisan Policy Center
Washington, D.C.
February 18, 2016

Thank you, Secretary Cisneros, for your opening remarks and introduction. I also want to thank the Bipartisan Policy Center for extending the invitation for me to speak today on our work at the Federal Housing Finance Agency (FHFA). I think all of you will agree that the things I am going to talk about deserve bipartisan attention and collaboration like we have seldom seen in recent years.

This speech has two parts, an easy part and a difficult part. Both parts reflect a philosophy that I hope all of you agree we have tried to encourage since I became the Director of FHFA – a philosophy of open, honest, and transparent discussion and decision making that helps demystify what FHFA, Fannie Mae, and Freddie Mac do and how those things relate to housing finance stakeholders.

The first part of my speech is easy because it looks retrospectively at some of the things we have accomplished and how we have managed Fannie Mae and Freddie Mac (the Enterprises) in conservatorship to accomplish them. By saying that this part of the speech is easy, however, I want to be careful not to suggest that all the decisions I will highlight were easy or noncontroversial when they were being considered. It has been my experience that when decisions produce positive results down the road, we tend to forget how controversial or complicated these decisions might have been at the time they were made.

The second part of the speech is difficult, both because it looks forward – something I have shown much less inclination to do up to this point in my time as Director of FHFA – and because looking forward is inherently more difficult and almost always tends to generate more controversy. After two full years as Director of FHFA, however, I think it's timely for me to talk not only about our accomplishments, but also about some of the challenges and risks we face, some of which will surely become more difficult for us to control the longer the conservatorships continue. While my primary responsibility as conservator may be to manage the Enterprises in the present as I have said on a number of occasions, I believe that I have an obligation, both in my role as conservator and in my role as regulator, to be frank and transparent about our challenges and risks. By doing so, I hope these remarks will ignite some dialogue that could well be difficult, but I believe is also critically needed.

The Unprecedented Conservatorships of Fannie Mae and Freddie Mac
Some background is necessary to frame both parts of the speech. Congress established FHFA in 2008 during the height of the financial crisis, and one of the Agency's first acts was to place the Enterprises into conservatorship. Under the Senior Preferred Stock Purchase Agreements (PSPAs), the U.S. Department of the Treasury (Treasury Department) has provided essential financial commitments of taxpayer funding to support the Enterprises' compromised financial status. During the first four years of

conservatorship, the Enterprises drew a total of $187.5 billion from Treasury, but neither Enterprise has made a further draw since 2012. Fannie Mae has approximately $118 billion of its PSPA commitment remaining, and Freddie Mac has approximately $141 billion remaining. Since the beginning of conservatorship through the end of 2015, the Enterprises paid approximately $241 billion in dividends to the Treasury Department. Under the provisions of the PSPAs the Enterprises' dividend payments do not offset the amounts drawn from the Treasury Department.

Virtually everyone would agree that today we have a much safer and more stable housing finance system than when FHFA placed the Enterprises in conservatorship. I also think that most people would attribute a significant part of these improvements to decisions made in conservatorship. Guarantee fees have increased by two and a half times since 2009, and our review last year concluded that overall guarantee fee levels are now appropriate. Stronger credit standards have removed unsound risk layering and, in a manner consistent with safety and soundness, we have increasingly focused on how to support sustainable access to credit for homeowners, one of the Enterprises' statutory obligations.

Delinquencies and foreclosures have gone down on the Enterprises' legacy books of business, and the number of REO properties held by the Enterprises has decreased significantly. The number of HARP refinances has surpassed 3.3 million and the Enterprises have taken more than 3.6 million other actions to prevent foreclosures. The Enterprises' retained portfolios have decreased by over half since March 2009, and their portfolios are now more focused on supporting their core business operations. The Enterprises' multifamily programs had strong performance through the crisis, and they continue to share risk with private investors. Their multifamily purchases provide needed liquidity for the general multifamily market, with an increasing focus on affordable rental housing.

We have completed efforts to revamp and improve the Representation and Warranty Framework, and we have strengthened counterparty standards for mortgage insurers and non-bank Seller/Servicers. We have started and significantly ramped up credit risk transfer programs at both Freddie Mac and Fannie Mae, with both Enterprises now regularly transferring substantial credit risk to private investors on over 90 percent of their typical 30-year, fixed-rate acquisitions. We have a target for Freddie Mac to start using the Common Securitization Platform (CSP) in 2016, and a target for the Single Security to go into effect with both Enterprises using the CSP to support their major securitization activities in 2018.

In all of these things, we have also placed greater attention on diversity and inclusion in the Enterprises' business operations, consistent with legal standards and with projections that the future composition of homeowners, renters, and the country as a whole will be more diverse.

FHFA's Role as Regulator and Conservator. As this list highlights, FHFA's role as conservator of Fannie Mae and Freddie Mac has been unprecedented in its scope, complexity, and duration – especially when you consider Fannie Mae and Freddie Mac's role in supporting over $5 trillion in mortgage loans and guarantees. This is an extraordinary role for a regulatory agency also because we are obligated to fulfill both the role of supervisor and the role of conservator at the same time, and because we are now approaching eight full years of having these obligations. So let me also describe briefly how FHFA has managed these dual responsibilities.

Like other federal financial regulators, FHFA conducts safety and soundness supervision with a deliberate distance between FHFA and the Enterprises. Members of our supervision staff, many of whom are located onsite at Fannie Mae and Freddie Mac, conduct examinations that focus on areas of highest risk to the Enterprises. They produce reports of examination and make findings as to whether the Enterprises need to make corrective actions in particular areas.

In contrast, our role as conservator involves a different kind of relationship with the Enterprises. Under the Housing and Economic Recovery Act of 2008, FHFA has the full authority of the Enterprises' boards of directors, management, and shareholders while the Enterprises are in conservatorship. This means that FHFA has ultimate authority and control to make business, policy, and risk decisions for the Enterprises, and the Enterprises' boards know that their job is to meet our expectations.

However, managing these Enterprises in conservatorship requires much more of a joint effort than would occur under a normal regulatory relationship. For example, while an examiner would review board or management minutes after the meetings have taken place, members of FHFA's Division of Conservatorship team attend management and board meetings as part of our conservatorship functions, and I personally attend and preside at executive sessions of Enterprise board meetings.

FHFA's Management of Fannie Mae and Freddie Mac in Conservatorship. There are four key approaches that we use to manage the unique nature of these conservatorships. Using these approaches, we have been able to fulfill our statutory obligations to ensure safety and soundness, to preserve and conserve Enterprise assets, to ensure liquidity in the housing finance market, and to satisfy the Enterprises' public purpose missions.

First, we set the overall strategic direction for the Enterprises in FHFA's Conservatorship Strategic Plan and in annual scorecards that outline our policy expectations. We set quarterly and year-end milestones for our scorecard objectives, and we conduct regular evaluations of whether the Enterprises are on track or behind in meeting our targets. Our final scorecard assessments at the end of each year factor into the compensation calculations for Fannie Mae and Freddie Mac executives.

Second, we delegate the day-to-day operations of the companies to their boards and senior management. With over 12,000 employees at the two Enterprises and considering the nationwide scope and technical nature of their businesses, we can't pull every lever and make every day-to-day operating decision. If we tried, I'm quick to acknowledge that their operations would grind to a halt. Under conservatorship, the Enterprises continue to operate as business corporations with boards of directors subject to corporate governance standards. The Enterprise boards are responsible – like boards of directors at other companies – for overseeing their business activities. They review budgets and set risk limits. They examine business plans and oversee senior management.

When FHFA first placed the Enterprises into conservatorship, FHFA selected new chief executive officers, reestablished their boards of directors, and approved new board members. FHFA has continued to approve all new CEOs and board members throughout conservatorship, and they are responsible for meeting our expectations and effectively running the companies. I meet several times a month with the CEOs of Freddie Mac and Fannie Mae. In addition to my attendance at board meetings, I have regular conversations and engagement with each Enterprise's board chair to help elevate issues that need to be resolved.

Third, we have carved out actions that are not delegated to the Enterprises that require advance approval by FHFA. Deciding which items we should delegate to the Enterprises and which should require FHFA approval is a judgment call and finding the right balance is an ongoing process. There are decisions that are obvious choices for FHFA to make, such as setting the core components of the guarantee fees charged by Fannie Mae and Freddie Mac. Others are closer calls. While we retain the authority to step in and make the call on any issue, even ones that we previously delegated, we have found that providing as much clarity as possible about roles and responsibilities serves everyone better.

The fourth prong of our conservatorship model is oversight and monitoring of Enterprise activities, and this is something that happens on an on-going basis – it's probably not an overstatement to say this takes place constantly. In addition to attending meetings of the management committees, FHFA staff members engage in regular dialogue with the management and operational teams at the Enterprises, regularly review information submitted by the Enterprises, and take action where appropriate.

Managing the Enterprises in conservatorship through this four-step approach – with regular adjustments to account for changing circumstances – has worked well. FHFA's conservatorship decisions have helped navigate the Enterprises through a financial crisis and, despite the substantial negative impact of the crisis, helped prevent it from being far worse.

The Challenges and Risks of a Protracted Conservatorship

However, an eight-year conservatorship is unprecedented, and managing the ongoing, protracted conservatorships of Fannie Mae and Freddie Mac poses a number of unique challenges and risks. This leads me to the more difficult part of these remarks.

I have consistently stated that our responsibility and role at FHFA as conservator is to manage in the present. However, as we work to appropriately manage challenges and risks in the present, we also have a responsibility to assess when these challenges and risks may escalate to the point that they negatively impact the Enterprises and the broader housing finance market in the future. By giving this speech today, I am signaling my belief that some of the challenges and risks we are managing are escalating and will continue to do so the longer the Enterprises remain in conservatorship. Consequently, I believe that I have a responsibility, both as regulator and as conservator, to identify and discuss this concern more openly.

Enterprises' declining capital buffers. The most serious risk and the one that has the most potential for escalating in the future is the Enterprises' lack of capital. FHFA suspended statutory capital classifications when the Enterprises were placed in conservatorship, and Fannie Mae and Freddie Mac are currently unable to build capital under the provisions of the PSPAs. The agreements require each Enterprise to pay out comprehensive income generated from business operations as dividends to the Treasury Department, and the amount of funds each Enterprise is allowed to retain is often referred to as the Enterprises' "capital buffer." This capital buffer is available to absorb potential losses, which reduces the need for the Enterprises to draw additional funding from the Treasury

Department. However, based on the terms of the PSPAs, this capital buffer is reducing each year. And, we are now over halfway down a five-year path toward eliminating the buffer completely.

Starting January 1, 2018, the Enterprises will have no capital buffer and no ability to weather quarterly losses – such as the non-credit related loss incurred by Freddie Mac in the third quarter of last year – without making a draw against the remaining Treasury commitments under the PSPAs. There are a number of non-credit related factors that could lead to a loss and result in a draw on those commitments: interest rate volatility; accounting treatment of derivatives, which are used to hedge risk but can also produce significant earnings volatility; reduced income from the Enterprises' declining retained portfolios; and, the increasing volume of credit risk transfer transactions, which transfer both the risk of future credit losses as well as current revenues away from the Enterprises to the private sector. A disruption in the housing market or a period of economic distress could also lead to credit-related losses and trigger a draw.

It is, of course, impossible to predict the exact ramifications of future draws of funds from the PSPA commitments. But let me offer a few observations.

First, and most importantly, future draws that chip away at the backing available by the Treasury Department under the PSPAs could undermine confidence in the housing finance market. The remaining funds available under the PSPAs provide the market with assurance that the Enterprises can meet their guarantee obligations to investors in mortgage-backed securities even while they are in conservatorship and don't have the ability to build capital. In effect, the Treasury Department's financial commitment to each Enterprise under the PSPAs is a source of capital that supports mortgage market liquidity. However, under the terms of the PSPAs, these funds can only go down and cannot be replenished. Future draws would reduce the overall backing available to the Enterprises, and a significant reduction could cause investors to view this backing as insufficient. It's unclear where investors would draw that line, but certainly before these funds were drawn down in full.

Investor confidence is critical if we are to have, as we do today, a well-functioning and highly liquid housing finance market that makes it possible for families to lock in interest rates, obtain 30-year, fixed-rate mortgages, and prepay a mortgage if they want to refinance or need to move. If investor confidence in Enterprise securities went down and liquidity declined as a result, this could have real ramifications on the availability and cost of credit for borrowers.

Second, future draws could lead to a legislative response adopted in haste or without the kind of forethought it should be given. I have been clear that conservatorship is not a desirable end state and that Congress needs to tackle the important work of housing finance reform. However, because of the intricacies of our housing finance system and the extremely high stakes for the housing finance market and for the economy as a whole if reform is not done right, I continue to hope that Congress can engage in the work of thoughtful housing finance reform before we reach a crisis of investor confidence or a crisis of any other kind. While it's not my place to meddle in political discussions, I'm also not hearing much discussion of housing finance reform in any of the presidential campaigns.

The role of market discipline in conservatorship. A less discussed, but related, challenge posed by a continuing conservatorship is Fannie Mae and Freddie Mac's insulation from normal market forces that would otherwise inform their operations and business practices. There are differing views about the Enterprises' business models leading up to the financial crisis, but in conservatorship the responsibility to create a regime of market discipline and appropriate competition falls squarely on FHFA's shoulders. The longer the Enterprises remain in conservatorship, the greater and more complicated this responsibility becomes.

This challenge presents itself in multiple decisions, including pricing. Although the Enterprises are not building capital while they are in conservatorship, FHFA expects Freddie Mac and Fannie Mae to determine their pricing as though they were holding capital and seeking an appropriate economic return on this capital. This is something that was very important to FHFA as we started to review and make adjustments to guarantee fees. We worked with the Enterprises to review the cost of capital as part of our assessment of the correct level of overall guarantee fees charged by the Enterprises. Without such an approach, it would be challenging to decide what guarantee fee levels to approve. Through our 2016 Scorecard priority to finalize a risk management framework, we are working to further our ability to evaluate these kinds of Enterprise business decisions.

Another challenge related to market discipline is the question of how the Enterprises should or should not compete against one another. As I discussed earlier, we have consciously structured the conservatorships of Freddie Mac and Fannie Mae so they continue to run as going concerns. We want them to continue to innovate and to compete on the kind of customer service they provide to lenders and on the quality of their business practices. We believe that competition in these areas is healthy for the Enterprises, good for the housing finance market, and good for borrowers.

However, we have also made a number of decisions that require the Enterprises to adopt aligned standards in certain areas, such as aligned counterparty requirements, to avoid excessive risk being placed on taxpayers. In conservatorship, we carefully determine when to allow competition and when to require alignment, requiring, of course, that all operations be executed in a safe and sound manner.

Planning amidst an uncertain future. A final challenge that being in protracted conservatorships forces us to face is how to manage and plan for the future when there is tremendous uncertainty about what the future holds. Experience demonstrates that it is difficult to manage the Enterprises in the present without establishing some kind of plans for the future. Here, I'm not talking about plans for housing finance reform, but plans for everyday operations, including strategic planning that every well-run business does and project planning that's necessary to continue key initiatives. Without looking somewhat down the road, FHFA and the Enterprises would both lose their momentum and jeopardize day-to-day success. The key dilemma when you have an uncertain future, however, is how far down the road to look and how to retain the necessary talent to implement either short- or longer-term plans.

This challenge drove my decision to authorize the increases in compensation for both Enterprise CEOs that proved to be so controversial. First, I recognized that our delegated model relies heavily on strong management teams to uphold their side of conservatorship. Second, I decided that to be responsible we needed to have the Enterprises engage in operations-focused strategic planning over a three-to-five year horizon. To do both of those things, we needed to ensure continuity by retaining senior-level staff and having reliable succession plans that minimized disruptions.

Of course, we have implemented the legislation that Congress passed to reinstate the prior CEO compensation limits, and it is not my intention here to debate the wisdom of the decision that Congress made. Having served in Congress, I understand that it was an easy political decision. However, the issue of reliable succession planning is another example of the many challenges presented by a long-term conservatorship. The fact is that the Enterprises run businesses that rely on a highly specialized and technically skilled workforce. Retaining that workforce is essential to the Enterprises' success and to FHFA's success as conservator. With continuing uncertainty about conservatorships of indefinite duration and what role the Enterprises will play in the future of housing finance, retaining skilled employees will be an increasing challenge.

Conclusion

We have made these ongoing conservatorships work thus far through the dedication of staff at FHFA and the staffs of both Enterprises and we, of course, remain committed to continuing this task. We know that the stakes are high for the housing finance market and for the broader economy. However, as I have indicated in my remarks today, there are substantial challenges and risks associated with the unprecedented size, complexity, and duration of the conservatorships of Fannie Mae and Freddie Mac. After more than two years at FHFA, I can assure you that these challenges are certainly not going away, and some of them are almost certain to escalate the longer the Enterprises remain in conservatorship.

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A Progress Report on the Private-Label Securities Market

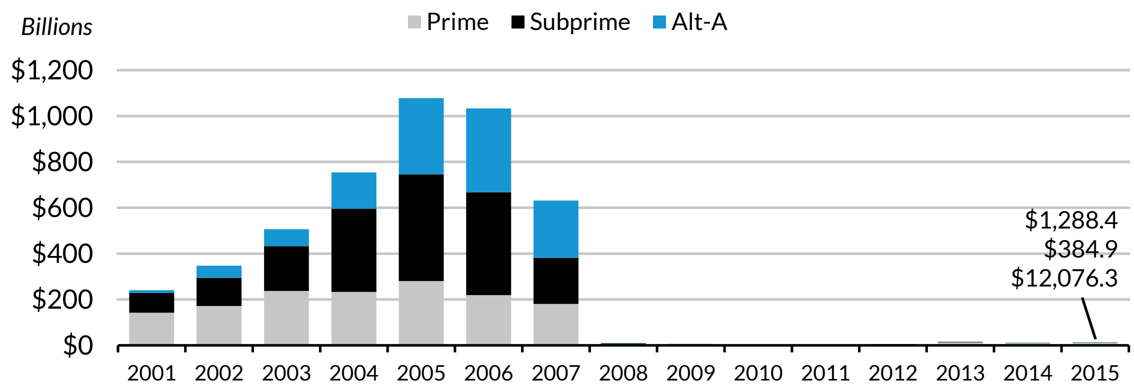
Laurie Goodman

March 2016

Issuance in the private-label securities (PLS) market has faded significantly since the financial crises. For the past eight years, securitization of products with no government involvement has been trifling compared with both 2005–07 and earlier periods. New prime securitization was just $12.1 billion in 2015—less than 9 percent of 2001's $142 billion total. Private-label securitization of newly prime, Alt-A, and subprime mortgages totaled $13.7 billion in 2015, versus $240.6 billion in 2001 (figure 1).

FIGURE 1

Non-agency Mortgage-Backed Securities Issuance, 2001–15



Sources*:* Inside Mortgage Finance and Urban Institute.

The low PLS issuance reflects two factors:

- Packages of loans are generally worth more to banks than what they would fetch in the PLS market; and
- Many investors are unwilling to engage in the PLS market because of the weak governance structures of these securities.

During the crisis, the PLS mortgage market suffered the most dislocation of any securitized product group because of severe and widespread home price depreciation, which highlighted the structural weaknesses of these securities. Some of these weaknesses have been corrected in recent deals: the cash flow waterfall is more favorable to the senior bonds, the loan underwriting process is rigorous, due diligence standards have been implemented, and loan-level information is more robust and more consistent across deals. However, many investors remain on the sidelines, in large part because they believe that the conflicts of interest between the deal sponsors/servicers and the investors have not yet been adequately addressed.

Two noteworthy efforts have tried to address these governance issues: the US Department of the Treasury's PLS initiative, announced in 2014, and the Structured Finance Industry Group's RMBS 3.0 Task Force, established in 2013. As part of the PLS initiative, the US Treasury has spent the past 18 months convening market participants—including institutional investors, issuers, servicers, ratings agencies, due diligence firms and other key stakeholders—to discuss reforms needed to restart the PLS market. As expressed by Monique Rollins, Treasury's deputy assistant secretary for capital markets, in a February speech,

> While the PLS market can provide a channel for mortgage financing that is responsible and not reliant on a taxpayer-backed guarantee, its return must happen in a reformed and sustainable way….While we do not see the PLS channel as a total panacea, it is one of a number of channels that can responsibly improve access to credit and strengthen the housing recovery. (Rollins 2016)

In a tangible sign of progress from the PLS initiative, some participants recently published key principles governing the role of deal agents, who are charged with looking out for the interests of investors. This concept is largely missing from existing deals.

The RMBS 3.0 Task Force was founded by the Structured Finance Industry Group (SFIG), an industry trade association. Task force participants include issuers, investors, rating agencies, servicers, lawyers, trustees, and diligence firms. The task force has summarized its efforts in the third edition of its green paper, released in November (SFIG 2015). More participants, but fewer large investors, are involved with the SFIG effort than with the PLS initiative. Some participants are in both groups.

In September 2015, we wrote about the state of the PLS market and what was needed to revive it (Goodman 2015). In particular, we made the case that action was needed along three dimensions: the introduction of an agent to look out for the interests of investors (the deal agent), standardization of deal documentation, and servicing improvements. We believe the Treasury and SFIG reform efforts have made considerable progress on our first two goals and some progress toward the third.

Why Is This Important?

The disappearance of the PLS market has already affected the availability and cost of mortgages for borrowers who do not have the necessary credit to qualify for government-backed loans. And this group of borrowers is larger than it might otherwise be. Many mortgage originators impose credit overlays on Federal Housing Administration (FHA) and government-sponsored enterprise (GSE) loans. These originators still fear repurchase and indemnification requests, litigation, and the high cost and reputational risk of servicing nonperforming loans. In addition, self-employed borrowers with good credit often do not qualify for government-backed loans because they pose documentation issues; households with more than two borrowers or income sources that fluctuate substantially from year to year are also likely to experience difficulties in qualifying for government backed loans. Banks are generally not interested in holding in portfolio loans made to these borrowers.

The one group unable to obtain government-backed lending not yet affected by the absence of a PLS market is wealthy borrowers with loans over the conforming loan limits (for GSE loans, $625K in high-cost areas, $417K nationwide). Banks are willing to put these loans on their balance sheet. If banks retreat from holding mortgages before the PLS market restarts, then these borrowers will also be affected.

The failure to restart the PLS market could have a much deeper and more problematic impact should policymakers ultimately decide to pull back on the government's role in the market, as many housing policy reformers have proposed. If this occurs, and banks do not step up, creditworthy borrowers with conforming loans will face both higher rates and credit availability issues.

The Introduction of a Deal Agent

In the pre-crises deals, which are now commonly referred to as Legacy RMBS or RMBS 1.0, most market participants believed that no one was charged with looking after investor interests, and there was no practical mechanism for investors to look out for themselves. As a result, a brutal combination of conflicts of interest and lack of enforcement in securitizations worked to the detriment of investors: representations and warranties were not enforced, decisions made on behalf of the trust had no transparency, investors received no communications or reports about the status of their deals beyond standard servicing reports (which contained less detail than investors felt was necessary), and servicing oversight was minimal. Many of these issues have not been corrected in RMBS 2.0, the post-crises deals done to date. But recent efforts are beginning to move the market in the right direction.

The Treasury Department's PLS initiative made its largest impact by outlining the concept of a deal agent—a concept that has the support of a wide ranging group of investors, issuers, and potential deal agents. Investors have long believed that they need a party to look out for their interests, but prior discussions typically broke down on specific roles and responsibilities and the scope of liability. Under the “Proposed Deal Agent Agreement: Key Principles,” one document that arose from the Treasury group’s effort, the deal agent would be selected by the deal sponsor and would have a duty of loyalty and a duty of care to the trust as a whole. That is, the deal agent would be charged with “protecting the interests of the RMBS trust, maximizing the net present value of its assets and making certain strategic decisions in the limited circumstances that doing so becomes necessary” (Pagani and Callahan 2016). The responsibilities of the deal agent would include (1) reviewing representations and warranties, (2) overseeing servicers, and (3) reporting to bondholders monthly.

Under many RMBS 2.0 deals, certain events (such as delinquency) after a certain number of days (generally 120) would trigger a third party to determine whether a breach of representations and warranties has occurred. The key principles formalized and strengthened this role under a deal agent. The deal agent is authorized to obtain all information necessary to make such a determination, including credit files, servicing files, and underwriting guidelines. If a breach has occurred, the deal agent is authorized to enforce repurchase demands. The deal agent would also have some discretion to conduct reviews not generated by trigger events, such as when there are patterns of unusual loan behavior.

On the servicing side, the deal agent would make sure servicers focus on maximizing the value of the assets and do no self-dealing. The deal agent would ensure the servicer was complying with its own articulated standards and would have the authority to review breaches of servicing obligations. The deal agent would also have the ability to pursue claims against servicers, even terminating them if necessary. The deal agent would also be responsible for ensuring that all cash flows from the transaction are reconciled monthly.

In this effort, SFIG has developed a comprehensive list of all roles and functions and who will play each role within an RMBS 3.0 transactions. This matrix contained in the green paper (SFIG 2015) included a deal agent. Because of the work being done under Treasury’s PLS initiative SFIG chose to focus exclusively on functions; it did not address the deal agent’s scope of liability (duties of care and loyalty). The green paper also recognized that not all securitization sponsors will opt to include a deal agent.

Yet, agreeing what the deal agent should do is not the same as agreeing on implementation. In particular, no consensus has been reached on which entities should be deal agents and how they should be compensated. If they are unregulated, will investors require minimum levels of capital? Will rating agencies give “credit” for the inclusion of a deal agent (through lower subordination levels), which would make the economics of deals with an agent more favorable? Moreover, the structures must be explicit about who has what responsibility to the investor. Where do the responsibilities of the trustee end and those of the deal agent begin? In short, while there has been huge progress, many operational issues remain to be resolved. While market participants generally agreed that this role would be very valuable on less-than-prime deals, some have doubts about whether a deal agent is cost-effective in prime transactions. This number may grow or shrink depending on the costs of the deal agent in the first few deals.

Standardization

Each security sponsor has its own documentation, and deals are not standardized across sponsors (although there are many "standard elements"). When investors purchased a tranche of an RMBS 1.0 deal, they generally satisfied themselves by reading the deal summary, if that. They did not realize that in some cases, RMBS 1.0 agreements contained ambiguous language or contradictory instructions. Since the crisis, many investors claim they are reading every page of the documentation of RMBS 2.0 deals, including the deal summary, the prospectus, and the pooling and servicing document, totaling many hundreds of pages. Sometimes investors read certain sections twice, as they are concerned something adverse to their interest is buried in the documents.

The need for this level of due diligence does not lend itself to a scalable market. There is clearly a desire for more standardization and/or transparency of documentation in a manner that reflects best practices, making it easy for investors to quickly understand how the deal they are evaluating differs from the standard.

SFIG has taken a huge step in this direction with the release of the third version of its green paper (SFIG 2015). This 272-page paper is the culmination of an effort that began in October 2013. The first 224 pages of this document suggest standardization of the clauses governing representations and warranties, repurchase governance, and other enforcement mechanisms. The paper goes through the language that a number of originators are using and proposes standardized language that accomplishes the same objective.

Even in the green paper, many representations and warranties have more than one standard form. This variation stems from several factors. First, banks that rely on retail origination and nonbank aggregators have differences in what they are willing to attest to in a securitization they sponsor. Second, issuers have different levels of risk tolerance and different internal policies and procedures. As a result, certain items require several standard variants. In other cases, investors prefer a stronger form of the representation some deal sponsors are willing to make. When there are a number of different forms, SFIG identified Category 1 reps as the most investor friendly.

Again, there is no guarantee that securitization sponsors will adopt this standard language, but it is another huge step in the direction of progress.

Servicing

The market participants convened by the Treasury discussed servicing issues at length, and they felt strongly that minimum servicing standards need strengthening by requiring servicers to provide better transparency, maximizing the value of the collateral to the trust, and better aligning interests between servicers and the trust. The formalization of the deal agent concept addresses some of these concerns. However, many servicing issues still need to be addressed.

Investors would like to see servicers provide better transparency on all loan modifications (e.g., new rate and term, extension, forgiveness or forbearance amount, and capitalization of delinquent payments). This includes modifications generated by mortgage settlements. The deal agent would be charged with seeing that servicers follow the policies the servicer has laid out, upholding investor interests in loan modification and loss mitigation. The deal agent would spot-check loan modifications, making sure the net present value test had been applied properly, and spot-check loans using foreclosure alternatives (short sales and deeds-in-lieu of foreclosure) to make sure investor interests were upheld. The deal agent would also be charged with doing (or overseeing) a loan-level cash flow reconciliation, as well as a line-item reconciliation of loan liquidation proceeds; the servicer would need to provide the information for the deal agent to complete or oversee this.

While it is clear that the servicer compensation structure may need to be reformed to better align the incentives of servicers and investors, it is less clear how to do this, and conflicts abound. Below are some of the remaining issues, along with some potential solutions.

Maximize or Optimize?

"Maximizing the value of the collateral to the trust as a whole" means different things to different investors. Some investors believe that modifications should maximize net present value—that is, optimize the result. Other market participants are comfortable as long as the modifications are NPV positive and the servicer's policies are clearly stated.

Servicer Compensation

Some market participants have suggested that the trust, rather than the primary servicer, should own the mortgage servicing rights. The primary servicer would then be compensated on a fee-for-service basis, allowing for the higher costs of servicing delinquent loans. However, the servicing rights on a performing loan are valuable, and this would significantly change the economics of the deal. Some issuers and servicers have said this suggestion is a nonstarter.

Advancing Issues

Many market participants would like to see a 120-day trigger, after which servicers would stop making advances to investors, as they believe such a trigger increases standardization and reduces subjectivity. However, such a trigger has drawbacks. Under certain circumstances, the senior tranche would not receive the contractual interest payments or the subordinate bond would be written down to pay interest to the senior tranches.

First-/Second-Lien Conflicts

A serious conflict of interest arises if a servicer services the first mortgage and owns the second. One solution is to require transfer of the servicing rights on one of the two liens if the first becomes delinquent. Another solution is to disclose the conflict, and have the deal agent monitor these loans more closely.

Vertical Integration of the Servicer

Many servicers outsource some items, including default management and real-estate-owned servicing, to affiliated entities. One solution: The deal agent could review the agreements for the use of an affiliate, and make the servicers document that the charges are consistent with current market prices. If the deal agent does not get proper documentation or is not convinced of the results, they could prohibit the use of an affiliated party.

Solicitation for Refinancing of Borrowers in PLS Transactions

Many servicers are also originators of new loans and have an incentive to aggressively solicit pristine borrowers with perfect credit histories for refinancing. Legacy PLS transactions did not allow for solicitation, but there was no enforcement vehicle. And, it may be counterproductive *not* to offer to refinance loans that are delinquent or in imminent default. This problem can be solved by requiring the servicer to provide annual certification of nonsolicitation of current borrowers who are not in imminent default. The deal agent could review refinancing activity and terminate the servicer if the certification has been violated.

Conclusion

The development of the deal agent concept and the recommendations to bring more standardization to PLS documentation are important steps forward in the revival of the PLS market. But more work needs to be done to refine and implement these principles. Perhaps the biggest unknown on the deal agent concept is the costs. If the rating agencies give “credit” for the inclusion of a deal agent, which makes the deal more economical, and/or the costs are small, deal agents will likely be adopted broadly for prime deals. If no “credit” is given, and the costs are large, it is unclear when or if the deal agent concept will be broadly adopted for prime jumbo deals. Moreover, conflicts of interest between the servicer and the investors still need addressing.

Nonetheless, the tremendous amount of work done through the Treasury’s PLS initiative and the SFIG’s RMBS Task Force has created a much more positive working relationship between investors and securitization sponsors. This relationship allows for an easier, or at least more collaborative, resolution of the remaining issues. The real test for the PLS market will be when the banks pull back and the economics of private-label securitizations become more compelling. When that happens, the groundwork has hopefully been set for a PLS revival.

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Before joining Urban, Goodman spent 30 years as an analyst and research department manager at a number of Wall Street firms. From 2008 to 2013, she was a senior managing director at Amherst Securities Group, LP, a boutique broker/dealer specializing in securitized products, where her strategy effort became known for its analysis of housing policy issues. From 1993 to 2008, Goodman was head of global fixed income research and manager of US securitized products research at UBS and predecessor firms, which was ranked first by *Institutional Investor* for 11 straight years. She has also held positions as a senior fixed income analyst, a mortgage portfolio manager, and a senior economist at the Federal Reserve Bank of New York.

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Delivering on the Promise of Risk-Sharing

by
Laurie Goodman, Jim Parrott and Mark Zandi

December 1, 2015

Prepared by

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Delivering on the Promise of Risk-Sharing

During the financial crisis, taxpayers stepped up to back the lion's share of the mortgage market. By putting Fannie Mae and Freddie Mac, the government-sponsored enterprises (GSEs), into conservatorship and expanding Federal Housing Administration (FHA) lending to fill the void left by a retreating private label securities market, the government staved off the collapse of the housing finance system and with it the real possibility of an economic depression. But this also put the taxpayer on the hook for most of the credit risk being taken in the mortgage market.

Since that dark time, the FHA and the GSEs have slowly pulled back on the risk they are taking, with much of the reduction occurring through the GSEs' so-called risk-sharing transactions. These deals first began in 2013 when the GSEs were each required by their regulator, the Federal Housing Finance Agency, to share the risk on $30 billion of mortgage-backed securities. The FHFA increased the requirement in 2014 to $90 billion and then again in 2015, to $120 billion for Freddie and $150 billion for Fannie. This year, taxpayers will likely shoulder about half the credit risk in all the mortgage loans originated (see Chart 1), down from well over three-fourths of the risk at the peak of taxpayers' support in 2010.[1] More tellingly, the GSEs are now sharing risk on about 90% of the balance on newly acquired 30-year fixed-rate loans, their core business.[2]

While there is a clear consensus that the GSEs should continue sharing the vast majority of their risk, there is much less clarity over what form or forms that risk-sharing should take. To help answer this question, we attempt to clarify what we should be trying to accomplish in risk-sharing and then evaluate the available structures with those objectives in mind.

In our analysis we find no obviously superior structure, but a range of choices that each present different strengths and weaknesses that will only be fully understood when tested in the market. We conclude that it is critical for the GSEs to expand the types of risk-sharing transactions they are engaged in beyond the relatively narrow range done to date. The GSEs should also be more transparent about the terms and pricing of the transactions so that policymakers and stakeholders are in a better position to evaluate the relative merits of the design choices.

Design choices

At the highest level, the GSEs face two key design choices in structuring a risk-sharing transaction:[3] which tranches of credit risk to share; and whether they share that risk before purchasing the loan, on the "front end" of the transaction, or after they have purchased it and put it into a pool for securitization, on the "back end."[4]

Mortgage credit risk is generally clarified in three tranches: first loss risk, mezzanine risk, and catastrophic risk.[5] In taking the first loss risk, the GSEs cover the initial losses on defaulted mortgage loans in a guaranteed pool. In taking the mezzanine risk, they take those losses that are greater than the first loss, but less than the losses that occur only in the most severe economic and housing market downturns, which we call the catastrophic risk.

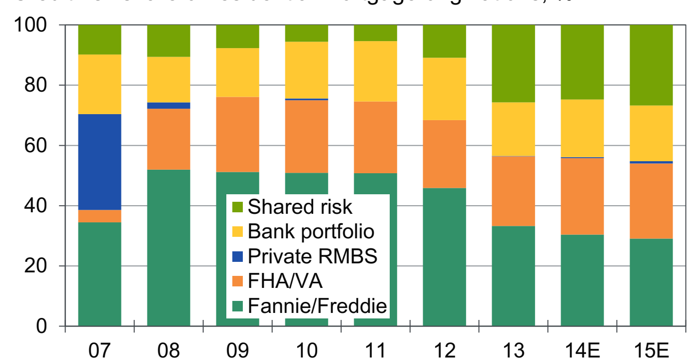
In a back-end transaction, the GSEs transfer some of the credit risk they have assumed on a pool of mortgages to a capital markets investor—typically asset managers or hedge funds—or to a reinsurance company.[6] The GSEs collect their normal guarantee fees from lenders for covering the entirety of the credit risk, but they pay investors and reinsurers for shouldering some of that risk.

To date most of the GSEs' risk-sharing transactions have been on the back end. Freddie Mac issued the first of these deals in July 2013, selling the mezzanine risk on a pool of loans to the capital markets. Since then, Freddie has issued 15 such deals, through Structured Agency Credit Risk (STACR) structures, covering $397 billion in notional collateral or 23.4% of their book of business.

Fannie issued its first back-end deal in October 2013, also selling mezzanine risk. Since then it has issued nine similar deals, through Connecticut Avenue Securities (CAS) structures, covering $485 billion of collateral or 17.3% of its total book of business. The GSEs share the risk with STACR or CAS for a period of 10 years, after which the risk reverts to the GSEs.

Chart 1: Taxpayers Take Much of Mortgage Risk

Credit risk share of residential mortgage originations, %



Sources: Fannie Mae, Moody's Analytics

These back-end deals have changed over time, with the GSEs continuing to broaden the footprint of the program, primarily within these two original structures:

» The first STACR and CAS deals laid off risk on mortgage pools with original loan-to-value ratios (LTV) of 60% to 80%. Beginning in May 2014, they began to lay off the risk on mortgages with over 80% LTVs.
» The first STACR and CAS deals did not lay off first loss risk. Freddie began to lay off first loss risk through back-end transactions in February 2015, while Fannie has yet to lay off first loss risk through these transactions.
» The losses on the first STACR and CAS deals were dictated using a pre-set severity schedule rather than actual losses. Freddie did its first sharing of actual loss in April 2015 and Fannie in October 2015.

When Fannie and Freddie share risk through the CAS and STACR deals, they are required to hold at least 5% of the risk in each tranche.[7] In many cases, the GSEs will hold more and sell it later to a reinsurer. Freddie Mac has done this extensively, with one deal in 2013, three in 2014, and eight in 2015. Fannie has only begun to do this more recently, with the first transaction in December 2014, but has been very active in this space in 2015, with five transactions through late November.

In a front-end transaction, a private mortgage insurer (MI) or lender takes some credit risk prior to the sale of the loan to the GSEs, with the GSEs lowering their guarantee fees to reflect the commensurate reduction in credit risk they assume when purchasing the loan.

The GSEs are already required by their charters to do front-end risk sharing on loans with LTV ratios of 80% or more.[8] To date they have largely met this requirement by sharing risk with mortgage insurers, sharing more risk the higher the LTV. On loans with an 80% LTV, for instance, the MIs are responsible for 12% of the loss, while on loans with a 97% LTV, they are responsible for 35% of the loss. The GSEs could share even more risk this way, deepening the MIs' coverage or expanding the range of loans subject to MI coverage. This "deep cover MI" would be a straightforward expansion of current private mortgage insurance. To date neither Fannie nor Freddie has shared risk in this way.

The GSEs can also share risk on the front end by allowing lenders to retain some level of first loss risk in the loans they sell to the GSEs. In these "lender recourse" transactions, lenders agree to sell Fannie or Freddie a certain volume of loans within a certain range of characteristics, retaining a certain level of risk.

Lender recourse transactions to date have taken two forms: those in which the lender holds the risk and those in which the lender lays the risk off in the form of a capital markets transaction. Fannie and Freddie have done a few transactions of the first form, with Redwood absorbing the first 1% of the losses in one such deal and Penny Mac the first 3% or so in another. Fannie has also done lender recourse transactions of the second form, with lenders absorbing the first 4% to 5% of the risk and then laying off most of that risk into the capital markets. To date there have been three of these now-named "L Street Transactions": JP Morgan did the first in October 2014 and Wells Fargo and JP Morgan have each done one in 2015.

It is important to remember that under all forms of risk-sharing, the GSEs are still responsible for ensuring that investors in the mortgage securities they issue and insure receive their principal and interest in a timely way. Risk-sharing does not obviate this responsibility or compromise the security of the MBS investment. It only off-loads some of the costs of that responsibility to other private investors able to take on that risk, and hence reduces the taxpayers' exposure to mortgage credit risk.

Evaluating the risk-sharing options

First, we take it to be important that the GSEs share first loss risk, not only mezzanine risk. As with mezzanine risk, there is substantial demand for first loss risk from a wide range of strong private financial institutions, making it unnecessary for taxpayers to bear it. The taxpayer should take only the risk that the private market cannot bear effectively and safely, which is the risk of catastrophic loss.

The choice between front-end and back-end risk-sharing is more complicated. To evaluate it, it is vital to be clear about what it is we are trying to accomplish in risk-sharing and then assess how the choices help meet these objectives. We find six primary objectives of risk-sharing:

» Reducing risk to the taxpayer
» Maintaining broad borrower access to credit
» Maintaining broad lender access to the secondary market
» Maximizing transparency
» Minimizing volatility through economic cycles
» Reducing risk in the financial system

In Table 1, we summarize the results of our analysis.

It is worth noting that we do *not* take the view that it is an objective of risk-sharing that the economics of these transactions be passed on in their entirety to the borrower. While there are benefits of such a dynamic, particularly where the private sector is willing to price the credit more cheaply than the GSEs, there are also costs. It leads to more sensitive risk-based pricing, for instance, which will drive up the cost of credit for those of higher risk and indeed for everyone in times of stress. So it is important to be cognizant of how the economics flow through to borrowers in each of these structures, but it is important only to the degree that it affects how they serve the other objectives, like access to credit and minimizing volatility.

Reducing risk to the taxpayer

There are many ways for the GSEs to reduce taxpayers' risk, including reducing loan limits, raising guarantee fees and tightening underwriting standards. But unlike these alternatives, risk-sharing presents an opportunity to reduce taxpayer risk without significant disruption to the flow of credit. This is because it does not limit taxpayer risk by decreasing the credit risk taken into the system, but by allowing the private sector to take on more of that risk.

The question, then, is which forms of risk-sharing will reduce taxpayer risk most effectively. Back-end risk-sharing reduces

Table 1: Pre-Season Rankings: How Well Do the Alternatives Appear to Meet the Goals?

	Front-End Risk Sharing		Back-End Risk Sharing	
Goals:	**Deep Cover MI**	**Lender Recourse**	**CAS/STACR**	**Reinsurance**
Reducing taxpayer risk	Poses counterparty risk and risk of GSE-like monoline model, but both can be addressed	Poses modest counterparty risk, but can be addressed	Effective in good economic times; unclear in tough times	Poses modest counterparty risk, but can be addressed
Maintaining broad borrower access to credit	Poses risk of overlays and risk-based pricing, but both can likely be addressed	Poses risk of overlays and risk-based pricing, but both can likely be addressed	Effective	Effective
Maintaining broad lender access to the secondary market	Effective	Only available to larger banks, which will put smaller banks at a disadvantage	Effective	Effective
Maximizing transparency	Effective	FHFA would need to require measures to make transparent	Effective	FHFA would need to require measures to make transparent
Minimizing volatility	Effective	Capital will be less fleeting than the capital markets, but more than MI	Ineffective	Capital will be less fleeting than the capital markets, but more than deep cover MI
Mitigating risk in the financial system	How effective will depend on how counterparty and monoline issues addressed	How effective will depend on how modest counterparty risk is addressed	Ineffective	Effective but structure likely limited in scope

taxpayer risk more cleanly than does front-end risk sharing, because the GSEs do not have counterparty risk to the asset managers, hedge funds, and other capital market institutions that participate. These investors put the capital needed to cover their risk up front when they purchase the bonds issued by the GSEs in the risk-sharing transactions.[9] And while the GSEs do have counterparty risk to the reinsurers that participate in back-end risk-sharing deals, the reinsurers are large, highly rated multiline insurers, and the mortgage credit risk they have taken on has been quite modest, at least so far.[10]

In a front-end risk-sharing deal, the GSE would have some counterparty risk with a lender or private MI unless the latter puts up a pool of capital to cover the risk. The counterparty risk posed by lenders will be mitigated by the capital requirements under Basel III international regulatory standards. The counterparty risk posed by MIs will also be mitigated by a set of recently adopted rules, but has several components, each worth addressing in turn.

First, there is the risk that a given MI will not be able to pay out a required claim. Second, there is the risk that the MIs may not be *willing* to pay a claim required of them even when they are able. And third, there is the fact that they are heavily exposed to precisely the same kind of risk to which the GSEs are exposed, making them subject to stress at exactly the time the GSEs will need them most.

Recently adopted policies will mitigate the first two of these risks. The ability to pay risk posed by the MIs will be mitigated by the Private Mortgage Insurance Eligibility Requirements' capital standards that go into effect in January 2016.[11] And the willingness to pay risk will be mitigated by the new MIs' Master Policy Agreements with the GSEs, which went into effect in 2015.

To further mitigate their counterparty risks on front-end risk-sharing transactions, the FHFA could take any number of steps: requiring counterparties to put up even more capital or other highly liquid assets against the risk being taken on; requiring them to share some of their risk with diversified reinsurers or the private capital markets; and further strengthening the PMIERS or the Master Policy Agreements. [12]

Maintaining broad borrower access to credit

Ensuring broad access to credit for creditworthy borrowers is central to the purpose of the GSEs. There are two key components of access to credit, availability and cost. Today, the GSEs determine the credit profiles they are willing to guarantee, though lenders typically place somewhat more restrictive credit overlays on the loans they are willing to sell to them.[13] And the GSEs are able to keep the cost to higher credit risk borrowers down by charging them less than their credit warrants, while charging lower credit risk borrowers more than theirs warrants.

In back-end transactions this dynamic is left largely unchanged, as the GSEs simply pool loans that have already been sold to them in the normal course of business and then sell off a portion of the credit risk into the capital markets. The purchaser of the risk has no say in which loans make it into the pool or on what pricing terms. What investors are willing to pay for pools will be affected by the credit risk of the loans included, however, which could inform the GSEs' own pricing of loans. So while the back-end transactions do not impact the availability and cost of credit directly, over time they could impact it indirectly.

In front-end transactions, the party taking on the first loss risk, the lender or the MI, could directly affect the availability and cost of credit. They could limit the loans they are willing to originate or insure, and price that business in a way that more closely tracks the risks involved. Giving them this kind of discretion could have a significant impact on access to credit, as the parties bearing deep first loss coverage may price higher risk loans in a way that puts them out of reach for many borrowers or not make them at all.

However, there are at least three ways to maintain broad access to credit in front-end transactions. The most straightforward would be for the GSEs to charge guarantee fees sufficient to carry out the amount of desired cross-subsidization. The guarantee fees would thus cover their operating costs, the cost associated with covering catastrophic losses, and the cost involved in cross-subsidizing lending.

A second solution, albeit more complicated, would be for the GSEs to require that lenders or MIs taking first loss risk meet the same affordability goals that the GSEs are required to meet. There could be incentives for MIs and lenders to achieve these goals and penalties for those who do not.

And a third solution, also more complicated, would be to put borrowers who fit within the GSE credit box but the MI companies or recourse lenders will not cover into a high-risk pool. The MIs or recourse lenders would pay a fee based on the loans they do insure that would cover the costs of providing insurance for these borrowers. This approach is similar to how high-risk groups are insured in other insurance markets, like the auto and workers' compensation markets.

Maintaining broad lender access to the secondary market

Maintaining access to the secondary markets for a broad range of lenders, large and small, community-focused and national, is another critical function of the GSEs. The GSEs must take care not to compromise that access for smaller lenders in the name of risk-sharing structures that give larger lenders a prohibitive competitive advantage.

This is not an issue for front-end deep MI transactions, as lenders of all sizes will simply continue to do business precisely as they do today. Nor is it an issue for back-end transactions with the capital markets, as the GSEs will still aggregate loans from lenders of all sizes before the risk is shared.

However, it could be an issue for lender recourse or L Street Transactions, as these are only practically available to larger lenders, which may use them to gain an advantage over other originators. To mitigate this risk the GSEs must take care not to underprice the guarantee fee charged in these transactions and keep the cash window to the GSEs open for lenders of all sizes.

Maximizing transparency

The terms and pricing of risk-sharing transactions should be completely transparent. This is important for several reasons. First it will open the process up to more competition, which will improve the terms of the deals for the taxpayer and lead to pricing that best captures the market's assessment of the risk involved. Second, it will attract more capital into the space as market participants better understand where the economics warrant additional investment. And finally, it will make clearer the relationship between the economics of these transactions and the fees ultimately paid by the borrower.

In short, transparency will make it easier for policymakers and regulators to ensure that the GSEs are sharing risk in a way that maximizes the interests of taxpayers and borrowers. While transparency is likely to make market estimates of the amount of the cross-subsidization more explicit, transparency is not in itself inconsistent with cross-subsidization.

Risk-sharing transactions that are bid in the open market will be inherently transparent. It will take extra steps to ensure transparency in one-off transactions that are negotiated with only a few counterparties. This means that back-end risk-sharing deals with capital markets and front-end deep cover MI deals will lend themselves most readily to the needed transparency, but the GSEs will need to take additional measures to provide it in back-end deals with reinsurers and front-end deals with lenders.

Minimizing volatility in the cost of sharing credit risk

In their sharing of risk, the GSEs should not over-rely on procyclical sources of private capital, which flood in at low cost in good times and disappear or become prohibitively costly during times of economic stress.

Back-end risk sharing is likely to be more procyclical, because asset managers, hedge funds, and other capital market investors are highly sensitive to shifts in risk tolerance in the financial system. When times are good and credit risk concerns are low, these investors are willing to allocate capital towards credit at a relatively low price. This describes well the current environment, with the Federal Reserve's easy monetary policy, the improving job market, steadily rising house prices, and tight underwriting. With these conditions, capital markets investors are eager to invest in credit risk for even a modest premium.

But perceptions about risk and other market conditions often shift quickly. An instructive example can be found in recent swings in the fixed-income market, including the market for below-investment grade corporate bonds. As investors' perceptions of the risk in these markets changed, the prices they demanded for their investments shot up dramatically. A year ago, the spread between below-investment grade corporate bonds and risk-free 10-year Treasury bonds was close to 350 basis points. Today the spread is over 600 basis points (see Chart 2). Back-end risk-sharing deals, with asset managers and hedge funds bidding on risks rated much as are these corporate bonds, are subject to precisely the same swings in prices.

When their perception of the risk and reward in these investments changes dramatically, the costs to the GSEs of off-loading credit risk will rise significantly. This will leave the GSEs and the FHFA with a difficult choice: have the GSEs absorb the spike in cost, severely cutting into the GSEs' profits

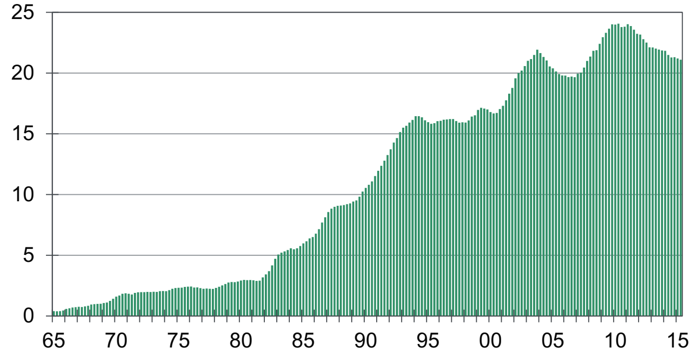
Chart 2: Wild Swings in Fixed Income Markets

Spread between high-yield corporates and 10-yr Treasuries, bps

Sources: Federal Reserve, Bloomberg, Moody's Analytics

Chart 3: GSEs Are a Large Part of Credit Markets

Fannie & Freddie share of private nonfinancial debt outstanding, %



Sources: Federal Reserve Board, Moody's Analytics

and perhaps driving them into the red; pass that cost on to the borrower in the form of higher guarantee fees, leading to higher mortgage rates or tighter underwriting standards; or suspend the sharing of risk altogether until the period of stress passes.

This risk can be mitigated somewhat by expanding the investor base for back-end transactions. If policymakers can expand the pool of investors that bid on these transactions to include institutions that rely more on equity and are focused on a long-term presence in the market, like Real Estate Investment Trusts and insurance companies, then capital will be available to take credit risk at more reasonable prices deeper into economic cycles.

Front-end transactions with MIs and lenders are least subject to these swings. MIs are in the long-term business of taking mortgage credit risk, so they will not raise their pricing as much in bad times or lower it as much in good times. And lenders are likely to manage some of their risk in times of stress by limiting their lending rather than pulling out of the market altogether.

It is worth noting here that we do not give much credence to the argument that front-end deep cover MI would result in *lower* costs on average through the economic cycle relative to the current system.[14] The MIs would charge less through a cycle only if their required return on equity or capitalization were lower than that implied by the GSEs in their guarantee fees and loan level pricing adjustments. There is no reason to believe either to be the case.

Reducing systemic risk

The GSEs remain among the world's largest financial institutions. Together, they backstop over $4 trillion in U.S. residential mortgages, almost one-fifth of the $26 trillion in U.S. nonfinancial private sector credit outstanding (see Chart 3). How they share this risk thus has enormous implications for the stability of the entire economy.

Asset managers, hedge funds, and other capital market participants in back-end transactions are more likely to use debt to finance their participation. By passing risk off through these transactions, the GSEs are increasing leverage in the system and with it the risk overall, which is further exacerbated by the lack of transparency over the sources of that leverage.

Well-capitalized reinsurance companies participating in back-end deals are likely to bring more equity capital into the financial system. But their role in these transactions is likely to be constrained by their limited capacity to take on mortgage credit risk.[15]

Institutions that do front-end risk-sharing are also more likely to use equity rather than debt to take on the new risk, suggesting that these transactions will not increase systemic risk—unless, that is, they present significant counterparty risk. While we view the PMIERs and Basel III as adequate to addressing this issue in the case of the MIs and lenders, respectively, if the GSEs view these steps as inadequate they are easily strengthened or supplemented.

What should be done?

With the private label securities market still moribund, risk-sharing by the GSEs has been the only way to meaningfully reduce taxpayer risk in the housing finance system. We believe the FHFA and GSEs should continue to move down this path aggressively, but in a manner that better serves the long-term objectives of the effort.

While it is clear that the GSEs should engage in more risk-sharing transactions for both first loss *and* mezzanine risk, it is less clear whether to share that risk through front-end or back-end transactions as there are strengths and weaknesses in both. Some front-end transactions look better at maintaining broad lender access to the secondary markets and minimizing volatility and risk in the financial system. Some back-end transactions, on the other hand, look better at limiting counterparty risk and maintaining broad access to credit, though front-end transactions could likely meet these objectives with some modest safeguards.

Given these crosscurrents, we would be well-served during this early stage of risk-sharing for the FHFA to require the GSEs to do *both* back-end and front-end risk-sharing on a significant scale. This will allow us to better judge the costs and benefits of each through different parts of the economic cycle.

To allow for this level of evaluation, though, the GSEs and the FHFA must collect and analyze critical information on each structure used, on everything from the credit risk that is being taken on, to what is paid for the risk, the market appetite for the structure, its impact on the availability and pricing of credit, and its impact on the broader financial system. As it becomes clear how each structure performs according to the objectives above, the successes should be scaled up and the failures abandoned.

The FHFA should also require the GSEs to be much more transparent in their risk-sharing transactions (see Box: Improving transparency). This includes providing regular and detailed updates on the performance of each risk-sharing structure. This will inform market participants, increasing competition and thus resulting in lower mortgage rates and increased access for mortgage borrowers. It will also help stakeholders and policymakers understand the direction the FHFA and GSEs are headed and put legislators in a much better position when they do return to the table to discuss what system should replace the current one, if any.

It has been more than seven years since Fannie Mae and Freddie Mac were put into conservatorship and taxpayers on the hook for the bulk of the credit risk in the mortgage market. While unavoidable at first, forcing taxpayers to bear this risk is increasingly unnecessary and undesirable as private capital is willing and able to take it. Fortunately, risk-sharing is an effective means of shifting this risk away from the taxpayer and into the private market in ways that can help the market, borrowers and taxpayers over time. To fulfill that promise, however, the FHFA and GSEs need to be clearer about the long-term objectives of the effort and more resolute in approaching it with them in mind.

Improving transparency

There are several ways to improve transparency in both back-end and front-end risk-sharing deals:

1. Currently in the CAS and STACR transactions the loans are segmented into those with LTVs of 60% to 80% and those that have LTVs >80%. However, loan level pricing adjustments are based on both LTV and FICO scores. Currently, since no information is collected by FICO/LTV cuts it is very difficult to inform pricing on these loan level pricing adjustments.

   It would be relatively easy to segment tranches by FICO and LTV. For example, the 60% to 80% LTV bucket could be carved into three or four FICO buckets. A potential issue is liquidity—investors might perceive these tranches to be less liquid than earlier deals. This could be overcome if Freddie and Fannie allow the FICO buckets in either the 60% to 80% or the >80% LTV bucket to be recombined into a single security with the appropriate weights. Freddie Mac currently allows this in many collateralized mortgage obligations transactions, in which the tranches are referred to as MACRS (Modifiable and Combinable REMICs).

2. There is currently no price transparency under the front-end risk-sharing arrangements with lenders. Fannie Mae and Freddie Mac pick a lender and negotiate a structure and a price, with the market receiving little transparency into the terms and none into price. A different lender may be willing to strike the GSEs a far better deal, but no one—including the GSEs and FHFA—would know.

   The GSEs should instead specify publicly the risk that they are trying to lay off and the criteria for awarding that risk. Items in the term sheet might include the fact that the lender needs to keep the first 1% of the risk, the amount must be fully collateralized, and a breakdown of the characteristics of the loans that are expected to be delivered. Qualified lenders would bid on the front-end risk-sharing transaction, and the GSEs would provide the market information by publishing the cover bid (the second to the highest).

3. Under the back-end risk-sharing arrangements with re-insurers, there is also no price transparency. Again we suggest competitive bidding, with the GSEs publishing the cover bid.

Endnotes

1 This includes the risk in FHA lending and in GSE lending not off-loaded to private investors via the risk-sharing deals. The risk taken in the risk-sharing deals is measured by the face value of the deals.

2 This is for 30-year fixed-rate loans with LTVs above 60%. It does not include HARP refinance loans, 15- and 20-year mortgages, adjustable rate mortgages, and loans with very low LTVs acquired by the GSEs. More detail is available in "Overview of Fannie Mae and Freddie Mac Credit Risk Transfers," FHFA Research Report, August 2015.

3 Other related design choices include risk-sharing with entities or via structured transactions and loan-level vs. pool-level credit enhancement.

4 A thorough description of the various forms of the GSE credit risk-sharing transactions is available in "Overview of Fannie Mae and Freddie Mac Credit Risk Transfers," FHFA Research Report, August 2015.

5 It is important to clarify what we mean by first loss. On virtually every deal, there will be a certain, often very minimal, level of losses that are eventually incurred. This is better understood as an actual cost than a risk and is arguably best borne by the financial entity with the lowest cost of funds. As the GSEs set their implied capital levels at roughly the level of the private sector institutions with which they would share risk, it does not really matter who bears it from an economic point of view. We are here focused instead on a deeper level of first loss, which is uncertain and thus better considered a risk than a certain cost. When discussing "first loss" in this paper, we mean this deeper tranche of risk.

6 According to the FHFA, asset managers have purchased over half of the back-end risk-sharing transactions, hedge funds more than 30%, and banks, sovereign wealth funds and REITs the remainder of the transactions.

7 On transactions in which they share first loss risk, the GSEs are retaining substantially more than 5% of the risk.

8 HARP refinances on high LTV mortgages are an exception as they do not require credit enhancement.

9 There is the caveat that back-end capital market deals done so far also rely on future income from the investment spread to help cover the risk.

10 Multiline reinsures pose counterparty risk in that various assumptions must be made regarding correlations across risks that these institutions are insuring. As demonstrated during the financial crisis, these correlations can change dramatically in stressed environments.

11 An analysis of the PMIERS is available in "Putting Mortgage Insurers on Solid Ground," Mark Zandi, Jim Parrott and Cris DeRitis, Moody's Analytics white paper, August 2014.

12 It is important to note that under PMIERS, the MIs are capitalized at a level that appears consistent with the GSEs' implicit capitalization. The MIs thus pose counterparty risk to the GSEs, but taxpayers are equally exposed whether the MIs or GSEs are taking the credit risk. Moreover, MIs have the option of adding more capital to cover losses in excess of what is originally capitalized to. Indeed, some MIs did this during the crisis.

13 For more on why see "Opening the Credit Box," Jim Parrott and Mark Zandi, Moody's Analytics and Urban Institute white paper, September 2013.

14 The costs to borrowers under deep cover MI is found to be modestly lower than in the current system in a recent study, "Analysis of Deep Cover Mortgage Insurance," Milliman Client Report for U.S. Mortgage Insurers, October 2015. The lower costs are largely the result of the cancellation of MI as the loan balance is amortized to 78% as required under HOEPA, while the GSEs continue to charge a guarantee fee.

15 The reinsurance industry's capacity to take on mortgage credit risk in the current back-end deals with the GSEs is an estimated $30 billion in risk-in-force. This estimate is based on the working assumption that one-fourth of the total reinsurance industry, based on total capital, is willing to take some mortgage risk exposure. Given that there is approximately $500 billion of reinsurance capital (this is a conservative estimate), this translates into $125 billion of reinsurance capital that is willing to take on some mortgage risk exposure. If we further assume that reinsurers leverage their mezzanine mortgage risk exposure 5 to 1 (given that they are interested in the benefits of some risk diversification), but do not want to allocate more than 5% of their capital to mortgage risk (given that it is not seen as a core line of business), this translates into just over $30 billion of exposure capacity. Another approach assumes that reinsurers would apply some maximum exposure limit to their mortgage risk exposure. A reasonable assumption is that they would not want to lose more than 10% of their capital after credit for run-rate earnings or two times earnings (based on a 10% baseline return on capital) as a result of a worst-case mortgage loss scenario. This translates into $25 billion of exposure capacity. These estimates are also consistent with the approximately $270 billion of industry property catastrophic (cat) limit, which is a core focus of the reinsurance industry. Since mortgage risk is a non-core risk for reinsurers, it is unlikely to amount to more than about 10% of the property cat limit.

About the Authors

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Laurie Goodman is the director of the Housing Finance Policy Center at the Urban Institute. The center is dedicated to providing policymakers with data-driven analyses of housing finance policy issues that they can depend on for relevance, accuracy, and independence. Before joining Urban in 2013, Goodman spent 30 years as an analyst and research department manager at a number of Wall Street firms, including Amherst Securities Group, LP and UBS. Goodman was inducted into the Fixed Income Analysts Hall of Fame in 2009. Laurie currently serves on the board of directors of MFA Financial, a Real Estate Investment Trust, is an advisor to Amherst Capital Management, and is a member of the Bipartisan Policy Center's Housing Commission, and the Federal Reserve Bank of New York's Financial Advisory Roundtable. She has published more than 200 journal articles and has co-authored and co-edited five books. Goodman has a BA in mathematics from the University of Pennsylvania and an MA and PhD in economics from Stanford University.

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A Glimpse at the Future of Risk Sharing

Laurie Goodman and Jim Parrott

February 2016

The Federal Housing Finance Agency's annual scorecard lays out the responsibilities of Fannie Mae and Freddie Mac in implementing the FHFA's strategic plan. Perhaps because compliance with these responsibilities determines a significant amount of their executives' pay, Fannie and Freddie rarely if ever fail to meet them. So the scorecard offers a rare glimpse into where they are likely headed in the next year.

In this brief we look at the responsibilities outlined in the 2016 scorecard for credit risk transfer. We conclude that the housing market is likely to see a leveling off of Fannie Mae's Connecticut Avenue Securities (CAS) and Freddie Mac's Structured Agency Credit Risk (STACR) programs, the introduction of risk sharing on collateral with terms of 20 years, and an increase in first-loss and front-end risk sharing. We also discuss the importance of expanding the investor base for these transactions and why it will be challenging to do so.

Leveling Off of CAS and STACR

The 2016 scorecard requires that the government-sponsored enterprises (GSEs) transfer credit risk on at least 90 percent of the unpaid principal balance of newly acquired single-family, non-HARP, fixed-rate loans with terms longer than 20 years and loan-to-value ratios over 60 percent.

In prior years, the goals were based entirely on the amount of reference collateral covered in these deals. The GSEs were each required to do risk sharing on $30 billion in collateral in 2013, with that number increasing to $90 billion in 2014. In 2015, Fannie Mae was required to do $150 billion in credit risk transfer and Freddie Mac $120 billion, reflecting a divergence in the institutions' capacities. Both

GSEs have exceeded these requirements each year. In 2015, for instance, Fannie Mae transferred the risk on $187 billion of collateral and Freddie Mac on $210 billion.

The FHFA's shift from setting goals by volume of loans makes economic sense, as the strategy's success should not hinge so significantly on the total volume of loans being done in a given year. If the goal continued to be expressed in numbers of loans, the GSEs would be compelled to be overly aggressive in low-volume years and allowed to be overly passive in high-volume years. Nonetheless, the shift in measurement is unlikely to significantly expand risk sharing.

Box 1 shows our calculations, which we explain here.

- Total GSE issuance in 2015 was $846 billion. We assume that production for 2016 falls 12 percent, to $744 billion, because of the rising interest-rate environment. This assumption is in line with market forecasts provided by the Mortgage Bankers Association, Fannie Mae, and Freddie Mac.
- We estimate that 65 percent of this production, or $484 billion, will fall into one of the loan categories targeted in the scorecard. This estimate is up from 60 percent in 2015. With interest rates expected to be flat or rising and refinancing falling off in 2016, the two main categories of production that fall outside the targeted categories—HARP production and 15-year loans—will be down. Hence slightly more of the production will fall into targeted categories.
- If we assume the GSEs again exceed their scorecard goals, transferring 95 percent of the unpaid principal balance on newly acquired single-family mortgages in the targeted category, they will cover $460 billion in collateral. This total is 16 percent higher than the $397 billion in transfers the previous year.
- CAS and STACR issuance totaled $12.5 billion in 2015: $5.9 billion through CAS and $6.6 billion through STACR. A 16 percent increase in issuance, holding constant the mix between CAS, STACR, and other credit risk-transfer structures, would suggest $14.5 billion in new credit risk-transfer deals.
- The mix of deal structures will likely change, however, as spreads in the CAS and STACR deals have widened meaningfully over the past few months.[1] If the spreads on back-end credit risk transfers to reinsurers or front-end transfers to lenders widen less, these channels may represent considerably better execution for the deals, leading to a drop in the portion of total risk sharing done through CAS and STACR.

BOX 1

Anticipated Risk-Sharing Supply

Comparing the 2016 goal of 90 percent of targeted newly acquired loans with 2015's goal of a dollar reference collateral target:

Total GSE issuance 2015:	$846 billion
2016 issuance expected ($846 billion x 0.88):	$744 billion
2016 issuance in the targeted category ($744 billion x 0.65):	$484 billion
2016 GSE transfers, exceeding goals ($484 billion x 0.95):	$460 billion
Increase in GSE transfers from 2015 to 2016	$67 billion (16%)

Total CAS and STACR issuance:

Fannie Mae:	$5.9 billion
Freddie Mac:	$6.6 billion
Total:	$12.5 billion

If we assume a 16 percent increase in back-end risk-sharing deals, it would suggest $14.5 billion in new CRT deals overall. And this may be high because if CAS/STACR spreads widen, reinsurance execution may be more favorable. In addition, we would expect more front-end transactions in 2016.

Shift in Collateral

The FHFA scorecard also requires the GSEs to evaluate, and implement if economically feasible, ways to transfer credit risk on other types of newly acquired single-family mortgages excluded from the targeted loan categories. Though neither GSE has indicated what alternative forms of collateral it is considering, Freddie's recent release of data on *all* fixed-rate amortizing mortgages, regardless of term, suggests that the agency is considering fixed-rate mortgages with shorter terms.

Table 1 compares how often shorter-term mortgages originated between 1999 and 2012 experienced credit events, meaning they went more than 180 days delinquent or experienced a short sale, foreclosure sale, or deed-in-lieu before six months. (Defaults since 2012 have been negligible.) We have divided all fixed-rate single-family mortgages into three buckets by their original terms: 15 or fewer years (≤180 months), 15.1–20 years (181–240 months), and 20.1–30 years (241–360 months). The shorter mortgages perform much better. Using mortgages issued in 2007 as an example, 3.03 percent of loans in the first bucket experienced a credit event. This rate is less than half the rate of loans in the second bucket and less than a quarter the rate of loans in the third bucket. Given that transferring the risk on riskier collateral tends to be more economical, we believe that the GSEs are most likely to try to transfer the risk on mortgages with 20-year terms. The number of those mortgages available for transfer is quite small.

TABLE 1

Freddie Mac Data on Fixed-Rate Mortgages by Original Term, 1999–2012

	Loan Count				FICO			
	a.<=180M	b.181-240M	c.241-360M	All	a.<=180M	b.181-240M	c.241-360M	All
1999-2004	.	.	6,080,174	6,080,174	.	.	718.9	718.9
2005	268,507	88,122	1,327,439	1,684,068	734.8	718.6	722.8	724.5
2006	125,000	50,104	1,072,969	1,248,073	734.3	717.1	722.3	723.3
2007	101,860	43,176	1,049,260	1,194,296	738.4	722.9	722.2	723.6
2008	148,953	36,961	978,162	1,164,076	746.7	740.6	739.2	740.2
2009-2010	752,452	149,957	2,335,328	3,237,737	765.7	766.6	761.9	763.0
2011-2012	1,308,742	221,855	3,010,886	4,541,483	764.5	765.5	758.9	760.8
All	2,705,514	590,175	15,854,218	19,149,907	758.5	750.0	734.8	738.7

	LTV				% experiencing a credit event			
	a.<=180M	b.181-240M	c.241-360M	All	a.<=180M	b.181-240M	c.241-360M	All
1999-2004	.	.	73.9	73.9	.	.	3.35%	3.35%
2005	58.5	66.8	72.0	69.6	2.66%	5.37%	9.21%	7.97%
2006	57.2	65.5	72.3	70.5	3.13%	6.95%	11.63%	10.59%
2007	57.5	65.5	73.4	71.8	3.03%	7.00%	12.85%	11.80%
2008	59.3	65.7	71.7	69.9	1.94%	3.33%	7.41%	6.58%
2009-2010	58.6	65.0	67.9	65.6	0.28%	0.38%	0.96%	0.78%
2011-2012	62.0	67.9	73.8	70.1	0.06%	0.08%	0.13%	0.11%
All	60.2	66.5	72.6	70.6	0.74%	2.24%	4.32%	3.75%

Source: Freddie Mac, 2015.

Shift to More First-Loss Risk Sharing

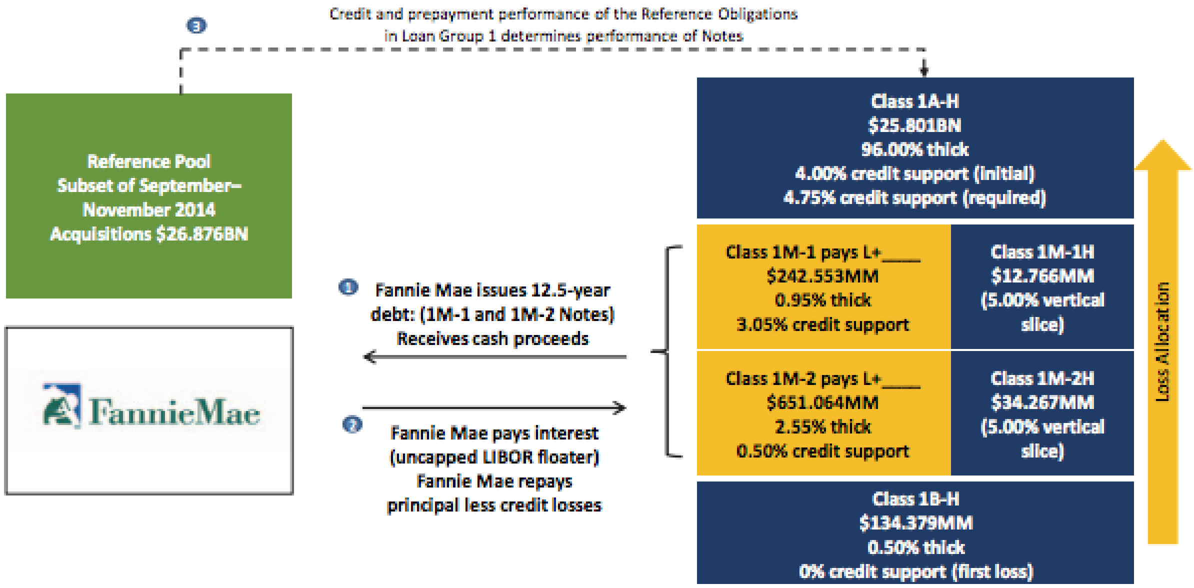
The FHFA also requires the GSEs to transfer "a substantial portion of the credit risk on the targeted loan categories covering most of the credit losses that are projected to occur during stressful economic scenarios."

This requirement represents another shift of emphasis for the FHFA, which had previously measured success by the amount of collateral covered. To understand how much credit risk the GSEs transfer in a given transaction, we need to assess it tranche by tranche. For example, in Fannie Mae's most recent transaction, the agency retained the first 50 basis points (bps), sold 95 percent of the next 350 bps in two tranches—1M-1 (2.55 percent thick) and 1M-2 (0.95 percent thick), and retained all of the risk in the bottom tranche. This structure is illustrated in figure 1.

FIGURE 1

Connecticut Avenue Securities Transaction 2015-CO4

Group 1

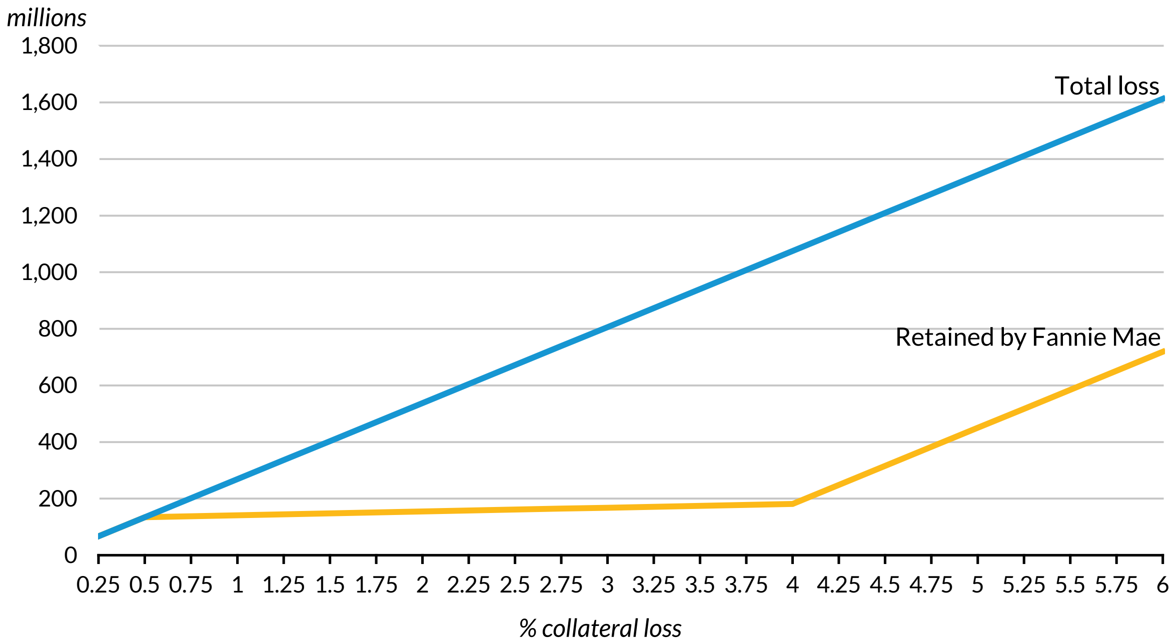


Source: Fannie Mae.
Note: Tranches with an "H" are not issued or sold; Fannie Mae retains the risk for these tranches.

Figure 2 compares the losses that Fannie could suffer on the pool of loans absent the deal to those it could suffer under the terms of the deal. Under the deal Fannie absorbs 100 percent of the first 50 bps, 5 percent of the next 350bps, and 100 percent of any losses beyond that. Expressed as the share of loss transferred, Fannie transfers 0 percent at 50 bps collateral losses, 52 percent of the risk at a 100 bps of collateral loss, 71 percent of the risk at 200 bps of collateral loss, and 83 percent of the risk at 400 bps of collateral losses. When losses exceed 400 bps, Fannie takes the remaining risk, and the value of the securities sold to investors falls to zero. Thus, the share of risk laid off declines as losses exceed 400 bps. At 500 bps of collateral losses, for instance, Fannie sells 66 percent of the risk; at 600 bps, Fannie sells 55 percent of the risk.

FIGURE 2

Credit Risk Transfer of Connecticut Avenue Securities Transaction 2015-CO4



Source: Authors' calculations based on Fannie Mae data.

Fannie has essentially sold off almost all risk in the middle of the capital structure. In order to increase the amount of risk covered going forward, the agency will have to increase either its catastrophic risk or its first-loss exposure. Increasing Fannie's catastrophic risk exposure appears infeasible. If the current mix of loans in the targeted categories were to go through the same dramatic home price depreciation that we saw in the Great Recession, losses would be less than 400 bps. The GSEs are already sharing most losses below 400 bps—except, that is, the first loss. Fannie thus appears to have little choice but to share more first-loss risk in order to meet its goals.

Constraints on the Investor Base and the Resulting Shift to More Front-End Risk Sharing

The GSEs and the FHFA both want as broad and deep a base of investors in their credit risk transfer deals as possible, as it would bring greater competition and thus a better and less volatile execution for them. Yet the investor base to date has been relatively narrow and thin, so the FHFA scorecard requires the GSEs to work on ways to expand and deepen it.

Approximately 150 investors have participated in the credit risk transfers to date, with anywhere from 50 to 75 participating in a given deal. The investor base for the first tranche in the CAS and STACR structures (the M-1) has been dominated by money managers and insurance companies. In the Fannie

Mae deal described in figure 1, 72 percent of first-tranche investors were asset managers and 28 percent were insurance companies. The next tranche, the M-2, has been dominated by hedge fund investors, which made up 59 percent of the investors in this tranche of the figure 1 deal. Twenty-eight percent of M-2 investors were asset managers, and 12 percent were real estate investment trusts (REITs). In addition to the narrow range of investors, the number of investors within each category is relatively small. If any one group retreats significantly, then spreads will likely widen considerably.

Four primary factors constrain the expansion of the investor base.

- **Constrained liquidity.** Investors are unable to sell significant positions in CAS or STACR deals without widening spreads significantly because market-makers are only willing to hold modest positions given the capital requirements. US banks that use the simplified supervisory formula approach to calculate capital must hold a dollar of capital for every dollar invested in the bonds, a prohibitively high level for most.[2]
- **Limitations on REITs.** There are two limitations on REIT investments in CAS and STACR deals. First, the Internal Revenue Service requires that at least 75 percent of a REIT's income and 75 percent of its assets come from "qualified" sources. While both CAS and STACR are considered qualified assets (because they are deemed government securities), neither is considered qualified income. Credit-linked notes, which we may see GSEs using more frequently going forward, don't qualify as either assets or income. Second, the US Securities and Exchange Commission requires that "whole pools" make up 55 percent of a REIT's assets, yet neither CAS nor STACR tranches is considered a whole pool. These two restrictions make it impossible for REITs to scale up their investment in this space.
- **Uncertainty over registration requirements.** The US Commodities Futures Trading Commission requires institutions that issue or invest in derivatives to register as "commodity pool operators," which brings with it significant reporting requirements and operational costs. The commission granted the GSEs a waiver for issuing CAS and STACR deals, and investors have inferred from that decision that they are similarly exempt from registering. Uncertainty over how long the GSEs' waiver will remain in place, and whether it covers investors, has had a chilling effect on investment.
- **Prohibition of insurers' participation.** The National Association of Insurance Commissioners evaluates the risk of possible investments by insurers. State insurance regulators use these ratings to determine whether the insurance companies they regulate can make certain investments and, if so, what capital they must hold against them. To date the association has rated the CAS and STACR transactions as risky enough to require a prohibitive level of capital.

Unfortunately, all these impediments have one thing in common: they fall outside the domain of the FHFA. So while the FHFA and the GSEs may want to expand the investor base, removing the barriers to expansion will require the cooperation of other independent agencies or action by Congress.

Fortunately, the FHFA and GSEs *can* broaden the investor base somewhat by expanding their risk-sharing efforts beyond the CAS and STACR structures that face these limitations. To that end, the FHFA's strategic plan also asks the GSEs to analyze the prospects for front end risk-sharing, the results from which will be used to inform a request for input on how best to pursue this form of risk-sharing.

In a recent paper, we and Mark Zandi (2015) made the case for what objectives risk sharing should try to meet and evaluated how well positioned various structures are to meet those objectives. We found that no one structure dominates. From this we concluded that the GSEs would be wise to expand the range of structures used beyond the back-end, second-loss structures that have dominated to date, so that policymakers are in a better position to judge what structures will meet their objectives over time. The conclusion here, that such an expansion is also one of the few ways FHFA and the GSEs can expand their investor base, further bolsters that argument.

Conclusion

Policymakers agree nearly universally that the housing finance system needs to attract more private capital. Yet the private-label securities market remains moribund and the potential for additional growth of portfolio lending limited, leaving the GSEs' risk-sharing effort the most promising—perhaps the only—way to achieve the objective for the foreseeable future. Policymakers also broadly support a future housing finance system in which the taxpayer's risk is insulated behind significant private capital, yet precisely what forms that private capital should take is highly uncertain. So it is important that the FHFA not only maximize the amount of risk shared through these transactions, but that it do so in a way that increases our understanding of what kind of system we should be migrating toward. This means expanding the range of structures that appear promising and broadening and deepening the market for them so we can test their full potential. The responsibilities that the FHFA has laid out for the GSEs in the 2016 scorecard should do precisely this, pushing them to expand beyond CAS and STACR and into a broader pool of investors.

Notes

1. For example, the bottom mezzanine tranche of the January Freddie deal (STACR 2016-DNA 1) priced 85 bps wider than their November deal (STACR 2015-DNA3)—a spread of 555 bps over LIBOR versus 470 bps over LIBOR.
2. See SIFMA letter from Chris Killian and David Oxner to Congressional Members Richard Shelby, Sherrod Brown, Jeb Hensarling and Maxine Waters on CRT, December 7, 2015. http://www.sifma.org/issues/item.aspx?id=8589957919

Reference

Goodman, Laurie, Jim Parrott, and Mark Zandi. 2015. *Delivering on the Promise of Risk-Sharing.* West Chester, PA, and Washington, DC: Moody's Analytics and Urban Institute.

About the Authors

Laurie Goodman is the director of the Housing Finance Policy Center at the Urban Institute. The center is dedicated to providing policymakers with data-driven analyses of housing finance policy issues they can depend on for relevance, accuracy, and independence.

Before joining Urban in 2013, Goodman spent 30 years as an analyst and research department manager at a number of Wall Street firms. From 2008 to 2013, she was a senior managing director at Amherst Securities Group, LP, a boutique broker/dealer specializing in securitized products, where her strategy effort became known for its analysis of housing policy issues. From 1993 to 2008, Goodman was head of global fixed income research and manager of US securitized products research at UBS and predecessor firms, which was ranked first by *Institutional Investor* for 11 straight years. Before that, she was a senior fixed income analyst, a mortgage portfolio manager, and a senior economist at the Federal Reserve Bank of New York.

Goodman was inducted into the Fixed Income Analysts Hall of Fame in 2009. She serves on the board of directors of MFA Financial, is an advisor to Amherst Capital Management, and is a member of the Bipartisan Policy Center's Housing Commission, the Federal Reserve Bank of New York's Financial Advisory Roundtable, and the New York State Mortgage Relief Incentive Fund Advisory Committee. She has published more than 200 journal articles and has coauthored and coedited five books. Goodman has a BA in mathematics from the University of Pennsylvania and an MA and PhD in economics from Stanford University.

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ROADMAP

TO GSE REFORM LEGISLATION

ROADMAP to GSE REFORM
July 2014

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The bills are available at these links: PATH Act; the Waters discussion draft; and H.R. 5055. S. 1217 began as a Corker-Warner bill in 2013, was replaced by a Johnson-Crapo version that began as a March 2014 discussion draft that was marked up April 29, 2014, with both one amendment and a second amendment. This summary incorporates the March 2014 draft with its most recent amendments.

This Roadmap does not include provisions of the PATH Act that do not overlap with the other proposals. These include FHA reforms, covered bond provisions, and most of Titles IV and V. The stand-alone summary of the PATH Act does cover those provisions.

	PATH Act, H.R. 2767	S. 1217	Waters Discussion Draft	H.R. 5055
Definitions		**§ 2 Definitions** *Affiliate* means any person that controls, is controlled by, or is under common control with another person. *Affordable rental housing* means a rental housing unit that is considered affordable for extremely low-, very low-low-, and moderate-income families if the rent charged, including utilities or a utility allowance, does not exceed 30% of the respective income limit in that market area for extremely low-, very low-, low-, or moderate-income families, respectively, of the size appropriate for the number of bedrooms in the unit, as HUD establishes. *Agency transfer date* means the date that is 6 months after enactment. *Appropriate Federal banking agency* has the same meaning as in FDIA § 3(q), and the NCUA in the case of any credit union. *Approved aggregator* means an entity that is approved by the FMIC pursuant to § 312. *Approved entity* means— • An approved guarantor; • An approved multifamily guarantor; • An approved aggregator;	**§ 2 Definitions** *Administration* means the National Mortgage Finance Administration ("NMFA") established under title I. *Approved private mortgage insurer* means an insurer that is approved by the NMFA pursuant to § 221 to provide private mortgage insurance on eligible mortgages. *Approved servicer* means a servicer that is approved by the NMFA pursuant to § 222 to administer eligible mortgages. *Charter* means the Fannie Mae or Freddie Mac charter acts. *Covered security* means a mortgage-backed security— • Collateralized by eligible mortgages; • Which is issued subject to such credit risk sharing mechanism, product, structure, contract, or other securitization agreement as established by the NMFA pursuant to title II; and • Which is eligible for and receives insurance by the NMFA pursuant to title II. *Director* means the Director of the NMFA unless the context otherwise requires.	*Bank* and *savings association* have the meaning given those terms under FDIA § 3. *Certification date* means the earlier of— • The date Ginnie Mae makes the certification under § 201(h); and • The date 2 years after enactment. *Charter Act* means the Fannie Mae or Freddie Mac charter act, respectively. *Credit union* means any federal or state credit union, as defined under § 101 of the Federal Credit Union Act (12 U.S.C. 1752). *Director* means the Ginnie Mae Director, as established by § 101(c)(1). *Eligible mortgage*— • Has the same meaning as qualified mortgage under TILA § 129C(b)(2)(A), as such meaning may be adjusted by the Director; and • Includes such other minimum standards as may be established by the Platform, to ensure the quality of mortgages used to collateralize Platform MBS. *Eligible multifamily mortgage loan* means a commercial real estate loan— • Secured by a property with—

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		• An approved private mortgage insurer; and
		• An approved servicer.
		
		Approved guarantor means an entity that is approved by the FMIC pursuant to § 311.
		
		Approved multifamily guarantor means an entity that is approved by the FMIC pursuant to § 703.
		
		Approved private mortgage insurer means an entity that is approved by the FMIC pursuant to § 313.
		
		Approved servicer means an entity that is approved by the FMIC pursuant to § 314.
		
		Area means a metropolitan statistical area, a micropolitan statistical area, and a noncore area, as such areas may be established by OMB.
		
		Board and *Board of Directors* mean the FMIC Board unless the context otherwise requires.
		
		Chairperson means the Chairperson of the FMIC Board unless the context otherwise requires.
		
		Charter means the Fannie Mae or Freddie Mac charter act.
			Eligible mortgage means a mortgage—
			• That is a residential real estate loan secured by a property with 1 to 4 units that has been originated in compliance with TILA § 129C(b), commonly referred to as the Ability-to-Repay and QM Rule;
			• Has a maximum original principal obligation amount that does not exceed the conforming loan limitation for the area determined under § 504;
			• The outstanding principal balance of which at the time of purchase of insurance under title II—
			  ○ Less than 80% of the value of the property;
			  ○ Not less than 80% but not more than 85% of the value of the property, provided that not less than 12% of the unpaid principal balance, accounting for any downpayment required under subparagraph (D) [there is none; apparently means § 2(7)(A)(iv)], is insured by—
			    ▪ An approved private mortgage insurer; or
			    ▪ Lender recourse or other credit enhancement that meets standards comparable to the standards required of private mortgage insurers under § 211;
			  ○ Is not less than 85% but not more
				○ 5 or more residential units; or
				○ 2 or more residential units, if the Director waives the 5+ requirement for purposes of a demonstration or pilot program;
				• The primary source of repayment for which is expected to be derived from rental income generated by the property;
				• The term of is 5 to 40 years;
				• That satisfies any additional underwriting criteria the Director establishes to balance supporting access to capital with managing credit risk to the Fund, including—
				  ○ A maximum LTV ratio;
				  ○ A minimum debt service coverage (DSC) ratio; and
				  ○ Considerations for restrictive or special uses of a property, including nonresidential uses, properties for seniors, manufactured housing, and affordability restrictions, and the impact of such uses on LTV and DSC ratios; and
				• That satisfies any additional underwriting criteria that the Director may establish.
				
				Enterprise or *GSE* means Fannie Mae, Freddie Mac, or any affiliate of either.
				
				Fund means the insurance fund established under § 202(g).

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		Community Development Financial Institution ("CDFI") has the same meaning as in § 103 of the Riegle Community Development and Regulatory Improvement Act of 1994 (12 U.S.C. 4702).
		
		Community land trust means a nonprofit organization or State or local government that owns real property and leases the land through homeownership programs that—
		• Use a ground lease to—
		  o Make real property affordable to low- or moderate-income borrowers; and
		  o Stipulate a preemptive option to purchase the real property from the home owner at resale so that the affordability of the real property is preserved for successive low- and moderate-income borrowers;
		• Monitor properties to ensure affordability is preserved over resales; and
		• Support homeowners to promote successful homeownership and prevent foreclosure.
		
		Corporation means the FMIC.
		
		Covered entity means—
		• An approved guarantor;
		• An approved multifamily guarantor; and
			than 90% of the value of the property securing the mortgage, provided that not less than 25% of the unpaid principal balance of the mortgage, accounting for any downpayment required under subparagraph (D), is insured by—
			▪ An approved private mortgage insurer; or
			▪ Lender recourse or other credit enhancement that—
			  ♦ Meets standards comparable to the standards required of private mortgage insurers under § 211; and
			  ♦ Is approved by the NMFA; or
			o Is not less than 90% but not more than 95% of the value of the property securing the mortgage, provided that not less than 30% of the unpaid principal balance of the mortgage, accounting for any downpayment required under subparagraph (D), is insured by—
			▪ An approved private mortgage insurer; or
			▪ Lender recourse or other credit enhancement that—
			  ♦ Meets standards comparable to the standards required of private mortgage insurers
				Ginnie Mae means the Government National Mortgage Association.
				
				Market participant means any insurance company, bank, saving association, credit union, or REIT insuring or reinsuring any part of a security issued by the Platform.
				
				Participating aggregator means an aggregator of eligible mortgages that collateralize Platform MBS pursuant to title II.
				
				REIT has the meaning given such term under IRC § 856(a).

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		• An approved aggregator that is neither an insured depository institution nor an affiliate of an insured depository institution.
		
		Covered guarantee transaction means a transaction, as the FMIC shall define by regulation, involving the agreement to guarantee on—
		• Any eligible mortgage loan;
		• Any pool of such eligible mortgage loans; or
		• The payment of principal and interest on covered securities collateralized by eligible mortgage loans before payments insured by the FMIC are made.
		A covered guarantee transaction—
		• Shall not be construed to be—
		  ○ A contract of sale of a commodity for future delivery or a swap under the Commodity Exchange Act; or
		  ○ A contract of insurance or reinsurance under any Federal or State law regulating the sale, underwriting, provision, or brokerage of insurance;
		• Shall not be subject to any requirement of Commodity Exchange Act; and
		• Shall not be subject to any requirement imposed under State law pertaining to the sale, underwriting, provision, or brokerage of insurance or reinsurance.
			under § 211; and
			  ♦ Is approved by the NMFA;
			• Having a downpayment which shall be equal to not less than 5% of the purchase price of the property securing the mortgage, unless the mortgage meets such other requirements as the NMFA shall specify to protect against the additional risk;
			• That is insured by an approved State licensed title insurance company;
			• That contains such terms and provisions with respect to insurance, property maintenance, repairs, alterations, payment of taxes, default, reserves, delinquency charges, foreclosure proceedings, anticipation of maturity, additional and secondary liens, and other matters, including matters that set forth terms and provisions for establishing escrow accounts, performing financial assessments, or limiting the amount of any payment made available under the mortgage as the NMFA may prescribe; and
			• That contains such other terms or characteristics as the NMFA, in consultation with the CFPB, may determine necessary or appropriate.
			
			The NMFA shall issue rules to provide that such term shall also include—	

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		Covered market-based risk-sharing transaction means any private market transaction, as the FMIC shall define by regulation, involving a covered security issued subject to a standard risk-sharing mechanism, product, contract, or other security agreement approved by the FMIC under § 302. A covered market-based risk-sharing transaction— • Shall not be construed to be a contract of insurance or reinsurance under any Federal or State law regulating the sale, underwriting, provision, or brokerage of insurance; and • Shall not be subject to any requirement imposed under State law pertaining to the sale, underwriting, provision, or brokerage of insurance or reinsurance. *Covered security* means— • A single-family covered security; and • A multifamily covered security. *Credit risk-sharing mechanism* means any mechanism, product, structure, contract, or security agreement by which a private market holder assumes the first loss position, or any part of such position, associated with the pool of eligible mortgage loans collateralizing a covered security, or by which an approved guarantor or approved multifamily guarantor	• Loans on rental properties that are not covered by the standards referred to in subparagraph (A)(i) (1 to 4 unit properties with loans that meet the ability-to-repay rule); and • Loans made to first-time homeowners having an initial downpayment of 3.5%. *Enterprise* means Fannie Mae, Freddie Mac, or an affiliate thereof. *Federal banking agency* means, individually, the Federal Reserve, OCC, FDIC, CFPB, NCUA, SEC, CFTC, FHFA, and Treasury; and Federal banking agencies means all of them collectively. *FHLB* means a bank established under the FHLB Act. *FHLB System* means the FHLBs and the Office of Finance and any authorized subsidiary of one or more FHLBs. *Insured depository institution* means an insured depository institution under FDIA § 3 or a credit union that is a depository institution under Federal Reserve Act § 19(b). *Issuer* means the Mortgage Securities Cooperative established under § 211 (page 11 lines 19 – 21). *Issuer* means the issuer	

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		manages the credit risk related to guarantees provided for covered securities. *CSP* means the securitization infrastructure FHFA announced on October 4, 2012, and developed by the GSE while under conservatorship, under the authority of FHFA pursuant to the 1992 Act, and commonly referred to as the common securitization platform. *Days* means— • With respect to any period of time less than or equal to 10 days, business days; and • With respect to any period of time greater than 10 days, calendar days. *Depository institution holding company* has the same meaning as FDIA § 3(w)(1) (12 U.S.C. 1813(w)(1)). *Eligible borrower* means a borrower who applies for an eligible mortgage loan and meets the standards required of a borrower to be approved for an eligible mortgage loan. *Eligible mortgage loan* means an eligible single-family mortgage loan and an eligible multifamily mortgage loan. *Eligible multifamily mortgage loan* means a	established under § 211 to issue covered securities and to purchase insurance offered by the NMFA pursuant to title II on a covered security subject to applicable rules concerning first loss credit enhancement (page 13 lines 1 – 6). *NMFA certification date* means the date on which the Director certifies that the NMFA is operational and able to perform the insurance functions for covered securities, which date shall be not later than 5 years after the enactment, unless extended by not more than one additional year by Treasury for cause. *Senior Preferred Stock Purchase Agreement* means: • The Amended and Restated Senior Preferred Stock Purchase Agreement, dated September 26, 2008, as such Agreement has been amended on May 6, 2009, December 24, 2009, and August 17, 2012, respectively, and as such Agreement may be further amended and restated, entered into between Treasury and each GSE, as applicable; and • Any provision of any certificate in connection with such Agreement creating or designating the terms, powers, preferences, privileges, limitations, or any other conditions of the Variable Liquidation Preference Senior Preferred	

<table>
<tr><th></th><th>PATH Act, H.R. 2767</th><th>S. 1217</th><th>Waters Discussion Draft</th><th>H.R. 5055</th></tr>
<tr><td></td><td></td><td>commercial real estate loan—
• Secured by a property with 5 or more residential units, or with 2 or more units if the FMIC waives the requirement for 5 for purposes of carrying out a demonstration or pilot program;
• The primary source of repayment for which is expected to be derived from rental income generated by the property;
• The term of which may not be less than 5 years but not more than 40 years, but may be less than 5 years subject to FMIC standards;
• That satisfies any additional underwriting criteria established by the FMIC to balance supporting access to capital with managing credit risk to the MIF, including—
o A maximum LTV;
o A minimum debt service coverage ratio; and
o Considerations for restrictive or special uses of a property, including non residential uses, properties for seniors, manufactured housing, and affordability restrictions, and the impact of such uses on LTV and debt service coverage ratio; and
• That satisfies any additional underwriting criteria that may be established by the FMIC.</td><td>Stock of a GSE issued or sold pursuant to such Agreement

Transfer date means the date that is 1 year after the date of enactment.</td><td></td></tr>
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		Eligible single-family mortgage loan means a loan that—
		• Has been originated in compliance with minimum standards issued by the FMIC by regulation, provided that such standards—
		  ○ Are uniform and equal in kind, nature, and application regardless of—
		    ▪ The originator of the mortgage loan; or
		    ▪ The role performed by an approved entity with respect to the mortgage loan;
		  ○ Are, to the greatest extent possible, substantially similar to the QM regulations issued by the CFPB under TILA § 129C(b) (15 U.S.C. 1639c); and
		  ○ Permit—
		    ▪ Residential real estate loans secured by a property with 1 to 4 single-family units, including units that are not owner-occupied;
		    ▪ Loans secured by manufactured homes, as defined by § 603(6) of the National Manufactured Housing Construction and Safety Standards Act of 1974 (42 U.S.C. 5402(6));
		    ▪ Residential real estate loans secured by a property with 1 to 4		

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		single-family units that are originated by a State housing finance agency, as defined in § 106 of the Housing and Urban Development Act of 1968 (12 U.S.C. 1701x); ▪ Loans originated by a CDFI; ▪ Loans originated by a mission-based non-profit lender; ▪ Loans secured by real property in a permanently affordable homeownership program or community land trust; and ▪ Loans to entities that provide non-owner occupied rental housing with care providers for individuals with intellectual and developmental disabilities. • Has a maximum original principal obligation amount that does not exceed the applicable loan limit under § 304; • Has an outstanding principal balance at the time of purchase of insurance available under Title II that does not exceed 80% of the property value unless— ○ For such period and under such circumstances as the FMIC may require, the seller agrees to repurchase or replace the loan upon FMIC demand in the event the loan is in default;		

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		○ An approved private mortgage insurer guarantees or insures— ▪ Not less than 12% of the unpaid principal balance, accounting for any down payment required under subparagraph (D) [the reference to subparagraph (D) apparently means § 2(29)(a)(iv), the bullet below that sets down payment requirements], for loans in which the unpaid principal balance exceeds 80% but not more than 85% of the property value; ▪ Not less than 25% of the unpaid principal balance, accounting for any down payment required under subparagraph (D), for loans in which the unpaid principal balance exceeds 85% but not more than 90% of the property value; ▪ Not less than 30% of the unpaid principal balance, accounting for any down payment required under subparagraph (D), for loans in which the unpaid principal balance exceeds 90% but not more than 95% of the property value; and ▪ Not less than 35% of the unpaid principal balance, accounting for any down payment required		

	PATH Act, H.R. 2767	S. 1217	Waters Discussion Draft	H.R. 5055
		under subparagraph (D), for loans in which the unpaid principal balance exceeds 95% of the property value; or ○ That portion of the unpaid principal balance which exceeds 80% of the property value is subject to other credit enhancement that— ▪ Meets standards comparable to the standards required of private mortgage insurers under clause (ii) [apparently referencing § 2(29)(A)(iii)(II), setting the required amount of MI coverage]; and ▪ Is approved by the FMIC; • Has a down payment that is— ○ For a first-time homebuyer, as shall be defined by the FMIC by regulation, equal to not less than 3.5% of the purchase price of the property; or ○ For non first-time homebuyers, equal to— ▪ Not less than 3.5% of the purchase price, if such purchase occurs before, or less than 1 year after, the system certification date; ▪ Not less than 4% of the purchase price, if such purchase occurs between 1 year and 2 years after the system certification date;		

	PATH Act, H.R. 2767	S. 1217	Waters Discussion Draft	H.R. 5055
		▪ Not less than 4.5% of the purchase price, if such purchase occurs between 2 and 3 years after the system certification date; or ▪ Not less than 5% of the purchase price, if such purchase occurs during any period after the period set forth in subclause (III) [unclear reference]; • Satisfies standards related to establishing title or marketability of title, as may be required by the FMIC, which standards may include the required purchase of title insurance on the property securing the loan; • Contains such terms and provisions with respect to insurance, property maintenance, repairs, alterations, payment of taxes, default, reserves, delinquency charges, foreclosure proceedings, anticipation of maturity, additional and secondary liens, and other matters, including matters that set forth terms and provisions for establishing escrow accounts, performing financial assessments, or limiting the amount of any payment made available under the loan as the FMIC may prescribe; and • Contains such other terms, characteristics, or underwriting criteria as the FMIC, in consultation with the CFPB, may		

	PATH Act, H.R. 2767	S. 1217	Waters Discussion Draft	H.R. 5055
		determine necessary or appropriate; or It also includes a loan refinanced pursuant to § 305(i) authority. This is FMIC authority, if there is a sustained house price decline, with approval, to permit transfer of guarantees of eligible loans if the loans are refinanced. *Enterprise* (or GSE) means Fannie Mae, Freddie Mac, and any affiliate thereof. *Extremely low-income* means— • In the case of owner-occupied units, income not in excess of 30% of the median income of the area; and • In the case of rental units, income not in excess of 30% of the median income of the area, with adjustments for smaller and larger families, as determined by HUD. *FHFA* means— • Prior to the agency transfer date, the FHFA; • On and after the agency transfer date but prior to the system certification date, the Federal Housing Finance Agency established within the FMIC under title IV; and • On and after the system certification date, the FMIC. *FHFA Director* has the same meaning as the term Director in section 401(1).		

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		Federal regulatory agency means, individually, the Federal Reserve, OCC, FDIC, CFPB, NCUA, SEC, CFTC, FHFA; and *Federal regulatory agencies* means those agencies collectively.
		
		FHLB means a bank established under the Federal Home Loan Bank Act (12 U.S.C. 1421 et seq.).
		
		Federal Home Loan Bank System means the FHLBs and the Office of Finance and any authorized subsidiary of one or more FHLBs.
		
		First loss position, with regard to a covered security, means both—
		• Either of the following—
		  ○ That fully-funded position to which any credit loss on such covered security resulting from the nonperformance of underlying mortgage loans will accrue and be absorbed, to the full extent of the holder's interest in such position; or
		  ○ The guarantee provided by an approved guarantor or approved multifamily guarantor with respect to an eligible single-family mortgage loan, pool of eligible single-family mortgage loans, or a covered security or eligible multifamily mortgage loan, pool of eligible multifamily		

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		mortgage loans, or a multifamily covered security, as applicable; and • Such position or guarantee, as applicable, which is required to absorb any initial credit loss on a covered security prior to the FMIC becoming obligated to make any payment of insurance in accordance with this Act. *HUD-approved housing counseling agency* means an agency HUD certified under section 106(e) of the Housing and Urban Development Act of 1968 (12 U.S.C. 1701x(e)). *Insured depository institution* means such an institution, as defined under FDIA § 3 (12 U.S.C. 1813) and an insured credit union, as defined under § 101 of the FCUA (12 U.S.C. 1752). *Issuer* means, with respect to a covered security, an approved aggregator who issues such covered security through the Platform. For a noncovered security, *issuer* has the meaning in the Securities Act and SEC regulations. The Platform shall not be deemed to be an issuer of covered or noncovered securities for purposes of the Securities Act of 1933. *Low-income* means—		

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		• In the case of owner-occupied units, income not in excess of 80% of median income of the area; and
		• In the case of rental units, income not in excess of 80% of median income of the area, with adjustments for smaller and larger families, as determined by HUD.
		
		Market participant means any—
		• Approved entity;
		• Private market holder; and
		• Member of the Securitization Platform.
		
		Median income means, with respect to an area, the unadjusted median family income for the area, as determined and published annually by HUD.
		
		Mission-based non-profit lender means an organization that—
		• Is exempt from taxation pursuant to § 501(c)(3) of the Internal Revenue Code;
		• Makes any of the following—
		    o Residential real estate loans for the purpose of promoting or facilitating homeownership for poor or lower- or moderate-income, disabled, or other disadvantaged persons or families; or
		    o Real estate loans for the purpose of promoting or facilitating affordable rental housing for low-income persons or families subject to any		

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		other additional criteria established by the FMIC;
		• Sets interest rates on such loans that—
		  ○ Are lower than the bank prime loan rate, as determined under the Federal Reserve's Statistical Release of selected interest rates (the H.15) for the last day of the most recent weekly release of such rates; or
		  ○ Are, after adjusting for inflation, no-interest loans or loans with interest rates at or below the interest rates for mortgage loans generally available in the market;
		• Except for making loans described above, does not engage in the business of a mortgage originator or mortgage broker;
		• Conducts its activities in a manner that serves public or charitable purposes;
		• Receives funding and revenue and charges fees in a manner that does not incentivize the organization or its employees to act other than in the best interests of its clients;
		• Compensates employees in a manner that does not incentivize employees to act other than in the best interests of its clients; and
		• Meets such other requirements as the FMIC determines appropriate.
		
		Moderate-income means		

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		• In the case of owner-occupied units, income not in excess of median income of the area; and • In the case of rental units, income not in excess of median income of the area, with adjustments for smaller and larger families, as determined by HUD. *Mortgage aggregator* means a person that— • Purchases or receives from a third party residential real estate loans or commercial real estate loans; and • Delivers, transfers, or sells such loans to the Securitization Platform, including for issuance of securities through the Platform. *Mortgage-backed security (MBS)* means an ABS, as defined in § 3(a) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)), that is collateralized by— • A mortgage loan, including any residential real estate loan or commercial real estate loan; or • A collateralized mortgage obligation of MBS. *Mortgage originator* has the same meaning as in TILA § 103(cc)(2) (15 U.S.C. 1602(cc)(2)). *Multifamily business* means the GSE activities and processes of—		

	PATH Act, H.R. 2767	S. 1217	Waters Discussion Draft	H.R. 5055
		• Purchasing, selling, lending on the security of, or otherwise dealing in multifamily mortgage loans; • Securitizing a pool of multifamily mortgage loans; and • Issuing multifamily securities. *Multifamily covered security*'' means a multifamily mortgage-backed security— • Collateralized by eligible multifamily mortgage loans; and • Which is FMIC-insured pursuant to § 303. *Multifamily mortgage-backed security* means an MBS collateralized by commercial real estate loans secured by properties with 5 or more residential units in accordance with the requirements of this Act. *Noncovered security* means any mortgage-backed security other than a covered security. *Noneligible mortgage loan* means any mortgage loan other than an eligible mortgage loan. *Office of Finance* means the FHLB System Office of Finance. *Permanently affordable homeownership program* includes programs administered by		

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		community land trusts, nonprofit organizations, or State or local governments that—
		• Use a ground lease, deed restriction, subordinate loan, or similar legal mechanism to—
		  o Make real property affordable to low- or moderate-income borrowers; and
		  o Stipulate a preemptive option to purchase the real property from the homeowner at resale to preserve the affordability of the real property for successive low- and moderate-income borrowers;
		• Monitor properties to ensure affordability is preserved over resales; and
		• Support homeowners to promote successful homeownership and prevent foreclosure.
		
		Person means an individual, corporation, company (including a limited liability company or joint stock company), association (incorporated or unincorporated), mutual or cooperative organization, partnership, trust, estate, society, or any other legal entity.
		
		Platform and *Securitization Platform* mean the securitization infrastructure established under part I of subtitle C of title III.		

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		Platform Directors means the board of directors of the Securitization Platform. *Platform security* means an MBS issued by an issuer through facilities of the Securitization Platform. *Private label MBS market* means the market in which noncovered securities are issued, bought, and sold. *Private market holder* means the holder or holders, other than an approved guarantor or an approved multifamily guarantor, of the first loss position with respect to eligible mortgage loans collateralizing any covered security insured in accordance with this Act. *Regulated entity* means— • Fannie Mae, Freddie Mac, and any affiliate thereof; • Any FHLB; and • The Securitization Platform. *Residential real estate loan* includes any— • Real estate mortgage loan; • Personal property loan secured solely by the home itself; • Hybrid land-home loan for a manufactured home, as defined by § 603(6) of the National Manufactured Housing Construction and Safety		

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		Standards Act of 1974 (42 U.S.C. 5402(6)), to which the requirements of paragraph (29)(A)(v) shall not apply [referring to, in the definition of Eligible single-family mortgage loan, the FMIC standards for establishing marketability of title]; and • Mortgage loan secured by real property in a community land trust or permanently affordable homeownership program. *Safety and Soundness Act* or the *1992 Act* means the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (12 U.S.C. 4501 et seq.). *Senior Preferred Stock Purchase Agreement* means— • The Amended and Restated Senior Preferred Stock Purchase Agreement, dated September 26, 2008, as such Agreement has been amended on May 6, 2009, December 24, 2009, and August 17, 2012, respectively, and as such Agreement may be further amended and restated, entered into between Treasury and each GSE, as applicable; and • Any provision of any certificate in connection with such Agreement creating or designating the terms, powers, preferences, privileges, limitations, or any other conditions of the Variable		

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		Liquidation Preference Senior Preferred Stock of a GSE issued or sold pursuant to such Agreement. *Single-family activities*'' means the FMIC activities and processes in providing insurance for single-family covered securities as provided in this Act. *Single-family covered security* means a single-family mortgage-backed security— • Collateralized by eligible single-family mortgage loans; and • Which is FMIC- insured pursuant to § 303. *Small mortgage lender* means a community bank, credit union, mid-sized bank, nondepository institution, CDFI, a mission-based non-profit lender, or housing finance agency that originates residential real estate loans or commercial real estate loans. *Standardized covered security* and *standardized security for single-family covered securities* mean a single-family covered security that is— • Issued by an issuer through the Platform; and • In a form, and includes the standardized and uniform terms for the security and transaction that have been, developed by		

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		the Platform Directors and approved by FMIC for use across various issuances. *Standardized noncovered security* and *standardized single-family noncovered security* mean a single-family noncovered security that is— • Issued by an issuer through the Platform; and • In a form, and includes the standardized and uniform terms for the security and transaction that have been, developed by the Platform Directors for use across various issuances. *State* means any State, territory, or possession of the U.S., D.C., Puerto Rico, the Northern Mariana Islands, Guam, American Samoa, or the Virgin Islands or any Federally recognized Indian tribe, as defined by the Interior Secretary under § 104(a) of the Federally Recognized Indian Tribe List Act of 1994 (25 U.S.C. 479a-1(a)). *System certification date* means the date on which the FMIC Board certifies that the requirements of § 601 have been met. *Very low-income* Means— • In the case of owner-occupied units, families having incomes not greater than		

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		50% of the median income of the area; and • In the case of rental units, families having incomes not greater than 50% of the median income of the area, with adjustments for smaller and larger families, as determined by HUD. For purposes of the Housing Trust Fund and the Capital Magnet Fund established under §§ 1338 and 1339 of the 1992 Act, and the Market Access Fund established under § 504, *very low-income* means— • In the case of owner-occupied units, income in excess of 30% but not greater than 50% of the median income of the area; • In the case of rental units, income in excess of 30% but not greater than 50% of the median income of the area, with adjustments for smaller and larger families, as determined by HUD.		
New Agency Created		**TITLE I—FANNIE MAE and FREDDIE MAC** Effective on the agency transfer date, the FMIC shall take all steps necessary to dissolve and eliminate the GSEs pursuant to this Act. Their charters shall be repealed pursuant to title VI. **TITLE II—FMIC** **§ 201 Establishment** Establishment	**§ 101 Establishment** Establishment There is hereby established the NMFA which shall have the powers hereinafter granted. Purpose NMFA's purpose shall be to— • Provide access to affordable mortgage credit, including 30-year fixed rate mortgages, by supporting a robust secondary mortgage market and the	

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		Effective on the agency transfer date, there is established the FMIC, which is charged with ensuring the safety and soundness of, and compliance with laws and regulations, fair access to financial services, and fair treatment of customers by the institutions and other persons subject to its jurisdiction and which shall have the powers hereinafter granted.
		
		<u>Purpose</u>
		The purpose of the FMIC shall be to—
		• Facilitate a liquid, transparent, and resilient single-family and multifamily mortgage credit market by supporting a robust secondary mortgage market, including during the transition to the new housing finance system;
		• Provide insurance on any mortgage-backed security that satisfies the requirements under this Act to become a covered security;
		• Monitor and supervise approved entities to the extent provided in this Act;
		• Supervise the regulated entities; and
		• Facilitate the broad availability of mortgage credit and secondary mortgage market financing through fluctuations in the business cycle for eligible single-family and multifamily lending across all—
		  o Regions;
		  o Localities;
			production of RMBS; and
			• Protect the taxpayer from absorbing losses incurred in the secondary mortgage market during periods of economic stress.
			
			<u>Federal Status</u>
			The NMFA shall be an independent agency of the Federal Government.
			
			<u>Succession</u>
			The NMFA shall have succession until dissolved by Act of Congress.
			
			<u>Principal Office</u>
			The NMFA shall maintain its principal office in D.C. and shall be deemed, for purposes of venue in civil actions, to be a resident thereof.
			
			<u>Authority to Establish Other Offices</u>
			The NMFA may establish such other offices in such other place or places as it may deem necessary or appropriate in the conduct of its business.
			
			<u>Prohibition</u>
			The NMFA shall not engage in mortgage origination.	

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		◦ Institutions; ◦ Property types, including housing serving renters; and ◦ Eligible borrowers. • Ensure continued, widespread availability of an affordable, long-term, fixed-rate, prepayable mortgage, such as a 30-year, fixed-rate mortgage; and • Preserve and maintain a liquid forward execution market for single-family eligible mortgage loans and single-family covered securities, such as the TBA market; <u>General Supervisory and Regulatory Authority</u> • Each approved entity shall, to the extent provided in this Act, be subject to FMIC supervision and regulation. • The FMIC shall have general regulatory authority over each regulated entity and the Office of Finance, and shall exercise such general regulatory authority to ensure that the purposes of this Act, any amendments made by this Act, and any other applicable law for which the FMIC has responsibility are carried out. <u>Federal Status</u> The FMIC shall be an independent agency and an instrumentality of the Federal Government.		

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		<u>Succession</u> The FMIC shall have succession until dissolved by an Act of Congress. <u>Principal Office</u> The FMIC shall maintain its principal office in the District of Columbia and shall be deemed, for purposes of venue in civil actions, to be a resident thereof. <u>Authority to Establish Other Offices</u> The FMIC may establish such other offices in such other place or places as it may deem necessary or appropriate in the conduct of its business. <u>Prohibition</u> The FMIC shall not engage in mortgage loan origination.		
New Agency Management		**§ 202 Management of FMIC** <u>Board of Directors</u> • The FMIC's management shall be vested in a Board consisting of 5 members who shall be appointed by the President, by and with the advice and consent of the Senate, from among individuals who— o Are citizens of the United States; and o Have demonstrated technical, academic, or professional understanding of, and practical, disciplinary, vocational, or regulatory experience working in, housing and	**§ 102 Director** <u>Establishment of Position</u> There is established the position of the Director of the NMFA, who shall be the head of the NMFA. <u>Appointment; Term</u> • The Director shall be appointed by the President, by and with the advice and consent of the Senate, from among individuals who— o Are citizens of the U.S.; and o Have a demonstrated understanding	

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		housing finance.
		• Not more than 3 of the members of the Board may be members of the same political party.
		• The Board shall advise the Chairperson regarding overall strategies and policies to carry out the duties and purposes of this Act.
		
		<u>Chairperson and Vice Chairperson</u>
		• One of the appointed board members shall be designated by the President to serve as Chairperson of the Board. Except as provided for the initial term, the Chairperson shall be appointed for a term of 5 years, unless removed before the end of such term by the President for cause. The President may remove the Chairperson for inefficiency, neglect of duty, or malfeasance in office.
		• The Chairperson—
		  ○ Shall—
		    ▪ Be the active executive officer of the FMIC, subject to supervision by the Board;
		    ▪ Oversee the prudential operations of each regulated entity; and
		    ▪ Ensure that each approved entity and regulated entity operates in a safe and sound manner, including—
			of financial management or oversight and have a demonstrated understanding of the capital markets, including the mortgage securities markets and housing finance.
			• The Director shall be appointed for a term of 5 years, unless removed before the end of such term for cause by the President.
			• A vacancy in the position of Director that occurs before the expiration of the term for which a Director was appointed shall be filled in the same manner, and the Director appointed to fill such vacancy shall be appointed only for the remainder of such term. If the Senate has not confirmed a Director, the President may designate either the individual nominated but not yet confirmed for the position of Director, the FHFA Director, or other individual, to serve as the Acting Director, and such Acting Director shall have all the rights, duties, powers, and responsibilities of the Director, until such time as a Director is confirmed by the Senate.
			• An individual may serve as the Director after the expiration of the term for which appointed until a successor has been appointed or confirmed.
			• The Director shall be compensated at the rate prescribed for level II of the Executive Schedule under 5 U.S.C.	

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		♦ Through the maintenance of adequate capital, standards, and internal controls; and ♦ By ensuring compliance with the rules, regulations, guidelines, and orders issued pursuant to this Act; and ○ May exercise such incidental powers as may be necessary or appropriate to assist the FMIC in fulfilling the duties and responsibilities of the FMIC in the supervision and regulation of each approved entity and regulated entity. • The Chairperson may delegate to officers and employees of the FMIC any of the functions, powers, or duties of the Chairperson, as the Chairperson considers appropriate. • One of the Board members shall be designated by the President to serve as Vice Chairperson of the Board. Except as provided for the initial term, the Vice Chairperson shall be appointed for a term of 5 years, unless removed before the end of such term by the President for cause. The President may remove the Vice Chairperson for inefficiency, neglect of duty, or malfeasance in office. • Except as provided in § 402 [FHFA transition], in the event of a vacancy in	§ 5313. <u>FSOC Membership</u> The Dodd-Frank Act is amended— • In § 2(12)(E) (definition of primary financial regulatory agency) by replacing FHFA with the FMIC with respect to the MIF and the FHLBs or the FHLB System. • In § 111(b)(1)(H) (FSOC voting members) by replacing the FHFA Director with the NMFA Director.	

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		the position of Chairperson of the Board or during the absence or disability of the Chairperson, the Vice Chairperson shall act as Chairperson. • Except as provided in § 402, in the event of vacancies in the positions of Chairperson and Vice Chairperson, or during the absence or disability of both the Chairperson and the Vice Chairperson, the President shall designate 1 of the other members as Acting Chairperson. • Any person confirmed to serve as Chairperson, or acting as Chairperson, whether designated to act as such by the President or acting in such capacity by operation of this paragraph or section 402, shall for the period that such person is serving as Chairperson or acting as Chairperson— o Act for all purposes as the Chairperson; and o Have all the rights, duties, powers, and responsibilities of the Chairperson. <u>Staggered Terms; Term Continuation</u> • The initial member of the Board designated as Chairperson shall serve a term of 30 months. • The initial member of the Board designated as Vice Chairperson shall		

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		serve a term of 30 months. • One of the other initial members of the Board appointed pursuant to subsection (a)(1) and not designated as Chairperson or Vice Chairperson under subsection (b) shall serve a term of 30 months and the other 2 initial members shall serve a term of 4 years. • After the expiration of such initial terms, all subsequent appointed members of the Board shall serve for a term of 5 years. • Each appointed member of the Board, including any member appointed as Chairperson or Vice Chairperson, may continue to serve after the expiration of the term of office to which such member was appointed until the expiration of the next session of Congress subsequent to the expiration of said fixed term of office. <u>Vacancy; Manner of Fulfillment</u> Any vacancy on the Board shall be filled in the manner in which the original appointment was made, and the person appointed to fill such vacancy shall be appointed only for the remainder of such term. <u>Compensation of Members</u> The Chairperson shall receive compensation at the rate prescribed for Level II of the Executive Schedule under 5 U.S.C. § 5313. All other members of the Board shall receive		

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		compensation at the rate prescribed for Level III of the Executive Schedule under 5 U.S.C. § 5314. <u>Ineligibility for Other Offices During Service; Postservice Restriction</u> No member of the Board may, during the time such member is serving in such capacity and for the 2-year period beginning on the date such member ceases to serve as a member of the Board be an officer, employee, or director of, or hold stock or have beneficial ownership in, any— • Insured depository institution; • Insured depository institution holding company; • Federal Reserve bank; • Regulated entity; • Approved entity; or • Non-bank financial institution or company that originates eligible mortgage loans. Upon taking office, each member of the Board shall certify under oath that such member has complied, and will comply, with this subsection and such certification shall be filed with the secretary of the Board. <u>Status of Directors, Officers, and Employees</u> • A member of the Board, officer, or employee of the FMIC has no liability under the Securities Act of 1933 (15		

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		U.S.C. 77b et seq.) with respect to any claim arising out of or resulting from any act or omission by such person within the scope of such person's employment in connection with any transaction involving the disposition of assets (or any interests in any assets or any obligations backed by any assets) by the FMIC. This subsection shall not be construed to limit personal liability for criminal acts or omissions, willful or malicious misconduct, acts or omissions for private gain, or any other acts or omissions outside the scope of such person's employment. • This subsection does not affect— o Any other immunities and protections that may be available to such person under applicable law with respect to such transactions; or o Any other right or remedy against the FMIC, against the U.S. under applicable law, or against any person other than an FMIC Director, officer, or employee participating in such transactions. • This subsection shall not be construed to limit or alter in any way the immunities that are available under applicable law for Federal officials and employees not described in this subsection. Independence		

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		Each member of the Board shall be independent in performing his or her duties. To be considered independent for purposes of this subsection, a member of the Board—
		• May not, other than in his or her capacity as a member of the Board or any committee thereof—
		  o Accept any consulting, advisory, or other compensatory fee from the FMIC; or
		  o Be a person associated with the FMIC or with any of its affiliates; and
		• Shall be disqualified from any deliberation involving any transaction of the FMIC in which the member has a financial interest in the outcome of the transaction.
		
		<u>Administration</u>
		Except as may be otherwise provided in this Act, the Board shall administer the affairs of the FMIC fairly and impartially and without discrimination.
		
		<u>Voting</u>
		A majority vote of all members of the Board is necessary to resolve all voting issues of the FMIC.
		
		<u>Meetings</u>
		The Board shall meet in accordance with the		

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		FMIC bylaws at the call of the Chairperson, and not less frequently than once each quarter. <u>Quorum</u> Three members of the Board then in office shall constitute a quorum. <u>Bylaws</u> A majority of the members of the Board may amend the bylaws.		
Advisory Committee		**§ 203 Advisory Committee** <u>Establishment</u> • The FMIC shall establish an Advisory Committee to advise the Office of Consumer and Market Access and the Board of Directors on developments in the primary and secondary mortgage markets that have material effects on the ongoing mission of the FMIC. • The Advisory Committee shall provide advice and recommendations to the Office of Consumer and Market Access and the Board as to material developments in the following areas: o Housing prices and affordability. o The effectiveness of consumer protections in the housing market. o Volume and characteristics of mortgage loan originations. o The condition of the rental housing market. o Small lender participation in the	**§ 103 Advisory Board; Status of Employees** <u>Establishment of Advisory Board</u> • The NMFA shall establish an Advisory Board to advise and consult with the NMFA in the exercise of its activities with regard to covered securities and covered multifamily securities, and to provide information on practices and market conditions in the secondary mortgage market. • In appointing the members of the Advisory Board, the Director shall appoint experts who— o Have demonstrated technical, academic or professional understanding of, and practical, disciplinary, vocational, or regulatory experience working in, the fields of mortgage lending, mortgage insurance markets, or asset management; o Have demonstrated technical,	

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		secondary mortgage market. ○ Access to credit in rural and underserved communities. ○ Competition among approved market entities. ○ Fair, equitable, and nondiscriminatory access to mortgage credit for individuals and communities. <u>Composition and Qualifications</u> • The Advisory Committee shall be composed of 14 members as follows: ○ One member who shall have a demonstrated technical, academic, or professional understanding of, and practical, disciplinary, vocational, or regulatory experience working with, non-depository mortgage originators having less than $10,000,000,000 in total assets. ○ One member who shall have a demonstrated technical, academic, or professional understanding of, and practical, disciplinary, vocational, or regulatory experience working with, credit unions having less than $10,000,000,000 in total assets. ○ One member who shall have a demonstrated technical, academic, or professional understanding of, and practical, disciplinary, vocational, or regulatory experience working with,	academic, or professional understanding of, and practical, disciplinary, vocational, or regulatory experience working with lenders having less than $10,000,000,000 in total assets, who shall comprise not fewer than one-third of the members of the Advisory Board; ○ Have demonstrated technical, academic, or professional understanding of, and practical, disciplinary, vocational, or regulatory experience working in multifamily housing development, who shall comprise not fewer than one-fourth of the members of the Advisory Board; and ○ Have demonstrated technical, academic, or professional understanding of, and practical, disciplinary, vocational, or regulatory experience working in the development of housing for extremely-low, very-low, and low-income individuals, which shall comprise not fewer than one-fifth of the members of the Advisory Board. • The Advisory Board shall meet from time to time, but, at a minimum, shall meet at least four times in each year. • Members of the Advisory Board who are not full-time employees of the U.S.	

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		banks having less than $10,000,000,000 in total assets. ◦ One member who shall have demonstrated technical, academic, or professional understanding of, and practical, disciplinary, vocational, or regulatory experience working with, banks having more than $500 billion in total assets. ◦ One member who shall have demonstrated technical, academic, or professional understanding of, and practical, disciplinary, vocational, or regulatory experience working with, regional banks having between $10 billion and $500 billion in total assets. ◦ One member who shall have a demonstrated technical, academic, or professional understanding of, and practical, disciplinary, vocational, or regulatory experience with private mortgage insurance. ◦ One member who shall have a demonstrated technical, academic, or professional understanding of, and practical, disciplinary, vocational, or regulatory experience with securitization. ◦ One member who shall have a demonstrated technical, academic, or professional understanding of, and practical, disciplinary, vocational, or	shall— ◦ Be entitled to receive compensation at a rate fixed by the Director while attending meetings of the Advisory Board, including travel time; and ◦ Be allowed travel expenses, including transportation and subsistence, while away from their homes or regular places of business. • The Director shall periodically submit to the Senate Banking and House Financial Services Committees a written report outlining the activities of the Advisory Board, the input provided to the NMFA from the Advisory Board, and any actions taken to act upon the recommendations of the Advisory Board. Such periodic reports may be included in the report required under § 106. <u>Status of Employees</u> • A director, Advisory Board member, officer, or NMFA employee has no liability under the Securities Act of 1933 with respect to any claim arising out of or resulting from any act or omission by such person within the scope of such person's employment in connection with any transaction involving the NMFA. This subsection shall not be construed to limit personal liability for criminal acts or omissions, willful or malicious	

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		regulatory experience with investor protection and institutional investors. ○ One member who shall have a demonstrated technical, academic, or professional understanding of, or practical, disciplinary, or vocational experience with consumer protection. ○ One member who shall have a demonstrated technical, academic, or professional understanding of, and practical, disciplinary, vocational, or regulatory experience with policies and programs to support sustainable homeownership. ○ One member who shall have a demonstrated technical, academic, or professional understanding of, or practical, disciplinary, or vocational experience with multifamily housing development. ○ One member who shall have a demonstrated technical, academic, or professional understanding of, or practical, disciplinary, or vocational experience with affordable rental housing. ○ One member who shall have a demonstrated technical, academic, or professional understanding of, or practical, disciplinary, or vocational experience with asset management. ○ One member who shall have a demonstrated technical, academic, or	misconduct, acts or omissions for private gain, or any other acts or omissions outside the scope of such person's employment. • This subsection does not affect— ○ Any other immunities and protections that may be available to such person under applicable law with respect to such transactions; or ○ Any other right or remedy against the NMFA, against the U.S. under applicable law, or against any person other than a director, Advisory Board member, officer, or NMFA employee, participating in such transactions. • This subsection shall not be construed to limit or alter in any way the immunities that are available under applicable law for Federal officials and employees not described in this subsection.	

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		professional understanding of, and vocational experience with State bank, non-bank, or insurance regulation. • Of those members of the Advisory Committee with a credit union or bank background, at least 1 shall have practical, disciplinary, or vocational experience working in rural areas and with rural borrowers. • Of those members of the Advisory Committee, at least 1 shall have demonstrated practical, academic, disciplinary, or vocational experience with fair lending practices and policies and programs that promote fair, equitable, and nondiscriminatory access to credit in underserved markets. <u>Member Selection</u> Members of the Advisory Committee shall be appointed to the Committee by the Chairperson, subject to approval by a majority of the Board. <u>Meetings</u> The Advisory Committee shall meet no less frequently than once during each calendar quarter.		
OIG		**§ 204 Office of the Inspector General** <u>Office of Inspector General</u> • On the agency transfer date, there is	**§ 104 OIG** <u>Office of Inspector General</u> • There is established the NMFA Office of	

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		established the FMIC Office of Inspector General (OIG). • The head of the OIG shall be the FMIC Inspector General, who shall be appointed by the President, by and with the advice and consent of the Senate, in accordance with § 3(a) of the Inspector General Act of 1978 (5 U.S.C. App.). • During the period beginning on the agency transfer date and ending on the date on which the IG is confirmed, the person serving as the IG or the Acting IG for the OIG within the FHFA on the date that is 1 day prior to the agency transfer date shall act for all purposes as, and with the full powers of, the FMIC IG. • Beginning on the agency transfer date, the authority of the FMIC OIG shall include all rights and responsibilities of the FHFA OIG as such rights and responsibilities existed on the day before the agency transfer date. <u>Provision of Property and Facilities</u> The FMIC Chairperson shall provide the FMIC OIG with— • Appropriate and adequate office space at each FMIC central and field office location, together with such equipment, office supplies, and communications facilities and services as may be necessary for the IG to operate such	the Inspector General (OIG). The head shall be the NMFA IG, who shall be appointed by the President. • In addition to carrying out the requirements established under the Inspector General Act of 1978, the IG shall— ○ Conduct, supervise, and coordinate audits and investigations relating to the programs and operations of the NMFA, including the adequacy of placement of credit risk and oversight of approved entities, with respect to— ▪ The oversight and supervision of the FHLBs and the FHLB System; and ▪ The contracting practices and procedures of the NMFA; and ○ Recommend policies for the purpose of addressing any deficiencies, inefficiencies, gaps, or failures in the administration of such programs and operations. • Beginning 1 year after the NMFA certification date, and annually thereafter, the IG and an independent actuary contracted for by the Director shall each conduct an examination and issue a separate report regarding— ○ The adequacy of insurance fees charged by the Director under title II;	

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		offices; and • The necessary maintenance services for any such office, and the equipment and facilities located in any such office. <u>Hiring of Employees, Experts, and Consultants</u> Notwithstanding paragraphs (7) and (8) of § 6(a) of the Inspector General Act of 1978 (5 U.S.C. App.), the FMIC IG may select, appoint, and employ such officers and employees as may be necessary— • For carrying out the functions, powers, and duties of the OIG; and • To obtain the temporary or intermittent services of experts or consultants or an organization of experts or consultants, subject to the applicable laws and regulations that govern such selections, appointments, and employment, and the obtaining of such services, within the FMIC. <u>Submission of Budget</u> For each fiscal year, the FMIC IG shall transmit a budget estimate and request for funds to the FMIC Chairperson. The budget request shall— • Specify— o The aggregate amount of funds requested for such fiscal year for OIG's operations; and	o The adequacy of the MIF established under title II; and o The effectiveness of credit risk placement and capital requirements adopted by the NMFA, including the extent to which the Government is protected from loss and the increase in costs to borrowers. <u>Amendments to Inspector General Act Of 1978</u> Section 11 of the Inspector General Act of 1978 [apparently meaning § 12] is amended— • In paragraph (1) (defining head of establishment), by adding the NMFA Director; and • In paragraph (2) (defining establishment), by adding the NMFA. <u>Compensation</u> The annual rate of basic pay of the IG shall be the annual rate of basic pay provided for positions at level III of the Executive Schedule under 5 U.S.C. § 5314.	

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		◦ The amount requested for all training needs, including a certification from the IG that the amount requested satisfies all training requirements for the OIG for that fiscal year; and • Specifically— ◦ Identify and specify any resources necessary to support the Council of the Inspectors General on Integrity and Efficiency; and ◦ Justify the need for any resources identified and specified for OIG's operations for the fiscal year. <u>Amendments to Inspector General Act of 1978</u> The Inspector General Act of 1978 is amended— • In § 6(e)(3), by inserting FMIC after FEMA; • In § 8G(a)(2), by striking FHFB; and • In § 12— ◦ In paragraph (1) (defining head of establishment), by striking FHFA Director and inserting FMIC Chairperson; and ◦ In paragraph (2) (defining establishment), by striking FHFA and inserting FMIC. <u>Effective Date</u> The amendments made by this section shall		

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		take effect on the agency transfer date.		

Staff, Experts, Consultants		**§ 205 Staff, Experts, and Consultants**
		Compensation
		• The Board may appoint and fix the compensation of such officers, attorneys, economists, examiners, and other employees as may be necessary for carrying out the FMIC's functions.
		• Rates of basic pay and the total amount of compensation and benefits for all FMIC employees may be—
		  ○ Set and adjusted by the Board without regard to the provisions of chapter 51 or subchapter III of chapter 53 of 5 U.S.C.; and
		  ○ Reasonably increased, notwithstanding any parity limitation, if the Board determines such increases are necessary to attract and hire qualified employees.
		• The Board may provide additional compensation and benefits to FMIC employees, of the same type of compensation or benefits that are then being provided by any agency referred to under FIRREA § 1206 (12 U.S.C. 1833b) or, if not then being provided, could be provided by such an agency under applicable provisions of law, rule, or regulation. In setting and adjusting the total amount of compensation and benefits for employees, the Board shall
			§ 105 Staff, Experts, and Consultants
			Compensation
			• The Director may appoint and fix the compensation of such officers, attorneys, economists, examiners, and other employees as may be necessary for carrying out the NMFA's functions.
			• Rates of basic pay and the total amount of compensation and benefits for all NMFA employees may be—
			  ○ Set and adjusted by the Director without regard to the provisions of chapter 51 or subchapter III of chapter 53 of title 5 U.S.C.; and
			  ○ Reasonably increased, notwithstanding any limitation set forth in paragraph (3), if the Director determines such increases are necessary to attract and hire qualified employees.
			• The Director may provide additional compensation and benefits to NMFA employees, of the same type of compensation or benefits that are then being provided by any agency referred to under FIRREA § 1206 (12 U.S.C. 1833b) or, if not then being provided, could be provided by such an agency under applicable provisions of law, rule, or regulation. In setting and adjusting the total amount of compensation and	

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		consult with and seek to maintain comparability with the agencies referred to under FIRREA § 1206. Detail of Government Employees Upon the request of the Board, any Federal Government employee may be detailed to the FMIC without reimbursement from the FMIC, and such detail shall be without interruption or loss of civil service status or privilege. Experts and Consultants The FMIC may procure the services of experts and consultants as the FMIC considers necessary or appropriate. Technical and Professional Advisory Committees The Board may appoint such special advisory, technical, or professional committees as may be useful in carrying out the FMIC's functions.	benefits for employees, the Director shall consult with and seek to maintain comparability with the agencies referred to under FIRREA § 1206. Detail of Government Employees Upon the request of the Director, any Federal Government employee may be detailed to the NMFA without reimbursement, and such detail shall be without interruption or loss of civil service status or privilege. Experts and Consultants The Director may procure the services of experts and consultants as the Director considers necessary or appropriate. Technical and Professional Advisory Committees The Director may appoint such special advisory, technical, or professional committees as may be useful in carrying out the functions of the NMFA.	
Reports, Testimony, Audits		**§ 206 Reports; Testimony; Audits** Reports After the system certification date, the FMIC shall submit, on an annual basis, to the Senate Banking and House Financial Services Committees a written report of its operations, activities, budget, receipts, and expenditures for the preceding 12-month period. The report shall include—	**§ 106 Reports; Testimony; Audits** Reports The NMFA shall submit, on an annual basis, to the Senate Banking and House Financial Services Committees a written report of its operations, activities, budget, receipts, and expenditures for the preceding 12-month period. The report shall include an analysis of—	

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		• An analysis of—
		  ○ With respect to the MIF—
		    ▪ The current financial condition of the MIF;
		    ▪ The exposure of the MIF to economic conditions and an analysis of any stress tests conducted with respect to the Fund;
		    ▪ An estimate of the resources needed for the MIF to achieve the purposes of this Act; and
		    ▪ Any findings, conclusions, and recommendations for legislative and administrative actions considered appropriate to the future activities of the FMIC;
		  ○ Whether or not the actual MIF reserve ratio met—
		    ▪ The reserve ratio set for the preceding 12-month period; or
		    ▪ The reserve ratio goals established in § 303(c)(7);
		  ○ The detailed plan of the FMIC to ensure that the goals set for the MIF reserve ratio are met and maintained for the next 12-month period;
		  ○ The state of the private label MBS market, including the submission of a reasonable set of administrative, regulatory, and legislative proposals on how to limit the Federal Government's footprint in the
			• With respect to the MIF—
			  ○ The current financial condition of the MIF;
			  ○ The exposure of the MIF to changes in those economic factors most likely to affect the condition of that fund;
			  ○ A current estimate of the resources needed for the MIF to achieve the purposes of this Act; and
			  ○ Any findings, conclusions, and recommendations for legislative and administrative actions considered appropriate to the future activities of the NMFA;
			• The secondary mortgage market, the housing market, and the economy, including the affordability of mortgage finance, and the use of stress tests, and how such analysis was used to determine and set the reserve ratio for the MIF for the preceding 12-month period;
			• The state of the private markets for placement of first-loss credit risk, current optimal methods, and the estimated cost for a loan of placing such risk;
			• Whether or not the actual MIF reserve ratio met—
			  ○ The reserve ratio set for the preceding 12-month period; or
			  ○ The reserve ratio goals established in § 203(e);
			• How the NMFA intends to ensure that the	

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		secondary mortgage market; o How and the extent to which the FMIC and the Small Lender Mutual established under § 315(a)(1) has fulfilled its obligations to ensure that community and mid-size banks, credit unions, and other small lenders have equitable and meaningful access to the secondary mortgage market; and o The report required under § 208(b)(2)(B) [state of covered securities market]; • A discussion of the significant problems faced by consumers in shopping for or obtaining mortgage credit or services; • A justification of the FMIC's budget for the preceding 12-month period; • A list of the significant rules and orders adopted by the FMIC, as well as other significant initiatives conducted by the FMIC, during the preceding 12-month period and the plan of the FMIC for rules, orders, or other initiatives to be undertaken during the next 12-month period; • A list, with a brief statement of the issues, of the public supervisory and enforcement actions to which the FMIC was a party during the preceding 12-month period; • The actions of the FMIC taken regarding rules, orders, and supervisory actions with	goals set for the MIF reserve ratio are to be met and maintained for the next 12-month period, and such analysis shall include a detailed and descriptive plan of the actions that the NMFA intends to take pursuant to its authorities under this Act; • How the NMFA has provided access to affordable mortgage credit, including 30-year fixed rate mortgages, in its support of a robust secondary mortgage market and the production of residential mortgage-backed securities; • The state of the private label MBS market, and such analysis shall include the submission of a reasonable set of administrative, regulatory, and any appropriate legislative proposals on how to minimize the Federal Government's footprint in the secondary mortgage market; and • The effect that change in loan limits would have on the secondary mortgage market, the housing market, and the economy. <u>Testimony</u> The Director of the NMFA, on an annual basis, shall provide testimony to the Senate Banking and House Financial Services Committees. <u>Audits</u>	

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		respect to covered entities; and • An assessment of significant actions by State attorneys general or State regulators relating to Federal law within the FMIC's jurisdiction. <u>Testimony</u> After the system certification date, the Chairperson shall appear annually before the Senate Banking and House Financial Services Committees to provide testimony on the report. <u>Reports to OMB</u> The FMIC shall provide OMB copies of the— ○ FMIC's financial operating plans and forecasts as prepared by the FMIC in the ordinary course of its operations; and ○ Quarterly reports of the FMIC's financial condition and results of operations as prepared by the FMIC in the ordinary course of its operations. This subsection shall not be construed to— ○ Require any obligation on the part of the FMIC to consult with, or obtain the consent or approval of, OMB respect to any such reports, plans, forecasts, or other information; or ○ Authorize any jurisdiction or oversight by OMB over the affairs or operations of the FMIC.	• GAO shall annually audit the financial transactions and conditions of the NMFA and the MIF in accordance with the U.S. generally accepted government auditing standards as may be prescribed by GAO. The audit shall be conducted at the place or places where accounts of the NMFA and the MIF, as applicable, are normally kept. • GAO representatives shall have access to the personnel and to all books, accounts, documents, papers, records (including electronic records), reports, files, and all other papers, automated data, or property belonging to or under the control of or used or employed by the NMFA or the MIF pertaining to its financial transactions and necessary to facilitate the audit required under this subsection, and such representatives shall be afforded full facilities for verifying transactions with the balances or securities held by depositories, fiscal agents, and custodians. • All such books, accounts, documents, records, reports, files, papers, and property of the NMFA and the MIF used to carry out the audit shall remain in the possession and custody of the NMFA and the MIF, as applicable. • GAO may obtain and duplicate any such books, accounts, documents, records,	

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		<u>Audit</u> • GAO shall annually audit the financial transactions of the FMIC and MIF. This audit shall be completed in accordance with the U.S. generally accepted government auditing standards as may be prescribed by GAO. The audit shall be conducted at the place or places where FMIC's accounts are normally kept. • Notwithstanding any other provision of law, upon request and in such reasonable form as GAO may request, GAO shall have access to— o Any records, books, accounts, documents, reports, files, papers, property, or other information under the control of or used by the FMIC; o Any records or other information under the control of a person or entity acting on behalf of or under the authority of the FMIC, to the extent that such records or other information are relevant to an audit required under this subsection; and o The officers, directors, employees, financial advisors, staff, working groups, and agents and representatives of the FMIC (relating to the activities on behalf of the FMIC of such agent or representative).	working papers, automated data and files, or other information relevant to such audit without cost to GAO and GAO's right of access to such information shall be enforceable pursuant to 31 U.S.C. § 716(c). • GAO shall submit to Congress a report of each such annual audit. The report to Congress shall set forth the scope of the audit and include— o The statement of assets and liabilities and surplus or deficit; o The statement of income and expenses; o The statement of sources and application of funds; o Such comments and information as GAO may deem necessary to inform Congress of the financial operations and condition of the NMFA, together with such recommendations with respect thereto as GAO may deem advisable; o Condition of the MIF; o Actions of the NMFA regarding the placement of credit risk by originators or the issuer; o Adequacy of the NMFA's analysis of the impact of such actions concerning credit risk on the affordability of mortgages for borrowers; o Adequacy of underwriting standards	

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		All such records, books, accounts, documents, reports, files, papers, property, or other information shall remain in the possession and custody of the FMIC. • GAO may, as it considers appropriate, make and retain copies of the records, books, accounts, documents, reports, files, papers, property, or other information to which GAO is granted access. • GAO shall submit to Congress a report of each such annual audit not later than six and one-half months following the close of the year covered by such audit. The report shall set forth the scope of the audit and include— o The statement of assets and liabilities, as well as any surplus or deficit; o The statement of income and expenses; o The statement of sources and application of funds; o Such comments and information as GAO may deem necessary to inform Congress of the financial operations and condition of the FMIC, together with such recommendations with respect thereto as GAO may deem advisable; and o A description of any program,	imposed by the NMFA; and o Adequacy of NMFA oversight of retained assets of the Issuer. • For the purpose of conducting an audit under this subsection, GAO may employ by contract, without regard to § 3709 of the Revised Statutes of the U.S. (41 U.S.C. 5), professional services of firms and organizations of certified public accountants for temporary periods or for special purposes. • Upon GAO request, the Director of the NMFA shall transfer to GAO from funds available, the amount requested by GAO to cover the reasonable costs of any such audit and report. GAO shall credit funds transferred to the account at Treasury established for salaries and expenses of GAO, and such amounts shall be available upon receipt and without fiscal year limitation to cover the full costs of the audit and report.	

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		expenditure, or other financial transaction or undertaking observed in the course of the audit, which, in GAO's opinion, has been carried on or made without authority of law. A copy of each report shall be furnished to the President and to the Chairperson at the time such report is submitted to Congress. • For conducting this audit, GAO may employ by contract, without regard to § 3709 of the U.S. Revised Statutes (41 U.S.C. 5), professional services of firms and organizations of certified public accountants for temporary periods or for special purposes. • Upon GAO request, the Chairperson shall transfer to GAO from funds available the amount requested by GAO to cover the reasonable costs of any such audit and report. GAO shall credit funds transferred to the account at the Treasury established for GAO salaries and expenses, and such amounts shall be available upon receipt and without fiscal year limitation to cover the full costs of the audit and report.		
Agency Offices		**§ 207 Specific Offices** Establishment The FMIC shall establish within the FMIC any office required to be established by this Act, may establish such other offices or	**§ 241 Office of Underwriting** Establishment There is established within the NMFA an Office of Underwriting which shall be headed by the Deputy Director of Underwriting, who	

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		suboffices as are necessary and proper for the functioning of the FMIC, and may eliminate or consolidate such other offices or suboffices. Except as may otherwise be specifically provided, the head of any such office shall be appointed by the Board.
		
		<u>Underwriting</u>
		The FMIC shall establish an Office of Underwriting in the FMIC, whose functions shall include ensuring that eligible single-family mortgage loans that collateralize a single-family covered security insured under this Act comply with the requirements of this Act and minimize risk to the MIF.
		
		<u>Securitization</u>
		The FMIC shall establish an Office of Securitization in the FMIC, whose functions shall include—
		• Overseeing and supervising the Securitization Platform established under part I of subtitle C of title III; and
		• Ensuring that small mortgage lenders have equitable access to—
		  ○ The Securitization Platform, including through the development and facilitation of options such as multi-guarantor pools and multilender pools of eligible single-family mortgage loans to be securitized and issued as single-
			shall be appointed by the Director.
			
			<u>Responsibilities</u>
			The Office of Underwriting shall ensure, through oversight, analysis, and examination, that eligible mortgages that collateralize a covered security insured under this Act comply with the requirements of this Act, including with respect to—
			• The submission of complete and accurate loan data on eligible mortgages;
			• The identification of ineligible mortgage loans;
			• Assisting lenders with originating high-quality, lower-risk eligible mortgages; and
			• Any other activity that the Director determines appropriate.
			
			§ 242 Office of Securitization
			<u>Establishment</u>
			There is established within the NMFA an Office of Securitization which shall be headed by the Deputy Director of Securitization, who shall be appointed by the Director.
			
			<u>Responsibilities</u>
			• The Office of Securitization shall—
			  ○ Oversee and supervise the common securitization platform developed by the business entity announced by the FHFA and established by the GSEs,	

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		family covered securities through such Platform; and o Any small lender mutual established or approved under § 315. FHLBs • Upon the system certification date, the FMIC shall establish an Office of FHLB Supervision in the FMIC, whose functions shall include— o Overseeing, coordinating, and supervising the FHLBs and the FHLB System; o Supervising any authorized subsidiary of 1 or more FHLBs that is an approved aggregator pursuant to § 312(m), including with respect to the capitalization of any such subsidiary; o Serving as the central point of coordination with the FMIC with respect to any regulations or regulatory actions relating to the role of an FHLB or subsidiary or joint office thereof, as a covered entity; and o Monitoring whether any regulation or regulatory action taken with respect to an FHLB or subsidiary or joint office thereof, approved under § 312 in its role as a covered entity does not adversely impact the traditional liquidity and advance mission of the	including by requiring that the platform have system capabilities to permit the issuance of multi-lender covered securities; and o Ensure that credit unions, community and mid-size banks, and small non-depository lenders have equitable access to any such platform, including through the development and facilitation of options for multi-lender pools of eligible mortgages to be securitized and issued as covered securities through such platform. • The NMFA, acting through the Office of Securitization, may promulgate rules— o Regarding the use of such common securitization platform; and o To permit securities other than covered securities to be issued through such platform for reasonable compensation. Any such rule may include a requirement that any security to be issued through the common securitization platform be subject to a uniform securitization agreement developed under § 233 and such other requirements as the NMFA shall specify. Such rules shall include any rules necessary to differentiate adequately between securities of a private sector issuer that are not guaranteed by the MIF and covered securities issued by the Issuer.	

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		FHLBs and FHLB System. • Effective on the system certification date, there are transferred to the Office of FHLB Supervision all functions of the FHFA of the FMIC relating to— o The supervision of the FHLBs and the FHLB System; and o All rulemaking authority of the FHFA of the FMIC relating to the FHLBs and the FHLB System. **§ 208 Office of Consumer and Market Access** Establishment The FMIC shall establish an Office of Consumer and Market Access in the FMIC. Responsibilities • The Office of Consumer and Market Access shall administer the Market Access Fund established under § 504. • The Office of Consumer and Market Access shall— o Monitor, on a macro level, the national, regional, and area single-family and multifamily housing finance markets to identify underserved markets, communities, and consumers in accordance with the market segments identified and defined under § 210; o Coordinate with Federal and State	**§ 243 Office of FHLB Supervision** Establishment There is established within the NMFA an Office of FHLB Supervision which shall be headed by the Deputy Director of FHLB Supervision, who shall be appointed by the Director. Responsibilities The Office of FHLB Supervision shall oversee, coordinate, and supervise the FHLBs and the FHLB System, including the transition of all activities transferred to the administration pursuant to § 301.	

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		agencies regarding existing policies and initiatives that address— ▪ The housing needs of underserved markets, communities, and consumers; and ▪ The affordable housing needs of markets, communities, and consumers; and ○ Provide information on business practices and technical assistance to market participants regarding communities identified as underserved with regards to addressing the housing needs of consumers in that community. • The Office of Consumer and Market Access shall, on an annual basis, submit a report to Congress on the state of the covered securities market, and make such report available to the public. The report shall include— ○ An assessment of the extent to which the covered securities market is providing liquidity to eligible borrowers in all segments of the mortgage origination primary market, including underserved segments identified and defined by the FMIC under § 210; and ○ Provide recommendations for such legislative, regulatory, or administrative actions as may be		

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		necessary to address any deficiencies in the availability of mortgage credit in any market or region identified pursuant to § 208(b)(2(B)(i) [may mean § 208(b)(2)(A)(i)] via existing Federal programs or the covered securities market. • In preparing each such report, the Office of Consumer and Market Access— o Shall use, to the maximum extent practicable, publicly available data and data otherwise collected under this Act; and o Shall not include or review any confidential information or information collected by the FMIC as part of its supervisory or examination authorities that is confidential. • The Office of Consumer and Market Access shall, on a biennial basis, conduct a study on incentives to encourage mortgage lenders and mortgage originators to address the housing needs of underserved markets and communities. • The FMIC shall include the annual report on the state of the covered securities market, and the study on incentives, in the annual report required under § 206 [to Congress]. • The Office of Consumer and Market Access shall consult with the FHLBs and any small lender mutual established or		

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		approved under § 315 on approaches, methods, and practices designed to address the housing needs of underserved markets and communities. **§ 209 Office of Multifamily Housing** The FMIC shall establish an Office of Multifamily Housing in the FMIC, whose functions shall include— • Developing, adopting, and publishing specific eligibility criteria to ensure that eligible multifamily mortgage loans that collateralize multifamily covered securities insured under this Act comply with the requirements of this Act; and • Performing any other activity relating to the multifamily housing finance system that the FMIC may determine appropriate to fulfill the requirements of this Act.		
Market Access		**§ 210 Equitable Access for Lenders and Borrowers** Equitable Access in Underserved Market Segments • The FMIC shall seek to support the primary mortgage market for eligible mortgage loans on an equitable, nondiscriminatory, and non-exclusionary basis to help ensure that all eligible borrowers have access to mortgage credit, including underserved segments of the primary mortgage market as identified and defined by the FMIC.		

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		• The FMIC shall, by regulation, identify and define not more than 8 segments of the primary mortgage market in which lenders and eligible borrowers have been determined to lack equitable access to the housing finance system facilitated by the FMIC. This regulation shall set forth the criteria by which the FMIC identified such underserved market segments. The identified segments may include the following: o Historically underserved communities, including rural and urban communities. o Manufactured housing. o Small balance loans. o Low- and moderate-income creditworthy borrowers. o Preservation of existing housing stock created by state or Federal laws. o Affordable rental housing. • The FMIC shall require that each approved guarantor and approved aggregator engaged in a covered guarantee transaction or in a covered market-based risk-sharing transaction submit on annual basis a public report describing the actions taken by such approved guarantor or approved aggregator during the year, consistent with its business judgment, to provide		

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		credit to the underserved market segments identified and defined by the FMIC pursuant to this subsection, including corporate practices designed to serve such identified market segments. The annual report shall be approved by the board of directors and signed by the chief executive officer of the approved guarantor or approved aggregator submitting the report. The FMIC may establish an optional template for the annual report. Such an annual report shall not be subject to prior review or approval by the FMIC. The FMIC shall, in establishing the requirements for the annual report by guarantors and aggregators, coordinate with other Federal and State agencies, as necessary, to reduce duplicative reporting requirements. <u>Limitations</u> • In carrying out this title, the FMIC shall not interfere with the exercise of business judgment of an approved aggregator or approved guarantor in determining which specific mortgage loans to include in a covered guarantee transaction or a covered market-based risk-sharing transaction, including through the FMIC's use of— o The approval process for a guarantor or an aggregator established under		

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		subtitle B of title III;
		  ◦ Its general supervisory and examination authorities under subtitle B of title III; or
		  ◦ Information collected under this section or §§ 501 or 208.
		• Nothing in this subsection shall prevent the imposition of the variable incentive-based fees authorized in § 501, nor shall it exempt covered entities from compliance with the Fair Housing Act and ECOA as required in § 408(d).
		• The FMIC shall take appropriate measures designed to ensure that the requirements under this section are implemented in a manner consistent with safety and soundness principles.		

Taxpayer Protection		**§ 211 Office of Taxpayer Protection** <u>Establishment</u> The FMIC shall establish an Office of Taxpayer Protection whose functions shall include the responsibilities set forth below. <u>Responsibilities</u> • The Office of Taxpayer Protection shall semi-annually study and report to the Senate Banking and House Financial Services Committees on: ◦ Market concentration in the secondary mortgage markets, including MIF exposure to the ten largest approved aggregators and		**§ 203 Authority to Protect Taxpayers in Unusual and Exigent Market Conditions** <u>In General</u> If Ginnie Mae, upon the written agreement of the Federal Reserve Chairman and the Treasury Secretary, and in consultation with the HUD Secretary, determines that unusual and exigent circumstances have created or threaten to create an anomalous lack of mortgage credit availability within the single-family housing market, multifamily housing market, or entire U.S. housing market that could materially and severely disrupt the functioning of the U.S. housing finance system, Ginnie Mae may, for a period of 6

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		approved guarantors, as measured by the total outstanding principal balance at origination of eligible single-family mortgage loans collateralizing single-family covered securities for which the aggregator or guarantor has obtained insurance provided under this Act in the previous 6 months; ○ The general state of underwriting standards in the origination of eligible single-family mortgage loans and the effect of insurance provided under this Act on such underwriting standards; ○ Whether the insurance under this Act produces a subsidy to any approved entity or approved entities; ○ A comparison of the treatment in the secondary mortgage markets of Ginnie Mae MBS and single-family covered securities insured under this Act, including: ▪ A discussion of the characteristics of loans collateralizing Ginnie Mae MBS and eligible single-family mortgage loans collateralizing single-family covered securities insured under this Act. ▪ An analysis of any actions taken in the secondary mortgage markets to manipulate Ginnie		months— • Modify or waive the reinsurance requirements of the Reinsurance Bid Program or the Guarantor Program; and • Establish provisional standards for approved entities. <u>Considerations</u> In exercising such authority under unusual and exigent circumstances, Ginnie Mae shall consider the severity of the conditions present in the housing markets and the risks presented to the Fund in exercising such authority. <u>Terms and Conditions</u> Insurance provided under unusual and exigent circumstances shall be subject to such additional or different limitations, restrictions, and regulations as Ginnie Mae may prescribe. <u>Bailout Strictly Prohibited</u> In exercising the authority for unusual and exigent circumstances, Ginnie Mae may not— • Provide aid to an approved entity or an affiliate of the approved entity, if such approved entity is in bankruptcy or any other Federal or State insolvency proceeding; or • Provide aid for assisting a single and specific company avoid bankruptcy or any other Federal or State insolvency proceeding.

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		Mae's guarantee and the insurance provided under this Act to the advantage of the secondary mortgage markets; and o What steps the FMIC has taken to minimize any potential long-term costs to taxpayers and the MIF relating to risks identified in the study. • The Office of Taxpayer Protection shall annually report to the Senate Banking and House Financial Services Committees on: o The adequacy of the first loss position required under this Act, including the sufficiency of any permissible risk-sharing or risk-mitigation permitted as a substitute for equity capital intended to cover the initial credit loses on a covered security before use of MIF, the ability of the first loss position to absorb credit loss on covered securities, and to protect taxpayers; and o The performance of eligible single-family mortgage loans collateralizing single-family covered securities insured under this Act based on current underwriting standards and how that performance differs from the performance of noneligible loans based on the underwriting standards		<u>Notice</u> Not later than 7 days after authorizing insurance or establishing provisional standards under unusual and exigent circumstances, Ginnie Mae shall submit to the Senate Banking and House Financial Services Committees a report that includes— • The justification for the exercise of such authority; • Evidence that unusual and exigent circumstances have created or threatened to create an anomalous lack of mortgage credit availability within the single-family housing market, multifamily housing market, or entire U.S. housing market that could materially and severely disrupt the functioning of the U.S. housing finance system; and • Evidence that failure to exercise such authority would have undermined the safety and soundness of the housing finance system. <u>Additional Exercise of Authority</u> • Subject to the limitation below (3 times in any 3-year period), the authority granted for unusual and exigent circumstances may be exercised for 2 additional 9-month periods within any given 3-year period, provided that Ginnie Mae, upon written agreement of the Chairman of the

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		for such noneligible loans, including with respect to: ▪ DTI ratios; ▪ LTV ratios; ▪ Credit history; ▪ Loan documentation; ▪ Occupancy status; ▪ Credit enhancements; ▪ Housing counseling by a HUD-approved counseling agency; ▪ Loan payments; ▪ Loan purpose, such as purchase or refinance; ▪ Loan product; ▪ Origination channel; ▪ Other underwriting criteria that would be useful to the Director of Taxpayer Protection; and o Recommended legislative, regulatory, or administrative actions to: ▪ Address any need to further limit MIF exposure to any one approved entity or business practice; ▪ Foster and encourage a robust private secondary mortgage market to noneligible mortgage loans and MBS that Ginnie Mae does not insure; and ▪ Assist the FMIC in protecting taxpayers, including recommending whether a		Federal Reserve and Treasury Secretary, and in consultation with the HUD Secretary— o Determines— ▪ For a second exercise of unusual and exigent circumstances authority, that a second exercise is necessary; or ▪ For a third exercise of such authority, by an affirmative vote of the Director of Ginnie Mae and an affirmative vote of 2⁄3 or more of the Federal Reserve Board then serving, that a third exercise is necessary; and o Provides notice, justification, and evidence to Congress. • Any additional exercise of authority under this subsection may occur consecutively or non-consecutively. <u>Limitation</u> The authority granted to Ginnie Mae under this section may not be exercised more than 3 times in any given 3-year period, which 3-year period shall commence upon the initial exercise of such authority. <u>Normalization and Reduction of Risk</u> Following any exercise of authority under this section, Ginnie Mae shall— • Establish a timeline for approved entities

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		countercyclical increase in the MIF reserve ratio or of approved guarantor capital standards is necessary to protect taxpayers. • The Office of Taxpayer Protection shall annually report to the Senate Banking and House Financial Services Committees on system-wide leverage in the secondary mortgage market. • The Office of Taxpayer Protection shall annually report to the Senate Banking and House Financial Services Committees on early payment defaults in eligible single-family mortgage loans for the preceding year, including any eligible single-family mortgage loan that becomes delinquent or that is in default within 24 months of origination. • In preparing such reports, the Office of Taxpayer Protection: o Shall use, to the maximum extent practicable, publicly available data and data otherwise collected under this Act; o Shall not include or review any confidential information or information collected by the FMIC as part of its supervisory or examination authorities that is confidential.		to meet the approval standards set forth in this Act; and • In a manner and pursuant to a timeline that will minimize losses to the Fund, establish a program to either— o Sell, in whole or in part, the first loss position on securities described in this section to private market holders; or o Transfer for value to approved entities, or work with approved entities to sell, in whole or in part, the first lost position on securities described in this section. <u>Authority to Respond to Sustained National Home Price Decline</u> • In the event of a significant decline of national home prices, in at least 2 consecutive calendar quarters, Ginnie Mae may for a period of 6 months permit the transfer of guarantees of eligible mortgage loans that secure securities issued under this Act if such eligible mortgage loans are refinanced, regardless of the value of the underlying collateral securing such eligible mortgage loans. Such authority may be exercised for additional 6-month periods. • Ginnie Mae shall not provide insurance under this Act to any security issued under this Act that includes mortgage

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				loans that do not meet the definition of an eligible mortgage loan, except for mortgage loans refinanced from eligible mortgage loans in securities issued under this Act. • No provision in this section shall be construed as permitting Ginnie Mae to lower any other requirement related to the requirements set forth under the definition of an eligible mortgage loan.

Agency Duties		**TITLE III—DUTIES and RESPONSIBILITIES**
		Subtitle A—Duties and Authorities
		§ 301 Duties and Responsibilities
		<u>Duties</u>
		The principal duties of the FMIC shall be to—
		• Carry out this Act in a manner that fulfills the purposes of the FMIC as described in § 201(b);
		• Minimize any potential long-term cost to the taxpayer, including through the use of the MIF, the assessment of insurance fees, and the approval of approved entities and credit risk-sharing mechanisms;
		• Facilitate fair access to the secondary mortgage market for small mortgage lenders originating eligible single-family and multifamily mortgage loans, including through the establishment, approval, and oversight of small lender mutuals;
			§ 201 NMFA Duties and Responsibilities
			<u>Standards</u>
			In carrying out the duties under § 101(b), the NMFA shall—
			• Minimizes any potential long-term negative cost on the taxpayer;
			• Ensure, to the maximum extent possible—
			    o A liquid and resilient national housing finance market for single-family and multifamily housing; and
			    o The availability of affordable mortgage credit, including the 30-year fixed rate mortgage;
			• Develop standard form credit risk-sharing mechanisms, products, structures, contracts, or other security agreements that place private capital in the position of taking first losses on credit risk in front of the insurance fund for covered securities insured under this Act;
			• Provide insurance on any covered	

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		• Ensure integrity and discipline in the mortgage market, particularly by monitoring the safety and soundness of regulated entities and approved entities;
		• Ensure that approved entities maintain the capacity to further the requirements of the FMIC pursuant to § 201(b)(5) [FMIC purpose to credit and financing through business cycles] and that approved guarantors, approved multifamily guarantors, and approved aggregators are in compliance with § 210(a)(3) [required annual reports on underserved markets];
		• Promote the standardization of the secondary mortgage market through the use of uniform securitization agreements, servicing agreements, and the Securitization Platform; and
		• Increase transparency in single-family and multifamily mortgage markets, including through the national mortgage loan database.
		• Take necessary steps to prevent abuse and deceptive practices in the use of the credit risk-sharing mechanisms, including by:
		  o Creating appropriate standards relating to:
		    ▪ The vintages or categories of covered securities that are referenced by a credit risk-sharing mechanism;
		    ▪ Standardization of credit risk-
			security on which requirements for first loss regarding credit risk have been met either in the markets or by the Issuer;
			• Ensure that all geographic locations have access to both single-family and multifamily mortgage credit;
			• Charge and collect fees in exchange for providing such insurance, whereby such fees shall be sufficient to protect the taxpayer from the risk of providing such insurance and to fund the activities and operations of the NMFA;
			• Establish and maintain a MIF;
			• Facilitate securitization of eligible mortgages originated by credit unions and community and midsize banks without securitization capabilities;
			• Enforce discipline and integrity in the market for covered securities by setting standards for the Issuer and for approval of private mortgage insurers, servicers, bond guarantors, and other potential obligors;
			• Establish, operate, and maintain a database for the collection, public use, and dissemination of uniform loan level information on eligible mort gages consistent with protecting the privacy of the borrower;
			• Develop, adopt, and publish standard uniform securitization agreements for covered securities;	

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		sharing mechanism terms and features; and ▪ Measures that prevent the duplicative sale by a guarantor of the same mortgage credit risk in the same pool of eligible single-family mortgage loans; and ○ Requiring additional disclosures and affirmative representations that must be made by entities that create and issue credit risk-sharing mechanisms. <u>Scope of Authority</u> The authority of the FMIC shall include the authority to exercise such incidental powers as may be necessary or appropriate to fulfill the duties and responsibilities of the FMIC set forth in this Act. <u>Delegation of Authority</u> The Board of Directors may delegate to any duly authorized employee or representative, any power vested in the FMIC by law.	• Establish, operate, and maintain an electronic registry system for eligible mortgages that collateralize covered securities insured under this Act; • Oversee and supervise use of the common securitization platform developed by the business entity announced by FHFA and established by the GSEs; • Examine any loans held by the Issuer to ensure that assets that can feasibly be securitized without excessive costs are sold; • Monitor the state of the markets for placing credit risk and determine the cost to the borrower of differing methods; • Ensure that capital requirement placed on the Issuer and the reserve requirements of the MIF are adequate to address credit or counterparty risk held by the Issuer; and • Ensure that credit unions and community and mid-size banks have equal access to the common securitization platform and any other securitization platforms and are not discriminated against through discounts for volume pricing or other mechanisms. <u>Scope of Authority</u> NMFA's authority shall include the authority to exercise such incidental powers as may be necessary or appropriate to fulfill the NMFA's duties and responsibilities set forth under	

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			§ 101(b). Delegation of Authority The Director may delegate to NMFA officers and employees any of the NMFA functions, powers, or duties, as the Director determines appropriate.	
Credit Risk Sharing Mechanisms	**§ 106 Mandatory Risk-Sharing** The 1992 Act is amended by adding § 1328, Mandatory Risk-Sharing Transactions: • The Director shall require each GSE to develop and undertake transactions involving the GSEs' guarantee of securities and obligations based on or backed by mortgages on residential real properties designed principally for occupancy of from 1 to 4 families that provide for private market participants to share or assume credit risk associated with such mortgages, as follows: • The Director shall require that not less than 10% of the annual business of each GSE (measured in a manner the Director shall determine) in guaranteeing such securities and obligations involve such transactions. • The Director shall require that each GSE undertake multiple types of the following various transactions and structures: Transactions involving increased MI requirements, credit-linked notes and securities, senior and subordinated	**§ 302 Standards for Credit Risk-Sharing Mechanisms** Approval • The FMIC shall develop, adopt, and publish, after notice and comment, standards for the consideration and, as appropriate, the approval of credit risk-sharing mechanisms that shall require that the first loss position of private market holders on single-family covered securities is— ○ Adequate to cover losses that might be incurred in a period of economic stress, including national and regional home price declines, such as those observed during moderate to severe recessions in the U.S.; and ○ Not less than 10% of the principal or face value of the single-family covered security at the time of issuance. • It shall be unlawful for any person to intentionally create and issue any instrument or security as a first loss position on a single-family covered	**§ 202 Credit Risk-Sharing Mechanisms, Products, Structures, Contracts, or Other Security Agreements** In General The Director shall adopt rules concerning credit risk sharing mechanisms, products, structures, contracts, or other security agreements used to place or retain first-loss positions regarding credit risk by the Issuer with regard to a covered security or the originator regarding loans placed in such securities. Private Capital Private capital backing covered securities may include that of private market participants that purchase notes linked to credit risk or that guarantee credit risk, credit risk held by the originator, credit risk covered by capital set aside for credit risk by the Issuer, or similar mechanisms approved by the Director. Residual Credit Risk With regard to each product developed, the Director shall determine the amounts of credit risk losses that the product would cover and, if	**§ 202 Insurance Program – Either of Two** In General Ginnie Mae shall insure 100% of each security issued by the Platform, as provided in this section. Private Reinsurance Ginnie Mae shall establish either a Reinsurance Bid Program or a Guarantor Program. In selecting which, Ginnie Mae shall determine which program is the most efficient way to operate the insurance requirements under this Act by incorporating private sector pricing. ***Reinsurance Bid Program*** A Reinsurance Bid Program shall include the following: • Before any particular quarter (or such other time period determined by Ginnie Mae), Ginnie Mae shall enter into contracts with market participants to reinsure the first 5% of loss on all securities issued by the Platform in such quarter (or other time period).

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	security structures, and such other structures and transactions as the Director considers appropriate to increase private market assumption of credit risk.	security that such person knows or in the exercise of reasonable care should have known does not satisfy the requirements of this section. Violations shall be punishable in accordance with 18 U.S.C. § 1343.
		
		<u>Approval of Credit Risk-Sharing Mechanisms</u>
		• In approving such credit risk-sharing mechanisms, the FMIC shall—
		  ○ Consider proposals that include credit-linked structures or other instruments that are designed to absorb credit losses on single-family covered securities;
		  ○ Consider any credit risk-sharing mechanisms undertaken by the GSEs;
		  ○ Ensure that the first loss position is fully funded to meet the 10% requirements;
		  ○ Ensure that each type of proposed mechanism—
		    ▪ Enables the FMIC to verify that the first loss position is fully funded;
		    ▪ Minimizes any potential long-term cost to the taxpayer;
		    ▪ Accommodates the availability of mortgage credit on equal and transparent terms in the secondary mortgage market for small mortgage lenders and
			relevant, the amount of counterparty credit risk created by the product. The Director shall determine the amount of capital that the Issuer shall hold to cover such residual credit and counterparty risk.
			
			<u>Content of Rules</u>
			Such credit risk-sharing rules shall be designed to maximize the amount of first loss credit risk that can be placed in the private markets, while minimizing additional costs to the borrowers. Such rules may apply to either the loan originators or the issuer, or both.
			
			<u>Standard</u>
			The Director shall ensure that the private capital used to cover first loss credit risk, combined with the capital required to be retained by the Issuer, is adequate to cover losses that might be incurred as a result of adverse economic conditions, wherein such conditions are generally consistent with the economic conditions, including national home price declines, observed in the U.S. during moderate to severe recessions experienced during the last 100 years.
			
			<u>Protection of Taxpayers</u>
			If the Director permits the Issuer to place or the originators to retain or place less than 5% of the first-loss credit risk, it shall adjust the amount of the capital requirements for the Issuer accordingly and may adjust the g-fee
				• Prior to any particular quarter (or such other time period determined by Ginnie Mae), Ginnie Mae shall sign—
				  ○ Contracts with market participants to reinsure the last 95% of loss on all securities issued by the Platform in such quarter (or other time period); and
				  ○ A retrocession contract with each such market participant under which Ginnie Mae will agree to offer retrocessional reinsurance to reinsure up to 90% of such 95% reinsured amount on a *pari passu* basis. (95 x 0.9 = 85.5)
				
				Guarantor Program
				A Guarantor Program shall include the following:
				• The mortgage originator or aggregator that wishes to deliver a pool of eligible mortgage loans to the Platform for securitization shall, prior to delivering such pool, contract directly with a market participant to insure the first 5% of loss on all securities issued by the Platform that are securitized by such pool of eligible mortgage loans.
				• For each such Platform security, Ginnie Mae shall sign—
				  ○ Contracts with market participants to reinsure the last 95% of loss on the

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		lenders from all geographic locations, including rural locations; ▪ Allows for broad availability of mortgage credit and secondary mortgage market financing through fluctuations in the business cycle for eligible single-family lending across all— ♦ Regions; ♦ Localities; ♦ Institutions; ♦ Property types, including housing serving renters; and ♦ Eligible borrowers; ▪ Fulfills the requirements under § 314 with respect to loan modifications and foreclosure prevention; ▪ Does not prevent the securitization of refinanced or modified single-family eligible mortgage loans within single-family covered securities during a period when the authority under § 305(i) [to respond to sustained home price declines] is exercised; ▪ Does not diminish market liquidity and resiliency; ▪ Does not prevent the refinancing	paid to the MIF to protect taxpayers against the additional risk assumed by the MIF. The Director also may determine to increase the extent to which private mortgage insurance is required in connection with loans placed in guaranteed securities. <u>Consultation</u> In determining the appropriate balance between placement of first losses credit risk and capital requirements, the Director shall consult with Treasury and the Federal Reserve. The Director also shall conduct such consultation concerning the appropriate level of g-fees to be contributed to the MIF. <u>Development Window for Risk-Sharing Mechanisms</u> • The Director shall complete the development and implementation of the initial mechanisms, products, structures, contracts, or other security agreements not later than 5 years after enactment. • In developing such mechanisms, products, structures, contracts, or other security agreements, the Director shall— o Examine proposals that include a senior-subordinated deal structure, credit-linked structures, and the use of regulated guarantors with sufficient equity capital to absorb losses associated with moderate or	security; and o A retrocession contract with each such market participant under which Ginnie Mae will agree to offer retrocessional reinsurance to reinsure up to 90% of such 95% reinsured amount on a *pari passu* basis. • If Ginnie Mae determines that it would be an efficient way to operate the insurance requirements under this Act and would encourage the incorporation of private sector pricing, Ginnie Mae may allow mortgage originators and aggregators who insure the first 5% to select the market participant who reinsures the 95%. If a market participant is selected by a mortgage originator or aggregator: o Such market participants shall be required to meet the same standards as a market participant selected by Ginnie Mae; and o For purposes of determining the insurance fee, Ginnie Mae shall contract with a private sector insurer to estimate the risk that the market participant may default. <u>Additional Program Requirements</u> • Ginnie Mae shall use a competitive bidding process to determine which market participants should be granted contracts under the Reinsurance Bid

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		of underwater eligible single-family mortgage loans; and ▪ Does not present an unnecessary risk to the MIF; and ○ Consider whether the approval of any credit risk-sharing mechanism will impair the operation and liquidity of forward market executions for single-family eligible mortgage loans and single-family covered securities, such as the TBA market, taking into consideration other risk-sharing options available to market participants. • The FMIC shall— ○ Provide prompt notice to any person seeking approval for a credit risk-sharing mechanism of the approval or denial of that credit risk-sharing mechanism; and ○ Make available on the website of the FMIC detailed information regarding approved mechanisms. • The FMIC may, from time to time and in its discretion— ○ Conduct reviews of approved credit risk-sharing mechanisms to determine whether such credit risk-sharing mechanisms continue to satisfy the considerations for approval; ○ Assess the functioning of the forward	severe economic downturns; ○ Consider any risk-sharing mechanisms, products, structures, contracts, or other security agreements undertaken by the business entity announced by FHFA and established by the GSEs to provide a common securitization platform for issuers in the secondary mortgage market; ○ Consider how each proposed mechanism, product, structure, contract, or other security agreement— ▪ Minimizes any potential long-term negative cost to the taxpayer; ▪ Impacts the availability of mortgage credit for consumers; ▪ Impacts the ability of small financial institutions, such as credit unions and community banks, to participate in the housing finance markets; ▪ Influences mortgage affordability; ▪ Allows for loan modifications and foreclosure prevention alternatives; ▪ Interacts with the TBA market; and ▪ Facilitates market liquidity and resiliency; and	Program, and under the Guarantor Program unless Ginnie Mae lets originators and aggregators select the 95% reinsurer. • With respect to any market participant that Ginnie Mae selects under a risk-sharing program, Ginnie Mae shall select an insurance broker, through a competitive bidding process, that will solicit bids, on behalf of Ginnie Mae, for the reinsurance contracts. • As part of a retrocession contract under either a Reinsurance Bid Program or a Guarantor Program, the market participants shall be paid a competitively-determined ceding commission for the underwriting and administrative costs of providing such reinsurance. • Ginnie Mae may, if it determines it appropriate— ○ Phase-in the 5 percent requirements under either program, by originally requiring a lower percentage; and ○ Phase-in the 90 percent requirement under either program, by originally requiring a higher percentage. <u>Insurance Fee and Terms</u> • Ginnie Mae shall set the insurance fee applicable to securities issued by the Platform in advance on a quarter-by-quarter basis, through forward contracts

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		market for eligible single-family mortgage loans and single-family covered securities, including the TBA market, to determine whether any approved credit risk-sharing mechanism has adversely affected the liquidity or resilience of such market; and o Suspend the approval of— ▪ Any credit risk-sharing mechanism that it determines does not satisfy the considerations for approval; or ▪ Any credit risk-sharing mechanism that it determines has adversely affected the liquidity or resilience of the forward market for eligible single-family mortgage loans and single-family covered securities, or the TBA market. o The FMIC shall develop an expedited process for the reinstatement of the approval of any credit risk-sharing mechanism that is suspended. If a credit risk-sharing mechanism is suspended, the credit risk-sharing mechanism may be adapted or revised, as necessary, for reconsideration for reinstatement of the approval of the credit risk-sharing mechanism under this expedited process. The suspension of the	o Ensure that lenders of all sizes and from all geographic locations, including rural locations, have equitable access to secondary mortgage market financing. • Not later than 1 year after enactment, and annually thereafter until 5 years after enactment, the Director shall submit a report to the Senate Banking and House Financial Services Committees that— o Analyzes of the cost of placing credit risk exposure in the private markets, examining credit spreads in the markets; surveys by other agencies of credit conditions; comparisons between the cost of raising funds in the capital markets and the pricing of mortgage credit risk; and such other measures as the NMFA believes are appropriate in analyzing the cost and availability of private credit risk placement; o Details the benefits and drawbacks of each mechanism, product, structure, contract, or other security agreement that the Director considered in carrying out the requirement of this section; o Describes the operation and execution of any mechanisms, products, structures, contracts, or other security agreements that the Director determines best fulfills the	established with market participants based on the volume and type of securities Ginnie Mae anticipates the Platform issuing during such quarter. • The insurance fee shall reflect the anticipated cost to Ginnie Mae of providing insurance, including the cost of obtaining reinsurance. Ginnie Mae may adjust the insurance fee to reflect the historic quality of deliveries and rating of mortgage loans made by the mortgage originators or aggregators that originated or aggregated the mortgage loans included in the pool of eligible mortgage loans backing the security being insured, but in making such adjustments, Ginnie Mae shall ensure that the weighted average of the entire book of business matches the ultimate price determination. • The rate charged by a private market participant that contracts with Ginnie Mae pursuant to either the Reinsurance Bid Program or the Guarantor Program— o May not change during the first 100-day period for which such reinsurance is effective; and o Shall be adjusted based on market conditions, on a period to be determined by the Director. <u>Standards for Market Participants</u> • Ginnie Mae shall issue such general

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		approval of any credit risk-sharing mechanism shall have no effect on the status of single-family covered securities and related instruments using the credit risk-sharing mechanism that were issued prior to the suspension. • In addition to credit risk-sharing mechanisms approved by the FMIC, the FMIC shall consider and may approve additional fully-funded credit risk-sharing mechanisms that— o May be employed by an approved guarantor to manage the credit risk relating to guarantees provided for single-family covered securities; and o Do not represent the first loss position with respect to single-family covered securities. Nothing in this paragraph shall be construed to limit an approved guarantor from engaging in other forms of risk sharing or risk mitigation using mechanisms that have not been considered or approved by the FMIC. • Not later than 1 year after the agency transfer date, and annually thereafter until the system certification date, the FMIC shall submit a report to the Senate Banking and House Financial Services Committees that— o Discusses each credit risk-sharing	requirements of this section, and explains how the Director arrived at this determination. After the 5-year period and submission of the report required under subparagraph (A) [which requires multiple annual reports], each time the Director develops an additional credit risk-sharing mechanism, product, structure, contract, or other security agreement that fulfills the requirements of this section, the Director shall submit a report to the Senate Banking and House Financial Services Committees addressing the identical concerns required to be addressed in those reports.	standards for market participants under either the Reinsurance Bid Program or the Guarantor Program as Ginnie Mae determines appropriate. • Notwithstanding any other provision of law, Ginnie Mae shall require a market participant in either the Reinsurance Bid Program or the Guarantor Program to maintain at least an A-credit rating and shall consult with credit rating agencies and State insurance commissions, where applicable, to verify such rating. Ginnie Mae may waive or modify this credit rating requirement with respect to a new market participant. • For market participants in either the Reinsurance Bid Program or the Guarantor Program, Ginnie Mae shall establish, by regulation, capital standards and related solvency standards necessary to implement the provisions of this Act. o The regulations required under this paragraph shall define all such terms as are necessary to carry out the purposes of this paragraph. o In defining instruments and contracts that qualify as capital, Ginnie Mae— ▪ Shall include such instruments and contracts that will absorb losses before the Fund; and ▪ May assign significance to those instruments and contracts based

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		mechanism that the Chairperson considered; o Describes how the operation and execution of each approved credit risk-sharing mechanism fulfills the requirements of this section; and o Explains how the FMIC arrived at the determinations, including a discussion of the data considered. • On the system certification date and annually thereafter, the FMIC shall publish in the Federal Register a list of the credit risk-sharing mechanisms that it approved or suspended, addressing the identical concerns as in the report to Congress and, with respect to any suspension, the considerations that are no longer satisfied. • The FMIC shall include in the reports a description of the credit risk-sharing mechanisms approved for multifamily guarantors pursuant to § 703. <u>Collateral Diversification Standards</u> The FMIC shall establish, after notice and comment, standards for the appropriate minimum level of diversification for eligible single-family mortgage loans that collateralize single-family covered securities that are issued subject to an approved credit risk-sharing mechanism in order to reduce the credit risk such single-family covered		on the nature and risks of such instruments and contracts. o Solely for the purposes of calculating a capital ratio appropriate to the business model of a market participant, Ginnie Mae shall consider for the denominator— ▪ Total assets; ▪ Total liabilities; ▪ Risk in force; or ▪ Unpaid principal balance. o The capital and related solvency standards shall be designed to— ▪ Ensure the safety and soundness of a market participant; ▪ Minimize the risk of loss to the Fund; ▪ In consultation and coordination with the Federal Reserve, FDIC, and OCC, reduce the potential for regulatory arbitrage between capital standards for market participants and capital standards promulgated by Federal regulatory agencies for insured depository institutions and their affiliates; and ▪ Be specifically tailored to accommodate a diverse range of business models that may be employed by market participants. • To prevent or mitigate risks to the U.S.

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		securities could pose to the MIF. <u>Rule of Construction</u> Nothing in this section shall be construed to require the FMIC to approve any credit risk-sharing mechanism. <u>Applicability of the Commodity Exchange and Securities Acts</u> • No counterparty that enters into a swap, as defined by § 1a of the Commodity Exchange Act (7 U.S.C. 1a) (CEA), for purposes of structuring any FMIC-approved credit risk-sharing mechanism, which is designed to be used or is used by a private market holder to assume losses and to reduce the specific risks arising from losses realized under such credit risk-sharing mechanism associated with any single-family covered security insured in accordance with §§ 303 or 305, shall be deemed, by reason of such swap transaction, to be a commodity pool, as defined in CEA § 1a. Before approving any credit risk-sharing mechanism that would be exempt from the CEA, the FMIC shall consult with the CFTC. • Any credit risk-sharing mechanism that is approved by the FMIC pursuant to this section, which is designed to be used or is used by a private market holder to assume losses and to reduce the specific risks		secondary mortgage market that could arise from the material financial distress or failure, or ongoing activities, of large market participants that insure securities under this Act, Ginnie Mae— o Shall establish by regulation supplemental capital requirements for such large market participants; and o May establish by regulation such other standards that Ginnie Mae determines necessary or appropriate. o Shall define the term "large market participant". <u>Conflict of Interests</u> Ginnie Mae shall issue regulations to prevent conflicts of interest by market participants contracting with Ginnie Mae under this section. <u>Insurance Fund</u> • There is established an insurance fund (the "Fund"), which Ginnie Mae shall— o Maintain and administer; and o Use to cover losses incurred under this section with respect to MBS. • Ginnie Mae shall endeavor to ensure that the Fund attains a reserve balance— o Of 1.25% of the sum of the outstanding principal balance of the securities for which insurance is

	PATH Act, H.R. 2767	S. 1217	Waters Discussion Draft	H.R. 5055
		arising from loses realized under such credit risk-sharing mechanism associated with any single-family covered security insured in accordance with §§ 303 or 305, shall be exempt from section 27B of the Securities Act of 1933 (15 U.S.C. 77z-2a). Before approving any credit risk-sharing mechanism that would be exempt from § 27B, the FMIC shall consult with the SEC.		being provided under this Act within 5 years of the date on which the Director determines that the Platform is fully functioning, and to strive to maintain such ratio thereafter, subject to clause (ii); and o Of 2.50% of the sum of the outstanding principal balance of the securities for which insurance is being provided under this Act within 10 years of the date on which the Director determines that the Platform is fully functioning, and to strive to maintain such ratio at all times thereafter. • Notwithstanding insurance fees and terms set quarterly to cover Ginnie Mae's costs, Ginnie Mae may raise or lower the fee charged for insurance under this section to maintain the reserve balance. • The Fund shall be credited with any fees received by Ginnie Mae in exchange for insurance made available under this section. • Amounts in the Fund may not be invested in any— o Standardized MBS insured under this Act; or o MBS issued by the GSEs. • The full faith and credit of the U.S. is pledged to the payment of all amounts that may be required to be paid under any

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				insurance provided under this section. **§ 302 Risk-Sharing Pilot Programs** Not later than 12 months after enactment, each GSE shall establish a risk-sharing pilot program to develop private sector first-loss positions on MBS. Such first-loss positions shall be a percentage of the principal or face value of an MBS, as determined from time-to-time by the Director, taking into consideration market conditions and the capability of the private sector to assume credit risk. **§ 404 Other Forms of Multifamily Risk-Sharing** The Director may establish such other methods and manner of risk-sharing and risk transfer relating eligible multifamily mortgage loans, in addition to the methods and manners authorized under this title, as may be appropriate taking into consideration the particular nature and characteristics of the multifamily housing finance market, which may include any risk-sharing activities of the GSEs relating to the multifamily housing business. **§ 405 Ginnie Mae Securitization of FHA Risk-Sharing Loans** <u>Qualified Participating Entities Risk-Sharing Program</u> Sections 542(b)(8) and 542(c)(6) of the Housing and Community Development Act of

	PATH Act, H.R. 2767	S. 1217	Waters Discussion Draft	H.R. 5055
				1992 (12 U.S.C. 1715z–22(b)(8)) (which prohibits Ginnie Mae from securitizing certain multifamily loans in risk sharing arrangements) is amended to permit Ginnie Mae to securitize at the discretion of the Director, any multifamily loan insured under this section, provided that— • FHA provides mortgage insurance based on the unpaid principal balance of the loan, as shall be described in the risk-sharing agreement; • FHA shall not require an assignment fee for mortgage insurance claims related to the securitized mortgages; and • Any successors and assigns of the risk-sharing partner (including the holders of credit instruments issued under a trust mortgage or deed of trust pursuant to which such holders act by and through a trustee therein named) shall not assume any obligation under the risk-sharing agreement and may assign any defaulted loan to the FHA in exchange for payment of the mortgage insurance claim. • The risk-sharing agreement shall provide for reimbursement to Ginnie Mae by the risk-sharing partner or partners for either all or a portion of the losses incurred on the loans insured. There is a conforming amendment to Ginnie Mae's charter.
MIF		**§ 303 Insurance; MIF**	**§ 203 MIF**	

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		Authority The FMIC shall, in exchange for a fee, insure the payment of principal and interest on a covered security with respect to any failure to pay on such covered security subject to the requirements of this section. Terms and Conditions The FMIC shall, by regulation, establish terms and conditions for the provision of insurance under this Act. The terms and conditions shall, for single-family covered securities, include terms and conditions that ensure— • Eligible single-family mortgage loans collateralizing single-family covered securities have been delivered to the Platform; and • With respect to each single-family covered security, either— o Private market holders have taken a first loss position that satisfies § 302; or o An approved guarantor has provided a guarantee in satisfaction of § 311. The terms and conditions shall, for multifamily covered securities, include terms and conditions that ensure, with respect to each multifamily covered security, that an approved multifamily guarantor has provided a guarantee in satisfaction of § 703. Cash Payments; Continued Operations	Establishment There is established the MIF, which the NMFA shall— • Maintain and administer; and • Use to cover losses incurred on covered securities insured under this Act, when such losses exceed the first position losses absorbed by private market holders of such securities and the capital held by the Issuer pursuant to § 213. Deposits The MIF shall be credited with any— • Insurance fee amounts required to be deposited in the Fund under this section; and • Amounts earned on investments of MIF funds that are not employed. Fiduciary Responsibility The Director shall have the responsibility to ensure that the MIF remains financially sound. Use • The MIF shall be solely available to the NMFA for use by the NMFA to carry out the functions authorized by this Act and may not be used or otherwise diverted to cover any other expense of the Federal Government. • Notwithstanding any other provision of law, amounts received by the MIF	

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		The FMIC shall facilitate the timely and unconditional payment of principal and interest on covered securities insured under this Act by paying, in cash when due, any shortfalls of principal and interest due on the covered security, and continuing to charge and collect any fees for the provision of insurance relating to the covered security in the event of any losses that may be incurred:
		• In excess of the first loss position assumed by a private market holder;
		• In the case of a covered security that is guaranteed by an approved guarantor or approved multifamily guarantor as a result of the guarantor's insolvency; or
		• Upon the servicer's or guarantor's failure to transfer to the bond administrator for the covered security funds in amounts necessary to make timely payment of principal and interest due on the covered security.
		
		<u>Cost Recovery</u>
		If the FMIC makes a payment on a covered security based on a servicer's or guarantor's failure.to transfer funds necessary to make timely payment of principal and interest due, the FMIC shall recover such amount paid, and reasonable costs and expenses, from the servicer or guarantor.
		
		<u>MIF</u>
			pursuant to fees shall not be subject to apportionment for the purposes of 31 U.S.C. chapter 15 or under any other authority.
			
			<u>MIF Reserve Ratio Goals</u>
			• The Director shall endeavor to ensure that the MIF attains a reserve balance—
			  o Of 1.25% of the sum of the outstanding principal balance of the covered securities for which insurance is being provided under this title within 7 years of the NMFA certification date, and to strive to maintain such ratio thereafter, subject to the following; and
			  o Of 2.25% of the sum of the outstanding principal balance of the covered securities for which insurance is being provided under this title within 12 years of the NMFA certification date, and to strive to maintain such ratio at all times thereafter.
			• The Director may reduce such percentages if a determination is made that the level of reserves held by the MIF is considered to be actuarially fair by an actuary hired by the NMFA for that purpose. To be considered to be actuarially fair for this purpose, reserves held in the MIF, in combination with the	

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		• On the agency transfer date, there shall be established the MIF, which the FMIC shall—
		  o Maintain and administer;
		  o Use to carry out the insurance functions authorized under this Act, including any function or action authorized under § 305; and
		  o Invest.
		• The MIF shall be credited with any—
		  o Fee amounts required to be deposited in the MIF under this section;
		  o Amounts earned on investments;
		  o Assessment amounts authorized to be deposited into the Fund under § 405(b); and
		  o Assessment amounts required to be deposited into the Fund under § 608(c).
		• In determining the amount of any FMIC-charged fee, the FMIC shall charge a separate fee for single-family covered securities and multifamily covered securities, as appropriate for each asset class. The FMIC shall keep and maintain separate accounting for deposits in the MIF related to fee amounts charged and collected for the insurance of single-family covered securities and multifamily covered securities.
		• The FMIC has the responsibility to ensure that the MIF remains financially sound.
			capital held by the Issuer for the risks that it holds, should be adequate to cover losses at least equal to any experienced in the housing markets over the last 100 years.
			
			<u>Maintenance of Reserve Ratio; Establishment of Fees</u>
			• The NMFA shall charge and collect a fee, and may in its discretion increase or decrease such fee, in connection with any insurance provided under this title to—
			  o Achieve and maintain the reserve ratio goals;
			  o Achieve such reserve ratio goals, if the actual balance of such reserve is below the goal amounts; and
			  o Fund the operations of the NMFA.
			• In exercising the fee authority, the NMFA shall consider—
			  o The expected operating expenses of the MIF;
			  o The risk of loss to the MIF in carrying out the requirements under this Act;
			  o The risk presented by, and the loss absorption capacity of, the credit enhancement that is provided on the pool of eligible mortgages collateralizing the covered security to be insured under this title;
			  o Economic conditions generally	

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		• The MIF shall be solely available to the FMIC to carry out the functions authorized by this Act and for the expenses of the FMIC and for— o Compensation of FMIC employees; o Purposes of— ▪ Funding the CSP; and ▪ Establishing the Securitization Platform under § 321, multifamily subsidiaries under § 701, the initial Small Lender Mutual under § 315, and any other entity authorized by this Act that facilitates an orderly transition to the new housing finance system; and o All other FMIC expenses. The MIF may not be used or otherwise diverted to cover any other expense of the Federal Government. • Notwithstanding any other provision of law, amounts in the MIF shall not be subject to apportionment for the purposes of chapter 15 of 31 U.S.C. or under any other authority. • Amounts in the MIF shall not be construed to be Government or public funds or appropriated money. • The FMIC shall endeavor to ensure that the MIF attains a reserve ratio— o Of 1.25% of the sum of the outstanding principal balance of the	affecting the mortgage markets; o The extent to which the reserve ratio of the MIF met— ▪ The reserve ratio set for the preceding 12-month period; or ▪ The reserve ratio goals; and o Any other factor that the NMFA determines appropriate. • The required fee— o Shall be set at a uniform amount applicable to all institutions purchasing insurance under this title; o May not vary— ▪ By geographic location; or ▪ By the size of the institution to which the fee is charged; o May not be based on the volume of insurance to be purchased by an originator; and o May vary based on past performance of loans supplied by the originator. • Any fee amounts collected under this subsection shall be deposited in the MIF. <u>Investments</u> Amounts in the MIF that are not otherwise employed— • Shall be invested in obligations of the U.S.; and • May not be invested in any covered security insured under this Act.	

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		covered securities for which insurance is being provided under this title within 5 years of the system certification date; and o Of 2.50% of the sum of the outstanding principal balance of the covered securities for which insurance is being provided under this title within 10 years of the system certification date, and after that date, endeavor to ensure that the MIF maintains a reserve ratio of not less than 2.50% of the sum of the outstanding principal balance of the covered securities for which insurance is being provided under this title. • The FMIC shall charge and collect a fee, and may in its discretion increase or decrease such fee, in connection with any insurance provided under this title to achieve and maintain the MIF reserve ratio goals and fund the FMIC's operations. • In establishing fees, the FMIC shall consider— o The expected operating expenses of the MIF; o The risk of loss to the MIF in carrying out the requirements under this Act; o The risk presented by, and the loss	<u>Initial Funding</u> FHFA, in consultation with Treasury, shall have authority to dedicate a portion of the g-fees received by the GSEs during the period in which they continue to conduct new business to initial funding of the MIF. **§ 204 Insurance** <u>Authority</u> The Director shall, upon application and in exchange for a fee in accordance with § 203(f), insure the payment of principal and interest on a covered security with respect to losses that may be incurred on such security. Payment under the insurance shall take place after first loss credit risk placement or retention and the capital of the Issuer has been exhausted, as determined by the NMFA. <u>Cash Payments; Continued Operations</u> In the event of a payment default on an eligible mortgage that collateralizes a covered security insured under this section that exceeds the first loss position assumed by a private market holder and the capital of the Issuer has been exhausted, the NMFA shall— • Pay, in cash when due, any shortfalls in payment of principal and interest under the eligible mortgage; and • Continue to charge and collect any fees for the provision of insurance relating to the covered security.	

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		absorption capacity of, the credit risk-sharing mechanism or guarantee that is provided on the pool of eligible mortgage loans collateralizing the covered security to be insured under this title; ○ Economic conditions generally affecting the mortgage markets; ○ The extent to which the MIF reserve ratio met— ▪ The reserve ratio set for the preceding 12-month period; or ▪ The reserve ratio goals; and ○ Any other factors that the FMIC determines appropriate. • The fee— ○ Except as below, shall be set at a uniform amount applicable to all institutions purchasing insurance under this title; ○ May not vary— ▪ By geographic location; or ▪ By the size of the institution to which the fee is charged; and ○ May not be based on the volume of insurance to be purchased. This shall not prohibit or be construed to prohibit the FMIC from charging separate and distinct fees based on the type or form of credit risk-sharing mechanism applicable to the covered security to be insured.	<u>Full Faith and Credit</u> The full faith and credit of the U.S. is pledged to the payment of all amounts which may be required to be paid under any insurance provided under this section. <u>Prohibition on Federal Assistance</u> Subject to the next sentence and notwithstanding any other provision of law, no Federal funds may be used to purchase or guarantee obligations of, issue lines of credit to, provide direct or indirect access to any financing provided by the U.S. Government to, or provide direct or indirect grants and aid to any private market holder of the first loss position on a covered security which, on or after the date of enactment of this Act, has defaulted on its obligations, is at risk of defaulting, or is likely to default, absent such assistance from the U.S. Government. This prohibition shall not apply with respect to liquidity facilities intended to address market conditions or related to the timing of payments.	

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		• Any fee amounts collected shall be deposited in the MIF. • The full faith and credit of the U.S. is pledged to the payment of all amounts from the MIF which may be required to be paid under any insurance provided under this title. • The Board of Directors may request Treasury to invest such portion of amounts in the MIF that, in the judgment of the Board, is not required to meet the "current--suggested deletion needs of the" FMIC. Treasury shall invest such portions in U.S. obligations bearing interest at a rate determined by Treasury, taking into consideration, at the time of the investment, market yields on outstanding U.S. marketable obligations of comparable maturity. Amounts in the MIF may not be invested in any— o Covered security insured under this title; or o MBS issued by the GSEs. <u>Mandatory Loss Review by FMIC IG</u> If the MIF is required to make any payment of principal or interest, or both, on a covered security with respect to losses incurred on such covered security to any holder of such covered security, the FMIC IG shall— • Review and make a written report to the FMIC regarding the FMIC's decision to		

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		insure such covered security and the FMIC's supervision of all market participants involved in the creation, issuance, servicing, guarantee of, or insurance of such covered security, which shall ascertain why the covered security resulted in a loss to the MIF, and make recommendations for preventing any such loss in the future; and
		• Provide a copy of the report to
		  ○ GAO;
		  ○ The appropriate Federal banking agency or State regulatory authority, as appropriate, of any market participant involved in the creation, issuance, servicing, guarantee of, or insurance of such covered security; and
		  ○ The Senate Banking and House Financial Services Committees.
		• The IG shall provide the report as expeditiously as possible, but in no event later than 6 months after the date on which the loss was incurred.
		• The FMIC shall disclose any such report on losses, upon a FOIA request, without excising—
		  ○ Any portion under section 552(b)(5) [exemption from disclosure for inter-agency or intra-agency communication not available to nonlitigants]; or		

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		○ Any information under paragraph (4) (other than trade secrets) [trade secrets and confidential information] or paragraph (8) [examination reports] of 5 U.S.C. § 552(b). This does not require the FMIC to disclose the name of any holder of the covered security, or information from which the identity of such a person could reasonably be ascertained. • GAO shall, under such conditions as it determines to be appropriate, review any such IG report and recommend to the FMIC improvements in the supervision of market participants.		
MIF Initial Funding		**§ 608 Initial Fund Level for the MIF** <u>Fund Amount on System Certification Date</u> The FMIC shall endeavor to ensure that the MIF attains a reserve ratio of 0.75% of the sum of the outstanding principal balance of the covered securities for which insurance is projected to be provided under this Act for the 5 year-period beginning on the system certification date. <u>Report to Congress on Projection</u> The projection shall be determined by the FMIC and reported to the Senate Banking and House Financial Services Committees. <u>Assessments</u> Pursuant to the authorities granted to the		

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<tr><th></th><th>PATH Act, H.R. 2767</th><th>S. 1217</th><th>Waters Discussion Draft</th><th>H.R. 5055</th></tr>
<tr><td></td><td></td><td>FMIC under § 1316(i) of the 1992 Act, as added by § 405 (transition assessments), the amount of funds required to be held by the MIF under subsection (a) shall be acquired through assessments on the GSEs. The assessments required under this subsection shall be in effect for the period beginning on enactment and ending on the system certification date. The assessments required under this subsection shall be deposited in the MIF.</td><td></td><td></td></tr>
<tr><td>Loan Limits</td><td>§ 105 Modifications to Increases in Conforming Loan Limits
The conforming loan limit under current law is adjusted by adding an amount tied to house price increases, and if house prices decrease, there is no adjustment. This would be amended to permit the adjustment to be a decrease when house prices decrease.
The bill would strike a sentence (the “Repealed Sentence”) that increases the conforming loan limit, for a particular house size, in areas where 115% of the median house price, for that size house, exceeds the conforming loan limit for the same size house, to the lesser of 150% of the conforming loan limit for that size house, or 115% of the median house price for that size house.
It would add a provision that increases the conforming loan limit in some</td><td>§ 304 Loan Limits; Housing Price Index
<u>Establishment</u>
The FMIC shall establish limitations governing the maximum original principal obligation of eligible single-family mortgage loans that may collateralize a covered security to be insured by the FMIC under this title.

<u>Calculation of Amount</u>
This loan limit shall be calculated with respect to the total original principal obligation of the eligible single-family mortgage loan and not merely with respect to the amount insured by the FMIC.

<u>Maximum Limits</u>
Except as provided below, the maximum loan limit shall not exceed:
<table><tr><th># Units</th><th>Limit</th></tr><tr><td>1</td><td>$417,000</td></tr></table></td><td>§ 504 Conforming Loan Limits
Beginning on the date of the enactment, the limitations governing the maximum original principal obligation of conventional mortgages that may be purchased by Fannie Mae or Freddie Mac the Federal National shall be:
<table><tr><th># Units</th><th>Limit</th></tr><tr><td>1</td><td>$417,000</td></tr><tr><td>2</td><td>$533,850</td></tr><tr><td>3</td><td>$645,300</td></tr><tr><td>4</td><td>$801,950</td></tr></table>
These limitations shall be adjusted effective January 1 of each year beginning after the date of enactment of this Act. Each such adjustment shall be made by adding to each such amount (as it may have been previously adjusted) a percentage thereof equal to the percentage increase, during the most recent 12-month</td><td>§ 201(f)
<u>Loan Limits; Housing Price Index</u>
Ginnie Mae shall establish limitations governing the maximum original principal obligation of eligible mortgage loans that may collateralize a security issued under this Act.
The limitation loan limit shall be calculated with respect to the total original principal obligation of the eligible mortgage loan and not merely with respect to the amount insured by Ginnie Mae.
The maximum loan limit amount shall not exceed:
<table><tr><th># Units</th><th>Limit</th></tr><tr><td>1</td><td>$417,000</td></tr><tr><td>2</td><td>417,000 x 1.28 or $533,760</td></tr><tr><td>3</td><td>417,000 x 1.55 or $646,350</td></tr><tr><td>4</td><td>417,000 x 1.92 or $800,640</td></tr></table></td></tr>
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<td>circumstances.
o The new provision only applies, for properties of any size in a particular area, if, as of the date of enactment, the loan limits in effect for the area for any size property were determined under the Repealed Sentence.
o If the new provision applies, it applies only for five years.

Calculations under the new provision are as follows. They use an amount that varies for five years and that depends on house size:

<table>
<tr><td>s</td><td>Year 1</td><td>Year 2</td><td>Year 3</td><td>Year 4</td><td>Ye</td></tr>
<tr><td></td><td>20,000</td><td>40,000</td><td>60,000</td><td>80,000</td><td>100</td></tr>
<tr><td></td><td>25604</td><td>51,208</td><td>76,812</td><td>102,416</td><td>128</td></tr>
<tr><td></td><td>30,950</td><td>61,900</td><td>92,850</td><td>123,800</td><td>154</td></tr>
<tr><td></td><td>38,463</td><td>76,926</td><td>103,389</td><td>153,852</td><td>192</td></tr>
</table>
To calculate the loan limit for an X-unit home in an area where 115% of the median house price for an X-unit home exceeds the conforming loan limit for an X-unit, use the lesser of the following three amounts:
• The difference between:
o 150% of the conforming loan limit for a X-unit house (use 150% of the applicable limit for all calculations); and
o The dollar amount from the table for</td>
<td><table>
<tr><td>2</td><td>417,000 x 1.28 or $533,760</td></tr>
<tr><td>3</td><td>417,000 x 1.55 or $646,350</td></tr>
<tr><td>4</td><td>417,000 x 1.92 or $800,640</td></tr>
</table>
• These limits shall be adjusted effective January 1 of each year beginning after the effective date of this Act. Each adjustment shall be made by adding to each such amount (as it may have been previously adjusted) a percentage thereof equal to the percentage increase, during the most recent 12-month or 4-quarter period ending before the time of determining such annual adjustment, in the housing price index maintained by the Chairperson. If the change in such house price index during the most recent 12-month or 4-quarter period ending before the time of determining such annual adjustment is a decrease, then no adjustment shall be made for the next year, and the next upward adjustment shall take into account prior declines in the house price index, so that any adjustment shall reflect the net change in the house price index since the last adjustment. Declines in the house price index shall be accumulated and then reduce increases until subsequent increases exceed prior declines.
• The limits may be increased by not more than 50% with respect to properties</td>
<td>or 4-quarter period ending before the time of determining such annual adjustment, in the housing price index maintained pursuant to § 1322 of the 1992 Act. If the change in such house price index during the most recent 12-month or 4-quarter period ending before the time of determining such annual adjustment is a decrease, then no adjustment shall be made for the next year, and the next adjustment shall take into account prior declines in the house price index, so that any adjustment shall reflect the net change in the house price index since the last adjustment. Declines in the house price index shall be accumulated and then reduce increases until subsequent increases exceed prior declines.
• The limitations shall be increased by not to exceed 50% with respect to properties located in Alaska, Guam, Hawaii, and the Virgin Islands.</td>
<td>• The limits shall be adjusted effective January 1 of each year beginning after the effective date of this Act. Each adjustment shall be made by adding to each such amount (as previously adjusted) a percentage thereof equal to the percentage increase, during the most recent 12-month or 4-quarter period ending before the time of determining such annual adjustment, in the housing price index maintained by Ginnie Mae pursuant to this section. If the change in such house price index during the most recent 12-month or 4-quarter period ending before the time of determining such annual adjustment is a decrease, then no adjustment shall be made for the next year, and the next upward adjustment shall take into account prior declines in the house price index, so that any adjustment shall reflect the net change in the house price index since the last adjustment. Declines in the house price index shall be accumulated and then reduce increases until subsequent increases exceed prior declines.
• The limits may be increased by not more than 50% with respect to properties located in Alaska, Guam, Hawaii, and the Virgin Islands. The limits shall also be increased, with respect to properties of a</td>
</tr>
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	the house size and year; • 115% of the median house price in the area for an X-unit house; or The limit in effect for the house size (number of units) and area under the Repealed Sentence, as in effect immediately before enactment, as of the date of enactment.	located in Alaska, Guam, Hawaii, and the Virgin Islands. Such foregoing limits shall also be increased, with respect to properties of a particular size located in any area for which 115% of the median house price for such size residence exceeds the otherwise applicable limit for such size residence, to the lesser of 150% of such limit for such size residence or the amount that is equal to 115% of the median house price in such area for such size residence. <u>Housing Price Index</u> The FMIC shall establish and maintain a method of assessing a national average single-family house price for use in calculating the loan limits for eligible single-family mortgage loans, and other averages as the FMIC considers appropriate, including— • Averages based on different geographic regions; and • An average for houses whose mortgage collateralized single-family covered securities. In establishing the method of assessing house prices, the FMIC may take into consideration the data collected in carrying out the functions described under § 333, and such other data, existing house price indexes, and other measures as the FMIC considers appropriate.		particular size located in any area for which 115% of the median house price for such size residence exceeds the limit for such size residence set forth in the chart above, to the lesser of 150% of the limit for such size residence or the amount that is equal to 115% of the median house price in such area for such size residence. • Ginnie Mae shall establish and maintain a method of assessing a national average single-family house price for use in calculating the loan limits for single-family mortgage loans, and other averages as Ginnie Mar considers appropriate, including— o Averages based on different geographic regions; and o An average for houses whose mortgage collateralized single-family covered securities. In establishing the method of assessing house prices, Ginnie Mae may take into consideration such data, including existing house price indexes, and other measures as Ginnie Mae considers appropriate. <u>Authority for Loan-Level Enhancement</u> With respect to an eligible mortgage loan that is or will be contained in a pool of mortgages delivered to the Platform, the mortgage originator of such mortgage loan may enter

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				into agreements with market participants to provide loan-level enhancement of such mortgage loan.
Exigent Circumstances		**§ 305 Authority to Protect Taxpayers in Unusual and Exigent Market Conditions** <u>In General</u> If the FMIC, upon the written agreement of the Chairman of the Federal Reserve and Treasury Secretary, and in consultation with HUD, determines that unusual and exigent circumstances have created or threaten to create an anomalous lack of mortgage credit availability within the single-family housing market, multifamily housing market, or entire U.S. housing market that could materially and severely disrupt the functioning of the U.S. housing finance system, the FMIC may, for a period of 6 months— • Provide insurance in accordance with § 303 to any single-family covered security regardless of whether such security has satisfied the requirements of § 302; and • Establish provisional standards for approved entities, notwithstanding any standard required under subtitle B or § 703, pursuant to § 607. <u>Considerations</u> In exercising such authority, the FMIC shall consider the severity of the conditions present in the housing markets and the risks presented		

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		to the MIF in exercising such authority. Terms and Conditions Insurance provided under such a determination shall be subject to such additional or different limitations, restrictions, and regulations as the FMIC may prescribe. Bailout Strictly Prohibited In exercising this authority, the FMIC may not— • Provide aid to an approved entity or an affiliate of the approved entity, if such approved entity is in bankruptcy or any other Federal or State insolvency proceeding; or • Provide aid to assist a single and specific company avoid bankruptcy or any other Federal or State insolvency proceeding. Notice Not later than 7 days after authorizing insurance or establishing provisional standards under this section, the FMIC shall submit to the Senate Banking and House Financial Services Committees a report that includes— • The justification for the exercise of authority to provide such insurance or establish such provisional standards; • Evidence that unusual and exigent circumstances have created or threatened to create an anomalous lack of mortgage		

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		credit availability within the single-family housing market, multifamily housing market, or entire U.S. housing market that could materially and severely disrupt the functioning of the U.S. housing finance system; and
		• Evidence that failure to exercise such authority would have undermined the safety and soundness of the housing finance system.
		
		<u>Additional Exercise of Authority</u>
		Subject to the limitation below, the authority to provide insurance in unusual and exigent circumstances may be exercised for 2 additional 9-month periods within any given 3-year period, provided that the FMIC, upon the written agreement of the Chairman of the Federal Reserve and the Treasury Secretary, in consultation with HUD—
		• Determines—
		  ○ For a second exercise of such authority, by an affirmative vote of 2⁄3 or more of the Board of Directors then serving, that a second exercise of such authority is necessary; or
		  ○ For a third exercise of such authority, by an affirmative vote of 2⁄3 or more of the Board of Directors then serving, and an affirmative vote of 2⁄3 or more of the Federal Reserve Board then serving, that a third		

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		exercise of such authority is necessary; and • Provides the same notice to Congress as for any exercise of such authority. Any additional exercise of authority under this subsection may occur consecutively or non-consecutively. <u>Limitation</u> The authority granted to the FMIC under this section may not be exercised more than 3 times in any given 3-year period, which 3-year period shall commence upon the initial exercise of authority. <u>Normalization and Reduction of Risk</u> Following any exercise of authority under this section, the FMIC shall— • Establish a timeline for approved entities to meet the approval standards set forth in this Act; and • In a manner and pursuant to a timeline that will minimize losses to the MIF, establish a program to either— o Sell, in whole or in part, the first loss position on covered securities issued pursuant to this section to private market holders; or o Transfer for value to approved entities, or work with approved entities to sell, in whole or in part, the first lost position on covered		

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		securities issued pursuant to this section. <u>Authority to Respond to Sustained National Home Price Decline</u> • In the event of a significant decline of national home prices, in at least 2 consecutive calendar quarters, the FMIC, by an affirmative vote of 2⁄3 or more of the Board of Directors then serving, may for a period of 6 months permit the transfer of guarantees of eligible mortgage loans that secure covered securities if such eligible mortgage loans are refinanced, regardless of the value of the underlying collateral securing such eligible mortgage loans. • This authority may be exercised for additional 6-month periods, if upon each additional extension of such authority there is an affirmative vote of 2⁄3 or more of the Board of Directors then serving. • The FMIC shall not provide insurance under this section to any covered security that includes mortgage loans that do not meet the definition of an eligible mortgage loan, as defined by this Act, except for mortgage loans refinanced from eligible mortgage loans in covered securities. • No provision in this section shall be construed as permitting the FMIC to		

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		lower any other requirement related to the requirements set forth under the definition of an eligible mortgage loan.		
Agency Powers		**§ 306 General Powers** Corporate Powers The FMIC shall have the power— • To adopt, alter, and use a corporate seal, which shall be judicially noticed; • To enter into, execute, and perform contracts, leases, cooperative agreements, or other transactions, on such terms as it may deem appropriate, with any agency or instrumentality of the U.S., or with any political subdivision thereof, or with any person, firm, association, or corporation; • To execute, in accordance with its bylaws, all instruments necessary or appropriate in the exercise of any of its powers; • In its corporate name, to sue and to be sued, and to complain and to defend, in any court or tribunal of competent jurisdiction, Federal or State, but no attachment, injunction, or other similar process, mesne or final, shall be issued against the property of the FMIC; • To conduct its business without regard to any qualification or similar statute in any U.S. State; • To lease, purchase, or acquire any property, real, personal, or mixed, or any interest therein, to hold, rent, maintain,	**§ 205 General Powers** Corporate Powers The NMFA shall have power— • To adopt, alter, and use a corporate seal, which shall be judicially noticed; • To enter into and perform contracts, leases, cooperative agreements, or other transactions, on such terms as it may deem appropriate, with any agency or instrumentality of the U.S., or with any State, Territory, or possession, or Puerto Rico, or with any political subdivision thereof, or with any person, firm, association, or corporation; • To execute, in accordance with its bylaws, all instruments necessary or appropriate in the exercise of any of its powers; • In its corporate name, to sue and to be sued, and to complain and to defend, in any court of competent jurisdiction, State or Federal, but no attachment, injunction, or other similar process, mesne or final, shall be issued against the property of the NMFA; • To conduct its business without regard to any qualification or similar statute in any State of the U.S., including D.C., Puerto Rico, and the Territories and possessions	

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		modernize, renovate, improve, use, and operate such property, and to sell, for cash credit, lease, or otherwise dispose of the same, at such time and in such manner as and to the extent that it may deem necessary or appropriate; • To prescribe, repeal, and amend or modify, rules, regulations, or requirements governing the manner in which its general business may be conducted; • To accept gifts or donations of services, or property, real, personal, or mixed, tangible, or intangible, in aid of any of its purposes; • To appoint and supervise personnel employed by the FMIC; • To establish and maintain divisions, units, other offices within the FMIC, including those established in §§ 207, 208, and 209, to carry out the responsibilities of this Act, and to satisfy the requirements of other applicable law; and • To manage the affairs of the FMIC and conduct the business of the FMIC, as necessary. <u>Litigation Authority</u> • In enforcing any provision of this Act, any regulation or order prescribed under this Act, or any other provision of law, rule, regulation, or order, or in any other	of the U.S.; • To lease, purchase, or acquire any property, real, personal, or mixed, or any interest therein, to hold, rent, maintain, modernize, renovate, improve, use, and operate such property, and to sell, for cash or credit, lease, or otherwise dispose of the same, at such time and in such manner as and to the extent that it may deem necessary or appropriate; • To prescribe, repeal, and amend or modify, rules, regulations, or requirements governing the manner in which its general business may be conducted; • To accept gifts or donations of services, or of property, real, personal, or mixed, tangible, or intangible, in aid of any of its purposes; and • To do all things as are necessary or incidental to the proper management of its affairs and the proper conduct of its business, including the establishment of such subgroups or corporate entities as are useful in conducting its business. <u>Expenditures</u> Except as may be otherwise provided in this title, in 31 U.S.C. chapter 91, or in other laws specifically applicable to Government corporations, the NMFA shall determine the necessity for, and the character and amount of	

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		action, suit, or proceeding to which the FMIC is a party or in which it is interested, and in the administration of conservatorships and receiverships, the FMIC may act in its own name and through attorneys or other agents acting on its behalf. • Except as otherwise provided by law, the FMIC shall be subject to suit (other than suits for claims for money damages) by a regulated entity or market participant with respect to any matter under this Act or any other applicable provision of law, rule, order, or regulation under this Act, in the U.S. district court for the judicial district in which the regulated entity or market participant has its principal place of business, or in the U.S. District Court for D.C., and the FMIC may be served with process in the manner prescribed by the Federal Rules of Civil Procedure. <u>Expenditures</u> Except as may be otherwise provided in this title, the FMIC shall determine the necessity for, and the character and amount of its obligations and expenditures, and the manner in which they shall be incurred, allowed, paid, and accounted for. <u>Exemption from Certain Taxes</u> The FMIC, including its franchise, capital, reserves, surplus, mortgage loans or other	its obligations and expenditures, and the manner in which they shall be incurred, allowed, paid, and accounted for. <u>Exemption from Certain Taxes</u> The NMFA, including its franchise, capital, reserves, surplus, mortgages or other security holdings, and income shall be exempt from all taxation now or hereafter imposed by the U.S., by any territory, dependency, or possession thereof, or by any State, county, municipality, or local taxing authority, except that any real property of the NMFA shall be subject to State, territorial, county, municipal, or local taxation to the same extent according to its value as other real property is taxed. <u>Exclusive Use of Name</u> No individual, association, partnership, or corporation, except the bodies corporate named under section 101, shall hereafter use the words “National Mortgage Finance Administration” or any combination of such words, as the name or a part thereof under which the individual, association, partnership, or corporation shall do business. Violations of the foregoing may be enjoined by any court of general jurisdiction at the suit of the proper body corporate. In any such suit, the plaintiff may recover any actual damages flowing from such violation, and, in addition, shall be entitled to punitive damages (regardless of the existence or nonexistence of actual damages)	

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		security holdings, and income shall be exempt from all taxation now or hereafter imposed by the U.S., by any territory, dependency, or possession thereof, or by any State, county, municipality, or local taxing authority, except that any real property of the FMIC shall be subject to State, county, municipal, or local taxation to the same extent according to its value as other real property is taxed. <u>Exclusive Use of Name</u> No individual, association, partnership, or corporation, except the FMIC, shall hereafter use the words "Federal Mortgage Insurance Corporation" or any combination of such words, as the name or a part thereof under which such individual, association, partnership, or corporation shall do business. Violations may be enjoined by any court of general jurisdiction at the suit of the FMIC. In any such suit, the plaintiff may recover any actual damages flowing from such violation, and, in addition, shall be entitled to punitive damages (regardless of the existence or nonexistence of actual damages) of not exceeding $1,000 for each day during which such violation is committed or repeated. <u>Fiscal Agents</u> The Federal Reserve banks are authorized and directed to act as depositories, custodians, and fiscal agents for the FMIC, for its own account or as fiduciary, and such banks shall	of not exceeding $100 for each day during which such violation is committed or repeated. <u>Fiscal Agents</u> The Federal Reserve banks are authorized and directed to act as depositories, custodians, and fiscal agents for the NMFA on behalf of the MIF, and such banks shall be reimbursed for such services in such manner as may be agreed upon. The NMFA, in consultation Federal Reserve, may authorize use of the Federal Reserve banks by the Issuer. **§ 801 Authority to Issue Regulations** The NMFA may prescribe such regulations and issue such guidelines, orders, requirements, or standards as are necessary to carry out this Act, or any amendment made by this Act.	

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		be reimbursed for such services in such manner as may be agreed upon, and the FMIC may itself act in such capacities, for its own account or as fiduciary, and for the account of others. <u>Other Powers</u> The FMIC is authorized to assess and collect fees on regulated entities and approved entities, including for applications, examinations, and other purposes, as authorized by this Act. <u>FHLB Assessment</u> The FMIC shall have authority to assess a fee on the FHLBs to cover the necessary costs related to supervising the FHLBs. The costs associated with the FHLBs' secondary market activities pursuant to § 312 shall be covered by this fee. <u>Fair Housing Rule of Construction</u> Nothing in this Act shall be construed as authorizing the FMIC to waive, repeal, amend, or modify fair housing requirements, including under the Fair Housing Act or ECOA.		
Exemptions / Risk Retention Amendment	**§ 407 Repeal of Credit Risk Retention Regulations** The Dodd-Frank Act is amended: • To strike § 941, risk retention. Section 941(a), which defines ABS in the	**§ 307 Exemptions** <u>Securities Exempt from SEC Regulation</u> • All securities insured or guaranteed by the FMIC shall, to the same extent as securities that are direct obligations of or	**§ 206 Exemptions** <u>Securities Exempt from SEC Regulation</u> • All covered securities insured or guaranteed by the NMFA shall, to the same extent as securities that are direct	

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	Securities Exchange Act, is also repealed. • The OCC, Federal Reserve, FDIC, CFPB, and SEC "may not issue any rule or regulation to require risk retention, the creation or maintenance of a premium capture cash reserve account, or any similar mechanism, unless directly authorized by an Act of Congress." • To make both of these amendments effective on July 21, 2010, "as if included in" the Dodd-Frank Act.	obligations guaranteed as to principal or interest by the U.S., be deemed to be exempt securities within the meaning of the laws administered by the SEC. • The first sentence of § 3(a)(2) of the Securities Act of 1933 (15 U.S.C. 77c(a)(2)) is amended by inserting "or any security insured or guaranteed by the Federal Mortgage Insurance Corporation;" after "Federal Reserve bank;". • Section 27B(c) of the Securities Act of 1933 (15 U.S.C. 77z-2a(c)) is amended by adding at the end the following: ''(3) purchases or sales of any asset-backed security that is a credit risk-sharing mechanism approved by the Federal Mortgage Insurance Corporation in accordance with section 302 or section 703(c) of the Housing Finance Reform and Taxpayer Protection Act of 2014, which credit risk-sharing mechanism is designed to be used or is used, as determined by the [FMIC], by a private market holder to assume losses and to reduce the specific risks arising from losses realized under such credit risk-sharing mechanism associated with any pool of eligible mortgage loans that collateralizes a covered security insured in accordance with section 303 or 305 of that Act.".	obligations of or obligations guaranteed as to principal or interest by the U.S., be deemed to be exempt securities within the meaning of the laws administered by the SEC. • The first sentence of § 3(a)(2) of the Securities Act of 1933 (15 U.S.C. 77c(a)(2)) is amended by adding "or any covered security, as such term is defined under section 2 of the Housing Opportunities Move the Economy Forward Act of 2014;" after "Federal Reserve bank;". <u>QRM Exemption</u> Section 15G(e) of the Securities Exchange Act of 1934 (risk retention) is amended— • In paragraph (3)(B). This language currently exempts from all of § 15G mortgage loan assets or securitizations based on an asset insured or guaranteed by federal agencies, but the GSEs and FHLBs are not agencies for this purpose. The bill would remove the FHLBs from this exclusion from the agency definition. • By adding at the end the following: Notwithstanding any other provision of this section, the requirements of this section shall not apply to any covered security, as such term is defined in § 2 of the Housing Opportunities Move the Economy Forward Act of 2014, insured	

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		Risk Retention Exemption Section 15G(e) of the Securities Exchange Act of 1934 (risk retention) is amended— • In paragraph (3)(B). This language currently exempts from all of § 15G mortgage loan assets or securitizations based on an asset insured or guaranteed by federal agencies, but the GSEs and FHLBs are not an agencies for this purpose. The bill would remove the FHLBs from this exclusion from the agency definition. • By adding at the end the following: Notwithstanding any other provision of this section, the requirements of this section shall not apply to any covered security, as such term is defined under § 2 of the Housing Finance Reform and Taxpayer Protection Act of 2014, insured or guaranteed by the FMIC or any institution that is subject to the supervision of the FMIC. Counterparties Exempt from the CEA Section 1a(10) of the Commodity Exchange Act is amended by adding at the end: “Solely as it relates to the specific role of a counterparty in connection with the swap transaction described in this paragraph, the term ‘commodity pool’ does not include any counterparty that enters into any swap for	or guaranteed by the NMFA.	

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		purposes of structuring a credit risk-sharing mechanism that is approved by the Federal Mortgage Insurance Corporation in accordance with section 302 or section 703(c) of the Housing Finance Reform and Taxpayer Protection Act of 2014, which credit risk-sharing mechanism is designed to be used or is used, as determined by the Federal Mortgage Insurance Corporation, by a private market holder to assume losses and to reduce the specific risks arising from losses realized under such credit risk-sharing mechanism associated with any pool of eligible mortgage loans that collateralizes a covered security insured in accordance with section 303 or 305 of that Act."		
Regulatory Coordination		**§ 308 Regulatory Consultation and Coordination** Consultation Permitted The FMIC may, in carrying out any duty, responsibility, requirement, or action authorized under this Act, consult with the Federal regulatory agencies, any individual Federal regulatory agency, Treasury, HUD, any State banking regulator, any State insurance regulator, and any other State agency, as the FMIC determines necessary and appropriate. Coordination Required The FMIC shall, as required by this Act, in carrying out any duty, responsibility, requirement, or action authorized under this	**§ 226 Protection of Privilege and Other Matters Relating to Disclosures by Market Participants** Information Sharing and Maintenance of Privilege The *FDIA* is amended— • In § 11(t), which currently provides that covered agencies may share information without waiving privileges, by adding the NMFA to the definition of covered agency. This change is also made in § 306(g)(3). • In § 18(x), which currently provides that submitting information to certain regulators does not waive privileges, by adding the NMFA to the list of agencies.	**§ 104 Regulatory Consultation and Coordination** Consultation Permitted The Director may, in carrying out any duty, responsibility, requirement, or action authorized under this Act, consult with the Federal regulatory agencies, any individual Federal regulatory agency, Treasury, any State banking regulator, any State insurance regulator, and any other State agency, as the Director necessary and appropriate. Coordination Required The Director shall, as appropriate, in carrying out any duty, responsibility, requirement, or action authorized under this Act, coordinate with the Federal regulatory agencies, any

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<tr><td></td><td></td><td>Act, coordinate with the Federal regulatory agencies, any individual Federal regulatory agency, Treasury, HUD, any State banking regulator, any State insurance regulator, any other State agency.

<u>Avoidance of Duplication</u>
To the fullest extent possible, the FMIC shall—
Avoid duplication of examination activities, reporting requirements, and requests for information;
Rely on examination reports made by other Federal or State regulatory agencies relating to an approved entity and its subsidiaries, if any; and
Ensure that approved entities are not subject to conflicting supervisory demands by the FMIC and other Federal regulatory agencies.
<u>Protection of Privileges</u>
Pursuant to these authorities to consult and coordinate, to facilitate the consultative process and coordination, the FMIC may share information with the Federal regulatory agencies, any individual Federal regulatory agency, Treasury, HUD, any State bank supervisor, any State insurance regulator, any other State agency, or any foreign banking authority, on a one-time, regular,</td><td><u>Permissible Consultation with Federal Banking Agencies</u>
Pursuant to its authority under § 103(c), to facilitate the consultive process, the NMFA may share information with the Federal banking agencies, or any individual Federal banking agency, or any State bank supervisor, or foreign banking authority, on a one-time, regular, or periodic basis as determined by the NMFA regarding the capital, asset and liabilities, financial condition, risk management practices or any other practice of the Issuer or any approved private mortgage insurer, servicer, bond guarantor, or other entity.
Information so shared by the NMFA shall not be construed as waiving, destroying, or otherwise affecting any privilege or confidential status that the Issuer or any approved private mortgage insurer, servicer, bond guarantor or any other person may claim with respect to such information under Federal or State law as to any person or entity other than such agencies, agency, supervisor, or authority.
No provision of this subsection may be construed as implying or establishing that—
Any person waives any privilege applicable to information that is</td><td>individual Federal regulatory agency, Treasury, any State banking regulator, any State insurance regulator, any other State agency.

<u>Avoidance of Duplication</u>
To the fullest extent possible, the Director shall—
Avoid duplication of examination activities, reporting requirements, and requests for information;
Rely on examination reports made by other Federal or State regulatory agencies relating to an approved entity and its subsidiaries, if any; and
Ensure that market participants and participating aggregators are not subject to conflicting supervisory demands by Ginnie Mae and other Federal regulatory agencies.
<u>Protection of Privileges</u>
Pursuant to the authorities to consult and coordinate, to facilitate the consultative process and coordination, the Director may share information with the Federal regulatory agencies, any individual Federal regulatory agency, Treasury, any State bank supervisor, any State insurance regulator, any other State agency, or any foreign banking authority, on a one-time, regular, or periodic basis, as determined</td></tr>
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		or periodic basis, as determined by the FMIC, regarding the capital assets and liabilities, financial condition, risk management practices, or any other practice of any market participant. • Information so shared by the FMIC shall not be construed as waiving, destroying, or otherwise affecting any privilege or confidential status that any market participant or any other person may claim with respect to such information under Federal or State law as to any person or entity other than such agencies, agency, supervisor, or authority. • No provision of this subsection may be construed as implying or establishing that— o Any person waives any privilege applicable to information that is shared or transferred under any circumstance to which this subsection does not apply; or o Any person would waive any privilege applicable to any information by submitting the information directly to the Federal regulatory agencies, any individual Federal regulatory agency, any State bank supervisor, any State insurance regulator, any other State agency, or any foreign banking authority, but for this subsection.	shared or transferred under any circumstance to which this subsection does not apply; or o Any person would waive any privilege applicable to any information by submitting the information directly to the Federal banking agencies, or any individual Federal banking agency, or any State bank supervisor, or foreign banking authority, but for this subsection.	by the Director, regarding the capital assets and liabilities, financial condition, risk management practices, or any other practice of any market participant or participating aggregator. • Information so shared by the Director shall not be construed as waiving, destroying, or otherwise affecting any privilege or confidential status that any market participant, participating aggregator, or any other person may claim with respect to such information under Federal or State law as to any person or entity other than such agencies, agency, supervisor, or authority. • No provision of this subsection (protection of privileges) may be construed as implying or establishing that— o Any person waives any privilege applicable to information that is shared or transferred under any circumstance to which this subsection does not apply; or o Any person would waive any privilege applicable to any information by submitting the information directly to the Federal regulatory agencies, any individual Federal regulatory agency, any State bank supervisor, any State insurance regulator, any other State agency, or

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		Federal Agency Authority Preserved Unless otherwise expressly provided by this section, no provision of this section shall limit or be construed to limit, in any way, the existing authority of any Federal agency.		any foreign banking authority, but for this subsection. Federal Agency Authority Preserved Unless otherwise expressly provided by this section, no provision of this section shall limit or be construed to limit, in any way, the existing authority of any Federal agency. Federal Regulatory Agency For purposes of this section, the term "Federal regulatory agency" means, individually, the Federal Reserve, OCC, FDIC, CFPB, NCUA, SEC, CFTC, and FHFA.
Eligible Mortgages and QM	**§ 408 Mortgages in Qualified Securities** TILA § 129C (15 U.S.C. 1639c) is amended by adding: "This section and any regulations promulgated under this section do not apply to a mortgage serving as collateral for a qualified security, as such term is defined under § 321 of the Protecting American Taxpayers and Homeowners Act of 2013." TILA § 129C contains the ability-to-repay rule, and prohibitions on: prepayment penalties on non-QM loans; financing single-premium credit insurance; mandatory arbitration in mortgages; and agreements to waive a cause of action relating to a mortgage.	**§ 336 Required Harmonization of Standards Within Eligible Mortgage Criteria** In General The FMIC shall consult and coordinate with the CFPB to ensure that the minimum standards issued by the FMIC with respect to eligible single-family mortgage loans pursuant to § 2(29) remain, to the greatest extent possible, substantially similar to rules promulgated by the Bureau pursuant to TILA § 129C(b) (QM) provided that any revisions to, or amendments of, such minimum standards issued by the FMIC— • Conform to all of the other requirements set forth under § 2(29); and • In the determination of the FMIC, do not negatively impact the MIF.		

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		Annual Report on any Changes or Differences in Rules The FMIC shall annually submit to the Chair and Ranking Member of the Senate Banking and House Financial Services Committees a report that— • Describes any such changes to the minimum standards; • Describes the economic analysis developed and used by the FMIC for any such changes to ensure such changes do not violate the duties of the FMIC to protect the MIF; and • Identifies any changes that occurred and differences that exist between the minimum standards developed, adopted, and maintained by the FMIC and the CFPB's QM rules.		
Rulewriting Authority		**§ 309 Authority to Issue Regulations** General Authority The FMIC may prescribe such regulations and issue such guidelines, orders, requirements, or standards, as necessary to carry out this Act, or any amendment made by this Act, and to ensure— • Competition among approved entities in the secondary mortgage market; • Liquidity in the secondary mortgage market and the forward execution market for single-family eligible mortgage loans and single-family covered securities, such		

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		as the TBA market; and • Mitigation of systemic risk in the secondary mortgage market. <u>Capital Standards</u> • For each type of covered entity the FMIC shall establish, by regulation, capital standards and related solvency standards necessary to implement the provisions of this Act. • The regulations required under this subsection shall define all such terms as are necessary to carry out the purposes of this subsection. In defining instruments and contracts that qualify as capital, the FMIC— ○ Shall include such instruments and contracts that will absorb losses before the MIF; and ○ May assign significance to those instruments and contracts based on the nature and risks of such instruments and contracts. • Solely for the purposes of calculating a capital ratio appropriate to the business model of the applicable entity, the FMIC shall consider for the denominator— ○ Total assets; ○ Total liabilities; ○ Risk in force; or ○ Unpaid principal balance. • The capital and related solvency		

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		standards established under this subsection shall be designed to— o Ensure the safety and soundness of a covered entity; o Minimize the risk of loss to the MIF; o In consultation and coordination with Federal Reserve, FDIC, OCC, and NCUA, reduce the potential for regulatory arbitrage between capital standards for covered entities and capital standards promulgated by Federal regulatory agencies for insured depository institutions and their affiliates; and o Be specifically tailored to accommodate a diverse range of business models that may be employed by covered entities. • To prevent or mitigate risks to the U.S. secondary mortgage market that could arise from the material financial distress or failure, or ongoing activities, of covered entities that are large approved aggregators and approved guarantors that engage in covered guarantee transactions, the FMIC, by regulation— o Shall establish supplemental capital requirements for covered entities that are large approved aggregators and approved guarantors; and o May establish such other standards for covered entities that are large approved aggregators and approved		

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		guarantors that the FMIC determines necessary or appropriate. <u>Market Share Limitation for Certain Large Entities</u> The FMIC shall establish, by regulation, market share limitations for large approved aggregators and approved guarantors that would take effect only in the event the FMIC has reason to believe the supplemental capital requirements and other standards are insufficient to prevent or mitigate risks to the U.S. secondary mortgage market that could arise from the material financial distress or failure, or ongoing activities, of such approved aggregators and approved guarantors. <u>Recognition of Distinctions Between Approved Entities and FHLBs</u> • Prior to promulgating any regulation or taking any other formal or informal action of general applicability and future effect relating to the FHLBs, including the issuance of an advisory document or examination guidance, the Chairperson, in consultation with the Office of FHLB Supervision, shall consider the differences between the FHLBs and the approved entities with respect to— ○ The FHLB— ▪ Cooperative ownership structure; ▪ Mission of providing liquidity to		

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		its members; ▪ Affordable housing and community development mission; ▪ Capital structure; and ▪ Joint and several liability; and ○ Any other differences that the FMIC considers appropriate. • The FMIC, in coordination with the Office of FHLB Supervision, shall establish capital standards, as required under§ 309(b), with respect to an FHLB, or subsidiary or joint office thereof, that is approved as an aggregator under § 312, that: ○ Are adequate to support the role of an FHLB as a covered entity, consistent with the safe and sound operations of the FHLB(s) involved; and ○ Do not adversely impact the traditional liquidity and advance business of the FHLB system or the marketability or creditworthiness of FHLB consolidated obligations. <u>Regulations Relating to Force-Placed Insurance</u> The FMIC shall, by regulation, set standards for the purchase of force-placed insurance by market participants. These standards shall not concern the regulation of the business of insurance or preempt any state law, regulation,		

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		or procedure concerning the regulation of the business of insurance. <u>Use and Protection of Personally Identifiable Information</u> • In collecting information from any person, in publicly releasing information held by the FMIC, or in requiring approved entities to publicly report information, the FMIC shall take steps to ensure that proprietary, personal, or confidential consumer information that is protected from public disclosure under the FOIA, the Privacy Act of 1974, or any other provision of law, is not made public. • With respect to the application of any provision of the Right to Financial Privacy Act of 1978 to a disclosure by an approved entity subject to this subsection, the approved entity shall be treated as if it were a financial institution, as defined in 12 U.S.C. § 3401. • Unless otherwise specified by this Act, any personally identifiable information obtained or maintained by the FMIC in connection with any supervision or enforcement authority or function, including the Office of General Counsel and FMIC OIG, may not be disclosed to any non supervisory or non enforcement office, division, or employee of the		

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		FMIC, or to any other Federal or State agency unless— ○ The information is necessary and appropriate for such office, division, or employee of the FMIC to comply with this Act, and the office, division, or employee cannot reasonably obtain the information through the normal course of business of such office, division, or employee; ○ The other Federal or State agency has satisfied any conditions of information ○ Sharing that the FMIC may establish, including treatment of personally identifiable information and sharing of information that shall conform to the standards for protection of the confidentiality of personally identifiable information and for data integrity and security that are applicable to Federal agencies; or ○ The records are relevant to a legitimate law enforcement inquiry, or intelligence or counterintelligence activity, investigation or analysis related to international terrorism within the jurisdiction of the receiving entity. • Any office created under § 207(a)(1)(B) [other offices the FMIC establishes as necessary and proper] shall develop		

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		standards regarding treatment and confidentiality of personally identifiable information and the collection and sharing of information that are tailored to the purpose or mission of the office; and obtain approval from the Chairperson of such standards prior to the operation of the office. <u>Consumer Privacy</u> The FMIC shall not obtain from an approved entity any personally identifiable financial information about a consumer from the financial records of the approved entity, except— • If the financial records are reasonably described in a request by the FMIC and the consumer provides written permission for the disclosure of such information by an approved entity to the FMIC; or • As may be specifically permitted or required under other applicable provisions of law and in accordance with the Right to Financial Privacy Act of 1978 (12 U.S.C. 3401 et seq.).		
Approval of Guarantors		**§ 310 Equivalency in Protection of the MIF** In order to protect the MIF and promote multiple sources of first loss positions, the FMIC shall seek to ensure equivalent loss absorption capacity between approved credit risk-sharing mechanisms pursuant to § 302 and capital standards for approved guarantors	**§ 223 Authority Related to Oversight of Bond Guarantors and Other Private Market Credit Risk Guarantors** <u>Standards for Approval</u> The NMFA shall develop, adopt, and publish standards for the approval by the NMFA of bond guarantors or private market participants	**§ 403 Approval and Supervision of Multifamily Guarantors** <u>In General</u> The Director shall develop, adopt, publish, and enforce standards for the approval by the Director of multifamily guarantors to— • Issue securities collateralized by eligible

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		pursuant to § 311. **Subtitle B—Approval and Supervision of Guarantors** **§ 311 Approval and Supervision of Guarantors** Standards for Approval of Guarantors The FMIC shall develop, adopt, and publish standards for the approval by the FMIC of guarantors to guarantee the timely payment of principal and interest on securities collateralized by eligible single-family mortgage loans and insured by the FMIC. The standards shall include— • The financial history and condition of the guarantor; • A requirement that the guarantor maintain capital levels as defined by the FMIC; • The capability of the guarantor's management; • The general character and fitness of the guarantor's officers and directors, including their compliance history with Federal and State laws and rules and regulations of self-regulatory organizations as defined in § 3(a)(26) of the Exchange Act as applicable; • The risk presented by the guarantor to the MIF; • The adequacy of insurance and fidelity coverage of the guarantor;	that will guarantee credit risk related to covered securities. Such standards shall cover any credit risk holder that will have a continuing obligation to the originator or Issuer. The standards shall include— • The financial history and condition of the guarantor; • Minimum capital levels adequate to ensure that the guarantor can meet any credit losses it guarantees; • The general character and fitness of the management of the guarantor, including compliance history with Federal and State laws; • The risk presented by the guarantor to the MIF; • The adequacy of insurance and fidelity coverage of the guarantor; • A requirement that the guarantor submit audited financial statements to the Director; • A requirement that the guarantor meet a minimum tangible threshold as the NMFA determines necessary; and • Any other standard the NMFA deems appropriate. Rule of Construction A covered security that a bond guarantor has insured or in which a bond guarantor or other private market entity has guaranteed credit risk shall be deemed to have satisfied the	multifamily mortgage loans; and • Guarantee the timely payment of principal and interest on such securities collateralized by eligible multifamily mortgage loans and insured by Ginnie Mae. Required Standards The standards shall include standards sufficient to ensure that— • Each multifamily guarantor is well-capitalized; and • Credit risk-sharing levels under any such guarantees are commensurate with such levels under the Delegated Underwriting and Servicing Lender Program and the Capital Market Execution Program Series K Structured 2Pass-Through Certificates originated and offered under the Program Plus Lender Program. Pricing Ginnie Mae shall charge a g-fee for guarantees provided pursuant to this section and such fee shall be determined by Ginnie Mae— • In the same manner and using the same procedures used pursuant to title II to determine g-fees for securities backed by single-family housing mortgages, with such changes as Ginnie Mae determines to be necessary to account for the

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		• The ability of the guarantor to—
		  ○ At the discretion of the guarantor, transfer investment risk and credit risk to private market holders in the single-family market in accordance with the credit risk-sharing mechanisms approved by the FMIC under § 302;
		  ○ Create mechanisms to guarantee multi-lender pools; and
		  ○ Ensure that eligible single-family mortgage loans that collateralize a single-family covered security insured under this title are originated in compliance with the requirements of this Act;
		• The capacity of the guarantor to take the first loss position;
		• That the guarantor has the capacity to guarantee eligible single-family mortgage loans in a manner that furthers the purposes of the FMIC described in § 201(b)(5) [FMIC purpose to credit and financing through business cycles], but this shall not be construed to prevent the FMIC from approving a small or specialty guarantor, provided that the guarantor has the capacity to adequately diversify its risk to meet appropriate safety and soundness concerns;
		• A requirement that the guarantor timely issue publicly available audited financials
			requirements for placement of credit risk under § 202, provided that it meets all requirements of the NMFA.
			
			<u>Application and Approval</u>
			• The NMFA shall establish an application process, in such form and manner and requiring such information as the NMFA may require, for the approval under this section of bond guarantors and private market entities that will guarantee credit risk.
			• If an insured depository institution seeks such approval, such institution may only submit its application via a separately capitalized affiliate or subsidiary.
			• The NMFA may approve any such application provided the bond guarantor or private market entity meets the required standards.
			• The NMFA shall—
			  ○ Publish in the Federal Register a list of newly approved bond guarantors and private market entities that will guarantee credit risk; and
			  ○ Maintain an updated list of approved bond guarantors and private market entities that will guarantee credit risk on the NMFA's website.
			
			<u>Review, Suspension, and Revocation of Approved Status</u>
				differences between the single-family guarantee business and the multifamily guarantee business; and
				• Taking into account the differences between the g-fees structures of the two GSEs.
				
				<u>Distinctions</u>
				The Director shall take into account, in carrying out this section, in providing any issuing platform, and in establishing any requirements relating to the guarantee of securities collateralized by eligible multifamily mortgage loans, the particular nature and characteristics of such securities and loans, as distinguished from eligible mortgages and securities guaranteed pursuant to title II, and as may be necessary to accommodate the multifamily housing financing market.

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		prepared in accordance with GAAP used in the industry;
		• That the guarantor is in compliance with § 210(a)(3) [required annual reports on underserved markets];
		• That the guarantor has substantial analytical capabilities to effectively manage credit risk;
		• That the guarantor does not originate eligible single-family mortgage loans and is not an affiliate of a person that actively engages in the business of originating eligible single-family mortgage loans; and
		• Any other standard the FMIC determines necessary to protect the MIF.
		To promote consistency and minimize regulatory conflict, the FMIC shall consult and coordinate with appropriate Federal and State regulators and officials when developing standards pursuant to this subsection.
		
		<u>Application and Approval</u>
		• The FMIC shall establish an application process, in such form and manner and requiring such information as the FMIC may require, for the approval of guarantors under this section. The FMIC shall establish internal timelines for its processing of applications, including timelines for any action to approve or to deny an application.
			• The NMFA may review the status of any approved bond guarantor or private market entities that will guarantee credit risk if the NMFA is notified of or becomes aware of any violation by the insurer of this Act or the rules promulgated pursuant to this Act.
			• If the NMFA determines, in such a review that an approved bond guarantor or private market entity that will guarantee credit risk no longer meets the standards for approval, the NMFA shall revoke the approved status of such guarantor or entity.
			• The revocation of the approved status of a bond guarantor or private market entity to guarantee credit risk shall have no effect on the status of any covered security.
			• The NMFA shall—
			  o Publish in the Federal Register a list of any approved bond guarantors or private market entities that will guarantee credit risk who lost their approved status; and
			  o Maintain an updated list of such guarantors and entities on the NMFA's website.
			
			<u>Appeals</u>
			• A bond guarantor or private market entity that will guarantee credit risk who submits an application to become	

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		• The FMIC may approve any guarantor application, provided the guarantor meets the applicable standards. • The FMIC shall have authority to deny any application if an officer or director of the guarantor has, at any time before approval been subject to a statutory disqualification pursuant to § 3(a)(39) of the Exchange Act or suspended, removed, or prohibited under FDIA § 8(g), prohibited pursuant to FDIA § 8(e)(6) or (7), subject to an action resulting in a written agreement or statement under FDIA § 8(u)(1), for which a violation may be enforced by an appropriate Federal banking agency, or subject to any final order issued under FDIA § 8. • The FMIC shall— o Provide prompt notice to a guarantor of the approval or denial of any application of the guarantor to become an approved guarantor under this section; o Publish a notice in the Federal Register upon approval of any guarantor; and o Maintain an updated list of approved guarantors on the FMIC's website. <u>Requirement to Maintain Approval Status</u> • If the FMIC determines that an approved guarantor no longer meets the standards	approved under this section may appeal a decision of the NMFA denying such application. • An approved bond guarantor or private market entity that will guarantee credit risk may appeal a decision of the NMFA suspending or revoking the approved status of such guarantor or entity. • Any bond guarantor or private market entity that will guarantee credit risk who files such an appeal shall file the appeal with the NMFA not later than 90 days after the date on which the person receives notice of the decision of the NMFA being appealed. • The NMFA shall make a final determination with respect to an appeal not later than 180 days after the date on which the appeal is filed. <u>Limitations on Approved Bond Guarantors or Other Private Market Credit Risk Guarantor</u> With respect to any eligible mortgage or covered security insured under this Act, an approved bond insurer or other private market credit insurer may not also provide insurance unless it meets such additional standards as the NMFA may specify.	

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		for such approval or violates the requirements under this Act, including any standards, regulations, or orders promulgated in accordance with this Act, the FMIC may— o Suspend or revoke the approved status of the approved guarantor; or o Take any other action with respect to such approved guarantor as may be authorized under this Act. • The suspension or revocation of the approved status of an approved guarantor shall have no effect on the status as a covered security of any covered security collateralized by eligible mortgage loans with which the approved guarantor contracted before the suspension or revocation. • The FMIC shall— o Promptly publish a notice in the Federal Register upon suspension or revocation of the approval of any approved guarantor; and o Maintain an updated list of such approved guarantors on the website of the FMIC. • In this subsection, the term "violate" includes any action, taken alone or with others, for or toward causing, bringing about, participating in, counseling, or aiding or abetting, a violation of the requirements under this Act.		

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		Prudential Standards for Supervision
		The FMIC shall prescribe prudential standards for approved guarantors in order to—
		• Ensure—
		  o The safety and soundness of approved guarantors; and
		  o The maintenance of approval standards by approved guarantors; and
		• Minimize the risk presented to the MIF.
		
		Reports and Examinations
		For purposes of determining whether an approved guarantor is fulfilling the requirements under this Act, the FMIC shall have the authority to require reports from and examine approved guarantors, in the same manner and to the same extent as the FDIC has with respect to insured depository institutions under FDIA § 9.
		
		Enforcement
		The FMIC shall have the authority to enforce the provisions of this Act with respect to approved guarantors, in the same manner and to the same extent as the FDIC has with respect to insured depository institutions under 12 U.S.C. 1818(b) through (n).
		
		Capital Standards
		• Pursuant to the requirement to establish		

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		capital and related solvency standards under § 309(b), the FMIC shall establish standards for approved guarantors that require an approved guarantor— o To hold 10 percent capital; and o To maintain solvency levels adequate for the approved guarantor to withstand losses that might be incurred by the approved guarantor in a period of economic stress, including national and regional home price declines, such as those observed during moderate to severe recessions in the U.S. For these purposes, the FMIC shall consider the extent, amount, and form of risk-sharing and risk mitigation through the use by approved guarantors of credit risk-sharing mechanisms approved pursuant to § 302(b)(4). The FMIC shall allow such risk-sharing and risk mitigation to fulfill required amounts of capital such that it ensures an equivalent amount of loss absorption capacity as required under § 302(a)(1)(B) while maintaining an appropriate structure of capital as determined by the FMIC. • The FMIC shall conduct appropriate stress tests of approved guarantors that have total assets of more than $10,000,000,000, provided that such		

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		stress tests shall be— o Specifically tailored to the business model of the approved guarantor; o Utilized to— ▪ Ensure the safety and soundness of the approved guarantor; and ▪ Minimize the risk the approved guarantor may present to the MIF; and o Coordinated with the Federal Reserve, if the approved guarantor is an affiliate of an insured depository institution. <u>Resolution Authority for Failing Guarantors</u> • Notwithstanding any other provision of Federal law, the law of any State, or the constitution of any State, the FMIC shall— o Have the authority to act, in the same manner and to the same extent, with respect to an approved guarantor, as the FDIC has with respect to insured depository institutions under 12 U.S.C. §§ 1821(c) through (s), 1822, and 1823 [conservatorship and receivership authority], while tailoring such actions to the specific business model of the approved guarantor, as may be necessary to properly exercise such authority under this subsection; o In carrying out any such authority,		

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		act, in the same manner and to the same extent, with respect to the MIF as the FDIC may act with respect to the Deposit Insurance Fund under such FDIA authorities; o Prescribe regulations governing the applicable rights, duties, and obligations of an approved guarantor placed into resolution under this subsection, its creditors, counterparties, and other persons, as the FMIC deems necessary to properly exercise such receivership and conservatorship authority; o Consistent with such FDIA authorities provided to the FMIC, immediately place an insolvent approved guarantor into receivership; and o Upon placing an approved guarantor into receivership, treat single-family covered securities insured under § 303 in the same manner as the FDIC treats deposit liabilities under FDIA § 11(d)(11)(A)(ii) and insured deposits under FDIA § 11(f), where the FMIC has the same right of subrogation as the FDIC has under FDIA § 11(g). • The FMIC may not exercise any such authority with respect to any approved guarantor unless the total amount of the expenditures by the FMIC and obligations		

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		incurred by the FMIC in connection with the exercise of any such authority with respect to such approved guarantor is the least costly to the MIF, consistent with the least cost approach specified in the FDIA (12 U.S.C. 1811 et seq.), of all possible methods for meeting the FMIC's obligations under this Act and expeditiously concluding its resolution activities, subject to FDIA § 13, where the FMIC and Board of Directors have the same authority as the FDIC and the FDIC's board. • The FMIC, in carrying out any authority provided in this subsection, shall prescribe regulations to ensure that any amounts owed to the U.S., unless the U.S. agrees or consents otherwise, shall have priority following administrative expenses of the receiver when satisfying unsecured claims against an approved guarantor, or the receiver therefor, that are proven to the satisfaction of the receiver. <u>Hearing</u> Upon notice of denial of an application for approval or upon a notice of suspension or revocation of the approved status of an approved guarantor, the applicant or approved guarantor shall be afforded a hearing under 12 U.S.C. 1818(h), in the same manner and to the same extent as if the FMIC were the		

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		appropriate Federal banking agency, provided that the approved guarantor submits a request to the FMIC for a hearing not later than 10 days after the date on which the notice is published. <u>Permission to Carry Out Other Activities</u> Nothing in this Act prohibits an approved guarantor from being an affiliate of an approved aggregator, provided that each aggregator and each guarantor, independent of each other, meets the approval standards established by the FMIC under this title. <u>Provision of Pool Level Insurance</u> Subject to such standards as the FMIC may provide, an approved guarantor may provide insurance or other credit enhancement on a pool of eligible single-family mortgage loans collateralizing a single-family covered security insured under this title. <u>Prohibited Activity</u> An approved guarantor may not— • Originate eligible single-family mortgage loans; or • Be an affiliate of a person that actively engages in the business of originating eligible single-family mortgage loans. <u>Guarantors Required to Pay Claims</u> Subject to such standards as the FMIC may		

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		provide, an approved guarantor may not for any reason withhold payment of funds that would ensure holders of single-family covered securities receive timely payment of principal and interest on single-family covered securities. The FMIC shall by regulation develop a process for the mediation and resolution of disputed payment amounts.		

Approval of Aggregators, or Originators and Aggregators	**§ 322(f) Standards for Aggregators**
	The Utility may develop, adopt, and publish standards for aggregation of eligible collateral by entities, institutions, or companies other than an issuer. Notwithstanding any such standards developed by the Utility, any FHLB may act as an aggregator and offer the service of aggregation to any member of such FHLB, subject to regulations prescribed by the Director.
		§ 312 Approval and Supervision of Aggregators
		<u>Standards for Approval of Mortgage Aggregators</u>
		• The FMIC shall develop, adopt, and publish standards for the approval by the FMIC of mortgage aggregators to deliver eligible single-family mortgage loans to the Securitization Platform for securitization by such aggregator as a single-family covered security.
		• The standards shall include standards with respect to the ability of mortgage aggregator to—
		  o Aggregate eligible single-family mortgage loans into pools, including multi-lender pools, as appropriate;
		  o Transfer investment risk and credit risk to private market participants in accordance with the credit risk-sharing mechanisms approved by the FMIC under§ 302;
		  o Ensure equitable access to the secondary mortgage market for
				§ 103 Regulation of Market Participants and Aggregators
				<u>Approval Authority</u>
				The Platform [created in § 201] shall be available for use only by originators and aggregators of mortgages who meet standards for eligibility for such use, as shall be established by the Ginnie Mae Director (in this section referred to as the "Director").
				
				<u>General Supervisory and Regulatory Authority</u>
				Pursuant to such authority:
				• All market participants and participating aggregators shall, to the extent provided in this section, be subject to the supervision and regulation of the Director.
				• Ginnie Mae shall have general regulatory authority over each market participant and participating aggregator and shall exercise such general regulatory authority to ensure that the purposes of this section are carried out.

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		single-family covered securities for all institutions regardless of size or geographic location; and ○ Ensure that eligible single-family mortgage loans that collateralize a single-family covered security insured under this title are originated in compliance with the requirements of this Act. • The standards shall also include— ○ The financial history and condition of the mortgage aggregator; ○ The adequacy of the capital structure of the mortgage aggregator; ○ The capability of the mortgage aggregator's management; ○ The general character and fitness of the mortgage aggregator's officers and directors, including their compliance history with Federal and State laws and rules and regulations of self-regulatory organizations as defined in § 3(a)(26) of the Exchange Act as applicable; ○ The risk presented by the mortgage aggregator to the MIF; ○ The adequacy of insurance and fidelity coverage of the mortgage aggregator; ○ A requirement that the mortgage aggregator submit audited financial statements to the FMIC; ○ That the mortgage aggregator has the		<u>Principal Duties</u> Among the principal duties of the Director shall be— • To oversee the prudential operations of each market participant and participating aggregator; and • To ensure that— ○ Each market participant and participating aggregator operates in a safe and sound manner, including maintenance of adequate capital and internal controls; and ○ Each market participant and participating aggregator complies with this section and the rules, regulations, guidelines, and orders issued under this section. <u>Prudential Management and Operations Standards</u> • The Director shall establish prudential standards, by regulation or guideline, for market participants and participating aggregators to— ○ Ensure— ▪ The safety and soundness of market participants and participating aggregators; and ▪ The maintenance of approval standards by market participants and participating aggregators;

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		capacity to aggregate mortgage loans in a manner that furthers purposes of the FMIC described in section § 201(b)(5). This shall not be construed to prevent the FMIC from approving a small or specialty mortgage aggregator, provided that the mortgage aggregator has the capacity to adequately diversify its risk to meet appropriate safety and soundness concerns; o That the mortgage aggregator is in compliance with § 210(a)(3); and o Any other standard the FMIC determines necessary to protect the MIF. To promote consistency and minimize regulatory conflict, the FMIC shall consult and coordinate with appropriate Federal and State regulators and officials when developing standards pursuant to this subsection. <u>Application and Approval</u> • The FMIC shall establish an application process, in such form and manner and requiring such information as the FMIC may require, for the approval of mortgage aggregators under this section. • The FMIC shall establish internal timelines for its processing of applications under this section, including timelines for any action to approve or to		and o Minimize the risk presented to the Fund. • In establishing such prudential standards, the Director shall distinguish between prudential standards for market participants and such standards for participating aggregators. <u>Authority to Require Reports</u> • The Director may require, by general or specific orders, a market participant or participating aggregator to submit regular reports, including financial statements determined on a fair value basis, on the condition (including financial condition), management, activities, or operations of the market participant or participating aggregator, as the Director considers appropriate. • The Director may require, by general or specific orders, a market participant or participating aggregator to submit special reports on any of these topics or any other relevant topics, if, in the judgment of the Director, such reports are necessary to carry out the purposes of this Act. <u>Examinations and Audits</u> The Director may conduct such examinations and audits, including on-site examinations and audits, of market participants and participating

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		deny an application under this section. • The FMIC may approve any application, provided the mortgage aggregator meets the applicable standards. • The FMIC shall have authority to deny any application if an officer or director of the mortgage aggregator has, at any time before approval been subject to a statutory disqualification pursuant to § 3(a)(39) of the Exchange Act or suspended, removed, or prohibited under FDIA § 8(g), prohibited pursuant to FDIA § 8(e)(6) or (7), subject to an action resulting in a written agreement or statement under FDIA § 8(u)(1), for which a violation may be enforced by an appropriate Federal banking agency, or subject to any final order issued under FDIA § 8. • The FMIC shall— o Provide prompt notice to a mortgage aggregator of the approval or denial of any application of the mortgage aggregator to become an approved aggregator under this section; o Publish a notice in the Federal Register upon approval of any mortgage aggregator; and o Maintain an updated list of approved aggregators on the website of the FMIC.		aggregators as the Director considers appropriate to ensure compliance with this Act, to determine the condition of market participants and participating aggregators for the purpose of determining and ensuring their financial safety and soundness, and otherwise in any case that the Director determines an examination is necessary or appropriate. <u>Conflict of Interest Standards</u> The Director shall establish standards, by regulation or guideline, for market participants and participating aggregators as the Director considers appropriate to avoid any conflicts of interest among market participants. <u>Capital Stress Tests</u> The Director, in consultation with the Federal Reserve, shall— • Establish and carry out such risk-based capital tests as appropriate to evaluate whether each market participant and participating aggregator is maintaining a level of capital sufficient to absorb losses and support operations during adverse economic conditions so that they do not pose undue risks to their communities, other institutions, or the broader economy; and • Establish capital standards for market participants and participating aggregators based on such tests, which shall include

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		Requirement to Maintain Approval Status
		• If the FMIC determines that an approved aggregator no longer meets the standards for such approval or violates the requirements under this Act, including any standards, regulations, or orders promulgated in accordance with this Act, the FMIC may—
		  ○ Suspend or revoke the approved status of the approved aggregator; or
		  ○ Take any other action with respect to such approved aggregator as may be authorized under this Act.
		• The suspension or revocation of the approved status of an approved aggregator shall have no effect on the status as a covered security of any covered security collateralized by eligible mortgage loans with which the approved aggregator contracted before the suspension or revocation.
		• The FMIC shall—
		  ○ Promptly publish a notice in the Federal Register upon suspension or revocation of the approval of any approved aggregator; and
		  ○ Maintain an updated list of such approved aggregators on the FMIC's website.
		• In this subsection, the term "violate" includes any action, taken alone or with others, for or toward causing, bringing
				the following classifications: well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized.
				
				Enforcement
				The Corporation shall have the authority to enforce the provisions of this Act with respect to market participants and participating aggregators, in the same manner and to the same extent as the FDIC has with respect to insured depository institutions under the provisions of FDIA § 8(b) through (n).
				
				Requirement to Maintain Approved Status
				• If the Director determines that a market participant or a participating aggregator under this section no longer meets the standards for such approval or violates the requirements under this Act, including any standards, regulations, or orders promulgated in accordance with this Act, the Director may—
				  ○ Suspend or revoke the status of the market participant or participating aggregator as approved to utilize the Platform; or
				  ○ Take any other action with respect to such market participant or a participating aggregator as may be authorized under this Act.

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		about, participating in, counseling, or aiding or abetting, a violation of the requirements under this Act.
		
		<u>Prudential Standards for Supervision</u>
		• Subject to the requirement below for the FMIC to consult with regulators for approval standards for depositories, the FMIC shall prescribe prudential standards for approved aggregators in order to—
		  ○ Ensure—
		    ▪ The safety and soundness of approved aggregators; and
		    ▪ The maintenance of approval standards by approved aggregators; and
		  ○ Minimize the risk presented to the MIF.
		• In prescribing such prudential standards, the FMIC shall—
		  ○ Distinguish between prudential standards for approved aggregators that are insured depository institutions, approved aggregators that are affiliates of insured depository institutions, and approved aggregators that are neither insured depository institutions nor affiliates of insured depository institutions; and
		  ○ Consult and coordinate with Federal and State banking agencies when
				• The suspension or revocation of the approved status of a market participant or a participating aggregator under this section shall have no effect on the status as an insured security of any security collateralized by eligible mortgages and insured prior to the suspension or revocation.
				• The Director shall—
				  ○ Promptly publish a notice in the Federal Register upon suspension or revocation of the approval of any market participant or a participating aggregator; and
				  ○ Maintain an updated list of such approved market participants and participating aggregators on the website of Ginnie Mae.
				• In this subsection, the term *violate* includes any action, taken alone or with others, for or toward causing, bringing about, participating in, counseling, or aiding or abetting, a violation of the requirements under this Act.
				
				<u>Resolution Authority</u>
				• Notwithstanding any other provision of Federal law, the law of any State, or the constitution of any State, the Director shall—
				  ○ Have the authority to act, in the same manner and to the same extent, with

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		establishing prudential standards for approved aggregators that either are insured depository institutions or affiliates of insured depository institutions, to minimize duplication and conflicts with the prudential standards set by the appropriate Federal or State banking agencies of insured depository institutions or the affiliates of insured depository institutions. • Nothing in this section shall supersede the prudential standards established by the appropriate Federal banking agency. <u>Reports and Examinations</u> For purposes of gathering information to determine whether an approved aggregator is fulfilling the requirements under this Act, the FMIC shall have the authority to require reports from and examine approved aggregators as follows: • For approved aggregators that are neither an insured depository institution nor an affiliate of an insured depository institution, the FMIC shall have the authority to require reports from and examine approved aggregators, in the same manner and to the same extent as the FDIC has with respect to insured depository institutions under FDIA § 9(a). • For approved aggregators that are an		respect to a market participant or participating aggregator that the Director determines is classified as critically undercapitalized, as the FDIC has with respect to insured depository institutions under FDIA §§ 11(c) through (s), 12, and 13, while tailoring such actions to the specific business model of the market participant or participating aggregator, as the case may be, as may be necessary to properly exercise such authority under this subsection; ○ In carrying out such authority with respect to a critically undercapitalized market participant or participating aggregator, act, in the same manner and to the same extent, with respect to the Fund as the FDIC may act with respect to the Deposit Insurance Fund under FDIA §§ 11(c) through (s), 12, and 13; and ○ Consistent with FDIA §§ 11(c) through (s), 12, and 13, immediately place an insolvent market participant or participating aggregator into receivership. • Notwithstanding such resolution authority, if an insolvent participating aggregator is an insured depository institution or an affiliate of an insured depository institution, the Director shall

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		insured depository institution or an affiliate of an insured depository institutions: ○ To the fullest extent possible, the FMIC shall— ▪ Rely on the examinations, inspections, and reports of the appropriate Federal or State regulatory agencies; ▪ Avoid duplication of examination activities, reporting requirements, and requests for information; and ▪ Ensure that the depository institution holding company and the subsidiaries of the depository institution holding company are not subject to conflicting supervisory demands by the FMIC and appropriate Federal and State banking agencies. ○ If the FMIC determines that the examinations, inspections, and reports obtained from other regulators are insufficient for the FMIC to adequately supervise approved aggregators, for compliance with this Act, the FMIC shall have the authority to require reports from and examine approved aggregators, in the same manner and to the same extent as the Federal Reserve has with respect to		recommend, in writing, to such participating aggregator's appropriate Federal banking agency or State banking regulator to resolve such participating aggregator pursuant to FDIA § 11(c) and other appropriate FDIA sections or appropriate Federal or State law, as applicable. • The Director may not exercise any resolution authority with respect to any market participant or any participating aggregator that is not an insured depository institution or an affiliate of an insured depository institution, unless— ○ The Director determines that the exercise of such authority is necessary to ensure proper and continued functioning of the secondary mortgage market; and ○ The total amount of the expenditures by the Director and obligations incurred by the Director in connection with the exercise of any such authority with respect to such market participant or participating aggregator is the least costly to the Fund, consistent with the least cost approach specified in the FDIA, of all possible methods for meeting Ginnie Mae's obligations under this Act and expeditiously concluding its resolution activities.

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		subsidiaries of bank holding companies institutions under 12 U.S.C. § 1844(c)(1) and (2). ○ Before commencing an examination of an approved aggregator, the FMIC shall provide reasonable notice to, and coordinate with, the appropriate Federal banking agency or State regulatory agency. ○ Nothing in this Act shall limit the authority of the FMIC to require reports of and examine an approved aggregator— ▪ To verify the sale of, and funds received, from the first loss position; and ▪ When the FMIC becomes aware— ♦ Of a material threat to the safety and soundness of the approved aggregator; ♦ That the approved aggregator is in material violation of this Act or FMIC rules; or ♦ That the activities of the approved aggregator threaten the financial stability of the housing finance system or the MIF. <u>Enforcement</u>		• The Director, in carrying out any resolution authority, shall ensure that any amounts owed to the U.S., unless the U.S. agrees or consents otherwise, shall have priority following administrative expenses of the receiver when satisfying unsecured claims against a market participant or participating aggregator, or the receiver therefor, that are proven to the satisfaction of the receiver.

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		The FMIC shall have the authority to enforce the provisions of this Act with respect to approved aggregators, in the same manner and to the same extent as the FDIC has with respect to insured depository institutions under FDIA § 8(b) through (n), provided that to the extent that the FMIC and an appropriate Federal banking agency are each authorized to enforce prudential standards with respect to an approved aggregator that is an insured depository institution or an affiliate of an insured depository institution, the appropriate Federal banking agency shall have primary authority to enforce such standards. <u>Capital Standards</u> For approved aggregators that are neither an insured depository institution nor an affiliate of an insured depository institution: • Pursuant to the requirement to establish capital and related solvency standards under § 309(b), the FMIC shall establish standards for approved aggregators that require an approved aggregator— ○ To hold capital in an amount comparable to that which is required to be held by insured depository institutions and their affiliates with respect to their applicable aggregating activities; and ○ To maintain solvency levels adequate for the approved aggregator to withstand losses that might be		

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		incurred by the approved aggregator in a period of economic stress, including national and regional home price declines, such as those observed during moderate to severe recessions in the U.S.
		• The FMIC shall conduct appropriate stress tests of such approved aggregators that have total assets of more than $10,000,000,000, provided that such stress tests shall be—
		  ○ Specifically tailored to the business model of the approved aggregator; and
		  ○ Utilized to—
		    ▪ Ensure the safety and soundness of the approved aggregator; and
		    ▪ Minimize the risk the approved aggregator may present to the MIF.
		
		<u>Resolution Authority for Failing Aggregators</u>
		• Notwithstanding any other provision of Federal law, the law of any State, or the constitution of any State, the FMIC shall—
		  ○ Have the authority to act, in the same manner and to the same extent, with respect to an approved aggregator that is not an insured depository institution as the FDIC with respect to insured depository institutions		

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		under 12 U.S.C. §§ 1821(c) through (s), 1822, and 1823 [conservatorship and receivership authority], while tailoring such actions to the specific business model of the approved aggregator, as may be necessary to properly exercise such authority under this subsection; ○ In carrying out any such authority, act, in the same manner and to the same extent, with respect to the MIF as the FDIC may act with respect to the Deposit Insurance Fund under such FDIA authorities; ○ Prescribe regulations governing the applicable rights, duties, and obligations of an approved aggregator that is not an insured depository institution placed into resolution under this subsection, its creditors, counterparties, and other persons, as the FMIC deems necessary to properly exercise its conservatorship and receivership authorities; and ○ Consistent with such FDIA authorities provided to the FMIC immediately place an insolvent approved aggregator that is not an insured depository institution into receivership. • If an insolvent approved aggregator is an insured depository institution, the FMIC		

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		shall recommend, in writing, to such approved aggregator's appropriate Federal banking agency or State banking regulator to resolve such approved aggregator, which agency shall have sole authority to resolve such aggregator pursuant to FDIA § 11(c) or appropriate Federal or State law, as applicable. • The FMIC may not exercise any resolution authority with respect to any approved aggregator that is not an insured depository institution or an affiliate of an insured depository institution unless the total amount of the expenditures by the FMIC and obligations incurred by the FMIC in connection with the exercise of any such authority with respect to such approved aggregator is the least costly to the MIF, consistent with the least cost approach specified in the FDIA, of all possible methods for meeting the FMIC's obligations under this Act and expeditiously concluding its resolution activities, subject to FDIA § 13 where the FMIC and Board of Directors shall have the same authority as the FDIC and its board. • The FMIC, in carrying out any authority provided in this subsection, shall prescribe regulations to ensure that any amounts owed to the U.S., unless the U.S. agrees or consents otherwise, shall have		

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		priority following administrative expenses of the receiver when satisfying unsecured claims against an approved aggregator, or the receiver therefor, that are proven to the satisfaction of the receiver. <u>Hearing</u> Upon notice of denial of an application for approval or upon a notice of suspension or revocation of the approved status of an approved aggregator, the applicant or approved aggregator shall be afforded a hearing under FDIA § 8(h), in the same manner and to the same extent as if the FMIC were the appropriate Federal banking agency, provided that the approved aggregator submits a request for a hearing not later than 10 days after the date on which the notice is published. <u>Permission to Carry Out Other Activities</u> Nothing in this Act prohibits an approved aggregator from being an affiliate of an approved guarantor, if each aggregator and each guarantor, independent of each other, meets the approval standards established by the FMIC under this title. <u>Information Sharing Regarding Insured Depositories and Their Affiliates</u> • To the extent the FMIC has relevant information indicating that an approved aggregator that is an insured depository or		

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		an affiliate of an insured depository: o Faces a material threat to its safety and soundness, including insufficient capital, o May be in material violation of Federal banking law, or o May threaten the financial stability of the housing finance system or the MIF, the FMIC shall notify, in writing, such appropriate Federal banking agency that such conditions exist. The FMIC shall have no authority to enforce prudential standards established by an appropriate Federal banking agency pursuant to the appropriate Federal banking agency's authority. • To the extent an appropriate Federal banking agency or State banking agency has relevant information indicating that an approved aggregator that is an insured depository institution or an affiliate of an insured depository institution o Faces a material threat to its safety and soundness, including insufficient capital, o May be in material violation of this Act or FMIC rules, or o May threaten the financial stability of the housing finance system or the MIF, such appropriate Federal banking agency or State banking agency shall notify, in		

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		writing, the FMIC that such conditions exist. <u>Rule of Construction Regarding Preservation of FMIC Authority</u> Nothing in this section limits, or shall be construed to limit, the authority of the FMIC to provide exemptions to, or adjustments for, the provisions of this section based on the asset size of approved aggregators, or other criteria, as the FMIC deems appropriate, in order to reduce regulatory burdens while appropriately balancing protection of the MIF. <u>FHLBs, Joint Offices, and Bank Subsidiaries as Aggregators</u> • Section 12 of the FHLB Act (12 U.S.C. 1432) is amended, effective on the system certification date, by adding at the end: "(c) Subject to such regulations as may be prescribed by the Agency, in coordination with the Federal Mortgage Insurance Corporation, 1 or more Federal Home Loan Banks may establish a subsidiary or joint office in any form under the laws of any state, subject to approval of the Corporation. Any subsidiary or joint office established under this subsection shall be restricted to engaging in activities related to being an approved aggregator, as that term is defined under section 2 of Housing Finance Reform and Taxpayer Protection Act of 2014.		

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		"(d) Subject to such regulations as may be prescribed by the Agency, in coordination with the Federal Mortgage Insurance Corporation, 1 or more Federal Home Loan Banks or any subsidiary or joint office of a Federal Home Loan Bank established under subsection (c) may apply to become, and may become, an approved aggregator, as that term is defined under section 2 of the Housing Finance Reform and Taxpayer Protection Act of 2014." • Section 10(a) of the FHLB is amended, effective on the agency transfer date— ○ In paragraph (2)(B), by adding that long-term advances made be made for the purpose of CDFIs (even if not for small businesses, small farms, small agri-businesses, and community development activities, as under current law). ○ In paragraph (3)(E), by adding the bold text below, that advances may be secured by "Secured loans for small business, agriculture, or community development activities or securities representing a whole interest in such secured loans, in the case of any community financial institution **or community development financial institution"** and it would define CDFI the same as in § 103 of the Riegle Community		

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		Development and Regulatory Improvement Act (12 U.S.C. § 4702). • Notwithstanding FHLB Act § 11, and covered security secured by eligible mortgage loans transferred to the Platform by an FHLB or subsidiary or joint office thereof, acting as an approved aggregator, shall not be designated as, or considered to be the joint and several obligations of the FHLBs.		
Standards for Qualified Issuers	**§ 322(g) Standards for Qualified Issuers** <u>Standards for Qualified Issuers</u> • The Utility shall develop, adopt, and publish standards for an issuer to qualify as a qualified issuer. Such standards shall only include— ○ The experience, financial resources, and integrity of the issuer and its principals, including compliance history with Federal and State laws; ○ The adequacy of insurance and fidelity coverage of the issuer with respect to errors and omissions; and ○ A requirement that the issuer submit audited financial statements to the Utility, who shall make such statements publicly available through its website. • The Utility shall establish an application process for the qualification of issuers, in such form and manner and requiring such			

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	information as the Utility may prescribe, in accordance with such standards. o The Utility shall approve any application unless the issuer does not meet the adopted standards. o The Agency shall publish a list of newly qualified issuers in the Federal Register and the Utility shall maintain an updated list of qualified issuers on its Web site. • The Utility may review the status of a qualified issuer if the Utility is notified that a claim has been made against the issuer by a trustee with respect to a violation of a contractual term in a securitization document of the issuer. o If the Utility determines, subject to the approval of the Director, in such a review, that an issuer no longer meets the standards for qualification, the Utility shall revoke the issuer's qualified status. The revocation of an issuer's qualified status shall— ▪ Have no effect on the qualified status of any security issued before such revocation; and ▪ Not relieve the issuer of any obligation associated with any representation or warranty or any repurchase obligations related to any qualified security issued before such revocation. o The Utility shall establish standards			

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	by which a qualified issuer who no longer meets the standards for qualification may remediate and return to meeting the standards, without losing the issuer's qualified status. o The Agency shall publish a list of issuers who are no longer qualified in the Federal Register and the Utility shall maintain an updated list of such issuers on its Web site.			
Standards for Trustees	**§ 322(h) Standards for Trustees** • There shall at all times be one or more trustee for each pool of mortgages that acts as collateral for a qualified security. • The Director shall issue regulations regarding the qualifications of trustees that shall, to the extent practicable, be consistent with the qualification provisions applicable to trustees under section 310(a) of the Trust Indenture Act of 1934 (15 U.S.C. 77jjj(a)). • The Director shall issue conflict of interest regulations that apply to a qualified trustee. Such regulations shall, to the extent practicable, be consistent with those conflict of interest provisions applicable to an indenture trustee under section 310(b) of the Trust Indenture Act of 1934 (15 U.S.C. 77jjj(b)). • Any time a trustee brings a claim against a qualified issuer on behalf of investors			

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	with respect to a standard form securitization agreement, the trustee shall notify the Director of such claim.
	• For the purpose of protecting investor rights, each trustee shall—
	  o Maintain a list of all investors (beneficial owners) in a qualified security;
	  o Update such list from time to time;
	  o Not make such list available to investors (beneficial owners); and
	  o Act as a means to communicate information about the qualified security to investors (beneficial owners) and act as a means for investors (beneficial owners) to communicate with each other.
	• A trustee shall not be liable for the content of any information provided to the trustee by an investor (beneficial owner) that the trustee communicates to another investor (beneficial owner).
	• A person who becomes an investor (beneficial owner) in a qualified security shall promptly notify the trustee of such security of the change in ownership.			

Approval of PMIs		**§ 313 Approval of PMIs** <u>Approval Standards</u> The FMIC shall develop, adopt, and publish standards for its approval of private mortgage insurers to provide private mortgage loan insurance on eligible single-family mortgages	**§ 221 Approval of PMIs** <u>Standards for Approval of Private Mortgage Insurers</u> The NMFA shall develop, adopt, and publish standards for the approval by the NMFA of private mortgage insurers to provide private	

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		that collateralize single-family covered securities. The standards shall include— • The financial history and current financial condition, including capital and loss reserves to comply with any applicable State law or regulation, of the insurer; • The capability of the insurer's management; • The general character and fitness of the insurer's officers and directors, including their compliance history with Federal and State laws and rules and regulations of self-regulatory organizations as defined in § 3(a)(26) of the Exchange Act as applicable; • That the insurer has the capacity to insure eligible single-family mortgage loans in a manner to comply with any applicable State law or regulation that furthers the purposes of the FMIC to facilitate the broad availability of mortgage credit and secondary mortgage market financing through fluctuations in the business cycle for eligible single-family and multifamily lending across all regions, localities, institutions, property types including rental, and eligible borrowers. This shall not be construed to prevent the FMIC from approving a small or specialty private mortgage insurer, provided that the private insurer has the capacity to adequately diversify its risk to meet	mortgage insurance on eligible mortgages. The required standards shall include— • The financial history and condition of the insurer; • The adequacy of the insurer's capital structure, including whether the insurer has sufficient capital to cover the first loss insurance obligations it assumes under this Act and that might be incurred in a period of economic stress, including, but not limited to, any period of economic stress that would result in a 30% (or greater) national home price decline; • The general character and fitness of the management of the insurer, including compliance history with Federal and State laws; • The risk presented by such insurer to the MIF; • The adequacy of insurance and fidelity coverage of the insurer; • A requirement that the insurer submit audited financial statements to the Director; and • Any other standard the NMFA determines necessary or appropriate. <u>Application and Approval</u> • The NMFA shall establish an application process, in such form and manner and requiring such information as the NMFA may require, for the approval of private	

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		solvency standards required by any applicable State law or regulation. • The risk presented by such insurer to the MIF; • The adequacy of insurance and fidelity coverage of the insurer; • A requirement that the insurer submit audited financial statements to the FMIC; and • Any other standard the FMIC, after notice and comment, determines necessary to avoid significant risk to the MIF, provided the standard does not materially conflict with State law. To promote consistency and minimize regulatory conflict, the FMIC shall consult and coordinate with appropriate Federal regulators and State regulators and officials when developing these standards. <u>Application and Approval</u> • The FMIC shall establish an application process, in such form and manner and requiring such information as the FMIC may require, for the approval of private mortgage insurers under this section. The FMIC shall establish internal timelines for its processing of applications, including timelines for any action to approve or to deny an application. • The FMIC shall notify the appropriate State insurance regulator upon receipt of	mortgage insurers under this section. • The NMFA may approve any application provided the private mortgage insurer meets the required standards. • The NMFA shall— ○ Publish in the Federal Register a list of newly approved private mortgage insurers; and ○ Maintain an updated list of approved private mortgage insurers on its website. <u>Review, Suspension, and Revocation of Approved Status</u> • The NMFA may review the status of any approved private mortgage insurer if the NMFA is notified of or becomes aware of any violation by the insurer of this Act or the rules promulgated pursuant to this Act. • If the NMFA determines, in such a review, that an approved private mortgage insurer no longer meets the standards for approval, the NMFA may suspend or revoke the approved status of such insurer. • The suspension or revocation of an approved private mortgage insurer's approved status shall have no effect on the status of any covered security or on previously contracted insurance written by such private mortgage insurer.	

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		any application of by a private mortgage insurer to become an approved private mortgage insurer. • The FMIC may approve any such application if the insurer meets the adopted standards. • The FMIC shall have authority to deny any application if an officer or director of the insurer has, at any time before approval been subject to a statutory disqualification pursuant to § 3(a)(39) of the Exchange Act or suspended, removed, or prohibited under FDIA § 8(g), prohibited pursuant to FDIA § 8(e)(6) or (7), subject to an action resulting in a written agreement or statement under FDIA § 8(u)(1), for which a violation may be enforced by an appropriate Federal banking agency, or subject to any final order issued under FDIA § 8. • The FMIC shall: o Provide prompt notice to a private mortgage insurer of the approval or denial of any application of the private mortgage insurer to become an approved private mortgage; o Publish a notice in the Federal Register upon approval of any private mortgage insurer; o Maintain an updated list of approved private mortgage insurers on the FMIC's website; and	• The NMFA shall— o Publish in the Federal Register a list of any approved private mortgage insurers who lost their approved status; and o Maintain an updated list of such insurers on its website. <u>Appeals</u> • A private mortgage insurer who submits an application to become an approved private mortgage insurer may appeal a decision of the NMFA denying such application. An approved private mortgage insurer may appeal a decision of the NMFA suspending or revoking the approved status of such insurer. • Any insurer who files such an appeal shall file the appeal with the NMFA not later than 90 days after the date on which the person receives notice of the decision of the NMFA being appealed. • The NMFA shall make a final determination with respect to an appeal not later than 180 days after the date on which the appeal is filed. <u>Avoidance of Conflicts of Interest</u> With respect to any eligible mortgage collateralizing a covered security insured under this Act, an approved private mortgage insurer may not provide insurance both—	

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		○ Provide prompt notice to the appropriate State insurance regulator upon the approval or denial of any application of a private mortgage insurer. • Any insurer who was approved to insure mortgage loans for a GSE the day before the FMIC publishes provisional standards for approving insurers under § 607(a)(2) and was in good standing on that day: ○ Shall be deemed conditionally approved for one year from the date the FMIC publishes those § 607(a)(2) provisional standards; ○ Shall, within six months after the FMIC publishes insurer approval standards under § 313(a) apply for approval and; ○ Shall, if it applied within that six months, receive approval or denial of its application within one year after the FMIC publishes § 607(a)(2) provisional standards. <u>Review, Suspension, and Revocation of Approved Status</u> • If the FMIC determines that an approved private mortgage insurer no longer meets the standards for approval, or violates the requirements under this section, including any standards, regulations, or orders promulgated in accordance with this Act,	• In satisfaction of the credit enhancement required under § 2(7)(C) [apparently meaning § 2(7)(A)], and • To cover the first loss position of private market holders of such covered security, unless such mortgage insurer meets such heightened standards as the NMFA may establish.	

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		the FMIC may: o Provide prompt notice to the appropriate State insurance regulator that the FMIC determines that an approved private mortgage insurer no longer meets the approval standards; o Suspend or revoke the approved status of such insurer, or o Take any other action with respect to such approved insurer as may be authorized under this Act. • The suspension or revocation of an approved private mortgage insurer's approved status shall have no effect on the status as a covered security of any covered security collateralized by eligible mortgage loans with which the approved private mortgage insurer contracted prior to the suspension or revocation. • The FMIC shall: o Promptly publish in the Federal Register a notice of suspension or revocation of an insurer's approval, and o Maintain an updated list of approved insurers on its website. • In this subsection, the term "violate" includes any action, taken alone or with others, for or toward causing, bringing about, participating in, counseling, or aiding or abetting, a violation of the requirements under this Act.		

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		State Regulation
		The appropriate State insurance regulator of an approved private mortgage insurer has primary authority to examine and supervise the approved private mortgage insurer.
		
		Reports and Examinations
		• For purposes of determining whether an approved private mortgage insurer is fulfilling the requirements under this Act, the FMIC may, in coordination with the insurer's appropriate State insurance regulator, including providing that regulator to join the FMIC in an on-site examination, examine or review any approved private mortgage insurer if the FMIC has substantial reason to believe—
		  o That an approved private mortgage insurer has engaged in a material violation or pattern of violations of this Act or the rules promulgated pursuant to this Act; or
		  o That the activities of an approved private mortgage insurer may threaten the financial stability of the housing finance system or the MIF.
		• The FMIC shall conduct an examination of an approved private mortgage insurer once, but not more than once, every 3 years, provided the approved private mortgage insurer has not been examined		

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		on-site by an appropriate State insurance regulator. • In conducting such an exam or review, the FMIC shall— ○ Provide reasonable notice to, and coordinate with, the appropriate State insurance regulator before commencing an examination of the insurer ○ To the fullest extent possible, avoid duplication of examination activities, reporting requirements, and requests for information, including by relying on existing examinations, inspections, and reports of the appropriate State insurance regulator; and ○ Ensure that the approved private mortgage insurer is not subject to conflicting supervisory demands by the FMIC and State insurance regulators, as appropriate. • The State insurance regulator of an approved private mortgage insurer shall notify the FMIC if there has been a final determination that the insurer is in a troubled hazardous financial condition, provided that the FMIC agrees to maintain the confidentiality or privileged status of the documents, material, or other information received from the insurer's state insurance regulator.		

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		Enforcement • The FMIC shall have the authority to enforce the provisions of this section with respect to private mortgage insurers, in the same manner and to the same extent as the FDIC has with respect to insured depository institutions under FDIA § 8(b) through (n), provided the FMIC demonstrates that the enforcement action is necessary to avoid significant risk to the MIF. • Before taking any enforcement action against an approved private mortgage insurer, the FMIC shall promptly notify, consult, and coordinate with, the appropriate State insurance regulator. Resolution Authority • For any approved private mortgage insurer that the FMIC has substantial reason to believe is insolvent, as defined by State law, and would otherwise be subject to receivership proceedings under State law, the FMIC shall recommend, in writing, that the State insurance regulator for such private mortgage insurer take such actions as are necessary and authorized under applicable State law to resolve such private mortgage insurer. • Notwithstanding this requirement, if, after the end of the 60-day period beginning on		

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		the date on which the FMIC provides its written recommendation to the regulator, the appropriate State insurance regulator has not filed the appropriate judicial action in the appropriate State court to place such private mortgage insurer into receivership under the laws and requirements of the State, the FMIC shall have the authority to stand in the place of the appropriate regulatory agency and file the appropriate judicial action in the appropriate State court to place such a private mortgage insurer into receivership under the laws and requirements of the State. <u>Hearing</u> Upon notice of denial of an application or upon a notice of suspension or revocation of the approved status of an approved private mortgage insurer, the applicant or approved private mortgage insurer shall be afforded a hearing under FDIA § 8(h), in the same manner and to the same extent as if the FMIC were the appropriate Federal banking agency, provided that the approved private mortgage insurer submits a request to the FMIC for a hearing not later than 10 days after the date on which the notice is published. <u>Rule of Construction Regarding Preservation of FMIC Authority</u> Nothing in this section limits, or shall be		

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		construed to limit, the authority of the FMIC to provide exemptions to, or adjustments for, the provisions of this section based on the asset size of approved private mortgage insurers, or other criteria, as the FMIC deems appropriate, in order to reduce regulatory burdens while appropriately balancing the protection of the MIF.		

Approval of Servicers / Servicing Standards	**§ 322(b) Servicing Standards**
	The Utility shall develop, adopt, and publish—
	• Servicing standards, including for the modification, restructuring, or work-out of any mortgage that serves as collateral for a qualified security; and
	• A servicer succession plan, which may include provisions for—
	  ○ A specialty servicer that can replace the existing servicer if the performance of the mortgage pool deteriorates to specified levels; and
	  ○ A plan to achieve consistency in servicing systems related to systematic note-taking, consistent mailing addresses, and other points of contact for borrowers to use, among other items.
	
	Standards for Servicer Reporting
	The Utility shall develop, adopt, and publish standards for the reporting obligations of servicers of any mortgage that serves as
		§ 314 Approval of Servicers
		Standards for Approval of Servicers
		• The FMIC shall, by regulation, establish standards for the approval by the FMIC of servicers to administer eligible single-family mortgage loans, including standards with respect to—
		  ○ The collection and forwarding of principal and interest payments;
		  ○ The maintenance of escrow accounts;
		  ○ The collection and payment of taxes and bona fide insurance premiums;
		  ○ The maintenance of records on eligible single-family mortgage loans;
		  ○ The establishment of loss mitigation options that seek to enhance value and prevent, to greatest extent possible, the need to trigger a claim on insurance offered by the FMIC pursuant to this title, including by—
		    ▪ Establishing, by rule, a consistent process through which borrowers who submitted an
			§ 222 Approval of Servicers and Mortgage Servicing Standards
			Standards for Servicers
			The NMFA shall develop, adapt, and publish standards for the approval by the NMFA of servicers to administer eligible mortgages, including standards with respect to—
			• The financial history and condition of the servicer;
			• The general character and fitness of the management of the servicer, including compliance history with Federal and State laws;
			• The risk presented by such servicer to the MIF;
			• A requirement that the servicer submit audited financial statements to the NMFA; and
			• Any other standard the NMFA determines necessary or appropriate.
			
			Additional Required Servicer Standards
			The NMFA shall also develop and publish additional standards for servicers that
				§ 204 Servicing Rights; Representations and Warranties
				Servicing Rights
				The servicing rights for MBS issued by the issuing platform shall be controlled by—
				• The reinsurance company reinsuring the first 5% loss position on such securities; or
				• In the case of securities that do not have a reinsurance company reinsuring the first 5% or with respect to which the reinsurance company is insolvent, Ginnie Mae.
				
				Advancing Payments
				The party controlling the servicing rights shall also control the advancing of payments.
				
				Representations and Warranties
				• With respect to each pool securitized by the Issuing Platform, there shall be a collateral manager who shall—
				  ○ Oversee representations and warranties;

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	collateral for a qualified security.	initial loan modification request will be evaluated by servicers and the securitization trust for an affordable loan modification; and ▪ Providing clear guidance regarding the treatment of second lien holders, taking into consideration the priority and subordination of liens under Federal and State laws; ○ The advancement of principal and interest payments to investors in the case of a delinquency by a borrower until such time as the borrower has made all payments in arrears, the borrower entered into a repayment plan or modification, a regulated entity has purchased the loan, or the property securing the eligible single-family mortgage loan has been liquidated, including specification that the servicer shall recover advances upon a permanent modification; ○ The establishment of procedures under which the servicer may initiate or continue a foreclosure, in accordance with applicable Federal and State laws and regulations that— ▪ Take into account— ♦ The servicer's evaluation of, and agreements with,	administer eligible mortgages, including standards with respect to— • Compensation structures which incent servicers to maximize returns to investors on both performing and non-performing eligible mortgages; • The collection and forwarding of principal and interest payments; • The maintenance of escrow accounts; • The collection and payment of taxes and bona fide and reasonable insurance premiums; • The application of fees imposed on borrowers in connection with the servicing of an eligible mortgage, which shall be reasonably related to costs; • The maintenance of records on eligible mortgages; • The establishment of foreclosure loss mitigation programs that seek to enhance investor value and prevent, to the greatest extent possible, the need to trigger any claim on insurance offered by the NMFA pursuant to this title, including through affordable loan modifications, which shall include as an option modifications that reduce the unpaid principal balance of an eligible mortgage, consistent with a publically available net present value determination as defined by the NMFA; • The establishment of procedures for the servicer to refrain from initiating a	○ Act for the benefit of investors; and ○ In the case of a mortgage loan that is in breach of the representations and warranties, facilitate the repurchase or replacement of such mortgage loan with a mortgage loan that is in compliance with representations and warranties. • In general. ○ All contracts for private label securities issued after enactment shall include the following provisions: ▪ The qualification, responsibilities, and duties of trustees, including requirements set forth in the indenture or pooling and servicing agreement, or any applicable provisions of the Trust Indenture Act of 1939 (15 U.S.C. 77aaa et seq.). ▪ Trustees of private label securities shall have a fiduciary duty to protect the financial interests of investors of such securities. • For purposes of this paragraph, a trustee's fiduciary duty means that a trustee shall at all times oversee, monitor, and manage the trust that owns the mortgage loans securing the private label securities in the financial interests of the trust and its

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		borrowers for loss mitigation options; ♦ Potential losses caused by delays in collateral recovery; and ♦ The need to minimize risks to the MIF; and ▪ Provide the borrower, upon request, documentation establishing the right of the mortgagee to foreclose; ○ The provision of eligible single-family mortgage loan information to borrowers, upon request, including a copy of the pooling and servicing agreement and securitization trust requirements that address the ability of the servicer to offer loss mitigation options; and ○ Implementing the terms of any loss mitigation and foreclosure prevention as required by any uniform securitization agreement developed under § 326. • The standards shall also include— ○ The financial history and condition of the servicer; ○ The capability of the servicer's management; ○ The general character and fitness of the servicer's officers and directors, including their compliance history	judicial or non-judicial foreclosure, or where a foreclosure has been initiated, from taking any additional steps in the judicial or non-judicial foreclosure, once an initial request for loss mitigation has been made by the homeowner, until completion of the review of any loss mitigation application, including written notice to the homeowner documenting any denial and a requisite appeal process; • A proscription against any servicer maintaining any financial interest in insurance products related to mortgages serviced by the servicer or its affiliates other than the coverage provided by the insurance; • The advancement of principal and interest payments to investors in the case of a delinquency by a borrower until such time as the borrower has made all payments in arrears or the property securing the eligible mortgage has been liquidated, including provisions for the cessation of advances when there is no longer any reasonable possibility of the recovery of such advances from the liquidation of the property or as appropriate to facilitate modification of the loan pursuant to subparagraph (G); • The provision of information to the borrower, upon request, documentation establishing the right to foreclose; and	investors, with the same degree of care and skill that a prudent person would exercise or use under the circumstances in the conduct of such person's own affairs. In determining financial interests, the trustee's fiduciary duty shall consider all investors in a securitization, rather than the interests of any particular class of investors. A trustee that is deemed to be acting in accordance with its fiduciary duty to the trust shall not be liable to any investor, and shall not be subject to any injunction, stay, or other equitable relief sought by such investor, based solely upon such actions. • The governing documents of any private label securities issued after the date of the enactment of this Act shall automatically be deemed to include a trustee's fiduciary duty. The trustee's fiduciary duty may not be abrogated or altered by the parties to such documents and may not be amended by parties to contracts for private label securities. • Nothing in this paragraph shall be construed to relieve any party of its duties to participants and beneficiaries of any employee benefit plan under the Employee Retirement Income Security Act (29 U.S.C. 1101 et seq.). • To the extent that the provisions of this paragraph conflict with any provision of

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		with Federal and State laws and rules and regulations of self-regulatory organizations as defined in § 3(a)(26) of the Exchange Act as applicable; ○ The risk presented by such servicer to the MIF; and ○ Minimum operational and management standards for the servicer, including with respect to— ▪ Internal controls; ▪ Recordkeeping; ▪ Internal audit systems; ▪ The maintenance of adequate liquidity and reserves; and ▪ Reporting standards to the FMIC and investors, including audited financial statements. • To promote consistency and minimize regulatory conflict, the OCC, Federal Reserve, FDIC, CFPB, NCUA, and the FMIC shall— ○ Consult and coordinate with each other in developing and issuing regulations with respect to the rules and standards for the servicing of eligible single-family mortgage loans; and ○ Review existing regulations with respect to mortgage loan servicing rules and standards. • To promote consistency and minimize regulatory conflict, the FMIC shall	• The provision of eligible single-family mortgage loan information to borrowers, upon request, including a copy of the pooling and servicing agreement and securitization trust requirements that may restrict the ability of the servicer to offer loss mitigation options. <u>Standards for Servicing Eligible Mortgages</u> The NMFA shall develop, adopt, and publish standards regarding the servicing of eligible mortgages which shall provide as follows: • A servicer of an eligible mortgage, approved pursuant to this subsection, or any affiliate of such servicer, may not own, or hold any interest in, any other residential mortgage loan that is secured by a mortgage, deed of trust, or other equivalent consensual security interest on the same dwelling or residential real property that is subject to the eligible mortgage. This shall not apply to— ○ A servicer of a residential mortgage loan, or an affiliate of such a server, that owns the sole interest in the mortgage, deed of trust, or other security interest that secures the residential loan serviced by the servicer; or ○ A servicer that is a State or local housing agency or State or local housing finance agency.	the Trust Indenture Act of 1939, the provisions of the Trust Indenture Act shall apply, but only to the extent of the conflict. • Ginnie Mae shall— ○ Within 3 years of enactment, conduct a first study to evaluate— ▪ The structure of compensation for trustees of private label securities; ▪ Any changes to such compensation attributable to the imposition of the fiduciary duty required under this paragraph; and ▪ Any effects of the imposition of such fiduciary duty on liquidity in the market for private label securities; ○ Within 3 years of enactment, conduct a second study to evaluate any effects of the imposition of the fiduciary duty required under this paragraph upon borrowers, including if the imposition of such fiduciary duty results in additional costs and expenses to borrowers; and ○ Report to Congress describing any findings and conclusions of the studies, within a year of commencing each. • For purposes of this paragraph, the term

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		consult and coordinate with appropriate State regulators when developing and issuing regulations with respect to the rules and standards for the servicing of eligible single-family mortgage loans.
		
		<u>Application and Approval</u>
		• The FMIC shall establish an application process—
		  ○ In such form and manner and requiring such information as the FMIC may require, for the approval of servicers under this section; and
		  ○ That does not discriminate against or otherwise disadvantage small servicers.
		• The FMIC may approve any application provided the servicer meets the adopted standards. The FMIC shall notify any applicant seeking to become an approved servicer of the decision of the FMIC with respect to such approval as promptly as practicable.
		• The FMIC shall have authority to deny any application if an officer or director of the servicer has, at any time before approval been subject to a statutory disqualification pursuant to § 3(a)(39) of the Exchange Act or suspended, removed, or prohibited under FDIA § 8(g), prohibited pursuant to FDIA § 8(e)(6) or (7), subject to an action resulting in a
			For this purpose, "affiliate" means, with respect to a servicer, any person or entity that controls, or is controlled by, or is under common control with such servicer, as the NMFA shall prescribe by regulation.
			• If a borrower's insurance policy has not been paid, the servicer shall make payments on the current policy or seek reinstatement of such policy where necessary and then make such payments, unless the policy has been terminated for reasons other than nonpayment. If escrow funds are not available, the servicer shall advance such funds. If the current policy cannot be, continued and force-placed insurance is provided, the costs and the coverage should be substantially equivalent to that provided in a standard homeowner's insurance policy. For this purpose, "force-placed insurance" has the meaning given such term in RESPA§ 6(k).
			• No servicer of an eligible mortgage shall render a real estate settlement service in connection with a transaction involving an eligible mortgage through a subsidiary of such person or through insourcing. For this purpose, "insourcing" means providing for services to be conducted by the servicer's affiliated entities.
			• Each servicer of an eligible mortgage, or
				"private label security" means MBS not issued by the Platform.
				
				<u>Mandatory Arbitration</u>
				Disputes between parties to a security issued by the Issuing Platform shall be subject to mandatory arbitration.

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		written agreement or statement under FDIA § 8(u)(1), for which a violation may be enforced by an appropriate Federal banking agency, or subject to any final order issued under FDIA § 8. • Any servicer who was approved to service mortgage loans for a GSE on the day before enactment, and was in good standing as of such date, shall be deemed to be an approved servicer for purposes of initial servicer approval by the FMIC and thereafter and subject to the requirements of this section as an approved servicer. • The FMIC shall, by regulation, provide exemptions to, or adjustments for, approved servicers that service 7,500 or fewer eligible single-family mortgage loans, to reduce regulatory burdens while appropriately balancing protection of the MIF. An approved servicer and its subsidiaries and affiliates are considered a single entity for this purpose. • RESPA § 6 is amended by adding: The CFPB shall, by regulation, provide exemptions to, or adjustments for, the provisions of this section for servicers that service 7,500 or fewer mortgage loans, to reduce regulatory burdens while appropriately balancing consumer protections. An approved servicer and its subsidiaries and affiliates are considered a single entity for this purpose.	agents of such servicer, shall, with respect to the borrower, establish— ○ A single electronic record for each account, the contents of which shall be accessible throughout the servicer, or agents of such servicer, including to all loss mitigation staff, all foreclosure staff, and all bankruptcy staff; and ○ A single point of contact for the borrower for all loss mitigation activities. • Each servicer of an eligible mortgage, or agents of such servicer, shall— ○ Maintain adequate staffing and systems for tracking borrower documents and information that are relevant to foreclosure, loss mitigation, bankruptcy, and ○ Other servicing operations; ○ Maintain adequate staffing and caseload limits for employees responsible for handling foreclosure, loss mitigation, bankruptcy, and related communication with borrowers and housing counselors; ○ Set reasonable minimum experience, education, and training requirements for loan modification staff; and ○ Document electronically each action on a foreclosure, loan modification, bankruptcy, or other servicing file, including all communication with the	

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		• The FMIC shall— ○ Publish a notice in the Federal Register upon approving any servicer under this section; and ○ Maintain an updated list of approved servicers on its website. <u>Review, Suspension, and Revocation of Approved Status</u> • The FMIC may examine or review any approved servicer if the FMIC has substantial reason to believe that a servicer has engaged in a material violation or pattern of violations of this Act or the rules promulgated pursuant to this Act, including— ○ Any failure by an approved servicer to comply with terms set forth in any uniform securitization agreement developed under § 326; or ○ Through the identification of any information indicating abnormal eligible single-family mortgage loan performance within the loan portfolio of the approved servicer. • In addition to this authority, the FMIC shall conduct an examination or review of an approved servicer once, but not more than once, every 2 years, provided that such examination or review shall be limited to compliance with this Act or regulations promulgated under this Act.	borrower and other parties. • Each servicer of an eligible mortgage, for any transfer of servicing to a successor servicer, shall— ○ Inform the successor servicer (including a subservicer) whether a loan modification is pending; ○ Ensure that the successor servicer shall accept and continue processing prior loan modification requests; and ○ Ensure that successor servicer shall honor trial and permanent loan modification agreements entered into by the transferring servicer. <u>Coordination with Other Regulators</u> In developing the servicer and servicing standards, the NMFA shall coordinate with the CFPB, and, to the extent the NMFA determines practical and appropriate, the other Federal Banking agencies. <u>Application and Approval</u> • The NMFA shall establish an application process— ○ In such form and manner and requiring such information as the NMFA may require, for the approval of servicers; and ○ That does not discriminate against or otherwise disadvantage small servicers.	

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		• In conducting such an exam or review, the FMIC shall— ○ Provide reasonable notice to, and coordinate with, the appropriate Federal banking agency, CFPB, or State regulatory agency, as appropriate, for an approved servicer that is regulated by such Federal banking agency, CFPB, or State regulatory agency before commencing an examination of the approved servicer under this section; and ○ To the fullest extent possible— ▪ Rely on the examinations, inspections, and reports of the appropriate Federal banking agency, CFPB, or State regulatory agency, as appropriate, for an approved servicer that is regulated by such Federal banking agency, CFPB, or State regulatory agency; ▪ Avoid duplication of examination activities, reporting requirements, and requests for information; and ▪ Ensure that approved servicers are not subject to conflicting supervisory demands by the FMIC, appropriate Federal banking agencies, CFPB, or State regulatory agencies, as	• The NMFA may approve any servicer's application provided the servicer meets the required standards. • The NMFA shall— ○ Cause to be published in the Federal Register a list of newly approved servicers; and ○ Maintain an updated list of approved servicers on its website. • The NMFA shall by rule, after consultation with the CFPB, provide exemptions to, or adjustments for, the provisions of this section for approved small servicers, in order to reduce the regulatory burdens while appropriately balancing protection of the MIF. <u>Review, Penalty Assessment, Suspension and Revocation of Approved Status</u> • The NMFA shall periodically review the performance of approved servicers. In connection with such review, the NMFA shall periodically publish a publicly-available scorecard outlining servicer performance relative to benchmarks. • The NMFA may assess civil monetary penalties, consistent with § 225, in connection with a servicer failing to comply with any standards pursuant to the servicing of eligible mortgages under this section. • The NMFA may review the status of any	

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		appropriate. • To facilitate any such exam or review, each approved servicer shall, on an annual basis and in accordance with such requirements as the FMIC may establish, certify in writing to the FMIC that the approved servicer is in compliance with the approval standards, all other requirements of this Act, and any rules promulgated pursuant to this Act. o The FMIC shall have the authority to impose enforcement penalties with respect to an approved servicer who submits a certification that contains false or misleading information, in the same manner and to the same extent as the FDIC has with respect to insured depository institutions under FDIA § 8(b) through (n), except that the penalties under subsection (j) shall not apply. o If the FMIC takes any enforcement action against an approved servicer, the FMIC shall notify the approved servicer's appropriate Federal banking agency, CFPB, or State regulator, if applicable. • If the FMIC determines, in any such exam or review, that an approved servicer no longer meets the standards for approval, the FMIC may suspend or revoke the approved status of such	approved servicer if the NMFA is notified of or becomes aware of any violation by the servicer of this Act or the rules promulgated pursuant to this Act, including any failure by an approved servicer to comply with the terms set forth in any uniform securitization agreement developed under this Act. • In conducting such a review, the NMFA shall— o Provide reasonable notice to, and coordinate with, the appropriate Federal banking agency or State regulatory agency, as appropriate, for an approved servicer that is regulated by such Federal banking agency or State regulatory agency before commencing an examination of the approved servicer; and o To the fullest extent possible— ▪ Rely on the examinations, inspections, and reports of the appropriate Federal banking agency or State regulatory agency, as appropriate, for an approved servicer that is regulated by such Federal banking agency or State regulatory agency; ▪ Avoid duplication of examination activities, reporting requirements, and requests for information; and	

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		servicer. • The suspension or revocation of an approved servicer's approved status shall have no effect on the status of any covered security. • The FMIC shall— o Publish in the Federal Register a list of any approved servicers who lost their approved status; and o Maintain an updated list of such servicers on its website. Appeals A servicer who submits an application to become an approved servicer may appeal a decision of the FMIC denying such application. An approved servicer may appeal a decision of the FMIC suspending or revoking the approved status of such servicer. • Any servicer who files such an appeal shall file the appeal with the FMIC not later than 90 days after the date on which the person receives notice of the decision being appealed. • The FMIC shall make a final determination with respect to an appeal not later than 180 days after it is filed. Transfer of Servicing • For any eligible single-family mortgage loan or pool of eligible single-family mortgage loans insured by the FMIC	▪ Ensure that approved servicers are not subject to conflicting supervisory demands by the NMFA, appropriate Federal banking agencies, or State regulatory agencies, as appropriate. • If the NMFA determines, in such a review, that an approved servicer no longer meets the standards for approval, the NMFA may suspend or revoke the approved status of such servicer. The suspension or revocation of an approved servicer's approved status shall have no effect on the status of any covered security. • The NMFA shall— o Cause to be published in the Federal Register a list of any approved servicers who lose their approved status; and o Maintain an updated list of such servicers on its website. Appeals • A servicer who submits an application to become an approved servicer may appeal a decision of the NMFA denying such application. • An approved servicer may appeal a decision of the NMFA suspending or revoking the approved status of such	

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		under this title and in accordance with rules promulgated by the FMIC, the FMIC may require the approved servicer to enter into a subservicing arrangement with any independent specialty servicer approved by the FMIC. These rules shall— ○ Set forth with clarity the performance conditions of an approved servicer that would warrant or necessitate such a subservicing arrangement; ○ Require that the performance condition warranting or necessitating the use of such a subservicing arrangement be of such type or character so as to materially and adversely affect the ability of the FMIC to recover any amounts owed to the FMIC; and for this purpose, define the term "materially and adversely affect"; ○ Require that any approved servicer be provided a reasonable amount of time, provided that such time does not present a risk to the MIF, to rebut, address, or correct any determination of the FMIC regarding a performance condition, and only permit the FMIC to carry out the authority upon expiration of this period of time; ○ Limit the scope of any such authority to eligible single-family mortgage	servicer. • Any servicer who files an appeal shall file the appeal with the NMFA not later than 90 days after the date on which the person receives notice of the decision being appealed. • The NMFA shall make a final determination with respect to an appeal not later than 180 days after the date on which the appeal is filed. <u>Borrower Ombudsman</u> The NMFA shall establish an Office of the Ombudsman to receive complaints from homeowners, homeowners' representatives, and other designated third parties. The Ombudsman shall have the authority to investigate, including the right to obtain information, documents, and records, in whatever form kept, from the servicer, and to resolve disputes between any homeowner and the servicer of an eligible mortgage. The Ombudsman shall coordinate with the CFPB in doing so. <u>Transfer of Master Servicing</u> • The Issuer shall have the right to transfer master servicing on a covered security in the event that the current approved servicer or servicers have failed to appropriately protect the MIF. • Subject to the rules promulgated by the	

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		loans that share similar underwriting, borrower, and performance characteristics; ○ Ensure that the scope of any such authority is not applied broadly and without further limitation; and ○ Notwithstanding the above, provide that an approved servicer may be subject to more extensive programmatic discipline or correction measures, as determined by the FMIC, if, during any 5-year period— ▪ The servicing duties that are the subject of the current use of the FMIC's authority under this subsection marks the third instance of the use of such authority with respect to the same approved servicer; and ▪ With respect to the prior 2 separate and individual instances of the use of such authority, the same approved servicer failed to cure any identified performance conditions or implement corrective measures as determined by the FMIC. • If a required transfer to a subservicer occurs, the approved servicer from whom such servicing duties are extinguished shall cease to receive compensation for any such servicing activities related to	Issuer, if the credit risk-sharing on a covered security required pursuant to § 202 is provided by an approved bond guarantor, such guarantor shall have the right to transfer master servicing on a covered security in the event that the approved bond guarantor can demonstrate that the current approved servicer or servicers have failed to appropriately protect their investment, including by failing to meet any additional required servicer standard identified under § 222(a)(2). • If the credit-risk sharing on a covered security required pursuant to § 202 is provided using any other mechanisms for private credit risk-sharing other than by such bond guarantors, and the Issuer has not yet already exercised such right to transfer master servicing on a covered security, the private market holders of the first loss position in a covered security may petition the Issuer for a change in approved servicers if the private market holders can demonstrate that their current approved servicer or servicers have failed to appropriately protect their investment, including by failing to meet any additional required servicer standard identified under § 222(a)(2). • Once such transfer of servicing has occurred, the approved servicer from	

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		those duties. • The FMIC may establish a succession plan for each approved servicer, including provisions for— o A specialized servicer to replace the approved servicer if the performance of the eligible single-family mortgage loan pool serviced by such approved servicer deteriorates to specified levels; and o A plan to achieve continuity of contact for borrowers upon the replacement of the approved servicer. This shall not be construed as authorizing the FMIC to circumvent, evade, or otherwise disregard its rules when facilitating a servicing transfer. <u>Petitions for Change of Servicer by Private Market Holders</u> The FMIC shall develop a process by which private market holders of the first loss position in a single-family covered security may petition the FMIC for a change in approved servicers, including specialized servicers for individual eligible single-family mortgage loans, if the private market holders can demonstrate that its investment was not appropriately protected by the current approved servicer, including by failing to meet any standard or requirement for servicer approval. If a change in servicers is approved—	whom such servicing rights are extinguished shall cease to receive compensation for any such servicing activities related to those rights. • Once such transfer of servicing has occurred, the servicer to whom the servicing rights were transferred shall suspend the completion of any foreclosure for an eligible mortgage loan whose servicing rights have been transferred for a period of 60 days. • The NMFA may establish a succession plan for each approved servicer, including provisions for— o A specialized servicer to replace the approved servicer if the performance of the eligible single-family mortgage loan pool serviced by such approved servicer deteriorates to specified levels; and o A plan to achieve continuity of contact for borrowers upon the replacement of the approved servicer. • The NMFA shall develop a process by which an approved servicer shall provide notice to the NMFA of any transfer of any servicing rights of such approved servicer to another approved servicer. This required process shall include the development of procedures to permit the NMFA to prevent, halt, or rescind any transfer of servicing rights from an	

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		• The change must occur within 30 days after FMIC approval; and • Once the change has occurred, the approved servicer from whom such servicing rights are extinguished shall cease to receive compensation for any such servicing activities related to those rights. <u>Notice of Transfer of Servicing by Current Servicer</u> The FMIC shall develop a process by which an approved servicer shall provide notice to the FMIC of any transfer of any servicing rights of such approved servicer to another approved servicer. This process shall include the development of procedures to permit the FMIC to prevent, halt, or rescind any transfer of servicing rights from an approved servicer to a servicer that is not approved to service eligible single-family mortgage loans or to any servicer whose approved status has been suspended or revoked. <u>General Authority Regarding Servicing Transfers</u> The FMIC may develop such other standards with respect to the transfer of servicing rights by approved servicers as the FMIC determines necessary and appropriate to facilitate an orderly transfer of servicing rights after the suspension or revocation of the approved	approved servicer to a servicer that is not approved to service eligible single-family mortgage loans under this section or to any servicer whose approved status has been suspended or revoked.	

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		status of a servicer. <u>Study of Servicer Compensation for Non-Performing Single-Family Loans</u> The FMIC shall carry out a study of servicing compensation for non-performing single-family mortgage loans, including alternatives to existing servicing compensation structures. The study shall include recommendations for the optimal structure of servicer compensation, in order to— • Improve service for borrowers; • Reduce financial risk to servicers; and • Provide flexibility for guarantors to better manage non-performing single-family mortgage loans. Not later than 1 year after enactment, the Chairperson shall issue a report to the Congress containing any findings and determinations made in carrying out the study. <u>Rule of Construction</u> Nothing in this section shall prohibit a mortgage originator from retaining rights to service the eligible single-family mortgage loans it originated, if the mortgage originator meets the standards to be an approved servicer, or qualifies for an exemption.		
Approval of Small Lender Mutuals / FHLB		**§ 315 Authority to Establish and Approve Small Lender Mutuals** <u>Establishment of Small Lender Mutuals</u> • The FMIC shall establish one entity		**§ 205 FHLBs** <u>FHLB Membership of Lenders</u> FHLB Act § 4 (12 U.S.C. 1424) is amended by adding:

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Membership and Pooling		known as the "Small Lender Mutual," which shall be an approved small lender mutual, owned by and operated for the benefit of its members.
		• The FMIC shall, by regulation, establish standards for the approval by the FMIC of such other small lender mutuals as may be necessary.
		
		<u>Purposes</u>
		The purpose of the Small Lender Mutuals shall be as follows:
		• To address the needs of small mortgage lenders with respect to covered securities.
		• To purchase eligible mortgage loans to securitize a covered security from its member participants—
		  ○ For cash, on a single loan basis; or
		  ○ Through the sale of a portion of a multi-lender pool or multi-guarantor pool collateralized by eligible mortgage loans securitized in a covered security.
		• To obtain all necessary and appropriate credit enhancements for covered securities to support the lending activities of small mortgage lenders.
		• To implement policies and procedures that ensure that the access rules and fees of any small lender mutual are not prohibitive and do not discriminate against originators of eligible mortgage
				• Any lender that satisfies the requirements for FHLB membership by an insured depository institution, insurance company, or CDFI shall be eligible to become an FHLB member.
				• Ginnie Mae shall issue regulations specifying that FHLBs shall issue a separate class of stock to such lenders who become members, and Ginnie Mae shall determine the applicable restrictions and requirements for such stock.
				
				<u>FHLB Pooling Services for Eligible Mortgages</u>
				FHLB Act § 11 is amended by adding:
				Each FHLB shall provide pooling services to both members and non-members who wish to pool eligible mortgages for securitizing through the Issuing Platform established by title II of the Partnership to Strengthen Homeownership Act of 2014. For this purpose, 'eligible mortgage' has the meaning given that term under § 2 of the Partnership to Strengthen Homeownership Act of 2014.

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		loans or approved aggregators on the basis of size, composition, business line, or loan volume. • To appropriately manage the risk of the small lender mutual to ensure the continued safety and soundness of such mutual. <u>Provisions to Ensure the Effective Operations of Small Lender Mutuals</u> • Not later than 1 year after enactment, FHFA shall conduct an assessment of the intellectual property, technology, infrastructure, and processes of the GSEs relating to the operation and maintenance of the systems needed to ensure small mortgage lender access to the secondary mortgage market to determine the needs of the single required Small Lender Mutual. This assessment shall be submitted to the Transition Committee established under § 404, or the Board if confirmed pursuant to § 404(d), and included in the transition plan required under § 602. • After the agency transfer date and before the system certification date, FHFA, consistent with title VI— ○ Shall dispose of the intellectual property, technology, infrastructure, and processes of the GSEs relating to the operation and maintenance of the		

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		systems needed for small mortgage lenders to access the secondary mortgage market; and ○ May manage such disposition through the sale, transfer, licensing, or leasing of such intellectual property, technology, infrastructure, and processes of a GSE to the single required Small Lender Mutual to ensure that the Small Lender Mutual can access the secondary mortgage market and fulfill the purposes of the section. • After the agency transfer date and before the system certification date, FHFA, consistent with § 604(h), may transfer to a subsidiary or subsidiaries of the GSEs any function, activity, infrastructure, property, including intellectual property, technology, or any other object or service of an enterprise that the FMIC determines is necessary and available for the single required Small Lender Mutual to carry out its activities and operations. • The initial capital necessary for the single required Small Lender Mutual to purchase a subsidiary or to purchase, lease, or license the GSE systems, and to perform all other activities and functions of the Small Lender Mutual, including the ability of the Small Lender Mutual to operate a cash window for the purchase of		

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		individual eligible mortgage loans, shall be provided by the GSEs. o The amount of any initial capital required to be provided by the GSEs shall be determined by the FMIC based on the needs of the Small Lender Mutual to carry out its activities and functions, as well as by the current volume of business from the GSE-approved sellers that are eligible to participate as a member of the Small Lender Mutual. o The amount of any initial capital required to be provided by the GSEs shall be repaid by the single required Small Lender Mutual on a schedule jointly agreed to by the Small Lender Mutual and the FMIC. Such repayment shall be completed within 7 years from the system certification date. The FMIC, after consultation with the mutual board of the single required Small Lender Mutual, may extend the repayment period for an additional 3 years, if, in the sole discretion of the FMIC, the FMIC deems such extension necessary. <u>Ensuring Fair Competition</u> FHFA may, consistent with the public interest, for the maintenance of fair competition among all small lender mutuals, and the purposes set forth in this section,		

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		provide, through a licensing agreement or other agreement, access to any transferred technology or platform.
		
		<u>Eligibility</u>
		Eligibility to participate as a member in any small lender mutual shall be limited to any—
		• Insured depository institution having less than $500,000,000,000 in total consolidated assets at the time of the initial participation of the institution in the small lender mutual;
		• Non-depository mortgage originator that—
		  o Has a minimum net worth of $2,500,000;
		  o Has annual eligible mortgage loan production of less than $100,000,000,000; and
		  o Either
		    ▪ Prior to the system certification date, was approved to sell mortgage loans to a GSE on the date that is 1 day prior to the establishment or approval of the small lender mutual, provided that such originator was in good standing as of such date; or
		    ▪ Meets the standards established by the small lender mutual;
		• FHLB; and
		• The following if they meet the standards		

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		established by the small lender mutual: ○ CDFIs; ○ Mission-based non-profit lender; and ○ Housing finance agency. Each entity eligible to participate as a member of a small lender mutual: • May not be required to become an approved entity under this Act to access any function or operation of a small lender mutual; and • Shall meet all applicable standards and requirements under this Act. <u>Eligibility Thresholds</u> The FMIC may adjust the eligibility thresholds if the FMIC, in consultation with the mutual board of a small lender mutual, determines that— • The thresholds do not facilitate the purposes of the small lender mutual; • The thresholds restrict small multifamily lenders' participation in the small lender mutual; or • The eligibility thresholds pose a risk to the MIF. <u>Platform Membership</u> Each small lender mutual shall be a member of the Securitization Platform. <u>Funding Authority</u> • The mutual board of each small lender		

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		mutual shall charge and collect fees from its member participants for membership in the small lender mutual to cover the costs of— ○ In the case of the single required Small Lender Mutual— ▪ The purchase of any function, activity, infrastructure, property, including intellectual property, technology, or any other object or service from a GSE; ▪ Any initial capital for the establishment of a cash window; and ▪ The repayment by the single required Small Lender Mutual of its initial capital, provided that any fee charged to cover such repayment amounts is applicable only to those member participants identified and approved after the establishment date of the Small Lender Mutual and before the 7- or 10-year repayment date; and ○ The continued operation of the small lender mutual, including to build capital reserves and to manage risks. • In addition, the mutual board of the single required Small Lender Mutual may charge and collect a fee from member participants identified and approved after the 7- or 10-year repayment date to		

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		compensate member participants identified and approved prior to such repayment date for the share of the fees paid by such member participants to cover the cost of repayment by the single required Small Lender Mutual of its initial capital. • The mutual board of each small lender mutual may, in its discretion and upon consultation with the FMIC, increase or decrease any authorized fee. The mutual board of each small lender mutual shall, on an annual basis and upon any increase or decrease of any fee, provide the FMIC with a schedule of the fees charged by the small lender mutual to its member participants. • The authorized fees — ○ Shall be equitably assessed; and ○ Shall not discriminate against originators of eligible mortgage loans or approved aggregators based on size, composition, business line, or loan volume. • If a small lender mutual, in consultation with the FMIC, determines that any fee or fees authorized this subsection are prohibitive or discriminatory, the small lender mutual may, in the interest of building the membership of the small lender mutual, lower any such fee or fees. Each small lender mutual shall, in		

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		consultation with the FMIC, set reasonable criteria for any determination that a fee is prohibitive or discriminatory. The criteria shall consider the potential impact on the financial safety and soundness of the small lender mutual. Governance • The mutual board of each small lender mutual, in consultation with the FMIC, shall take all reasonable steps necessary to establish governance provisions that reflect the important role in the mortgage market played by the member participants of small lender mutuals. • The management of each small lender mutual shall be vested in a board of 15 directors (the "mutual board"), which shall include representatives of approved member participants of the small lender mutual. • The FMIC shall make initial appointments of the members of the mutual board for the single required Small Lender Mutual. Each such initial appointment shall be for a term of 1 year. Upon expiration of the 1-year period, the member participants of the single required Small Lender Mutual shall elect the members of its mutual board from within its membership. • The mutual board of each small lender		

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		mutual shall have at least 1 independent director to serve the public interest. This independent director shall have history of representing consumer or community interests on banking services, credit needs, housing, or financial consumer protections. • No more than one-third of the directors of the Small Lender Mutual's mutual board may be held by a single category of member participants, defined as community banks, credit unions, nondepository mortgage originators, FHLBs, HFAs, CDFIs, and mission-based non-profit lenders. • The Small Lender Mutual's mutual board shall select, on a rotating basis from representatives of its directors, an individual to serve as Platform Director under § 322. If more than one Small Lender Mutual is approved under this section, each shall rotate the § 322 representative position • Member participants of each small lender mutual shall have equal voting rights on any matters before the small lender mutual of which it is a member, regardless of the size of the individual member participant. • For these governance purposes, a member participant and its subsidiaries, joint offices, and affiliates, shall be treated as a		

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		single entity and shall be entitled to cast a single vote on any matters before the small lender mutual of which it is a member.
		
		<u>Approval of Member Participants</u>
		• Each mutual board shall develop standards and procedures to approve the application of member participants in the small lender mutual. The standards shall include standards relating to the—
		  o Prospective members' compliance history with Federal and State law;
		  o Safety and soundness of prospective member participants; and
		  o Mortgage underwriting practices of the prospective member.
		• In approving any prospective member to become a member participant in a small lender mutual, the mutual board of that small lender mutual may consult and share information with either the appropriate Federal banking agency and state regulator of the prospective member, or with the CFPB if the CFPB supervises the prospective member.
		  o Information so shared shall not be construed as waiving, destroying, or otherwise affecting any privilege or confidential status that a prospective member may claim with respect to such information under Federal or		

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		State law as to any person or entity other than the board of directors or its appropriate Federal banking agency. ○ No provision of this subsection may be construed as implying or establishing that— ▪ Any prospective member waives any privilege applicable to information that is shared or transferred under any circumstance to which this subsection does not apply; or ▪ Any prospective member would waive any privilege applicable to any information by submitting the information directly to its primary Federal or State regulator, but for this subsection. • Each mutual board shall develop streamlined membership standards and procedures for any lender who was approved to sell loans to a GSE the day before enactment, and was in good standing as of then. <u>Authority to Become an Approved Aggregator</u> Each small lender mutual may apply to the FMIC for approval to become an approved aggregator pursuant to § 312. <u>Cash Window</u>		

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		• Each small lender mutual shall have the ability to operate a cash window for the purchase of individual eligible single-family mortgage loans.
		• To ensure the safety and soundness of each small lender mutual, the FMIC shall establish standards for the regulation, supervision, and operation of each cash window.
		• The FMIC may, if it determines necessary or appropriate, establish a process and criteria for approved guarantors and approved aggregators to apply to the FMIC for approval to operate a cash window for the purchase of individual eligible single-family mortgage loans. It the FMIC does so, it—
		  ○ May grant approval to an approved guarantor or an approved aggregator that applies to operate a cash window for the purchase of individual eligible single-family mortgage loans only if the FMIC determines that—
		    ▪ The approved guarantor or approved aggregator meets the criteria; and
		    ▪ The operation of the cash window would not pose a risk to the MIF; and
		  ○ To ensure the safety and soundness of each approved guarantor and approved aggregator, shall establish		

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		standards for the regulation, supervision, and operation of each cash window that an approved guarantor or approved aggregator is approved to operate under this paragraph. • FHFA may, consistent with the public interest and for the maintenance of fair competition among entities providing cash window services, provide, through a licensing agreement or other agreement, access to any technology or platform relating to a cash window transferred to a GSE subsidiary. <u>Recognition of Distinction Between Small Lender Mutuals and Other Aggregators</u> Prior to promulgating any regulation or taking any other formal or informal action of general applicability, including the issuance of an advisory document or examination guidance, the FMIC shall consider the differences between small lender mutuals and other approved aggregators with respect to— • The cooperative ownership structure of small lender mutuals; • The purposes of small lender mutuals; • The capital structure of small lender mutuals; and • Any other differences that the FMIC considers appropriate.		

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		Coordination of Servicer Approval Each mutual board may coordinate with the FMIC to facilitate the application process for its member participants to become approved servicers of the FMIC pursuant to § 314. Multifamily Study Not later than 1 year after the agency transfer date, the FMIC shall conduct and complete a study to determine— • The access needs of small multifamily mortgage lenders to the secondary multifamily mortgage market; and • Whether the single required Small Lender Mutual can meet the access needs of small multifamily mortgage lenders.		
Approval of Collateral Risk Managers		**§ 327 Approval and Standards for Collateral Risk Managers** Standards for Approval of Collateral Risk Managers The FMIC shall develop, adopt, and publish standards for the use of collateral risk managers who may work with the Platform, as well as trustees and servicers of MBS to manage mortgage loan collateral, including standards with respect to— • Tracking mortgage loan repurchases; • Compliance with obligations under any applicable securitization documents; and • Managing any disputes and the resolution process.		

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		Additional Required Standards The standards shall include the review of foreclosure loss mitigation programs established under § 314 for approved servicers.		
Covered Entity Oversight		**§ 316 Supervisory Actions Related to Capital and Solvency** Capital Classifications • The FMIC shall establish, by regulation, capital classifications regarding the levels of capital maintained by each type of covered entity. The FMIC shall classify covered entities according to the following capital classifications: A covered entity shall be classified as: o *Well capitalized* if it meets all capital and solvency standards in § 309(b). o *Adequately capitalized* if it meets some, but not all, capital and solvency standards in § 309(b). o *Undercapitalized* if it fails to meet any of the capital and solvency standards in § 309(b). o *Significantly undercapitalized* if it is significantly below any of the capital and solvency standards in § 309(b). o *Critically undercapitalized* if it is critically below any of the capital and solvency standards in § 309(b). • The FMIC may reclassify a covered entity if— o At any time, the FMIC determines, in	**§ 224 Additional Authority Relating to Oversight of Market Participants** In carrying out its authorities under this subtitle, the NMFA may, in its discretion, develop, publish, and adopt such other additional standards or requirements as the NMFA determines necessary to ensure— • Competition among approved private mortgage insurers, servicers, bond guarantors, and other approved private market participants in the secondary mortgage market; • Competitive pricing among approved private mortgage insurers, servicers, bond guarantors, and other approved private market participants in the secondary mortgage market; and • Access to affordable mortgage credit, including 30-year fixed rate mortgages, in the secondary mortgage market. **§ 225 Civil Money Penalties** Authority The NMFA may, in its discretion, impose a civil money penalty on the Issuer or any approved private mortgage insurer, servicer, bond guarantor, or other entity previously	

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		writing, that the covered entity is engaging in conduct that could result in a rapid depletion of capital held by the covered entity; ○ After notice and an opportunity for hearing, the FMIC determines that the covered entity is in an unsafe or unsound condition; ○ Pursuant to the requirements of this title, the FMIC deems the covered entity to be engaging in an unsafe or unsound practice; ○ The covered entity does not submit a capital restoration plan within the applicable time period that is substantially in compliance with regulations for such plans adopted by the FMIC; ○ The FMIC does not approve the capital restoration plan submitted by the covered entity; or ○ The FMIC determines that the covered entity has failed to comply with the capital restoration plan and fulfill the schedule for the plan approved by the FMIC in any material respect. • In addition to any other action authorized under this title, including the reclassification of a covered entity for any reason not specified in this subsection, if the FMIC makes any discretionary reclassification, the FMIC may classify a	approved by the NMFA that has failed to comply with or otherwise violates— • Any standard adopted by the NMFA pursuant to this subtitle; or • Any other requirement or provision of this Act, or any order, condition, rule, or regulation issued pursuant to this Act, applicable to the Issuer or to such private mortgage insurer, servicer, bond guarantor, or other entity as the case may be. <u>Procedures</u> • The NMFA shall establish standards and procedures governing the imposition of civil money penalties under this section. Such standards and procedures— ○ Shall provide for the NMFA notify the Issuer or any approved private mortgage insurer, servicer, bond guarantor, or other entity, as the case may be, in writing of the determination of the NMFA to impose the penalty, which shall be made on the record; ○ Shall provide for the imposition of a penalty only after the Issuer or any approved private mortgage insurer, servicer, bond guarantor, or other entity, as the case may be, has been given an opportunity for a hearing on the record; and	

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		covered entity as appropriate. • A covered entity shall make no capital distribution if, after making the distribution, the covered entity would be classified as anything other than well capitalized or adequately capitalized. The FMIC may permit a covered entity, to the extent appropriate or applicable, to repurchase, redeem, retire, or otherwise acquire shares or ownership interests if the repurchase, redemption, retirement, or other acquisition— o Is made in connection with the issuance of additional shares or obligations of the covered entity in at least an equivalent amount; o Will reduce the financial obligations of the covered entity or otherwise improve the financial condition of the covered entity; o Will enhance the ability of the covered entity to promptly meet the minimum capital level for the covered entity; o Contributes to the long-term financial safety and soundness of the covered entity; or o Furthers the public interest. <u>Adequately Capitalized</u> • The FMIC shall require a covered entity that is classified as adequately capitalized	o May provide for review by the NMFA of any determination or order, or interlocutory ruling, arising from a hearing. • In determining the amount of a penalty, the NMFA shall give consideration to factors including— o The gravity of the offense; o Any history of prior offenses; o Ability to pay the penalty; o Injury to the public; o Benefits received; o Deterrence of future violations; and o Such other factors as the NMFA may determine, by regulation, to be appropriate. <u>Action to Collect Penalty</u> If the Issuer or any previously approved private mortgage insurer, servicer, bond guarantor, or other entity, as the case may be, fails to comply with an order by the NMFA imposing a civil money penalty under this section, the NMFA may bring an action in the U.S. District Court for D.C. to obtain a monetary judgment against the Issuer or any previously approved private mortgage insurer, servicer, bond guarantor, or other entity, as the case may be, and such other relief as may be available. The monetary judgment may, in the court's discretion, include the attorneys' fees and other expenses incurred by the U.S. in connection with the action. In an action under	

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		to— o Submit to the FMIC a capital restoration plan; and o Implement the plan after approval. • The FMIC may take, with respect to an adequately capitalized covered entity, any of the actions authorized to be taken with respect to an undercapitalized covered entity, if the FMIC determines that such actions are necessary to carry out the purposes of this subtitle. <u>Undercapitalized</u> • The FMIC shall require a covered entity that is classified as undercapitalized to— o Submit to the FMIC a capital restoration plan; and o Implement the plan after approval. • An undercapitalized covered entity shall not permit its average total assets during any calendar quarter to exceed its average total assets during the preceding calendar quarter, unless— o The FMIC has accepted the capital restoration plan of the covered entity; o Any increase in total assets is consistent with the capital restoration plan; and o The ratio of capital to total assets of the covered entity increases during the calendar quarter at a rate sufficient to enable the covered entity	this subsection, the validity and appropriateness of the order imposing the penalty shall not be subject to review. <u>Settlements</u> The NMFA may compromise, modify, or remit any civil money penalty which may be, or has been, imposed under this section. <u>Deposit of Penalties</u> The NMFA shall use any civil money penalties collected under this section to help fund the MIF. <u>Suspension and Revocation Authority.</u> Nothing in this section shall limit the authority of the NMFA to suspend or revoke the approved status of any private mortgage insurer, servicer, bond guarantor, or other entity previously approved by the NMFA.	

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		to become adequately capitalized within a reasonable time.
		• An undercapitalized covered entity shall not, directly or indirectly, acquire any interest in any entity or engage in a new activity, unless—
		  o The FMIC has accepted the capital restoration plan of the covered entity, the covered entity is implementing the plan, and the FMIC determines that the proposed action is consistent with and will further the achievement of the plan; or
		  o The FMIC determines that the proposed action will further the purpose of this section.
		• The FMIC shall—
		  o Closely monitor the condition of any undercapitalized covered entity;
		  o Closely monitor compliance with the capital restoration plan, restrictions, and requirements imposed on an undercapitalized covered entity under this section; and
		  o Periodically review the capital restoration plan, restrictions, and requirements applicable to an undercapitalized covered entity to determine whether the plan, restrictions, and requirements are achieving the purpose of this section.
		• The FMIC may take, with respect to an		

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		undercapitalized covered entity, any of the actions authorized to be taken with respect to a significantly undercapitalized covered entity, if the FMIC determines that such actions are necessary to carry out the purpose of this subtitle.
		
		<u>Significantly Undercapitalized</u>
		• The FMIC shall require a covered entity that is classified as significantly undercapitalized to—
		  o Submit to the FMIC a capital restoration plan; and
		  o Implement the plan after approval.
		• In addition to any other actions taken by the FMIC, the FMIC may, at any time, take any of the following actions with respect to a covered entity that is classified as significantly undercapitalized:
		  o Limit any increase in, or order the reduction of, any obligations of the covered entity, including off-balance sheet obligations.
		  o Limit or prohibit the growth of the assets of the covered entity, or require reduction of the assets of the covered entity.
		  o Require the covered entity to raise new capital in a form and amount determined by the FMIC.
		  o Require the covered entity to		

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		terminate, reduce, or modify any activity that creates excessive risk to the covered entity, as determined by the FMIC. o Take 1 or more of the following actions: ▪ Order or hold a new election for the board of directors of the covered entity. ▪ Require the covered entity to dismiss from office any director or executive officer who had held office for more than 180 days immediately before the date on which the covered entity became undercapitalized. ▪ Require the covered entity to employ qualified executive officers (who, if the FMIC so specifies, shall be subject to approval by the FMIC). <u>Critically Undercapitalized</u> • The FMIC shall have the authority to resolve a critically undercapitalized covered entity that is a regulated entity pursuant to § 1367 of the 1992 Act. • The FMIC shall have the authority to resolve a critically undercapitalized covered entity that is not a regulated entity pursuant to the resolution authority granted to the FMIC under §§ 311(h),		

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		312(h), 313(g), and 703(i), as applicable.		
Acquisitions of Covered Entities		**§ 317 Ownership, Acquisitions, and Operations of Covered Entities** Acquisitions of Covered Entities It shall be unlawful, except with the prior approval of the FMIC, for any person to— • Directly or indirectly own, control, or have power to vote 10% of any class of voting shares of any covered entity (except to the extent that voting stock is required to be purchased by Federal statute as a condition to participate in the covered entity's programs); • Control in any manner the election of a majority of the directors or trustees of any covered entity; • Exercise a controlling influence over the management or policies of any covered entity; • Merge or consolidate with any covered entity; or • Divest a covered entity, or any substantial line of business of a covered entity, into any surviving entity. Application and Approval Process The FMIC shall establish, by regulation, an application, in such form and manner and requiring such information as the FMIC may require, for the approval of acquisitions, mergers, consolidations, or divestitures. The FMIC shall—		

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		• Establish internal timelines for its processing of applications under this section, including timelines for any action to approve or to deny an application under this section; and • Notify any applicant of the FMIC's decision to approve or to deny their application as promptly as practicable. <u>Standards for Approval of Application</u> The FMIC shall establish, by regulation, standards for the approval by the FMIC of acquisitions, mergers, consolidations, or divestitures. The standards shall, at a minimum, be based on— • The application process established by the FMIC; • The financial history and condition of the applicant; • The capability of the applicant's management; • The general character and fitness of the applicant's officers and directors, including their compliance history with Federal and State laws and rules and regulations of self-regulatory organizations as defined in § 3(a)(26) of the Exchange Act as applicable; • The risk presented by such acquisition, merger, consolidation, or divestiture to the MIF; • Any other standard the FMIC determines		

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		necessary to promote competition and mitigate market dislocations among covered entities in the secondary mortgage market; and
		• Any other standard the FMIC determines necessary or appropriate.
		
		<u>Approval</u>
		The FMIC—
		• May approve any application made pursuant to this section if the applicant meets the standards; and
		• May not approve—
		  o Any application under this section which would result in a monopoly; or
		  o Any other proposed acquisition or merger or consolidation under this section whose effect in any area of the U.S. may be substantially to lessen competition, or to tend to create a monopoly, or which in any other manner would be in restraint of trade, unless the FMIC finds that the anti-competitive effects of the proposed transaction are clearly outweighed in the public interest by the probable effect of the transaction in meeting the needs of consumers and the communities served.
		• Shall have authority to deny any application if an officer or director of the applicant has, at any time before approval		

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		been subject to a statutory disqualification pursuant to § 3(a)(39) of the Exchange Act or suspended, removed, or prohibited under FDIA § 8(g), prohibited pursuant to FDIA § 8(e)(6) or (7), subject to an action resulting in a written agreement or statement under FDIA § 8(u)(1), for which a violation may be enforced by an appropriate Federal banking agency, or subject to any final order issued under FDIA § 8. <u>Restrictions on Engaging in Other Lines of Business</u> • An approved guarantor or approved multifamily guarantor may not engage in any activity relating to the business of insurance, other than any activity carried out by an approved guarantor or approved multifamily guarantor and approved by the FMIC pursuant to §§ 311 or 703. • An approved guarantor or approved multifamily guarantor may engage in any business activity unrelated to the business of insurance, subject to— ○ The prior approval of the FMIC; and ○ Any terms and conditions set forth by the FMIC. • This shall not be construed to prevent an approved guarantor from being an affiliate of a private mortgage insurer if approved by the FMIC.		

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		<u>Limits on Support or Guarantee Arrangement</u> • An approved guarantor or approved multifamily guarantor may not enter into any agreement, covenant, or other arrangement (including credit risk-sharing arrangement) with an affiliate or other person to support, guarantee, or finance any operation or activity of that affiliate. • Subject to any terms and conditions established by the FMIC, by regulation or order, an approved guarantor or approved multifamily guarantor may enter into an agreement, covenant, or other arrangement with an affiliate solely for the purpose of supporting, guaranteeing, or financing an operation or activity of the approved guarantor or approved multifamily guarantor. • Nothing in this section shall supersede the § 23A and 23B requirements of the Federal Reserve Act (transactions with affiliates). <u>Anti-Steering Requirement</u> The FMIC shall by regulation prohibit discounts made by an approved guarantor for any mortgage originator that is an investor, or affiliate of an investor, in the approved guarantor that are not otherwise available to other similar mortgage originators. The FMIC IG shall annually report to the FMIC and		

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		Congress on guarantors' practices and internal controls with respect to steering or preferential treatment for their investors prohibited by this section.		
New Utility Findings, Purposes, Definitions	**§ 302 Findings and Purposes** Findings The Congress finds that— • The liquidity and efficiency of the national housing finance market is enhanced by a robust secondary market for residential mortgage loans, including securities backed by residential mortgage loans; • The financial crisis that began in 2007 revealed weaknesses in the market infrastructure related to residential mortgage-backed securities, including— ○ Weaknesses in standards— ▪ For underwriting and servicing residential mortgage loans that may be collateral for mortgage-backed securities; and ▪ For issuers and trustees of such securities; ○ Weaknesses in the manner of recording and registering ownership and security interests in residential mortgage loans that backed pools of securities; and ○ Weaknesses in the availability of information to assess performance of pools;			

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	• Weaknesses revealed in the financial crisis created uncertainty and impeded timely and successful resolution of troubled residential mortgage loans, and have impeded the return of private capital to the market for securities backed by residential mort- gage loans in the absence of a Federal guarantee of timely payment of principal and interest to investors; and • Improved standards and information availability and a national system for registering mort- gage-related documents, including notes, mortgages and deeds of trust, and ownership and security interests established therein, with standard procedures for demonstrating the right to act with regard to such notes or other registered data, would assist in addressing these weaknesses. <u>Purposes</u> The purposes of the national mortgage market utility created by this title are— • To enhance efficiency, liquidity, and security in the secondary market for residential mortgages, including mortgage-backed securities; • To establish standards related to originating and servicing eligible collateral and for issuers and trustees of qualified securities, which would be			

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	exempt from the Securities Act of 1933; • To improve uniformity, quality and accessibility of information related to the performance of residential mortgage loans; • To operate a common securitization platform that could be available to issuers of residential mortgage-backed securities; • To foster the use and uniformity of electronic methods for the creation, authentication, transmission, storage, and availability of materials relating to mortgages; • To provide a central repository for notes, mortgages, and other mortgage-related information, and address problems that can arise when paper notes cannot be produced, due to loss or destruction as a result of natural disaster or other causes; and • To provide a uniform procedure for demonstrating the right to act with regard to such notes or other registered data for all actions in any State or Federal proceeding, judicial or nonjudicial, involving such notes or other data. **§ 303 Definitions** With respect to the Utility, *Affiliate* means any entity that controls, is controlled by, or is under common control with, the Utility.			

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	Agency means FHFA.
	
	Depositor means—
	• Any person authorized to submit documents or data for registration with the Repository; and
	• Any person qualified pursuant to § 331 (relating to organization and operation of the Repository) to inform the Repository of—
	  o Newly identified interest holders, whether through creation, assignment, or transfer; or
	  o Changes to interests of existing holders, including through modification, amendment, or restatement of, or dis- charge related to, any registered mortgage- related document.
	
	Director means the FHFA Director.
	
	Eligible Collateral means a residential mortgage loan that meets any standard for mortgage classification established pursuant to § 322 (relating to standards for qualified securities).
	
	Enterprise or GSE means Fannie Mae, Freddie Mac, or any affiliate thereof.
	
	Mortgage-related document means any			

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	document or other information or data related to the use of residential real estate as security for a loan, including documents establishing an obligation to repay a loan secured by residential real estate, establishing a security interest in real estate, establishing the value of the real estate at the time the security interest is created, and insuring clear title to residential real estate pledged as security, or as the Director by regulation may define, and may include electronic documents. *Organizer* means the person or entity that establishes the Utility. *Participant* means any person authorized to use data maintained or created by the Repository that is not otherwise available to the public. *Platform* means the securitization infrastructure FHFA announced on October 4, 2012, and as developed by a GSE or the GSEs in conservatorship, under FHFA authority under the 1992 Act. *Repository* means the national mortgage data repository organized under § 331. *Utility* means the national mortgage market utility established under § 311. *Utility-Affiliated Party* means—			

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	• Any director, officer, employee or controlling stockholder of, or agent for, the Utility;
	• Any shareholder, affiliate, consultant, or joint venture partner of the Utility, and any other person, as determined by the Director (by regulation or on a case-by-case basis) that participates in the conduct of the affairs of the Utility;
	• Any independent contractor of the Utility (including any attorney, appraiser or accountant) if—
	  ○ The independent contractor knowingly or recklessly participates in any violation of law or regulation, any breach of fiduciary duty or any unsafe or unsound practice; and
	  ○ Such violation, breach or practice caused, or is likely to cause, more than a minimal financial loss to, or a significant adverse effect on, the Utility.			

Securitization Utility / Platform / Cooperative Establishment	**§ 311 Establishment** <u>Authority of Director</u> Under such regulations as the Director may prescribe, the Director shall provide for the organization, incorporation, examination, operation, and regulation of a national mortgage market utility ("Utility"), and issuance of a charter for such Utility. The Utility shall be organized, operated, and	**Subtitle C—Securitization Platform and Transparency in Market Operations** **Part I—Securitization Platform** **§ 321 Establishment of the Securitization Platform** <u>In General</u> The FMIC shall establish an entity known as the Securitization Platform (or Platform) that shall be a utility owned by and operated for	**§ 211 Establishment of the Mortgage Securities Cooperative** <u>Establishment</u> There shall be established a cooperative entity to be known as the Mortgage Securities Cooperative that shall serve as the sole issuer for covered securities to be insured under § 204.	**§ 201 Issuing Platform** <u>Establishment</u> There is established within Ginnie Mae an entity to be known as the Issuing Platform (the "Platform"), which shall issue standardized MBS to increase homogeneity in the eligible securities market. The Platform may— • Make contracts, incur liabilities, and borrow money;

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	managed as a not-for-profit entity.
	
	<u>Formation of Utility; Application</u>
	• Subject to the terms of this subtitle and any regulations issued by the Director, a person or entity may file an application with the Director to establish the Utility. The Utility may be chartered as a corporation, mutual association, partnership, limited liability corporation, cooperative, or any other organizational form that the applicant may deem appropriate.
	• An application for establishment of the Utility shall include—
	  ○ The proposed articles of association;
	  ○ A statement of the general object and purpose of the Utility, consistent with the provisions of this subtitle;
	  ○ The proposed capitalization and business plan for the Utility;
	  ○ The proposed State whose law would govern, by election of the applicant, the operation of the Utility to the extent not otherwise covered by this subtitle;
	  ○ Information on the financial resources of the applicant;
	  ○ A statement of the relevant housing finance experience of the applicant;
	  ○ Identification of the proposed senior managers of the Utility, and the
		the benefit of its members as—
		• A nonprofit cooperative; or
		• A cooperative entity other than a nonprofit cooperative that—
		  ○ Best achieves the purposes and obligations of the Platform under § 325; and
		  ○ Serves the public interest.
		
		<u>Regulated by the FMIC</u>
		• The Platform shall be regulated and supervised by the FMIC.
		• The Platform shall not be an agency or instrumentality of the Federal Government.
		• The FMIC shall determine the legal form of incorporation of the Platform.
		• The FMIC shall—
		  ○ Determine in which of the several States to incorporate the Platform; and
		  ○ Have the authority to amend the State of incorporation to best effectuate the purposes and obligations of this part and other provisions of this Act.
		• Not later than 1 year after the agency transfer date, the FMIC shall file and submit the necessary documents to incorporate the Platform in the State the FMIC determines.
		
		<u>Funding by the FMIC and Transfer of</u>
			<u>Membership</u>
			Institutions that wish to issue insured covered securities through the Issuer, or to contribute loans into a mechanism for aggregating loans from multiple originators, shall be members of the Issuer, subject to such rules as established or approved by the NMFA.
			
			<u>Governance</u>
			Governance of the Issuer shall be on the basis of one-member, one-vote. The board of the Issuer shall have representation of originators of a range of sizes and charters to ensure that small institutions are adequately represented. The NMFA may establish or approve rules regarding governance and board representation.
			
			<u>Common Securitization Platform</u>
			Subject to such rules as the Director may establish, the Issuer may use the common securitization platform established by the GSEs to issue covered securities that are subject to the guarantee, subject to such requirements as the FHFA Director and Treasury shall establish.
			
			<u>Corporate Powers</u>
			The Issuer shall have power—
			• To adopt, alter, and use a corporate seal, which shall be judicially noticed;
			• To enter into and perform contracts,
				• Purchase, sell, receive, hold, and use real and personal property;
				• Create, execute, and administer trusts; and
				• Take such actions as the Platform determines are necessary or incidental to carry out the Platform's duties under this Act.
				
				<u>Delivery of Pool to the Platform</u>
				A mortgage originator or aggregator that wishes to make use of the Platform and have Ginnie Mae insure the securities issued by the Platform shall deliver to the Platform a pool of eligible mortgage loans.
				
				<u>Securitization</u>
				The Platform shall, upon receiving a pool of eligible mortgages—
				• Create standardized MBS collateralized by such mortgages; and
				• Transfer the standardized MBS to the mortgage originator or aggregator from which the Platform received the pool of eligible mortgages that are collateralizing the securities or the designee of such originator or aggregator.
				
				<u>Standardized Criteria for Securities</u>
				In issuing securities under this section, the Platform shall establish standardized criteria for such securities, including—

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	relevant experience of such individuals; and o Any other information the Director determines to be necessary to evaluate the back- ground, experience, and integrity of the applicant and the proposed senior managers, or information otherwise relevant to determine the likely success of the proposed Utility. <u>Issuance of Charter and Chartering Criteria</u> • Within 2 years of enactment, the Director shall issue a charter for the Utility to the applicant that the Director determines, in the Director's sole discretion, has the managerial, financial, and operational resources to succeed, consistent with the purposes of this subtitle. At the discretion of the Director, the charter may require the Utility to obtain specific approval from the Director before commencing any business operation, including operations related to the Platform or the Repository, which approval shall be provided when the Director determines, in the Director's sole discretion, that the Utility demonstrates appropriate operational, managerial, and governance capability with regard to such operation, including successful completion of testing and transition periods.	<u>Property</u> • At a time established by the FMIC, the FMIC shall transfer to the Platform such funds as the FMIC, in consultation with the Platform Directors, determines may be reasonably necessary for the Platform to begin carrying out its activities and operations. • Consistent with Title VI, the FHFA, in consultation with the FMIC and, as appropriate, the GSEs, may direct the GSEs to transfer or sell to the Platform any property, including but not limited to, intellectual property, technology, systems, and infrastructure (including technology, systems, and infrastructure developed by the GSEs for the CSP), as well as any other legacy systems, infrastructure, and processes that may be necessary for the Platform to carry out the functions and operations of the Platform. • As may be necessary for the FMIC, the FHFA, and the GSEs to comply with legal, contractual, or other obligations, the FHFA shall have the authority to require that any such transfer to the Platform occurs as an exchange for value, including though the provision of appropriate compensation to the GSEs or other entities responsible for creating, or contracting with, the CSP. • The transfer or sale of property to the	leases, cooperative agreements, or other transactions, on such terms as it may deem appropriate, with any agency or instrumentality of the U.S., or with any State, Territory, or possession, or Puerto Rico, or with any political sub division thereof, or with any person, firm, association, or corporation; • To execute, in accordance with its bylaws, all instruments necessary or appropriate in the exercise of any of its powers; • In its corporate name, to sue and to be sued, and to complain and to defend, in any court of competent jurisdiction, State or Federal, but no attachment, injunction, or other similar process, mesne or final, shall be issued against the property of the Issuer; • To conduct its business without regard to any qualification or similar statute in any State of the U.S., including D.C., Puerto Rico, and the Territories and possessions of the U.S.; • To lease, purchase, or acquire any property, real, personal, or mixed, or any interest therein, to hold, rent, maintain, modernize, renovate, improve, use, and operate such property, and to sell, for cash or credit, lease, or otherwise dispose of the same, at such time and in such manner as and to the extent that it may	• Uniform loan delivery, servicing, and pooling requirements; • Remittance requirements; • Underwriting guidelines and refinance programs; • The credit quality of the guarantee provided to each security; • Servicing standards and loan repurchase policies; • Disclosure policies; • Security terms and features; and • Standards for the appropriate minimum level of diversification for the mortgage loans that collateralize such securities, in order to reduce the credit risk such securities could pose to the Fund. <u>Securitization Fee</u> The Platform shall charge a fee for securitization services provided under this section. Such fee shall be set by the Director and shall be in an amount sufficient to offset the costs to the Platform of carrying out this section. <u>Certification</u> Ginnie Mae shall, upon a determination that the Platform is able to efficiently carry out the issuance of standardized mortgage-backed securities and that there exists a sufficient number of market participants to serve as insurers and reinsurers under § 202, certify to

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	• In making such a determination, the Director shall consider the competence, experience, and integrity of the applicant and proposed senior managers of the Utility, and the financial and operational resources and future prospects of the Utility. The Director may not issue a charter if the applicant fails to— ○ Comply with all applicable formation requirements; ○ Provide all information requested by the Director; ○ Demonstrate the competence, experience, and integrity necessary to operate the Utility in a safe and sound manner; ○ Demonstrate sufficient financial resources necessary to operate the Utility in a safe and sound manner; ○ Provide the Director with assurances that it will operate and maintain the Platform in an open-access manner that does not discriminate against eligible loan originators, aggregators, or qualified issuers; or ○ Provide the Director with assurances that the Utility will make available to the Director, on an on-going basis, such information on the operation and activities of the Utility, or any affiliate of the Utility, that the Director deems necessary to ensure the safe and sound operation of the	Platform shall, as appropriate, be managed by the FHFA to obtain resolutions that maximize the return for the GSEs' senior preferred shareholders to the extent that such resolutions— ○ Are consistent with facilitating— ▪ A deep, liquid, and resilient secondary mortgage market for single-family and multifamily MBS to support access to mortgage credit in the primary mortgage market; and ▪ An orderly transition from housing finance markets facilitated by the GSEs to housing finance markets facilitated by the FMIC with minimum disruption in the availability of loan credit; ○ Are consistent with applicable Federal and State law; ○ Comply with the requirements of this Act and the amendments made by this Act; and ○ Protect the taxpayer from having to absorb losses incurred in the secondary mortgage market. • The FHFA may not require the GSEs to make such a sale to the Platform that involves the disposition of the property or assets of the GSEs unless FHFA determines that the sale— ○ Is consistent with an orderly	deem necessary or appropriate; • To prescribe, repeal, and amend or modify, rules or requirements governing the manner in which its general business may be conducted; • To accept gifts or donations of services, or of property, real, personal, or mixed, tangible, or intangible, in aid of any of its purposes; and • To do all things as are necessary or incidental to the proper management of its affairs and the proper conduct of its business, including the establishment of such subgroups or corporate entities as are useful in conducting its business. <u>Exemption from Certain Taxes</u> The Issuer, including its franchise, capital, reserves, surplus, mortgages or other security holdings, and income shall be exempt from all taxation now or hereafter imposed by any territory, dependency, or possession thereof, or by any State, county, municipality, or local taxing authority, except that any real property of the Issuer shall be subject to State, territorial, county, municipal, or local taxation to the same extent according to its value as other real property is taxed. <u>Exclusive Use of Name</u> No individual, association, partnership, or corporation, except for the Issuer, shall	the Congress that such determination has been made. <u>Duty to Serve all Markets</u> • In carrying out its responsibilities under this title, Ginnie Mae shall facilitate the broad availability of mortgage credit and secondary mortgage market financing through fluctuations in the business cycle for single-family and multifamily lending across all— ○ Regions; ○ Localities; ○ Institutions; ○ Property types, including housing serving renters; and ○ Borrowers. • Ginnie Mae shall issue a semiannual report to the Congress on— ○ How Ginnie Mae is carrying out the duties to serve all markets; and ○ The extent to which the provisions of this title and the programs carried out pursuant to this title are benefitting underserved communities. <u>Exemption From SEC Laws and Regulations</u> Standardized MBS issued by the Platform shall be exempt from the Federal securities laws (as defined under Exchange Act § 3(a)) and all regulations issued pursuant to such laws.

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	Utility and to enforce compliance with this subtitle.
	• Within 30 days of denying any application for the issuance of a charter, the Director shall provide the applicant with a written explanation of the basis for the denial.
	
	<u>Authority to Suspend</u>
	• The authority of the Director shall include the authority to suspend the charter of the Utility, if the Director determines, in the Director's discretion, that—
	  ○ The organizers have failed to make adequate progress in establishing the Utility or any business operation;
	  ○ The organizers engaged in waste of appropriated funds made available for establishment of the Repository; or
	  ○ Such suspension is necessary for any other reason related to safe and sound operation of the Utility.
	• The Director shall issue regulations to address suspension of the charter, including a process for remediation.
	
	<u>Status</u>
	• The Utility is not, and shall not be deemed to be, a department, agency, or instrumentality of the U.S. Government and shall not be subject to title 5 or 31 of
		transition from housing finance markets facilitated by the enterprises to efficient housing finance markets facilitated by the FMIC with minimum disruption in the availability of loan credit;
		  ○ Does not impede or otherwise interfere with the ability of the FHFA or FMIC to carry out the functions and requirements of this Act;
		  ○ Does not transfer, convey, or authorize any guarantee or Federal support, assistance, or backing, implicit or explicit, related to any such property or assets being sold; and
		  ○ Will maximize the return for the senior preferred shareholders.
		
		<u>Platform Operability</u>
		The FMIC shall establish sufficient redundancies in the Platform so that in the event of operational disruption of the Platform, there is sufficient back-up capacity to—
		• Process payments on existing securities issued through the Platform; and
		• Structure, form, and enable issuers to issue new securities through the Platform.
		
		<u>Use by Other Entities in Exigent Circumstance</u>
			hereafter use the words "Mortgage Securities Cooperative" or any combination of such words, as the name or a part thereof under which the individual, association, partnership, or corporation shall do business. Violations may be enjoined by any court of general jurisdiction at the suit of the proper body corporate. In any such suit, the plaintiff may recover any actual damages flowing from such violation, and, in addition, shall be entitled to punitive damages (regardless of the existence or nonexistence of actual damages) of not exceeding $100 for each day during which such violation is committed or repeated.	

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	the U.S. Code. • Notwithstanding any other provision of law, the Utility shall be subject to the exclusive supervision and regulation by the Agency, and shall not be subject to supervision or regulation by any other Federal department or agency or by any State. The Utility is authorized to conduct its business without regard to any qualification or similar statute in any State. • The Utility shall be exempt from all taxation imposed by the U.S., any U.S. territory, dependency, or possession, or any State, county, municipality, or local taxing authority, except that any real property of the Repository shall be subject to State, territorial, county, municipal, or local taxation to the same extent according to its value as other real property. <u>Directors</u> Next row down. <u>Reports to Congress</u> Commencing with the first annual report of the Director following the date of the enactment of this Act, the annual report of the Director under § 1319B of the 1992 Act (12 U.S.C. 4521) shall include a description of the Agency's activities with regard to	• On and after the system certification date, if the FMIC determines that operational or other problems with the Platform do not permit the Platform to operate in a manner that allows the Platform to achieve the purposes and obligations of the Platform under § 325, the FMIC shall have the authority to permit the Platform Directors to use entities other than the Platform to perform issuance functions required to be performed by the Platform for issuers and that are necessary for the proper functioning of the secondary mortgage market. • Any entity permitted to perform issuance functions that would ordinarily be expected to be performed by the Platform shall be regulated and supervised, as appropriate, by the FMIC as if such entity were the Platform itself.		

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	organization, incorporation, examination, operation, and regulation of the Utility.			

Securitization Platform Management	**§ 311(f) Directors**
	The Utility shall be governed by a board of directors, which shall consist of a number of directors determined by the Director to meet the needs of the Utility, of which—
	• Not less than two members shall be from larger financial institutions;
	• Not less than two members shall be from smaller financial institutions;
	• Not less than two members shall have expertise in residential mortgage securitizations;
	• Not less than two members shall have expertise in legal and electronic documentation and systems; and
	• Such other members as the Director may provide, who shall have such qualifications as the Director may establish in the charter or by regulation to meet the requirements for independence and any provisions of applicable State law.
		§ 322 Management of the Platform
		<u>Platform Directors</u>
		• The Platform Directors shall have all the powers necessary to carry out the purposes, powers, and functions of the Platform, and in the exercise of such purposes, powers, and functions, and upon approval of the FMIC, shall adopt such rules and guidance and issue such orders as they deem necessary and appropriate.
		• The Platform Directors shall develop policies and procedures to monitor and mitigate potential conflicts of interest in carrying out the purposes, powers, and functions of the Platform.
		• The initial Platform Directors shall be comprised of 5 directors, each of whom shall be appointed by the Board of Directors but none of whom shall be a member of the Board of Directors. The initial Platform Directors shall be appointed not later than 180 days after the later of—
		  ○ The filing of the necessary documents to incorporate the Platform as required under § 321(c); or
		  ○ The approval of the incorporation of the Platform by the relevant State.		

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		• Each initial Platform Director shall serve for a term of 1 year. The Board of Directors may— ○ In its discretion, extend for an additional year the term of each initial Platform Director; and ○ Upon a determination by the FMIC that the Platform membership does not reflect the diversity or variety of market participants required to conduct the election of the Platform Directors (below), extend for an additional 2 years the term of each initial Platform Director. • The initial Platform Directors shall— ○ Draft and enact initial bylaws and other governance documents for the operation of the Platform, including policies and procedures to monitor and mitigate conflicts of interest; ○ Establish criteria for membership in the Platform consistent with the requirements of § 323; ○ Establish any necessary initial fee structures or usage fee structures under § 324; and ○ Organize and conduct the election of the Platform Directors from the Platform members. • Upon the expiration of the term of the members of the initial Platform Directors, the members of the Platform shall, in		

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		accordance with the following, elect new Platform Directors. ○ The elected Platform Directors shall reflect the diverse range of Platform members, including large, mid-size, and small business members. The elected Platform Directors shall be comprised of nine directors as follows: ▪ Eight member directors, including: ♦ Seven who shall be elected from representatives of Platform members, at least 1 of whom shall represent the interests of small mortgage lenders; and ♦ One who shall be a representative of a small lender mutual established under § 315. ▪ One independent director. The independent director shall not be an affiliated of any member in the Platform, and shall have demonstrated knowledge of, or experience in, financial management, financial services, risk management, information technology, or housing finance, which may include affordable housing finance.		

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		○ The Chairperson of the Platform Directors shall be elected from among the elected Platform Directors. ○ Each elected Platform Director shall serve for a term of 2 years, but: ▪ The first elected chairperson of the Platform Directors shall be elected to serve for a term of 2 years; and ▪ Of the first 8 other Platform Directors not elected to serve as chairperson: ♦ Four shall be elected to serve for a term of 2 years. ♦ Four shall be elected to serve an initial term of 1 year. ○ Platform Directors shall have equal voting rights on any matters before the Platform Directors. ○ Procedures for the nomination and election of Platform Directors shall be prescribed by the bylaws adopted by the Platform Directors in a manner consistent with the purposes and provisions of this part. • The elected Platform Directors, with approval from the FMIC, may choose to restructure or reorganize the Platform Directors in a manner different than what is specified following a determination by		

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		the Platform Directors and the FMIC that a different Platform board structure or Platform board composition would better achieve the purposes and obligations of this Act, or better serve the owners of the Platform in a manner consistent with the public interest. <u>Executive Officers</u> The Platform Directors shall appoint a chief executive officer, chief financial officer, comptroller, chief regulatory officer, and any other officers as the Platform Directors deem necessary to carry out the management and administration of the functions and operations of the Platform.		
Securitization Platform Members		**§ 323 Membership in the Platform** <u>Application</u> • A person seeking to become a member in the Platform, or to be reinstated as a member in the Platform, shall file an application with the Platform Directors. • Consistent with achieving a broad membership that includes small mortgage lenders, as well as large, mid-size, and small business members, the Platform Directors shall develop procedures and standards for— o The application of persons seeking to become members in the Platform; and o The approval of applicants for		

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		membership in the Platform. • The standards for the approval by the Platform Directors of an approved entity as a member in the Platform shall be consistent with and supplement any standards, requirements, and obligations applicable to the approved entity under subtitle B of this title, or any other provision of this Act. <u>Members</u> The Platform Directors may approve as a member of the Platform any person that applies for membership in the Platform that is— • A mortgage aggregator; • A mortgage guarantor; • A mortgage originator; • An FHLB or a subsidiary or joint office approved under § 312 of one or more FHLBs; • A small lender mutual established or approved under § 315; or • Any other market participant, provided that in the sole determination of the Platform Directors, having such market participant as a member of the Platform is necessary or helpful to fulfilling the purposes and obligations of the Platform under § 325. <u>Termination</u>		

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		The Platform Directors may terminate membership in the Platform of any member for failure to adhere to any standards established by the Platform Directors.		

Securitization Platform Fees	**§ 313 Transfer of Ownership of Platform**
	• Within 6 months of enactment, the Director shall determine a method for recovering the cost to each GSE of developing the Platform, in consultation with Treasury, and agree on a valuation of the Platform upon transfer to the Utility.
	• Not later than the end of the 1-year period beginning on the date of the issuance of the charter of the Utility by the Director, the Director shall oversee the transfer to the Utility of ownership of the Platform. At the time of such transfer, the agreed value of the Platform shall be deemed transferred to the Utility, and shall be repaid to the Treasury by the Utility within 10 years after such transfer.
	• After transfer of the Platform to the Utility, to the extent feasible the Platform shall be made available to the Agency on terms and conditions applicable to other users, to assist with managing the wind-down of any GSE for which the Agency is conservator or receiver pursuant to § 1367 of the 1992 Act (12 U.S.C. 4617).
	
	§ 314 Funding
		§ 324 Fees
		<u>In General</u>
		The Platform Directors may assess and collect fees, and may, in their discretion, increase or decrease such fees, from the members in the Platform—
		• For initial membership in the Platform;
		• To maintain ongoing membership in the Platform;
		• For use of the Platform; and
		• To cover the ongoing costs of the functions and operations of the Platform, including—
		  ○ The purchase of property, technology, and systems developed by either GSE or others;
		  ○ To develop and invest in new technology;
		  ○ To build a capital base that would be able to offset, or otherwise mitigate, losses that might occur due to the potential operational failure of the Platform; and
		  ○ To conduct any other activities approved by the Platform Directors.
		
		<u>Initial Fee</u>
		Upon approval of its application to become a		

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	• There is authorized to be appropriated $150,000,000 for the establishment and initial oversight, regulation, and supervision of the Utility and its operation (initial funding).
	• The Utility shall repay to the Treasury of the U.S. the amount of the initial funding within 10 years after the Utility is chartered.
	• After establishment, all expenses of the Utility shall be paid for by fees collected based on services provided by and operations of the Utility. The Utility shall—
	  o Establish, subject to the approval of the Director, a fee schedule and may differentiate fees based on classes or types of services, operations, and users of services or operations, and such differentiation shall not be deemed discriminatory; and
	  o Review and publish the fee schedule not less frequently than annually, but may review, revise, and publish the schedule more frequently than annually.
		member in the Platform, each new approved member shall pay to the Platform a fee in an amount to be determined by the Platform Directors, provided that such fee amount is consistent with obtaining a broad membership in the Platform that includes small mortgage lenders, as well as large, mid-size, and small business members.
		
		<u>Usage Fees</u>
		• Each member in the Platform shall pay usage fees, as such fees are determined by the Platform Directors.
		• The Platform Directors shall, not less than annually, review the fee structure established under this subsection and submit any resulting recommendations to amend the fee structure to the FMIC.
		• Except as below, usage fees charged and collected shall be equitably assessed and based upon the member's use of the services offered by the Platform, as such use is to be measured by the total principal balance of the mortgage loans or MBS securitized for the member through the Platform.
		  o If the Platform Directors determine that certain entities face a barrier to use the Platform, the Platform Directors may adopt a tiered usage fee structure to promote greater access and a more competitive		

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		market for the Platform that may include differential fee structures for usage fee charges incurred by housing finance agencies, small mortgage lenders, CDFIs, mission-based nonprofit lenders, community land trusts, permanently affordable homeownership programs, or other organizations selected by the FMIC. o The Platform Directors may adopt a tiered usage fee structure that may include differential fee structures for usage fee charges for the issuance of noncovered securities that differ from the usage fees charged for the issuance of covered securities. • Usage fees charged under this subsection shall be paid by the member at the time the mortgage loans or MBS are delivered by the member to the Platform. <u>FMIC Review of Initial Fees and Usage Fees</u> • The Platform Directors shall submit any fee structure proposal for initial fees or usage fees to the FMIC. The FMIC shall approve any initial fee or usage fee structure proposed by the Platform Directors unless the FMIC determines that the fee structure is not consistent with— o Facilitating, a deep, liquid, and resilient secondary mortgage market		

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		for MBS; and o The purposes and obligations of the Platform under § 325. • If the FMIC does not issue an order of disapproval of an initial fee or usage fee structure proposed by the Platform Directors within 60 days following the submission of the proposed initial fee or usage fee structure to the FMIC, the proposed initial fee or usage fee structure shall automatically go into effect for the Platform and its members. • If the FMIC disapproves an initial fee or usage fee structure proposed by the Platform Directors, the Platform Directors may— o Submit to the FMIC a revised fee or usage fee structure for approval; or o If applicable, use the existing approved fee or usage fee structure.		
Securitization Powers / Activities	**§ 312 General Powers; Authorized and Prohibited Activities** <u>General Powers</u> The Utility may— • Adopt and use a corporate seal; • Determine a State whose law will govern the corporate business activities of the Utility; • Adopt, amend, and repeal by-laws; • Sue or be sued, subject to § 334 (relating to judicial review); • Make contracts, incur liabilities, borrow	**§ 325 Purposes and Obligations of the Platform** <u>Purpose</u> The purposes of the Platform are to— • Purchase and receive from its members eligible mortgage loans or securities collateralized by eligible mortgage loans for securitization by issuers as covered securities; • Issue to its members standardized covered securities, or other covered securities, issued by issuers and insured by the	**§ 212 Issuer Standards** <u>In General</u> The NMFA shall develop, adopt, and publish standards for issuance of covered securities, including standards with respect to the Issuer's ability to— • Aggregate eligible mortgage loans into pools; • Securitize eligible mortgage loans for sale to private investors as a covered security; • Transfer or otherwise place credit risk with private market participants in	

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	money, and issue notes, bonds, or other obligations; • Purchase, receive, hold, and use real and personal property and other assets necessary for the conduct of its operations; • Elect or appoint directors, officers, employees and agents, subject to § 311(f); and • Upon receipt of the Director's prior written approval, establish subsidiaries or affiliates that shall be subject to the same rights, duties and responsibilities as the Utility. <u>Authorized Activities</u> The Utility shall— • Develop standards related to originating, servicing, pooling, and securitizing residential mortgage loans in accordance with §§ 321 – 325; • Operate and maintain the Platform and establish fees for use of the Platform; • Establish the Repository and establish fees for registration of mortgage-related documents and maintenance and use of data of the Repository, in accordance with §§ 331 – 335; • Perform any other service or engage in any other activity that the Director determines, by regulation or order, to be incidental to the activities enumerated in	FMIC pursuant to this Act; • Purchase and receive from its members noneligible mortgage loans or securities not collateralized by eligible mortgage loans for securitization by issuers as noncovered securities, to the extent desired or requested by its members; and • Issue to its members standardized noncovered securities, or other noncovered securities issued by issuers, that are not insured by the FMIC pursuant to this Act, to the extent desired or requested by its members. <u>Powers and Functions</u> The powers and functions of the Platform are to— • Develop the ability to issue, and to issue, standardized covered securities, insured by the FMIC, in accordance with subsection (e); • Develop, adopt, and publish standardized securitization documents and agreements (including, but not limited to, uniform pooling, trust, and custodial agreements)— ○ Required for all covered securities issued by or through the Platform in accordance with § 326(a) (and which shall be made optional for all noncovered securities issued through the Platform); and	accordance with the risk-sharing mechanisms developed by the NMFA under § 202; • Ensure equitable access to the secondary mortgage market for covered securities for all institutions regardless of size or geographic location; • Create mechanisms for multi-lender pools for smaller lenders that will be acceptable to the private market; and • Ensure that eligible mortgage loans that collateralize a covered security insured under this title are originated in compliance with the requirements of this Act. <u>Additional Required Standards</u> Such standards shall include— • The financial condition of the Issuer; • The adequacy of the capital structure of the Issuer; • The risk presented by the Issuer to the MIF; • The adequacy of insurance and fidelity coverage of the Issuer; • A requirement that the Issuer submit audited financial statements to the NMFA; • The capacity of the Issuer to secure first loss credit enhancement on its own behalf or to ensure that its member provide such enhancement to loans insured through the	

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	this subsection; and • Establish fees for the provision of other related or incidental services not inconsistent with the purposes of this subtitle. <u>Prohibited Activities</u> The Utility shall not— • Originate, service, insure, or guarantee any residential mortgage or other financial instrument that is associated with a residential mortgage; • Guarantee timely payment of principal or interest on any mortgage-related security; • Adopt access rules or fees for the Platform the effect of which is to discriminate against eligible loan originators, aggregators, or qualified issuers based on size, composition, business line, or loan volume; or • Perform any service or engage in any activity other than those authorized under this subtitle, unless such activity has been determined by the Director to be incidental to an authorized activity. **§ 322(k) through (n) Data Standards; Public Involvement** <u>Data Standards; Disclosure Standards</u> • The Utility shall develop, adopt, and publish standard data definitions for all aspects of loan origination, appraisals,	○ Which— ▪ Shall be drafted in consultation with the FMIC, CFPB, HUD, and such other Federal regulatory agencies as the Platform Directors determine appropriate; ▪ May rely on existing documentation and forms the GSEs or other Federal regulatory agencies require, to the extent the Platform Directors determine practical or appropriate; and ▪ Before being issued through the Platform, shall be approved by the FMIC as being consistent with the requirements under § 326(a) and with facilitating a deep, liquid, and resilient secondary mortgage market for MBS; • Develop standardized documents approved by the FMIC for servicing and loss mitigation standards pursuant to § 314 for eligible mortgage loans that collateralize the covered securities issued through the Platform to its members, which shall be based on standards set by the FMIC and which may rely on existing documentation and forms the GSEs or other Federal or State regulatory agencies require, to the extent the Platform Directors determine practical or	Issuer; • Standards for membership by originators of mortgages, including standards relating to the safety and soundness of prospective members and regarding the underwriting and other practices of such members, including the retention or placement of credit risk; and • Any other standard the NMFA determines necessary or appropriate. **§ 213 Capital Requirements** <u>Establishment</u> The NMFA shall establish capital standards that the Issuer shall be required to meet in order to protect the MIF from the risk of loss. Such standards shall take account the risk of the mortgages securitized and the quality of the first-loss credit risk placement or retention by originators or the Issuer. <u>Building Capital</u> The NMFA shall not require that all capital be paid in advance prior to the operation of the Issuer, but may allow capital of the Issuer to be built through retained earnings. Such capital may include preferred shares issued by Treasury for the purpose of providing early capitalization to the Issuer. The NMFA may determine to treat any required capital to be paid in to the Issuer to differ by the size of the member.	

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	and servicing. In developing such definitions, the Utility shall consider the data standard-setting work undertaken by MISMO through the GSEs' Uniform Mortgage Data Program announced by FHFA on May 24, 2010. • The Utility shall develop, adopt, and publish standards for disclosure of loan origination, appraisal, and servicing data, including data required relating to underwriting criteria, for residential mortgage loans that comprise qualified securities, and that allow for trading of qualified securities in a forward market. • In developing the data and disclosure standards required by this subsection, the Utility shall ensure that such standards are coordinated. • In prescribing the definitions and standards required under this sub- section, the Utility shall take into consideration issues of consumer privacy and all statutes, rules, and regulations related to privacy of consumer credit information and personally identifiable information. Such standards shall expressly prohibit the identification of specific borrowers. • When reviewing any disclosure standards established under this subsection, the Director shall consult with the SEC. <u>Timing of Issuance; Agency Review;</u>	appropriate; • As expressly provided in § 326(b)(2)(F), develop, adopt, and publish the required contractual terms for contracts for noncovered securities issued through the Platform, which shall be— ○ Developed in consultation with the FMIC, CFPB, HUD, and such other Federal regulatory agencies as the Platform Directors determine appropriate; and ○ Before being issued through the Platform, approved by the FMIC as being consistent with the requirements under § 326(b) and with facilitating a deep, liquid, and resilient secondary mortgage market for MBS; • Develop, adopt, and publish optional standardized securitization documents and agreements (including, but not limited to, uniform pooling, trust, and custodial agreements) tailored for noncovered securities issued through the Platform, and which may be used as desired or requested by the members of the Platform, in accordance with § 326(c), and which standardized securitization documents and agreements— ○ Shall be drafted in consultation with the FMIC, CFPB, HUD, and such other Federal regulatory agencies as	<u>Added Risk</u> To the extent that market conditions have limited the level of credit risk that may be placed in the private markets, the NMFA shall increase the capital requirements to which the Issuer is subject in order to provide adequate protection to the MIF for the added risk. <u>Form</u> The NMFA may determine the form in which such capital shall be held, and any other standard that the NMFA determines to be necessary or appropriate. **§ 214 Limited Authority to Hold Eligible Mortgage Loans** <u>Authority</u> The Issuer may hold a limited amount of eligible mortgage loans, subject to the oversight and rules of the NMFA, for the following purposes: • To work out troubled loans that were included in guaranteed issuance. • To assemble loans for current issuance. • To hold loans from the smallest lenders until such loans can be aggregated into multi-lender loans. • To hold multi-family loans until such loans can be securitized. <u>Securitization</u>	

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	<u>Authority to Revise Standards</u> • The Director shall issue any regulations required by this section within 12 months of enactment. The Utility shall issue any definitions, standards, rules, processes, or procedures required by this section within 12 months of issuance of the charter. • Any definition, standard, rule, process or procedure established by the Utility shall be submitted to the Director for review and approval prior to its implementation if, in the Director's discretion, the Director requires such submission. Any definition, standard, rule, process or procedure that the Director requires be submitted to the Agency for review and approval shall be reviewed within three months of submission. • The Utility may review, revise, and, if revised, re-publish any standard form securitization agreement or other definition, standard, rule, process, or procedure required to be developed by §§ 301 – 344 if the Utility determines review or revision to be necessary or appropriate to satisfy the goals of this subtitle. Any such revisions shall apply only to securitizations made after the date of such revision. <u>Effect of Conflict</u> In the event a definition, standard, rule,	the Platform Directors determine appropriate; ○ May rely on existing documentation and forms the GSEs or other Federal or State regulatory agencies require, to the extent the Platform Directors determine practical or appropriate; and ○ Before being issued through the Platform, shall be approved by the FMIC as being consistent with the requirements under § 326(c) and with facilitating a deep, liquid, and resilient secondary mortgage market for MBS; • To the extent otherwise provided in this subsection, the Platform Directors shall endeavor to use or rely on existing documentation and forms the GSEs or other Federal or State regulatory agencies require, to the extent the Platform Directors determine practical or appropriate; • Establish a strong business continuity plan that meets industry best practices and establish sufficient redundancies so that in the event of an operational failure of the Platform there is sufficient back-up capacity to process payments and issue covered and noncovered securities; • Verify that the eligible mortgage loans and securities collateralized by eligible	The NMFA shall examine the loans retained by the Issuer each year and may determine that loans held can be securitized promptly without undue economic burden. **§ 215 Responsibility to Ensure Broad Market Access** <u>Responsibility</u> Consistent with the purposes of this Act, the Issuer shall facilitate a robust secondary market for eligible mortgages across the spectrum of creditworthy borrowers, including borrowers in underserved rural and urban markets. <u>Evaluation and Reporting of Compliance</u> Within one year of the NMFA certification date, the NMFA shall establish guidelines or rules for evaluating compliance by the Issuer with its duty to facilitate such a market to ensure broad market access and for rating the extent of such compliance. The NMFA shall evaluate such compliance and rate the performance of the Issuer as to the extent of such compliance. The NMFA shall include in such evaluation and rating in the report submitted pursuant to § 106 for that year. <u>Prohibition of Consideration of Affordable Housing Fund and Capital Magnet Fund for Ensuring Broad Market Access</u> In determining whether the Issuer has complied with its duty to facilitate such a	

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	process, or procedure established by the Utility is in conflict with any definition, standard, rule, process, or procedure established by another Federal department or agency, the Director shall consult with the other Federal department or agency, and provide prompt written notification to the Senate Banking Committee and the House Financial Services Committee, of the conflict. <u>Public Involvement</u> In developing definitions, standards, rules, processes, and procedures required by this subtitle, the Utility shall work with market participants, including servicers, originators, and mortgage investors, and develop methods for gathering information and comment from such groups.	mortgage loans purchased and received by the Platform, including from any small lender mutual established or approved under § 315, for securitization as covered securities, meet the requirements for covered securities under this Act and any regulations adopted by the FMIC pursuant thereto; • Verify that the noneligible mortgage loans and securities not collateralized by eligible mortgage loans purchased and received by the Platform, including from any small lender mutual established or approved under § 315, for securitization as noncovered securities, meet the requirements for noncovered securities under this Act and any regulations adopted by the FMIC pursuant thereto; • For the purpose of securitization, purchase or receive from Platform members— ○ Eligible mortgage loans, pools of eligible mortgage loans, securities collateralized by eligible mortgage loans, or outstanding MBS issued by the GSEs for securitization as covered securities; and ○ Noneligible mortgage loans, pools of noneligible mortgage loans, or securities collateralized by noneligible mortgage loans for securitization as noncovered	market, the NMFA may not consider any amounts used under § 402 or § 403 of this Act. <u>Enforcing Compliance with the Responsibility to Ensure Broad Market Access</u> • The Director shall monitor and enforce compliance with the Issuer's duty to facilitate such a market. • If, after a review of the evaluation and rating in the § 106 report, the Director preliminarily determines that the Issuer has not fulfilled the responsibility to ensure broad market access, the Director shall provide written notice to the Issuer of such a preliminary determination, the reasons for such determination, and the information on which the NMFA based the determination. • During the 30-day period beginning on the date on which the Issuer is provided such notice, the Issuer may submit any written information that the Issuer considers appropriate for consideration by the Director in finally determining whether such failure has occurred or whether achievement of such duty was or is feasible. The Director may extend the period for response for good cause for not more than 30 additional days. • After the expiration of the response period, or upon receipt of information	

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		securities, to the extent desired or requested by members of the Platform; • For the purpose of securitization, facilitate the issuance by issuers of— ○ All covered securities of members of the Platform that are collateralized by eligible mortgage loans, or outstanding MBS issued by the GSEs; ○ All covered securities of members of the Platform that are pooled from— ▪ A single mortgage originator, mortgage aggregator, approved entity, or regulated entity; or ▪ Multiple mortgage originators, mortgage aggregators, approved entities, or regulated entities; ○ Noncovered securities collateralized by noneligible mortgage loans received from members of the Platform; and ○ Noncovered securities collateralized by noneligible mortgage loans received from members of the Platform that are pooled from— ▪ A single mortgage originator, mortgage aggregator, or regulated entity; or ▪ Multiple mortgage originators, mortgage aggregators, or regulated entities;	provided during such period by the Issuer, whichever occurs earlier, the Director shall issue a final determination as to whether the Issuer has failed to meet the duty. In making a final determination, the Director shall take into consideration any relevant information submitted by the Issuer during the response period. The Director shall provide written notice, including a response to any information submitted during the response period, to the Issuer, the Senate Banking and House Financial Services Committees, of the final determination that Issuer has failed to meet the duty and the reasons for each such final determination. • If the Director finds that the Issuer has failed to meet the duty, the Director may require that the Issuer submit a plan under this subsection subject to such deadline as the Director shall establish. ○ The Director shall review the submission by the Issuer, including a plan submitted under this subsection, and, not later than 30 days after submission, approve or disapprove the plan or other action. The Director may extend the period for approval or disapproval for a single additional 30-day period if the Director determines it necessary. The Director shall approve any plan the Director determines is likely to	

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		• Perform bond administration, data validation, and reporting for all covered and noncovered securities issued through the Platform, including those issued on behalf of any small lender mutual established or approved under § 315; • Facilitate systems to lower barriers to entry for new mortgage originators and approved entities or access to membership in the Platform; • Provide essential functions necessary to issue standardized TBA securities, for covered securities and, if appropriate, noncovered securities; • Manage operational and systems related risks associated with delivering covered and noncovered securities and receiving eligible and noneligible mortgage loans; • Develop the capability to offer securitization services to private label issuers; • Facilitate for issuers the securitizations for multifamily loans, establish common documentation, or develop other requirements necessary to permit the Platform, or a subsidiary or affiliate thereof, to be used for multifamily loan securitizations if the Platform Directors issue a determination that it would be desirable and practical for the Platform, or a subsidiary or affiliate thereof, to be used to issue or otherwise facilitate	succeed. ○ If the Director makes such a finding and the Issuer refuses to submit such a plan, submits an unacceptable plan, or fails to comply with the plan, the Director may issue a plan describing specific actions the Issuer will be required to take for the next calendar year and to make such improvements and changes in its operations as are reasonable in the remainder of the current year, in sufficient detail to enable the Director to monitor compliance periodically. ○ The Director shall provide written notice to the Issuer submitting a plan of the approval or disapproval of the plan (which shall include the reasons for any disapproval of the plan) and of any extension of the period for approval or disapproval. ▪ The Director may issue and serve a notice of charges under this subparagraph upon the Issuer if the Director determines that the Issuer has failed to submit a plan that complies with this section within the applicable period or the Issuer has failed to comply with a plan under this section. ▪ Each notice of charges shall contain a statement of the facts	

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		multifamily loan securitizations; and
		• Require the servicing documentation used for mortgage loans that collateralize securities issued through the Platform to provide a standard method (which may include use of a single e-verification system) for a mortgagor who has been denied a loan modification to verify such denial at no cost to the mortgagor.
		• Establish by the system certification date a Collateral Valuation Advisory Committee—
		  ○ Comprised of 9 members appointed by Platform Directors, including representatives of appraisers, mortgage originators (including small mortgage lenders), investors, real estate professionals, homebuilding professionals, consumer advocates, and Federal and state appraisal regulatory organizations;
		  ○ The purpose of the Committee shall be to:
		    ▪ Provide recommendations to the Platform and FMIC regarding secondary mortgage market residential appraisal guidelines, standards, and reporting formats consistent with RESPA, TILA, and all other applicable federal and state law;
			and shall fix a time and place at which a hearing will be held to determine on the record whether an order to cease and desist from such conduct should issue. If the Director finds on the record made at a hearing that any conduct specified in the notice of charges has been established, the Director may issue and serve upon the Issuer an order requiring the Issuer to submit a housing plan in compliance with this section and comply with the housing plan.
			▪ A cease and desist shall become effective upon the expiration of the 30-day period beginning on the date of service of the order upon the Issuer (except in the case of an order issued upon consent, which shall become effective at the time specified therein), and shall remain effective and enforceable as provided in the order, except to the extent that the order is stayed, modified, terminated, or set aside by action of the Director or otherwise.
			○ The Director may impose a civil money penalty, in accordance with the provisions of this subparagraph,	

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		▪ Make recommendations regarding the continuation of a repository for valuation reports, taking into account existing operational structures and contractual arrangements; and o Which shall as appropriate consult and coordinate with the FFIEC Appraisal Subcommittee. <u>Prohibited Activities</u> The Platform may not— • Guarantee any mortgage loans or MBS; • Assume or hold mortgage loan credit risk; • Purchase any mortgage loans for cash on a single loan basis for the purpose of securitization; • Undertake the issuance of any MBS by an issuer unless the first loss position is already held by a private entity; • Own or hold any mortgage loans or MBS for investment purposes; • Make or be a party to any representation and warranty agreement on any mortgage loans; or • Take lender representation and warranty risk. <u>Interoperability with Multifamily Loan Securitization Issuance</u> The Platform shall be developed in a manner that may permit, and would not preclude, the	on the Issuer if the Issuer has failed to— ♦ Submit information to the NMFA pursuant to subsection of this section; ♦ Submit a housing plan or perform its responsibilities under a remedial order issued within the required period; or ♦ Comply with a housing plan for the Issuer of this subsection. ▪ The Director shall establish standards and procedures governing the imposition of civil money penalties under this subparagraph. Such standards and procedures— ♦ Shall provide for the Director to notify the Issuer in writing of the determination of the Director to impose the penalty, which shall be made on the record; ♦ Shall provide for the imposition of a penalty only after the Issuer has been given an opportunity for a hearing on the record; and ♦ May provide for review by	

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		Platform, or any subsidiary or affiliate thereof, to be used for the issuance of multifamily loan securitizations, provided that the development of this vehicle for multifamily loan securitizations does not delay the ability of the Platform to perform its obligations under this section with respect to single-family securities by the system certification date. <u>Timing of Platform Capacity to Develop and to Issue Standardized Securities for the Single-Family Covered Securities</u> Not later than 2 years following the election of the elected Platform Directors under § 322(a)(3), the Platform shall develop the Platform's ability to issue, and issue, standardized securities for single-family covered securities, or as otherwise permitted under § 601. <u>Discretion to Issue Standardized Securities for Single-Family Noncovered Securities</u> The Platform Directors may develop an ability for the Platform to issue standardized securities for single-family noncovered securities, if the Platform Directors determine that sufficient demand exists among the Platform members for the Platform to issue such a product.	the Director of any determination or order, or interlocutory ruling, arising from a hearing. ▪ In determining the amount of a penalty under this subparagraph, the Director shall give consideration to factors including— ♦ The gravity of the offense; ♦ Any history of prior offenses; ♦ Ability to pay the penalty; ♦ Injury to the public; ♦ Benefits received; ♦ Deterrence of future violations; ♦ The length of time that the Issuer should reasonably take to achieve the duty; and ♦ Such other factors as the Director may determine, by regulation, to be appropriate. ▪ The Director may compromise, modify, or remit any civil money penalty, which may be, or has been, imposed under this subparagraph. ▪ The Director shall use any civil money penalties collected under this section to help fund the	

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			Housing Trust Fund established under § 1338 of the 1992 Act, the Capital Magnet Fund established under § 1339 of such Act, and the Market Access Fund established under § 404 of this Act, pursuant to the allocations provided in § 401 of this Act. <u>Consistency with Safety and Soundness</u> The NMFA shall take appropriate measures designed to ensure that the requirements under this section are implemented in a manner consistent with safety and soundness principles.	
Utility Regulation	**§ 315 Regulation, Supervision, and Enforcement** <u>General Oversight</u> The Director shall exercise, by rule, order, or guidance, oversight of the Utility, which shall include the authority to regulate, supervise, and examine the Utility and take enforcement actions against the Utility or any Utility-affiliated party, consistent with the 1992 Act. <u>Scope of Authority</u> The authority of the Director under this section shall include the authority to exercise such incidental powers as may be necessary or appropriate to fulfill the duties and responsibilities of the Director in the oversight, supervision, and regulation of the			

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	Utility. <u>Division of Utility Regulation</u> The Director shall establish within the Agency a Division of Utility Regulation, which shall— • Be headed by a Deputy Director designated by the Director from among individuals who are U.S. citizens who have a demonstrated understanding of financial management or oversight and of mortgage securities markets and housing finance; and • As requested by the Director, conduct examination and supervision activities, gather any information attendant to such activities, and provide recommendations to the Director regarding the safe and sound operation of the Utility and regarding any requests to revise, alter, or amend existing or proposed activities. <u>Consultation with Other Agencies</u> In exercising authority to regulate and supervise the Utility, the Director shall consult with other Federal departments and agencies that regulate or supervise entities, institutions, or companies that are or may become subject to standards, rules, processes, or procedures developed by the Utility (including issuers through the Platform and depositors or participants in the Repository), including the			

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	CFPB and any appropriate Federal banking agency (as defined under FDIA§ 3). <u>Annual Assessment</u> The Director shall establish and collect from the Utility an annual assessment in an amount not exceeding the amount sufficient to provide for reasonable costs (including administrative costs) and expenses of the Agency related to its oversight of the Utility. The amounts received by the Director from assessments under this section shall not be construed to be Government or public funds or appropriated money. Notwithstanding any other provision of law, the amounts received by the Director from assessments under this section shall not be subject to apportionment for the purpose of 31 U.S.C. chapter 15 or under any other authority. **§ 316 Civil and Criminal Liability** • Except as expressly authorized by U.S. statute, no person or organization (except the Repository, Utility, and Platform) shall use the term "National Mortgage Market Utility", "Common Securitization Platform", or "National Mortgage Data Repository", or such other name as the Director may establish in the charter of the Utility or any combination of words that appears to indicate that such use of the term conflicts with the operation of the Utility or any function created herein.			

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	No individual or organization shall use or display— o Any sign, device, or insignia prescribed or approved by the Utility for use of display by the Utility; o Any copy, reproduction or colorable imitation of any such sign, device, or insignia; or o Any sign, device or insignia reasonably calculated to convey the impression that it is a sign, device or insignia used by the Utility or prescribed by the Utility contrary to policies or procedures of the Utility prohibiting, limiting or restricting such use by any individual or organization. • The Agency or Utility may seek to enjoin or recover damages for any breach of this section and refer to the Attorney General any matters that may constitute criminal activity for a breach of this section. • Except as expressly authorized by statute of the U.S., no person or organization (except the Utility) shall operate a national registry or repository of mortgage-related documents. Any State of the U.S. may operate a State registry or repository system, subject to the laws of that State, provided that any such State registry or repository system does not conflict with the Repository or the			

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	purposes of this subtitle. • In any action for breach of contract, including breach of representation or warranty, or breach of privacy related to data collected and maintained by the Repository, no prevailing party may recover more than an amount established by the Director, by regulation. When issuing any such regulation, the Director shall take into consideration intentional, willful, reckless, or negligent actions or omissions. Such regulations shall be reviewed not less frequently than annually, and may be revised in the Director's discretion.			
Utility Qualified Securities	**§ 321 Qualified Securities** For purposes of §§ 301 – 344, *qualified security* means a security that— • Is collateralized by a class, or multiple classes, of residential mortgages established under § 322(a); • Is issued in accordance with a standard form securitization agreement under § 322(b); • Is issued by a qualified issuer in accordance with § 322(g); • Is issued through the Platform; and • Is not guaranteed, in whole or in part, by the U.S. Government. **§ 322(a) Standard Mortgage Classifications** • The Utility shall prescribe classifications			

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	for residential mortgages having various degrees of credit risk, ranging from a classification of mortgages having little to no credit risk to a classification of mortgages having higher credit risk. In prescribing such classifications the Utility shall seek to allow for the pricing of credit risk, allow for the trading of securities collateralized by each classification of mortgages established pursuant to this sub- section in the forward market, and maintain well-functioning liquid markets in securities collateralized by each of the classifications of mortgages established pursuant to this subsection. • For each such classification of mortgages, the Utility shall establish standards for each of the following underwriting criteria: o The ratio of the amount of the total monthly debt of the mortgagor to the amount of the monthly income of the mortgagor. o The ratio of the principal obligation under the mortgage to the value of the residence subject to the mortgage, at the time of mortgage origination. o Information on the credit history of the mortgagor, including credit scores of the mortgagor. o The extent of loan documentation and verification of the financial			

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	resources of the mortgagor used to qualify the mortgagor for the mortgage, including any appraisal. o Whether the residence subject to the mortgage is occupied by the mortgagor. o Whether any mortgage insurance or other type of insurance or credit enhancement was obtained at the time of origination. o The terms of the mortgage that determine the magnitude and timing of payments due from the mortgagor, including the term to maturity of the mortgage, the frequency of payment, the type of amortization, any prepayment penalties, and whether the interest rate is fixed or may vary. Terms shall include a 30-year fixed interest rate mortgage. o Such other underwriting criteria as the Utility may establish, consistent with the goals of §§ 301 – 344. • The Utility shall prescribe definitions for each of the following terms: o *Mortgage*, which definition shall include only mortgages on residential properties. o *Default*, with respect to a mortgage. o *Delinquency*, with respect to a mortgage. o *Loan Documentation*, with respect to a mortgage.			

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	○ Such other terms as the Utility may establish. **§ 322(c) Registration with Repository** The Utility shall require that any mortgage-related document associated with eligible collateral for qualified securities be registered with the Repository.			
Uniform Securitization Agreement	**§ 322(b) Standard Form Securitization Agreement** • The Utility shall develop, adopt, and publish standard form securitization agreements for eligible collateral. • The standard form securitization agreements shall include terms relating to— ○ Pooling and servicing; ○ Purchase and sale; ○ Representations and warranties, including representations and warranties as to compliance or conformity with standards established by the Utility, as appropriate; ○ Indemnification and remedies, including principles of a repurchase program that will ensure an appropriate amount of risk retention under the representations and warranties; and ○ The qualification, responsibilities,	**§ 326 Uniform Securitization Agreements for Covered Securities and Required Contractual Terms for Noncovered Securities** <u>Required Uniform Securitization Agreements for Covered Securities Issued by or Through the Platform</u> • The Platform Directors shall develop standard uniform securitization agreements for all covered securities to be issued through the Platform, as required pursuant to section § 325(b)(2). • The standard uniform securitization agreements shall include terms relating to— ○ Pooling and servicing, including the development of uniform standards and practices consistent with the standards specified by the FMIC pursuant to § 314; ○ Loss mitigation procedures consistent with those specified by the FMIC pursuant to § 314;	**§ 233 Uniform Securitization Agreements** <u>In General</u> The NMFA shall develop, adopt, and publish standard uniform securitization agreements for covered securities which are insured under this Act. <u>Required Content</u> The standard uniform securitization agreements shall include terms relating to— • Pooling and servicing, including the development of uniform standards and practices— ○ Regarding remittance schedules and payment delays; and ○ Permitting the transfer of servicing rights consistent with § 222(h); • Loss mitigation, including the development of uniform standards and practices— ○ Requiring servicers to offer homeowners affordable loan modifications, which shall include	

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	and duties of trustees.	○ Minimum representations and warranties; ○ Indemnification and remedies, including for the restitution or indemnification of the FMIC with respect to early term delinquencies of eligible mortgage loans that collateralize a covered security; ○ The requirements of the indenture for MBS that are exempt from the Trust Indenture Act of 1939 (15 U.S.C. 77aaa et seq.) and the requirements, responsibilities, and duties of trustees, as set forth in the indenture or pooling and servicing agreement; ○ The qualification, responsibilities, and duties of trustees; and ○ Any other terms or standards the Platform Directors, with approval of the FMIC, determine to be necessary or appropriate. • In developing the uniform securitization agreements, the Platform Directors shall also develop, adopt, and publish, upon approval by the FMIC, clear and uniform standards that define and illustrate what actions, or omissions to act, comprise a violation of the representations and warranties clauses that are made a part of such agreements. <u>Required Contractual Terms for Contracts for all Noncovered Securities Issued Through the</u>	modifications that reduce the unpaid principal balance of an eligible mortgage, consistent with a publically available net present value determination, as defined by the NMFA; and ○ Requiring servicers to refrain from initiating a judicial or non-judicial foreclosure, or where a foreclosure has been initiated, from taking any additional steps in the judicial or non-judicial foreclosure, once an initial request for loss mitigation has been made by the homeowner, until completion of the review of any loss mitigation application, including written notice to the homeowner documenting any denial and a requisite appeal process; • Representations and warranties, including representations and warranties as to compliance or conformity with the requirements of this Act; • Indemnification and remedies, including for the restitution or indemnification of the NMFA with respect to early term delinquencies of eligible mortgages collateralizing a covered security; • The qualification, responsibilities, and duties of trustees; and • Any other terms or standards the NMFA determines necessary or appropriate.	

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		Platform
		• All contracts for noncovered securities issued through the Platform shall include a set of required contractual terms relating to the obligations of the parties to each contract.
		• The required contractual terms for agreements for all noncovered securities issued through the Platform shall provide the obligations of the parties to a contract including the following considerations:
		  o Pooling and servicing.
		  o Loss mitigation procedures.
		  o Representations and warranties.
		  o Indemnification and remedies.
		  o The qualification, responsibilities, and duties of trustees, including but not limited to, requirements set forth in the indenture or pooling and servicing agreement, or any applicable provisions of the Trust Indenture Act of 1939 (15 U.S.C. 77aaa et seq.).
		  o Other terms or standards the Platform Directors, with approval of the FMIC, determine to be necessary or appropriate to protect or facilitate the operation of the Platform.
		• Parties to contracts for noncovered securities described under this subsection may supplement the required contractual terms with any additional contractual
			Defining Representation and Warranty Violations
			In developing the uniform securitization agreements, the NMFA shall also develop, adopt, and publish clear and uniform standards that define and illustrate what actions, or omissions to act, comprise a violation of the representations and warranties clauses that are made a part of such agreements.
			
			Consultation
			The NMFA shall work with industry groups, including the Issuer and servicers, originators, mortgage investors, and other interested entities, including stakeholders representing the interests of homeowners, to develop the uniform securitization agreements.
			
			Private Issuers Using Common Securitization Platform
			To the extent that the NMFA determines that private issuers may use the common securitization platform for private securities that are not insured by the MIF, the NMFA may determine the extent to which such uniform agreements are required for such private issuance.	

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		terms so desired by the parties to contracts for noncovered securities issued through the Platform. <u>Optional Uniform Securitization Agreements for Noncovered Securities Issued Through the Platform</u> The Platform Directors may develop optional uniform securitization agreements for use by noncovered securities that are issued through the Platform that include standards and obligations that are different from those included in the uniform securitization agreements for covered securities, provided that— • The agreements include the required contractual terms required for noncovered securities that are issued through the Platform; and • The Platform Directors determine that sufficient demand exists among the members of the Platform for the Platform to issue such optional uniform securitization agreements for use by noncovered securities. <u>Agreements for Noncovered Securities Issued off the Platform</u> Nothing in this section shall preclude, or require, noncovered securities that are not issued through the Platform from adopting the—		

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		• Uniform securitization agreements for covered securities issued through the Platform; • Optional uniform securitization agreements for noncovered securities issued through the Platform; or • Required contractual terms for contracts for noncovered securities issued through the Platform developed. <u>Consultation Required</u> The Platform Directors shall consult with market participatns, including servicers, originators, issuers, and mortgage investors, and community stakeholders and representatives of homeowners in developing— • The uniform securitization agreements; • The required contractual terms for contracts for noncovered securities issued by or through the Platform; and • The optional uniform securitization agreements for noncovered securities issued by or through the Platform.		
Loan Document Access	**§ 322(i) Independent Third Party** If the majority of investors (beneficial owners) in a pool of qualified securities chooses to hire an independent third party to act on behalf of the best interests of the investors (beneficial owners), such party shall— • Be granted access to the loan documents for the mortgage loans backing such	**Part II—Transparency in Market Operations** **§ 331 Review of Loan Documents; Disclosures** <u>In General</u> The FMIC, in consultation and coordination with the SEC, shall, by rule— • Require market participants, as	**§ 231 Review of Loan Documents; Disclosures** <u>In General</u> The NMFA shall, by rule— • Require that the Issuer— o Grant access to private market investors seeking to take the first loss position in a covered security to all—	

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	security and all servicing reports the servicer provides to investors (beneficial owners) or the trustee; • Be granted access to the list of investors (beneficial owners) maintained by the trustee, on the condition that the independent third party will not make the list available to the investors (beneficial owners); and • Have the right, on behalf of the investors (beneficial owners), to inform the trustee of such securities of any breach of the securitization agreement identified by the third party. **§ 322(j) Mandatory Arbitration** • All disputes between an owner of a qualified security and the qualified issuer of such security relating to representations and warranties shall be subject to mandatory arbitration procedures established by the Utility, in accordance with current market practices. • Investors (beneficial owners) and issuers subject to such a dispute shall have the right to agree on an independent arbitrator. If the parties cannot agree on an independent arbitrator, the Utility shall select an independent arbitrator for the parties. • The arbitrator shall provide the Utility with notice upon commencement of any	appropriate, to make available to private market investors in connection with the first loss position on a covered security, including through use of the Securitization Platform, all— ○ Documents relating to eligible mortgage loans collateralizing that covered security; and ○ Servicing reports of the approved servicer relating to such eligible mortgage loans; • Require market participants, as appropriate, to disclose to investors information that is substantially similar, to the extent practicable, to disclosures required of ABS issuers under § 13(a) or 15(d) of the Exchange Act until the covered security is fully paid, other than information the FMIC determines, in consultation and coordination with the SEC, is not applicable to a covered security, a particular type of covered security, or eligible mortgage loans collateralizing a covered security; • Require that all disclosures must be made consistent with the antifraud provisions of the Federal securities laws; and • Establish the timing, frequency, and manner in which such access and disclosures are made. <u>Access and Disclosures</u>	▪ Documents relating to eligible mortgage loans collateralizing that covered security; and ▪ Servicing reports of any approved servicer relating to such mortgages; and ○ Disclose any other material information that a reasonable investor would want to know, and make no material omission of such information, relating to eligible mortgage loans collateralizing a covered security; and • Establish the timing, frequency, and manner in which such access and disclosures are made. <u>Privacy Protections</u> In prescribing the rules required under this section, the NMFA shall take into consideration issues of consumer privacy and all statutes, rules, and regulations related to privacy of consumer credit information and personally identifiable information. Such rules shall expressly prohibit the identification of specific borrowers or the release of information that would enable the identification of a specific borrower.	

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	arbitration under this subsection. • Upon conclusion of any such arbitration, the arbitrator shall provide the Utility with— o The decision reached by the arbitrator; and The basis for the arbitrator's decision, including any evidence or testimony received during the arbitration process.	In prescribing these rules, the FMIC shall take into consideration— • The potential cost of such access and disclosures; • The effect of such access and disclosures on liquidity in the housing finance market; and • The interests of investors. <u>Privacy Protections</u> In prescribing these rules, the FMIC shall take into consideration issues of consumer privacy and all statutes, rules, and regulations related to privacy of consumer credit information and personally identifiable information. Such rules shall expressly prohibit the identification of specific borrowers.		
Investor Immunity		**§ 332 Investor Immunity** No cause of action may be brought under Federal or State law against a market participant that has taken the first loss position in a covered security or that has otherwise invested an any covered security, with respect to whether eligible mortgage loans that collateralize a covered security insured under this title have complied with the requirements of this Act, including with respect to any underwriting requirements applicable to such eligible mortgage loans, any representations or warranties made by a market participant with respect to such eligible mortgage loans, or whether the terms of any uniform	**§ 232 Investor Immunity** Any private market investor that has purchased the first loss position in a covered security or that has otherwise invested in any covered security insured under this Act shall have immunity and protection from civil liability under Federal and State law, and no cause of action may be brought under Federal or State law against such investor, with respect to whether or not eligible mortgages that collateralize a covered security insured under this Act have complied with the requirements of this Act, including, but not limited to, with respect to any underwriting requirements applicable to such mortgage, any	

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		securitization agreement have been met.	representations or warranties made by the Issuer with respect to such mortgages, or whether or not the terms of any uniform securitization agreement have been met.	
Mortgage Database		**§ 333 National Mortgage Database** <u>Transfer</u> Effective on the system certification date, there are transferred to the FMIC all functions of the FHFA of the FMIC relating to the rights, responsibilities, and obligations of the FHFA pursuant to the Inter-Agency Agreement (or any successor thereto) entered into by FHFA and the CFPB with respect to the development, construction, maintenance, operation, and funding of the National Mortgage Database. <u>Privacy</u> In exercising authority under this section, the FMIC and the CFPB shall— • Take steps to ensure the privacy of consumers, including prohibiting the identification of specific borrowers; • Minimize the collection and storage of personally identifiable information; and • Consider all statutes, rules, and regulations relating to the privacy of consumer credit information and personally identifiable information. <u>Duplication</u> The Chairperson and the CFPB Director shall	**§ 234 Uniform Mortgage Database** <u>Uniform Mortgage Database</u> The NMFA shall establish, operate, and maintain a database for the collection, public use, and dissemination of uniform loan level information on eligible mortgages relating to— • Loan characteristics; • Borrower information; • The property securing the eligible mortgages; • Loan data required at the time of application for insurance from the NMFA under this title; • The quality and consistency of appraisal and collateral data on eligible mortgages; • Industry-wide servicing data standards; • The identification of subordinate liens that have been issued on the property securing an eligible mortgage, as well as the performance of such subordinate liens; and • Such other data, datasets, information, facts, or measurements as the NMFA determines appropriate to improve and enhance loan quality and operational efficiencies within the secondary mortgage market.	

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		take all reasonable steps necessary to minimize conflicts and duplication of the data required under this section with data collected, published, or otherwise obtained by other Federal regulators, including the data disclosure system required under HMDA § 304(f) (12 U.S.C. 2803(f)). <u>Minimize Burden on Reporting Entities</u> If 2 or more entities are required by this section to report the same mortgage data relating to the same mortgage loan, the entities may, by agreement that is clearly communicated to the FMIC and the CFPB, determine that only 1 of such entities will report the data. If 1 of such entities reports the required mortgage data, it shall not be a violation of this section for the other entities not to report the data. <u>Access to Data</u> The FMIC and the CFPB shall each establish, and cause to be published in the Federal Register, the initial date on which— • The public shall begin to have access to any data put into the public domain, in accordance with this section and in a manner that is easily accessible to the public; and • All mortgage data is required to be put into the public domain, in accordance with this section.	<u>Considerations</u> In establishing the database, the NMFA shall take into consideration, build upon, and adopt to the extent the NMFA determines appropriate, the existing data standards developed by the FHFA, CFPB, Federal Reserve, OCC, and the SEC. <u>Regulations</u> The NMFA shall, by regulation— • Establish the manner and form by which any loan level information may be accessed by the public, including permitting members of the public to access information on properties at no charge; and • Require that such loan level information be made available to the public in a uniform manner, in a form designed for ease and speed of access, ease and speed of downloading, and ease and speed of use. <u>Protection of Personally Identifiable Information</u> The NMFA shall ensure the protection of any personally identifiable information contained in any information, or mix of information, collected and made available for public access, but may determine to allow access to data by address.	

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			Monthly Update The database shall be updated not less frequently than once a month. Consolidation of Reporting Systems The NMFA may choose to consolidate the Uniform Mortgage Database and the Electronic Registration System required under § 235 if the NMFA provides a written determination that such consolidation would improve the efficiency of mortgage data collection, the ease and speed of use of mortgage data, and the integrity and reliability of mortgage data, while preserving the protection of any personally identifiable information to the greatest extent possible.	

Electronic Mortgage Registration	**§ 331 Organization and Operation**
	• Under such regulations as the Director may prescribe, the Utility shall organize and operate a national mortgage data repository ("Repository").
	• In addition to organizing and operating the Repository, the Utility shall—
	  o Establish and operate a repository for mortgage-related documents;
	  o Establish standards for qualification of any depositor of mortgage-related documents to the Repository;
	  o Establish standards and procedures for submission of mortgage-related documents to the Repository,
		§ 334 Working Group on Electronic Mortgage Registration
		Establishment
		Not later than 180 days after the agency transfer date, the FMIC shall establish a working group to study—
		• Whether the establishment of a national electronic mortgage registry system is necessary; and
		• How to establish, operate, and maintain a national electronic mortgage registry system for single-family mortgage loans and multifamily mortgage loans.
		
		Composition
			§ 235 Electronic Registration of Eligible Mortgages
			Establishment of Electronic Registration System
			The NMFA shall establish, operate, and maintain an electronic registry system for all eligible mortgages purchased, guaranteed, or securitized by the Issuer. The system shall automate, centralize, standardize, and improve the tracking of changes in—
			• The ownership of mortgages, deeds of trust, promissory notes, and other instruments relating to a covered security interest under the Act; and
			• Servicing rights for any mortgage loan	

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	including required information and the type and format of information and data; ○ Establish procedures for validation of mortgage-related documents and the data contained in the Repository; ○ Establish standards and procedures for acceptance of mortgage-related documents (including electronic copies), and notice of acceptance, by the Repository; ○ Establish standards and procedures for registration of any mortgage-related document with the Repository, including notice of registration and the assignment of a unique identifier; ○ Establish standards and procedures for recording the creation, assignment, or transfer of an interest in any registered mortgage-related document; ○ Establish standards and procedures for qualification of depositors and participants in the Repository; ○ Establish procedures for proper demonstration of registration of mortgage-related documents with the Repository and recordation of an interest by the holder of an interest in any such document, subject to regulations issued by the Director in accordance with § 332 (relating to	The working group shall be composed of the following: • The Chairperson or the Chairperson's designee. • The CFPB Director; the Chairman of the FDIC, SEC, or the Federal Reserve; the Comptroller; or the designee of any of these; • A representative from the FHLB System and from a Federal Reserve Bank; • Individuals selected by the Chairperson from among the following: ○ State and local government agencies and representatives, including housing finance agencies and those with expertise in property records, electronic recording, and the UCC. ○ The National Conference of Commissioners on Uniform State Laws. ○ Industry groups, including single family and multifamily mortgage originators, title insurers, servicers, issuers, and investors. ○ Consumer groups, including representatives of homeowners, community stakeholders, and housing organizations. ○ Individuals with technical expertise, including those with expertise in designing, constructing, and maintaining mortgage databases.	covered under the Act. <u>Identification of Mortgages and Notes</u> The tracking system shall assign an identification number to each security instrument and its related promissory note upon initial registration with the system. The identification number shall continue to identify the security instrument and note through all subsequent assignments and transfers. The NMFA shall develop a numbering system that will assign unique numbers to participants to help in the identification of individual participants. <u>Individuals Authorized to Make Registry Entries</u> The NMFA shall develop procedures to register individuals authorized to make entries in the data system. The procedures shall require that servicers and agents of loan owners identify the principal for whom each individual is authorized to act, the scope of the agency, and the identity of the individual's employer. <u>Custody of Note</u> The tracking system shall identify by name and street address the entity holding physical custody of the original promissory note for each eligible mortgage purchased, guaranteed or securitized by the Issuer that is in paper form. If the note is in electronic format and it	

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	legal effect of registration with the Repository); ○ Establish and maintain a catalog of the mortgage-related documents registered with the Repository; ○ Establish standards and procedures for dis- position of mortgage-related documents, including safekeeping, long-term storage, or destruction of paper documents; ○ Establish standards and procedures for making data publicly available; ○ Ensure that data collected and maintained by the Repository are kept secure and protected against unauthorized disclosure, including disclosure of personally identifiable information that is not otherwise available as part of any public record; ○ Establish a process, including notification from the public, for identification and correction of incorrect information submitted to or maintained by the Repository; ○ Establish fees for registration of mortgage- related documents and maintenance and use of data, and for the provision of other related services not in- consistent with the purposes of §§ 301 – 344; and ○ Perform any other service or engage in any other activity that the Director determines, by regulation or order, to	<u>Duties</u> The duties of the working group are to assess and develop recommendations on the necessity for and feasibility of establishing, operating, and maintaining a national electronic mortgage registry system for single-family mortgage loans and multifamily mortgage loans to document custody and registration of mortgage loans, notes, titles, liens, deeds of trust, and other security instruments, in order to automate, centralize, standardize, and improve the tracking of changes in— • The ownership of mortgage loans, deeds of trust, and other security instruments; • The ownership of the beneficial interest in promissory notes secured by any mortgage loan, deed of trust, or other security instrument; • The servicing rights for any mortgage loan, deed of trust, or other security instrument; and • Such other information as the FMIC may require. <u>Considerations</u> In carrying out the duties under this section, the working group shall consider— • The cost to States and localities, including any impact on revenue generated by local recording of mortgage loan documents;	is not registered in the system, the system shall reference an electronic database where the note is registered. The electronic note registry shall be accessible to the public without charge. <u>Mandatory Participation</u> Participation in the registry system shall be mandatory for all eligible mortgages purchased, guaranteed, or securitized by the Issuer. Holders of loans or their agents shall have a duty to register each eligible mortgage purchased, guaranteed, or securitized by the Issuer and maintain the accuracy of current system data. All transfers, assignments, and other changes in the holding of covered promissory notes and security instruments, and servicing rights, shall be entered into the system. The tracking system will identify each entity entered in the system by name, address, and other contact information. If there is more than one servicer for a particular purchased, guaranteed, or securitized by the Issuer, each servicer shall be identified in the system, including whether the entity is a master servicer, subservicer, or other servicer. <u>Borrower Access to Information</u> To the extent that the NMFA permits issuers of private securities that are not insured under this Act to use the common securitization platform, it may adopt appropriate rules to ensure that a borrower has access to any	

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	be incidental to the activities enumerated in this subsection. • Each participant shall comply with such requirements as may be set by the Repository for using data maintained or created by the Repository, and use such designation as the Repository may provide, such as a unique identifier. **§ 332 Legal Effect of Registration with Repository** Notwithstanding any provision of State or Federal law to the contrary, by proper demonstration of registration with the Repository, any holder of an interest in any mortgage-related note shall satisfy any requirement for demonstration of a right to act regarding such note or other registered data that exists in State or Federal law, including any obligation to produce or possess an original note. The Director shall provide for the establishment of procedures for proper demonstration of registration of any mortgage-related document and of an interest by the holder of an interest in any such document with the Repository. Once registered with the Repository, such registration shall be a legal right enforceable in any judicial or nonjudicial process. **§ 333 Grants to States; Repayment** • There is hereby authorized to be	• The feasibility of allowing States and localities to continue to collect fees and revenue; • The implications of data accuracy on judicial and nonjudicial foreclosure; • The need to minimize conflicting mortgage loan registry requirements; • The need to provide consumers with access to key information about the ownership and servicing of their mortgage loans; • The need to provide data accuracy, security, and privacy; • The need to make data publicly available at minimal cost to consumers; • Existing State real property and commercial laws and any such laws in development, including an electronic mortgage registry law developed as a uniform State law proposal; • The costs and benefits of developing and maintaining a national mortgage registry system, including any potential impact on consumer mortgage credit and industry participants; • The feasibility of using existing industry standards and capabilities in the operation of a national mortgage registry system; and • Any research, reports, or other work undertaken by outside experts, including Federal and State entities.	information necessary under this section and § 234. <u>Enforcement of Registry Requirements; Sanctions</u> The NMFA shall develop a schedule of sanctions that shall be imposed upon an originator or holder or its agent in the event that the loan owner or agent fails to maintain accurate current information in the system for an eligible mortgage purchased, guaranteed, or securitized by the Issuer. The sanctions shall be in a form that will be effective to deter non-compliance. <u>Free Access</u> All information on the registry shall be electronically accessible, at no charge, to the public. <u>State and Local Law</u> Nothing in this Act shall be deemed to preempt or limit State and local law regarding recording or registration of interests in land or the foreclosure of interests in land.	

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	appropriated $50,000,000 to the Director for the establishment of a fund to be administered by the Agency for providing grants to States, on application to the Agency, to facilitate participation in the Repository by any depositor or participant or class of depositors or participants, or any other person upon appropriate demonstration to the Agency that such a grant would assist in the accomplishment of the purposes of this subtitle. Any such amounts appropriated and not granted by the Agency within five years of the date of the enactment of this Act shall be returned to the Treasury.
	• The Director shall cause to be collected from the Utility and deposit in the Treasury an amount equal to the aggregate amount provided as grants to States within 10 years after the first grant is made.
	
	§ 334 Judicial Review
	Except as otherwise expressly provided under this part, no person other than the Director or the Attorney General, or any duly authorized representative of the Director or the Attorney General, may proceed against the Repository in any State or Federal court. The prohibition in the preceding sentence shall not apply to a civil action against the Repository or any duly authorized agent thereof for breach of a contract, including breach of a representation
		<u>Report</u>
		Not later than 2 years after the working group is established, the working group shall issue a publicly available report, which shall—
		• Include recommendations—
		  ○ As to whether the establishment of a national electronic mortgage registry system is necessary or appropriate in the public interest or for the protection of the MIF; and
		  ○ On how to establish, operate, and maintain a national electronic mortgage registry system for single-family mortgage loans and multifamily mortgage loans; and
		• If the working group recommends that the establishment of the national electronic mortgage registry system is necessary or appropriate, outline the minimum requirements for such registry, which shall include considerations for the development and implementation of electronic mortgage registry systems by State and local government agencies, including requirements to ensure accurate reporting to such systems, and shall satisfy the recommendations of this report.
		
		<u>Rulemaking</u>
		• Beginning 5 years after publication of the		

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	or warranty, or breach of privacy related to data collected and maintained by the Repository or any duly authorized agent thereof. **§ 335 Transition Provisions** • The Agency shall provide for a transition period to permit the efficient implementation of the provisions of §§ 331 – 335. Such transition may include periods for testing, early adoption, and final mandatory adoption for all recorded mortgages. • The Repository shall accept electronic submissions and paper-based documents submitted electronically subject to rules of the Repository. Ten years after enactment, subject to an extension for up to 5 additional years if the Director determines appropriate, the Repository shall require only electronic submission.	report, the FMIC may, by rule, establish a national electronic mortgage registry system for single-family mortgage loans and multifamily mortgage loans, deeds of trust, or other security instruments in accordance with the findings of the report if— ○ The FMIC determines that electronic mortgage registry systems have not been created by State and local government agencies in accordance with the minimum requirements established in the report; and ○ The establishment of a national electronic mortgage registry system for single-family mortgage loans and multifamily mortgage loans remains necessary or appropriate in the public interest or for the protection of the MIF. • If the FMIC establishes a national electronic mortgage registry system, the FMIC shall provide approved entities a reasonable amount of time to correct a filing made in the national electronic mortgage registry system that is in direct conflict with any filing in a State or local real property recording system. The FMIC, in consultation with appropriate State and local government agencies responsible for real property recordation, may extend the period for a single period of not more than 5 years if the FMIC		

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		determines that the extension is necessary or appropriate. • To promote consistency in and minimize disruption to the housing finance system and systems for the local recording of loan documents, the FMIC shall consult and coordinate with appropriate State and local government agencies responsible for real property recordation when developing and issuing rules under this subsection. • The rules and standards promulgated under this section shall recognize and protect valid perfected security interests in registered mortgage-related documents. <u>Rules of Construction</u> • Nothing in this section shall be construed as implying or establishing a private right of action against an approved entity for filings made to the established national electronic mortgage registry system or other filing actions taken pursuant to subsection (f) (rulemaking). • Nothing in this section shall be construed as authorizing the FMIC, before the establishment of a national electronic mortgage registry system under subsection (f), to exercise supervisory or enforcement authority with respect to an approved entity relating to a real property filing action in a State or local real		

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		property recording system by the approved entity. • Nothing in this section shall be construed as preempting, altering, annulling, exempting, or affecting the applicability of any State or local law, including those laws relating to real property recording or foreclosure.		
Multiple Liens	**§ 413 Notice of Junior Mortgage or Lien** With respect to the dwelling of a borrower that serves as security for a securitized senior mortgage loan, if the borrower enters into any credit transaction that would result in the creation of a new mortgage or other lien on such dwelling, the creditor of such new mortgage or other lien shall notify the servicer of the senior mortgage loan of the existence of the new mortgage or other lien. **§ 414 Limitation on Mortgages Held by Servicers** • Neither the servicer of a residential mortgage loan, nor any affiliate of such servicer, may own, or hold any interest in, any other residential mortgage loan that is secured by a mortgage, deed of trust, or other equivalent consensual security interest on the same dwelling or residential real property that is subject to the mortgage, deed of trust, or other security interest that secures the residential mortgage loan serviced by the	**§ 335 Multiple Lender Issues** With respect to the dwelling of a borrower that serves as security for an eligible mortgage loan, if the borrower enters into any credit transaction that would result in the creation of a new mortgage loan or other credit lien on such dwelling where the LTV ratio of such credit transaction amount is 80% or more, the creditor (as defined in 12 C.F.R. § 1026.2(a)(17) shall notify the creditor of the senior eligible mortgage loan within 30 days after consummation.	**§ 701 Multiple Lender Issues** With respect to the dwelling of a borrower that serves as security for an eligible mortgage, if the borrower enters into any credit transaction that would result in the creation of a new mortgage or other lien on such dwelling where the loan-to-value ratio of such credit transaction amount is 80% or more, the creditor of such new mortgage or other lien shall seek and obtain the approval of the creditor of the senior eligible mortgage loan before any such credit transaction becomes valid and enforceable.	

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	servicer. • For these purposes, the following definitions apply: ○ *Affiliate* means "any company that controls, is controlled by, or is under common control with another company." ○ *Residential Mortgage Loan* means any consumer credit transaction that is secured by a mortgage, deed of trust, or other equivalent consensual security interest on a dwelling or on residential real property that includes a dwelling, other than a consumer credit transaction under an open end credit plan or an extension of credit relating to a plan described in section 11 U.S.C. § 101(53D). ○ *Servicer* has the meaning in TILA § 129A ["the person responsible for the servicing for others of residential mortgage loans (including of a pool of residential mortgage loans)"], except that such term includes a person who makes or holds a residential mortgage loan (including a pool of residential mortgage loans) if such person also services the loan. • For purposes of the ownership limitation, ownership of, or holding an interest in, a residential mortgage loan includes ownership of, or holding an interest in—			

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	o A pool of residential mortgage loans that contains such residential mortgage loan; or o Any security based on or backed by a pool of residential mortgage loans that contains such residential mortgage loan. • This section shall apply— o With respect to the servicer (or affiliate of the servicer) of a residential mortgage loan that is originated after the date of the enactment of this Act, on such date of enactment; and o With respect to the servicer (or affiliate of the servicer) of a residential mortgage loan that is originated on or before the date of the enactment of this Act, upon the expiration of the 12-month period beginning upon such date of enactment.			
Agency Transfer – Definitions		**TITLE IV—FHFA and FMIC TRANSITION** **§ 401 Definitions** In this title— *Director* means— • During the period beginning on the date of enactment of this Act and ending on the day before the agency transfer date, the Director of the Existing Agency; and • On and after the agency transfer date, the		

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		Director of the FHFA of the FMIC appointed under § 402(a)(2). *Existing Agency* means the FHFA, as constituted on the day before the agency transfer date. *Function* means any duty, obligation, power, authority, responsibility, right, privilege, activity, or program. *Regulated entity* Fannie Mae, Freddie Mac, or an FHLB. *Transition Committee* means the FMIC Transition Committee established under § 404(a)(1).		

Agency Transfer – the Transfer		**§ 402 FHFA Transition**
		<u>Establishment</u>
		Effective on the agency transfer date, there is established in the FMIC the FHFA, which shall be maintained as a distinct entity within the FMIC. The FHFA shall be headed by a Director, who shall be—
		• Appointed by the President, by and with the advice and consent of the Senate; and
		• A non-voting member of the Board of Directors.
		
		<u>FHFA Transfer</u>
		• Effective on the agency transfer date and unless otherwise specified by this Act, all
			§ 301 Powers and Duties Transferred
			<u>FHLB Functions Transferred</u>
			• There are transferred to the NMFA all functions of FHFA and its Director relating to—
			  o The supervision of the FHLBs and the FHLB System; and
			  o All rulemaking authority of the FHFA and its Director relating to the FHLBs and the FHLB System.
			• The NMFA shall succeed to all powers, authorities, rights, and duties that were vested in FHFA and its Director, including all conservatorship or receivership authorities, on the day before
				§ 101 Ginnie Mae Removal From HUD; Establishment as Independent Entity
				<u>In General</u>
				National Housing Act § 302(a)(2) (12 U.S.C. 1717(a)(2)) [creating Ginnie Mae] is amended by striking “in the Department of Housing and Urban Development” and inserting “independent of any other agency or office in the Federal Government.”
				
				<u>Conforming Amendments</u>
				Title III of the National Housing Act (12 U.S.C. 1716 et seq.) is amended—
				• In § 306(g)(3)(D) (12 U.S.C. 1721(g)(3)(D)), by striking “Secretary”

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		FHFA property and functions are transferred to the FHFA of the FMIC. • The individual serving as the Director of the Existing Agency the day before the agency transfer date may serve as the Director of the FHFA of the FMIC until the end of the term of such individual as Director of the Existing Agency under § 1312(b)(2) of the 1992 Act, as in effect on the day before the agency transfer date. • During the period beginning on the agency transfer date and ending on the date on which the first individual is appointed as Chairperson under § 202, the Director shall serve as the Transition Chairperson of the FMIC and shall exercise all authorities of the Chairperson, unless stated otherwise. In so serving, the Director shall not have the authority to establish any rule under § 2 or any rule relating to approved entities under title III. <u>Powers and Duties</u> • The Director of the FHFA of the FMIC shall— o Retain and exercise all powers, including conservatorship and receivership powers as amended by this Act, of the Director of the Existing Agency on the day before	the transfer date in connection with the functions and authorities transferred. Notwithstanding requirements for mandatory use of the receivership authority, the NMFA, in consultation with Treasury, HUD, and the Federal Reserve, shall have authority to determine whether the Issuer shall be placed in receivership, regardless of its capital level. • The transfer of functions shall take effect on the transfer date. <u>Continuation and Coordination of Certain Actions</u> All regulations, orders, determinations, and resolutions described shall remain in effect according to their, and shall be enforceable by or against the NMFA until modified, terminated, set aside, or superseded in accordance with applicable law by the NMFA, any court of competent jurisdiction, or operation of law. A regulation, order, determination, or resolution includes any that— • Was issued, made, prescribed, or allowed to become effective by the FHFA or a court of competent jurisdiction, and relates to functions transferred by this Act; • Relates to the performance of functions that are transferred by this section; and • Is in effect on the transfer date.	and inserting "Association"; • In § 307 (12 U.S.C. 1722), by striking "Secretary of Housing and Urban Development" and inserting "Association"; and • In § 317 (12 U.S.C. 1723i)— o In (a)(1), by striking "Secretary of Housing and Urban Development" and inserting "Director of the Association"; o In (c)(4), by striking "Secretary's" and inserting "Director of the Association's"; o In (d)(1), by striking "Secretary's" and inserting "Director of the Association's"; o In the heading for (f), by striking "BY SECRETARY"; and o By striking "Secretary" each place such term appears and inserting "Director of the Association". <u>Management; Director</u> National Housing Act § 308(a) (12 U.S.C. 1723(a)) is amended— • In the first sentence— o By striking "Secretary of Housing and Urban Development" and inserting "Director of the Association appointed pursuant to this subsection"; and o By striking "of the Secretary" and

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		the agency transfer date relating to the FHLB System, the FHLBs, and the GSEs; ○ Manage and implement actions authorized by the FMIC related to the transition to the new housing finance system that impact the conservatorship or receivership of regulated entities; and ○ Consult with other members of the Transition Committee and the Board of Directors as may be appropriate to fulfill the requirements of this Act. • Except as provided in § 604(a)(2), or as otherwise specifically provided in this Act, the Chairperson and the Board of Directors may not— ○ Intervene in any matter or proceeding before the Director, unless otherwise specifically provided by law; ○ Appoint, direct, or remove any officer or employee of the FHFA of the FMIC; or ○ Merge or consolidate the FHFA of the FMIC, or any of the functions or responsibilities of the FHFA of the FMIC, with any division, office, or other component of the FMIC. <u>Agency Expenditures and Budget</u> • After the agency transfer date, the Director of the FHFA of the FMIC—	<u>Disposition of Affairs</u> During the period preceding the transfer date, the FHFA Director, for the purpose of winding up FHFA's affairs connection with the performance of functions that are transferred by this section— • Shall manage the employees of such Agency and provide for the payment of the compensation and benefits of any such employees which accrue before the transfer date; and • May take any other action necessary for the purpose of winding up the affairs of the Office. <u>Use of Property and Services</u> • The NMFA may use FHFA property and services to perform functions which have been transferred to the NMFA until such time as the Agency is abolished under § 303 to facilitate the orderly transfer of functions transferred under this section, any other provision of this Act, or any amendment made by this Act to any other provision of law. • Any agency, department, or other instrumentality of the U.S., and any successor to any such agency, department, or instrumentality, that was providing supporting services to the Agency before the transfer date in	inserting "of the Director"; • In the second sentence, by striking "Secretary" and inserting "Director"; • In the third sentence— ○ By striking "in the Department of Housing and Urban Development"; and ○ By inserting before the period at the end the following: ", and shall be appointed for a term of 5 years, unless removed before the end of such term for cause by the President"; • In the last sentence, by striking "Secretary" and inserting "Director"; and • By adding at the end the following undesignated paragraph: "A vacancy in the position of Director that occurs before the expiration of the term for which a Director was appointed shall be filled in the manner established under paragraph (1), and the Director appointed to fill such vacancy shall be appointed only for the remainder of such term. If the Senate has not confirmed a Director, the President may designate either the individual nominated but not yet confirmed for the position of Director or another individual, to serve as the Acting Director, and such Acting Director shall have all the rights, duties, powers, and responsibilities of the Director, until

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		◦ Except as limited in amount below, may obligate and expend amounts available to the FHFA; and ◦ Shall submit regular updates to the Board of Directors. • During the period beginning on the agency transfer date and ending on the date on which the first individual is appointed as Chairperson under § 202, the Director shall require approval from the Transition Committee for any agency capital expenditure in excess of $5,000,000. • On and after the date on which the first individual is appointed as Chairperson under § 202, the Director shall require approval from the Board of Directors for any agency capital expenditure in excess of $5,000,0000. <u>Cooperation</u> During the period beginning on the date of enactment of this Act and ending on the system certification date, the Board of Directors and the Director shall cooperate and coordinate in the exercise of their respective authorities to facilitate and achieve an orderly transition from housing finance markets facilitated by the enterprises to housing finance markets facilitated by the FMIC with minimum disruption in the availability of credit.	connection with functions that are transferred to the NMFA shall— ◦ Continue to provide such services, on a reimbursable basis, until the transfer of such functions is complete; and ◦ Consult with any such agency to coordinate and facilitate a prompt and reasonable transition. <u>Continuation of Services</u> The NMFA may use the services of employees and other personnel of FHFA, on a reimbursable basis, to perform functions which have been transferred to the NMFA for such time as is reasonable to facilitate the orderly transfer of functions pursuant to this section, any other provision of this Act, or any amendment made by this Act to any other provision of law. <u>Savings Provisions</u> • The transfer of FHLB functions and § 303 shall not affect the validity of any right, duty, or obligation of the U.S., the FHFA Director, the FHFA, or any other person, that existed on the day before transfer date. • No action or other proceeding commenced by or against the FHFA Director in connection with the functions that are transferred to the NMFA under	such time as a Director is confirmed by the Senate. An individual may serve as the Director after the expiration of the term for which appointed until a successor has been appointed or confirmed." • 5 U.S.C. § 5315 is amended, in the item relating to the Ginnie Mae President by striking ". Department of Housing and Urban Development". <u>FSOC Membership</u> • Dodd-Frank Act § 2(12)(E), the definition of primary financial regulatory agency, is amended to define Ginnie Mae as the primary financial regulatory agency for the MIF established under § 202(g), the FHLBs or the FHLB System. • Dodd-Frank § 111(b)(1)(H), FSOC voting members, is amended to replace the FHFA Director with the Ginnie Mae Director. <u>Personnel</u> National Housing Act § 309(d) (12 U.S.C. 1723a(d)) is amended by striking paragraph (d)(1) and inserting the following: • The Director of the Association may appoint and fix the compensation of such officers and employees of the Association as the Director considers necessary to carry out the functions of the Association.

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		Coordination and Continuation of Certain Actions • All regulations, orders, determinations, and resolutions described in the paragraph below shall remain in effect according to the terms of such regulations, orders, determinations, and resolutions, and shall be enforceable by or against the FHFA of the FMIC until modified, terminated, set aside, or superseded in accordance with applicable law by the FHFA of the FMIC, any court of competent jurisdiction, or operation of law. • A regulation, order, determination, or resolution is described in this paragraph if it— ○ Was issued, made, prescribed, or allowed to become effective by— ▪ The Existing Agency; ▪ The Federal Housing Finance Board; or ▪ A court of competent jurisdiction, and relates to functions transferred by this section; ○ Relates to the performance of functions that are transferred by this section; and ○ Is in effect on the agency transfer date.	this section shall abate by reason of the enactment of this Act, except that the NMFA shall be substituted for the FHFA Director as a party to any such action or proceeding. Conforming Amendments Effective on the transfer date: The *FHLB Act* is amended— • By striking the Director and inserting the NMFA each place that term appears; • By striking Chairman of the Director of Governors and inserting Chairman of the Board of Governors each place that term appears; • By striking the Agency and inserting the NMFA each place that term appears; • In § 2(11), the definition of Director, by replacing it with a definition of NMFA to mean the NMFA; and • By striking § 2(12), the definition of FHFA. The *1992 Act* is amended in § 1316 (assessments) is amended by removing authority to assess the FHLBs. The *Right to Financial Privacy Act of 1978* is amended in § 1113(o) (exclusion for disclosure to or examination by FHFA), to replace FHFA with NMFA.	Officers and employees may be paid without regard to 5 U.S.C. chapter 51 and chapter 53 subchapter III relating to classification and GS pay rates. • In carrying out this subsection, Ginnie Mae shall appoint and develop human capital (which shall have such meaning as determined by Ginnie Mae, in consultation with the Board of Governors of the Federal Reserve, taking into consideration differences between the banking and insurance industries) necessary to ensure that it possesses sufficient expertise regarding the insurance industry and insurance issues. • In fixing and directing compensation under subparagraph (A), the Director of the Association shall consult with, and maintain comparability with, compensation of officers and employees of the OCC, Federal Reserve, and the FDIC. • In carrying out the duties of the Association, the Director of the Association may use information, services, staff, and facilities of any executive agency, independent agency, or department on a reimbursable basis, with the consent of such agency or department. • Notwithstanding any provision of law limiting pay or compensation, the Director of the Association may appoint

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		<u>Use of Agency Services</u>
		Any U.S. agency, department, or other instrumentality, and any successor to any such agency, department, or instrumentality, which was providing supporting services to the Existing Agency before the agency transfer date in connection with functions that are transferred to the FHFA of the FMIC shall—
		• Continue to provide such services, on a reimbursable basis, until the transfer of such functions is complete; and
		• Consult with any such agency to coordinate and facilitate a prompt and reasonable transition.
		
		<u>Savings Provisions</u>
		• Subsection (a) (establishing the FHFA of the FMIC) shall not affect the validity of any right, duty, or obligation of the U.S., the Director of the Existing Agency, or any other person, which—
		  ○ Arises under the 1992 Act, the Fannie Mae or Freddie Mac charters, or any other provision of law applicable with respect to the Existing Agency; and
		  ○ Existed on the day before the agency transfer date.
		• No action or other proceeding commenced by or against the Director of the Existing Agency in connection with functions that are transferred to the FHFA
			§ 303 Abolishment of FHFA
			Effective upon certification by Treasury that the Agency has substantially completed the actions necessary to wind down the remaining assets of the GSEs, FHFA and the FHFA Director's position are abolished.
			
			§ 304 Transfer of Property and Facilities
			Effective upon the certification by Treasury pursuant to § 303, all FHFA property shall transfer to the NMFA, except as determined by Treasury to be necessary to continue activities to wind down the GSEs.
			
			§ 305 Residual Corpus of GSEs in Conservatorship
			Upon certification of Treasury pursuant to § 303, the Agency may transfer the remaining assets and authority over the corpuses of GSEs to complete the wind down of those remaining assets.
				and compensate such outside experts and consultants as such Director determines necessary to assist the work of the Association.
				
				<u>Transitional Provision</u>
				Notwithstanding this section, from enactment until the Ginnie Mae Director is confirmed pursuant to National Housing Act § 308 as amended by this section, the person serving as the Ginnie Mae President shall act for all purposes as, and with the full powers of, the Director of the Association.
				
				<u>References</u>
				On and after the date of the enactment, any reference in Federal law to the Ginnie Mae President or to such Association shall be deemed a reference to such Ginnie Mae or to such Association, as appropriate, as organized pursuant to this subsection and the amendments made by this section.
				
				§ 102 Transfer to Ginnie Mae of FHFA Powers, Personnel, and Property
				<u>Powers and Duties Transferred</u>
				• There are transferred to Ginnie Mae and the Ginnie Mae Director all functions of FHFA and the FHFA Director. Ginnie Mae and its Director shall succeed to all powers, authorities, rights, and duties that were vested in FHFA and the FHFA Director, respectively, including all

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		of the FMIC shall abate by reason of the enactment of this Act, except that the Director of the FHFA of the FMIC shall be substituted for the Director of the Existing Agency as a party to any such action or proceeding.
		
		<u>Technical and Conforming Amendments</u>
		The following changes are effective on the agency transfer date. (Note that the technical changes in § 407 are effective on the system certification date.)
		
		The *1992 Act* is amended—
		• In § 1303(2), the definition of Agency, to mean the FHFA of the FMIC.
		• In § 1303(9), the definition of Director, to mean the Director of the Agency.
		• In § 1311(a), by striking language that creates FHFA and inserting language that creates the FHFA within the FMIC, which shall be maintained as a distinct entity within the FMIC.
		• In § 1312(b)(1), by striking language that the FHFA Director is appointed by the President and confirmed by the Senate, and inserting language that the Director is appointed in accordance with § 402(a)(2) of the Housing Finance Reform and Taxpayer Protection Act of 2014.
		• In § 1367(a)(7), which currently provides that the FHFA Director, when acting as
				conservatorship or receivership authorities, on the day before the transfer date in connection with the FHFA functions and authorities transferred.
				• Such transfer shall take effect 6 months after enactment Act.
				• All such FHFA regulations, orders, determinations, and resolutions shall remain in effect according to their terms, and shall be enforceable by or against Ginnie Mae until modified, terminated, set aside, or superseded in accordance with applicable law by Ginnie Mae, any court of competent jurisdiction, or operation of law. This includes a regulation, order, determination, or resolution if it—
				  ○ Was issued, made, prescribed, or allowed to become effective by FHFA or a court of competent jurisdiction, and relates to FHFA functions transferred;
				  ○ Relates to the performance of functions that are transferred by this subsection; and
				  ○ Is in effect on the transfer date [6 months after enactment].
				• During the period preceding the 6-month transfer date, the FHFA Director, for the purpose of winding up FHFA's affairs in connection with the performance of functions that are transferred by this

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		conservator or receiver, acts independently of other agencies, is amended to make an exception as may be provided in § 604(a)(2) of the Housing Finance Reform and Taxpayer Protection Act of 2014, or as otherwise specifically provided for in such Act.
		• In § 1367(b)(2)(D), which currently authorizes the FHFA Director, as conservator, to actions to put a GSE in sound condition and to carry on its business, is amended to provide that:
		  o On and after the agency transfer date, the Agency shall, as conservator, take such actions as are necessary—
		    ▪ To wind down of the operations of the GSEs in an orderly manner that complies with the 2014 Act;
		    ▪ To manage the GSEs' affairs, assets, and obligations and to operate the GSEs in compliance with the requirements of such Act;
		    ▪ To undertake and carry out any sale, transfer, or disposition authorized in §§ 315(c), 321(d), 604(i)(2), 701(b), or 702 of that Act to facilitate the orderly transition to the new housing finance system authorized by such Act; and
		    ▪ To maintain liquidity and
				section—
				  o Shall manage FHFA employees and provide for the payment of their compensation and benefits which accrue before such transfer date; and
				  o May take any other action necessary to wind up FHFA's affairs.
				• Ginnie Mae may use FHFA's property and services to perform functions transferred to Ginnie Mae until FHFA is abolished to facilitate the orderly transfer of functions under this Act, or any amendment made by this Act to any other provision of law. Any agency, department, or other instrumentality of the U.S., and any successor to any such agency, department, or instrumentality, that was providing supporting services to FHFA before the transfer date in connection with functions that are transferred to Ginnie Mae shall—
				  o Continue to provide such services, on a reimbursable basis, until the transfer is complete; and
				  o Consult with any such agency to coordinate and facilitate a prompt and reasonable transition.
				• Ginnie Mae may use the services of employees and other personnel of FHFA, on a reimbursable basis, to perform functions which have been transferred to Ginnie Mae for such time as is reasonable

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		stability in the secondary mortgage market until the GSEs have no authority to conduct new business. o The FMIC may, as conservator, take such actions as are— ▪ Necessary to put an FHLB in a sound and solvent condition; and ▪ Appropriate to carry on the business of an FHLB and preserve and conserve its assets and property. The *FHLB Act* is amended— • By striking Chairman of the Director of Governors each place that term appears and inserting Chairman of the Board of Governors; and • In § 2(11), the definition of Director, by replacing FHFA with Agency; and • In § 2(12), the definition of Agency, by replacing FHFA with the FHFA within the FMIC. The *FDIA* is amended— • In § 11(t), which currently provides that covered agencies may share information without waiving privileges, by adding the FMIC to the definition of covered agency. • In § 18(x), which currently provides that submitting information to certain regulators does not waive privileges, by		to facilitate the orderly transfer of functions pursuant to this Act, or any amendment made by this Act to any other provision of law. • The transfer and abolishment of FHFA shall not affect the validity of any right, duty, or obligation of the U.S., the FHFA Director, FHFA, or any other person, that existed on the day before the 6-month transfer date. • No action or other proceeding commenced by or against the FHFA Director in connection with the functions that are transferred to Ginnie Mae shall abate by reason of the enactment of this Act, except that Ginnie Mae shall be substituted for the FHFA Director as a party to any such action or proceeding. <u>Abolishment of FHFA</u> Effective upon the 6-month transfer date, FHFA and the position of the FHFA Director are abolished. <u>Transfer of Property and Facilities</u> Effective on the 6-month transfer date, all FHFA property shall transfer to Ginnie Mae. <u>References in Federal Law</u> On and after the 6-month transfer date, any reference in Federal law to the FHFA Director or FHFA, in connection with any function of

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		adding the FMIC to the list of agencies. The *FFIEC Act* is amended: • In § 1004 by adding the FMIC Chairman to the FFIEC; • In § 1011 by adding the FMIC to the FFIEC Appraisal Subcommittee; and • By adding § 1012, establishing a servicing subcommittee: The FFIEC has a Subcommittee on Mortgage Servicing, consisting of designees of heads of the Federal financial institution regulatory agencies, the CFPB, FMIC, FHFA, and a representative of the State Liaison Committee established under § 1007. *FIRREA* is amended in § 1216(a), which requires equal opportunity in the Federal Government for listed agencies, to remove FHFA and add FMIC. The *Housing and Urban-Rural Recovery Act of 1983* is amended in § 469, which requires HUD in cooperation with several agencies to report to Congress on mortgage delinquencies and foreclosures, to add FMIC to the list of agencies. The *Paperwork Reduction Act* is amended to replace FHFA with FMIC.		the FHFA Director or FHFA transferred shall be deemed a reference to the Ginnie Mae Director or Ginnie Mae, as appropriate and consistent with the amendments made by this Act.

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		Public Law 93-495, 12 U.S.C. § 250, which makes several agencies independent, is amended to add the FMIC. The *Right to Financial Privacy Act of 1978* is amended in § 1101(7), which defines supervisory agency, to add the FMIC. 5 U.S.C. § 5313, which applies Level II of the Executive Schedule to specified positions, is amended by adding the FMIC Chairperson. 5 U.S.C. § 3132(a)(1)(D), which excludes certain independent agencies from the definition of agency for SES purposes, to add FMIC to the excluded agencies. 18 U.S.C. is amended in §§ 212 (loan or gratuity to examiners), 657 (misapplication of funds by agency employees), 1006 (false entry by agency employees), 1014 (false statement on loan application to influence agency), and 1905 (federal employees divulging trade secret) by replacing FHFA with FMIC. The *Federal Credit Union Act* is amended in § 107(7)(e) to authorize Federal credit unions to invest in obligations backed by the FMIC. The *Bank Holding Company Act* is amended		

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		in § 5(c)(5)(B) to add to the definition of functionally regulated subsidiary an approved guarantor under § 311 of this Act.		
Agency Transfer – Employees		**§ 403 Transfer and Rights of FHFA Employees** Transfer • Effective on the agency transfer date, each employee of the Existing Agency, including each employee of the OIG of the Existing Agency, who is in good standing, shall be transferred to the FMIC for employment, and such transfer shall be deemed a transfer of function for purposes of 5 U.S.C. § 3503. • A transferred employee shall be appointed to a position in the FHFA of the FMIC. On and after the agency transfer date, the Chairperson, in consultation with the Director of FHFA of the FMIC, may reassign a transferred employee to a different component of the FMIC, if the reassignment is in the best interest of the FMIC. Guaranteed Positions Each transferred employee shall be guaranteed a position with the same status, tenure, grade, and pay as that held on the day immediately preceding the transfer. A transferred employee holding a permanent position on the day immediately preceding the	**§ 302 Transfer and Rights of FHFA Employees** Transfer Each FHFA employee that is employed in connection with functions that are transferred to the NMFA under § 301 shall be transferred to the NMFA for employment, not later than the transfer date, and such transfer shall be deemed a transfer of function for purposes of 5 U.S.C. § 3503. Status of Employees The transfer of functions under this title, and the abolishment of FHFA, may not be construed to affect the status of any transferred employee as an employee of an agency of the U.S. for purposes of any other provision of law. Guaranteed Positions Each transferred employee shall be guaranteed a position with the same status, tenure, grade, and pay as that held on the day immediately preceding the transfer. Employees who remain with FHFA to assist with wind down of the entities shall be ensured of transfer to the NMFA at a later date. Appointment Authority for Excepted	**§ 102(b)** Transfer and Rights of FHFA Employees • Each FHFA employee that is employed in connection with functions that are transferred to Ginnie Mae shall be transferred to Ginnie Mae for employment, not later than the 6-month transfer date, and such transfer shall be deemed a transfer of function for purposes of 5 U.S.C. § 3503. • The transfer of functions, and the abolishment of FHFA, may not be construed to affect the status of any transferred employee as an employee of a U.S. agency for purposes of any other provision of law. • Each such employee transferred shall be guaranteed a position with the same status, tenure, grade, and pay as that held on the day immediately preceding the transfer. • In the case of an employee occupying a position in the excepted service, any appointment authority established under law or by OPM regulations for filling such position shall be transferred. Ginnie Mae may decline such a transfer to the extent that such authority relates to a

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		transfer may not be involuntarily separated or reduced in grade or compensation during the 12-month period beginning on the date of transfer, except for cause, or, in the case of a temporary employee, separated in accordance with the terms of the appointment of the employee.
		
		<u>Appointment Authority for Excepted and SES Employees</u>
		In the case of an employee occupying a position in the excepted service or the SES, any appointment authority established under law or by OPM regulations for filling such position shall be transferred. However, the FMIC may decline such a transfer, to the extent that such authority relates to—
		• A position excepted from the competitive service because of its confidential, policymaking, policy-determining, or policy-advocating character; or
		• A noncareer appointee in the SES.
		
		<u>Employee Benefit Programs</u>
		• Any employee of the Existing Agency accepting employment with the FMIC as a result of a transfer may retain, for 12 months after such transfer occurs, membership in any employee benefit program of the Existing Agency or the FMIC, as applicable, including insurance, to which such employee belongs on the
			<u>Employees</u>
			In the case of an employee occupying a position in the excepted service, any appointment authority established under law or by OPM regulations for filling such position shall be transferred. However, the NMFA may decline such a transfer, to the extent that such authority relates to a position excepted from the competitive service because of its confidential, policymaking, policy-determining, or policy-advocating character.
			
			<u>Reorganization</u>
			If the NMFA determines, after the end of the 1-year period beginning on the transfer date, that a reorganization of the combined workforce is required, that reorganization shall be deemed a major reorganization for purposes of affording affected employee retirement under 5 U.S.C. § 8336(d)(2) or § 8414(b)(1)(B).
			
			<u>Employee Benefit Programs</u>
			• Any FHFA employee of accepting employment with the NMFA as a result of a transfer may retain, for 12 months after the date on which such transfer occurs, membership in any employee benefit program of the Agency or the NMFA, as applicable, including insurance, to which such employee belongs on the transfer date if—
			  ○ The employee does not elect to give
				position excepted from the competitive service because of its confidential, policymaking, policy-determining, or policy-advocating character.
				• If Ginnie Mae determines, after the 1-year period after the 6-month transfer date, that a reorganization of the combined workforce is required, that reorganization shall be deemed a major reorganization for purposes of affording affected employee retirement under 5 U.S.C. § 8336(d)(2) or 8414(b)(1)(B).
				• Any FHFA employee accepting employment with Ginnie Mae as a result of a transfer may retain, for 12 months after the transfer occurs, membership in any employee benefit program of FHFA or Ginnie Mae, as applicable, including insurance, to which such employee belongs on the 6-month transfer date if the employee does not elect to give up the benefit or membership and Ginnie Mae continues t=the benefit or program.
				  ○ Ginnie Mae shall pay the difference in the costs between the benefits that FHFA would have provided and those provided by this subsection.
				If any employee elects to give up membership in a health insurance program or the health insurance program is not continued by Ginnie Mae, the employee shall be permitted to select an alternate

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		date of the transfer, if— ○ The employee does not elect to give up the benefit or membership in the program; and ○ The benefit or program is continued by the FMIC. • The difference in the costs between the benefits which would have been provided by the Existing Agency and those provided by this section shall be paid by the FMIC. • If any employee elects to give up membership in a health insurance program or the health insurance program is not continued by the FMIC, the employee shall be permitted to select an alternate Federal health insurance program not later than 30 days after the date of such election or notice, without regard to any other regularly scheduled open season. <u>GSE Employees</u> To ensure an orderly transition to the new housing finance system established under this Act and to facilitate the organization, formation, and competency of the FMIC, the FMIC may hire employees from the GSEs. <u>Reorganization</u> If the FMIC determines that a reorganization of the workforce is required, the	up the benefit or membership in the program; and ○ The benefit or program is continued by the NMFA. • The difference in the costs between the benefits which would have been provided by FHFA and those provided by this section shall be paid by the NMFA. • If any employee elects to give up membership in a health insurance program or the health insurance program is not continued by the NMFA, the employee shall be permitted to select an alternate Federal health insurance program not later than 30 days after the date of such election or notice, without regard to any other regularly scheduled open season.	**Federal health insurance program not later than 30 days after the date of such election or notice, without regard to any other regularly scheduled open season.**

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		reorganization shall be deemed a major reorganization for purposes of affording affected employee retirement under 5 U.S.C. § 8336(d)(2) or § 8414(b)(1)(B).		
Agency Transfer – Transition Committee		**§ 404 Transition Committee** <u>Establishment and Purpose</u> Effective on enactment, there is established the FMIC Transition Committee. Its purpose shall be to— • Develop a plan to facilitate an orderly transition to a new housing finance system in accordance with this Act; and • Provide advice to the Transition Chairperson or the Board when consulted. <u>Composition</u> • The Transition Committee shall be comprised of— o The Director; o The Chairman of the FDIC; o The Comptroller of the Currency; o The Chairperson; and o Any member of the Board of Directors. • Until the date on which the first individual is appointed as Chairperson under § 202, the Director shall serve as the Chairperson of the Transition Committee. On and after that date, the Chairperson shall serve as the Chairperson of the Transition Committee. • In the event of a vacancy in the office of		

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		the head of a member agency, and pending the appointment of a successor, or during the absence or disability of the head of a member agency, the acting head of the member agency shall serve as a member of the Transition Committee in the place of that agency head. • As necessary to carry out the duties of the Transition Committee, the Chairperson of the Transition Committee may, before the agency transfer date, use employees of the Existing Agency, and on and after that date, use employees of the FMIC. <u>Transition Plan</u> The Transition Committee shall develop the transition plan required by § 602 of this Act. The transition plan may not be submitted to Congress under § 602, unless it is approved by a majority of the Transition Committee. <u>Dissolution</u> The Transition Committee shall be dissolved upon the later of— • The date on which the first individual is appointed as Chairperson under § 202; or • The date on which the transition plan is submitted to Congress in accordance with §§ 404(c)(2) and 602.		
Agency Transfer – Assessments		**§ 405 Transition Assessments** <u>In General</u> Section 1316(i) is added to the 1992 Act:	**§ 107 Initial Funding** <u>In General</u> Section 1316(i) is added to the 1992 Act:	

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		Notwithstanding title VI of the Housing Finance Reform and Taxpayer Protection Act of 2014 or any other provision of law, for the period beginning on the date of enactment of this subsection and ending on the system certification date, the Agency shall establish and collect from the GSEs annual assessments in addition to those required under § 1316(a) [paid to FHFA] in an amount not exceeding the amount sufficient to provide for the reasonable costs (including administrative costs) and expenses of the FMIC, including those purposes detailed in § 604(b)(4)(A) of the Housing Finance Reform and Taxpayer Protection Act of 2014. All amounts collected under this subsection shall be transferred to the FMIC. The annual assessment shall be payable semiannually for each fiscal year, on October 1 and April 1. <u>Treatment of Assessments</u> • FMIC must deposit these § 1316(i) assessments in the MIF. • Amounts received by the Existing Agency beginning on enactment until the agency transfer date from assessments imposed under § 1316(i) shall be held in an account of the Existing Agency and shall be transferred to the FMIC on the agency transfer date for deposit in the	Notwithstanding title V of the Housing Opportunities Move the Economy Forward Act of 2014 or any other provision of law, for the period beginning on the date of enactment of this subsection and ending on the NMFA certification date, the FHFA Director, in consultation with NMFA Director, shall establish and collect from the GSEs annual assessments in addition to those under § 1316(a) [paid to FHFA] in an amount not exceeding the amount sufficient to provide for the reasonable costs (including administrative costs) and expenses of the NMFA. All amounts collected under this subsection shall be transferred to the NMFA. The annual assessment shall be payable semiannually for each fiscal year, on October 1 and April 1. <u>Treatment of Assessments</u> • NMFA must deposit these § 1316(i) assessments in the manner provided in § 5234 of the Revised Statutes of the U.S. (12 U.S.C. 192) for monies deposited by the Comptroller of the Currency. • These § 1316(i) amounts received by the NMFA shall not be construed to be Government or public funds or appropriated money. • Notwithstanding any other provision of	

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		MIF. • Notwithstanding any other provision of law, amounts received by the FMIC from any assessment imposed under § 1316(i) shall not be subject to apportionment for the purposes of 31 U.S.C. chapter 15, or under any other authority. • Amounts received by the FMIC from any § 1316(i) assessment shall not be construed to be Government or public funds or appropriated money. • The Existing Agency shall use amounts received from assessments imposed under § 1316(i) solely to fund the MIF on the agency transfer date. The Existing Agency may request Treasury to invest such portions of the § 1316(i) amounts received. Pursuant to such a request, Treasury shall invest such amounts in Federal Government obligations— o Guaranteed as to principal and interest by the U.S. with maturities suitable to the needs of the Existing Agency; and o Bearing interest at a rate determined by Treasury, taking into consideration current market yields on outstanding marketable U.S. obligations of comparable maturity.	law, the § 1316(i) amounts received by NMFA shall not be subject to apportionment for the purpose of 31 U.S.C. chapter 15, or under any other authority. • NMFA may use any amounts received from § 1316(i) assessments o For compensation of NMFA employees; and o For all other NMFA. • NMFA may request Treasury to invest such portions of amounts received from § 1316(i) assessments that, in the NMFA's discretion, are not required to meet NMFA's current working needs. Pursuant to such a request, Treasury shall invest such amounts in Government obligations— o Guaranteed as to principal and interest by the U.S. with maturities suitable to the needs of the NMFA; and o Bearing interest at a rate determined by Treasury taking into consideration current market yields on outstanding marketable U.S. obligations of comparable maturity.	
Agency Transfer – FHFA of		**§ 406 Transfers on the System Certification Date; Continuation and Coordination of Certain Actions**		

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FMIC to FMIC		<u>Transfer of Functions</u>
		Effective on the system certification date and except as provided in § 333(a), there are transferred to the FMIC all functions of the FHFA of the FMIC and the Director thereof.
		
		<u>Coordination and Continuation of Certain Actions</u>
		All regulations, orders, determinations, and resolutions described below shall remain in effect according to the terms of such regulations, orders, determinations, and resolutions, and shall be enforceable by or against the FMIC until modified, terminated, set aside, or superseded in accordance with applicable law by the FMIC, any court of competent jurisdiction, or operation of law. This applies to a regulation, order, determination, or resolution that—
		• Was issued, made, prescribed, or allowed to become effective by—
		  ○ The Existing Agency;
		  ○ The FHFA of the FMIC;
		  ○ The Federal Housing Finance Board; or
		  ○ A court of competent jurisdiction;
		• Relates to the performance of functions that are transferred by subsection (a); and
		• Is in effect on the effective date of that transfer.
		
		<u>Use of Agency Services</u>		

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		Any agency, department, or other instrumentality of the U.S., and any successor to any such agency, department, or instrumentality, which was providing supporting services to the FHFA of the FMIC before the system certification date in connection with functions that are transferred to the FMIC shall—
		• Continue to provide such services, on a reimbursable basis, until the transfer of such functions is complete; and
		• Consult with any such agency to coordinate and facilitate a prompt and reasonable transition.
		
		<u>Savings Provisions</u>
		• The § 406 transfers shall not affect the validity of any right, duty, or obligation of the U.S., the Director of the FHFA of the FMIC, or any other person, which—
		  o Arises under the 1992 Act, the Fannie Mae or Freddie Mac charter acts, or any other provision of law applicable with respect to the FHFA; and
		  o Existed on the day before the system certification date.
		• No action or other proceeding commenced by or against the Director of the FHFA of the FMIC in connection with functions that are transferred to the FMIC shall abate by reason of the		

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		enactment of this Act, except that the FMIC shall be substituted for the Director of the FHFA of the FMIC as a party to any such action or proceeding.		
Agency Transfer – Technical Amendments		**§ 407 Technical and Conforming Amendments Relating to Abolishment of FHFA** The following changes are effective on the system certification date. (Note that the technical changes in § 402 are effective on the agency transfer date.) The *Local TV Act of 2000* is amended in § 1004(d)(2)(D)(iii), which prohibits loans made by entities that FHFA regulates from backing by the Local TV Loan Guarantee Board, by replacing FHFA with FMIC. The *Commodity Exchange Act,* in § 1a(39)(E) (defining prudential regulator) is amended by replacing FHFA with FMIC. *EESA* is amended: • In § 104(b)(3) by replacing the FHFA Director with the FMIC Chairperson, as a member of the Financial Stability Oversight Board; • In § 109(b) by replacing FHFA with FMIC, as an agency with whom Treasury must coordinate in foreclosure mitigation efforts; and	**§ 306 Technical and Conforming Amendments** The amendments made by this section shall take effect on enactment. On and after the date of enactment, any reference in Federal law to the FHFA Director or the FHFA, in connection with any function of the FHFA Director or the Federal Housing Finance Agency transferred under § 301, shall be deemed a reference to the Director of the NMFA or the NMFA, as appropriate and consistent with the amendments made by this Act. 18 U.S.C. is amended— • In § 1905 (federal employees divulging trade secret), by adding NMFA; • In § 212(c)(2)(F) (loan or gratuity to examiners), by adding NMFA as a federal financial institution regulatory agency. • In § 657 (misapplication of funds by agency employees), by adding NMFA to the list of agencies; • In § 1006 (false entry by agency employees), by adding NMFA to the list of agencies; • In § 1014 (false statement on loan	

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		• In § 110(a)(1)(A) by replacing FHFA with FMIC, in the capacity as GSE conservator, as a federal property manager for providing homeowner and tenant assistance. The *GSE charter acts* are amended in several places to replace FHFA with FMIC. The *FDIA* is amended in several places to replace FHFA with FMIC. The *FFIEC Act of 1978* is amended in § 1011 by removing FHFA from the FFIEC Appraisal Subcommittee. The *FHLB Act* is amended: • In § 2(11), the definition of Director, as amended by § 402, to replace agency with the FMIC Chairperson. • In § 2(12), the definition of Agency, as amended by § 402, to replace FHFA within the FMIC with the FMIC established under § 201. • In § 10(a)(3)(B) to permit advances to be collateralized by FMIC-insured covered securities, subject to regulations the FMIC may issue to ensure the safety and soundness of the FHLBs. • In § 11(h) to permit FHLBs to invest surplus funds in FMIC-insured covered securities, subject to regulations the	application to influence agency), by adding NMFA to the list of agencies. The *Flood Disaster Protection Act of 1973* is amended in § 102(b)(5) (agencies must require flood insurance) by adding NMFA to the list of agencies. 5 U.S.C. § is amended— • 5 U.S.C. § 5313, which applies Level II of the Executive Schedule to specified positions, is amended by adding the NMFA Director. • 5 U.S.C. § 3132(a)(1)(D), which excludes certain independent agencies from the definition of agency for SES purposes, by adding NMFA to the excluded agencies. The *Sarbanes-Oxley Act* is amended in § 105(b)(5)(B)(ii)(II), which authorizes PCAOB disclosures to several agencies without loss of privilege, by adding the NMFA Director to the list of agencies. The *FDIA* is amended— • In § 7(a)(2)(A) (giving FDIC access to examination reports of other agencies), by NMFA to the list of agencies. • In § 8(e)(7)(A)(vi) (persons prohibited from participating in a banking organization may not work in specified regulators), by adding NMFA to the list	

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		FMIC may issue to ensure the safety and soundness of the FHLBs. The *1992 Act* is amended: • In § 1303(2), as amended by § 402, the definition of Agency, to replace FHFA within the FMIC with the FMIC established under § 201. • By deleting § 1303(4), the definition of Federal Housing Finance Oversight Board. • In § 1303(9), as amended by § 402, the definition of Director, to replace Director of the Agency with FMIC Chairperson. • By deleting § 1313A, which established the Federal Housing Finance Oversight Board. • By deleting § 1317(d), which created the FHFA IG. • In § 1367 to replace FHFA with FMIC in headings. In *FIRREA*, by replacing FHFA with FMIC in § 402(e) (ARM loans that refer to agencies); § 1124 (AMC regulation); and § 1125(b) (writing AVM regulations). The *Flood Disaster Protection Act of 1973* is amended in § 102(f)(3)(A) (enforcement against the GSEs) by replacing the FHFA Director with the FMIC Chairperson.	of agencies; • In § 11(t), which currently provides that covered agencies may share information without waiving privileges, by adding the NMFA to the definition of covered agency. This change is also made in § 226(a)(1). • In section 33(e) (employee whistleblower protection for agency employees), by adding NMFA to the list of agencies. The *Riegle Community Development and Regulatory Improvement Act of 1994* is amended in § 117(e) (in making annual reports, the CDFI Fund must consult with several agencies) by adding NMFA to the list of agencies. The *Multifamily Assisted Housing Reform and Affordability Act of 1997* is amended in § 517(b)(4) (42 U.S.C. 1437f note) (mortgage restructuring and rental assistance sufficiency plans may include GSE enhancements) by adding that they may include NMFA enhancements. The *Paperwork Reduction Act* is amended by adding NMFA to the definition of independent regulatory agencies The *Local TV Act of 2000* is amended in § 1004(d)(2)(D)(iii), which prohibits	

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		HERA § 1002(b) (references in this Act) is amended by replacing FHFA with FMIC and by replacing FHFA Director with FMIC Chairperson. The *Housing and Urban-Rural Recovery Act of 1983* is amended in § 469 (requiring HUD in cooperation with several agencies to report to Congress on mortgage delinquencies and foreclosures) to remove FHFA from the list of agencies. The *Multifamily Assisted Housing Reform and Affordability Act of 1997* is amended in § 517(b)(4) (42 U.S.C. 1437f note) (mortgage restructuring and rental assistance sufficiency plans may include GSE enhancements) by replacing FHFA with FMIC. *Public Law 93-495*, 12 U.S.C. § 250, which makes several agencies independent, is amended to remove FHFA. The *Neighborhood Reinvestment Corporation Act* is amended in § 606(c)(3) (funding by several agencies is permitted) to replace FHFA with FMIC. The *Riegle Community Development and Regulatory Improvement Act of 1994* is amended in § 117(e) (in making annual	loans made by entities that FHFA regulates, from backing by the Local TV Loan Guarantee Board, to prohibit such backing for loans by entities the NMFA supervises. *FIRREA* is amended— • In § 1216(a), which requires equal opportunity in the Federal Government for listed agencies, by adding NMFA to the list of agencies; • In § 1216(c) (requiring listed agencies to have minority and women outreach programs for contracting), by adding NMFA to the list of agencies; • In § 402(e) (ARM loans that refer to agencies) by replacing FHFA with NMFA; • In § 1124 (AMC regulation) by adding NMFA to the list of agencies; and • In § 1125(b) (writing AVM regulations) by adding NMFA to the list of agencies. *EESA* is amended— • In § 104(b) by adding NMFA to the Financial Stability Oversight Board; • In § 109(b) by adding NMFA as an agency with whom Treasury must coordinate in foreclosure mitigation efforts; and The *Dodd-Frank Act* is amended—	

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		reports, the CDFI Fund must consult with several agencies) to replace FHFA with FMIC. The *Right to Financial Privacy Act of 1978* is amended in § 1113(o) (exclusion for disclosure to or examination by FHFA), to replace FHFA with FMIC. The *Sarbanes-Oxley Act* is amended in § 105(b)(5)(B)(ii)(II), which authorizes PCAOB disclosures to several agencies without loss of privilege, by replacing the FHFA Director with the FMIC Chairperson. The *Securities Exchange Act* is amended in § 15G (risk retention) by replacing FHFA with FMIC and by replacing FHFA Director with FMIC Chairperson. *TILA* is amended: • In § 129H(b)(4) (appraisals on HPMLs) by transfer rulewriting authority from FHFA to FMIC (the authority is interagency). • In § 129E(g)(1) and (h) (appraisal independence) by transfer rulewriting authority from FHFA to FMIC (the authority is interagency). On and after the system certification date, any	• In § 342(g)(1) (requiring several agencies to have an Office of Minority and Women Inclusion) by adding NMFA to the list of agencies; • In § 989E(a)(1) (establishing a Council of IGs on Financial Oversight), by adding NMFA's IG to the council. • In § 1481 (requiring HUD's multifamily mortgage resolution program and requiring HUD to coordinate with several agencies) by adding NMFA to the list of agencies. The *Housing and Urban-Rural Recovery Act of 1983* is amended in § 469 (requiring HUD in cooperation with several agencies to report to Congress on mortgage delinquencies and foreclosures) by adding NMFA to the list of agencies. The *Neighborhood Reinvestment Corporation Act* is amended in § 606(c)(3) (funding by several agencies is permitted) by adding NMFA to the list of agencies. The *Federal Insurance Office Act* (Dodd-Frank Title V Subtitle A) is amended in 31 U.S.C. § 313(r)(4) (defining federal financial regulatory agency) by adding NMFA to the list of agencies. The *Commodity Exchange Act,* in § 1a(39)(E)	

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		reference to FHFA or its Director in any law, rule, regulation, certificate, directive, instruction, or other official paper in force on the system certification date shall be considered to refer and apply to the FMIC and its Chairperson, respectively.	(defining prudential regulator) is amended— • By replacing FHFA with respect to a regulated entity with FHFA with respect to a GSE; and • By adding NMFA in the case of a swap dealer, major swap participant, security-based swap dealer, or major security-based swap participant that is an FHLB. *TILA* is amended: • In § 129H(b)(4) (appraisals on HPMLs) by adding NMFA to the list of agencies with rulewriting authority. • In § 129E(g)(1) and (h) (appraisal independence) by adding NMFA to the list of agencies with rulewriting authority. The *FFIEC Act of 1978* is amended in § 1011 adding NMFA to the FFIEC Appraisal Subcommittee.	
Transition Oversight		**§ 606 Oversight of Transition of the Housing Finance System** <u>Testimony</u> Beginning on the agency transfer date and ending on the system certification date, the Chairperson shall, on an annual basis, appear before the Senate Banking and House Financial Services Committees to provide testimony on the progress made in carrying out the requirements of this title. <u>IG Report on Transition</u>		

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		Beginning on the agency transfer date and ending on the system certification date, the FMIC IG shall, on an annual basis—
		• Submit a report to the Senate Banking and House Financial Services Committees—
		  o On the status of the transition to the new housing finance system authorized by this Act;
		  o That includes recommendations to facilitate an orderly transition to the new housing finance system authorized by this Act; and
		  o On the impact of various actions required by this Act on borrowers and small mortgage lenders; and
		• Appear before the Senate Banking and House Financial Services Committees to provide testimony on the report.
		
		<u>GAO Report on Transition</u>
		Not later than 18 months after the system certification date, GAO shall conduct a study and submit a report to the Senate Banking and House Financial Services Committees reviewing the transition required by this Act. The study shall review—
		• All property, including intellectual property, of the GSEs that may have been sold, transferred, or licensed for value pursuant to this title or any amendment made by this title;		

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		• The number and market share of each type of approved entity; and • The amount of any taxpayer repayment.		

Provisional Standards		**§ 607 Authority to Establish Provisional Standards**
		<u>Provisional Standards</u>
		• Notwithstanding any standard required under subtitle B of title III or § 703, the FMIC may establish provisional standards for the approval of approved entities in order to ensure the sufficient participation of financially sound entities in the housing finance system.
		• The FMIC is authorized to establish such provisional standards before the system certification date and such provisional standards shall—
		  o Be published in the Federal Register for notice and comment; and
		  o Remain in effect until the FMIC adopts and publishes final standards for the approval of approved entities pursuant to subtitle B of title III or § 703.
		• The FMIC is authorized to establish such provisional standards during periods when the authority of the FMIC under § 305 is exercised and such provisional standards shall—
		  o Be published in the Federal Register; and
		  o Remain in effect until the final date		

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		of the timeline established by the FMIC pursuant to § 305(h)(1). • Nothing allowing the FMIC to establish the provisional standards before the system certification date shall be construed to allow the FMIC to delay or otherwise not implement the phased-in capital standards for approved guarantors in § 607(c) in the required timeframe. <u>Oversight of Approved Entities</u> During any period in which such a provisional standard is in effect, the FMIC shall maintain all oversight and enforcement authorities with regard to approved entities in accordance with the requirements and authorities of subtitles B and C of title III and § 703. <u>Phased-In of Capital Standards for Approved Guarantors</u> • The requirement under § 311(g)(1)(A) shall take effect 8 years after the FMIC approves the first approved guarantor under this section. Beginning on the date the FMIC approves the first approved guarantor under this section and ending on that 8-year date, the FMIC shall— o Require an approved guarantor to maintain an appropriate level of capital necessary to help ensure an orderly transition pursuant to this title; and		

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		○ Increase annually, in equal increments, the required amount of capital to be held by the approved guarantor. • Each such capital level, including each such annual increase, shall only apply with respect to new business being guaranteed by an approved guarantor on and after the date each capital level becomes effective.		
Repeal of Mandatory Housing Goals	**§ 104(c) Limitations on GSE Authority** The 1992 Act is amended: • By striking §§ 1331 through 1336. This repeals the GSE affordable housing goals, including the duty to serve underserved markets, and their enforcement. • There are conforming amendments to: ○ Section 1303(28) (definition of low-income area); ○ Section 1324(b)(1)(A) (annual housing report); ○ Section 1339(h) (restriction on using Capital Magnet Fund to meet housing goals); ○ Section 1341 (housing goals enforcement); ○ Section 1345(to remove penalties for violations of the housing goals); ○ Section 1345(f), by removing language that civil money penalties collected for affordable housing goals and housing reports violations	**§ 408 Repeal of Mandatory Housing Goals** • Effective on enactment, the GSEs' mandatory housing goals are repealed. • Notwithstanding any other provision of this Act, approved entities and the Securitization Platform shall comply with Federal and State nondiscrimination laws, including the Fair Housing Act and ECOA. • In carrying out this Act, the FMIC shall comply with Federal and State nondiscrimination laws. The FMIC shall periodically review its policies, standards, and guidelines with respect to eligible mortgage loans, including but not limited to any AUS, to ensure that such policies, standards, and guidelines are consistent with this requirement. • The 1992 Act is amended in § 1325 as follows: **(a) IN GENERAL.** The Secretary of HUD	**§§ 506 and 507 Repeal of Mandatory Housing Goals** The 1992 Act is amended: • By striking §§ 1331 through 1336. This repeals the GSE affordable housing goals, including the duty to serve underserved markets, and their enforcement. • There are conforming amendments to: ○ Section 1303(28) (definition of low-income area); ○ Section 1324(b)(1)(A) (annual housing report); ○ Section 1341 (housing goals enforcement); ○ Section 1345(a) (to remove penalties for violations of the housing goals); and ○ Section 1371(a)(2) (housing goals enforcement). This does not eliminate the Issuer's responsibility to comply with the Fair	

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	fund the Housing Trust Fund. o Section 1371(a)(2) (housing goals enforcement).	shall— (1) by regulation, prohibit each enterprise**, approved guarantor, approved multifamily guarantor, approved aggregator, and the Securitization Platform** from discriminating in any manner in the purchase **or guarantee** of any mortgage **or MBS** because of race, color, religion, sex, handicap, familial status, age, or national origin, including any consideration of the age or location of the dwelling or the age of the neighborhood or census tract where the dwelling is located in a manner that has a discriminatory effect; (2)**(A)** by regulation, require each enterprise to submit data to the Secretary to assist the Secretary in investigating whether a mortgage lender with which the enterprise does business has failed to comply with the Fair Housing Act; **and** **(B) with respect to the market for covered guarantee transactions and covered market-based risk-sharing transactions, by regulation, require each approved guarantor, approved multifamily guarantor, and approved aggregator to submit data to the Secretary to assist the Secretary in investigating whether a mortgage lender with which the approved guarantor, approved multifamily guarantor, or approved aggregator does business has failed to comply with the Fair Housing Act.** (3)**(A)** by regulation, require each enterprise	Housing Act. The NMFA may impose reporting requirements or take other action as it deems necessary for enforcement purposes.	

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		to submit data to the Secretary to assist in investigating whether a mortgage lender with which the enterprise does business has failed to comply with the ECOA, and shall submit any such information received to the appropriate Federal agencies, as provided in ECOA § 704 for appropriate action; **and** **(B) with respect to the market for covered guarantee transactions and covered market-based risk-sharing transactions, by regulation, require each approved guarantor, approved multifamily guarantor, and approved aggregator to submit data to the Secretary to assist the Secretary in investigating whether a mortgage lender with which the approved guarantor, approved multifamily guarantor, or approved aggregator does business has failed to comply with ECOA, and shall submit any such information received to the appropriate Federal agencies, as provided in ECOA § 704, for appropriate action;** (4) obtain information from other regulatory and enforcement agencies of the Federal Government and State and local governments regarding violations by lenders of the Fair Housing Act and the ECOA and make such information available to the enterprises **and FMIC**; (5)**(A)** direct the enterprises to undertake various remedial actions, including suspension, probation, reprimand, or		

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		settlement, against lenders that have been found to have engaged in discriminatory lending practices in violation of the Fair Housing Act or the ECOA, pursuant to a final adjudication on the record, and after opportunity for an administrative hearing, in accordance with subchapter II of chapter 5 of title 5; and **(B) with respect to the market for covered guarantee transactions and covered market-based risk-sharing transactions, apply various remedial actions, including suspension, probation, reprimand, or settlement, against lenders that have been found to have engaged in discriminatory lending practices in violation of the Fair Housing Act or ECOA, pursuant to a final adjudication on the record, and after opportunity for an administrative hearing [under the APA].** (6)**(A)** periodically review and comment on the underwriting and appraisal guidelines of each enterprise to ensure that such guidelines are consistent with the Fair Housing Act and this section~~.~~**; and** **(B) with respect to the market for covered guarantee transactions and covered market-based risk-sharing transactions, periodically review and comment on the underwriting and appraisal guidelines of each approved guarantor, approved multifamily guarantor, and approved aggregator, and the policies, standards, and**		

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		guidelines of the Securitization Platform to ensure that such guidelines are consistent with the Fair Housing Act and this section. **(b) DEFINITIONS.** [incorporating definitions from § 2.]		
Affordable Housing Allocations	Section 104(c) repeals § 1337, affordable housing allocation.	**§ 501 Affordable Housing Allocations** Fee and Allocation of Amounts In addition to any fees for the provision of insurance established in accordance with title III, in each fiscal year the FMIC shall— • Charge and collect a fee as determined below for each dollar of the outstanding principal balance of eligible mortgage loans collateralizing covered securities for which insurance is being provided under this Act; and • Annually allocate or otherwise transfer— o 75% of such fee amounts to HUD to fund the Housing Trust Fund established under § 1338 of the 1992 Act; o 15% of such fee amounts to Treasury to fund the Capital Magnet Fund established under § 1339 of the 1992 Act; and o 10% to the FMIC to fund the Market Access Fund established under § 504. Determination of Fee The fee shall be determined as follows: • From enactment until the date that is 12	**§ 401 Affordable Housing Allocations** Fee and Allocation of Amounts Subject to suspensions below, and in addition to any fees for the provision of insurance established in accordance with title II, in each fiscal year the NMFA shall— • Charge and collect a fee of 10 basis points for each dollar of the outstanding principal balance of eligible mortgages collateralizing covered securities, and of eligible multifamily mortgages collateralizing covered multifamily securities pursuant to § 603, and on any securities insured through the common securitization platform where insurance is not being provided by the MIF; and • Of this amount, allocate or otherwise transfer— o 75% to HUD to fund the Housing Trust Fund, of which not more than 5% of the aggregate amount allocated to a State or State designated entity under this subsection shall be used for activities under § 1338 (c)(7)(B); o 15% to Treasury to fund the Capital	**§ 501 Affordable Housing Allocations** Fee and Allocation of Amounts In addition to any fees for the provision of insurance established in accordance with title II, in each fiscal year the Platform shall— • Charge and collect a fee in an amount equal to 10 basis points for each dollar of the outstanding principal balance of— o All eligible mortgage loans that collateralize securities insured under this Act; and o All other mortgage loans that collateralize securities on which Ginnie Mae guarantees the timely payment of principal and interest pursuant to title III of the National Housing Act; and • Allocate or otherwise transfer the fees annually— o 75% to HUD to fund the Housing Trust Fund; o 15% to Treasury to fund the Capital Magnet Fund; and o 10% to Ginnie Mae to fund the Market Access Fund established under § 504 of this Act.

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		months after the date of the approval of at least 2 approved guarantors, approved multifamily guarantors, or approved aggregators, the fee shall be 10 basis points for each dollar of the outstanding principal balance of eligible mortgage loans collateralizing covered securities insured under this Act. • Not later than 6 months after approval of at least 2 such parties, the FMIC shall, by regulation, after notice and comment, establish a formula for determining the fee that meets the following criteria: ○ The average of fees charged on the total outstanding principal balance of all eligible mortgage loans collateralizing covered securities insured under this Act shall be equal to 10 basis points. ○ The highest basis point fee charged to an approved guarantor, approved multifamily guarantor (collectively "Approved Guarantor"), or approved aggregator engaged in a covered guarantee transaction or an approved aggregator engaged in a covered market-based risk-sharing transaction shall not exceed 2 times the lowest basis point fee charged. ○ The formula shall provide that the amount by which any particular fee charged to an Approved Guarantor, or approved aggregator engaged in a	Magnet Fund; and ○ 10% to the Issuer to fund the Market Access Fund established under § 404 of this Act. <u>Suspension of Contributions</u> • The NMFA may temporarily suspend such allocations, for a period of not longer than one year, upon submission by the NMFA, to the House Financial Services and Senate Banking Committees, of a written determination that such allocations are contributing, or would contribute, to the financial instability of the Issuer. • The NMFA, upon written agreement with Treasury and HUD, may continue such suspension for periods of 6 months following the initial suspension, provided that the NMFA, with Treasury and HUD, provides a written determination to the House Financial Services and Senate Banking Committees that continuing the termination of such suspension would contribute to the financial instability of the Issuer.	<u>Continuing Obligation</u> The required fee shall be collected for the life of the security. <u>Suspension of Contributions</u> The Director may temporarily suspend allocations to the Housing Trust Fund, Capital Magnet Fund, and Market Access Fund, for an initial period of one year, upon submission to the Senate Banking and House Financial Services Committees of a written determination by the Director that such allocations are contributing, or would contribute, to the financial instability of the § 202 insurance Fund. The Director may continue such suspension for additional periods, each up to one year in length, pursuant to the same submission and determination requirements. <u>Rule of Construction</u> The cost of the required fee shall not be borne by eligible borrowers.

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		covered guarantee transaction or an approved aggregator engaged in a covered market-based risk-sharing transaction may be more or less than the average fee (on the total balance of all eligible loans collateralizing covered, insured securities) based upon consideration of the following: ▪ The performance of each Approved Guarantor, or approved aggregator engaged in a covered guarantee transaction and each approved aggregator engaged in a covered market-based risk-sharing transaction in serving underserved market segments, as identified and defined under § 210, relative to the performance of all other Approved Guarantors, or approved aggregators engaged in a covered guarantee transaction or covered market-based risk-sharing transaction. ▪ The performance of each Approved Guarantor, or approved aggregator engaged in a covered guarantee transaction and each approved aggregator engaged in a covered market-based risk-sharing transaction in serving underserved market segments, as identified and		

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		defined under § 210, relative to the level of primary market mortgage originations in each of the underserved market segments so identified and defined that were facilitated by the Approved Guarantor, or approved aggregator's engagement in a covered guarantee transaction or the approved aggregator's engagement in a covered market-based risk-sharing transaction. ▪ The relative extent to which each of the underserved market segments, as identified and defined under § 210, that have primary market mortgage originations facilitated by the Approved Guarantor, or approved aggregator's engagement in a covered guarantee transaction or the approved aggregator's engagement in a covered market-based risk-sharing transaction is underserved. ▪ The formula shall assign such weights to each of these factors as the FMIC determines necessary and appropriate. ▪ To measure the performance in		

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		serving underserved market segments, as identified and defined under § 210, by Approved Guarantor, or approved aggregators engaged in a covered guarantee transaction and approved aggregators engaged in a covered market-based risk-sharing transaction and the extent to which a market segment is underserved, the formula determined under this subsection shall provide for the use of— ♦ The identifications and definitions of underserved market segments established by the FMIC under § 210; ♦ Data and other information in the annual report filed with the FMIC by each Approved Guarantor, or approved aggregator engaged in a covered guarantee transaction and each approved aggregator engaged in a covered market-based risk-sharing transaction, as required under § 210; ♦ Loan level data, to the extent possible in the		

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		manner required by HMDA on activities related to covered securities; and ♦ Other publicly available data. ○ The FMIC, through a competitive process, shall select an entity independent of the FMIC to gather, use, and provide to the FMIC the data required to measure the performance in serving underserved market segments. This independent entity shall— ▪ Analyze the data and rank the approved guarantors, approved multifamily guarantors, or approved aggregators engaged in a covered guarantee transaction and the approved aggregators engaged in a covered market-based risk-sharing transaction, applying the formula established by the FMIC; and ▪ On an annual basis, provide the rankings. The annual rankings shall begin at a time to be determined mutually by the independent entity and the FMIC, so that the FMIC will be positioned to determine, charge, and collect the first incentive-based fees beginning on the date that is 12 months after the date		

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		of approval of at least 2 approved guarantors, approved multifamily guarantors, or approved aggregators. ○ The FMIC shall, by regulation, establish procedures for collecting the incentive-based fee on a periodic basis, and shall collect all incentive-based fees consistent with these procedures. ▪ Subject to the opt-outs below, the FMIC shall charge and collect the first incentive-based fees required under this subsection beginning on the date that is 12 months after the date of the approval of at least 2 approved guarantors, approved multifamily guarantors, or approved aggregators ▪ Subject to the opt-outs below, the FMIC shall charge and collect incentive-based fees annually on the first business day of each 12-month period that begins after the expiration of the initial 12-month period. ▪ The FMIC shall make appropriate adjustments to the incentive-based fee for any year based on the application of the formula and the measured performance in that year. Any		

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		such adjustments may take the form of a credit against the fee or an additional amount owing for the year. ▪ In determining the appropriate periodic basis for collecting the incentive-based fees, the FMIC shall take into consideration the need to make appropriate adjustments to the fees through credits or additional billings. ▪ This shall not be construed to waive, override, or in any manner supersede the requirement that the average fees be 10 basis points on the total loan balances. ○ Notwithstanding any provision of § 504 or any other provision of law, the FMIC may use up to 50% of the amounts in the Market Access Fund, determined as of the date that an incentive-based fee is to be charged in any year, to provide 1 or more approved guarantors, approved multifamily guarantors, or approved aggregators engaged in a covered guarantee transaction or approved aggregators engaged in a covered market-based risk-sharing transaction with additional incentives to serve underserved market segments, as identified and defined under § 210,		

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		through the award of a credit that may be applied to reduce the annual fee to any person that exceeds performance measures related to the service of such underserved market segments established by the FMIC. The FMIC shall establish, by regulation, the terms, conditions, and performance measures for the awarding of such credits. • An Approved Guarantor, or approved aggregator engaged in a covered guarantee transaction or an approved aggregator engaged in a covered market-based risk-sharing transaction may elect to be excepted from the incentive-based fee by notifying the FMIC in writing and agreeing to pay the fee described below. o For any 12-month period for which an incentive-based fee will be charged, an opt-out election may be made not later than 3 months before the beginning of such 12-month period. o Upon an opt-out, the FMIC shall charge, and collect, a fee in an amount equal to the highest fee charged by FMIC for the 12-month period under the independent party's annual performance ranking. o An opt-out shall not release, diminish, or otherwise affect any requirement set forth by this Act that		

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		requires a party to furnish to the FMIC such information as the FMIC is authorized by this Act to obtain, including the annual report required to be filed with the FMIC under § 210. <u>Continuing Obligation</u> The fee shall be collected for the life of the covered security. <u>Suspension of Contributions</u> The FMIC may temporarily suspend allocations upon a finding by the FMIC that such allocations are contributing, or would contribute, to the financial instability of the MIF. <u>Rule of Construction</u> The cost of the fee shall not be borne by eligible borrowers. <u>Suspension of Contributions</u> The FMIC may temporarily suspend such allocations upon a finding by the FMIC that such allocations are contributing, or would contribute, to the financial instability of the MIF.		
Housing Trust Fund	Section 104(c) repeals § 1338, housing trust fund. A conforming amendment removes a reference to § 1338, from § 1303(24)(B).	**§ 502 Housing Trust Fund** The 1992 Act, in § 1338, housing trust fund, is amended— • In subsection (a)(1) by permitting grants	**§ 402 Housing Trust Fund** Section 1338 of the 1992 Act is amended— • In subsection (a), by striking language	**§ 502 Housing Trust Fund** Section 1338 of the 1992 Act (12 U.S.C. 4568) is amended. • To add as a purpose of the Housing Trust

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		to federally-recognized tribes. • By repealing subsection (b), allocations for HOPE bond payments. • In (c)(2), which permits state grantees to fund tribally designated housing entities, by removing the definition of these entities, and providing that an Indian tribe receiving such grants may designate a federally recognized tribe or a tribally designated housing entity to receive such grant amounts. This shall not shall limit or be construed to limit the ability of an Indian tribe or a tribally designated housing entity from being a permissible designated recipient of grant amounts provided by a State under this section. • In (c)(3). Currently, this requires HUD to distribute funds to states to provide affordable housing to extremely low- and very-low households. This survives, but only receives amounts remaining after a new distribution. The new distribution is as follows: ○ HUD, acting through the Office of Native American Programs ("ONAP"), shall distribute via competitive grants the amounts determined below and made available under this subsection to federally recognized tribes and tribally designated housing entities. ○ The total amount to be distributed for	that has the GSEs fund the Housing Trust Fund under § 1338, and replacing it with funding pursuant to § 401 of the Housing Opportunities Move the Economy Forward Act of 2014. • By repealing subsection (b), allocations for HOPE bond payments. • In § 1338(c)(10)(A). This currently caps at 10% the § 1338(b) allocations to a state or state-designated entity used for housing production, preservation, and rehabilitation for homeownership. It would be amended to provide, of that such amounts: • In each fiscal year, the State or State designated entity shall ensure that, at a minimum, such amounts are distributed for the benefit of nonentitlement areas in that State in the same proportion that the total population of nonentitlement areas in that State bears to the total population of that State. For this purpose, "nonentitlement area" has the same meaning as under § 102(a)(7) of the Housing and Community Development Act of 1974 (42 U.S.C. 5302(a)(7)). • By striking § 1338(c)(10)(E), which prohibits goals credit to the GSEs for grants used for housing production, preservation, and rehabilitation for homeownership.	Fund to provide grants to federally-recognized tribes. • In (c)(2) (permissible state designees), to delete the 25 U.S.C. § 4103 definition of tribally designated housing entity and add: "An Indian tribe receiving grant amounts under this subsection may designate a federally recognized tribe or a tribally designated housing entity to receive such grant amounts. Nothing in this subsection shall limit or be construed to limit the ability of an Indian tribe or a tribally designated housing entity to be a permissible designated recipient of grant amounts provided by a State under this section." • To add a new distribution to paragraph (c)(3)(A). Currently, this requires HUD to distribute § 1338(c) funds by a formula to states for housing for extremely-low and very-low income households. That remains, but only from amounts left after the new distribution. The new distribution is not subject to the current §§ 1338(c)(3) formula, procedures, eligible activities, or tenant protections. The new distribution is as follows: ○ HUD, acting through the Office of Native American Programs ("ONAP"), shall distribute via competitive grants the amounts made

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		a fiscal year is the greater of $20,000,000, or 2% of the total amount of amounts allocated for the Housing Trust Fund under this section. ○ Competitive grant amounts received by a federally recognized tribe or a tribally designated housing entity may be used, or committed to use, only for those activities that are identified as eligible affordable housing activities under § 202 of the Native American Housing Assistance and Self–Determination Act of 1996 (25 U.S.C. 4132). ▪ In evaluating any application for the receipt of competitive grant amounts, HUD, acting through ONAP, shall consider with respect to the federally recognized tribe applicant or tribally designated housing entity applicant and to Indian reservations and other Indian areas associated with the federally recognized tribe applicant or served by the tribally designated housing entity applicant evaluation criteria, including the following: ♦ Level of poverty on the Indian reservation or in the Indian area.		available under this subsection to federally recognized tribes and tribally designated housing entities. ○ The amount to be distributed for a fiscal year is the greater of $20,000,000, or 2% of the total amount of amounts allocated for the Housing Trust Fund under this section. ○ Competitive grant amounts received by a federally recognized tribe or a tribally designated housing entity may be used or committed only for activities identified as eligible affordable housing activities under § 202 of the Native American Housing Assistance and Self–Determination Act of 1996 (25 U.S.C. 4132). ○ In evaluating an application, HUD, through the ONAP, shall consider with respect to the applicant and to Indian reservations and other Indian areas associated with the federally recognized tribe applicant or served by the tribally designated housing entity applicant evaluation criteria, including the following: ▪ Level of poverty on the Indian reservation or in the Indian area. ▪ Level of unemployment on the Indian reservation or in the Indian area.

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		♦ Level of unemployment on the Indian reservation or in the Indian area. ♦ Condition of housing stock on the Indian reservation or in the Indian area. ♦ Level of overcrowded housing, as measured by the number of households in which the number of persons per room is greater than 1. ♦ Presence and prevalence of black mold on the Indian reservation or in the Indian area. ♦ Demonstrated experience, capacity, and ability of the applicant to manage affordable housing programs, including rental housing programs, homeownership programs, and programs to assist purchasers with down payments, closing costs, or interest rate buy-downs. ♦ Demonstrated ability of the applicant to meet the requirements under the Native American Housing Assistance and Self-		▪ Condition of housing stock on the Indian reservation or in the Indian area. ▪ Level of overcrowded housing on the Indian reservation or in the Indian area, as measured by the number of households in which the number of persons per room is greater than one. ▪ Presence and prevalence of black mold on the Indian reservation or in the Indian area. ▪ Demonstrated experience, capacity, and ability of the applicant to manage affordable housing programs, including multifamily rental housing programs, homeownership programs, and programs to assist purchasers with down payments, closing costs, or interest rate buy-downs. ▪ Demonstrated ability of the applicant to meet the requirements under the Native American Housing Assistance and Self-Determination Act of 1996 (25 U.S.C. 4101 et. seq.), including the timely and efficient expenditure of funds. ▪ Such other criteria as HUD may specify to evaluate the overall quality of the proposed project,

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		Determination Act of 1996 (25 U.S.C. 4101 et. seq.), including the timely and efficient expenditure of funds. ♦ Such other criteria as may HUD may specify to evaluate the overall quality of the proposed project, the feasibility of the proposed project, and whether the proposed project will address the housing needs on the Indian reservation or in the Indian area. ▪ In evaluating any application for the receipt of competitive grant amounts authorized under this clause, the Secretary, acting through ONAP, shall permit a federally recognized tribe applicant or a tribally designated housing entity applicant to supplement or replace, in whole or in part, any data compiled and produced by the Census Bureau and upon which HUD, acting through ONAP, relies, provided such tribally-collected data meets HUD's standards for accuracy. ▪ Notwithstanding any other provision of law, competitive		its feasibility, and whether it will address the housing needs on the Indian reservation or in the Indian area. ○ In evaluating any application, HUD, acting through the ONAP, shall permit a federally recognized tribe applicant or a tribally designated housing entity applicant to supplement or replace, in whole or in part, any data compiled and produced by the Census Bureau and upon which HUD, acting through the ONAP, relies, provided such tribally-collected data meets HUD's standards for accuracy. ○ Notwithstanding any other provision of law, competitive grant amounts received under this clause shall not be considered Federal funds for purposes of matching other Federal sources of funds. • In § 1338(c)(3)(iv)(B), which currently requires HUD to make grants in fiscal years other than 2009, the bill removes the 2009 exception. • In § 1338(c)(4)(c). Currently, this sets an annual minimum allocation to each state, despite the formula, of $3 million. (The increase is deducted *pro rata* from the other states.) This is revised and has a new exception.

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		grant amounts received under this clause shall not be considered Federal funds for purposes of matching other Federal sources of funds. ▪ This new distribution is not subject to the preexisting distribution formula, its allocation requirements, activity and tenant protection requirements, or its required amount for homeownership. • Also in § 1338(c)(4)(B), the existing minimum state allocation is revised. Currently, if the formula would allocate less than $3 million to a state, the allocation for that state is increased to $3 million, with the increase deducted from the other states *pro rata*. This is revised: ○ The minimum allocation to a state is increased to $10 million. ○ However, if the allocation to the Housing Trust Fund under § 501(a)(2)(A) of the Housing Finance Reform and Taxpayer Protection Act of 2014 for a fiscal year is less than $1 billion, the minimum allocation to any state shall be the greater of $5 million or 1% percent of the total allocated for the Housing Trust Fund under § 1338 and the increase is deducted from the allocation above the minimum to the		○ The revision is to change $3 million to the greater of $10 million or 1% of the total allocation under § 1338. ○ The exception is, if the allocation to the Housing Trust Fund under § 501(a)(2)(A) of the Partnership to Strengthen Homeownership Act of 2014 for a fiscal year is less than $1 billion, the minimum to any state is the greater of $5 million or 1% percent of the total allocation under § 1338. • There is a new § 1338(c)(11): Nothing in this subsection shall be construed to limit the ability of a federally recognized tribe or a tribally designated housing entity from receiving grant amounts provided by a State under this section. • To add to §1338(f), definitions, that *federally recognized tribe*, *Indian area*, *Indian tribe*, and *tribally designated housing entity* have the meaning in § 4 of the Native American Housing Assistance and Self-Determination Act of 1996 (25 U.S.C. 4103), and that *Indian reservation* means land subject to the jurisdiction of an Indian tribe.

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		other states *pro rata*. • In § 1338(c)(5)(A) to require States or State-designated entities that receive grants under this subsection in a year to plan for achieving geographic diversity, including the distribution of grants to rural areas in proportion to housing needs in those areas. • In § 1338(c)(7)(A), eligible activities are amended as follows: Assistance for "the production, preservation, and rehabilitation of rental housing, including housing ~~under the programs identified in § 1335(a)(2)(B)~~ **subsidized under Federal law or comparable State or local laws** . . . ." [There is no § 1335(a)(2)(B).] • In § 1338(c)(9), which lists eligible recipients to include agencies, is amended to clarify that agencies include public housing agencies. • In § 1338(c), the following is added: Nothing in this subsection shall be construed to limit the ability of a federally recognized tribe or a tribally designated housing entity from receiving grant amounts provided by a State under this section. • In § 1338(f), to add: o The terms 'federally recognized tribe', 'Indian area', 'Indian tribe', and 'tribally designated housing		

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		entity' have the same meaning as in § 4 of the Native American Housing Assistance and Self-Determination Act of 1996 (25 U.S.C. 4103). ○ The term 'Indian reservation' means land subject to the jurisdiction of an Indian tribe. ○ The term 'rural area' means any community eligible for assistance under § 520 of the Housing Act of 1949. • In § 1338(g) (regulations) to add to the current requirement for regulations to require funding priority for, among other things, geographic diversity. The addition is that geographic diversity includes the distribution of grants to rural areas in proportion to housing needs in those areas.		
Capital Magnet Fund	Section 104(c) amends § 1339: • In § 1339(b)(1), by striking language that provides that the GSEs fund the Capital Magnet Fund under § 1337. • By repealing § 1339(h)(7), which prohibits goals credit to the GSEs for Capital Magnet Fund amounts used for housing development, preservation, rehabilitation, or purchase for extremely-low, very-low, and low-income families, or economic development activities, such as through loan-loss reserves, a revolving loan fund, an affordable housing fund, or	**§ 503 Capital Magnet Fund** Section 1339 of the 1992 Act is amended— • In subsection (b)(1), by striking language that provides that the GSEs fund the Capital Magnet Fund under § 1337, and replacing it with amounts transferred under § 501 of the Housing Finance Reform and Taxpayer Protection Act of 2014. • In subsection (c)(2), which provides that funds may be used to stabilize or revitalize low-income or underserved areas, by adding that funding is	**§ 403 Capital Magnet Fund** Section 1339 of the 1992 Act is amended— • In subsection (b)(1) by striking language that has the GSEs fund the Capital Magnet under § 1337, and replacing it with funding pursuant to § 401 of the Housing Opportunities Move the Economy Forward Act of 2014. • By repealing § 1339(h)(7), which prohibits goals credit to the GSEs for Capital Magnet Fund amounts used for housing development, preservation, rehabilitation, or purchase for extremely-	**§ 503 Capital Magnet Fund** Section 1339 of the 1992 Act is amended— • In subsection (c)(2), by adding tribal areas to the areas where expenditures for economic development activities and community service facilities are permissible. • In subsection (h)(2)(A), by adding tribal areas to the areas where Treasury should seek geographic diversity. • To add (unclear where) that *federally recognized tribe*, *Indian area*, *Indian tribe*, and *tribally designated housing*

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	risk-sharing loans.	permissible for activities designed to foster revitalization in areas experiencing severe economic distress and property disinvestment, including but not limited to demolition, property rehabilitation, and infrastructure configuration; and to add that funds may be used for tribal areas. • In (f)(4), which lists eligible uses of funds, adding (c)(3) activities. [There is no (c)(3).] • In subsection (h)(2)(A), which requires funding to be geographically diverse, including metropolitan and underserved rural areas, to add tribal areas.	low, very-low, and low-income families, or economic development activities, such as through loan-loss reserves, a revolving loan fund, an affordable housing fund, or risk-sharing loans.	*entity* have the meaning in § 4 of the Native American Housing Assistance and Self-Determination Act of 1996 (25 U.S.C. 4103), and that *Indian reservation* means land subject to the jurisdiction of an Indian tribe.
Market Access Fund		**§ 504 Market Access Fund** <u>Establishment</u> The FMIC shall establish the Market Access Fund, maintained and administered by the Office of Consumer and Market Access. <u>Deposits</u> The Market Access Fund shall be credited with— • The share of the fee charged and collected by the FMIC under § 501; and • Such other amounts as may be appropriated or transferred to the Market Access Fund. <u>Purpose</u> Amounts in the Market Access Fund shall be eligible for use by grantees to address the	**§ 404 Market Access Fund** <u>Establishment and Purpose</u> The NMFA shall establish and manage a Market Access Fund, which shall be funded with amounts allocated pursuant to § 401 of this Act. The purpose of the Market Access Fund is to promote innovation in housing finance and affordability. <u>Eligible Activities</u> Amounts allocated pursuant to this section shall be used for the following assistance: • For grants and loans, including through the use of pilot programs of sufficient scale, to support the research and development of sustainable homeownership and affordable rental programs, provided that such grant or	**§ 504 Market Access Fund** <u>Establishment</u> Ginnie Mae shall establish the Market Access Fund. <u>Deposits</u> The Market Access Fund shall be credited with— • The 10% share of the fee charged and collected by the Platform under § 501(a)(1)(B)(iii) [meaning (a)(2)(C)]; and • Such other amounts as may be appropriated or transferred to the Market Access Fund. <u>Purpose</u> Amounts in the Market Access Fund shall be

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		homeownership and rental housing needs of underserved or hard-to-serve populations by—
		• Providing grants and loans for research, development, and pilot testing of innovations in consumer education, product design, underwriting, and servicing;
		• Offering additional credit support for certain eligible mortgage loans or pools of eligible mortgage loans, such as by covering a portion of any capital required to obtain insurance from the FMIC under this Act, provided that amounts for such additional credit support do not replace borrower funds required of an eligible mortgage loan;
		• Providing grants and loans, including through the use of pilot programs of sufficient scale, to support the research and development of sustainable homeownership and affordable rental programs, which programs shall include manufactured homes purchased through real estate and personal property loans and manufactured homes used as rental housing, provided that such grant or loan amounts are used only for the benefit of families whose income does not exceed 120% of the median income for the area as determined by the FMIC, with adjustments for family size;
		• Providing limited credit enhancement,
			loan amounts are used only for the benefit of families whose income does not exceed 120% of the area median income as determined by the Director, with adjustments for family size.
			• To provide limited credit enhancement, and other forms of credit support, for product and services that—
			  ○ Will increase the rate of sustainable homeownership and affordable rental by individuals or families whose income does not exceed 120% of the area median income as determined by the Director, with adjustments for family size; and
			  ○ Might not otherwise be offered or supported by a pilot program of sufficient scale to determine the viability of such products and services in the private market.
			• Grants and loans, to be used in partnership with HUD, to redevelop abandoned and foreclosed properties in areas of greatest need.
				eligible for use by grantees to address the homeownership and rental housing needs of extremely low-, very low-, low-, and moderate-income and underserved or hard-to-serve populations by—
				• Providing grants and loans for research, development, and pilot testing of innovations in consumer education, product design, underwriting, and servicing;
				• Offering additional credit support for certain eligible mortgage loans or pools of eligible mortgage loans, such as by covering a portion of any capital required to obtain insurance from the Ginnie Mae under this Act, provided that amounts for such additional credit support do not replace borrower funds required of an eligible mortgage loan;
				• Providing grants and loans, including through the use of pilot programs of sufficient scale, to support the research and development of sustainable homeownership and affordable rental programs, which programs shall include manufactured homes purchased through real estate and personal property loans and manufactured homes used as rental housing, provided that such grant or loan amounts are used only for the benefit of families whose income does not exceed 120% of the median income for the area

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		and other forms of credit support, for product and services that— o Will increase the rate of sustainable homeownership and affordable rental housing, including manufactured homes purchased through real estate and personal property loans and manufactured homes used as rental housing, by individuals or families whose income does not exceed 120% of the area median income as determined by the FMIC, with adjustments for family size; and o Might not otherwise be offered or supported by a pilot program of sufficient scale to determine the viability of such products and services in the private market; • Providing housing counseling by a HUD-approved housing counseling agency; • Providing incentives to achieve broader access to credit; and • Providing grants and loans for activities designed to foster revitalization in areas experiencing severe economic distress and property disinvestment, including but not limited to demolition, rehabilitation, infrastructure configuration, and reuse of vacant land. <u>Annual Report</u> The Chairperson shall report to Congress, in		as determined by Ginnie Mae, with adjustments for family size; • Providing limited credit enhancement, and other forms of credit support, for product and services that— o Will increase the rate of sustainable homeownership and affordable rental housing, including manufactured homes purchased through real estate and personal property loans and manufactured homes used as rental housing, by individuals or families whose income does not exceed 120 percent of the area median income as determined by Ginnie Mae, with adjustments for family size; and o Might not otherwise be offered or supported by a pilot program of sufficient scale to determine the viability of such products and services in the private market; • Providing housing counseling by a HUD-approved housing counseling agency; and • Providing incentives to achieve broader access to credit. <u>Annual Report</u> The Ginnie Mae Director shall report annually to Congress on the performance and outcome of grants, loans, or credit support programs funded by the Market Access Fund, including an evaluation of how each grant, loan, or

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		its annual § 206 report, on the performance and outcome of grants, loans, or credit support programs funded by the Market Access Fund in accordance with its purposes, including—
		• An evaluation of how each grant, loan, or credit support program:
		  o Succeeded in meeting or failed to meet the need of certain populations, especially extremely low-, very low-, low-, and moderate-income and underserved or hard-to-serve populations; and
		  o Succeeded in maximizing or failed to maximize the advantage of public investment made for each such grant, loan, or credit support program.
		• For each Market Access Fund award for a grant, loan, or credit support program—
		  o The funds recipient;
		  o The purpose of the funds;
		  o The amount, excluding administrative costs, used to directly meet the identified purpose, including meeting the housing needs of extremely low-, very low-, low-, and moderate-income and underserved or hard-to-serve populations.
				credit support program—
				• Succeeded in meeting or failed to meet the need of certain populations, especially extremely low-, very low-, low-, and moderate-income and underserved or hard-to-serve populations; and
				• Succeeded in maximizing or failed to maximize the leverage of public investment made for each such grant, loan, or credit support program.

Restrictions on Political Activity		**§ 505 Additional Taxpayer Protections** <u>Not to be Used for Political Activities</u> Consistent with the existing requirements under §§ 1338(c)(10)(D) and 1339(h)(5) of	**§ 405 Additional Taxpayer Protections** <u>Not to Be Used for Political Activities</u> Consistent with the existing requirements under §§ 1338(c)(10)(D) and 1339(h)(5) of	

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		the 1992 Act and § 504 of this Act, HUD, Treasury, and the Office of Community and Market Access, respectively, shall ensure that grant amounts allocated by covered grantees to eligible recipients or allocated to individuals by such eligible recipients are not used for— • Political activities; • Political advocacy; • Lobbying, whether directly or through other parties; • Influencing the selection, nomination, election, or appointment of 1 or more candidates to any Federal, State or local office; • Personal counseling services; • Travel expenses; and • Preparing or providing advice on tax returns. <u>Penalties</u> • If an eligible recipient or any other individual in receipt of grant amounts described by this section violates any such restriction on funding political activity, HUD, Treasury, or the FMIC, as the case may be, may impose a civil penalty on such recipient or individual, as the case may be, of not more than $1,000,000 for each violation. • Whoever, being subject to the restrictions, knowingly participates, directly or	the 1992 Act, HUD and Treasury, respectively, shall ensure that grant amounts allocated by covered grantees to eligible recipients or allocated to individuals by such eligible recipients are not used for— • Political activities; • Advocacy; • Lobbying, whether directly or through other parties; • Influencing the selection, nomination, election, or appointment of one or more candidates to any Federal, State or local office; • Personal counseling services not related to preparing potential borrowers for homeownership or addressing avoidance of foreclosure; • Travel expenses; and • Preparing or providing advice on tax returns. <u>Penalties</u> If an eligible recipient or any other individual in receipt of grant amounts described by this section violates any provision of subsection (a) or (b) [apparently meaning (a), the ban on political activity], HUD or Treasury, as the case may be, may impose a civil penalty on such recipient or individual, as the case may be, of not more than $1,000,000 for each violation. These penalties shall be in addition to any other available penalty and may be	

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		indirectly, in any manner in conduct that results in a violation of such restrictions shall, notwithstanding 18 U.S.C. § 3571, be fined not more than $1,000,000 for each violation, imprisoned for not more than 5 years, or both. • These civil and criminal penalties shall be in addition to any other available civil remedy or any other available criminal penalty and may be imposed whether or not HUD, Treasury, or the FMIC, as the case may be, imposes other administrative sanctions. <u>Definition</u> As used in this section— *Covered grantee* means— • For purposes of the Housing Trust Fund, a State or State designated entity; and • For purposes of the Capital Magnet Fund, an eligible grantee as described under § 1339(e) of the 1992 Act; *Eligible recipient* means— • For purposes of the Housing Trust Fund, a recipient as described under § 1338(c)(9); and • For purposes of the Capital Magnet Fund, a recipient of assistance from the Capital Magnet Fund; *Capital Magnet Fund* means the Capital Magnet Fund established under § 1339, and	imposed whether or not HUD or Treasury imposes other administrative sanctions. <u>Definition</u> As used in this section— *Covered grantee* means— • For purposes of the Housing Trust Fund, a State or State designated entity; and • For purposes of the Capital Magnet Fund, an eligible grantee as described under § 1339(e); *Eligible recipient* means— • For purposes of the Housing Trust Fund, a recipient as described under § 1338(c)(9) and • For purposes of the Capital Magnet Fund, a recipient of assistance from the Capital Magnet Fund; *Capital Magnet Fund* means the Capital Magnet Fund established under § 1339 and *Housing Trust Fund* means the Housing Trust Fund established under § 1338.	

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		Housing Trust Fund means the Housing Trust Fund established under § 1338. Rule of Construction Nothing in restriction on funding political activity shall be construed to prevent funds from being used for— • HUD-approved housing counseling services; • Financial literacy education; or • Application fees, permits, or other construction-related expenses, if funds are authorized for such construction.		

Promoting Affordable Housing Investment		**§ 506 Promoting Affordable Housing Investement**
		• There is added to § 542(c) of the Housing and Community Development Act of 1992:
		  ○ Ginnie Mae may, at the Secretary's discretion, securitize any multifamily loan insured under this subsection, if:
		    ▪ FHA provides insurance based on the UPB as shall be described by regulation;
		    ▪ FHA shall not require an assignment fee for insurance claims related to the securitized mortgages;
		    ▪ The risk-sharing agreement must provide for reimbursement to the Secretary by the risk share partner or partners for either all		

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<tr><td></td><td></td><td>or a portion of the losses incurred on the loans insured, regardless of whether the servicing rights or other related mortgage interest have been transferred to a different entity; and
▪ Any entity that subsequently acquires the servicing rights or other related mortgage interest of the risk share partner or partners shall not assume any obligation under the risk-sharing agreement.
○ There is a conforming change to § 306(g)(1) of the National Housing Act relating to the same loans.
• Both of these revisions sunset September 30, 2021.</td><td></td><td></td></tr>
<tr><td>Criteria Before Transfer</td><td></td><td>TITLE VI—TRANSITION and TERMINATION of GSEs
§ 601 Minimum Housing Finance System Criteria to be Met Prior to System Certification Date
<u>System Certification Date</u>
The system certification date shall be the date that the Board of Directors, in its sole discretion, certifies by a majority vote that—
• The FMIC is able to undertake, in a manner found satisfactory to the Board, the duties specified by this Act, and any amendments made by this Act; and</td><td></td><td></td></tr>
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		• All the minimum criteria set forth below with respect to the housing finance system have been fully satisfied.
		
		Minimum Housing Finance System Criteria
		The Board of Directors shall consider the following minimum criteria in determining whether to certify that the new housing finance system is ready:
		• Treasury advised the Board of Directors that laws and contracts are in place to provide for compensation to the Department for its support of the GSEs and the housing finance system.
		• The Securitization Platform is developed and able to issue standardized securities for the single-family covered securities market.
		• At least 1 small lender mutual is fully operational and able to undertake the duties specified in § 315.
		• A sufficient number of approved entities have been approved pursuant the provisions of subtitle B of title III—
		  ○ To assume a reasonable level of first loss position through approved guarantors or through approved credit risk-sharing mechanisms established under § 302; and
		  ○ To generate a substantial volume of secondary mortgage market activity with respect to single-family eligible		

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		mortgage loans collateralizing single-family covered securities insured in accordance with this Act. • The FMIC has approved multiple multifamily guarantors pursuant to Title VII who are providing sufficient multifamily financing in the primary, secondary, and tertiary geographical markets, including in rural markets and through a diversity of experienced multifamily lenders. ○ Approved multifamily guarantors are meeting the requirements of this Act. ○ There is a competitive multifamily market for approved multifamily guarantors engaging in multifamily covered securities. ○ Noncompliance with the requirements of this Act by any individual approved multifamily guarantor shall not constitute grounds to prevent system certification. <u>Rule of Construction</u> The FMIC shall take all steps necessary to meet each of these minimum housing finance system criteria as expeditiously and efficiently as practicable. The FMIC may commence providing guarantees on single-family or multifamily covered securities before meeting all the minimum housing finance system criteria.		

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		<u>Notification to Congress</u>
		• The Chairperson shall promptly submit to the Senate Banking and House Financial Services Committees a written notification that the Board of Directors has certified that the minimum housing finance system criteria have been met.
		• The FMIC shall do so within 5 years of enactment.
		  ○ If the FMIC is unable to make such a certification within 5 years, the Board of Directors may, with an affirmative vote of the majority of the Board, extend the deadline an additional 2 years.
		  ○ If, after a first extension of 2 years, the FMIC is unable to make such a certification, the Board of Directors may, with an affirmative vote of at least 2⁄3 of the Board, extend the deadline an additional 2 years.
		  ○ If, after a second extension of 2 years, the FMIC is unable to make such a certification, the Board of Directors may, with a unanimous affirmative vote of the Board and upon the written agreement of the Chairman of the Federal Reserve and the Treasury Secretary, and in consultation with HUD, extend the deadline an additional year, and annually thereafter utilizing the same		

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		process until the Board of Directors makes the certification. **§ 602 Transition of the Housing Finance System** Transition Plan The Transition Committee established under § 404 shall develop a transition plan not later than 12 months after enactment to facilitate an orderly transition to the new housing finance system authorized by this Act. Contents of Plan The transition plan shall include— • Estimated timeframes by which to achieve the minimum housing finance system criteria set forth under § 601(b) within 5 years after enactment; • Detailed actions that the FMIC will take to achieve such minimum criteria; • Estimated timeframes and detailed actions that the FMIC, including FHFA, will take to provide an orderly wind down of the GSEs; • A detailed inventory of all intellectual property owned, held, or licensed by the GSEs, including patents, trademarks, software, credit evaluation systems, and data and information on mortgage performance and plans for using any such intellectual property, technology, infrastructure, or processes of the GSE in		

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		effecting the transition plan; • Description and updates on the ongoing operations of the FMIC, including the operations of FHFA; • Detailed plans and timeframes for establishing, as soon as practicable, a multifamily covered securities market; • Detailed plans and timeframes for establishing, as soon as practicable, a standardized security issued through the Securitization Platform for the single-family covered securities market; and • Detailed plans for increasing the level of credit risk-sharing in the secondary mortgage market. <u>Considerations</u> • For purposes of facilitating an orderly transition to the new housing finance system authorized by this Act, the FMIC shall consider in determining how to best fulfill the requirements of this title the estimated impact of various transition options with respect to the following: o Housing prices and affordability. o The effectiveness of consumer protections in the housing market. o Volume and characteristics of mortgage loan originations. o The condition of the rental housing market. o Small lender participation in the		

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		secondary mortgage market. o Access to credit in rural and underserved communities. o Competition among market participants. o The condition of the multifamily housing market. o Innovation among secondary mortgage market participants. o Taxpayer repayment. o Private capital in the secondary mortgage market. • A description and analysis of each such consideration shall be included in the following report to Congress. <u>Report to Congress</u> • Not later than 12 months after enactment and in accordance with § 404(c)(2), the Transition Committee shall submit the transition plan to the Senate Banking and House Financial Services Committees. • Not later than 1 year after the date on which the transition plan is submitted and annually thereafter until the system certification date, the Chairperson shall update the transition plan and submit such updated plan to the Senate Banking and House Financial Services Committees.		
Resolution Authority		**§ 603 Resolution Authority; Technical Amendments**		

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Amendments		The amendments made by this section shall take effect on the agency transfer date.
		
		Section 1367 of the 1992 Act (conservator and receivership authority) is amended:
		• By replacing “stockholder” and “stockholders” with “shareholder, member,” and “shareholders, members,” respectively, each place those terms appear;
		• By replacing “wind up” and “winding up” with “wind down” and “winding down” each place those terms appear;
		• In § 1367(a)—
		  ○ In paragraph (3)(G) (losses as a basis for conservatorship or receivership), by removing the requirement that there be no reasonable prospect for the regulated entity to become adequately capitalized;
		  ○ By replacing paragraph (3)(J) (undercapitalization as a basis for conservatorship or receivership) with a basis that the regulated entity is insolvent or near-insolvent;
		  ○ By striking paragraph (3)(K) (critical undercapitalization as a basis for conservatorship or receivership);
		  ○ In paragraph (4)(B) with conforming changes;
		  ○ In paragraph (4)(B) to remove the requirement that a conservator or		

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		receiver preserve and conserve the entity's assets. • In § 1367(b) — ○ In paragraph (2)(H) (payment of valid obligations "to the extent of proceeds from" contracts or assets), by replacing this with to the extent that funds are available; ○ In paragraph (2)(I)(i)(I) (conservator or receiver may exercise subpoena powers under § 1348 [which probably meant to refer to subpoena powers under § 1379D]), by amending this to refer to powers under part II of this subtitle [this subtitle does not have parts]; ○ In paragraph (2)(I)(iii) (this subsection does not limit the agency's power under §§ 1317 (examinations) or 1379B (public disclosure of orders)), by amending this to refer to subtitle B of this Act (§§ 4511 to 4603); ○ By replacing paragraph (3)(A) (receiver may determine claims under paragraph (4)) with: The Agency— ▪ May, as receiver, determine claims in accordance with the requirements of this subsection and any regulations prescribed under paragraph (4); and ▪ May define the term 'creditor'		

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		and may distinguish between creditors, in order to facilitate the orderly administration of the regulated entity in conservatorship or receivership, in accordance with the requirements of this section. ○ In paragraph (3)(B) (notice to creditors in winding up a closed entity), by striking the word closed; ○ In paragraph (5)(D)(iii)(II) (receiver may not disallow security interests in the entity's assets securing a loan), to read: "any **legally enforceable and perfected** security interest in the assets of the regulated entity securing any such extension of credit." ○ By striking paragraph (7) (arbitration to resolve claims); ○ In paragraph (10)(E) [as renumbered from the current (11)(E)] (disposition of assets to maximize returns and to ensure fair treatment), by also requiring the disposition to: ▪ Prohibit discrimination on the basis of race, sex, or ethnic group in the solicitation or consideration of offers; and ▪ Mitigate the potential for serious adverse effects to the financial system. • By replacing § 1367(c) (claims priority – administrative expenses, then senior		

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		debts, then junior debts, then shareholders) with: (1) IN GENERAL.— Unsecured claims against a regulated entity, or the receiver therefor, that are proven to the satisfaction of the receiver shall have priority in the following order: (A) Claims of the receiver for administrative expenses. (B) Any amounts owed to the U.S., unless the U.S. agrees or consents otherwise. (C) Wages, salaries, or commissions, including vacation, severance, and sick leave pay earned by an individual (other than an individual described in subparagraph (F)), but only to the extent of $12,475 for each individual (as indexed for inflation, by regulation of the Agency) earned not later than 180 days before the appointment of the Agency as receiver. (D) Contributions owed to employee benefit plans arising from services rendered not later than 180 days before the appointment of the Agency as receiver, to the extent of the number of employees covered by each such plan, multiplied by $12,475 (as indexed for inflation, by regulation of the Agency), less the		

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		aggregate amount paid to such employees under subparagraph (C), plus the aggregate amount paid by the receivership on behalf of such employees to any other employee benefit plan. (E) Any claim arising solely from a covered guarantee transaction involving the regulated entity. (F) Any other general or senior liability of the regulated entity (which is not a liability described under subparagraph (G), (H), or (I)). (G) Any obligation subordinated to general creditors (which is not an obligation described under subparagraph (H) or (I)). (H) Any wages, salaries, or commissions, including any vacation, severance, and sick leave pay earned, owed to senior executives and directors of the regulated entity. (I) Any obligation to shareholders or members arising as a result of their status as shareholders or members. (2) CLAIMS OF THE U.S.— Unsecured claims of the U.S. shall, at a minimum, have a higher priority than liabilities of the regulated entity that count as regulatory capital. (3) CREDITORS SIMILARLY SITUATED.— All creditors that are similarly situated under		

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		paragraph (1) shall be treated in a similar manner, except that the receiver may take any action (including making payments) that does not comply with this subsection, if— (A) the Agency determines that such action is necessary to— (i) maximize the value of the assets of the regulated entity; (ii) maximize the present value return from the sale or other disposition of the assets of the regulated entity; (iii) initiate and continue operations essential to implementation of the receivership or any limited-life regulated entity; (iv) minimize the amount of any loss realized upon the sale or other disposition of the assets of the regulated entity; or (v) preserve the financial stability of the U.S.; and (B) all creditors that are similarly situated under paragraph (1) receive not less than the amount provided in subsection (f)(2). (4) DEFINITION.—As used in this subsection, the term ‘administrative expenses of the receiver’ includes— (A) the actual, necessary costs and expenses incurred by the receiver in preserving the assets of a failed regulated entity or liquidating or		

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		otherwise resolving the affairs of a failed regulated entity; and (B) any obligations that the receiver determines are necessary and appropriate to facilitate the smooth and orderly liquidation or other resolution of the regulated entity. • By adding § 1367(d) (and redesignating (d) through (j) ((k) is repealed, as below)): (d) SUBROGATION.— (1) IN GENERAL.—Notwithstanding any other provision of Federal law, the law of any State, or the constitution of any State, the Agency, upon the payment to any person as provided in subsection (c) in connection with any covered guarantee transaction, shall be subrogated to all rights of the person against such regulated entity to the extent of such payment or assumption. (2) DIVIDENDS ON SUBROGATED AMOUNTS.—The subrogation of the Agency under paragraph (1) with respect to any regulated entity shall include the right on the part of the Agency to receive the same dividends, fees, or other amounts from the proceeds of the assets of such regulated entity and recoveries on account of stockholders' liability as would have been payable to the person on a claim related to the covered guarantee transaction. (3) WAIVER OF CERTAIN CLAIMS.—The		

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		Agency shall waive, in favor only of any person against whom stockholders' individual liability may be asserted, any claim on account of such liability in excess of the liability, if any, to the regulated entity or its creditors, for the amount unpaid upon such stock in such regulated entity, but any such waiver shall be effected in such manner and on such terms and conditions as will not increase recoveries or dividends on account of claims to which the Agency is not subrogated. • In § 1367(e), [as redesignated from the current (d)] o In paragraph (8) (qualified financial contracts), by adding: o The Agency may prescribe regulations requiring that regulated entities maintain such records with respect to qualified financial contracts (including market valuations) that the Agency determines to be necessary or appropriate in order to assist the Agency as receiver for a regulated entity in being able to exercise its rights and fulfill its obligations under this paragraph or paragraph (9) or (10). o By revising paragraph (9) as follows: (9) TRANSFER OF QUALIFIED FINANCIAL CONTRACTS.—		

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		(A) IN GENERAL.— In making any transfer of assets or liabilities of a regulated entity in default which includes any qualified financial contract, the conservator or receiver for such regulated entity shall either— ~~(A) transfer to 1 person—~~ **(i) transfer to 1 person, other than a person for which a conservator, receiver, trustee in bankruptcy, or other legal custodian has been appointed or which is otherwise the subject of a bankruptcy or insolvency proceeding—** (I) all qualified financial contracts between any person (or any affiliate of such person) and the regulated entity in default; (II) all claims of such person (or any affiliate of such person) against such regulated entity under any such contract (other than any claim which, under the terms of any such contract, is subordinated to the claims of general unsecured creditors of such regulated entity); (III) all claims of such regulated entity against such person (or any affiliate of such person) under any such contract; and (IV) all property securing, or any other credit enhancement for any contract described in **sub**clause (I), or any claim described in **sub**clause (II) or (III) under any such contract; or (~~B~~**ii**) transfer none of the financial contracts, claims, or property referred to under ~~subparagraph (A)~~ **clause (i)** (with respect to such person and any affiliate of such person).		

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		(B) TRANSFER TO FOREIGN BANK, FINANCIAL INSTITUTION, OR BRANCH OR AGENCY THEREOF.—In transferring any qualified financial contracts and related claims and property under subparagraph (A)(i), the Agency as receiver for a regulated entity shall not make such transfer to a foreign person unless, under the law applicable to such foreign person, to the qualified financial contracts, and to any netting contract, any security agreement or arrangement or other credit enhancement related to 1 or more qualified financial contracts, the contractual rights of the parties to such qualified financial contracts, netting contracts, security agreements or arrangements, or other credit enhancements, are enforceable substantially to the same extent as permitted under this section. • In § 1367(e)(13)(C)(ii) [as redesignated from the current subsection (d)] (which lists exceptions to the requirement for Agency approval to terminate a contract with a GSE in 90 days after a receivership) by adding a new exception for the rights of parties to netting contracts pursuant to subtitle A of title IV of the FDIA (12 U.S.C. 4401 et seq.). • In § 1367(g) [as redesignated from the		

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		current (f)] by revising it as follows: Except as provided in this ~~section or at the request of the Director~~ **title**, no court may take any action to restrain or affect the exercise of powers or functions of the Agency as ~~a conservator or a receiver~~ **the conservator or receiver hereunder, and any remedy against the Agency as conservator or receiver shall be limited to money damages determined in accordance with this title**. • In § 1367(j)(1)(A)(ii) [as redesignated from the current subsection (i)] (GSE receiver shall organize a limited-life regulated entity) by replacing shall with may, and a conforming amendment to a heading; • In § 1367(j)(2)(A) [as redesignated from the current subsection (i)] (GSE limited-life regulated entity succeeds to GSE charter) to provide that the limited-life entity succeeds to the GSE's registered status. • In § 1367(j)(3) [as redesignated from the current subsection (i)], by adding that, notwithstanding any other law, the Agency may permit a limited-life regulated entity to operate without any capital or surplus. • In § 1367(j)(3) [as redesignated from the current subsection (i)], by adding: • Upon the organization of a limited-life		

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		regulated entity, and thereafter, as the Agency may, in its discretion, determine to be necessary or advisable, the Agency may make available to the limited-life regulated entity, upon such terms and conditions and in such form and amounts as the Agency may in its discretion determine, funds for the operation of the limited-life regulated entity in lieu of capital. • In § 1367(j)(6)(A) [as redesignated from the current subsection (i)] (limited-life regulated entity survives 2 years unless the time is extended) to require, for a GSE but not an FHLB, the entity's wind down when the Agency determines necessary and appropriate. • In § 1367(j)(7)(A)(iv) [as redesignated from the current subsection (i)] (asset transfers require equitable treatment of similarly situated creditors, unless necessary to maximize the return on assets and the creditor receives no less than it would have if the Agency had liquidated the assets) by providing the Agency with discretion to distinguish between creditors to: o Maximize the value of the assets of the regulated entity; o Maximize the present value return from the sale or other disposition of the assets of the regulated entity;		

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		○ Initiate and continue operations essential to the implementation of the limited-life regulated entity; ○ Minimize the amount of any loss realized upon the sale or other disposition of the assets of the regulated entity; ○ Preserve the financial stability of the U.S.; and The Agency must ensure that all similarly situated creditors under subsection (c)(1) receive not less than they would have had the agency liquidated the assets and not formed a limited-life regulated entity. • In § 1367(j)(11)(C) [as redesignated from the current subsection (i)] (limited-life regulated entity may sometimes borrow with a super-priority lien after notice and hearing, but the lien may not be above loans backing GSE MBS) by removing the protection for loans backing GSE MBS, and requiring the hearing to be in federal court. • By striking § 1367(k), which prohibits a GSE receiver from revoking, annulling, or terminating a GSE charter. Finally, by adding that nothing in this 2014 Act, or any amendments made by this Act, except as may be explicitly provided for in this Act, or any amendment made by this Act, shall be deemed to alter the powers,		

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<tr><th></th><th>PATH Act, H.R. 2767</th><th>S. 1217</th><th>Waters Discussion Draft</th><th>H.R. 5055</th></tr>
<tr><td></td><td></td><td>authorities, rights, or duties that are vested in the FHFA or its Director with respect to supervision and regulation of the GSEs, until the FHFA and the position of its Director are transferred in accordance with Title IV.</td><td></td><td></td></tr>
<tr><td>Wind Down</td><td>§ 103 Termination of Conservatorship; Mandatory Receivership
Five years after enactment, the Director shall, with respect to each GSE, immediately appoint FHFA as receiver under § 1367 of the 1992 Act.

§ 109 Receiver’s Discretionary Authority to Create Receivership Entity
The 1992 Act § 1367(i) (limited-life regulated entities) is revised to read:
<u>Receivership Entity</u>
The Agency, as receiver, may establish a receivership entity in such form or structure as the Agency deems appropriate to meet the purposes of receivership and this section.
Upon creation of such receivership entity, the Agency may transfer to it any assets or liabilities of the regulated entity in default as the Agency, in its discretion, determines to be appropriate, and may authorize the receivership entity to perform any temporary function that the Agency, in its discretion, prescribes in accordance with this section. The transfer of any assets or liabilities of a regulated entity for which the Agency has been</td><td>§ 604 Wind Down
<u>Authority of FHFA Director</u>
Beginning on enactment and ending on the system certification date, the FHFA Director, in consultation with the FMIC, shall take such action, and may prescribe such regulations and procedures, as may be necessary to wind down the operations of the GSEs in an orderly manner that complies with the requirements of this Act and any amendments made by this Act.
Notwithstanding any such wind down authority—
The sale, exchange, license, or other disposition of any asset for value subject to the wind down required under this section shall be prohibited, if the FMIC—
In its discretion determines that such sale, transfer, exchange, license, or disposition would materially interfere with the ability of the FMIC to carry out the requirements of this Act; and
Notifies, in writing, the FHFA Director within 14 days of such</td><td>§ 501 Transition
<u>Cessation of New Business</u>
Upon the expiration of the 5-year period beginning on the date of the enactment, the Fannie Mae and Freddie Mac shall cease providing new guarantees on securities backed by mortgages and all other new business (other than the rollover of debt related to existing assets). At that time, the GSEs shall continue to manage activities related to the remaining portfolio, including outstanding debt and MBS, capital lease obligations, obligations with respect to letters of credit and bankers’ acceptances, and similar obligations, to minimize risk to Treasury and maximize return, with earnings to be distributed as specified below. Treasury may determine to extend such deadline for no more than one year for cause.

<u>Distribution of Earnings</u>
Upon the expiration of such 5-year (up to 6-year) period, the net GSE earnings from the beginning of the conservatorships until the end of such period shall be distributed in the following order of priority:
Repayment of the Senior Preferred Shares</td><td>TITLE III—WIND DOWN OF FANNIE MAE AND FREDDIE MAC
§ 301 Limitation on Business
The Ginnie Mae Director shall provide that, after the certification date—
The GSEs may not issue, guarantee, or purchase any security backed by mortgages on 1- to 4-family residences except as specifically authorized by this Act;
A GSE may act as a participating aggregator of eligible mortgages for securitization pursuant to § 201 if such eligible mortgages are originated by originators whose volume of such business is insufficient to allow for such originators to aggregate and securitize such mortgages, until the earlier of—
Such time as the Director determines that any other qualified entity or entities provide sufficient market access to such originators under competitive rates and terms and requires the GSEs to cease such business; or
The commencement of the receivership under § 304(a); and</td></tr>
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	appointed receiver shall be effective without any further approval under Federal or State law, assignment, or consent with respect thereto. Such authority is in addition to any other power the Agency may have as receiver or may confer on the receivership entity. • Notwithstanding any other provision of Federal or State law, any receivership entity established by the Agency pursuant to this section, its franchise, property and income, shall be exempt from all taxation now or hereafter imposed by the U.S., by any territory, dependency, or possession thereof, or by any State, county, municipality, or local taxing authority. • The Agency may promulgate such regulations as the Agency determines to be necessary or appropriate to implement this sub- section. • A receivership entity established pursuant to this section shall not be a U.S. agency, establishment, or instrumentality. (Under current § 1367(i), the limited-life entity succeeds to the GSE charter, can issue stock, winds up in 2 years without GSE charter repeal, and can obtain unsecured and super-priority credit.) **§ 110 Receiver's Authority to Repeal GSE Charter** The 1992 Act § 1367(k) (charter repeal	determination; and ○ The FMIC may direct the conservator of the GSEs to sell, transfer, exchange, license or otherwise dispose of any asset for value subject to the wind down required under this section, if the Board of Directors certifies by a majority vote that— ▪ Not completing such sale, transfer, exchange, license, or other disposition for value would be inconsistent with the transition plan approved pursuant to § 602; and ▪ Such sale, transfer, exchange, license, or disposition for value would not violate the duties of the conservator. <u>Authority of FMIC</u> Beginning on the system certification date, the FMIC shall take such action, and may prescribe such regulations and procedures, as may be necessary to wind down the operations of the enterprises in an orderly manner that complies with the requirements of this Act and any amendments made by this Act. <u>Resolution Plan</u> • Each GSE shall develop a resolution plan in order to facilitate an orderly transition to the new housing finance system	owned by the Treasury. • 10% rate of interest per year over the term of the Senior Preferred Shares. • Establishment of any reserve funds that Treasury determines are needed in connection with the wind-down of the GSEs businesses. • Payment of any deferred contributions to the Housing Trust Fund and Capital Magnet Fund that have not been paid. • Purchase of other outstanding preferred shares. • Purchase of outstanding common shares, for which purpose warrants held by the Treasury shall be treated as common stock. <u>Earnings after Cessation of New Business</u> GSE earnings that accrue after the date on which new business ceases (including reserves that are not needed) may be paid in accordance with the distribution schedule above after all obligations and earnings of the GSEs have been extinguished or received, including the proceeds of sales to the Issuer. <u>Sale of Assets</u> In connection with the wind down of the entities, Treasury, in consultation with the NMFA and the Agency, may determine to sell GSE assets, including the common securitization platform, multi-family	• A GSE may act as a reinsurer for MBS in accordance with § 202(b) until the commencement of the receivership. **§ 303 Continued Conservatorship** <u>Timing</u> The conservatorships of the GSEs in effect upon the enactment shall continue until the commencement of the receivership, subject to the transfer of FHFA functions to Ginnie Mae. <u>Aligning Purposes of Conservatorship</u> Notwithstanding § 1367(b)(2)(D) of the 1992 Act (12 U.S.C. 4617(b)(2)(D) (authorizing a GSE conservator to restore a GSE's solvency and preserve and conserve its assets), after enactment of this Act, the Director shall, as conservator of each GSE, take such actions as are necessary to manage the affairs, assets, and obligations of each GSE, and to operate each GSE, in compliance with this section. <u>Return of GSEs to Private Market</u> During the term of the GSE conservatorships, the Director shall— • Carry out the conservatorship in a manner that furthers achievement of the goals and terms of the mandatory receiverships; • Identify any GSE assets necessary for Ginnie Mae to carry out its functions and responsibilities under §§ 201, 202, and 401 of this Act; and

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	prohibition) is revised to read: • Five years after enactment, the charter of each GSE is repealed and the GSE shall have no authority to conduct new business under such charter, except that the charter provisions in effect immediately before such repeal shall continue to apply with respect to the rights and obligations of any holders of— ○ Outstanding debt obligations of the GSE, including any— ▪ Bonds, debentures, notes, or other similar instruments; ▪ Capital lease obligations; or ▪ Obligations in respect of letters of credit, bankers' acceptances, or other similar instruments; or ○ MBS guaranteed by the GSE. • The full faith and credit of the U.S. is pledged to the payment of all amounts which may be required to be paid under the continuing charter provisions. • Notwithstanding any other provision of law, provision 2(a) (relating to Dividend Payment Dates and Dividend Periods) and provision 2(c) (relating to Dividend Rates and Dividend Amount) of the Senior Preferred Stock Purchase Agreement (between Treasury and each GSE), or any provision of any certificate in connection with such Agreement creating or designating the terms, powers,	authorized by this Act. • Each GSE resolution plan shall be submitted to the FHFA Director not later than 90 days after the agency transfer date. • Each GSE resolution plan shall include a full description and valuation of the assets, liabilities, and contractual obligations of the GSE, and any other information that the FHFA Director may require. • Notwithstanding any provision of a GSE resolution plan, FHFA and the FMIC shall retain and exercise full discretion to the extent that either the Agency or the FMIC utilizes or relies on such a resolution plan, either in whole or in part, in fulfilling any duty or responsibility required by this Act. • After reviewing each GSE resolution plan, the FMIC shall make available to the public a summary of each such resolution plan. • After reviewing each GSE resolution plan, the FMIC shall conduct a valuation study of each GSE's business segments, including any technology, business unit, legacy book, and other assets and liabilities that may be sold for value in a manner consistent with the purposes and requirements of this Act.	businesses, and other assets to the Issuer. In affecting such sales, Treasury may issue new preferred shares to the Issuer. <u>Full Faith and Credit</u> The full faith and credit of the U.S. is pledged to ensure that all payments on any obligation of the GSEs are paid. Treasury remains obligated to ensure that the GSEs remain in a position to pay all holders of obligations or other outstanding debt in the GSEs, as well as employees who continue to be employed by the GSEs. **§ 502 Wind Down** <u>Wind Down</u> • Beginning on enactment and ending on the date certified by Treasury, the FHFA Director, in consultation with the NMFA and Treasury, shall take such action, and may prescribe such regulations and procedures, as may be necessary to wind down the operations of the GSEs in an orderly manner that complies with the requirements of this Act and any amendments made by this Act. Notwithstanding any such authority granted to the FHFA Director, the sale, transfer, exchange, or other disposition of any asset subject to the wind down required under this section shall be prohibited, if the NMFA— ○ In its discretion determines that such	• Prepare for the transfer of the GSEs' multifamily business in accordance with § 401 of this Act. **§ 304 Mandatory Receivership** <u>Commencement</u> The Director shall, with respect to each GSE, immediately appoint Ginnie Mae as receiver upon the later of the following: • The expiration of the 60-month period beginning on the date of the enactment of this Act, as the duration of such period may be adjusted pursuant to subsection (c). • The certification date has occurred and the Director has determined that— ○ A competitive private housing finance market has been established; ○ Competitive and equitable access to the Platform for smaller mortgage lenders is available; ○ The FHLB pooling services competitive with services made available by the GSEs before the certification date; ○ The FHLBs are capable of meeting the cash window needs of credit unions, community and mid-sized depository institutions, and non-depository mortgage originators with competitive rates and terms; and ○ The FHLBs have created a "to be

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	preferences, privileges, limitations, or any other conditions of the Variable Liquidation Preference Senior Preferred Stock of an GSE issued pursuant to such Agreement— ○ Shall not be amended, restated, or otherwise changed to reduce the rate or amount of dividends, except that any amendment to facilitate the sale of GSE assets shall be permitted; and ○ Shall remain in effect until the GSEs' MBS guarantee obligations are fully extinguished. • All g-fee amounts derived from the GSEs' single-family mortgage guarantee business in existence as of five years after the date of the enactment shall be deposited into the Treasury, for purposes of deficit reduction. • For purposes of the existing guarantee obligations, *Senior Preferred Stock Purchase Agreement* means— ○ The GSE agreement with Treasury dated September 26, 2008, as amended on May 6, 2009, December 24, 2009, and August 17, 2012, and as such Agreement may be further amended and restated; and ○ Any provision of any certificate in connection with such Agreement creating or designating the terms, powers, preferences, privileges,	<u>Prohibition on New Business</u> Effective on the system certification date, the GSEs shall have no authority to conduct new business under their charters. • For this purpose, "new business" means any new— ○ For both GSEs, purchase of, servicing of, or dealing in any insured or conventional mortgages under § 302(b) of Fannie Mae's charter or § 305(a) of Freddie Mac's charter; ○ For both GSEs, issue of an obligation under § 304(b) of Fannie Mae's charter or § 306(a) of Freddie Mac's charter, including— ▪ Bonds, notes, debentures, and other similar instruments; ▪ Capital lease obligations; ▪ Obligations in respect of letters of credit, bankers acceptances, or other similar instruments; ▪ Guarantees of new securities based on mortgages set aside; and ▪ Swap, security-based swap, derivative product, or other similar instrument; ○ For both GSEs, issue of a subordinated obligation of the GSE under § 304(e) of Fannie Mae's charter or under Freddie Mac's charter;	sale, transfer (other than to the NMFA or the Issuer), exchange, or disposition would materially interfere with the ability of the NMFA to carry out the requirements of this Act; and ○ Notifies, in writing, the FHFA Director within 14 days of such determination. • Notwithstanding any such authority granted to the FHFA Director, the FHFA Director— ○ Shall have no authority to sell, transfer, exchange, or otherwise dispose of any guarantee obligations described under § 501(a)(2) and (b)(2) [there is no § 501(a)(2); § 501(b)(2) is 10% interest on Treasury's preferred GSE shares]; and ○ Shall have no rights, claims, or title to, nor any authority to sell, transfer, exchange, or otherwise dispose of, g-fee amounts derived from the single-family mortgage guarantee business of the GSEs in existence as of the NMFA certification date. <u>Division of Assets and Liabilities; Authority to Establish Holding Corporation and Dissolution Trust Fund</u> Such wind down authority— • May include the establishment and	announced" market that is viable in all economic cycles. <u>Goals and Terms</u> Ginnie Mae shall carry out the GSE receivership under the authority of § 1367 of the 1992 Act, subject to the following requirements: • In carrying out the receivership of each GSE, Ginnie Mae shall strive to achieve both of the following goals: ○ Obtaining an adequate return of taxpayer investment in the GSE, taking into consideration the total cost to the taxpayers, the value provided to the GSE, and the risk and exposure to the Federal Government involved, together with interest on such investment at a rate determined by the Director, in consultation with the Federal Reserve and Treasury. ○ Removing barriers to private sector competition in the housing finance market by providing for the transfer of the assets of the GSE into the private sector to compete in a functioning housing finance market. • Any entities emerging from such receivership shall be fully private and any obligations and securities of such entities shall not constitute a debt or obligation of the U.S. nor or any agency or

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	limitations, or any other conditions of the Variable Liquidation Preference Senior Preferred Stock of a GSE issued or sold pursuant to such Agreement. **§ 102 Definitions** For purposes of this title, the following definitions shall apply: *Charter* means the Fannie Mae charter with respect to Fannie Mae, and the Freddie Mac charter with respect to Freddie Mac. *Director* means the FHFA Director. *Enterprise* or *GSE* means Fannie Mae or Freddie Mac.	o For Fannie Mae, purchase of a mortgage in Fannie Mae's secondary mortgage market operations under § 304(a) of Fannie Mae's charter; o For Fannie Mae, setting aside of any mortgages it held and any new issue and sale of securities based on the mortgages so set aside under § 304(d) of the Fannie Mae's charter; and o For Freddie Mac, issue of MBS under the Freddie Mac charter; • New business shall not include any new— o For both GSEs, purchase of a non-performing mortgage from a pool of mortgages previously set aside by the GSE; o For both GSEs, issue of an obligation if, after giving effect to the issuance, the aggregate amount of such obligations does not exceed 120% of the amount of mortgage assets permitted to be owned by the GSE under § 605; o For both GSEs, transfer of guarantees of MBS guaranteed by the GSE if the mortgage loans collateralizing such securities are refinanced, regardless of the value of the underlying collateral and the homeowner's current employment status and income; or	execution of plans to provide for an equitable division, distribution, and liquidation of the assets and liabilities of a GSE, including any infrastructure, property, including intellectual property, platforms, or any other thing or object of value, provided such plan complies with the requirements of this Act and any amendments made by this Act; and • May provide for establishment of— o A holding corporation organized under the laws of any State of the U.S. or D.C. for the purpose of winding down a GSE; and o One or more trusts to which to transfer— ▪ Outstanding debt obligations of a GSE; or ▪ Outstanding mortgages held for the purpose of collateralizing MBS guaranteed by a GSE. <u>Determination of Distributions of GSE Earnings</u> The amount of any proceeds to be paid pursuant to § 501(b) (distribution of earnings) shall be jointly determined by the FHFA Director, the NMFA, and Treasury. The wind down of each GSE required under this section shall be managed by the FHFA Director, in consultation with the NMFA and Treasury, to obtain resolutions that maximize the earnings distributed to the senior preferred	instrumentality thereof. • The receivership shall provide, notwithstanding any other provision of this Act, for the transfer of the GSEs' multifamily business in accordance with § 401 of this Act. • The receivership shall provide for— o The identification of any GSE assets that are not necessary for the operation of the limited-life entities; and o Making such assets available at auction for acquisition by any private entities, which shall include the private entities established pursuant to paragraph (6)(C). • The receivership shall provide for the restructuring of the Senior Preferred Stock Purchase Agreements between the GSEs and Treasury on September 26, 2008, as amended and restated thereafter, to— o Permit the redemption of senior preferred shares of the Treasury; o Provide for the cancellation of the warrants for the purchase of GSE common stock issued to Treasury; and o Provide for the appropriate level of compensation to the government for the financial support and commitment provided to the GSEs.

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		○ For both GSEs, entry into any swap, security-based swap, or other similar instrument, or purchase of sale of any derivative product, or other similar instrument, to facilitate the orderly wind down of the GSE and appropriate loss mitigation on any outstanding GSE guarantees under § 605. ○ For Fannie Mae, setting aside of mortgages Fannie Mae previously set aside, or any new issue and sale of securities based on the mortgages so previously set aside, to refund or replace an outstanding issue of securities based on mortgages previously set aside, if the face amount of the refunding or replacing MBS does not exceed the face amount of the MBS being refunded or replaced; ○ For Freddie Mac, issue of MBS, to refund or replace an outstanding issue of MBS, if the face amount of the refunding or replacing MBS does not exceed the face amount of the MBS being refunded or replaced. • Nothing in new business prohibition shall adversely affect the rights and obligations of any holders of— ○ Outstanding debt obligations of the GSE, including any— ▪ Bonds, notes, debentures, or	shareholder, to the extent that such resolutions— • Are consistent with the goal of supporting a sound, stable, and liquid housing market; • Are consistent with applicable Federal and State law; • Comply with the requirements of this Act and any amendments made by this Act; and • Protect the taxpayer. **§ 503 Aligning Purpose of Conservatorship with NMFA** <u>Power as Conservator</u> The 1992 Act is amended in § 1367(b)(2) by adding subparagraph (D): After the date of enactment of the Housing Opportunities Move the Economy Forward Act of 2014 the Agency shall, as conservator, take such actions as are necessary— • To ensure the efficient, effective, and expeditious wind down of the GSEs; • To manage the affairs, assets, and obligations of the GSEs and to operate the GSEs in compliance with the requirements of the Housing Opportunities Move the Economy Forward Act of 2014; • To assist the NMFA, in a consultative capacity, in carrying out the requirements under the Housing Opportunities Move	• Under the receivership— ○ The receiver shall organize a limited-life regulated entity for the GSE in accordance with § 1367(i) of the 1992 Act, except that— ▪ Any GSE assets and liabilities that the receiver determines are necessary to allow the limited-life regulated entity to operate independent from the resolution of the GSE shall be transferred to the limited-life regulated entity; and ▪ In winding up the affairs of the limited-life regulated entity, its remaining assets shall be made available to the successor entities and to other private guarantors engaged in providing insurance for eligible MBS in accordance with § 202; ○ The GSE charter shall be repealed; and ○ The receiver shall provide for reorganizing and chartering the successor entity to the limited life regulated entity as an entity established to operate as an insurer under § 202(b)(2)(A) of this Act or a participating aggregator of eligible mortgages for securitization pursuant to § 201 if such eligible mortgages are originated by originators whose

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		other similar instruments; ▪ Capital lease obligations; ▪ Obligations in respect of letters of credit, bankers' acceptances, or other similar instruments; or ▪ Swap, security-based swap, derivative product, or other similar instrument; or ○ MBS guaranteed by the GSE. • The prohibition on new business by the GSEs shall not prohibit, nor be construed to prohibit, the FMIC from managing the GSE. • The full faith and credit of the U.S. is pledged to the payment of all amounts which may be required to be paid under any obligation that is exempt from the new business prohibition or outstanding debt or MBS that the new business prohibition does not adversely affect, including any obligation issued on or after the system certification date to refund or replace an obligation that was outstanding on the day before the system certification date. ○ The GSEs shall include as eligible loans for the purposes of refinancing all current loans that qualify as eligible mortgage loans and meet those underwriting requirements for eligibility for same servicer refinancing, except that the GSEs	the Economy Forward Act of 2014; and • To maintain liquidity and stability in the secondary mortgage market with respect to the debt of the GSEs. <u>Rule of Construction</u> Nothing in this Act, or any amendments made by this Act, except as may be explicitly provided for in this Act, or any amendment made by this Act, shall be deemed to alter the powers, authorities, rights, and duties that are vested in the FHFA and the FHFA Director with respect to its supervision and regulation of the GSEs.	volume of such business is insufficient to allow for such originators to aggregate and securitize such mortgages. <u>Adjustment of Timing</u> Ginnie Mae may adjust the duration of the 5-year period for appointing Ginnie Mae receiver by establishing requirements to be met by market participants before such period may be considered to be concluded. Such requirements may include requirements regarding— • Ensuring that there is an adequate level of private capital available for efficient financing of single-family and multifamily housing mortgages through— ○ The market for initial public offerings; ○ Retained earnings of market participants; and • Ensuring that any anticompetitive liquidity advantages in mortgage-backed securities are adequately protected against. **§ 305 Repeal of GSE Charters** Section 1367 of the 1992 Act is amended • By striking the prohibition on GSE charter repeal and inserting: Effective upon the certification date (as defined in § 2 of the Partnership to

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		may not disqualify or impose varying rules based on LTV, combined LTV, employment status, or income with regard to refinancing mortgage loans that collateralize MBS issued by a GSE before the system certification date. ○ Notwithstanding the provisions of this section or any other provision of law, provision 2(a) relating to Dividend Payment Dates and Dividend Periods) and provision 2(c) (relating to Dividend Rates and Dividend Amount) of the Senior Preferred Stock Purchase Agreement, or any provision of any certificate in connection with such Agreement creating or designating the terms, powers, preferences, privileges, limitations, or any other conditions of the Variable Liquidation Preference Senior Preferred Stock of a GSE issued pursuant to such Agreement— ▪ Shall not be amended, restated, or otherwise changed to reduce the rate or amount of dividends in effect pursuant to such Agreement as of the Third Amendment to such Agreement dated August 17, 2012, except that any amendment to such Agreement shall be permitted if it facilitates the sale of assets of		Strengthen Homeownership Act of 2014), the GSE charters are repealed and the GSEs shall have no authority to conduct new business under such charter, except that the provisions of such charter in effect immediately before such repeal shall continue to apply with respect to the rights and obligations of any holders of— ○ Outstanding GSE debt obligations, including any— ▪ Bonds, debentures, notes, or other similar instruments; ▪ Capital lease obligations; or ▪ Obligations in respect of letters of credit, bankers' acceptances, or other similar instruments; or ○ MBS guaranteed by the GSE that are not eligible MBS insured by Ginnie Mae pursuant to § 202 of the Partnership to Strengthen Homeownership Act of 2014. • The full faith and credit of the U.S. is pledged to the payment of all amounts which may be required to be paid under any such GSE obligations • Notwithstanding any other provision of law, provision 2(a) and (c) (Dividend Payment Dates and Dividend Periods, and Dividend Rates and Dividend Amount) of the Senior Preferred Stock Purchase Agreement, as amended, or any provision of any certificate in connection with such

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		the GSEs to facilitate compliance with this title; and ▪ Shall remain in effect until the guarantee obligations that are exempt from the new business prohibition or outstanding debt or MBS that the new business prohibition does not adversely affect, are fully extinguished. • Notwithstanding the provisions of this section, all g-fee amounts derived from the mortgage guarantee business of the GSEs in existence as of the system certification date, after satisfying the fee amounts required to be collected by § 1327 of the 1992 Act (until 2021, g-fee increases are paid to Treasury and are not a reimbursement to the government for the costs or subsidy provided to a GSE) shall be subject to the terms of the Senior Preferred Stock Purchase Agreement. <u>Charters Revoked</u> Effective upon the date the guarantee obligations, that are backed by the full faith and credit of the U.S. for obligations that are exempt from the new business prohibition or outstanding debt or MBS that the new business prohibition does not adversely affect, are fully extinguished, the GSE charters are repealed, but not the provisions of Fannie Mae's charter act that relate to Ginnie Mae.		Agreement creating or designating the terms, powers, preferences, privileges, limitations, or any other conditions of the Variable Liquidation Preference Senior Preferred Stock of a GSE issued pursuant to such Agreement— o Shall not be amended, restated, or otherwise changed to reduce the rate or amount of dividends in effect pursuant to such Agreement as of the Third Amendment of August 17, 2012, except that any amendment to facilitate the sale of GSE assets shall be permitted; and o Shall remain in effect until the debt and MBS guarantee obligations are fully extinguished. • All g-fees derived from the GSEs' single-family mortgage guarantee business in existence as of the certification date shall be subject to the Senior Preferred Stock Purchase Agreement. • Ginnie Mae shall provide that during the 30-year period beginning upon the certification date, any GSE MBS may be exchanged, at the request of the holder, for securities insured under § 202 of the Partnership to Strengthen Homeownership Act of 2014, and Ginnie Mae shall ensure fungibility between such securities exchanged. Ginnie Mae may establish such terms and conditions for

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		Authority to Insure Outstanding MBS; GSE MBS
		• After the agency transfer date, and subject to such procedures, standards, terms, and conditions as may be adopted by the FMIC, the FMIC may—
		  ○ Upon application and in exchange for a fee determined by the FMIC, provide insurance on outstanding MBS issued by the GSEs; and
		  ○ Facilitate, including through the operations of the GSEs or the utilization of the Platform, the—
		    ▪ Exchange of MBS issued by either GSE for covered securities;
		    ▪ Exchange of MBS issued by 1 GSE for those of the other GSE;
		    ▪ Issuance of MBS by both GSEs through a single issuer; and
		    ▪ Issuance of REMIC securities, consisting of MBS issued by the GSEs.
		• The FMIC shall develop and adopt procedures, standards, terms, and conditions, to enable the FMIC and each of the GSE, as applicable, to implement each of such FMIC activities.
		• In the development and adoption of the procedures, standards, terms, and conditions, the FMIC shall consider the effect of each activity with respect to the
				such exchanges as Ginnie Mae considers appropriate, except that Ginnie Mae shall provide that in such exchanges the GSE MBS securities shall receive a risk weight of zero.
				
				§ 306 Ginnie Mae Authority Regarding Timing
				Authority
				The Director may extend any deadline in §§ 301 (GSE new business limitations), 303(a) (continuing the conservatorships), 304(a) (mandatory receivership), or § 305 (charter repeals), but only if the Director—
				• Makes a determination, after consultation with the Federal Reserve, that such deadline is posing significant risk to the housing market; and
				• Causes notice of such determination to be published in the Federal Register.
				
				Extensions
				• The first such extension shall be for a period of an additional 2 years.
				• If, after the first extension, the Director makes a determination after consultation with the Federal Reserve, that such deadline is posing significant risk to the housing market, the Director may extend the deadline an additional 2 years.
				• If, after the second extension, the Director makes a determination after consultation

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		following: o Lender access to the secondary mortgage market. o The liquidity and trading price of existing GSE MBS. o The ability of market participants and the GSEs to issue new MBS. o The costs to the GSEs or the FMIC to exchange, restructure, or insure MBS. <u>Report to Congress</u> Before the agency transfer date, the FHFA Director shall submit a study considering the feasibility of activities under the FMIC's authority to insure outstanding MBS to the Senate Banking and House Financial Services Committees. Following the agency transfer date, the FMIC shall provide updates on such activities in the transition plan (and in each annual update thereof) required under § 602. <u>Division of Assets and Liabilities; Authority to Establish Holding Companies, Trusts, and Subsidiaries</u> • The wind down action and procedures required under subsection (a): o Shall include the establishment and execution of plans to manage assets toward the liquidation of liabilities and provide for an equitable division, distribution, and liquidation of the assets and liabilities of a GSE,		with the Federal Reserve, that such deadline is posing significant risk to the housing market, the Director may, upon the written agreement of the Federal Reserve Chairman and the Treasury Secretary, and in consultation with the HUD Secretary, extend the deadline an additional year, and annually thereafter utilizing the same process until the Director makes a determination that such deadline does not pose a significant risk to the housing market. <u>Reports</u> If the Director extends any deadline, until the charters are repealed, the Director shall report monthly to Congress regarding the transition of the GSEs, the status of the business of the GSEs, and their market share.

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		including any infrastructure, property, including intellectual property, historic data, platforms, or any other thing or object of value, provided such plan complies with the requirements of this Act and any amendments made by this Act; ○ May provide for the establishment of— ▪ A holding corporation organized under the laws of any state for the purpose of winding down one GSE or both GSEs; ▪ 1 or more trusts to which to transfer— ♦ Outstanding debt obligations one GSE or both GSEs; or ♦ Outstanding mortgages held for the purpose of collateralizing MBS guaranteed by one GSE or both GSEs; and ▪ One or more subsidiaries or joint ventures with private entities for the purposes of facilitating an orderly wind down of one GSE or both GSEs and the transition to the new housing finance system; ○ May include the sale as a going concern of any holding company,		

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		trust, subsidiary, or joint venture with a private entity established by a GSE under this subsection; and ○ May provide that any holding company, trust, subsidiary, or joint venture sold as a going concern may be utilized to facilitate the formation of— ▪ A small lender mutual under § 315; ▪ An approved guarantor; ▪ An approved multifamily guarantor; ▪ An approved aggregator; or ▪ The Securitization Platform. • Any holding company, trust, subsidiary, or joint venture established by a GSE before or after the agency transfer date is eligible to be sold by the FHFA as a going concern for the purposes described in this section. <u>Recoupment by Senior Preferred Shareholders</u> • The wind down of each GSE shall be managed by the FMIC, to obtain resolutions that maximize the return for the senior preferred shareholders, to the extent that such resolutions— ○ Are consistent with the goals of facilitating— ▪ a deep, liquid, and resilient secondary mortgage market for		

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		single-family and multifamily MBS to support access to mortgage credit in the primary mortgage market; and ▪ an orderly transition from housing finance markets facilitated by the GSEs to housing finance markets facilitated by the FMIC with minimum disruption in the availability of loan credit; ○ Are consistent with applicable Federal and State law; ○ Comply with the requirements of this Act and the amendments made by this Act; and ○ Protect the taxpayer from having to absorb losses incurred in the secondary mortgage market. • If FHFA makes the determination below, the FHFA may conduct a sale, exchange, license, or other disposition for value of any line of business of a GSE, or any function, activity, assets, intellectual property, or service of a GSE, as a going concern. Such a sale is permitted if the FHFA determines that the sale, exchange, license, or other disposition for value — ○ Is consistent with the goal of an orderly transition from housing finance markets facilitated by the enterprises to efficient housing finance markets facilitated by the		

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		FMIC with minimum disruption in the availability of loan credit; o Does not impede or otherwise interfere with the ability of the FHFA or the FMIC to carry out the functions and requirements of this Act; o Does not transfer, convey, or authorize any guarantee or Federal support, assistance, or backing, implicit or explicit, related to any such business line, function, activity, or service; o Will maximize the return for the senior preferred shareholders as required under this subsection; and o Would not result in an uncompetitive primary or secondary mortgage market or otherwise limit competitiveness in the primary or secondary mortgage markets. • FHFA shall conduce a sale for value of each GSE's historic data, including loan-level historical performance data. FHFA may require that the purchaser: o Is the FMIC or Securitization Platform; o Makes the historic data available to the public in a searchable and easily accessible format as promptly as practicable; and o Takes appropriate steps to ensure the privacy of consumers, minimizes the		

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		collection and storage of personally identifiable financial information, and considers statuses, rules, and regulations relating to the privacy of consumer credit information and personally identifiable financial information.		
Portfolio Caps	**§ 104(a) Limitations on GSE Authority** The 1992 Act is amended by adding § 1369E**:** No GSE shall own mortgage assets in portfolio in excess of— • As of December 31, 2013, \$550,000,000,000; or • As of December 31 of each year thereafter, 85% of the aggregate amount of mortgage assets the GSE was permitted to own as of December 31 of the immediately preceding calendar year. In no event shall a GSE be required to own less than \$250,000,000,000 in mortgage assets. *Mortgage Assets* means, with respect to a GSE, assets consisting of mortgages, mortgage loans, mortgage-related securities, participation certificates, mortgage-backed commercial paper, obligations of REMICs and similar assets, in each case to the extent such assets would appear on the balance sheet of such GSE in accordance with GAAP in effect in the U.S. as of September 7, 2008, and	**§ 605 Portfolio Reduction** • On December 31 of the year after the date of enactment, and on December 31 of each year thereafter, until each GSE reaches the allowable size of the retained single-family portfolio, each GSE shall not own single-family mortgage loan assets in excess of 85% of the aggregate amount of the single-family mortgage loan assets that the GSE was permitted to own as of December 31 of the immediately preceding calendar year. [*See also* the end of § 701, which excludes limited multifamily loans.] • Not later than the system certification date, the FMIC shall establish an allowable amount of GSE-owned single-family mortgage loan assets in an amount equal to the amount necessary to facilitate— o The orderly wind down of the GSEs; and o Appropriate loss mitigation on any legacy guarantees of the GSEs. • For purposes of this section, *mortgage*	**§ 505 Portfolio Reduction** • Each GSE shall not own, as of any applicable date, mortgage assets in excess of— o As of December 31, 2014, \$552,500,000,000; and o On December 31 of each year thereafter until the NMFA certification date, 85% of the aggregate amount of the mortgage assets that the GSE was permitted to own as of December 31 of the immediately preceding calendar year. • On December 31 of the year in which the NMFA certification date occurs, the NMFA shall establish an allowable amount of GSE owned mortgage assets in an amount equal to the amount necessary to facilitate— o The orderly wind down of the GSEs; and o Appropriate loss mitigation on any legacy guarantees of the GSEs. • For purposes of this section, *mortgage assets* means, with respect to a GSE,	

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	without giving any effect to any change that may be made after that date, in respect of FAS 140 or any similar accounting standard.	*loan assets* means, with respect to a GSE, assets of such GSE consisting of mortgage loans, mortgage-related securities, participation certificates, mortgage-backed commercial paper, obligations of real estate mortgage loan investment conduits, and similar assets, in each case to the extent that such assets would appear on the GSE's balance sheet in accordance with GAAP as in effect in the U.S. as of September 7, 2008 (as set forth in the opinions and pronouncements of the Accounting Principles Board and the AICPA and statements and pronouncements of FASB from time to time, and without giving any effect to any change that may be made after September 7, 2008, in respect of SFAS 140 or any similar accounting standard.	assets of such GSE consisting of mortgages, mortgage loans, mortgage-related securities, participation certificates, mortgage-backed commercial paper, obligations of REMICs and similar assets, in each case to the extent such assets would appear on the balance sheet of such GSE in accordance with generally accepted accounting principles and held for the benefit of the GSEs.	
G-Fee Limits	**§ 104(b) Limitations on GSE Authority** The 1992 Act is amended by adding § 1327(f): • Notwithstanding any other provision of this section, the Director shall ensure, pursuant to an annual review, that each GSE charges a g-fee, in connection with any mortgage guaranteed after enactment, in an amount that the Director determines is equivalent to the amount that the GSE would charge if it were held to the same capital standards as private banks or financial institutions.			

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	• At least annually, the Director shall review each GSE's g-fees and determine how such fees compare to the amount determined by the Director as what it would charge if it were held to the capital standards of private banks or financial institutions. If the Director determines that a GSE charged lower g-fees, the Director shall, by order, require the GSE to increase such fees as the Director determines necessary to equal what the GSE would charge if it were held to the capital standards of private banks or financial institutions. • To determine the amount of any such increase, the Director shall establish a pricing mechanism as the Director considers appropriate, taking into consideration current market conditions, including the GSE's current market share, and any data collected pursuant to 12 U.S.C. § 4514a (FHFA's authority to require reports from the GSEs and FHLBs).			
Multifamily Findings			**§ 602 Findings** Congress finds the following: • Broad housing finance reform is necessary to provide stability and certainty to the housing market, and to protect taxpayers from future losses. • The multifamily housing businesses of Fannie Mae and Freddie Mac maintained	

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			appropriate underwriting standards during the recent housing bubble, and, as a result, did not incur significant losses during the financial crisis. • Due to the strong performance of their multifamily housing businesses, Fannie Mae and Freddie Mac were able to play an important countercyclical role in the multifamily housing market by increasing their financing for multifamily housing projects at the same time that private lenders were pulling back from the multifamily housing market. • The multifamily businesses of Fannie Mae and Freddie Mac have each developed successful risk-sharing programs that provide substantial protection for taxpayers by requiring private market entities to share losses with the GSEs. • Broad housing finance reform should strive to preserve the successful multifamily risk-sharing programs that Fannie Mae and Freddie Mac have developed. • In the context of broad housing finance reform that replaces Fannie Mae and Freddie Mac with a government-backed reinsurance program, the best way to ensure the continuation of the successful multifamily risk-sharing programs that Fannie Mae and Freddie Mac have	

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			developed is to— o Transfer Fannie Mae and Freddie Mac's multifamily housing businesses to the Issuer; o Subject the multifamily platform(s), as part of the Issuer, to supervision and oversight by the NMFA; and o Allow the multifamily platform(s), as part of the Issuer, to purchase catastrophic reinsurance from a government-backed agency, subject to minimum loss-sharing requirements that protect taxpayers from future bailouts. • The NMFA and the MIF should serve as the regulator and reinsurer for the multifamily platform(s) created by this Act as part of the Issuer.	
Multifamily Definitions			**§ 603 Definitions** For purposes of this Act, the following definitions shall apply: *Approved multifamily lender* means a lender that is approved by the Issuer under such rules as the NMFA provides. *Covered multifamily security* means a mortgage-backed security— • Collateralized by eligible multifamily mortgages; and • Which is eligible for insurance by the MIF pursuant to § 611.	

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			Eligible multifamily mortgage means a mortgage that— • Is secured by a property comprising five or more dwelling units; and • Is originated by an approved multifamily lender in accordance with the underwriting standards established by the NMFA under § 609(b)(2) of this Act. *Multifamily Platform* means the entity established in § 604 of this Act. *Multifamily Platform certification date* means the date on which the Issuer certifies that the Multifamily Platform is operational and able to perform the functions described in this Act, which date shall not be later than 5 years after enactment, except that Treasury may extend such 5-year period for not more than 12 additional months.	
Multifamily Subsidiaries		**TITLE VII--MULTIFAMILY** **§ 701 Establishment of Multifamily Subsidiaries** <u>Formation and Governance of Multifamily Subsidiaries</u> • The FHFA Director, in consultation with Treasury, shall direct the GSEs each to develop a plan, not later than 180 days after the date of enactment, to establish a multifamily subsidiary for purposes of expeditiously meeting the multifamily		**§ 401 Establishment of Multifamily Subsidiaries** <u>Formation and Governance</u> • The Ginnie Mae Director, in consultation with Treasury, shall direct the GSEs to develop a plan, within 180 days after enactment, to each establish a multifamily subsidiary to expeditiously— o Provide sufficient multifamily financing in the primary, secondary, and tertiary geographical markets,

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		market minimum criteria required under § 601. • Pursuant to § 604, FHFA shall direct each GSE to establish a multifamily subsidiary not later than 1 year after the date of enactment. <u>Transfer of Functions</u> • Notwithstanding title VI or any other provision of law, effective on the date on which the Fannie Mae multifamily subsidiary is established, all employees, functions, activities, infrastructure, property, including the DUS and Servicing Lender Program and other intellectual property, platforms, technology, or any other object or service of Fannie Mae necessary to the support, maintenance, and operation of its multifamily business shall be transferred and contributed, without cost, to the multifamily subsidiary. • In connection with such transfer, Fannie Mae shall contribute, in any form or manner the FHFA may determine, subject to the approval right of Treasury in the Senior Preferred Stock Purchase Agreement, any capital necessary to ensure that the multifamily subsidiary has, in the determination of the FHFA Director, sufficient capital to carry out its multifamily business, including the ability		including in rural markets and through a diversity of experienced multifamily lenders; and o Establish a competitive multifamily market for multifamily housing guarantors engaging in multifamily covered securities. • The Director shall direct the GSEs to establish the multifamily subsidiaries within 1 year of enactment. <u>Transfer of Functions</u> • Notwithstanding title III or VI or any other provision of law, effective when the multifamily subsidiary is established, all employees, functions, activities, infrastructure, property, including and intellectual property, platforms, technology, or any other object or service of the GSEs necessary to the support, maintenance, and operation of the GSEs' multifamily business shall be transferred and contributed, without cost, to each GSE's multifamily subsidiary. This includes transfer of: o The Delegated Underwriting and Servicing Lender Program (Fannie Mae); and o Capital Market Execution Program Series K Structured 2Pass-Through Certificates originated and offered under the Program Plus Lender

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		to obtain warehouse lines of credit. • In carrying out the transferred multifamily business, the multifamily subsidiary shall ensure that any such business continues to operate, as applicable, consistent with— o The DUS and Servicing Lender Program established by Fannie Mae; o Any other programs, activities, and contractual agreements of the GSEs that support the GSEs' provision of liquidity to the multifamily housing market; and o The provisions of this title. • Notwithstanding title VI or any other provision of law, effective on the date on which the Freddie Mac multifamily subsidiary is established, all employees, functions, activities, infrastructure, property, including the K Series Structured Pass-Through Certificates originated and offered under the Program Plus Lender Program and other intellectual property, platforms, technology, or any other object or service of Freddie Mac necessary to the support, maintenance, and operation of its multifamily business shall be transferred and contributed, without cost, to the multifamily subsidiary. • In connection with such transfer, Freddie Mac shall contribute, in any form or		Program (Freddie Mac). • In connection with the transfer, each GSE shall contribute, in any form or manner the Director may determine, subject to the approval right of Treasury in the Senior Preferred Stock Purchase Agreement, any capital necessary to ensure that each multifamily subsidiary has, in the determination of the Director, sufficient capital to carry out its multifamily business, including the ability to obtain warehouse lines of credit. • In carrying out the transferred multifamily business, each multifamily subsidiary shall ensure that any such business continues to operate, as applicable, consistent with— o The Delegated Underwriting and Servicing Lender Program established by Fannie Mae; o The Capital Market Execution Program Series K Structured 2Pass-Through Certificates originated and offered under the Program Plus Lender Program established by Freddie Mac; o Any other programs, activities, and contractual agreements of the GSEs that support their provision of liquidity to the multifamily housing market; and o The provisions of this title.

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		manner the FHFA may determine, subject to the approval right of Treasury in the Senior Preferred Stock Purchase Agreement, any capital necessary to ensure that the multifamily subsidiary has, in the determination of the FHFA Director, sufficient capital to carry out its multifamily business, including the ability to obtain warehouse lines of credit. • In carrying out the transferred multifamily business, the multifamily subsidiary shall ensure that any such business continues to operate, as applicable, consistent with— o The K Series Structured Pass-Through Certificates originated and offered under the Program Plus Lender Program established by Freddie Mac; o Any other programs, activities, and contractual agreements of the GSEs that support the GSEs' provision of liquidity to the multifamily housing market; and o The provisions of this title. <u>Multifamily Subsidiaries</u> • The multifamily subsidiaries established by the GSEs may retain a limited multifamily mortgage loan portfolio to— o Aggregate mortgage loans for pooled securities executions;		<u>Multifamily Subsidiaries</u> • The multifamily subsidiaries may retain a limited multifamily mortgage loan portfolio to— o Aggregate mortgage loans for pooled securities executions; o Implement pilot mortgage loan programs and other risk-sharing transactions and product modification testing; o Engage in the financing of properties with rent-regulatory restrictions, off-campus student housing, and senior and assisted living developments; and o Perform additional activities as may be established by the Director for facilitating the continuation of existing multifamily activities. • For purposes of expeditiously meeting the purposes of the subsidiaries, the multifamily subsidiaries shall not be subject to any portfolio reduction required under title III.

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		○ Implement pilot mortgage loan programs and other risk-sharing transactions and product modification testing; ○ Engage in the financing of properties with rent-regulatory restrictions, off-campus student housing, and senior and assisted living developments; and ○ Perform additional activities as may be established by the FMIC to facilitate the continuation of existing multifamily activities. • For purposes of expeditiously meeting the multifamily market minimum criteria required under § 601, the multifamily subsidiaries shall not be subject to the portfolio reduction required under § 605.		
Disposition of Multifamily Business		**§ 702 Disposition of Multifamily Businesses** Authority to Manage Disposition of Multifamily Businesses Notwithstanding any provision of title VI or any other provision of law, FHFA may, on or before the system certification date, manage the sale, transfer, or disposition for value of property, including intellectual property, technology, platforms, and legacy systems, infrastructure and processes of a GSE relating to the operation and maintenance of the multifamily business of a GSE. Required Establishment of Well-Functioning		**§ 402 Disposition of Multifamily Businesses** Notwithstanding any provision of title III or any other provision of law, the Director may, on or before the certification date, manage the sale, transfer, or disposition for value of property, including intellectual property, technology, platforms, and legacy systems, infrastructure and processes of a GSE relating to the operation and maintenance of its multifamily business. In exercising such authority, the Director shall manage any disposition of the multifamily business of a GSE in a manner consistent with— • The establishment of a well-functioning

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		<u>Multifamily Covered Security Market</u>
		In exercising such authority, FHFA shall manage any disposition of the multifamily business of a GSE in a manner consistent with—
		• The establishment of a well-functioning multifamily covered security market;
		• The provision of broad access to multifamily financing; and
		• Facilitating competition in the multifamily covered security market by—
		  o Providing open access to performance information on the legacy multifamily business of a GSE;
		  o Providing for reasonable licensing of the multifamily proprietary systems of a GSE; and
		  o Setting market share limitations, fees, or additional capital standards on multifamily business assets that were sold, transferred, or disposed.
				multifamily covered security market;
				• The provision of broad access to multifamily financing; and
				• Facilitating competition in the multifamily covered security market by—
				  o Providing open access to performance information on the legacy multifamily business of a GSE;
				  o Providing for reasonable licensing of the GSEs' multifamily proprietary systems; and
				  o Setting market share limitations, fees, or additional capital standards on multifamily business assets that were sold, transferred, or disposed.

Approval of Multifamily Guarantors / Insurance		**§ 703 Approval and Supervision of Multifamily Guarantors**
		<u>Standards for Approval</u>
		• The FMIC shall develop, adopt, and publish standards for the approval by the FMIC of multifamily guarantors to—
		  o Issue multifamily covered securities; and
		  o Guarantee the timely payment of principal and interest on multifamily
			§ 610 Multifamily Mortgage Insurance
			<u>Insurance Authority</u>
			Insurance for securities backed by multifamily loans shall be provided by the MIF.
			
			<u>Deposits</u>
			The MIF shall be credited with any—
			• Insurance fee amounts required to be deposited in the Fund by the NMFA;
			• G-fee amounts collected under subsection	

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		covered securities collateralized by eligible multifamily mortgage loans and insured by the FMIC. • The standards shall include— o The financial history and condition of the multifamily guarantor; o A requirement that the multifamily guarantor maintain capital levels as defined by the FMIC; o The capability of the multifamily guarantor's management; o The general character and fitness of the multifamily guarantor's officers and directors, including their compliance history with Federal and State laws and rules and regulations of self-regulatory organizations as defined in § 3(a)(26) of the Exchange Act as applicable; o The risk presented by the multifamily guarantor to the MIF; o The adequacy of insurance and fidelity coverage of the multifamily guarantor; o The ability of the multifamily guarantor to— ▪ Ensure that eligible multifamily mortgage loans that collateralize a multifamily covered security insured under this Act are originated in compliance with the requirements of this Act; ▪ Oversee multifamily servicers	(f) of this section [there is none; apparently means (d)]; and • Amounts earned on investments pursuant to subsection (g) of this section [there is none]. <u>Reserve Ratio Goals for MIF</u> The NMFA, consistent with its authority under § 203, shall endeavor to ensure that, with respect to multifamily lending and the capital dedicated to multifamily lending, the MIF attains a reserve balance— • Of 1.25% of the sum of the outstanding principal balance of the covered securities for which insurance is being provided under this title within 5 years of the Multifamily Platform certification date, and to strive to maintain such ratio thereafter, subject to the following; and • Of 2.25% of the sum of the outstanding principal balance of the covered securities for which insurance is being provided under this title within 12 years of the Multifamily Platform certification date, and to strive to maintain such ratio at all times thereafter. <u>Maintenance of Reserve Ratio; Establishment of Fees</u> • The MIF shall charge and collect a g-fee in connection with any insurance provided under this title, and the NMFA	

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		and special servicers conducting servicing activities on eligible multifamily mortgage loans, which may be governed under the terms of seller-servicer guides in effect at either of the GSEs on the date of enactment; and ▪ Oversee counterparties in credit risk-sharing transactions; ○ The capacity of the multifamily guarantor to take the first loss position, *pari passu* position, or transfer investment risk and credit risk to private market holders; ○ That the multifamily guarantor has the capacity to guarantee eligible multifamily mortgage loans in a manner that furthers the purposes of the FMIC as described in § 201(b)(5); ○ A requirement that the multifamily guarantor submit audited financial statements to the FMIC; ○ That the multifamily guarantor does not originate eligible multifamily mortgage loans and is not an affiliate of a person that actively engages in the business of originating eligible multifamily mortgage loans; and ○ A requirement that the multifamily guarantor has the capacity to meet the requirement of § 704.	may in its discretion increase or decrease such fee, to— ○ Achieve and maintain the reserve ratio goals; and ○ Fund the operations of the NMFA relating to multifamily lending. • In exercising such g-fee, the NMFA shall consider— ○ The expected operating expenses of the MIF relating to multifamily lending; ○ The risk of loss to the MIF in carrying out the requirements under this title; ○ The nature and level of the credit enhancement that private market entities are providing pursuant to the minimum loss-sharing requirement in § 611; ○ Economic conditions generally affecting the mortgage markets; ○ The extent to which the reserve ratio of the MIF relating to multifamily lending met— ▪ The reserve ratio set for the preceding 12-month period; or ▪ The reserve ratio goals; and ○ Any other factor that the NMFA determines appropriate. **§ 611 Catastrophic Insurance** <u>Authority</u> Subject to the minimum loss-sharing	

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		• To promote consistency and minimize regulatory conflict, the FMIC shall consult and coordinate with appropriate Federal and State regulators and officials when developing these standards.
		
		<u>Application and Approval</u>
		• The FMIC shall establish an application process, in such form and manner and requiring such information as the FMIC may require, for the approval of multifamily guarantors under this section.
		  ○ The FMIC shall establish internal timelines for its processing of applications under this section, including timelines for any action to approve or to deny an application under this section.
		  ○ Only a separately capitalized affiliate of an insured depository institution may be eligible to apply to become an approved multifamily guarantor. This shall not be construed to prohibit or otherwise restrict an entity that is not an insured depository institution from seeking to become an approved multifamily guarantor.
		  ○ The FMIC may establish an expedited application process for an applicant applying to become an approved multifamily guarantor,
			requirement below, the NMFA shall, upon application and in exchange for a fee in accordance with § 610, insure the timely payment of principal and interest on a covered multifamily security with respect to losses that may be incurred on such security.
			
			<u>Minimum Loss-Sharing Requirement</u>
			Prior to making any such commitment to provide insurance, the NMFA shall ensure that private market entities have agreed to take, in writing, in a form and manner acceptable to the NMFA—
			• The first at least 10% of losses on a pool of eligible multifamily mortgages collateralizing a covered multifamily security;
			• Losses on a covered multifamily security equal to at least 15% of the total losses on such security, subject to a *pari passu* loss-sharing agreement; or
			• At least a comparable amount of losses on a covered multifamily security, as determined by the NMFA.
			
			<u>Insurance in Severe Market Downturns</u>
			If the NMFA, in consultation with the Federal Reserve, Treasury, and HUD, determines that unusual and exigent circumstances have created or threatened to create an anomalous lack of mortgage credit availability within the housing markets that could materially and	

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		provided that any such applicant— ▪ Proposes to use a credit risk-sharing mechanism approved under subsection (c); and ▪ Otherwise meets the requirements of this section. • The FMIC may approve any application, provided the multifamily guarantor meets the established standards. • The FMIC shall have authority to deny any application if an officer or director of the multifamily guarantor has, at any time before approval been subject to a statutory disqualification pursuant to § 3(a)(39) of the Exchange Act or suspended, removed, or prohibited under FDIA § 8(g), prohibited pursuant to FDIA § 8(e)(6) or (7), subject to an action resulting in a written agreement or statement under FDIA § 8(u)(1), for which a violation may be enforced by an appropriate Federal banking agency, or subject to any final order issued under FDIA § 8. • The FMIC shall— ○ Provide prompt notice to a multifamily guarantor of the approval or denial of any application of the multifamily guarantor to become an approved multifamily guarantor under this section; ○ Publish a notice in the Federal	severely disrupt the functioning of the multifamily housing finance system of the U.S., the NMFA may provide insurance to any covered multifamily security regardless of whether such security has satisfied the minimum loss-sharing requirements, provided that the NMFA adjusts the g-fee paid to the MIF and capital requirements for the multifamily platform accordingly to protect taxpayers against the additional risk to the Fund, consistent with § 202. <u>Full Faith and Credit</u> The full faith and credit of the U.S. is pledged to the payment of all amounts which may be required to be paid under any insurance provided under this section. <u>Prohibition on Cross-Subsidization</u> Multifamily lenders shall not be required to recapitalize the Issuer as a result of a loss due to risks from single-family lending. Single-family lenders shall not be required to recapitalize the Issuer as a result of loses due to multi-family lending. **§ 612 Exemptions** • Consistent with § 205(c), the Multifamily Platform shall be exempt from all taxation imposed by the U.S., any territory, dependency, or possession of the U.S. or any State, county, municipality, or local taxing authority.	

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		Register upon approval of any multifamily guarantor; and o Maintain an updated list of approved multifamily guarantors on its website. <u>Credit Risk-Sharing Mechanisms</u> • The FMIC shall— o Consider and approve credit risk-sharing mechanisms that may be employed by an approved multifamily guarantor to manage the credit risk related to guarantees provided for multifamily covered securities; and o Approve any credit risk-sharing mechanism undertaken by a GSE as of the date of enactment of this Act, including— ▪ The Delegated Underwriting and Servicing Lender Program established by Fannie Mae; ▪ The K Series Structured Pass-Through Certificates originated and offered under the Program Plus Lender Program established by Freddie Mac; ▪ Any other program, activity, or contractual agreement of a GSE that supports the GSE's provision of liquidity to the multifamily housing market; and ▪ Any credit risk-sharing	All covered multifamily securities insured or guaranteed by the NMFA shall, to the same extent as securities that are direct obligations of or obligations guaranteed as to principal or interest by the U.S., be deemed to be exempt securities within the meaning of the laws administered by the SEC.	

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		mechanism based on such credit risk-sharing mechanisms undertaken by a GSE as of enactment, with modifications approved by the FMIC; • This shall not be construed to— o Prevent private market holders from taking a first loss position on multifamily covered securities guaranteed by an approved multifamily guarantor; or o Limit an approved multifamily guarantor from engaging in other forms of risk sharing using mechanisms that have not been considered or approved by the FMIC. • Each report required by § 302(b)(5) shall include a description of each credit risk-sharing mechanism approved by the FMIC pursuant to this subsection. • The FMIC shall— o Provide prompt notice to any person seeking approval for a credit risk-sharing mechanism of the approval or denial of that credit risk-sharing mechanism under this section; and o Make available on the FMIC's website updated information regarding approved credit risk-sharing mechanisms. • No counterparty that enters into a swap, as defined by § 1a of the Commodity		

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		Exchange Act, for purposes of structuring any credit risk-sharing mechanism that is approved by the FMIC pursuant to this section, which credit risk-sharing mechanism is designed to be used or is used by a private market holder to assume losses and to reduce the specific risks arising from losses realized under such credit risk-sharing mechanism associated with any multifamily covered security insured in accordance with §§ 303 or 305, shall be deemed, by reason of such swap transaction, to be a commodity pool, as defined in § 1a of the CEA. Before approving any credit risk-sharing mechanism that would be exempt from the CEA, the FMIC shall consult with the CFTC. • Any credit risk-sharing mechanism that is approved by the FMIC pursuant to this section, which credit risk-sharing mechanism is designed to be used or is used by a private market holder to assume losses and to reduce the specific risks arising from losses realized under such credit risk-sharing mechanism associated with any multifamily covered security insured in accordance with § 303 or § 305, shall be exempt from § 27B of the Securities Act of 1933. Before approving any credit risk-sharing mechanism that would be exempt from § 27B, the FMIC shall consult with the SEC.		

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		<u>Requirement to Maintain Approval Status</u>
		• If the FMIC determines that an approved multifamily guarantor approved under this section no longer meets the standards for such approval or violates the requirements under this Act, including any standards, regulations, or orders promulgated in accordance with this Act, the FMIC may—
		  ○ Suspend or revoke the approved status of the approved multifamily guarantor; or
		  ○ Take any other action with respect to such approved multifamily guarantor as may be authorized under this Act.
		• The suspension or revocation of the approved status of an approved multifamily guarantor shall have no effect on the status as a multifamily covered security of any multifamily covered security collateralized by eligible multifamily mortgage loans with which the approved multifamily guarantor contracted before the suspension or revocation.
		• The FMIC shall—
		  ○ Promptly publish a notice in the Federal Register upon suspension or revocation of the approval of any approved multifamily guarantor; and
		  ○ Maintain an updated list of such		

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		approved multifamily guarantors on the website of the FMIC. • In this subsection, the term “violate” includes any action, taken alone or with others, for or toward causing, bringing about, participating in, counseling, or aiding or abetting, a violation of the requirements under this Act. <u>Prudential Standards for Supervision</u> The FMIC shall prescribe prudential standards for approved multifamily guarantors in order to— • Ensure— o The safety and soundness of approved multifamily guarantors; and o The maintenance of approval standards by approved multifamily guarantors; and • Minimize the risk presented to the MIF. <u>Reports and Examinations</u> For purposes of determining whether an approved multifamily guarantor is fulfilling the requirements under this Act, the FMIC shall have the authority to require reports from and examine approved multifamily guarantors, in the same manner and to the same extent as the FDIC has with respect to insured depository institutions under FDIA§ 9(a).		

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		<u>Enforcement</u>
		The FMIC shall have the authority to enforce the provisions of this Act with respect to approved multifamily guarantors, in the same manner and to the same extent as the FDIC has with respect to insured depository institutions under FDIA § 8(b) through (n).
		
		<u>Capital Standards</u>
		• Pursuant to the requirement to establish capital and related solvency standards under § 309(b), the FMIC shall establish standards for approved multifamily guarantors as follows—
		    ○ The capital standard for eligible multifamily mortgage loans that collateralize FMIC-insured multifamily covered securities shall require an approved multifamily guarantor to hold 10% capital.
		    ○ An approved multifamily guarantor shall hold capital in an amount comparable to that required to be held by insured depository institutions and their affiliates with respect to their applicable aggregating activities.
		    ○ An approved multifamily guarantor shall maintain solvency levels adequate for it to withstand losses that it might incur in a period of economic stress, including national		

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		and regional multifamily housing price declines, such as those observed during moderate to severe recessions in the U.S. • For the purpose of the 10% requirement, the FMIC shall consider the extent, amount, and form of risk-sharing and risk mitigation through the use by approved multifamily guarantors of credit risk-sharing mechanisms approved pursuant to § 703(c). The FMIC shall allow such risk sharing and risk mitigation to fulfill required amounts of capital to be held while maintaining an appropriate structure of capital as determined by the FMIC. • For purposes of the 10% requirement, the FMIC shall seek to ensure equivalent capital treatment between approved credit risk-sharing mechanisms with similar performance histories. • To reflect the differences between single-family and multifamily businesses, the capital standards may differ from the capital standards established under § 311 for approved guarantors. • The FMIC shall conduct appropriate stress tests of approved multifamily guarantors that have total assets of more than $10,000,000,000, provided that such stress tests shall be— o Specifically tailored to the business		

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		model of the approved multifamily guarantor; and ○ Utilized to— ○ Ensure the safety and soundness of the approved multifamily guarantor; and ○ Minimize the risk the approved multifamily guarantor may present to the MIF. <u>Resolution Authority for Failing Multifamily Guarantors</u> • Notwithstanding any other provision of Federal law, the law of any State, or the constitution of any State, the FMIC shall— ○ Have the authority to act, in the same manner and to the same extent, with respect to an approved multifamily guarantor as the FDIC has with respect to insured depository institutions under 12 U.S.C. §§ 1821(c) through (s), 1822, and 1823 [conservatorship and receivership authority], while tailoring such actions to the specific business model of the approved guarantor, as may be necessary to properly exercise such authority under this subsection; ○ In carrying out any such authority, act, in the same manner and to the same extent, with respect to the MIF		

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		as the FDIC may act with respect to the Deposit Insurance Fund under such FDIA authorities; ○ Prescribe regulations governing the applicable rights, duties, and obligations of an approved multifamily guarantor placed into resolution under this section, its creditors, counterparties, and other persons, as FMIC deems necessary to properly exercise its conservatorship and receivership authority; ○ Consistent with such FDIA authorities provided to the FMIC, immediately place an insolvent approved multifamily guarantor into receivership; and ○ Upon placing an approved multifamily guarantor into receivership, treat FMIC-insured multifamily covered securities in the same manner as the FDIC treats deposit liabilities under FDIA § 11(d)(11)(A)(ii) and insured deposits under § 11(f), where the FMIC shall have the same right of subrogation as the FDIC has under § 11(g). • The FMIC may not exercise any such authority with respect to any approved multifamily guarantor unless the total amount of the expenditures by the FMIC and obligations incurred by the FMIC in		

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		connection with the exercise of any such authority with respect to such approved multifamily guarantor is the least costly to the MIF, consistent with the least cost approach specified in the FDIA, of all possible methods for meeting the FMIC's obligations under this Act and expeditiously concluding its resolution activities, subject to FDIA § 13 where the FMIC and Board of Directors have the same authority as the FDIC and its board. • The FMIC, in carrying out any authority provided in this subsection, shall prescribe regulations to ensure that any amounts owed to the U.S., unless the U.S. agrees or consents otherwise, shall have priority following administrative expenses of the receiver when satisfying unsecured claims against an approved multifamily guarantor, or the receiver therefor, that are proven to the satisfaction of the receiver. <u>Hearing</u> Upon notice of denial of an application for approval or upon a notice of suspension or revocation of the approved status of an approved multifamily guarantor, the applicant or approved multifamily guarantor shall be afforded a hearing under FDIA § 8(h) in the same manner and to the same extent as if the FMIC were the appropriate Federal banking agency, provided that the approved		

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		multifamily guarantor submits a request to the FMIC for a hearing not later than 10 days after the date on which the notice of denial, suspension, or revocation is published. <u>Prohibited Activity</u> An approved multifamily guarantor may not: • Originate eligible multifamily mortgage loans; or • Be an affiliate of a person that actively engages in the business of originating eligible multifamily mortgage loans. <u>Guarantors Required to Pay Claims</u> Subject to such standards as the FMIC may provide, an approved multifamily guarantor may not for any reason withhold payment of funds that would ensure holders of multifamily covered securities receive timely payment of principal and interest on multifamily covered securities. The FMIC shall by regulation develop a process for the mediation and resolution of disputed payment amounts.		
Multifamily Housing Requirement		**§ 704 Multifamily Housing Requirement** <u>In General</u> Each approved multifamily guarantor shall ensure, during each calendar year, that at least 60% of the rental housing units which are contained in the eligible multifamily mortgage loans that collateralize all multifamily covered securities guaranteed by each such approved		

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		multifamily guarantor during the previous 24-month period were, at the time of origination, affordable to low-income families.
		
		<u>Determination of Affordability of Rental Housing Units</u>
		For these purposes, the affordability of rental housing units contained in an eligible multifamily mortgage loan shall be determined at the time of loan commitment by using—
		• The most recent rent roll for an occupied property; or
		• In the case of rental housing units that are newly constructed or substantially rehabilitated, a final *pro-forma* rent roll.
		
		<u>Determination of Compliance</u>
		• The FMIC shall determine, during each calendar year, whether each approved multifamily guarantor has complied with the affordability requirement.
		• The FMIC may suspend or adjust the affordability requirement for an approved multifamily guarantor or guarantors—
		  ○ During a period of unusual and exigent market conditions in the multifamily housing market as determined pursuant to § 305; or
		  ○ Either—
		    ▪ Pursuant to information available to the FMIC		

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		demonstrating adverse market conditions in the multifamily housing market; or ▪ Pursuant to a written request to suspend or adjust the requirement made by an approved multifamily guarantor, which the FMIC may grant in whole or in part. • The FMIC may suspend or adjust the affordability requirement only if— o Market and economic conditions require such an action; or o Efforts to meet the requirement would result in— ▪ The constraint of liquidity in certain market segments; ▪ Over-investment in certain market segments; or ▪ Other consequences contrary to the intent of this section. The FMIC shall narrowly tailor any such suspension or adjustment to address the market conditions that prompted the suspension or adjustment. • The FMIC shall, promptly upon a decision to pursue a suspension or adjustment or upon receipt of a suspension or adjustment request, seek public comment for a period of 30 days. The FMIC shall make a determination regarding any proposed suspension or		

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		adjustment within 30 days after the public comment period. The FMIC may extend the determination period for a single additional 15-day period, but only if the FMIC requests additional information from the regulated entity or approved multifamily guarantor. • The FMIC shall review any suspension or adjustment at least annually to determine whether it satisfies the suspension or adjustment criteria. • The FMIC shall not less than annually, publish a list of all suspensions and adjustments, and seek public comment as to the continued necessity of such suspensions or adjustments. <u>Mixed Income Liquidity Study and Review</u> • Not later than 2 years after enactment, and periodically or as market conditions warrant thereafter, the FMIC shall conduct a study of liquidity in the market for financing the new construction or substantial rehabilitation of mixed-income properties containing multifamily units that— o Otherwise qualify under the affordability requirement under § 704(a); and o Are financed by tax-exempt bonds that are issued by a State or local housing finance agency.		

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		• The FMIC may adjust the affordability requirement under § 704(a), subject to the procedures provided under § 704(d)(2) through (5) for suspension or adjustment, if the FMIC finds based on a such study that— ○ Liquidity is constrained in the market for eligible multifamily mortgage loans for such mixed-income properties; and ○ It is necessary to foster liquidity in that market. <u>Rule of Construction</u> Nothing in this section shall be construed to authorize the FMIC to require an approved multifamily guarantor to exceed the 60% requirement of § 704(a). <u>Definitions; Applicability to GSEs</u> In this section— • *Approved multifamily guarantor* includes an enterprise or any multifamily subsidiary established pursuant to § 701; • *Multifamily covered security* includes a multifamily MBS guaranteed by a GSE or any multifamily subsidiary established pursuant to § 701; and • *Eligible multifamily mortgage loan* includes a multifamily mortgage loan collateralizing a security guaranteed by a GSE or any multifamily subsidiary		

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		established pursuant to § 701.		
Small Multifamily Properties		**§ 705 Establishment of Small Multifamily Property Program** <u>Pilot Program</u> The FMIC shall establish at least 1 pilot program, to be administered by the Office of Multifamily Housing, in consultation with the Office of Consumer and Market Access, to test and assess methods or products designed to increase secondary mortgage market access for multifamily properties comprised of not more than 50 units or with mortgages not exceeding $3 million (adjusted for inflation). <u>Activities</u> In administering the pilot program, the FMIC shall— • Review, and may approve, proposals from regulated entities or approved multifamily guarantors, including proposals focused on lending by small business lenders, to participate in the pilot program by carrying out activities to decrease barriers to secondary mortgage market access for multifamily properties comprised of not more than 50 units or with mortgages not exceeding $3 million (adjusted for inflation) through new risk-sharing, partnerships, or other mechanisms or incentives; and • Establish requirements governing the activities of the pilot program, including		

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		requirements with respect to— o Any mid-course alterations of activities permitted under the pilot program, information sharing, reporting, and evaluation of the results of a pilot program; and o The tracking of any allocations of amounts from the Market Access Fund. <u>Use of Market Access Fund</u> A regulated entity or approved multifamily guarantor that submits a proposal may request, as part of the proposal, allocations from the Market Access Fund as necessary to support its proposed activities. <u>Amendments to Pilot Program</u> The FMIC may amend such a pilot program as needed to accommodate the multifamily mortgage market. <u>Publication</u> The FMIC shall make publicly available the results of such a pilot program. <u>Requirement</u> The FMIC shall consider the results of such a pilot program for purposes of expanding and implementing new mechanisms to decrease barriers to secondary mortgage market access for multifamily properties comprised of not more than 50 units or with mortgages not		

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		exceeding $3 million (adjusted for inflation). Limitation on Funding The FMIC may not use funds from the MIF to fund any pilot program activities conducted by a regulated entity or approved multifamily guarantor under this section.		
Multifamily Housing Study		**§ 706 Multifamily Housing Study** The Office of Multifamily Housing established shall conduct a study on the expansion of the FHLBs Acquired Member Assets programs to eligible multifamily mortgage loans.		
Multifamily Housing Platform		**§ 707 Multifamily Platform Study** In General Not later than 18 months after the system certification date, the FMIC shall conduct a study on the need, feasibility, costs, and merits of creating a cooperatively-owned, nonprofit multifamily issuance platform to securitize eligible multifamily mortgage loans. Content of Study The study shall address— • Competition between existing approved multifamily guarantors; • The barriers to entry for new multifamily guarantors; • The costs associated with developing a new platform; • The funding of smaller-balance multifamily mortgage loans, including	**§ 604 Establishment of Multifamily Platform** In General The Issuer shall establish a separate group or entity within the Issuer to be known as the Multifamily Platform. Purposes The purpose of the Multifamily Platform is to— • Foster liquid, efficient, competitive, and resilient national multifamily housing finance markets; • Purchase, pool, and securitize eligible multifamily mortgages from approved multifamily lenders, and otherwise facilitate the issuance of covered multifamily securities; • Ensure equitable access to the secondary	

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		mortgage loans originated by credit unions and community and mid-size banks and other small-volume lenders in rural and other underserved communities; • Standardized definitions and reporting and payment requirements; • Stability in the multifamily lending market in times of stress; and • Such other information as the FMIC determines appropriate to further the purpose of the study. <u>Consideration</u> In conducting the study, the FMIC shall consider whether any identified need to establish a multifamily securitization platform can and will be met by the Platform established under § 321, or any subsidiary or affiliate thereof. <u>Report To Congress</u> Not later than 18 months after the system certification date, the FMIC shall submit the study to the Senate Banking and House Financial Services Committees.	mortgage market for all markets, including rural and underserved markets; • Facilitate credit loss mitigation on eligible multifamily mortgages; • Collect a g-fee in connection with any guarantee of timely payment of principal and interest on covered multifamily securities under this title; and • Provide a stable source of liquidity for the national multifamily housing markets in severe market downturns. <u>Authorized Activities</u> The Multifamily Platform is authorized to— • Purchase, service, sell, lend on the security of, and otherwise deal in eligible multifamily mortgages and covered multifamily securities, pursuant to commitments or otherwise; • Purchase insurance on a covered multifamily security from the NMFA under § 611; • Purchase, sell, receive, hold, and use real and personal property, and other assets necessary for the conduct of its operations; • Create, accept, execute, and otherwise administer in all respects such trusts as may be necessary to conduct the business of the Multifamily Platform; • Through the Issuer, issue covered multifamily securities; and	

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			• Perform all other functions and services as are necessary or incidental to the proper conduct of its business under this Act. <u>Authority to Delegate Certain Functions to Members</u> The Multifamily Platform may, in accordance with regulations promulgated by the NMFA, delegate underwriting and servicing functions that the Multifamily Platform is authorized to perform under this title, to approved multifamily lenders. <u>Multiple Forms of Loss-Sharing Deals Required to be Completed Each Year</u> The NMFA may require the Multifamily Platform to issue minimum amount, as determined by the NMFA, of covered multifamily securities each year which satisfy the minimum loss-sharing requirement under § 611(b). <u>Affordability</u> In any year, to the maximum extent practicable, at least 60% of the total dwelling units financed by mortgages purchased by the Multifamily Platform must be affordable to households earning not in excess of 80% of area median income, with adjustments for smaller and larger households as determined by the NMFA. The NMFA shall promulgate regulations to implement the requirements of	

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			this section. **§ 605 Transition** In General In accordance with the transition schedule established below, the NMFA shall transfer the appropriate functions, activities, infrastructure, property, including intellectual property, platforms, or any other object or service of a GSE relating to the multifamily guarantee business of a GSE, to the Multifamily Platform. Transition Schedule Not later than 12 months after the date of enactment of this Act, the NMFA shall develop and publish a schedule for transferring the systems, personnel, and assets of the GSEs' multifamily businesses to the Multifamily Platform. In developing the transition schedule, the NMFA shall seek, to the maximum extent possible, to minimize disruptions to the multifamily housing finance markets, and to preserve the going concern value of the GSEs' multifamily businesses. The transition schedule developed under this subsection shall establish a Multifamily Platform certification date. Initial Capitalization Amount Not later than 15 months after the date of enactment, the NMFA shall publish an Initial Capitalization Amount, which shall represent	

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			the capitalization that the NMFA determines the portion of the Issuer or such separate entity as the Issuer shall establish relating to the Multifamily Platform will require to begin operations, in accordance with the transition schedule, on the Multifamily Platform certification date. <u>Initial Capitalization Fund</u> Not later than 3 months after the NMFA publishes the Initial Capitalization Amount, the NMFA shall establish a segregated fund, to be known as the Initial Capitalization Fund. Beginning in the next calendar quarter after the Initial Capitalization Fund is established, the NMFA shall direct the GSEs to set aside and transfer, on a quarterly basis, the total net income attributable to each GSE's multifamily business to the Initial Capitalization Fund, until the GSEs have collectively transferred to the Initial Capitalization Fund an amount equal to the Initial Capitalization Amount. On the Multifamily Platform certification date, the NMFA shall transfer the funds held in the Initial Capitalization Fund to the Issuer. **§ 606 Membership** <u>Eligibility</u> Eligibility to participate as a member in the Multifamily Platform shall be limited to insured depository institutions and non-depository mortgage originators that— • Are, on the Multifamily Platform	

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			certification date, eligible to participate in either Freddie Mac's Program Plus Lender Program or Fannie Mae's Delegated Underwriting and Servicing Lender Program; or • Meet the standards established by the NMFA below. Standards for Approved Multifamily Lenders The NMFA shall develop, adopt, and publish standards for the approval by the Multifamily Platform of lenders to participate as members of the Multifamily Platform, which shall include standards with respect to— • The underwriting practices, procedures, and controls of the lender; • The financial history and condition of the lender; • The lender's ability to originate loans in different geographical markets, as well as the lender's ability to originate small multifamily loans; • The general character and fitness of the lender's management; and • Any other standard the NMFA determines necessary or appropriate. Review, Suspension or Revocation of Approved Status • The Issuer, or the NMFA, shall have the authority to review the status of any approved multifamily lender.	

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			• If the Issuer or the NMFA determines, in such a review, that an approved multifamily lender no longer meets the standards for approval, the NMFA may suspend or revoke the approved status of such lender. • The suspension or revocation of an approved multifamily lender's approved status shall have no effect on the status of any covered multifamily security. • An approved multifamily lender may appeal a decision of the Issuer or NMFA suspending or revoking the approved status of such servicer. <u>Nationwide Network of Multifamily Mortgage Lenders; Small Multifamily Mortgage Loans</u> The Multifamily Platform shall, to the maximum extent practicable, ensure that its membership provides the Multifamily Platform with access to a broad, nationwide network of multifamily mortgage lenders, which shall include a substantial number of approved multifamily lenders that— • Predominantly originate multifamily mortgage loans with a maximum original principal obligation amount that does not exceed \$3 million, or \$5 million in an area that is subject to a high cost area mortgage limit under title II of the National Housing Act (12 U.S.C. 1707 et seq.); or	

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			• Make a significant volume of such loans, as determined by the NMFA.
			
			§ 607 Governance of Multifamily Platform
			Board of Directors
			The management of the Multifamily Platform shall be vested in the board of directors of the Issuer, which shall include directors that represent Multifamily Platform members, as determined by the NMFA.
			
			Advisory Board
			There is established an Advisory Board for the Multifamily Platform, which shall be comprised of—
			• Members elected by the approved multifamily lenders, and who shall comprise at least the majority of the members of the Advisory Board; and
			• Independent members, appointed by the NMFA, who shall comprise not fewer than 1/5 of the members of the Advisory Board, of which—
			  o Not less than one member shall have professional or academic experience in low-income or very low-income multifamily housing;
			  o Not less than one member shall have professional or academic experience in rural multifamily housing; and
			  o Not less than one member shall have professional or academic experience	

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			in the financing of small multifamily housing loans. <u>No Preferences for Size</u> Approved multifamily lenders shall have equal voting rights on Advisory Board members and Issuer board members that represent the Multifamily Platform, regardless of the size of the individual approved multifamily lender. <u>Impartial Administration</u> The board of directors of the Issuer shall administer the affairs of the Multifamily Platform fairly and impartially and without discrimination. **§ 608 Capitalization; Funding** <u>Capital Structure Plan</u> Not later than 2 years after enactment, the NMFA shall, by regulation, establish a capital structure plan for the Multifamily Platform, which shall include— • A requirement that each member maintain a minimum capital contribution to the Multifamily Platform, the amount of which shall be determined by the NMFA, taking into account the minimum capital requirements under subsection (b); • A requirement that each member contribute an amount of capital to the Multifamily Platform based on either—	

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			◦ The volume of eligible multifamily mortgages that such member sells or submits for a guarantee through to the Multifamily Platform; or ◦ The percentage of the unpaid principal balance of the Multifamily Platform's total new business purchases for which the member is responsible; and • A requirement that each member maintain a minimum capital contribution to the Multifamily Platform. <u>Minimum Capital Requirements</u> The NMFA shall, by regulation, establish risk-based capital requirements for the Multifamily Platform that ensure that the Multifamily Platform operates in a safe and sound manner, and maintains sufficient capital and reserves to support the operations of the Multifamily Platform during severe market downturns, as defined in § 611(c). <u>Authority to Establish Membership Fees</u> The Issuer shall have the authority to establish, charge, and collect fees, and in its discretion increase or decrease such fees, on members of the Multifamily Platform, in order to cover the costs of the continued operation of the Multifamily Platform. **§ 609 Oversight of Multifamily Platform** <u>Deputy Director</u>	

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			There is established within the NMFA the position of Deputy Director, who shall—
			• Be responsible for the Division of Multifamily Lending;
			• Be designated by the Director of NMFA; and
			• Have a demonstrated understanding of financial management or oversight, and have a demonstrated understanding of the multifamily housing finance system.
			
			<u>Prudential Supervision of Multifamily Platform</u>
			The NMFA shall establish, by regulation or guideline, prudential standards for the Multifamily Platform relating to—
			• The safe and sound operation of the Multifamily Platform, including—
			  o Risk-based capital requirements;
			  o Management of the Multifamily Platform's risk exposures, including market, credit, interest rate, liquidity, and operational risk exposures; and
			  o Adequate and well-tested disaster recovery and business resumption plans for all major systems;
			• Minimum underwriting criteria for eligible multifamily mortgages, which may include criteria based on—
			  o The LTV of a multifamily mortgage; and
			  o The applicable debt service coverage	

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			ratio of a multifamily mortgage; • The adequacy and independence of internal controls, including processes and policies to identify, monitor, and control credit and counterparty risk, including concentrations of counterparty risk; • The adequacy and maintenance of liquidity reserves, which shall include a requirement that the Multifamily Platform maintain an adequate reserve of unencumbered, high quality liquid assets, which reserve shall be sufficient to support— o The Multifamily Platform's portfolio investments in eligible multifamily mortgages and covered multifamily securities; and o The continued operation of the Multifamily Platform in the event that the NMFA orders a recapitalization of the Multifamily Platform; • Procedures for recapitalization, including the exercise of the right to require additional capital from approved multifamily lenders; • Investments and acquisitions of assets by the Multifamily Platform; and • Maintenance of adequate records. <u>Reports by and Examinations of Multifamily Platform</u>	

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			• The NMFA may require, by general or specific orders, the Multifamily Platform to submit reports, including financial statements, to keep the NMFA informed as to—
			  o The condition (including financial condition), management, activities, or operations of the Multifamily Platform, any approved multifamily lender, approved servicer, or any other regulated entity, as the NMFA considers appropriate; and
			  o Compliance by the Multifamily Platform, any approved multifamily lender, approved servicer, or any other regulated entity, with the requirements of this title.
			• The NMFA may also require, by general or specific orders, the Multifamily Platform, any approved multifamily lender, approved servicer, or any other regulated entity, to submit special reports on any of such report topics or any other relevant topics, if, in the judgment of the NMFA, such reports are necessary to carry out the purposes of this title.
			• The NMFA may conduct examinations of the Multifamily Platform or any subsidiary whenever the NMFA determines that an examination is necessary or appropriate, to keep the NMFA informed as to—	

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			◦ The nature of the operations and financial condition of the Multifamily Platform or any subsidiary; ◦ The financial, operational, and other risks of the Multifamily Platform that may disrupt the liquid, efficient, competitive, and resilient national multifamily housing finance markets; and ◦ Compliance by the Multifamily Platform with the requirements of this title. <u>Delegated Functions</u> • When the Multifamily Platform delegates to an approved multifamily lender the performance of any functions or services authorized to be performed by the Multifamily Platform under this title— ◦ Such performance shall be subject to regulation and examination by the NMFA to the same extent as if such services were being performed by the Multifamily Platform; and ◦ The Multifamily Platform shall promptly notify the NMFA of such delegation of functions or services to an approved multifamily lender. • The NMFA is authorized to issue such regulations and orders as may be necessary to enable the NMFA to	

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			administer and to carry out the purposes of this section and to prevent evasions thereof. <u>Authority to Require Recapitalization</u> If the NMFA determines that the Multifamily Platform is in danger of depleting the capital dedicated to the Multifamily Platform due to defaults on multifamily lending, the NMFA shall order the Multifamily Platform to submit a plan for rebuilding the capital dedicated to multifamily lending. <u>Responsibility to Ensure Broad Market Access</u> The NMFA shall develop and enforce standards which ensure that the Multifamily Platform is serving, to the maximum extent practicable and consistent with the safe and sound operation of the Multifamily Platform, broad market access, consistent with section 215, including access for underserved markets, including public, federally assisted, and tax credit funded housing, and rural areas. In developing and enforcing such standards, the NMFA may not impose on the Multifamily Platform numerical quotas of specific multifamily mortgage originations. <u>Limitations on Portfolio of Multifamily Platform</u> Subject to § 214, the NMFA shall establish limitations on the Multifamily Platform's	

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			ability to hold eligible multifamily mortgages and covered multifamily securities on its balance sheet, which shall take into account the need for the Multifamily Platform to— • Aggregate eligible multifamily mortgages to be securitized in a covered multifamily security; • Engage in appropriate credit loss mitigation with respect to an eligible multifamily mortgage that is collateralizing a covered multifamily security; • Facilitate a reasonably liquid and orderly market for covered multifamily securities; and • Facilitate transactions involving affordable housing and the introduction of new multifamily mortgage products.	
General Provisions	**§ 107 Limitation of GSE Mortgage Purchases to QMs** Each GSE charter is amended by adding: Effective for mortgages with application dates on or after January 10, 2014, the GSE may only purchase, make commitments to purchase, service, sell, lend on the security of, or otherwise deal in a mortgage that is a QM. **§ 108 Prohibition Relating to Eminent Domain** Each GSE charter is amended by adding: Notwithstanding any other provision of law,	**§ 609 GAO Report on Full Privatization of Secondary Mortgage Market** Not later than 8 years after enactment, GAO shall submit a report to the Senate Banking and House Financial Services Committees on the feasibility of transitioning to and creating a fully privatized secondary mortgage market, including recommendations on how to best carry out any displacement of the insurance model established under this Act, and an assessment of the cost of mortgage credit and the impact on the economy if the secondary mortgage market is fully privatized.	**§ 802 Accounting Method** In any evaluation, oversight, audit, or analysis by the NMFA of the cost of the MIF, the insurance or guarantee activities of the NMFA required under this Act, including any fee or charge in connection with the provision of such insurance guarantee, or the financial transactions of the NMFA, the NMFA shall conduct any such evaluation, oversight, audit, or analysis based on the Federal Credit Reform Act of 1990 (2 U.S.C. 661 et seq.). **§ 803 Rule of Construction**	**§ 601 Rule of Construction for Senior Preferred Stock Purchase Agreements** Nothing in this Act shall be construed to alter, supersede, or interfere with the final ruling of a court of competent jurisdiction with respect to any provision of the Senior Preferred Stock Purchase Agreement or amendments thereof of a GSE. **§ 602 Treatment of CDFIs** Effective on the certification date, FHLB Act § 10(a) (12 U.S.C. 1430(a)) is amended— • To add, as a permissible purpose for long-

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	the GSE may not purchase or guarantee any mortgage that is secured by a structure or dwelling unit that is located within a county that contains any structure or dwelling unit that secures or secured a residential mortgage loan which mortgage loan was obtained by the State during the preceding 120 months by exercise of the power of eminent domain. For these purposes: • *Residential mortgage loan* means a mortgage loan that is evidenced by a promissory note and secured by a mortgage, deed of trust, or other security instrument on a residential structure or a dwelling unit in a residential structure, including a first or subordinate mortgage loan. • *State* includes D.C., Puerto Rico, and any U.S. territory or possession, and includes any agency or political subdivision of a State. **§ 323 Liability for Misleading Statements** • Any person who shall make or cause to be made any statement in any application, report, or document filed with the Agency or Utility pursuant to any provisions of this subtitle, or any rule, regulation, or order thereunder, which statement was at the time and in light of the circumstances under which it was made false or misleading with respect to any material	Not later than 6 months after that report, the FMIC shall submit to the Senate Banking and House Financial Services Committees a description of the legislative, administrative, and regulatory actions necessary to implement the recommendations of the report. **§ 801 Rule of Construction** Nothing in this Act shall be construed to alter, supersede, or interfere with the final ruling of a court of competent jurisdiction with respect to any provision of a GSE's Senior Preferred Stock Purchase Agreement or amendments thereof. **§ 802 Severability** If any provision of this Act or the application of any provision of this Act to any person or circumstance, is held invalid, the application of such provision to other persons or circumstances, and the remainder of this Act, shall not be affected thereby. **§ 803 Loan Transfer Notice** <u>In General</u> • TILA § 131(g)(2) (definitions for notice of new creditor, owner, or assignee) is amended by adding: ○ *Securitized residential mortgage* means any residential mortgage loan that serves as collateral for a fixed-income or other security that allows the security holder to receive	Nothing in this Act shall be construed to prohibit or otherwise restrict the ability of a holder of any loss position in any covered security insured under this Act from restructuring, retranching, or resecuritizing such position. **§ 804 Severability** If any provision of this Act or the application of any provision of this Act to any person or circumstance, is held invalid, the application of such provision to other persons or circumstances, and the remainder of this Act, shall not be affected thereby.	term advances, funding CDFIs. • To permit advances to CDFIs to be collateralized by securities representing a whole interest in secured loans for small business, agriculture, or community development activities.

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	fact, or who shall omit to state any material fact required to be stated therein or necessary to make the statements therein not misleading, shall be liable to any person (not knowing that such statement was false or misleading or of such omission) who, in reliance upon such statement or omission, shall have purchased or sold a qualified security issued under the indenture to which such application, report, or document relates, for damages caused by such reliance, unless the person sued shall prove that such person acted in good faith and had no knowledge that such statement was false or misleading or of such omission. A person seeking to enforce such liability may sue at law or in equity in any court of competent jurisdiction. In any such suit the court may, in its discretion, require an undertaking for the payment of the costs of such suit and assess reasonable costs, including reasonable attorneys' fees, against either party litigant, having due regard for the merits and good faith of the suit or defense. No action shall be maintained to enforce any liability created under this section unless brought within one year after the discovery of the facts constituting the cause of action and within three years after such cause of action accrued. • The rights and remedies provided by this	payments dependent on the cash flow from the mortgage loans; ○ *Servicer* has the meaning in § 129A except that it includes a person who receives any payments from a mortgagor, including any amounts for escrow accounts, and makes payments to the owner or other third parties, including payments made after default, pursuant to the terms of the relevant contracts, and excludes State and local housing agencies. • RESPA § 5(c)(3) [meaning 6(c)(3)] (notice of mortgage servicing transfers) is amended to require transferee servicers to notify borrowers within 15 days of the transfer effective date: ○ The application of all payments and charges, including the date received, as allocated to principal, interest, escrow, and other charges; ○ The status of the loan as of the transfer date, including whether the loan is in default and whether any loss mitigation application the borrower submitted is pending; and ○ An itemization and explanation for all arrearages claimed to be due as of the transfer date. <u>Safe Harbor for Mistaken Payments; Fees</u> TILA § 131 is amended by adding: (g) *Treatment of Mistaken Loan Payments*		

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	part shall be in addition to any and all other rights and remedies that may exist under the Securities Act of 1933 or the Securities Exchange Act of 1934 or otherwise at law or in equity; but no person permitted to maintain a suit for damages under the provisions of this subtitle shall recover, through satisfaction of judgment in one or more actions, a total amount in excess of the person's actual damages on account of the act complained of. **§ 324 Unlawful Representations** It shall be unlawful for any person in offering, selling, or issuing any qualified security pursuant to this subtitle to represent or imply in any manner whatsoever that any action or failure to act by the Agency or Utility in the administration of this subtitle means that the Agency or Utility has in any way passed upon the merits of, or given approval to, any trustee, indenture, or security, or any transaction or transactions therein, or that any such action or failure to act with regard to any statement or report files or examined by the Agency or Utility pursuant to §§ 301 – 344 or any rule, regulation, or order thereunder, has the effect of a finding by the Agency or Utility that such statement or report is true and accurate on its face or that it is not false or misleading.	*After Transfer* During the 60-day period beginning on the effective date of transfer of the servicing of any securitized residential mortgage loan, a late fee may not be imposed on the consumer with respect to any payment on such loan, and no such payment may be treated as late for any other purpose, if the payment is received by the transferor servicer (rather than the transferee servicer who should properly receive payment) on or before the applicable due date, including any grace period allowed under the loan documents. (h) *Fee Waive upon Transfer* (1) In General. The creditor, new owner, or assignee of the mortgage loan, by itself or through its servicer, may not impose or collect— (A) Any fee that is not listed as having been incurred in the notice to the consumer of the transfer of servicing of a securitized residential mortgage loan; or (B) Any fee incurred prior to the effective date of servicing transfer that is not disclosed on a periodic statement provided to the consumer prior to the effective date of servicing transfer of a securitized residential mortgage loan. (2) Definitions. For purposes of this subsection: • *Securitized residential mortgage* means any residential mortgage loan that serves as collateral for a fixed-income or other		

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	§ 325 Contrary Stipulations Void Any condition, stipulation, or provision binding any person to waive compliance with any provision of §§ 301 – 344 or with any rule, regulation, or order thereunder shall be void. **§ 341 Conforming Amendment to FHLB Act** Section 11 of the FHLB Act (12 U.S.C. 1431) is amended by adding authority for the FHLBs to aggregate for securitization through the common securitization platform residential mortgage loans originated by any member of the FHLB, pursuant to regulations issued by the Director. **§ 342 Conforming Amendments to Dodd-Frank** Section 803(8)(A) of the Dodd-Frank Act (12 U.S.C. 5462(8)(A)) is amended to define FHFA as the "Supervisory Agency" with respect to a designated financial market utility that is subject to FHFA's exclusive supervision. **§ 343 Conforming Amendments to Securities Act of 1933** • Section 3(a) of the Securities Act of 1933 (15 U.S.C. 77c(a)) is amended to define as exempt any qualified security, as defined in § 321.	security that allows the security holder to receive payments dependent on the cash flow from the mortgage loan; and • *Servicer* has the meaning in § 129A except that it includes a person who receives any payments from a mortgagor, including any amounts for escrow accounts, and makes payments to the owner or other third parties, including payments made after default, pursuant to the terms of the relevant contracts, and excludes State and local housing agencies. **§ 804 Determination of Budgetary Effects** The budgetary effects of this Act, for the purpose of complying with the Statutory Pay-As-You-Go Act of 2010, shall be determined by reference to the latest statement titled "Budgetary Effects of PAYGO Legislation" for this Act, submitted for printing in the Congressional Record by the Chairman of the Senate Budget Committee, provided that such statement has been submitted prior to the vote on passage. **§ 805 Investment Authority to Support Rural Infrastructure** The following is added to the FHLB Act § 11: In furtherance of its mission under § 5, each FHLB is authorized to purchase investment grade securities from nonmember cooperative lenders that have received financing from the		

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	• Section 27B of the Securities Act of 1933 (15 U.S.C. 77z–2a) is amended by striking subsection (d). [The section, Dodd-Frank § 621(b), prohibits ABS underwriters, placement agents, initial purchasers, sponsors, or their affiliates, within one year of the first sale of the ABS, from having conflicts of interest with investors. Its subsection (d) provides that the section does not limit the application of the Dodd-Frank risk retention requirement.] **§ 344 Conforming Amendments to Title 18** • Section 709 is amended by adding: Whoever uses the words "National Mortgage Data Repository" or such other name as the FHFA Director may establish in the charter of the repository or any combination of words that appears to indicate that such use of the term conflicts with the exclusive operation of the repository created by §§ 331 – 335 of the National Mortgage Market Utility Act of 2013 as a business name or any part of a business name, or falsely publishes, advertises, or represents by any device or symbol or other means reasonably calculated to convey the impression that he or it is the repository created by §§ 331 – 335. • There is a new § 1041:	Federal Financing Bank and that possess demonstrated experience in making loans to rural cooperatives. Such securities shall be secured investments collateralized by loans of the cooperative lender. The purchase of such securities shall be at the sole discretion of the FHLB, consistent with any Board regulations, restrictions, and limitations. **§ 806 Consolidation of Similar Housing Assistance Programs** <u>Report</u> Within two years of enactment, the FMIC, HUD, Treasury, Agriculture, VA, Labor, and Interior shall jointly submit to Congress, and post online, a report to: • Identify and evaluate, based on need and appropriateness, specific opportunities to consolidate similar housing assistance programs, which may include the programs identified in the August 2013 GAO report; • Provide recommendations for legislative action to appropriately streamline, consolidate, or eliminate similar housing assistance programs; and • Identify opportunities for cross-agency collaboration of housing assistance efforts. <u>Use of Administrative Authority</u> • OMB shall coordinate with HUD,		

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	Whoever, with regard to any mortgage-related document (as defined in § 303 of the National Mortgage Market Utility Act of 2013) or the registration of any document or any interest in any such document pursuant to that Act, makes any false statement or representation of fact, knowing it to be false, or knowingly conceals, covers up or fails to disclose any material fact the disclosure of which is required by such Act or regulation, shall be fined under this title, or imprisoned not more than five years, or both.	Treasury, Agriculture, VA, Labor, and Interior to consider and evaluate opportunities to eliminate, consolidate, or streamline housing assistance programs. • OMB, in coordination with HUD, Treasury, Agriculture, VA, Labor, and Interior, shall eliminate, consolidate, or streamline any identified programs they find appropriate. • Any administrative cost savings resulting from such consolidation, elimination, or streamlining shall be transferred 50% to the Housing Trust Fund and 50% to the Treasury's general fund for deficit reduction. • OMB shall report to Congress annually any actions taken to streamline similar housing assistance programs, and the resulting cost savings. • Nothing in this section shall be construed to grant OMB, HUD, Treasury, Agriculture, VA, Labor, or Interior any additional authority to eliminate, consolidate, or streamline housing assistance programs that they did not have before enactment of this Act. **§ 807 CFPB Review; GAO Report** <u>CFPB Review</u> • Within 3 months of enactment, the CFPB shall, after reviewing relevant data and consulting with stakeholders, including		

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		representatives of the manufactured housing industry and of consumers and homeowners, consider and review the application of TILA § 103(bb) and (cc) (high-cost mortgage definition and mortgage originator definitions) to manufactured housing loans, including: o The APR coverage test for high-cost mortgages; o The total points and fees coverage test for high-cost mortgages; and o The definition of mortgage originator. • The CFPB shall not be required to conduct the review if it does not receive relevant data that was not submitted by January 31, 2013. • This shall not be construed to require the CFPB to engage in rulemaking, including rulemaking to modify any rule related to § 103(bb) or (cc). • Within 10 months of enactment, GAO shall report to Congress on the manufactured housing loan market, which shall analyze: o The loan products available in such market and the performance of those products, and shall include a review of the underwriting standards and portfolios of creditors that originate manufactured housing loans, such as depository institutions and finance		

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		companies; o The characteristics of borrowers that participate in the manufactured housing loan market, including: ▪ The borrower's creditworthiness; ▪ The borrower's usage pattern; and ▪ The process for evaluating and comparing loan products prior to purchase; and o The potential impact on access to mortgage credit for manufactured housing loans if § 103(bb) and (cc) were applied to manufactured housing loans, including: ▪ The APR coverage test for high-cost mortgages; ▪ The total points and fees coverage test for high-cost mortgages; and ▪ The definition of mortgage originator. ▪ Delinquency and default in the manufactured housing loan market; and ▪ Competition in the manufactured housing loan market.		

Reforming the U.S. Housing Finance System

An Evaluation of the Prospects for Reforming
Fannie Mae and Freddie Mac

September 7, 2010

(Third Edition)

Introduction

Reforming Fannie Mae and Freddie Mac is a significant element of the administration's broader reform efforts to reengineer the U.S. housing finance system, which comprises more than 15% of the country's gross domestic product. The administration's reform proposals will likely touch on a broad number of participants in the housing system, ranging from Fannie Mae, Freddie Mac, the Federal Housing Administration (FHA), Ginnie Mae, the Federal Home Loan Bank (FHLB) System, the Rural Housing System (RHS), and Community Development Financial Institutions (CDFIs), to the housing processes and systems, which drive the mortgage origination, underwriting, securitization and after-market support of mortgages.

Background

The Housing System Landscape

Fannie Mae and Freddie Mac

Together, Fannie Mae and Freddie Mac have lost $224.7 billion since the onset of the financial crisis, which has triggered the injection of more than $150.3 billion of taxpayer funds to preserve the enterprises' solvency. The Congressional Budget Office projects that the taxpayers' losses on the GSEs will ultimately exceed $380 billion, making this the largest federal bailout ever. Other analysts suggest the losses on Fannie Mae and Freddie Mac could approach $1 trillion, if default and foreclosure rates remain high and property values continue to fall. These estimates vary largely because of the three different kinds of losses generated by the enterprises, including those (i) linked to the GSEs' $5 trillion of mortgage-backed securities (MBS) and loan guarantees; (ii) resulting from regular, ongoing operations in a declining housing market; and (iii) related to the GSEs' operating as de facto government agencies, subsidizing foreclosure-prevention efforts.

The GSEs' losses are destined to increase, as the enterprises dispose of growing levels of real estate owned. Fannie Mae's and Freddie Mac's losses on real estate owned (REO) are exacerbated by their geographic concentration in the hardest hit markets in the economic downturn—specifically Arizona, California, Florida, and Nevada. More than 42% of Freddie Mac's REO portfolio consists of properties in these four states, with a heavy concentration in California (20%). Similarly, Fannie Mae's REO portfolio is heavily concentrated in these four states (32.4%), with 12.9% of their portfolio located in California.

	Fannie Mae	Freddie Mac
Non-performing Assets on 06/30/10	$217.2 billion	$118.7 billion
% Total mortgage loans	7.29%	6.30%
Serious Delinquencies on 6/30/10		
Single-Family Mortgages	4.99%	3.96%
Multi-Family Mortgages	0.80%	0.28%
Real Estate Owned on 06/30/10		
Number of properties	129,310	62,190
Carrying value of REO	$13.0 billion	$11.3 billion
Disposal severity ratio	34.3%	38.0%
Fair Market Value on 6/30/10	($138.0 billion)	($46.3 billion)

Sources: Fannie Mae 2010 Second Quarter Credit Supplement, 08/06/10; Freddie Mac 2010 Second Quarter Financial Results Supplement, 08/09/10

Federal government agencies—Fannie Mae, Freddie Mac, and HUD—own in aggregate more than 46% of the nation's REO inventory, totaling 478,000 units, according to a June analysis by Radar Logic, prior to the release of second quarter results. In an analysis of mortgage delinquencies, Radar Logic projects the government's REO holdings may ultimately exceed 3.0 million units, as serious mortgage delinquencies (5 million homeowners) and 30 to 90 day delinquencies (2.3 million homeowners) move through the resolution process (and assuming a 35% cure rate). Zillow estimates that the federal government's losses on the foreclosure pipeline could exceed $300 billion, which would be borne by Fannie Mae, Freddie Mac, and FHA, unless commercial banks are compelled to take the losses through forced loan buybacks.

The U.S. Government's Potential REO Inventory	
30-90 Days Delinquent	1,032,000
90 Days Delinquent or in Foreclosure Process	1,820,000
REO	219,000
Total	3,071,000
Average Loan Value	$200,000
Total Loan Value of REO and Foreclosure Pipeline	$614 Billion
Average Discount in REO Sale Price Relative to Loan Value	40%
Loss to Tax Payer from REO Sales	$246 Billion
Short Sales (25% of Foreclosure Pipeline)	1,097,000
Total Loan Value of Homes Sold in Short Sales	$219 Billion
Average Discount in Short Sale Price Relative to Loan Value	40%
Loss to Tax Payer from Short Sales	$88 Billion
Total Losses to Taxpayer From Short and REO Sales	$333 Billion

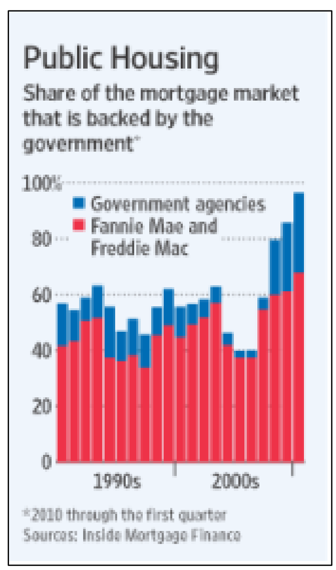
Although loan servicers and the GSEs have expended great efforts to help mitigate foreclosures through the Home Affordable Modification Program and Home Affordable Refinance Programs, only 341,000 permanent loan modifications have been completed with an additional 468,000 active trial modifications pending. According to Fannie Mae's March 31st disclosure, the re-default rate for the company's modified loans averaged 54%, six months after modification. As a result of loan modification efforts, the average time it takes for a homeowner who defaults on their mortgage to lose their property to foreclosure has increased 75%—from 251 days in January 2008 to 438 days in April 2010—further increasing the GSEs' losses on foreclosures, which averaged 44% (of the unpaid principal balance of REO properties sold) and 39% for Fannie and Freddie, respectively in the first quarter of 2010.

According to Zillow, the current median US home price is $204,900 is down 6.82% year-over-year on March 31st, while 23.3% of borrowers were underwater. The Zillow survey identifies 12 metro-markets in which 50% of area homeowners are underwater with heavy concentrations in California (5 metro markets), Florida (3), Nevada (2) and Arizona (1). Barring some unforeseen exogenous boost to housing, the price stability in the single-family real estate market will likely come to an end during the second half of 2010, as the unprecedented number of homes go into default and move through the foreclosure process.

FHA

Since 2006, FHA has expanded dramatically its presence in the mortgage market, increasing its originations from 3% to 30% of all mortgages in the first quarter of 2010. For the first time ever, FHA's mortgage originations in the first quarter, totaling $52.5 billion of home-purchase mortgages, exceeded that of Fannie and Freddie combined by more than 14%. FHA Commissioner David Stevens noted, "This is a market purely on life support, sustained by the federal government. Having FHA do this much volume is a sign of a very sick system."

On March 31, FHA insured nearly 6.2 million loans totaling $820 billion—of which 8.8% (536,858 loans) were severely delinquent and 12.23% were delinquent 30 days or more. Assuming the average FHA-insured loan balance of $132,300, FHA delinquent loan balances were an estimated $71.0 billion on March 31, 2010.



Federal Home Loan Banks

For nearly 80 years, the 12 FHLBs have served as a part of the U.S. housing finance infrastructure, providing a primary source of funding for its members. On June 30, these government-sponsored entities reported total assets of $937 billion and advances to members of $540 billion (collateralized largely by loan assets). In addition, the FHLB System has 7% of its assets ($67 billion) invested in mortgages that it acquired from member institutions. Approximately 80% of U.S. lending institutions relies on the FHLBs as a source of liquidity.

Over the past 20 years, the FHLB System has provided $3.7 billion of affordable housing grants to provide housing opportunities to underserved communities. For every $1 million that a FHLB lends, $14.3 million of additional housing units are built or rehabilitated, 158 jobs are created, and $24.6 million of general economic development is generated, wrote FHLB-Atlanta interim president Jill Spencer, in a comment letter to Treasury on reforming the housing finance system.

Challenges to Housing Reform

Market Dominance of GSEs

Complicating the policy options for reforming Fannie Mae and Freddie Mac is the mortgage market's heavy reliance on explicit government support of mortgages through the housing GSEs. Collectively, Fannie Mae, Freddie Mac, and FHA backed 96.5% of home mortgage originations during the first quarter of 2010, up from 90% a year ago. (The remaining non-government part of the origination market consisted of banks' portfolio lending, consisting largely of jumbo mortgages.) In aggregate, Fannie Mae and Freddie Mac's combined balance sheets of $1.6 trillion and mortgage guarantees comprise 53% of all outstanding U.S. mortgage debt today. Moreover, FHA's $820 billion of insured mortgages expands the government's mortgage guarantee to nearly 68% of all outstanding mortgages. Together, Fannie Mae, Freddie Mac, and FHA have become the mortgage industry's wastebasket for toxic mortgage debt. Simply put, the U.S. mortgage market would not function without the federal government's active involvement at this time.

Foreign Ownership of GSE debt and MBS

Foreign ownership of GSE debt and mortgage securities—not to mention that of the Federal Reserve Bank and Treasury—further complicate and likely limit the options for GSE reform. Prior to the 2008 financial crisis, Fannie Mae and Freddie Mac served as convenient off-budget tools for policymakers to subsidize housing through implicit guarantees of the GSEs. In September 2008, the government's implicit guarantee became explicit with the failure of Fannie Mae and Freddie Mac.

In his recently published memoir, former Treasury Secretary Henry Paulson recounted how Russian officials approached Chinese officials in the summer of 2008, suggesting that both countries sell large blocks of GSE debt as a means of forcing the U.S. to explicitly back the GSEs' issuances.

Although Paulson claimed that China opted not to collaborate with Russia, both countries reduced their investments in GSE debt by some $220 billion during the last six months of 2008 ($170 billion by Russia and $50 billion by China). This fire sale, in turn, drove spreads between agency debt and U.S. Treasury debt higher, which forced U.S. banks to quickly provide more collateral to support their borrowings in the repo market, as the value of their collateral (GSE debt) declined. This episode, which clearly illustrates the political risk that the U.S. government faces in its heavy dependence on foreign borrowing, also has implications on GSE reform. What policy options will the owners of agency debt determine are acceptable? When, if ever, will foreign investors accept implicit guarantees, when investing in U.S. mortgage products?

Impact of the Dodd-Frank Act

To address some of the excesses in the mortgage securitization market that contributed to the financial crisis, the Dodd-Frank Wall Street Reform and Consumer Protection Act attempts to remove incentives embedded in the "originate-to-distribute" securitization model by requiring MBS sponsors to retain 5% of credit risk inherent in the collateral assets. However, provisions in the bill carve out exemptions for assets issued or guaranteed by the U.S. government, any state, or agency—such as FHA, VA, and Farm Credit—which consist of qualified residential mortgage loans that conform to parameters to be established by regulation. (While Fannie Mae and Freddie Mac are not considered U.S. agencies, analysts expect the GSEs' conforming loans to be deemed qualified residential mortgages under the Dodd-Frank Act regulations that are to be written, and exempted from the 5% retention provision.) These "skin-in-the-game" provisions are expected to result in the predominance of "plain vanilla" mortgages, insured by FHA, Fannie Mae, and Freddie Mac, in the mortgage market, and further expand the role and dominance of these agencies, as the sole conduits for residential mortgage credit for the foreseeable future.

The Mortgage Interest Deduction

As Congress turns its attention to GSE reform, several other larger policy issues will take center stage—starting with housing subsidies and their impact on the federal budget. In a July 21st commentary, John E. Silvia, chief economist for Wells Fargo, wrote:

> "For some time, at least since the 1960s, public policy in the United States has been criticized as over-subsidizing housing relative to other forms of investment and saving by households and for society at large. For housing, there are special tax deductions and home improvement credits. In 1998, a special capital gains break was given to housing. Special lending agencies, the Government Sponsored Enterprises (GSEs), were set up, along with the Federal Housing Administration (FHA), to subsidize the secondary home mortgage market. Housing and housing credit has been mispriced so much and for so long that it is impossible to truly gauge the extent of the public subsidy of housing. What we do know is that there is very little true guidance of what housing is really worth, and therefore we remain very concerned that the scale of all public and private institutions that are committed to housing is a function of public subsidies as much as private demand. This is a risky proposition given the financial breakdown of the GSEs and the scale of federal debt today."

The country's growing budget deficits have triggered a policy debate over the cost of home mortgage interest deduction, which is expected to cost $637 billion over the five year period ending 2015, according to OMB. In addition, the exclusion of capital gains on primary residences is expected to cost $215 billion over the next five years with the deductibility of state and local property taxes for primary residences adding an additional $151 billion five-year cost to the federal government. Collectively, these subsidies will reduce federal revenue by over $1 trillion over a decade, representing more than 10% of the federal government's projected $9 trillion deficit. The administration's National Commission on Fiscal Responsibility and Reform will address this issue in its recommendations to Congress to address the country's fiscal challenges.

An indication of the Obama administration's position on the mortgage interest deduction is reflected in its 2010 budget, which proposed cutting the interest deduction for wealthy homeowners to generate a savings of $208 billion over a ten year period. According to the *Washington Post* reporter Zachary A. Goldfarb:

> "The administration's narrower view of who should own a home and what the government should to do to support them could have major implications for the economy as well as borrowers. Broadly, the administration may wind down some government backing for home loans, but increase the focus on affordable rentals."

Sustainability of Home Ownership

Congress will likely debate the sustainability of home ownership. Homeownership levels, which ranged from 63% to 65% from 1965 to 1995, peaked in late 2004 at 69% (entirely through debt financing). Federal Deposit Insurance Corporation (FDIC) Chairman Shelia Bair recently argued that homeownership levels were pushed to unsustainable levels during the housing boom and urged policymakers to revisit the unintended consequences of the nation's housing policy. If policymakers conclude that higher homeownership rates simply are not sustainable, then lawmakers may consider shifting subsidies from homeownership to the multifamily rental-housing sector.

The 30-Year Fixed-Rate Mortgage

As lawmakers consider GSE reform, both Democrat and Republican Members of Congress remain committed to the 30-year fixed-rate mortgage product. This mortgage product, argues former HUD economist Susan Woodward, is something Americans view "as a part of their civil rights." If so, the federal government's role in the mortgage market will remain, as federal subsidies are essential to preserving this mortgage product. No country—other than the U.S.—makes the 30-year fixed-rate mortgage product available to its citizens. Other related issues for policymakers to consider regarding the 30-year fixed-rate loan product include (i) who is targeted to receive the subsidy; (ii) the subsidy's cost; and (iii) how to deliver the subsidy efficiently and at no cost to the taxpayer.

TBA Market

Participants in the securitization market will urge policymakers to preserve the "To Be Announced" (TBA) trading market, which serves as the link between the primary and secondary markets and allows borrowers to lock rates for up to 90 days prior to closing (but exposes lenders to interest rate risk). Specifically, in the TBA market, lenders contract to sell loans that do not yet exist (the loans are to be announced) for securitization into a GSE MBS on a future, specified date up to 90 days before the loans settle. At the time of this trade, neither the eact pool, number of pools, or loans comprising the pool are known. Instead, the trade – in fact the entire market – is made possible only because of the fundamental assumption of the homogeneity and fungibility of the loans.

Importantly, the TBA market's homogeneity is made possible by (i) the conforming (Fannie Mae and Freddie Mac eligible) loan product, which is standardized with established and uniform underwriting guidelines and uniform loan documents; and (ii) the GSE guarantee, which equalizes the MBS in terms of credit risk. Market participants contend that any GSE "reform" which doefs not accommodate or provide a suitable replacement for the TBA market will undoubtedly reduce the mortgage originators' options to "rate lock" and likely increase mortgage costs to the end consumer.

Affordable Housing

The role and structure of the GSEs'—Fannie Mae, Freddie Mac, and the FHLBs—affordable housing goals will also be a contentious issue in the reform debate. Currently, 10% of the FHLBs' income is committed to an affordable housing fund that is then reinvested in affordable housing projects. The FHLB program is generally considered to be a success. Fannie Mae's and Freddie Mac's affordable housing goals are more complex and are set by their regulator annually. The GSE reform legislation passed in 2008 established an Affordable Housing Trust Fund and Capital Magnet Fund. While in conservatorship the GSEs' affordable housing commitments have been suspended, but the affordable housing issue will be a major point of contention, which will be debated along partisan lines in any reform effort. Republicans blame the affordable housing goals for "forcing" Fannie Mae and Freddie Mac to lower their underwriting standards and engage in funding risky loans, which they believe caused their massive losses.

Democrats and consumer advocates, who hotly contest this assertion, will work to ensure that the Affordable Housing Trust Fund survives in any final reform bill. Moreover, the Democrats will work to ensure that the reformed mortgage system generates fees dedicated to the Affordable Housing Trust Fund. Undoubtedly, the upcoming November elections will have an impact on the outcome of this issue. It is unclear, however, that the banking industry will engage on this issue, potentially opting instead to accept affordable housing as a cost of doing business, which will then be passed along to consumers.

Strengths and Weaknesses of the GSE Hybrid Model

Fannie Mae's and Freddie Mac's missions have been threefold: (i) facilitate the securitization of mortgages into MBS; (ii) stabilize and assist the secondary market for MBS; and (iii) support affordable housing, a responsibility assigned to the GSEs in the 1992 Federal Housing Enterprises Financial Safety and Soundness Act.

Historically, Fannie Mae and Freddie Mac have enjoyed a number of privileges under their federal charters and regulatory framework, including:

- Lower capital requirements than other financial institutions, which allowed the GSEs to maximize their use of leverage. (The 2008 GSE reform bill directed the regulator to eventually increase their capital requirements, but left the timing and level of capital that would eventually be required to the discretion of their regulator, the Federal Housing Finance Agecny (FHFA).

- Lower cost of capital, either through direct access to the Treasury, or in the debt markets, where the GSEs were perceived to have implied government backing. The GSEs' implied [and now explicit] federal guarantee of their debt allowed the GSEs to issue bonds whenever they needed for funds, regardless of market conditions, at interest rates lower than those granted to the best fully-private companies.

- Lower perceived level of risk borne by GSEs in the "eyes" of the market. With an explicit federal guarantee of GSE debt, investors did not judge Fannie Mae and Freddie Mac with the same risk standard that was applied to private companies, providing a benefit to both their debt and their stock. In turn, the GSEs' high leverage provided the enterprises exceptional returns on equity during prosperous times.

- Advantages in the capital market that gave the GSEs added operating flexibilities. Federal support allowed the GSEs to increase their financial flexibility by issuing callable long-term debt. The GSEs' debt securities were eligible for open-market transactions by the Federal Reserve Board, and for investment by insured banks and thrifts. The GSEs' debt securities were eligible for collateral for the federal government's deposits of tax revenues in banks.

- Favorable treatment of GSEs' MBS under Basel II. Historically, the GSEs' securities held by banks and thrifts required only a 20% risk weighting, as compared to the 50% risk weighting assigned to prudently underwritten private MBS under the Basel Accord. To date, no changes have been proposed to risk-weighting for agency MBS under Basel III.

- Line of credit with the Treasury. The Secretary of the Treasury is authorized to purchase up to $2.25 billion of their securities, effectively providing each GSE a $2.25 billion line of credit to the U.S. Treasury. The amount is not large, but the federal backing is unique.

- Exemption from state and local taxes.

- Exemption from filing with the SEC for purposes of the 1933 and 1934 Acts for debt offerings, saving both the expense of filing and the time needed to compile and write SEC disclosures. (The 2008 GSE reform bill repealed their exemption from the 1934 Act, but the exemption from 1933 Act remains.)

- Exclusive charters, which are a barrier to creation of new competitors and which ensure the GSEs' duopsony status cannot expire without direct Congressional action.

To evaluate GSE reform proposals, it is important to identify not only what changes need to be made to the enterprise models, but also what elements should be preserved. As government-sponsored entities that are publicly owned, the enterprises have successfully provided liquidity for the U.S. mortgage market, making possible the 30-year fixed-rate mortgage product. The GSEs implemented the standardization of the mortgage origination and of automated underwriting, created the credit scoring process, standardized the underwriting and securitization process, facilitated the TBA market, and established the standard for determining "acceptable" levels of credit risk. Fannie Mae and Freddie Mac have provided access to mortgage credit during economic downturns with the support of the Federal Reserve Board and Treasury. Prior to entering conservatorship, the GSEs were the largest players in the market for purchasing and securitizing multifamily loans, responsible for nearly one third of all multifamily debt, and they accounted for nearly 40% of the Low Income Housing Tax Credit projects across the country. The GSEs have also been large purchasers of state housing finance bonds; have partnered with non-profits to expand the secondary market for loans to low- and moderate-income buyers, and have made significant contributions to the low-income population, particularly in the metropolitan D.C. area, through their philanthropic activities.

The key disadvantage of the current GSE model is the moral hazard of the government's implicit guarantee of the enterprises. Specifically, the privately owned enterprises sought to expand their market share and profits through lower underwriting standards and distorted portfolio investments to maximize short-term profits. Ultimately, the taxpayers have borne the cost of the GSEs' moral hazard—$147.2 billion and growing. Some argue that the GSEs' implicit subsidy was not well-targeted to underserved borrowers, instead enriching select stakeholders, such as the GSEs' executives, GSE stockholders, realtors, and homebuilders. The GSEs' political power allowed the companies to avoid proper regulatory oversight, which permitted their rapid growth into "too big to fail" enterprises which resulted in cataclysmic losses.

In addition, despite the benefits that the GSEs brought to the mortgage market place, the GSEs, in their later years, stymied, rather than facilitated, advances in the mortgage system unless those advances specifically benefitted their bottom line.

On balance, the inherent weaknesses of the current GSE model to be addressed in reforming Fannie and Freddie include: (i) moral hazard arising from the government's implicit guarantee; (ii) concentration of risk, making the enterprises too big to fail (TBTF); (iii) the duopsony structure of Fannie and Freddie, which inhibited competition and innovation; (iv) inadequate capital; (v) weak regulatory oversight; (vi) lack of transparency of the loan underwriting process through the GSEs' automated underwriting system; (viii) GSEs' 37 broad patents, covering the loan underwriting process, automated underwriting systems, and cap-and-trade electronic systems, which have contributed to the enterprises' market dominance and have limited competition; and (vii) the enterprises' enormous political influence.

Fannie Mae and Freddie Mac Under Conservatorship

The GSE Agreements with Treasury

On September 6, 2008, Fannie Mae and Freddie Mac went into conservatorship and entered into agreements with Treasury (the Agreements) under which Treasury agreed to provide funding of up to $100 billion for each GSE, in exchange for dividends and other compensation to Treasury.[1]

On May 6, 2009, the Agreements were amended to increase amount of capital Treasury could supply, from $100 billion for each GSE to $200 billion for each.

On December 24, 2009, the Agreements were amended to remove the cap on possible Treasury funding. That cap now reads, for each GSE (emphasis added):

"Maximum Amount" means, as of any date of determination, the greater of (a) $200,000,000,000 (two hundred billion dollars), or (b) $200,000,000,000 plus the cumulative total of Deficiency Amounts determined for calendar quarters in calendar years 2010, 2011, and 2012, less any Surplus Amount determined as of December 31, 2012, and in the case of either (a) or (b), less the aggregate amount of funding under the Commitment prior to such date.[2]

The cap is $200 billion per GSE, or $400 billion in total, plus their Deficiency Amounts for 2010 through 2012, less amount of funding under Treasury's commitment, which began in 2008, through 2012. The amount Treasury funded under its commitment from inception through 2009 is $125 billion for both GSEs combined. While the amount of funding provided by Treasury for FY2010 through FY2012 is unknown, these funds are added to the cap and then backed out, so they may be ignored for this calculation.

The combined cap for both GSEs is $400 billion less $125 billion funded before 2010, for a total of $275 billion.[3] There is no sunset date by which Treasury must fund the GSEs. If a GSE were liquidated, Treasury's commitment would expire for that GSE. While Treasury is committed to preventing a GSE from having negative equity, there is no other requirement that it must commit all of its $275 billion by December 31, 2012.

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[1] www.ustreas.gov/press/releases/reports/seniorpreferredstockpurchaseagreementfnm1.pdf
[2] http://financialstability.gov/docs/HAMP/12242009/Fannie.pdf
[3] See this link for Treasury advances made prior to 2010: www.fhfa.gov/webfiles/15747/1Q10CapitalDisclosure52010.pdf

Conservatorship vs. Receivership

The powers of a conservator and of a receiver are similar in that each has power to operate the GSE. A conservator for Fannie Mae or Freddie Mac is permitted to take necessary actions to put the GSE in a sound and solvent condition.

A receiver, but not a conservator, "shall" place the GSE in liquidation and "realize upon its assets" including through asset sales or through transferring assets to a limited-life regulated entity. If a receiver were to use a limited-life regulated entity, that entity would succeed to the GSE's charter. FHFA would be required to wind down the affairs of the limited-life regulated entity, although only Congress may revoke the charter.

A receivership may wind down a GSE, while a conservator is designed to restore a GSE and keep its charter intact. This difference will make the conservatorship route more attractive to policymakers and other stakeholders interested in the survival of one or both GSE charters.

Divesting Toxic Assets

Both a conservator and a receiver have authority to transfer or sell any asset or liability of the GSE "without any approval, assignment, or consent[.]"

The Agreements restrict the GSEs' ability to sell assets if they are not in receivership. There are two significant exceptions:

They may sell assets "in the ordinary course of business consistent, with past practice[.]" These are not defined terms. Relevant here is that there may not be anyone challenging whether an asset sale is permissible. They may also sell assets to shrink their portfolios as the Agreements require. The Agreements set a maximum portfolio size, but not a minimum. It is possible that asset sales in any amount would be permissible under this exception.

FHFA's actions as a conservator, such as selling GSE assets, "shall not be subject to the direction or supervision of any other agency of the United States or any State[.]" These existing authorities provide flexibility to deal with the GSEs' assets in a number of ways.

Treasury's Preferred Stock Dividends

The Agreements currently require the GSEs to pay 10% dividends to Treasury on the amount of the Treasury funding (plus ten percent of an initial $1 billion "liquidation preference" fee, although Treasury did not fund this amount). The dividend payments are costly to the GSEs, currently $1.9 billion and $1.3 billion quarterly for Fannie Mae and Freddie Mac, respectively. Recently, the National Association of Realtors called upon the Obama administration to eliminate the GSEs' dividend payments, arguing such a move would provide support the housing market.

The GSEs' dividend payments could be lowered or eliminated by simply amending the Agreements. Given the history of amending the Agreements to the GSEs' benefit, this would not be unprecedented. Further, the September 2008 Agreements required the GSEs to pay Treasury a quarterly "periodic commitment fee" beginning in March 31, 2010, in an amount to be "mutually agreed" by Treasury and the GSEs, in consultation with the Federal Reserve. That Agreement provides that the Treasury may waive the fee for up to a year at a time, "in its sole discretion, based on adverse conditions in the United States mortgage market." The December 24, 2009 amendments to the Agreement did just that. It remains to be seen whether Treasury will ever require a periodic commitment fee.

Cost of the Government's "Implicit" Guarantee of Fannie Mae and Freddie Mac

In the Federal Reserve Bank of Atlanta's Economics Quarterly [First Quarter 2002], economists W. Scott Frame and Larry D. Wall wrote, "A subsidy in the form of an implicit guarantee creates the appearance of something for nothing: a lower-cost funding for the housing GSEs at no cost to the taxpayers. However, as with co-signing a loan, a seemingly costless guarantee can turn out to be very costly. Moreover, providing an implicit guarantee to cover debt obligations may increase risk-taking incentives if the GSE becomes financially distressed."

The authors' warning was clearly prescient—given the GSEs' failure six years later and subsequent financial crisis. With the benefit of hindsight, it is clear that the government's implicit guarantee of Fannie Mae and Freddie Mac has cost taxpayers some $150 billion today (and growing); the largest federal bailout in U.S. history. Many argue that the government's indirect support of homeownership through the GSEs were at the heart of the financial crisis—fueling demand for homes, driving up the cost of homeownership, and putting pressure on the marketplace to provide "affordable" mortgages by lowering underwriting standards. Ultimately, the mortgage finance system imploded and real estate values fell nearly 20% from their peak, triggering more than $885 billion of losses for U.S. banks and approximately $2.28 trillion of asset write-downs globally, according to an April 2010 estimate by the International Monetary Fund.

On balance, household wealth in the U.S. fell by approximately $17 trillion between 2007 and 2009. According to Pew Briefing Paper #18 by Phillip Swager, the economic and fiscal impact of the financial crisis has resulted in a loss of more than $105,000 per household in the U.S.

	Total impact of the crisis	**Per Household Loss**
GDP (total lost income)	$650 billion	$5,800
Employment (lost jobs)	5.5 million jobs	
Wages (total lost wages)	$360 billion	$3,250
Real estate wealth (July 08-March 09)	$3.4 trillion	$30,300
Stock wealth (July 08-March 09)	$7.4 trillion	$66,200
Fiscal cost (losses on TARP + GSEs)	$230 billion	$2,050

Source: Pew Briefing Paper #18, Cost of the Financial Crisis, Phillip Swagel, March 18, 2010

Reform Proposals

Appendix A provides a description of the proposals that various stakeholders have made concerning the reform of the housing financial system in general and GSEs specifically. In some cases, the stakeholders have set forth a list of reform principals or other commentary, which is noted accordingly. Table 1 provides a summary the stakeholders' proposals, which reflects a general coalescing around a privatization of Fannie Mae and Freddie Mac, operating either as co-operatives or privately-owned entities that operate under the utility model. In general, most stakeholders believe that some form of government subsidy, generally in the form an explicit guarantee of MBS for catastrophic losses, is needed to ensure the viability of the 30-year fixed-rate mortgage and other fixed rate products.

GSE Reform Issues

The stakeholders identified the following issues that need to be addressed in reforming Fannie Mae and Freddie Mac:

- Survival of the 30-year and 15-year fixed-rate mortgages;
- Government guarantee—form (explicit, implicit, or none) and element covered (MBS only and GSE debt);
- GSE debt and degree of allowable leverage;
- Retained mortgage portfolio;
- Support of affordable housing;
- Conforming loan limits;
- Affordable housing goals;
- Taxpayer protection, including loan buybacks and pursuit of fraud;
- Higher mortgage down payment requirement;
- Number of GSEs to resolve TBTF;
- How to raise capital for the new entities;
- GSE charter provisions;
- GSE patents and automated underwriting and information systems; and
- Names of these entities ("actually very critical component" of reforming the GSEs, according to a Wall Street analyst).

Table 1: GSE Reform Proposals

Stakeholder	Business model	Government Guarantee	Retained Portfolio	Regulator	Affordable Housing
Federal Reserve	Cooperative	Explicit-Tail Risk	De minimis	--	--
Trade Groups					
American Bankers Association	--	--	--	"Strong"	None
Housing Policy Council	Private Ins.	Explicit[1]	De minimis	FHFA	Fees to NHTF
Independent Community Bankers of America	--	Implicit	--	--	From Earnings
Mortgage Bankers Association	Utility	Explicit[1]	--	--	None
National Association of Home Builders	Private	Explicit[1]	--	--	--
National Association of Realtors	Cooperative	Explicit	--	--	Mission
National Low Income Housing Coalition	--	--	--	--	First Priority
Securities Industry and Financial Markets Assn.	--	Explicit[1]	--	"Strong"	--
Commercial Banks and Wall Street					
Bank of America	Multiple Models	(Based on Model)	Covered Bonds	--	--
Credit Suisse	Co-op or Utility	Explicit[1]	Smaller	FHFA	--
Wells Fargo	--	Explicit[1]	De minimis	"Strong"	--
Andrew Davidson & Co.	Cooperative	Explicit Sr. Bonds	--	--	--
Keefe Bruyette & Woods	Cooperative	Explicit (MBSs)	De minimis	(phase out)	--
Redwood Trust	Cooperative	Explicit (MBSs)	None	"Strong"	--
Foundations					
American Enterprise Institute	Private	--	--	--	None
Cato Foundation	Co-op	None	None	"Strong"	--
Center for American Progress	Utility/Co-op	Explicit (MBS)	De minimis	"Strict"	Fee on MBSs
Economic Policies for 21st Century	Private	Explicit[1]	None	--	--
Reason Foundation	Eliminate GSEs	None	--	--	FHA

[1]Explicit government guarantee on MBSs to cover catastrophic losses

GSE Transition Issues

The critical transition issues identified by stakeholders include:

- Good bank/bad bank structure with the 2005-2007 legacy assets largely comprising the bad bank;
    - Impact of FAS 166 and 167;
- Continued explicit guarantee of GSE debt and MBS;
- Retained portfolio run-off; and
- TBA market.

It is unclear which structural options Treasury will use for the GSEs during a transition to a reformed state. The structural options for the transition period include:

- ***Creation of a "Bad Bank."*** Under this scenario, an entity (the "Bad Bank") would be created to aggregate the toxic and perhaps most if not all of their portfolio assets, particularly the low-yielding assets of both GSEs. The aggregator institution could be supported by the GSEs (Treasury) and, private investors, or both. Treasury adopted a similar structure in the bailout and reorganization of Citigroup. If implemented before December 31, 2012, Treasury can advance an unlimited amount to the Bad Bank to cover its current and future losses. Under this framework, it may be possible for both GSE charters to survive.

- ***Creation of the "Good GSE(s)."*** Once freed of their troubled assets and with access to approximately $275 billion from the Treasury even after the end of 2012, one or both of the GSEs would be sufficiently capitalized to continue their guaranty business and potentially fund a small portfolio to support multi-family lending. Especially when the $275 equity infusion is combined with the GSEs' market dominance, the "Good GSE(s)" may be able to raise private capital through an initial public offering, similar to the General Motors ongoing public offering, the proceeds of which will be used toward the partial repayment of the taxpayers' bailout of the auto company.

- ***Implementation of a HERA tax on the GSEs to support affordable housing.*** Congress imposed a tax on Fannie Mae and Freddie Mac MBS issuances to support low-income housing. It was enacted in the Housing and Economic Recovery Act of 2008 (HERA), but FHFA suspended it when the agency placed Fannie Mae and Freddie Mac into conservatorship. GSE survival could activate this tax. Further, the 27% low- and very low-income home purchase mandates in HERA and in FHFA regulations, which were also weakened by the conservatorships, would also become fully applicable. The affordable housing groups and their policymaker allies can be expected to support such reinstituting these requirements on the "Good GSE(s)."

One potential impediment to this "Good GSE(s)" / "Bad Bank" structure is that the GSEs' guaranty will continue even if the assets are sold to a "Bad Bank." Under FAS 166 and 167, the GSEs will not be able to "cleanse" their balance sheet of this liability even by selling the assets. However, Fannie Mae, Freddie Mac, Treasury, and the Federal Reserve Board own much of the outstanding MBS, so the government might waive and absolve the GSEs of their guaranty obligations for the government-owned MBS. For privately-held MBS, though, the guaranty and the subsequently liability would continue. Under GAAP, the GSEs would need to continue to reflect this liability on their balance sheets.

To address this problem, FHFA could potentially treat one of the GSEs as a "Bad Bank" to absorb the toxic and low-yielding assets of both GSEs and potentially place the ""Bad Bank" into receivership. The other GSE would have a clean balance sheet, possibly receive a Treasury capital infusion, retain its charter, and make a clean start. Although unusual, the assets in the "Bad Bank" would continue to retain a guaranty by a GSE, albeit a different one for the assets transferred over from the "good" GSEs.

Whether these or other options are considered, it is possible that one or both GSEs could be returned to health without Congressional action or substantive reform. While the GSEs would eventually face increased capital requirements that would likely be phased in over time, the Good GSE(s) would continue with the implied backing of the Federal Government, as well as the other advantages the enterprises are provided under such a scenario.

Prospects For Reform

The prospects for GSE reform in the 112th Congress (2011-2012) are considered by many to be "highly likely." On Capitol Hill, insiders say that the administration's goal is to pass reform of the housing finance system, including Fannie Mae and Freddie Mac, before the 2012 presidential election— a move that would reframe the GSE bailout on the president's terms and take the issue off the table for the election cycle. Given the administration's legislative actions in health care and financial reform in the 111th Congress, "bold" action on housing policy and GSE reform by President Obama would not surprise observers, particularly if framed in the context of impact on the federal budget.

That said, the administration will likely be dealing with a very different Congress in the 112th session. Current polling trends could translate to significant Republican gains, which may threaten the Democrat's control of the House and severely reduce their Senate majority.

However, others argue that the administration will hold public relations events—listening sessions, participating in Congressional hearings—but will defer actual reform efforts until after the 2012 presidential election. Some argue this "discuss and delay" strategy affords the White House a number of advantages such as (i) providing additional time for the housing markets to stabilize and for private capital to return to the markets; (ii) resolving the issue of the mortgage deduction and any reduction—or elimination—as a means of dealing with growing deficits; and (iii) engaging in the reform debate with the 113th Congress having perhaps more Democratic members. Under this scenario, observers argue that pressure to reform the GSEs will have subsided and that only limited changes to Fannie Mae and Freddie Mac would be necessary.

Many are under the impression that the government's backing of the GSEs ends on December 31, 2012 and, as a result, a resolution of the GSEs status needs to be accomplished well before that date. We found that this is not correct. On a combined basis, the Treasury Department may advance approximately $275 billion to the GSEs after 2012.

Therefore, the only real driver to reform will be the political environment, which will be impacted by both public opinions and general economic conditions in an upcoming presidential election year.

There is also an emerging view that the way to transition the existing GSEs to a reformed system is to set up a "Good Bank" / "Bad Bank", whereby the toxic assets could be bled off into a "Bad Bank" where they could be restructured or liquidated. The thought was that one or both of the GSEs could take advantage of their Treasury backing, divest toxic assets, receive a Treasury recapitalization, and emerge from conservatorship with the GSE charter act intact. In the event of political gridlock over GSE reform, Treasury has the financial resources available to restructure Fannie Mae and Freddie Mac in conservatorship. Under this scenario, no further Congressional action would be needed for GSEs reform.

As noted earlier, though, FAS 166 and 167, which became effective on January 1, 2010, however, might mask the benefits of creating a "Bad Bank."

Treasury Begins the Reform Process

In testimony before Congress, Treasury Secretary Timothy Geithner told lawmakers that his agency plans to provide Congress a plan for GSE reform in early 2011—roughly six months after enactment of the Dodd-Frank Act. Treasury has engaged a team of Wall Street investment bankers to help the administration address the reengineering of the housing finance system, including the reform of the Fannie Mae and Freddie Mac post conservatorship. The consultants are expected to issue a "McKinsey-like" report analyzing the housing sector and the government's housing support programs (including the mortgage interest deduction), and making reform recommendations. The administration also announced that reform should potentially alter the current policies promoting homeownership in favor of rental housing.

On April 17, the Treasury Department requested public input (by July 23) on seven fundamental questions that would drive the reengineering of the mortgage system and reform of Fannie Mae and Freddie Mac. Treasury and HUD received 571 comment letters from a wide array of banks, trade groups, construction firms, state housing agencies, and affordable housing advocates, concerning the future of housing finance and reform of Fannie Mae and Freddie Mac. A summary of the major reform proposals is provided in Appendix A.

On August 17, Treasury held the Conference on the Future of Housing Finance in which administration and industry representatives, academics, and consumer advocates began the debate on GSE reform. A video of the Conference is available from CSPAN at http://www.c-spanvideo.org/program/295074-1. At the Conference, Treasury Secretary Geithner said: "[T]his Administration will side with those who want fundamental change. It is not tenable to leave in place the system we have today. We will not support returning Fannie and Freddie to the role they played before conservatorship, where they fought to take market share from private competitors while enjoying the privilege of government support. We will not support a return to the system where private gains are subsidized by taxpayer losses." Geithner believes that there's a "strong case to be made for a carefully designed [government] guarantee program in a reformed system"—with the challenge being to make certain that the any government guarantee is priced to cover the risk of losses and structured to minimize taxpayer exposure.

At the Conference, the banking community (and the Center for American Progress) appeared to coalesce around the GSE reform proposal by the Financial Services Roundtable. Under this proposal, the functions of Fannie Mae and Freddie Mac would be transferred to private entities owned by the top tier banks, which control roughly 80% of mortgage originations and securitizations. Substantively, this proposal could further expand the market penetration and role of these too-big-to-fail banks and ultimately transform these banks into new government-sponsored entities.

In a speech to the National Association of Real Estate Brokers, HUD Secretary Sean Donovan cautioned against taking "extreme measures" in reforming Fannie Mae and Freddie Mac, noting that the agencies "legacy assets are what's causing the problem today," not the profitable loans they are making today. The Secretary further stated: "In fact . . . [we] would see significantly more trouble in the housing market if we were to withdraw credit completely. A lot of those proposals just don't make sense when you think through exactly what's causing the problem, which are these legacy loans."

Treasury seems to be leaning towards a private industry solution, rather than a nationalization effort. Such an approach would put private capital at risk—through private equity in the GSEs' successor and through private mortgage insurance—ahead of the government, which would provide a catastrophic loss guarantee for mortgages. It is still early in the process, so the administration's final proposal is far from certain at this time.

House Financial Services Committee Moves Ahead with Reform

In an August 17 interview with Neill Cavuto on Fox Business, House Financial Services Committee Chairman Barney Frank said, "[Fannie Mae and Freddie Mac] should be abolished. The only question is what do you put in their place. . . . There is no more hybrid private-public. If we want to subsidize housing then we could do it upfront and let the budget be clear about that." FHA should be fully self-financing and Fannie Mae and Freddie Mac should be replaced with a new mechanism to help subsidize housing, Frank added.

Frank said his Committee will resume hearings on revamping the housing finance system when Congress returns from its August recess. He intends to move legislation next year, adding: "Look, you know, it depends on who wins the House." According to Committee staff, the Chairman plans to release a white paper outlining his plans to reform the reform of the housing finance system based upon the Financial Services Roundtable's reform proposal, in early October, before the November elections and in advance of any proposal being introduced by the administration and Treasury.

House Republicans' Views

Republicans on the House Financial Services Committee have outlined ten principles for GSE reform, which call for (i) winding down of Fannie Mae and Freddie Mac within four years; (ii) phasing out the elevated conforming loan limit over a two-year period; (iii) reducing the GSEs' retained mortgage portfolios by 25% over four years; (iv) phasing in higher capital requirements for the GSEs to reduce their leverage; (v) creating a regulatory framework for covered bonds in the U.S.; (vi) creating a regulatory safe-harbor for mortgages that meet underwriting standards consistent with the Federal Reserve's final HOEPA (high-cost mortgage loan) rule; (vii) eliminating the maturity mismatch that allows the GSEs to use very short-term borrowings to fund long-term assets; (viii) creating an Inspector General for FHFA and requiring the Inspector General to submit regular reports to Congress on the agency's GSE conservatorship activities; (ix) placing the GSEs' operations "on budget" and subjecting the enterprises' debt issuance to the national debt limit; and (x) immediately suspending the compensation packages for the GSEs' senior management and establishing a compensation system in accordance with the federal government's rates of pay for executive and senior level employees. "House Republicans support establishing a framework to reinvigorate housing finance that does not rely on government guarantees," said Representative Spencer Bachus (R-AL), the panel's ranking member.

In the event the Republicans win control of the House of Representatives, Representative Scott Garrett (R-NJ) would serve as chairman of the House Financial Services (HFS) Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprise. Thus, he will be in a position to advance the Equal Treatment for Covered Bonds Act, a bill he sponsored. Covered bonds are debt securities backed by cash flows from loans. Unlike with MBS, with covered bonds, the assets remain on the issuer's balance sheet. Specifically, his bill calls for (i) an amendment to the Federal Deposit Insurance Act to provide the same treatment for covered bonds as for other qualified financial contracts; (ii) defining a covered bond as a non-deposit recourse debt obligation of an insured depository institution; (iii) creating a minimum term of maturity for a covered bond of at least one year with no maximum term of maturity; (iv) allowing for a wide variety of asset classes to be eligible as collateral in the cover pool; (v) ensuring that a bank failure will not impair the value of the covered bonds; and (vi) establishing joint rulemaking authority for the Secretary of the Treasury, the Federal Reserve, Office of the Comptroller of the Currency, and the FDIC for new regulations affecting covered bonds.

During the Conference Committee negotiations on the Dodd-Frank Act, Garrett proposed that the covered bond provisions be added to the reform legislation—a proposal supported by House Financial Services Committee Chairman Barney Frank (D-MA) but successfully blocked by the Treasury Department. (Republican lawmakers view covered bonds as a securitization vehicle for the private sector, which would be viable only in a non-Fannie Mae and Freddie Mac world.) On July 28, 2010, however, Garrett's covered bond bill was separately marked-up and passed out of the House Financial Services Committee.[4] While it is doubtful that his bill will be enacted this year, it is a clear sign that it will be part of the overall reform debate.

The Taxpayers' Views

Another wildcard in this debate is public reaction to GSE reform, which will be driven by how the issues are packaged and sold to the American public. As noted by Robert Stowe England in the May issue of *Mortgage Banking*, "[A]ny proposal that emerges from Congress needs not just the support of the 'stakeholders' in mortgage finance, but the broad support of the public, too. Ultimately, both the fate of Fannie and Freddie, as well as reform of the mortgage finance market, will likely need to respond to the considerable public backlash against government over-reaching, rising deficits and debt, and wariness—if not weariness—about markets, companies and arrangements that involve government guarantees." The most important stakeholder of all with the largest financial stake in this issue—the U.S. taxpayer—may also play a role in the outcome of this political debate, particularly in a more Republican Congress.

[4] H.R. 5823, legislation sponsored by Rep. Scott Garrett (R-NJ), was passed by the House Financial Services Committee on July 28, 2010. Click here for information on the bill: http://www.thomas.gov/cgi-bin/bdquery/D?d111:1:./temp/~bdAbb7:@@@L&summ2=m&|/home/LegislativeData.php . Click here for the text of the bill: http://www.thomas.gov/cgi-bin/query/z?c111:H.R.5823 .

Summary

The debate over the reform of the nation's housing finance system, which has just begun, could prove to be as significant as the deliberations over the reforms to the nation's health care and financial services systems, which just concluded with the enactment of legislation this year.

Given the political controversy surrounding the GSEs, it seems likely that elected officials will want to enact some type of reform before the 2012 elections. The complexities involved, however, are significant. Sorting through the issues and designing a new system will be challenging and critically important, given that housing constitutes 15% of the country's GDP.

Appendix A: GSE Reform Proposals

Government Reform Proposals

Government Accountability Office (GAO)

In an October 2009 report, the GAO outlined the various options for structuring Fannie Mae and Freddie Mac post-conservatorship. Specifically, GAO proposed three structural frameworks for the reforming the GSEs:

Government agency

The housing GSEs could be transformed into a government entity that would (i) eliminate the enterprises' retained mortgage portfolios over time; (ii) establish sound underwriting standards and risk-sharing arrangements with the private sector; (iii) establish financial and accountability requirements for lenders; (iv) institute consumer protection standards for borrowers; and (v) eliminate responsibility for the affordable housing goals (instead, FHA's mortgage insurance programs would be expanded to address this objective).

A government entity, with access to Treasury-issued debt, may be ideally positioned to provide liquidity to the mortgage market during normal economic periods. However, a government entity that does not have a retained portfolio may face challenges supporting mortgage markets during time of financial stress and would require the support of Treasury or the Federal Reserve to purchase mortgage assets under such circumstances. A government entity would be expected to pursue housing opportunity programs for targeted groups given its public status. However, the agency may face challenges in managing a housing goal program, since some types of affordable loans, like multifamily loans, may be difficult to securitize and often have to be held in portfolio. Alternatively, fees could be assessed on the government entity's activities to support housing opportunities for targeted groups or FHA's mortgage insurance programs could be expanded.

The entity structure may represent less risk than the hybrid GSE structure because MBS issuance is less complicated and risky than managing a retained mortgage portfolio. However, this structure would be more complicated than that of Ginnie Mae's and could result in substantial taxpayer losses if mismanaged. A government entity could face greater challenges than private-sector entities in securing human and technological resources to manage complex processes or it might lack the operational flexibility to do so.

Key elements for regulatory oversight of a government agency structure would include (i) certain operational flexibilities to obtain appropriate staff and information technology to carry out responsibilities, (ii) risk-sharing agreements with private lenders or mortgage insurers, (iii) appropriate disclosures in the federal budget of risks and liabilities to ensure financial transparency, and (iv) robust Congressional oversight of operations.

Supporters of a government agency structure argue the implied federal guarantee and the enterprises' need to respond to shareholder demands to maximize profitability encouraged excessive risk-taking and ultimately resulted in their failures. In contrast, a government entity, which would not be concerned about maximizing shareholder value, would best ensure the availability of mortgage credit for primary lenders while minimizing risks associated with a hybrid GSE structure. Establishing a government agency also would help ensure transparency through appropriate disclosures of risks and costs in the federal budget.

Reconstituted GSEs

Fannie Mae and Freddie Mac could be reconstituted under a utility-business model by (i) reducing or perhaps eliminating retained mortgage portfolios as deemed appropriate depending on prioritization of numeric housing and safety and soundness objectives; (ii) establishing capital standards commensurate with relevant risks; (iii) developing additional regulations such as executive compensation limits; (iv) requiring appropriate financial disclosures in the federal budget to enhance transparency; and (v) ensuring strong congressional oversight of the enterprises' and FHFA's performance.

While the reconstituted GSEs may provide liquidity and other benefits to mortgage finance during normal economic times, the enterprises' ability to provide such support during stressful economic periods is questionable given current experience. With significantly smaller (or eliminated) retained mortgage portfolios, the capacity of reconstituted enterprises to provide support to mortgage markets during periods of economic distress also may be limited.

Reconstituted GSEs, with their responsibility to maximize profits for their shareholders, might find it difficult to support some public policy housing initiatives. Moreover, without a retained mortgage portfolio, the reconstituted GSEs may face challenges in implementing an affordable housing goal program. Alternatively, a reconstituted GSE could be permitted to maintain a relatively small portfolio to support affordable housing goals or by supporting housing opportunities for targeted groups through assessments on its activities.

The financial crisis highlighted problems with the hybrid GSE structure, including incentives to increase leverage and maximize portfolios. Reconstituting the GSEs would reestablish and might strengthen the incentive problems, which could lead to even greater moral hazard and safety and soundness concerns and increase systemic risks. Proposals to regulate GSEs like public utilities in principle could constrain excessive risk-taking, but the applicability of this model to the enterprises has not been established. Further, FHFA has not been tested as an independent safety and soundness and housing mission regulator, as the agency has largely acted as a conservator since its creation in July 2008.

Supporters of this proposal believe that reconstituting the enterprises would help ensure that they would remain responsive to market developments, continue to produce innovations in mortgage finance, and would be less bureaucratic than a government agency or corporation. They also advocate a variety of additional regulations and ownership restrictions to help offset the financial risks inherent in the for-profit GSE structure, including (i) eliminating or substantially downsizing the enterprises' mortgage portfolios; (ii) breaking up the enterprises into multiple GSEs to mitigate safety and soundness and financial stability risks; (iii) establishing public utility-type regulation for the enterprises that would establish limits on their profitability; and (iv) converting the enterprises into lender-owned associations to create incentives for mortgage lenders to engage in more prudent underwriting practices.

Privatization or termination

Privatizing or terminating the enterprises would eliminate many problems with the hybrid GSE model, including the conflict between public policy and private shareholders. Supporters of this proposal argue that privatized entities would align mortgage decisions more closely with market factors and that the resultant dispersal of credit and interest rate risk would reduce safety and soundness risks. Federal Reserve Chairman Ben Bernanke has suggested that privatized entities may be more innovative and efficient than government entities, and operate with less interference from political interests.

Under this structure, a transition period would mitigate any potential market disruptions and facilitate the development of a new mortgage finance system. A federal entity would be created to provide catastrophic mortgage insurance for lenders and help ensure that mortgage markets would continue functioning during stressful economic periods.

If key enterprise activities such as mortgage purchases and MBS issuances are provided by financial institutions, liquid mortgage markets could be reestablished in normal economic times. However, the capacity of private banks to support mortgage markets in times of financial distress without government support is questionable, given the failure or near failure of key financial institutions and the absence of private-label securitization during the current financial crisis. A federal mortgage insurer could help private lenders provide liquidity and other benefits in times of financial stress.

Privatization or termination would remove the traditional legislative basis, government sponsorship, for the enterprises to implement programs to serve the mortgage credit needs of targeted groups. However, the basis for such programs may remain if a government insurer for mortgage debt is established and the federal government guarantees its financial obligations. Furthermore, Congress might justify the programs on the grounds that large lenders that assume responsibility for key enterprise activities or purchase their assets are viewed as "too big to fail" and benefit from implied federal guarantees of their financial obligations.

Termination and reliance on private-sector firms would leave market discipline and regulators of financial institutions with responsibility for promoting safety and soundness. Moral hazard concerns would remain if some mortgage lenders were deemed "too big to fail." These concerns may be heightened because the current financial regulatory system already faces challenges in overseeing such organizations.

Additionally, safety and soundness concerns may remain if a federal entity were established to insure mortgage debt and did not charge appropriate premiums to offset the risks it incurred. FHA and the FHLB System may become more prominent if the enterprises were privatized or terminated.

The need for a new financial regulatory system, due to concerns about the current fragmented system, may be heightened to the extent that terminating or privatizing the enterprises results in larger and more complex financial institutions. In considering a new system, Congress should consider the need to mitigate taxpayer risks and consider establishing clear regulatory goals and a system-wide risk focus. If a new federal mortgage insurer is established, there should be an appropriate oversight structure for such an entity. This structure might include appropriate regulations and capital standards, the disclosure of risks and liabilities in the federal budget, and congressional oversight.

In a white paper, *Key Considerations for the Future of the Secondary Market and Government Sponsored Entities*, the Mortgage Bankers Association outlined nine possible models that could serve as potential redesign of Fannie Mae and Freddie Mac. Chart 1 provides a summary of these models and the types of investment products they could bring to the market.

Chart 1. High-level Menu of GSE-like Models

	Fully privatized	Covered bond	Hybrid covered bond	Co-op	Open charter	Limited charter	Improved GSE	Utility	FHA-Ginne-Type
Private Ownership	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	No
Government guarantee	No	No	No	Govt backstop	Insurance fund	Insurance fund	Govt backstop	Govt backstop	Explicit
Regulator	Bank/other regulators	Bank regulators	Bank regulators	FHFA-type	FDIC-type	FHFA-type	FHFA	FHFA-type	n.a.
Required portfolio	Market-driven	Yes	Yes	*de minimus*	*de minimus*	*de minimus*	Safety & soundness	*de minimus*	No
Investment vehicles brought to market									
Whole loans	Yes	No	No	No	No	No	No	No	No
Pass-thru MBS	Yes	No	No	Backstop	Govt	Govt	Backstop	Backstop	Govt
Structured MBS	Yes	No	No	Yes	Yes	Yes	Yes	Yes	Yes
(Re-)REMIC/CDO	Yes	No	No	Yes	Yes	Yes	Yes	Yes	No
Mortgage REIT	Yes	No	No	No	No	No	No	No	No
Corporate debt	Yes	No	No	n.a.	n.a.	n.a.	Yes	n.a.	n.a.
Secured debt	Yes	Yes	Yes	n.a.	n.a.	n.a.	No	n.a.	n.a.
Shareholder equity	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	No

Federal Reserve

In *The Regional Economist*, James Bullard, president and CEO of the Federal Reserve Bank of St. Louis, wrote, “At a minimum, we need to break up these GSEs—perhaps into regional companies—to open up the market to private players and restructure the incentives under which they operate.”

On May 13 at the Federal Reserve Bank of Philadelphia’s Reinventing Older Communities conference, Joseph Tracy, Executive Vice President (EVP) and senior advisor to the president of the Federal Reserve Bank of New York, presented a proposal to reform Fannie Mae and Freddie Mac using a lender cooperative model. Tracy’s design principles for the lender cooperative model included (i) preserving what has what has worked well in the past—specifically standardized underwriting and the TBA market; (ii) incorporating economies of scale and scope; (iii) providing transparent and on-balance sheet subsidies with new entities focused on the “core” housing market and having FHA focused on affordable housing goals and mission; (iv) tasking fiscal authorities to conduct fiscal policy with Treasury being the “buyer of last resort”; and (v) assigning the “tail-risk” in housing to government through explicit government insurance that has a transparent price.

Tracy urges policymakers to preserve the TBA trading market, which serves as the link between the primary and secondary markets and allows borrowers to lock rates for up to 60 days prior to closing (but exposes lenders to interest rate risk). Under Tracy’s proposal, lenders would hedge this risk efficiently by selling mortgages one to three months forwards, while lenders would have to stockpile these loans in a conduit for private label securitizations. Liquidity would be provided through standardized underwriting, diversification through pooling of loans, and the assumption of homogeneity through guarantees and forward trading. The benefits of the TBA market include enhanced liquidity and reduced hedging costs.

According to Tracy, the requirements for TBAs would include (i) a small number of issuers (since privatization and fragmentation are not compatible); (ii) some actual homogeneity of mortgages through standardized underwriting criteria and procedures, along with the government guarantee; and (iii) significant back-office operations and creditworthy counterparties. Under the lender cooperative model, mutually-owned co-ops—akin to the Federal Home Bank System structure—would engage only in residential lending. Only member institutions with an equity stake in the organization could sell mortgages to the co-op to be securitized. Guarantee fees would be assessed to pay for the government’s tail risk premiums and to contribute to the cooperative’s credit loss pool. In designing this cooperative structure, policymakers would have to address a number of design issues, including (i) triggers for government’s tail risk insurance, such as MBS level, vintage level or size of mutual loss pool; (ii) the types of mortgage products the co-op could securitize, with a focus on standardized products with sufficient history to price tail insurance; and (iii) the number of cooperatives to form, recognizing that a small number preserves economies of scale.

Tracy argued that the co-operative model offers a number of advantages. First, this structure preserves the TBA market and would encourage loan standardization. The business model would have little incentive for "mission creep" or to create a concentration of power over lenders, since profits would flow back to the members. The co-op's mutual credit loss pool would provide financial incentives for members to monitor risk. Moreover, the structure reduces moral hazard, since the co-op would absorb loan losses ahead of the government. The disadvantages of the co-operative model include (i) limited access to capital markets; (ii) weaker incentives to innovate than the private model; and (iii) potential for weaker governance relative to other models.

Trade Groups

American Bankers Association (ABA)

In a July 21 comment letter on the reform of housing finance, the ABA did not endorse a specific model for reforming Fannie Mae and Freddie Mac. Instead, the trade group outlined 11 guiding principles to govern reform of the housing finance system, including: The primary goal of any government-sponsored enterprise in the area of mortgage finance should be to provide stability and liquidity to facilitate the ability of the primary mortgage market to provide credit for borrowers who have the credit and skill sets required to maintain homeownership.

In return for the GSE status and any benefits conveyed by that status, these entities must agree to maintain their mission in all economic environments.

Strong regulation, examination, and authority for prompt corrective action of any future GSE must be a key element of reform. Regulation also must include review and control for systemic risk.

Any GSE involved in the mortgage markets must be strictly confined to a well-defined and regulated secondary market role and should not be allowed to compete with the private, primary market.

Any reform of the secondary mortgage market must recognize the vital role the FHLBs play and must in no way harm the traditional advance businesses of FHLBs or access to advances by their members, particularly for community banks which play a vital role in providing mortgage finance and economic development.

GSEs must be allowed to pursue reasonable risks and rewards, but the risk/reward equation must be transparent and more rigorously defined and regulated.
GSEs must operate within a framework of market procedures and regulation governing the securitization of all mortgage assets.

Strong minimum regulatory standards are necessary to ensure sound underwriting for all mortgages. Insured depositories already comply with strong underwriting standards and

are subject to vigorous examination. Comparable standards should be established for all loan originators with comparable levels of effective regulatory oversight.
True sales treatment and regulatory capital charges should appropriately reflect the reality of true risk-shifting activities, as well as balance sheet exposures. Accounting and regulatory changes should reflect and align the risks of mortgage securities and their underlying assets.

Affordable housing goals or efforts undertaken to broaden housing affordability are more suited to other programs and entities than the GSEs—whose principal focus should be on providing stability and liquidity to the primary market. Any affordable housing goals required of the GSEs should be in furtherance of their primary goals of promoting primary market stability and liquidity and should be delivered through and driven by the primary market, and should be structured in the form of affordable housing funds available to provide subsidies for affordable projects. GSEs must provide for fair and equitable access to all primary market lenders selling into the secondary market through the GSEs.

American Securitization Forum (ASF)

In a July 21 comment letter on reform of the Housing Finance System, the ASF urged policymakers to carefully consider and evaluate how reforms of the housing finance system will impact the securitization market, specifically with regard to the TBA Market. Tom Deutsch, Executive Director of ASF, wrote, "Any GSE 'reform' which does not accommodate, or suitably replace, the existing GSE MBS TBA market will undoubtedly impact mortgage originators both severely and negatively by reducing the originators' options to "rate lock" and thus satisfy consumer needs. As is always the case, these impacts will surely disproportionately fall on the nation's smaller finance companies as well as the community bank sector." Deutsch also cautioned that any hard and fast policy that would prohibit the maintenance of GSE portfolios would narrow the universe of available options to the government in times of crisis. Deutsch also points out to policymakers, "[T]he best solution [for minimizing real estate bubbles] is probably a structural one, to encourage borrowers and lenders to focus relatively more on personal credit, and relatively less on real estate values, thus helping to re-order the housing finance system, at least as regards securitization, more strongly to a proper fixed-income market."

Given the current legislative, regulatory and legal pending actions that currently cloud the mortgage securitization market for "at least" the next two years, "ASF strongly believes that federal housing finance policy should work to restart the non-agency residential secondary market in a rational and coordinated way," wrote Deutsch. " We believe that a single, national standard arising out of the Dodd-Frank Act, and implemented by joint interagency regulatory rulemaking will best achieve the housing finance policy goals of promoting responsible underwriting and market transparency, while addressing the need of industry participants to have a clear, practical and efficient approach. A fragmented approach to regulating these markets, in which various regulatory bodies (and, indeed, all three branches of government) develop slightly different rules governing the exact same subject matter, is unlikely to produce efficient results and prove to be a drag on the mortgage market. Risk retention mandates associated with residential mortgage credit risk need to be practical and flexible, and need to recognize that there are many paths to the mountaintop. … Responsible, user-friendly non-agency securitization markets should be viewed as a tool to help gradually reduce concentrations of these risks in …[FHA and Ginnie Mae], as well as transferring these risks outside of the banking system."

Financial Services Roundtable (FSR)

On April 14, Anthony Reed, VP of Capital Markets for SunTrust Mortgage, testified before the House Financial Services Committee on behalf of The Housing Policy Council of the Financial Services Roundtable (HPC) regarding reform of the housing finance system.

Reed set forth three goals for reforming the secondary market, including (i) ensuring the steady flow of capital to the housing market to support the 30-year, fixed-rate mortgage; (ii) minimize losses to taxpayers by eliminating the government's implicit and explicit guarantees to the GSEs' successors; and (iii) a mechanism to ensure adequate funding for affordable housing.

Specifically, the HPC proposes the creation of four to eight federally-chartered, privately-owned Mortgage Securities Insurance Companies (MSICs) to provide the credit enhancement function and the establishment of a (single) Mortgage-Backed Security Issuance Facility to create and administer MBS that are guaranteed by MSICs. The MSICs would support affordable housing initiatives through the contribution of revenue that would be distributed to state and local housing finance agencies. Any successors to the GSEs would NOT be required or permitted to maintain large mortgage portfolios for investment purposes. Instead, the MSICs could maintain small portfolios to facilitate the development of new products and to support certain types of mortgages, such as multifamily loans, that have limited markets. The MSICs would be chartered and regulated by the FHFA, which would establish strong capital and liquidity requirements, set underwriting standards, and establish loan limits. The federal government would be called on to provide an "explicit" back-up guarantee—in the form of catastrophic re-insurance—directly to MBS issuances, but not to the MSICs themselves. Losses would be incurred by the borrower (the down payment), PMI, MSIC's equity, and the MSIC's reserve fees—ahead of the government's guarantee on MBS losses.

Independent Community Bankers of America (ICBA)

On April 14, Jack E. Hopkins, testified on behalf of the ICBA before the House Financial Services Committee regarding reform of the housing finance system. Instead of submitting a proposal for GSE reform, the Hopkins outlined ICBA's key reform principles that should guide reform of the secondary market and the GSEs' successor(s). The group's principles call for the creation of a strong and reliable secondary market that is impartial, and secondary market entities (GSEs' successors) with a limited mission focused on supporting residential and multifamily housing in all U.S. communities.

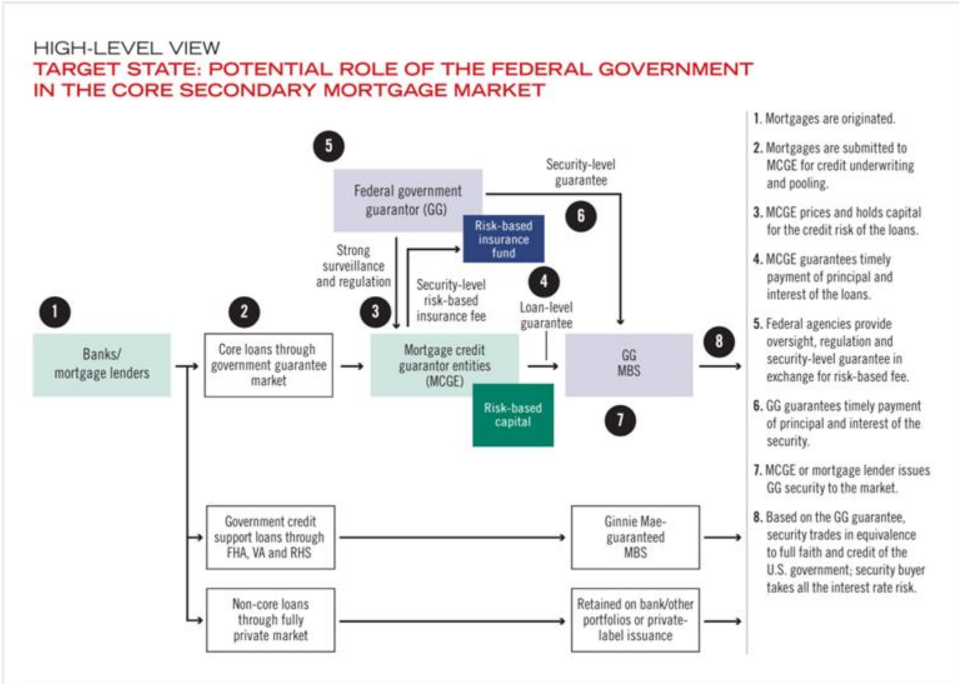
Reform efforts should result in the creation of multiple secondary market entities that have operational flexibility to hold mortgages in portfolio when market conditions dictate. The reform efforts should eliminate the conflicting requirements of a public mission with private ownership and dedicate a portion of the secondary market entities' earnings to support affordable housing programs. Government "ties" should continue with the GSEs' successor to ensure "continued and steady access to the capital markets."

Mortgage Bankers Association (MBA)

In an August 2009 white paper, MBA outlined a GSE reform proposal, calling for the creation of a new line of MBS, which would have a security-level, federal government guaranteed "wrap" (the "GG") and private, loan-level guarantees from privately-owned, government-chartered and regulated mortgage credit-guarantor entities (MCGEs). The GG, modeled after Ginnie Mae, would explicitly carry the full faith and credit of the U.S. government, supported by risk-based fees charged on the securities at issuance and on an on-going basis. MCGEs would manage credit risk through (i) risk-based pricing; (ii) originator retention of risk through representations and warranties; and (iii) private mortgage insurance. Through the GG and MCGEs, the credit risk from the mortgages would be "removed" from the MBS, while the security investor would bear the interest rate risk. The GG is not intended to support the entire mortgage market, but only those mortgage products needed to keep the secondary market for core mortgage products liquid and functioning in all environments.

Initially, two or three MCGEs private-owned, mono-line institutions would to be chartered to focus solely on the mortgage credit guarantee and securitization business. These entities would be overseen by a strong regulator, who would grant charters, determine underwriting guidelines, approve new products, and assure capital adequacy. The regulatory regime would be similar to that of a public utility with the MCGEs earning a conservative return on equity. While the MCGEs would have standard corporate powers to raise debt and equity, none of the entities' issuances would be guaranteed—either implicitly or explicitly—by the federal government.

MBA contends that any federal mortgage securitization and guarantee program must not be distorted by any additional public or social housing policy goals. Instead, these policy goals should be implemented through FHA, VA, RHS, and Ginnie Mae, which provide government credit support for affordable housing.



Mortgage Insurance Companies of America (MICA)

In a July 21 comment letter on reform of the housing finance system, Suzanne Hutchinson, EVP of the Mortgage Insurance Companies of America, urged the administration to continue the role of private mortgage insurance in the housing finance system, as a means of placing private capital at risk to defray mortgage losses in the housing market. Hutchinson noted that PMI companies are well positioned to help expand affordable housing opportunities in a responsible manner. “MICA strongly recommends that [private] mortgage insurance remain a required and structurally integrated component of the housing finance system,” wrote Hutchinson. MICA also recommends that automated underwriting programs of new securitizers be carefully reviewed by their regulators with input made available by all parties related to the underwriting and insurance of loans. Further, MICA urges the regulator to consider allowing all parties to comment on the desirability of proposed changes to the automated underwriting systems, specifically related to the underwriting terms and major changes to the securitizing entities’ internal models concerning default probability and depth of losses for high risk loans. MICA recommends that the regulator give serious consideration to requiring mortgage insurance on all loans with combined LTV ratios of 75% or more.

National Association of Home Builders (NAHB)

On April 14, Rich Judson testified on behalf of NAHB before the House Financial Services Committee regarding reform of the housing finance system. Judson told lawmakers that NAHB supports the creation of private companies, called conforming mortgage conduits (CMCs) to purchase mortgages from approved institutions—banks, savings institutions, and credit unions—and to securitize these assets in MBS. While the CMCs would guarantee the timely payment of the collateral that securitizes its MBS, the federal government would not provide an implicit or explicit guarantee of these payments. Instead, the entities would pay an insurance fee for mortgage securities that receive a federal guarantee, which would support the conventional mortgage market (using conforming loan limits) under catastrophic conditions. CMCs' reserves, the federal guarantee, and private mortgage insurance would cover loss exposure in CMCs' MBS. The CMCs would have to maintain adequate capital and loan loss reserves appropriate for their risk exposure.

National Association of Realtors (NAR)

In a July 21 comment letter on reform of the housing finance system, the NAR advocated using the co-operative model for the creation of two non-profit, government-chartered market authorities ("market authorities"), which function as self-sustaining organizations. These entities would ensure strong, robust financing environment for homeownership and multifamily housing with a mission of promoting housing affordability for the under-served segment of the population. The market authorities "excess" revenues would be used to accumulate a strong capital base to support the secondary market, to withstand countercyclical downturns, and to support innovation. Under this proposal, the federal government would clearly and explicitly guarantee the business of the market authorities, which would be off-set by mortgage insurance (for loan-to-value (LTV) ratios greater than 80%) and MBS guarantee fees. The entity, governed by a chief executive officer and board of directors comprised of industry participants and consumer representatives, would be supervised by a strong regulator, FHFA, with the entities' political independence "mandatory." The market authorities would ensure that sound and sensible underwriting standards are established for loans purchased and securitized with transparency and verifiability for MBS collateral. NAR noted, however, that reform of the credit rating agency sector is also necessary to address the inherent conflict of the current system.

National Low Income Housing Coalition (NLIHC)

On April 14, Shelia Crowley, President of the NLIHC, testified before the House Financial Services Committee regarding reform of the housing finance system. Crowley outlined six principles to guide reforming the U.S. housing finance system, which included:

- Federal subsidies to the housing sector should be directed to meeting the needs of those with the most serious housing problems first.
- All segments of the housing finance sector have a duty to contribute to solving the most serious housing problems.
- Federal policy should not favor one form of tenure over another; rather, federal policy should incentivize balance in the housing market and the full range of housing choices in every community.

- Federal policy should reward housing forms that are of reasonable size and are earth friendly, that is, policy should reward moderation, not excess.
- Federal policy should make sure the housing finance system has enough liquidity to assure a robust single-family and multifamily housing market at affordable interest rates.
- Federal policy should maximize the capacity of mission driven, public or non-profit housing providers to achieve tangible results in solving the nation's housing woes.

Crowley recommended that lawmakers immediately provide $1.065 billion of capital to fund the National Housing Trust Fund. Moreover, the National Housing Trust Fund campaign recommends that Congress provide at least $15 billion annually over the next decade to meet affordable housing needs. Crowley recommended that this funding level be accomplished through a five basis point annual fee on financial institutions' borrowings from the Federal Reserve Bank and the FHLB System. In addition, Congress could levy a fee on mortgage securitizations by any capital market participant. Crowley also suggested that Congress reform the mortgage interest deduction and enact a federal rent credit to provide low-income renters a subsidy similar to that received by homeowners.

Securities Industry and Financial Markets Association (SIFMA)

In a July 20 comment letter to Treasury regarding reform of the housing finance system, SIFMA wrote, "[I]f some form of a GSE exists in the future, it should be established with a limited specific charter that outlines a limited and specific mission, along with a strong regulator empowered to regulate and manage the activities of the entity in all appropriate ways, but acts in coordination with entities such as Treasury and [the] Federal Reserve to ensure the safety and soundness of the broader financial system. Changes to this charter and mission should be solely within the purview of Congress." SIFMA urged policymakers (i) to determine what they want from mortgage market before addressing what to do with the GSEs; (ii) to foster the forward market for MBS (the TBA market), which is key to a successful, liquid, affordable and national mortgage market; (iii) to provide some form of explicit government guarantee on MBS to maintain liquidity in the TBA market, possibly through a government insurance wrap that stands behind any private sector or other corporate guarantee; and (iv) to avoid bifurcating the market into pre- and post-reform markets, as the administration addresses GSE legacy issues.

Commercial Banks

Bank of America

In a July 21 comment letter, Bank of America's General Counsel Gregory Baer said GSE reform could consist of multiple reform models, each dealing with a different type of mortgage. For example, a government guarantee could be provided for low-income loans, while an FDIC model could be applied to loan balances up to a conforming loan limit and a purely private sector model could apply to loans above the conforming loan limit. Specifically, securitization of low-dollar balance mortgages to underserved communities could be managed by a government run or guaranteed entity, which is exclusively charged with an affordable housing mandate. FHA or a new entity would serve as a pure government instrumentality and appear "on-balance sheet" to ensure transparency. This entity could also focus on increasing rental availability and promote first time homebuyer assistance.

With regard to restarting the non-agency residential mortgage secondary market, Baer suggested that a single, national standard arising from the Dodd-Frank Act and implemented by a joint interagency regulatory rulemaking will "best achieve the housing finance policy goals of promoting responsible underwriting and market transparency, while addressing the need of industry participants to have a clear, practical and efficient approach."

Baer wrote, "The government should attempt to encourage the growth of the covered bond market, which allows banks to make and hold mortgage loans at relatively lower cost, but subject to capital requirements and proper underwriting incentives. This model has proven effective around the world but never developed in this country because of the presence of Fannie Mae and Freddie Mac." Baer also noted that a public or public-private solution will be required to address the GSEs' legacy assets and obligations.

Credit Suisse

In an October 2009 white paper, Credit Suisse set forth five key objectives for GSE reform, which include (i) preserving TBA market liquidity; (ii) minimizing disruption to the market and maximizing continuity, (iii) improving the GSEs' control and risk management, (iv) minimizing operational involvement by government, and (v) continuing operations even in the event of a catastrophic credit event. Credit Suisse's proposal focuses on preserving the GSEs in order to avoid disrupting the housing finance market.

Under this proposal, the GSEs would be broken up into "good GSEs," called primary mortgage guarantors (PMGs) that retain healthy guarantee and portfolio assets, and "bad" GSEs that house and run off toxic assets, bearing the "full faith and credit" government insurance wrap for catastrophic losses. The PMGs would run scaled-backed portfolios, roughly half their current size, to smooth out market distortions and maintain their role as counter-cyclical buyers of mortgages. To avoid mission creep, both FHFA and Congress would review the PMGs' product proposals. The PMGs would have a line of credit with the Federal Reserve, which would be collateralized with MBS purchased with credit. The PMGs would be restricted to basic mortgage products with known risk profiles and prohibited from buying non-prime mortgages, such as Alt-A and subprime loans. They would be strictly regulated by FHFA and have their capital requirement doubled immediately and then doubled again over the next couple of decades. The new GSEs would have affordable housing goals only for the multifamily market.

Wells Fargo

In a July 21 comment letter, John Gibbons, EVP of Wells Fargo's Home Mortgage Capital Markets, endorsed the framework for GSE reform proposed by the HPC and MBA. Specifically, Wells Fargo suggested that Fannie and Freddie be replaced by a small number of federally-chartered, privately-capitalized mortgage conduits that would have exclusive access to the government's explicit guarantee of mortgages for catastrophic losses. Wells Fargo wrote,

> "Assuming a private sector solution is desired, one can either adopt a regulated utility model or rely on competition and lower barriers to entry to limit monopolistic returns."

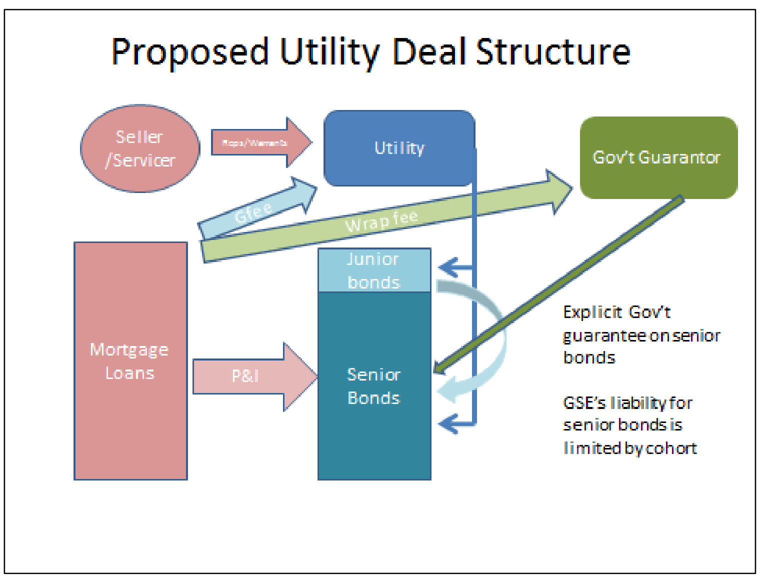
These single-purpose entities charter would restrict their activities to mortgage securitization, which would be allowed to hold a limited mortgage portfolio for operational and other specified purposes. The conduits would have limited charter privileges, which are limited to support of the liquidity of new securities, and exclude current GSE privileges such as exemptions from state and local taxes, use of the Federal Reserve as a fiscal agent, and a direct line of credit from Treasury. A strong regulator, who would serve as the chartering authority, would (i) ensure that the entities maintained high capital levels; (ii) approve the conduits' products and underwriting guidelines; (iii) establish portfolio limits; and (iv) serve as receiver in the event of impending failure.

Wells Fargo estimates that this proposed structure would be "tolerable" with conduits charging an estimated 72 basis points to guarantee a loan, which would increase mortgage rates about 50 basis points above current levels.

Wall Street

Andrew Davidson & Co.

In the spring of 2009, Andrew Davidson & Co., a leading provider of risk analytics and consulting for the mortgage and asset-backed securities industry, proposed that the GSEs be reconstituted as securitization-only vehicles, called Federal Securitization Co-operatives (FSC). These entities would create MBS with senior bonds, explicitly guaranteed by the federal government, and junior bonds, guaranteed by the utility. Andrew Davidson argues that allowing the FSCs to sell junior



bonds in the marketplace will provide more efficient pricing of MBS and, if implemented appropriately, would create market discipline for mortgage credit. Moreover, the use of junior bonds would allow the government to increase its protection from losses without significantly increasing mortgage rates. Andrew Davidson recommends that these entities—two to five in number—be based upon the utility model with ownership structured as co-operatives, owned by the mortgage originators.

Keefe Bruyette & Woods (KBW)

In a July 10 comment letter to Treasury regarding reform of the housing finance system, KBW's Chairman and Chief Executive Officer John G. Duffy outlined a co-operative framework for reforming the GSEs, using the FHLB System template as a model.

Specifically, Duffy recommended a phasing out of the GSEs' portfolio retention activities, which would involve segregating the enterprises' legacy assets into a Bad GSE (a vehicle with no equity, used only to run off assets) and Good GSE with a "meaningful" minimum capital requirement of 5% for mortgages on which the entity retains credit risk. Under the cooperative model, any bank that originates an agency conforming loan for sale to the GSE would be required to retain 5% of the loan balance as an equity investment in the GSE. For the industry as a whole, a 5% capital requirement would approximate $43 billion of which $2.2 billion would be Tier One capital, representing approximately 25 basis points of total capital. Given banks' ability to leverage, non-banks would be at a disadvantage under this proposed structure and may require a special capital structure to ensure they are able to compete effectively with banks in the mortgage origination market. Similar to the FHLBs, the cooperatives would have board of directors representing their institution's ownership capital in the entities.

KBW estimates that the transition of mortgage assets to the Good GSE would take five to seven years—at which point the entity would have capital of approximately $250 billion. This level of capital would allow the entity the ability to maintain "moderate" investment portfolios needed to guarantee mortgages with little, if any, leverage needed. KBW believes that the new entity would need to hold some mortgages in portfolio in order to facilitate securitizations and improve the market's liquidity.

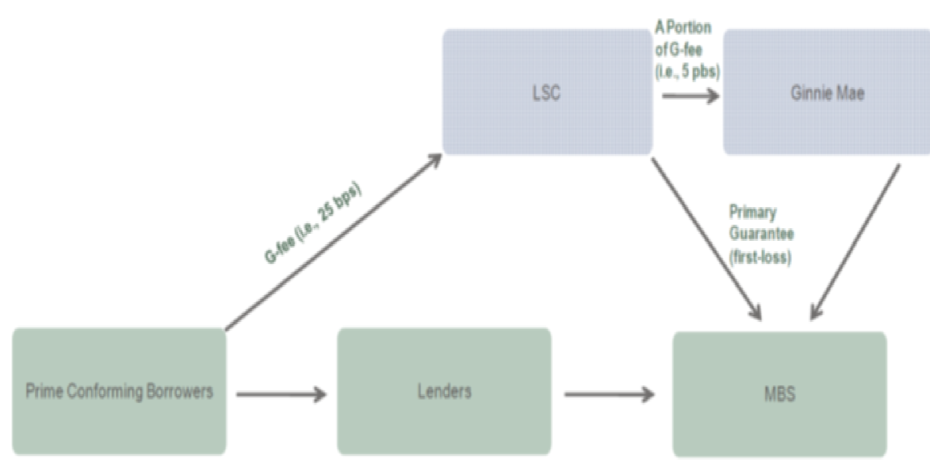
KBW's proposed GSE structure would likely result in higher rates for 30-year fixed-rate mortgages, which would likely move borrowers towards adjustable rate hybrid ARMs with shorter term resets of 5 to 7 years. Borrowers would clearly bear more interest rate risk, which KBW argues is a reasonable price to pay for financial stability. KBW believes that the issue of explicit government guarantees is moot in today's environment. That said, the explicit government guarantee would have a budgetary impact only to the extent that the new entity's capital and revenue are insufficient to cover potential losses, similar to FHA. Thus, KBW believes that the GSE successor entities should be set up to issue MBS with an explicit government guarantee.

REIT

Redwood Trust

In a July 25 comment letter on the reform of the housing finance system, Martin S. Hughes CEO of Redwood Trust [a Mill Valley, CA-based REIT], said the long-term objective of reform should be a mortgage market divided into two segments—one public, one private, both robust and with private capital filling the majority of the market's needs. However, given the complexities of the U.S.'s $11 trillion mortgage market, Hughes cautioned it will take years to transform the market into a structure that achieves that objective. Thus, a "credible, actionable transition plan" is needed, which provides an uninterrupted flow of mortgage credit to borrowers, while significantly reducing excessive reliance on government financing and the resulting burden on taxpayers. Specifically, Hughes proposes the creation of a Lender Sponsored Cooperative (LSC) to serve as a transition entity, which would continue to serve the liquidity needs of the prime conforming segment of the residential mortgage market by guaranteeing prime conforming MBS. The LSC, which would function similar to FHA with no leverage or portfolio activity, would be lender-owned to ensure that the lenders maintain appropriate levels of "skin in the game."

Figure 1. The LSC Concept



Similar to Fannie Mae and Freddie Mac, the LSC would collect a guarantee fee from mortgage remittances to cover the costs of the cooperative's guarantee. Ginnie Mae, or some other government entity, would also provide a backup guarantee on the MBS for which it would receive a portion of the guarantee fee. A LSC transition structure would have several benefits, including (i) taking the government out of the first-loss position on new mortgage debt and putting private capital at risk ahead of the government, except for a limited part of the market; (ii) preserving the TBA market and the 30-year fixed rate mortgage; (iii) providing a relatively simple plan that uses the existing platforms of the GSEs through a merger and transfer of the enterprises' infrastructures to the LSCs; (iv) utilizing the self-policing structure of a cooperative; and (v) facilitating a restart of the private securitization market as the conforming loan limit is phased down to $325,000 and limits for high cost areas are adjusted, as appropriate.

The Redwood Trust plan calls for a sunset provision to help ensure that this structure is used only for a transitionary period. Hughes calls for a strong regulator for the LSC, who would require at least double the 45 basis points capital requirement previously mandated for Fannie Mae and Freddie Mac. The multiple layers of credit enhancement under the Redwood Trust plan would include (i) strict, safe loan underwriting standards; (ii) substantial down payment requirements, ranging from 10% to 20% depending on the borrower's credit profile.; (iii) the LSC's strong capital and reserve levels; (iv) representations and warranties from creditworthy lenders with appropriate enforcement mechanisms; (vi) provision of a capital call for LSC members under certain circumstances; (vii) a strict safety and soundness regulator for the LSC; (viii) the LSC guarantee; and (ix) the government back-up guarantee.

Foundations

American Enterprise Institute (AEI)

In April 14 testimony before Congress, AEI resident fellow Alex J. Pollock proposed seven steps toward a sound mortgage finance system in the U.S., which included (i) creation of a private secondary market for prime conforming mortgages in which private capital is at risk; (ii) transition to a "no" GSE world with subsidies merged into HUD structures and subject to the budgetary process and on budget, using fair and transparent accounting; (iii) facilitation of credit risk retention by the loan originators; (iv) the development of countercyclical strategies, such as falling LTV ratios as asset prices inflate and higher loan loss reserves during "good' times; (v) development of clear, straightforward disclosures of key information to borrowers; (vi) the reintroduction of savings as an explicit goal of mortgage finance; and (vii) in the event GSEs survive, avoid the use of government-insured banks to promote the enterprises' finances.

Aspen Institute

In a July 20 comment letter to Treasury regarding reform of the housing finance system, the Aspen Institute proposes to transform the U.S. housing policy through a dedicated down payment savings vehicle, called Home Savings Accounts (HSA), with government incentives for low- and middle-income Americans. The Institute argues that HSAs are a pragmatic way to give these groups a safer and more secure path to homeownership. Under the proposal, savers with incomes under $50,000 ($100,000 for married couples) would get a 50% match on their contributions, up to a lifetime cap of $5,000. HSAs could only be withdrawn for down payment and closing costs, when buying a home, but could be converted into retirement accounts without penalty. These interest-bearing accounts would be FDIC-insured. The Aspen Institute projects that approximately 4.5

million HSAs would be opened over a five year period for an estimated cost to the federal government of $10 billion. While not trivial, this program's cost would be inconsequential relative to cost of the federal government's current housing policies, projected to total $850 billion from 2009 to 2013 by the Joint Committee on Taxation.

The Cato Institution

In March 23 testimony before Congress, Mark Calabria, director of Cato's Financial Regulation studies, recommended privatizing Fannie Mae and Freddie Mac and perhaps using the FHLBs' co-operative model. Whether public or private, Calabria suggested breaking up Fannie Mae and Freddie Mac into a dozen equal sized entities that are not too big to fail. The new entities' securities should be subjected to the 1933 Securities Act and 1934 Securities Exchange Act, and statutory treatment of GSEs' debt as "government debt" should be eliminated. These new entities should (i) be chartered by the regulator, not Congress; (ii) be subject to the bankruptcy code; (iii) be allowed to issue only MBS; (iv) be prohibited from participating in the guarantee business; (v) require cash down payments of 5% for mortgages they purchase, which would increase to 10% over several years, with piggy-back loans prohibited; (vi) eliminate loan limits and housing goals by setting loan sizes based upon income for a given geographic area, such as three times the state's median income; and (vii) be prohibited from issuing unsecured debt; (viii) limit or bar foreign central banks from holding GSE debt; and (ix) be prohibited from retaining mortgage portfolios. Additionally, bank regulators should be required to treat GSE debt as non-government corporate debt.

Center for American Progress (CAP)

In a December 2009 white paper, CAP published a white paper on GSE reform, calling for the creation of a limited number of charter mortgage issuers (CMIs) to issue government-guaranteed MBS for both single-family and multifamily mortgages in exchange for a small fee, used to create an actuarially sound Taxpayer Protection Insurance Fund. While the CMIs' MBS would be explicitly guaranteed by the federal government, the entities debt and equity would explicitly NOT be guaranteed.
CAP recommends that the GSEs' affordable housing goals be eliminated. Instead, all MBS issuers would be called upon to support underserved communities through a fee charged on each MBS issuance that would support the Affordable Housing Trust Fund, the Capital Magnet Fund (for CDFIs) and perhaps other vehicles for financing affordable housing. In addition, CAP calls for the CMIs to maintain a limited retained mortgage portfolio to the extent that it serves certain public purposes, such as providing countercyclical liquidity and liquidity for affordable multifamily housing for both fixed-income and mixed use development and small multifamily. (The roles of FHA, VA, Ginnie Mae, and RHS would continue.)

The CMIs would also be subject to the general duty to serve underserved communities. CAP suggests measuring the CMIs' securitization activities in underserved markets by examining the percentage of the issuer's overall securitization, based upon the number of loans securitized (not the dollar amount), that fall into underserved markets relative to that for all other non-CMI issuers. CAP suggests also factoring in whether the issuer is enhancing access to credit in underserved markets in other ways, such as through participation in deals, investments and grants with other organizations, such as CDFIs, that effectively serve these markets. If an issuer fails to meet this evaluation, it would be penalized with heightened requirements to serve underserved communities, which might include grants, volunteering, counseling and/or payment of substantial additional fees to the Affordable Housing Trust Fund or Capital Magnet Funds.

Under this proposal, the CMIs would be structured under the utility model (with the co-operative model considered as an alternative), as privately-owned entities whose profits are subject to regulation. CAP notes that the success of this framework hinges on the ability of new CMIs to attract sufficient levels of private capital, which the authors fear may be problematic due to profit constraints, higher capital requirements, and a stricter regulatory structure.

CAP proposes a stringent regulatory regime for the CMIs to address product approval, capitalization requirements, reserve requirements, and operational and credit risks. CAP proposes reducing the size of the CMIs' retained mortgage portfolios, by allowing (only) investments for certain purposes, such as mixed-income and mixed-use development and small multifamily, providing capacity for crises and financial downturns, and testing new products.

The CMIs' primary regulator would (i) determine the specific characteristics of the mortgages eligible for securitization; (ii) set the conforming loan limits; (iii) require adequate capital levels to cover mortgage risk and ensure adequacy of the taxpayer protection insurance fund to protect against catastrophic loss; (iv) set managed returns to ensure durable capital investment to support the housing market without encouraging risky behavior or "undu[e] capture" of the value provided by a government guarantee; (vi) have the authority to place CMIs into conservatorship; and (vii) ensure that the CMIs serve all markets at all times in a fair and equitable manner.

CAP also recommends uniform comprehensive regulation of any institution seeking to securitize any U.S. mortgage. This regulatory system should (i) set strict limits on the types of MBS that could be issued for all loan collateral types and amounts; (ii) require approval to issue all MBS, including those collateralized by jumbo mortgages, to level the playing field and eliminate competition from unregulated entities; (iii) establish a strong prudential risk oversight regime, including rigorous capital and risk standards; (iv) require some form of "skin in the game" risk retention for all mortgage originators; (v) set standards for acceptable underwriting and mortgage characteristics; and (vi) set a small fee to support the Affordable Housing Trust Fund and Capital Magnet Funds (funds that Congress created in 2008 for Fannie Mae and Freddie Mac).

The CAP proposal leaves open a number of issues, including (i) how many CMIs would be formed; (ii) which model—the utility or cooperative structure—should be used; (iii) how to make certain the entities can raise adequate capital; and (iv) how the structure would promote innovation.

Economic Policies for the 21st Century

In a May 24 white paper issued by Economic Policies for the 21st Century, authors Donald Marron and Phillip Swagel argue that the reformed GSEs should be private companies, with a narrow focus on buying and securitizing conforming mortgages, and that qualify for government backing. These fully private entities, with no remaining linkage—implicitly or explicitly—to the federal government, would be subject to rigorous regulatory oversight. These new entities would have no retained mortgage portfolios, other than a warehouse line, and have no associated debt. They would compensate the government for its explicit backing of MBS by paying actuarially-sound fees to pay taxpayers for the insurance. The government's backstop for MBS would be triggered only after a firm's shareholders are wiped out.

Under this model, all special government benefits for Fannie Mae and Freddie Mac would be repealed and their lines of credit with Treasury would be terminated. Over time, the authors believe that Fannie Mae and Freddie Mac would evolve into either specialized firms focused on securitization or would become part of a vertically integrated financial services firm that both originates and securitizes mortgages. Support for affordable housing could be structured through a fee on mortgage securitizations or tax on the entities themselves, but carried out transparently through regular appropriations channels.

The authors believe that securitization of conforming loans should be opened to competition and the government should encourage other firms, also subject to regulatory oversight, to participate in this market. These private firms may also purchase from the government the MBS-level guarantee. Competition in the securitization market helps ensure that the subsidy embedded in the government guarantee is passed along to homeowners and homebuyers. Following a long transition period for competition in the securitization space to evolve, operating restrictions on the new Fannie and Freddie could be allowed to roll off over time. Eventually, these entities could be allowed to have retained portfolios, along with their competitors. Eventually, these new entities could become vertically integrated or acquired by banks.

Reason Foundation

In April 14 testimony before Congress, Anthony Randazzo, Reason's director of economic research, urged policymakers to begin taking steps now to phase out Fannie Mae's and Freddie Mac's operations through (i) a four to five year divesture of the GSEs' mortgage portfolios and liabilities, liquidation of assets, and winding down of their purchasing and securitization operations; (ii) shifting the GSEs' bad assets into a bad bank holding company entity, preferably serviced by a private sector asset manager; and (iii) shifting the GSEs' affordable housing mission to FHA. Randazzo argues that reform efforts should begin now, by reducing conforming loan limits to restrict the GSEs' operations the jumbo market and limit the timeframe in which the GSEs can hold individual mortgages and MBS in their portfolio. He urges Congress to provide a framework that identifies ways the private sector can assume the GSEs' current role in the market.

Urban Institute

In a May 2010 white paper issued on behalf of the Urban Institute, the New York University's Furman Center for Real Estate evaluated the major reform proposals for Fannie Mae and Freddie Mac proposed by the Center for American Progress, Credit Suisse, the Mortgage Bankers Association, and the HPC. The authors, Ingrid Gould Ellen, John Napier Tye and Mark A. Willis, noted that few, if any, proposals explicitly address multifamily housing finance and suggested it may be possible to create mortgage insurance funds at the state and local levels, similar to those run by the State of New York Mortgage Agency (SONYMA). The SONYMA works with pre-approved lenders to develop loan programs tailored to meet local needs, and with government subsidies, in the form of 100% credit insurance on loans sold to pension plans and 75% first-loss insurance for loans sold to private investors. As a result of its own revenue stream from the mortgage transfer tax and limited losses, SONYMA has been able to achieve an AA rating. The authors question if this success could be replicated and expanded over a broader geographic region through a federal government MBS wrap and prudent creation of criteria for structuring the insurance funds (e.g., addressing the level of top loss provided on individual transactions, the ratio of reserves to risk, the mechanisms for claims payment, and criteria for selecting originators). The explicit government guarantee would provide an investment grade rating, which could be used to help create a secondary market for these locally-underwritten and locally-tailored loans. The goal of such a system would be to standardize origination of the loans and their subsequent purchase by institutional investors.

The authors also note that covered bonds are another vehicle that could expand the amount of funds available for a bank to lend, and would have three distinct advantages over MBS as a method of mortgage finance. These include (i) the potential of reducing principal-agent problems, because the banks themselves hold the mortgages securing the covered bonds; (ii) the banks can modify these mortgages if necessary, because the mortgages remain on their balance sheet; and (iii) these bonds also have the potential—depending on their structure—of improving the options for homeowners who find themselves underwater. The authors note that there is uncertainty regarding the level of liquidity that covered bonds can provide relative to MBS. Moreover, it may be difficult for covered bonds to achieve "the minimum efficient scale" to compete with the GSEs' MBS, wrote the authors. There are also important questions about whether covered bonds could be cost-competitive with existing mortgage finance options that are available today, in light of their economies of scale and the government subsidies that are in place. Instead of replacing existing mortgage products, covered bonds may be a useful vehicle to increase market liquidity for non-conventional mortgage products, such as jumbo mortgages.

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A Private Lender Cooperative Model for Residential Mortgage Finance

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August 2010

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A Private Lender Cooperative Model for Residential Mortgage Finance
Toni Dechario, Patricia Mosser, Joseph Tracy, James Vickery, and Joshua Wright
Federal Reserve Bank of New York Staff Reports, no. 466
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JEL classification: G21, E02, G28, G01

Abstract

We describe a set of six design principles for the reorganization of the U.S. housing finance system and apply them to one model for replacing Fannie Mae and Freddie Mac that has so far received frequent mention but little sustained analysis – the lender cooperative utility. We discuss the pros and cons of such a model and propose a method for organizing participation in a mutual loss pool and an explicit, priced government insurance mechanism. We also discuss how these principles and this model are consistent with preserving the "to-be-announced," or TBA, market – particularly if the fixed-rate mortgage remains a focus of public policy.

Key words: GSE, MBS, mortgage

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For the past several decades Freddie Mac and Fannie Mae ("the housing GSEs")[1]have played a central role in U.S. residential mortgage finance. The design of what replaces the GSEs, which are currently in conservatorship, is of enormous consequence to the performance of the U.S. housing market going forward. In our opinion, the goals of the efforts to reorganize Freddie and Fannie should be to promote the availability and stability of mortgage finance for the core of the housing market while minimizing systemic risk and costs to taxpayers. Any new structure should be designed to be resilient over the business cycle so that mortgage financing neither dries up during periods of market stress nor expands excessively during periods of market ebullience.

The recent financial crisis demonstrated how the implicit government guarantee and unique market structure of agency MBS can support the availability of mortgage credit during times of severe market stress. Figures 1 and 2 show the relative stability of the supply of mortgages eligible for securitization through Fannie and Freddie ("conforming mortgages"), compared to jumbo mortgages, which are of similar credit quality to conforming loans but are not eligible for agency securitization because of their larger size.[2]

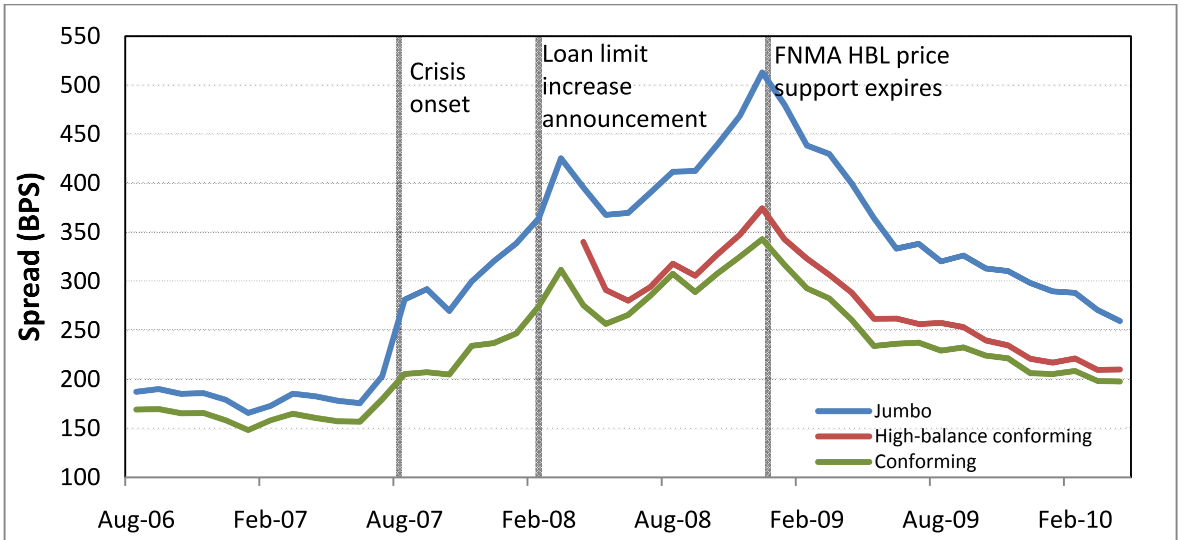
Prior to the onset of the financial crisis, the jumbo segment accounted for around one-quarter of the value of mortgage originations (Figure 2), and the interest rate spread between jumbo and conforming loans was small and declining (Figure 1). However, as the crisis unfolded after August 2007, spreads between jumbo rates and conforming loan rates widened sharply from about 25 basis points to over 100 basis points, and the share of jumbo mortgage originations fell from 30 percent to only 10 percent. This sharp decline in jumbo mortgage supply reflected a collapse in non-agency MBS issuance after mid-2007, and the effect of increasing credit risk premia given the lack of a government credit guarantee on jumbo loans.

In response to this trend, and to provide additional support for the mortgage market, the conforming loan limit was increased in high housing-cost areas in February 2008, from $417,000 to as much as $729,750.[3] For loans that fell between the old and new conforming loan limits ("high-balance conforming loans"), which now became eligible for agency securitization, interest rates

[1] While the FHLB system also comprises GSEs, we will use this term to refer only to Fannie Mae and Freddie Mac for simplicity's sake.
[2] The conforming loan limit is set each year by the GSEs' regulator (the Federal Housing Finance Agency (FHFA), formerly the Office of Federal Housing Enterprise Oversight, or OFHEO) based on its home price index. The GSEs are forbidden by their charters to purchase loans above that limit.
[3] The $729,750 limit was established on a temporary basis and renewed several times, even after a permanent higher limit of $625,500 was set in August 2008. See Vickery and Wright (2010) forthcoming, for a more detailed discussion.

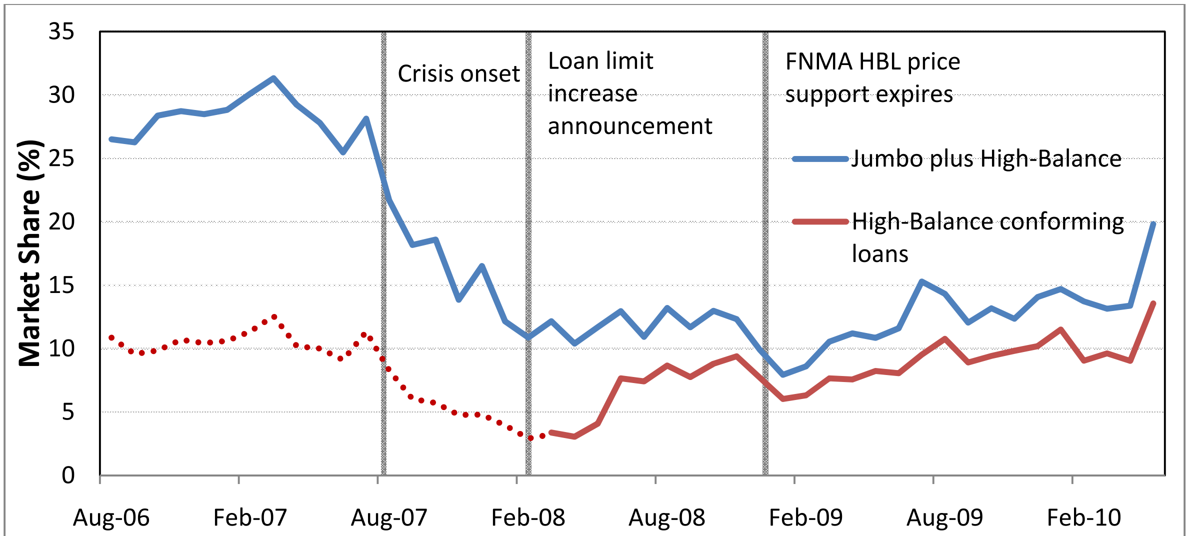
quickly returned to levels very close to those for standard conforming loans, and the quantity of lending expanded significantly. However, the supply of mortgage finance above the new higher conforming loan limits remained low, reflecting the inability of originators to securitize or hedge the credit risk on those loans.

Figure 1. Mortgage Rates and Treasury Yield Spread



Source: HSH Associates

Figure 2. Market Share of Jumbo and High-Balance Conforming Loans



Source: Lender Processing Services

Principles for Reform

The paper by Ellen, Tye and Willis (2010) provides a good background on U.S. housing finance and the basic options for reorganizing the GSEs. There are six principles that we believe should guide the selection among these various options.

1. If possible we should preserve what worked well with the GSEs, in particular standardization of mortgage underwriting and the "to-be-announced" (TBA) market. Both are important for providing liquidity to the market.
2. Economies of scale and scope are important design considerations. Scale economies in securitizing mortgages suggest that any mortgage securitizer-insurers should be relatively few in number so long as the design can address how this choice impacts competition in the market. While the GSEs were active in providing lending to the multi-family sector, these loans proved to be difficult to securitize and generally remained within the GSEs' portfolios as whole loans. This suggests that there are few economies of scope here and consideration should be given to separating the support mechanisms for single- and multi-family lending.
3. Government housing subsidies should be transparent and accounted for on the government's balance sheet. Affordable housing goals will likely be more effective if the mandate is focused in one government agency such as the FHA. In contrast, the new entities replacing the GSEs should be given the mandate to focus on the "core" of the housing market and not be taxed with affordable housing targets.[4]
4. In periods of market stress, it may be necessary to have a liquidity provider or perhaps even a "buyer of last resort" for mortgage securities, but this should not be carried out by the new entities unless they are explicitly a part of the federal government. If a private model is selected, the new entities should not be allowed to have a large portfolio either for investment purposes or to perform a buyer of last resort role, since this creates incentives to emphasize the profitability of the portfolio over policy objectives.
5. A lesson from the recent financial crisis is that the government ineluctably owns the catastrophe or "tail" risk in housing credit, and if it cannot avoid providing the insurance, then it should make that insurance explicit and fairly priced so that there is no expected long-run cost to the government.

[4] The "core" of the housing market would exclude the subprime sector. The new entities should be required to meet all fair lending standards and to promote non-discriminatory access to mortgage credit.

6. The design of any successor to the GSEs must take a stand on whether the 30-year fixed rate amortizing mortgage with no prepayment penalty is going to remain a key mortgage product. We assume that U.S. households and policymakers will continue to have a preference for the fixed rate mortgage as a staple of housing finance because it insulates homeowners from fluctuations in interest rates. As a result, securitization will remain an attractive alternative for mortgage originators (because they do not wish to hold such assets on balance sheet against their short-term liabilities or devote capital and liquidity resources to supporting them) and so an active secondary market will be needed to support it.

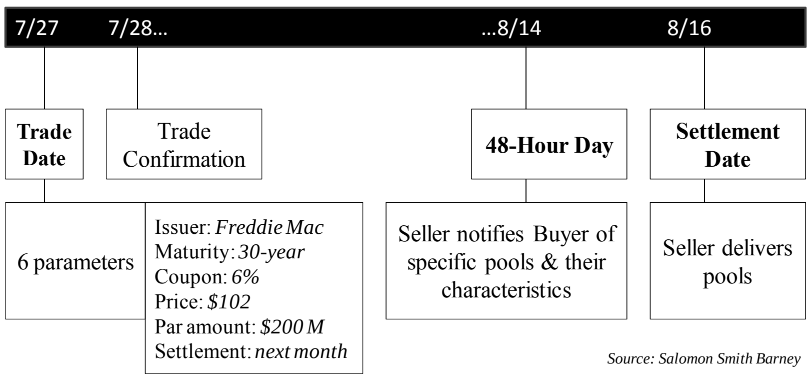
The TBA Market

With respect to the first principle, a great legacy of Freddie and Fannie is that they helped to create a deep and liquid market for residential mortgage finance in the United States. The implicit government credit guarantee and the liquidity of the agency MBS market have lowered and stabilized mortgage rates paid by households. Crucially, this liquidity relies not only on the implicit guarantee and the size of the market, but also on certain technical features of the way agency MBS are traded – a factor whose importance has been underappreciated by most commentators.

The vast majority of agency MBS trading occurs in what is known as the TBA ("to-be-announced") forward market. In a TBA trade, participants agree on a price to transact a given volume of agency MBS at a specified future date (the settlement date). As the name suggests, the defining feature of a TBA trade is that the actual identity of the securities to be delivered at settlement is not specified on the trade date. Instead, participants agree only on 6 general parameters of the securities to be delivered. A timeline for a typical TBA trade is shown in Figure 2, including three key dates. On the day of the trade, the buyer and the seller establish the 6 general parameters, including the date the corresponding cash and security will actually be exchanged, which may be anywhere from 3 to 90 days later.

This process is enabled by the GSEs' exemptions from the Securities Act of 1933 and by the standardization and automation of the mortgage underwriting process promoted by the GSEs, which have also significantly lowered the transaction costs associated with originating, servicing, and refinancing a mortgage. The TBA market allows mortgage lenders to sell mortgages forward before they are even originated, reducing the length of time needed to "warehouse" the loans on balance sheet before issuing an MBS. In addition, the TBA market provides a cheap way for lenders to hedge the interest rate risk involved in offering borrowers the ability to lock-in a rate for 30 days while closing on a mortgage. TBA trading is thus a key link between the primary and secondary mortgage market and constitutes a major difference from non-agency or "private-label" MBS – in addition to the credit guarantee of the GSEs.

Figure 2. Example TBA Timeline



Similar to Treasury futures, TBAs trade on a "cheapest to deliver" basis: traders assume they will receive the collateral with the most disadvantageous characteristics and trade every TBA at the corresponding price. This convention is much more counterintuitive when applied to mortgages than Treasuries, since there are so many more features by which mortgage pools can differ from one another. The assumption of homogeneity helps take what is a fundamentally heterogeneous set of individual underlying mortgages and transform them into a very large set of fungible – and therefore liquid – fixed-income instruments.

This assumption of homogeneity is of course also supported by the perceived government backing of the GSEs, which has traditionally assuaged concerns about the underlying mortgage credit risk. However, other factors contribute meaningfully to TBA fungibility as well. At the loan level, the standardization of lending criteria for loans eligible for agency MBS (despite some variation over the years[5]) constrains the variation among the borrowers and properties underlying the MBS. At the security level, homogenizing factors include the geographic diversification

[5] Fannie and Freddie did venture into guaranteeing and securitizing some low-quality Alt-A loans in the last decade, but this was arguably due to competitive pressure from the private-label securitizers, long after the GSEs succeeded in establishing the conforming loan standards.

incorporated into the pooling process, the limited number of issuers, and the simple structure of pass-through security features[6].

Despite the standardization of the securities, the delayed disclosure inherent in the TBA trading process runs contrary to the underlying philosophy of securities law regarding disclosure and transparency. In fact, TBAs are only legal because the GSEs are exempt from the Securities Act of 1933, which requires issuers to file detailed registration documents at the SEC and to list the specific assets underlying any asset-backed securitization before it is issued. Without this exemption, the GSEs couldn't issue TBAs since at the time of issuance, only the limited set of security parameters and the conforming loan underwriting standards are laid out, rather than specific collateral. In a TBA, the underlying mortgage loans have not been identified and may not even have been originated yet (which is essential to the ratelock-hedging function described below). That is, the TBA trade date can precede the origination date of the underlying loans. This contrasts sharply with private-label MBS, whose loans must be originated before trading because they require many more disclosures with the SEC. Since they are ineligible for TBA trading, non-agency MBS are much less liquid than agency MBS and while it might be possible to make them eligible, this would require significant amendment of current securities law. More generally, TBA trading can probably be sustained with a variety of organizational structures, but fits most easily with institutions that receive some level of government support.

TBA trading thus greatly simplifies the analytical problem confronting participants in agency MBS markets, restricting its scope to the more tractable set of risks associated with the parameters of the TBA contract. Importantly, this has attracted a number of investors who are unwilling to perform credit analysis – notably foreign central banks, and a variety of mutual funds and hedge funds who specialize in interest-rate analysis. That translates into more capital for financing mortgages and thus lower rates for homeowners. Some economists have proposed formal models for how the temporary restriction of information in TBAs decreases information asymmetries and enhances liquidity[7].

TBAs also facilitate hedging and funding by allowing lenders to pre-arrange prices for mortgages that they are still in the process of originating. This effectively allows them to hedge their exposure to interest-rate risk after a borrower locks in a rate. This exposure occurs when borrowers

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[6] TBAs are only possible for "pass-through" securities, whereby the underlying mortgage principal and interest payments are forwarded to security-holders on a *pro rata* basis, with no tranching or structuring of cash flows.

[7] See Glaeser & Kallal (1997).

exercise an option that lenders frequently give successful mortgage applicants to lock in a mortgage rate (usually the primary mortgage rate prevailing on the date of the application's approval) for a period of 60 to 90 days. Lenders face the risk that interest rates rise – and mortgage valuations fall – after having promised a rate to borrowers but before the loan closes and they get to sell the loan to the secondary market. Lenders can eliminate this risk by selling a TBA forward and manage their hedges dynamically with options or a hedging mechanism unique to TBAs known as the "dollar roll". (Dollar rolls provide an additional financing vehicle, drawing in market participants whose financing and risk management needs are better suited to the idiosyncrasies of this instrument[8]).

It is important to note that not all agency MBS are traded as TBAs. Some loans that the GSEs are authorized to purchase are not eligible for delivery as part of a TBA contract, because the criteria for TBA eligibility are set by a private industry trade group – that excludes the GSEs – rather than any governmental authority. These loans trade at significant discounts relative to TBAs due to differences in various prepayment characteristics and, crucially, liquidity[9]. The lack of direct government influence over the TBA trading conventions is all the more notable in light of the repeated failures of private mortgage futures contracts, which in part reflect the challenges of coordinating action among market participants.

Structure of Cooperative Utility Model

One model for replacing Fannie Mae and Freddie Mac that has so far received frequent mention but little sustained analysis is the lender cooperative utility. Yet while each different model for a successor to the GSEs has its own strengths and weaknesses, a private lender cooperative utility may provide the best overall solution based on the design principles listed earlier. Under this model, securitization would be carried out by a mortgage securitization cooperative that would be mutually owned by a membership consisting of financial institutions engaged in residential mortgage lending. Cooperative or mutual structures have existed for more than a century in the U.S. financial system, ranging from clearing houses (e.g. CME until 2000, DTC, CLS, ICE Trust), banking (e.g. mutual savings banks, credit unions and the FHLB system) and agricultural finance (e.g. the Farm Credit System). The main goal of a cooperative is to provide services to its members and because

[8] The alternative is MBS repo (repurchase transactions), which is a somewhat more expensive means of financing agency MBS and differs in a variety of features – see Vickery & Wright (2010), forthcoming.
[9] Vickery & Wright (2010) provide a detailed comparison between TBAs and one of these ineligible loan-types.

those members are also the cooperative's owners, any excess profits generated by the cooperative are returned to the members. Similarly, losses are shared on a pro-rata basis based on each member's equity stake.

Basic Structure and Governance

Only members would be eligible to sell mortgages to the securitization cooperative, and each member would also hold an equity stake in the cooperative entity. Membership should include a broad range of institutions, including large and small lenders, as well as both banks and nonbanks. All these members would be able to directly securitize loans through the cooperative and provide correspondent services for non-member access. Such correspondent relationships are a common practice already, due to larger firms' ability to negotiate more favorable guarantee fees with the GSEs, and provide large banks a substantial portion of the mortgages they sell to the GSEs for securitization. Key decision-making authority would be delegated to a Board of Directors made up primarily of cooperative members, but also including independent directors. Since the bulk of mortgage lending tends to be concentrated amongst a small group of financial institutions (currently over 60% of origination is performed by only 4 institutions[10]), the cooperative's charter should include provisions to protect small institutions and ensure that they have equal access to the cooperative's services.[11]

Capital and Guarantee Fees

Each member would be required to provide equity capital to the cooperative. The capital structure would include initial ownership shares of paid in equity and a mutualized loss pool. Members' contributions to the mutualized loss pool would depend on the volume of mortgages securitized (i.e. the intensity of the institution's use of the cooperative, analogous to the approach used within the FHLB system). The mutualized loss pool would, over time, build up to provide the bulk of the capital base and serve as a reserve against credit-related mortgage losses.

As with Freddie and Fannie, the cooperative would receive MBS guarantee fees up front and on a flow basis. These fees would be split among several uses: 1) payments of the required

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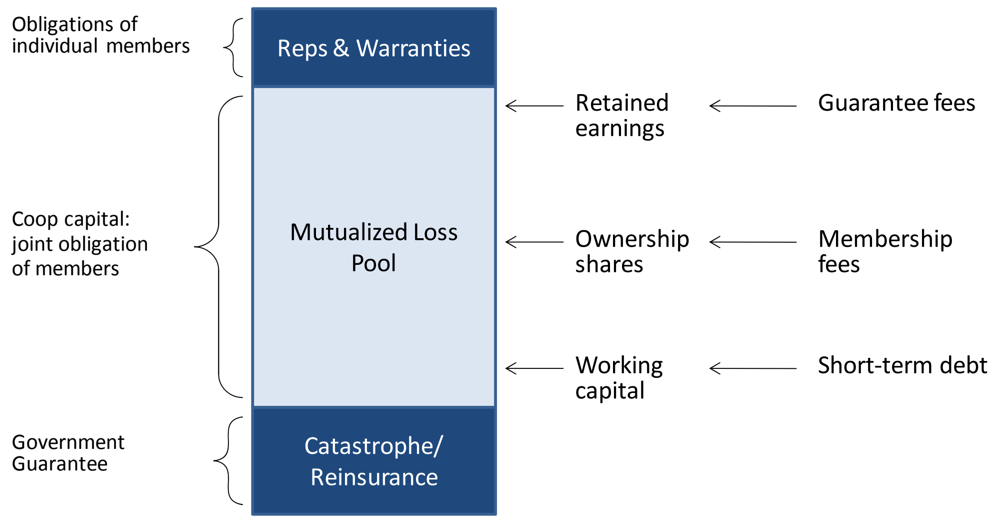
[10] See http://www.mortgagestats.com/residential_lending/.

[11] Consistent with this principle, the FHLB system limits the voting rights of any individual institution, and places geographic restrictions on the composition of the Board of Directors in each district, that limits the influence of the largest shareholders. If anything, the FHLB system has been accused of tilting too strongly towards smaller institutions.

reinsurance fee to the government for tail risk insurance; 2) payments into the general revenue of the cooperative to cover operating and non-credit-related expenses; and 3) payments to the mutualized reserve pool used to cover credit losses. An example of a capital waterfall for the cooperative is shown in Figure 3.

Figure 3. Capital Waterfall for a Private Lender Cooperative Utility



The lender cooperative would focus on the "core" of the housing market, letting the FHA take the lead on programs for first-time homebuyers as well as mortgage products to make homeownership more affordable for low-income households. We anticipate that this core market would contain only a few standard mortgage products such as the 30-year fixed rate mortgage and plain vanilla adjustable rate mortgages. Innovation in mortgage products would occur in the periphery of the market outside of the cooperative. Products could be considered to be added to the core product set only after sufficient history on these products has been accumulated to be able to estimate the government's tail risk premium. Since the tail risk is explicitly priced by the government, there is a good argument for the government to avoid "taxing" the lender cooperative to support any specific housing initiatives or assigning it any housing subsidy mandates. The possibility that the tail-risk insurance may be underpriced does not in our opinion make a good case for placing affordable housing mandates on the cooperative. A better response would be to adjust the price for the insurance and to focus the mandates in a government entity such as the FHA. However, even a tax is better than quotas or other targets that would distort the cooperative's business decisions.

An important design issue is how to structure the government tail risk insurance for the lender cooperative. The choice involves a tradeoff between increased pooling on the one hand, which implies that the government insurance would pay out infrequently and in response to systemic events, and on the other hand the degree to which the lender cooperative is still a "going concern" at the time of the payout. At one extreme, the tail risk insurance could be provided to each specific mortgage (like FHA insurance). At the loan level, the insurance is likely to be triggered by idiosyncratic factors such as health shocks and divorce that impact a borrower's ability to pay. Alternatively, the insurance could also be specified at the MBS security level (as in GNMA pool insurance). By pooling across mortgages, insurance payouts would be less likely to be triggered by idiosyncratic factors affecting individual borrowers, but would still be susceptible to idiosyncratic and more regional shocks as opposed to macro shocks[12]. This could be addressed by pooling across MBS securities in a specific "vintage" which could be defined by a particular time period in which the securities were created. Finally, the trigger for the insurance could be defined at the level of the cooperative's mutualized insurance fund. That is, the insurance pays out when credit losses have eroded the cooperative's mutualized loss pool below some minimum threshold.

This last triggering mechanism insures that payouts would only occur in response to systemic events, yet may leave the lender cooperative in a weak position to maintain lending even after the government support is provided. A goal of the new entity is to enable the provision of mortgage lending even in periods of stress in credit markets through a robust securitization mechanism that facilitates mortgage liquidity. This suggests that the best tradeoff for the trigger point in the government tail risk insurance would be applying it to whole vintages of MBS. In doing so, the vintage should be defined in such a way that clear information regarding the performance of the vintage is only available after the vintage is closed for new issuance. This would prevent adverse selection whereby lenders know that a vintage is performing poorly enough to likely trigger government payouts and therefore those lenders with low-quality loans to opt into the vintage and those lenders with higher-quality mortgages to opt out.

The other advantage of the vintage-based trigger is that problems with any given vintage or set of vintages will be less likely to inhibit the ability of the lending cooperative to continue to perform its securitization function going forward. As a result, the cooperative remains a going concern even in periods when the insurance is triggered. This in combination with lending standards

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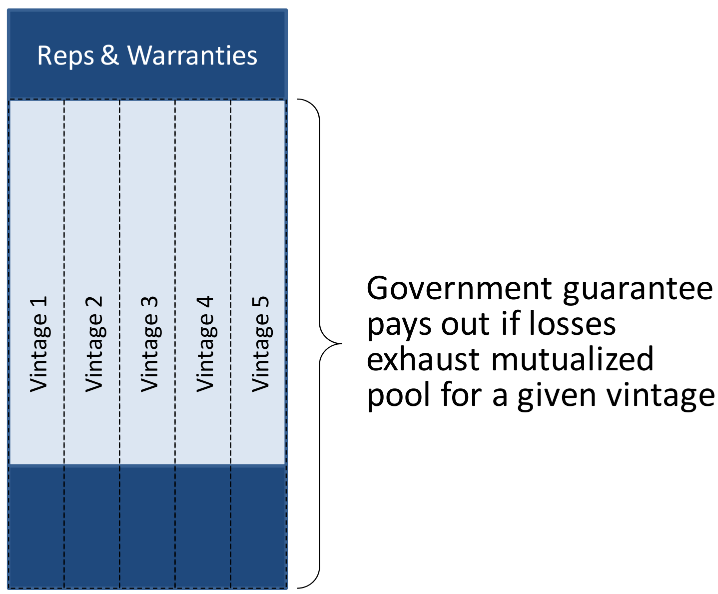
[12] Even in normal times with rising house prices and a growing economy, the GSEs had to pay out for losses on individual MBS every year.

and insurance pricing that are constant over the credit cycle should help to limit the pro-cyclicality of the provision of residential mortgage credit. The government tail risk insurance provides a "fire break" between existing vintages and new lending, and helps to insure that the mutualized insurance fund is never depleted to the point where market participants question the viability of the cooperative and the market it supports. This is illustrated in Figure 4.

Figure 4. Vintage-Level Insurance for a Private Lender Cooperative Utility



Limiting moral hazard is always a concern whenever the government is providing tail risk insurance. Lending standards have to be maintained to insure that the insurance is only paying out in the case of true tail events. Otherwise, a race to the bottom could occur among lenders, implying that the "tail" is growing in size over time. Two factors will help to limit moral hazard for the lender cooperative. The first factor is putting borrowers in the first-loss position ahead of the government. Minimum down payment requirements should be enforced for all mortgage products that the government provides insurance on. These down payment requirements should not vary over the cycle.[13] In addition, borrowers should not be able to purchase private mortgage insurance as an alternative to making the required down payment unless they pay a higher mortgage rate to the

[13] Maintaining minimum down payment requirements would help to mitigate the pro-cyclicality of leverage over the cycle which can exacerbate asset price cycles. It may also be helpful to redesign the mortgage contract to prohibit the borrower from taking on subsequent 2nd-liens that push the combined LTV above the allowed maximum. This would still allow a borrower to borrow against gains in house prices but would maintain the collateral buffer for the cooperative.

cooperative and therefore to the government. The second factor is that the cooperative would absorb losses on the securities in each vintage ahead of the government. These losses are shared across the members of the cooperative, but weighted toward those that participated most heavily in each vintage, which provides incentives for the members to maintain high credit standards, and importantly, to monitor one another.[14] The cooperative may choose to reinsure some of the credit loss exposure to the mutual insurance fund through a private mortgage insurer, subject to regulatory approval.

Regulation and oversight

While the first loss positions of the borrower and the cooperative are important safeguards against moral hazard, the government would still need to provide regulatory oversight of the cooperative. The FHFA (or a successor agency) would be responsible for regulatory oversight and management of the government's tail risk insurance fund. The FHFA would need enhanced regulatory powers including 1) approval of all new mortgage products and lines of business that can be conducted by the cooperative; 2) direct oversight of the risk-based pricing framework for guaranteeing principal and interest; 3) oversight of the cooperative's risk management systems, such as stress testing; and 4) the ability to veto any changes in guarantee fees or dividends.

Higher minimum capital standards, as well as more stringent risk-based capital standards would be required to protect the government's insurance fund. In addition, the regulator should be removed from the annual appropriations process in order to minimize political influence. The regulator could also determine, establish, and manage the government's tail risk insurance fund. One option is that tail risk premia could be paid into a reserve account which builds up over time, analogous to the reserve funds of the FDIC or FHA. If this reinsurance fund is depleted due to significant mortgage credit losses, it must be replenished by charging higher tail risk insurance premia. An alternative approach is "true" insurance, where tail-risk premia are set at some fixed level, and any excess losses are simply charged to general government revenue.

[14] The performance of each member's mortgages can also be tracked by the cooperative as a discipline device. If a particular member's mortgages are performing consistently below standard, that member can be prohibited from issuing new mortgages into the cooperative until its underwriting problems have been corrected to the satisfaction of the cooperative.

A disadvantage of FDIC-style insurance is that it could exacerbate cycles in mortgage lending, because reinsurance premia would be raised exactly when the mortgage and housing market are under stress. Conversely, there would be pressure to reduce tail insurance premia during periods when defaults are low and the reserve account is large, potentially fuelling excessive credit booms during such periods. An intermediate solution may be charging the government reinsurer to recoup losses on tail risk reinsurance, but only over a longer period (e.g. 10 years). This should reduce the effect on mortgage rates in the short run, since the recoupment is smoothed over a long period of time. Regulation could also stipulate that the fund not seek to recoup past losses during periods of market stress, to further reduce pro-cyclicality.

Advantages and disadvantages of the cooperative model

There are several potential advantages associated with the private lender cooperative model as a successor to the GSEs.

- *Low costs, narrow mission.* Cooperatives have incentives to minimize costs, and to maintain a narrow mission to avoid cannibalizing members' other profitable business activities. For instance, DTC provides clearing and settlement for its members but not custodial services, which is provided by several of its members. We envision that several members of the cooperative would also be active participants in lending in the peripheral mortgage market outside of the "core" products securitized by the cooperative.
- *May help limit monopoly power.* A mutual organization may have fewer incentives to exercise market power over mortgage originators than a for-profit enterprise. A for-profit firm has incentives to exercise monopoly power to increase profits, as Freddie and Fannie have arguably done in the past. Under a cooperative structure, excess profits are simply returned to members (i.e. to the lenders themselves) on a pro rata basis, proportional to securitization activity. Assuming competition amongst lenders in the primary market is high, any increase in fees charged by the cooperative would be at least partially competed away in the primary markets, since originators would be aware they could increase their share of the cooperative's profits by originating more mortgages. An important caveat, however, is that this argument assumes mortgage originators do not collude, either implicitly or explicitly. In a range of industries, trade organizations have acted as a coordinating device for enforcing

collusive arrangements, particularly when they allow participants to monitor the output and pricing of their competitors, and to punish behavior that undermines the market power of the cartel.[15]

- *Low risk-taking.* Mutualization of credit losses should provide incentives for members to monitor the activities of the cooperative, and to be conservative when setting criteria for membership, eligible mortgages, and the sensitivity of guarantee fees to mortgage risk. Consistent with this view, research on thrifts and insurance companies has found that mutuals engage in less risk than otherwise similar stock-owned firms.[16]
- *Inside monitors.* Equity holders that are also mortgage bankers could in principle be more effective monitors of the securitizer's activities than a dispersed group of outside shareholders.
- *Maintains standardization benefits.* The cooperative model could be used to maintain the key standardization benefits of the current system, including the TBA market, and leverages existing credit guarantee pricing and evaluation platforms established by Freddie and Fannie.
- *Minimize government involvement.* In this approach, government's role is limited to providing tail risk insurance and regulating the cooperative. This limits the potential for political pressures to influence the operation of the cooperative, at least relative to a public option.
- *Simplifies pricing.* The lender cooperative simplifies pricing of tail risk compared to the government bond insurer option. Guarantee fees are paid to the cooperative and the government only needs to price and charge the tail risk to the cooperative.

There are several potential disadvantages associated with the private lender cooperative model as a successor to the GSEs.

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[15] Genesove and Mullin (2001) show how communication through a trade association facilitated collusion in the sugar industry. McAndrews and Rob (1996) theoretically analyzes the competitive benefits of a cooperative compared to a for-profit structure in the case of a natural monopoly (e.g. a wholesale switch in an ATM network). Their model structure assumes the cooperative enables competitors in the downstream market to collude. Under this assumption, there is no clear benefit of a cooperative structure in terms of promoting competition.

[16] Esty (1997) presents evidence from the 1980s that mutual savings banks held less risky portfolios than otherwise similar stock-owned savings banks. Lamm-Tenant and Starks (1993) presents similar evidence for insurance firms. See these papers and Flannery and Frame (2006) for more references. One caveat in applying the lessons of these studies to the current setting is that members of mutual thrifts and insurers hold both debt and equity claims, which limits risk-shifting problems, contributing to the conservative approach taken by mutually owned firms. But in this case, the securitization cooperative would issue outside debt, so risk-shifting incentives would still be present, especially if the cooperative is highly leveraged.

- *Governance may be weaker.* Historically, cooperatives often have weak governance over management, because of their dispersed membership, and lack of market discipline or threat of takeover. For example, Cole and Mehran (1998) present evidence that firm performance of mutual thrifts increases after conversion to stock firms; also associated with an increase in the share of inside equity. Given the government reinsurance of tail risk, limiting risk taking and upside returns may be a desirable outcome. In addition, the concentrated nature of mortgage lending may mitigate weak monitoring incentives (e.g. in the first half of 2009, Freddie's top 10 sellers provided 71 percent of securitization volume).
- *Limited access to capital markets.* Access to equity capital is limited to members of the cooperative. Greater access to capital markets to fund growth is often cited as a key reason for demutualization by thrifts and insurers (see evidence in Viswinathan and Cummings (2003)). However, in a tail risk event, experience has shown that all financial firms lose access to capital markets, so the advantages of a shareholder structure in this respect may be limited.
- *Broad participation may be difficult.* Relatedly, an initial capital infusion would be required to set up the de novo cooperative. Small or poorly capitalized mortgage lenders may be unwilling to supply this capital. The Government Accountability Office (2009) cites comments from an unnamed community bank trade group that small institutions may be unwilling to supply sufficient capital to the mutual entity, in light of previous losses on preferred stock investments in Fannie and Freddie.
- *Investment and innovation would be more limited.* Focus on cost minimization could result in insufficient resources devoted to necessary activities, such as hiring strong management and technical staff, investing in risk management and operational systems, and so on. Lack of a strong profit motive also reduces incentives for the cooperative to innovate.

Conclusion

The Treasury Department has declared its intention to foster a broad-based debate on the future of the U.S. housing finance system. Given this mandate and the clear failure of a variety of institutions across the U.S. housing system, it is important to proceed from an accurate diagnosis of what went wrong. Together, the Ellen et al. and Levitin & Wachter papers lay out many of the key failures and many of the potential solutions. In this paper, we laid out six design principles and explored one model that has so far received frequent mention but little sustained analysis – the lender cooperative utility. We have also discussed the importance of the TBA market and how a cooperative model could accommodate and sustain this product's remarkable success. While cooperative structures face significant challenges, particularly in their governance, we believe these problems are tractable and outweighed by the advantages a cooperative has in addressing some of the central incentive problems evident in Fannie Mae and Freddie Mac.

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Lunch General Session: State of the Real Estate Markets

Thursday, March 31st
12:45pm – 2:30pm
Marriott Marquis, Washington DC

Speaker:
Spencer Levy, Americas Head of Research, CBRE

REIT Wise®

NAREIT's Law, Accounting & Finance Conference

March 30 - April 1 2016

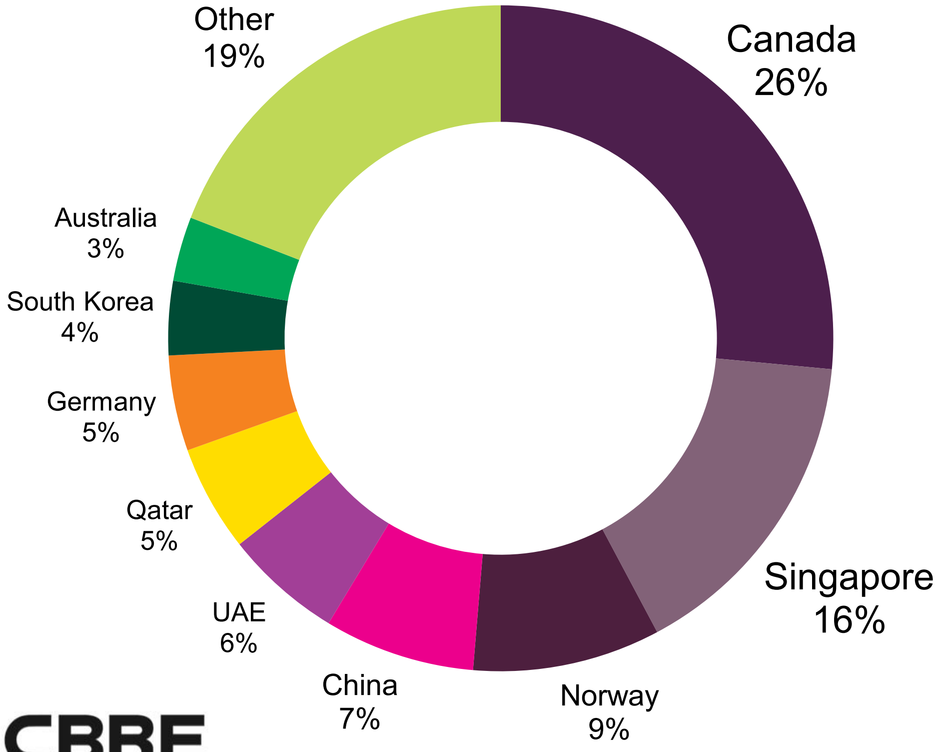
Commercial Real Estate Market Overview

Spencer G. Levy, CBRE
Head of Americas Research

CBRE

Macro Overview

FOREIGN CAPITAL FLOWS TO U.S. IN 2015



All Product: $92.77 B

Top Markets	Volume ($M)
Manhattan	$27,235.9
Los Angeles	$4,218.4
Chicago	$3,516.8
DC	$3,457.2
Boston	$3,416.8
Other	$50,926.8
Total	**$92,771.9**

CBRE

Source: RCA

FOREIGN CAPITAL BIG DRIVER OF DC

DISTRICT OF COLUMBIA OUTLOOK

Market (2015)	Number of Sales	Total ($M)
Manhattan	42	$13,060.9
D.C.	17	$2,885.9
Boston	15	$2,228.0
Seattle	9	$1,267.0
Chicago	13	$1,026.4
San Francisco	12	$982.0
Atlanta	14	$949.2
Los Angeles	13	$753.4
Houston	5	$700.5
Other	145	$5,241.9
Total	**285**	**$29,095.1**

Overseas capital investments in D.C.'s real estate totaled more than $8.8 billion since 2010.

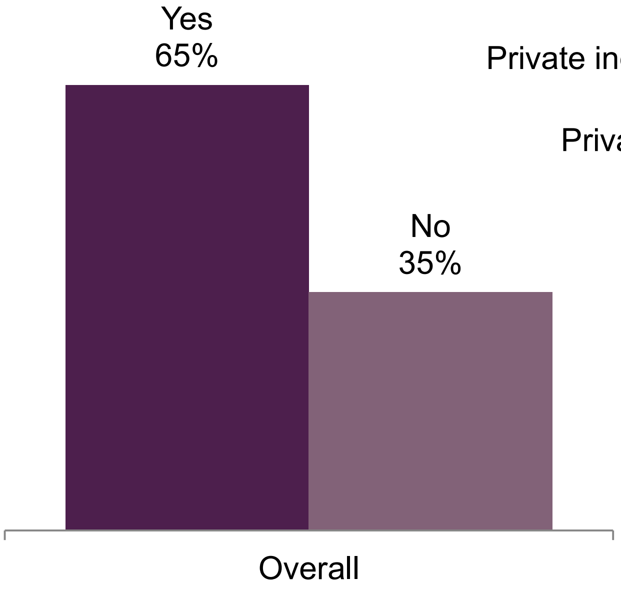
Country	Number of Sales	Total ($M)
Germany	13	$2,046.2
Norway	5	$1,422.6
South Korea	4	$931.0
Canada	10	$847.5
Japan	5	$813.6
Israel	8	$625.5
Australia	7	$605.8
Kuwait	2	$516.0
UK	4	$461.5
Other	5	$461.2
Total	**63**	**$8,831.1**

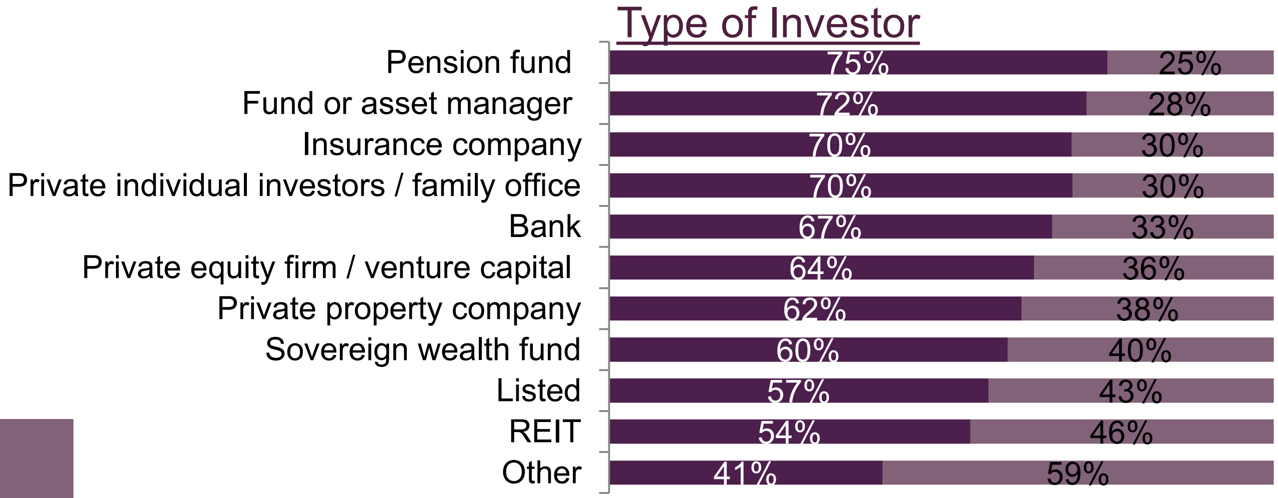
USA

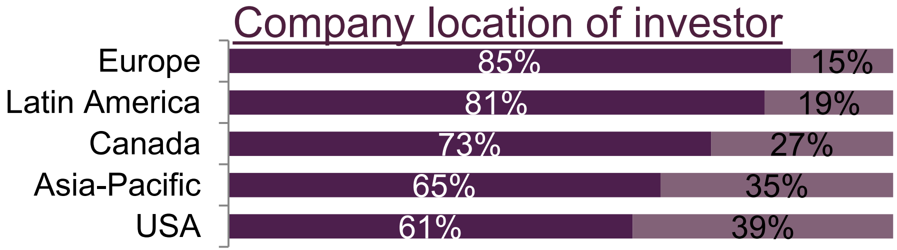
CBRE

PURCHASES TO EXCEED SALES

Will your purchases exceed your sales in 2016?



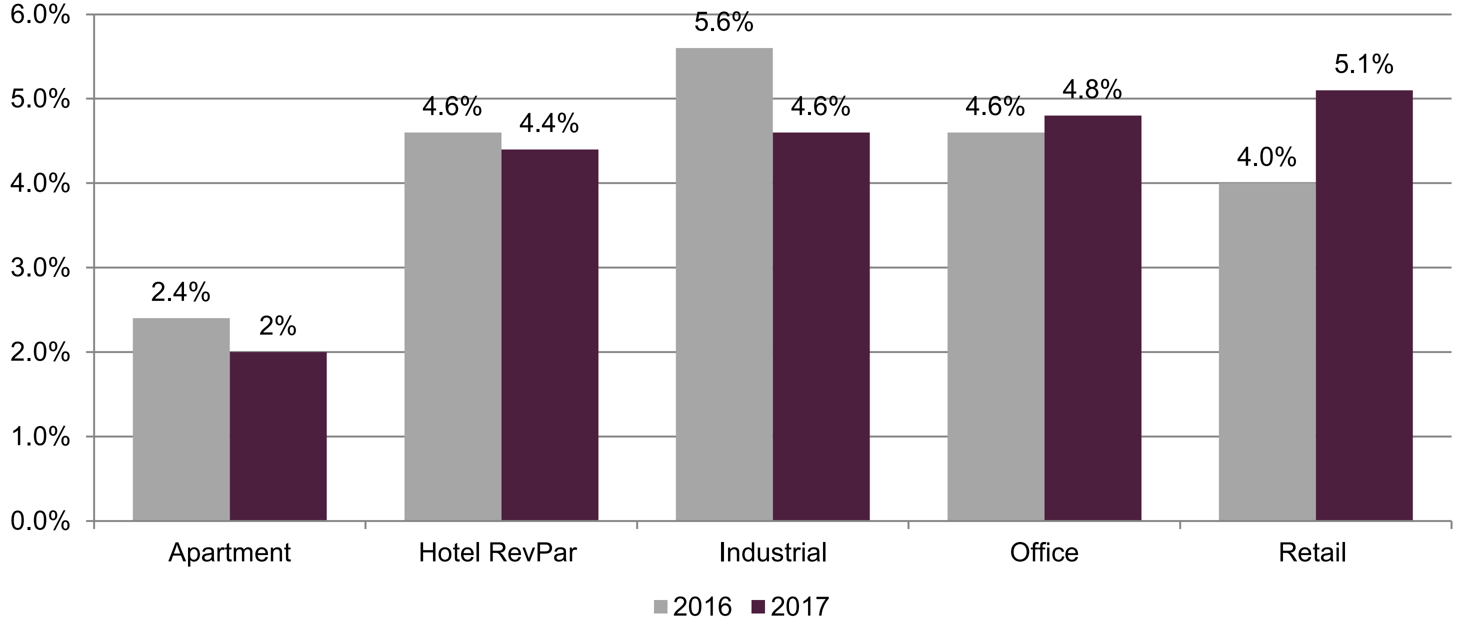




Source: CBRE Research, Global Investor Intentions Survey 2016.

CBRE HOUSE VIEW FORECAST

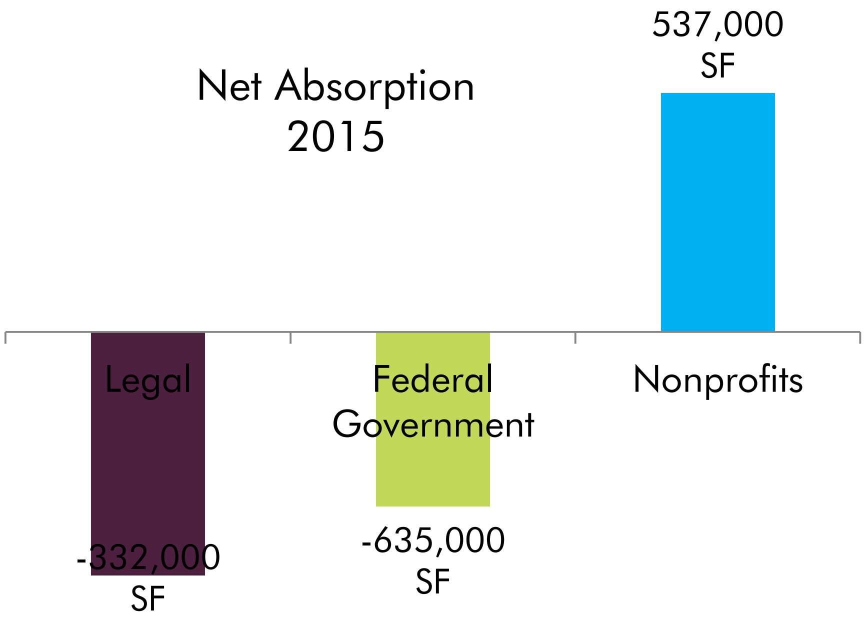
- Total Sales: Up 4-5%
- Rent Growth %:

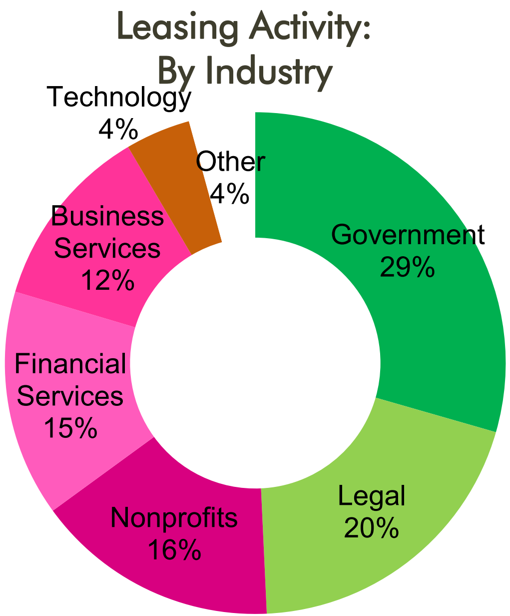


CBRE

Source: Econometric Advisors

NON PROFITS NEW DRIVER OF DC





Lightning Round

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Zombie Companies

Oil

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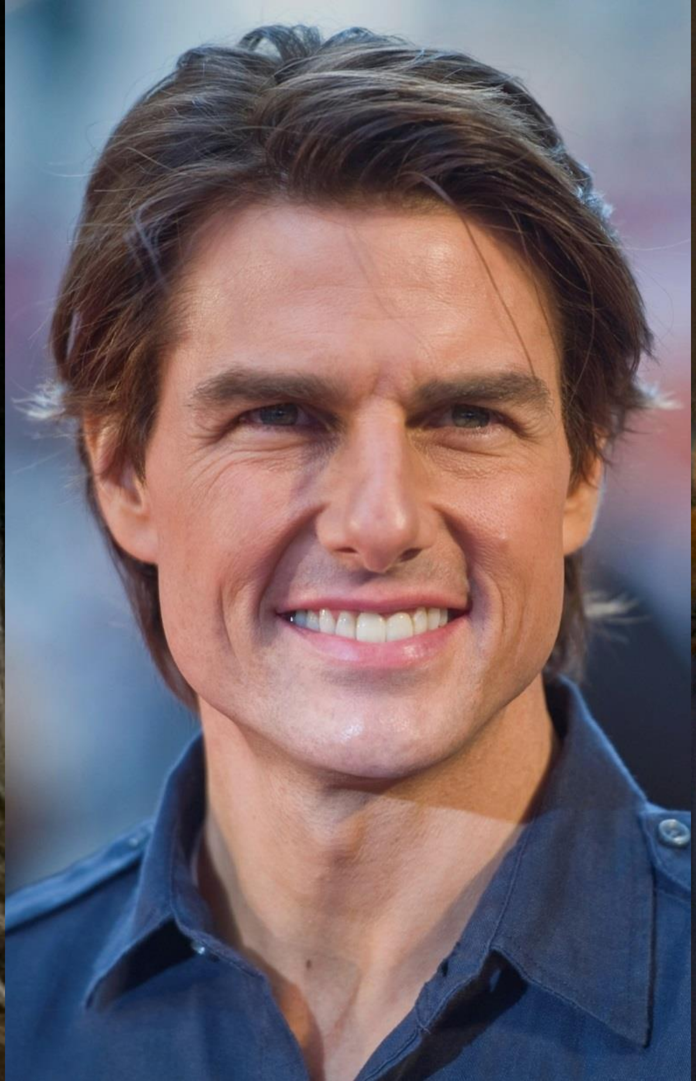
The Fed

2016 U.S. GDP Growth %?

CBRE

Occupier


MARKET VS. LOCATION

Reflects leading decision drivers for location strategy at the city, country or region level

Talent availability	Access to new markets and customers	Quality of location infrastructure and amenities	Real estate costs
50%	40%	36%	31%

Reflects leading decision drivers for building selection within a market

Building and floorplate design	Real estate costs	Lease options	Quality of location infrastructure and amenities
51%	46%	35%	33%

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Source: CBRE Americas Occupier Survey, 2015/2016.

LABOR SHORTAGES AND COSTS ARE LEADING CONERNS

Tech &Telecom 55%

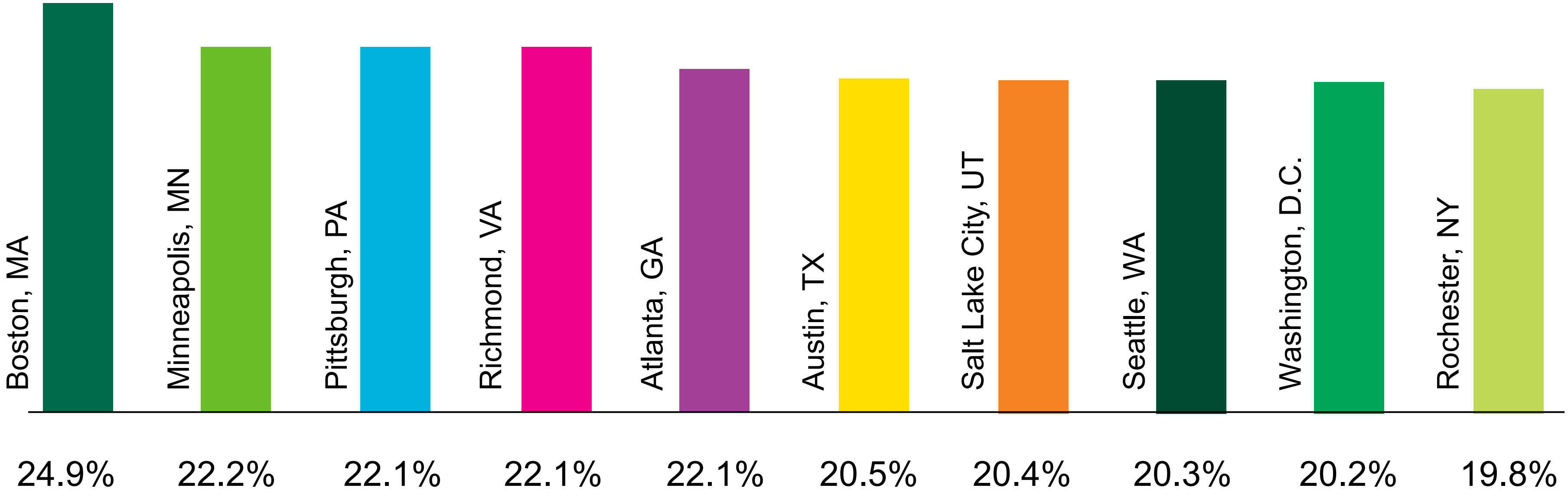
Banking & Finance 51%

Skilled Labor Shortage	Cost Escalation	Economic Uncertainty	Technology Disruption	Tighter Regulation
44	44	36	31	30

Source: CBRE Americas Occupier Survey, 2015/2016.

SEEKING HIGHLY EDUCATED YOUNG TALENT

U.S. Average = 14.0%



*Millennials aged 20-29 years.

Source: U.S. Census Bureau, 2014.

“OLD SCHOOL” CITIES RANK HIGH ON INFRASTRUCTURE

TOP 5

1	New York City
2	San Francisco
3	Los Angeles
4	Washington, D.C.
5	Chicago

BOTTOM (TOP 50)

39	Austin
40	Raleigh
43	Nashville

Sources: University of Minnesota, Center for Transportation Studies, Oct. 2015.

WHAT IS MOST IMPORTANT TO YOUR EMPLOYEES

Reflects features identified as most important to the labor force

44%
Connectivity to partners and suppliers

42%
Flexible working

39%
Flexible workspace

34%
Amenities

33%
Indoor environmental quality

24%
Public transport accessibility

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Source: CBRE Americas Occupier Survey, 2015/2016.

CO-WORKING SPACE

HOW DO USERS EXPERIENCE COMMUNITY IN THEIR CO-WORKING ENVIRONMENT?

Source: CBRE Research user survey, October–November 2015.

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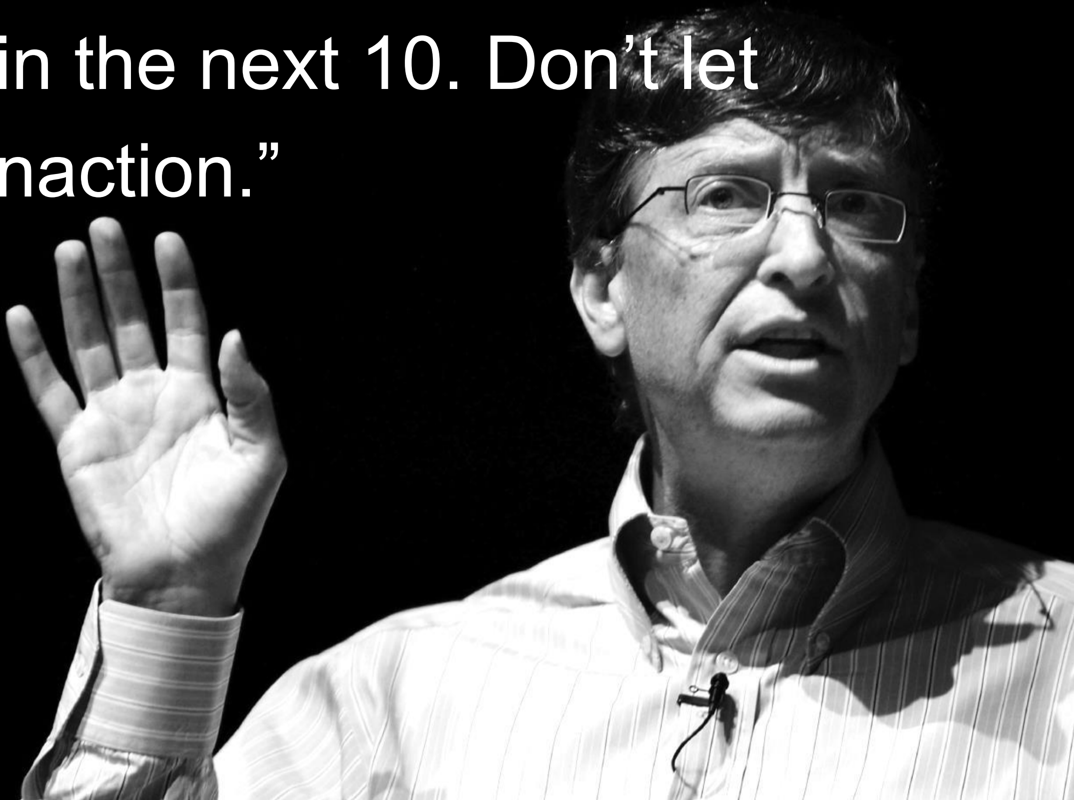
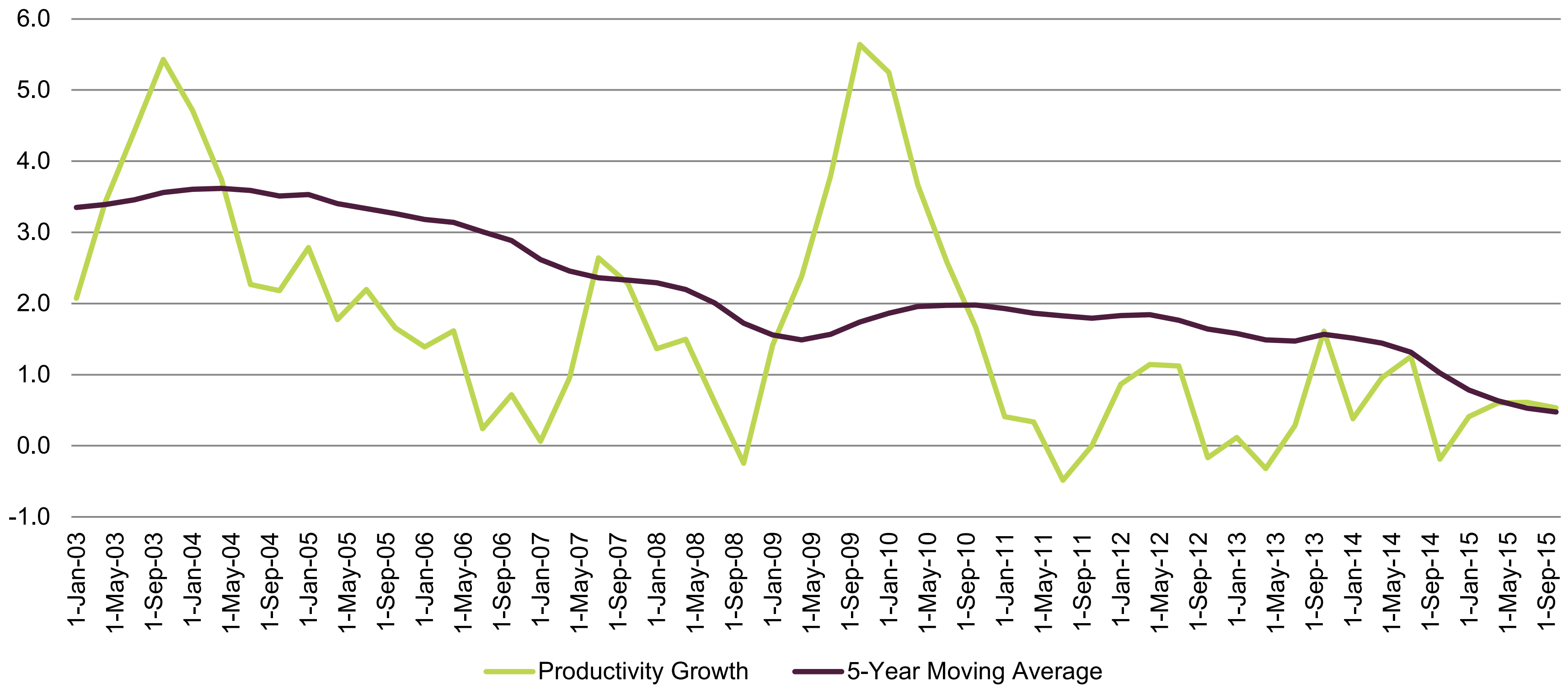
“We always overestimate the change that will occur in the next two years and underestimate the change that will occur in the next 10. Don’t let yourself be lulled into inaction.”

—Bill Gates



PRODUCTIVITY



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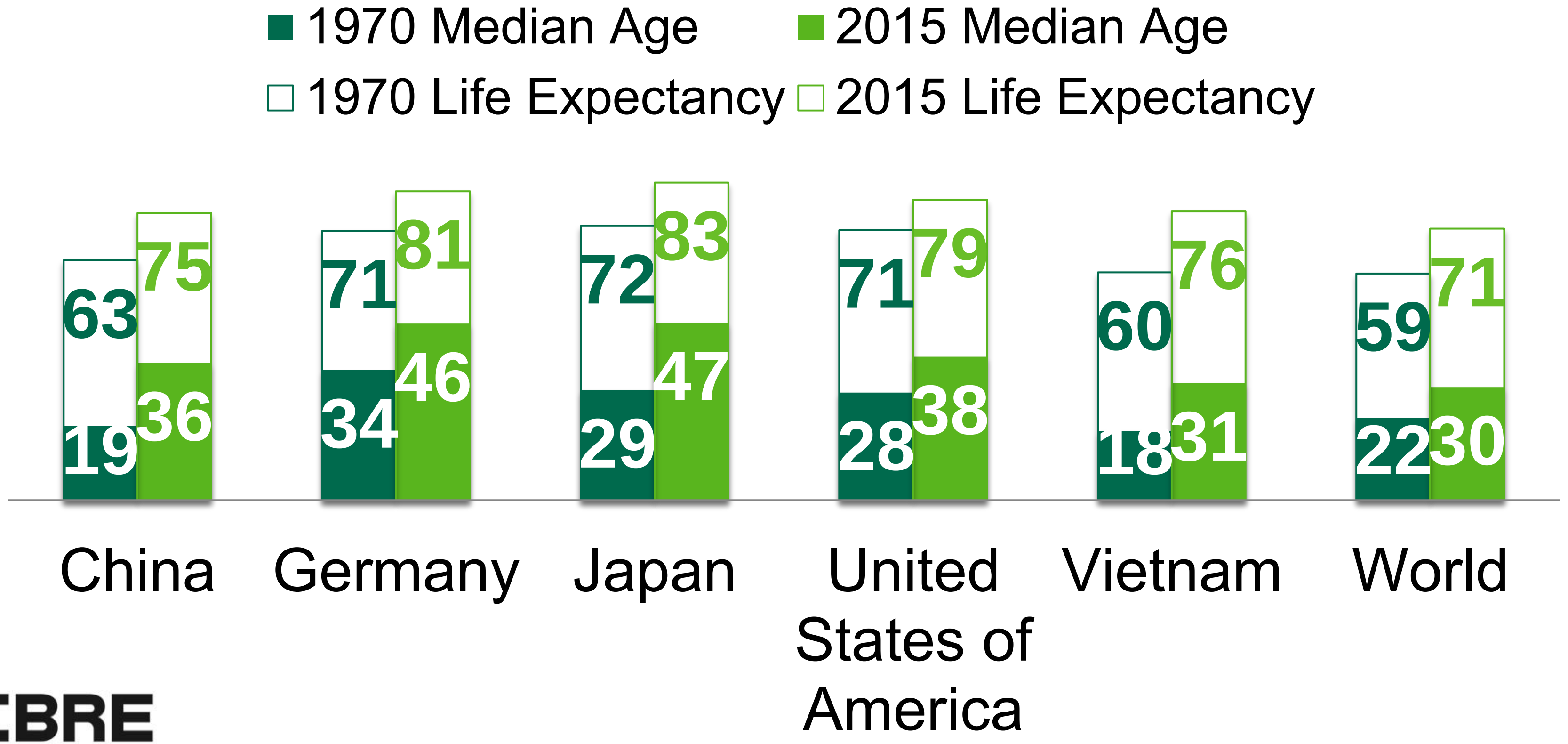
DEMOGRAPHIC TIME BOMB OR OPPORTUNITY?



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Lightning Round #2

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3D Printing

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Air b-n-b

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Temporary Office Space

CBRE

"This Time It's Different"

Investor

THE INVESTOR: HIT IT WHERE THEY AIN'T

Wee Willie Keeler

BEST METROS FOR INVESTMENT

Which metro in the Americas do you believe to be the most attractive for property investment purchase?

2016 Rank	Metro	2015 Rank
1	Los Angeles	4
2	New York	2t
3	Dallas/Ft. Worth	2t
4	San Francisco	1
5	Toronto	*
6	Atlanta	9t
7	Seattle	5
8	Washington, D.C.	8
9	Denver	*
10	Boston	*
11	Chicago	9t
12	Austin	6
13	São Paulo	*
14	Miami/So. Florida	9t
15	Calgary	*
16	Phoenix	*
17	Charlotte	*

Canada
Top Ranked Metros:

1. Toronto
2. Calgary
3. Vancouver

Latin America
Top Ranked Metros:

1. São Paulo
2. Mexico City

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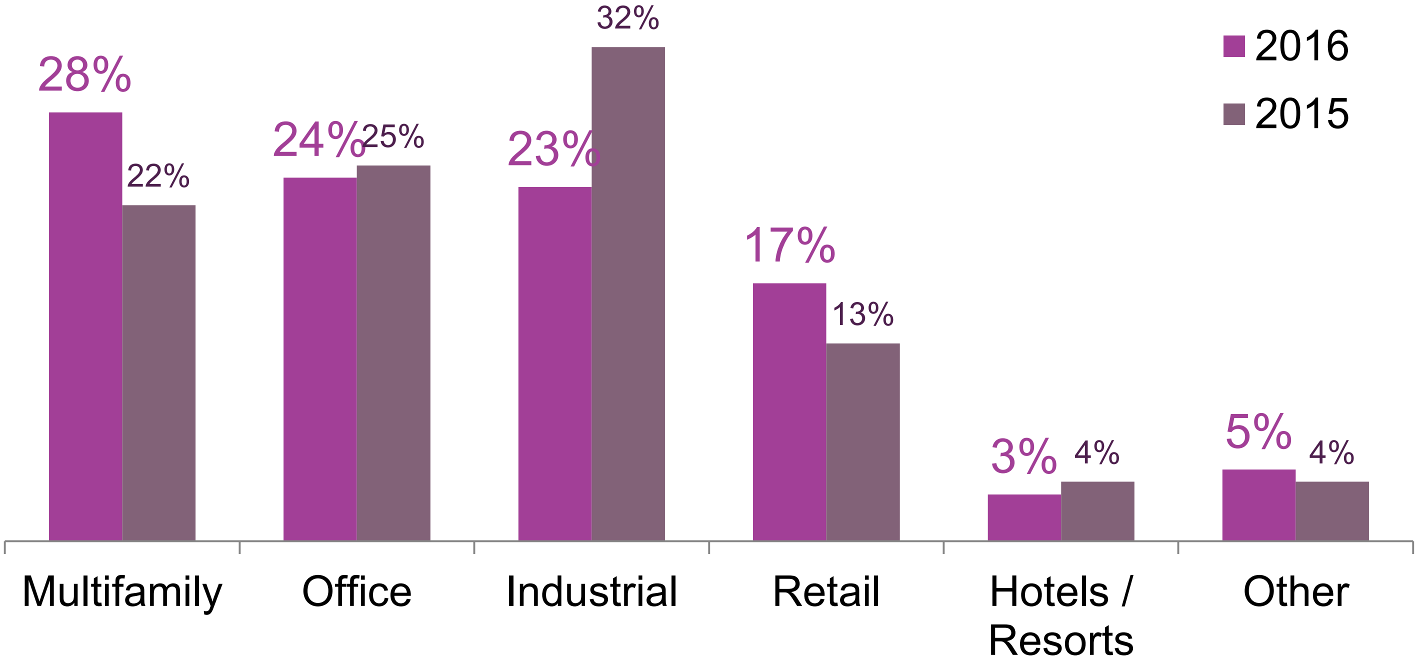
Source: CBRE Research, Global Investor Intentions Survey 2016. *Not in top 15.

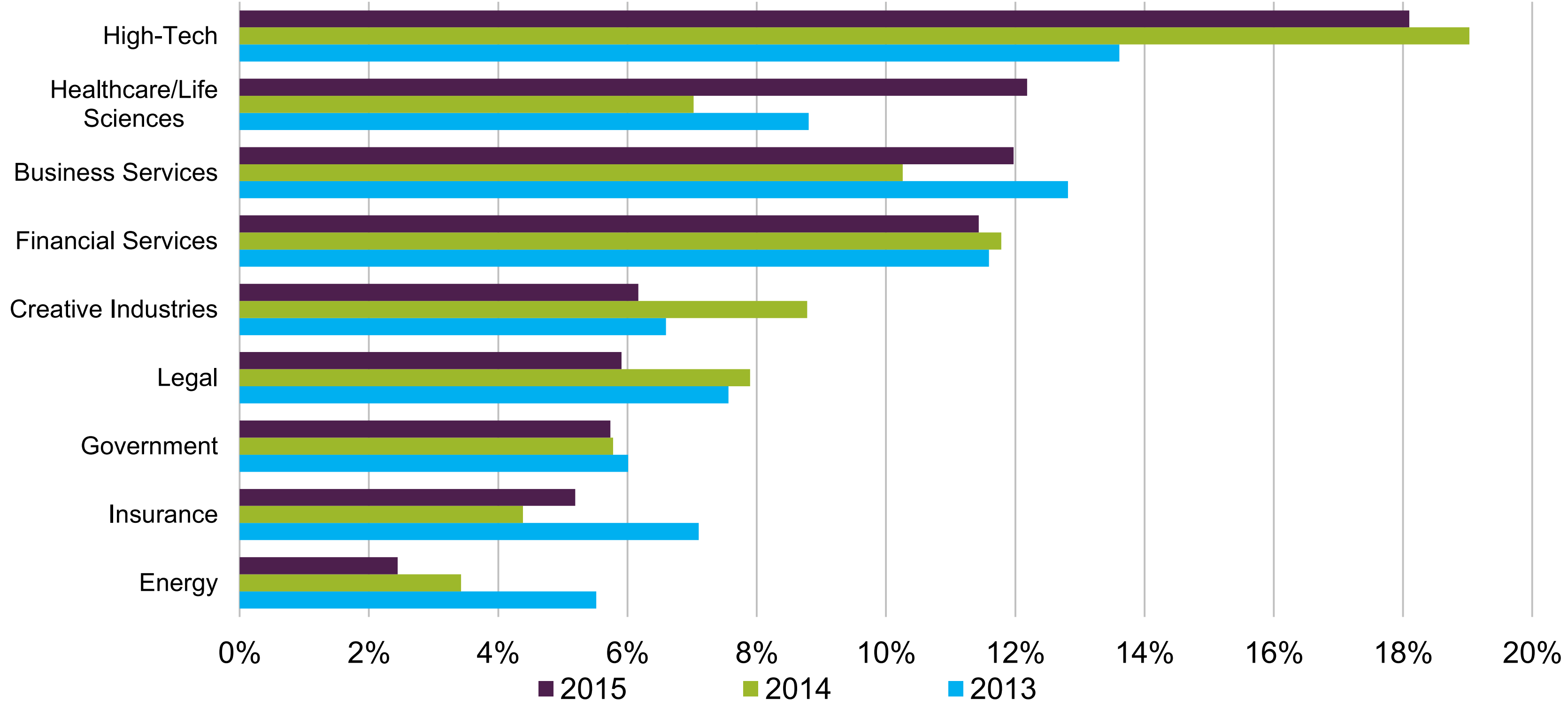
PREFERRED PROPERTY SECTOR



Source: CBRE Research, Global Investor Intentions Survey 2016.

TECH & HEALTHCARE LEAD DEMAND

U.S. Leasing Trends by Industry



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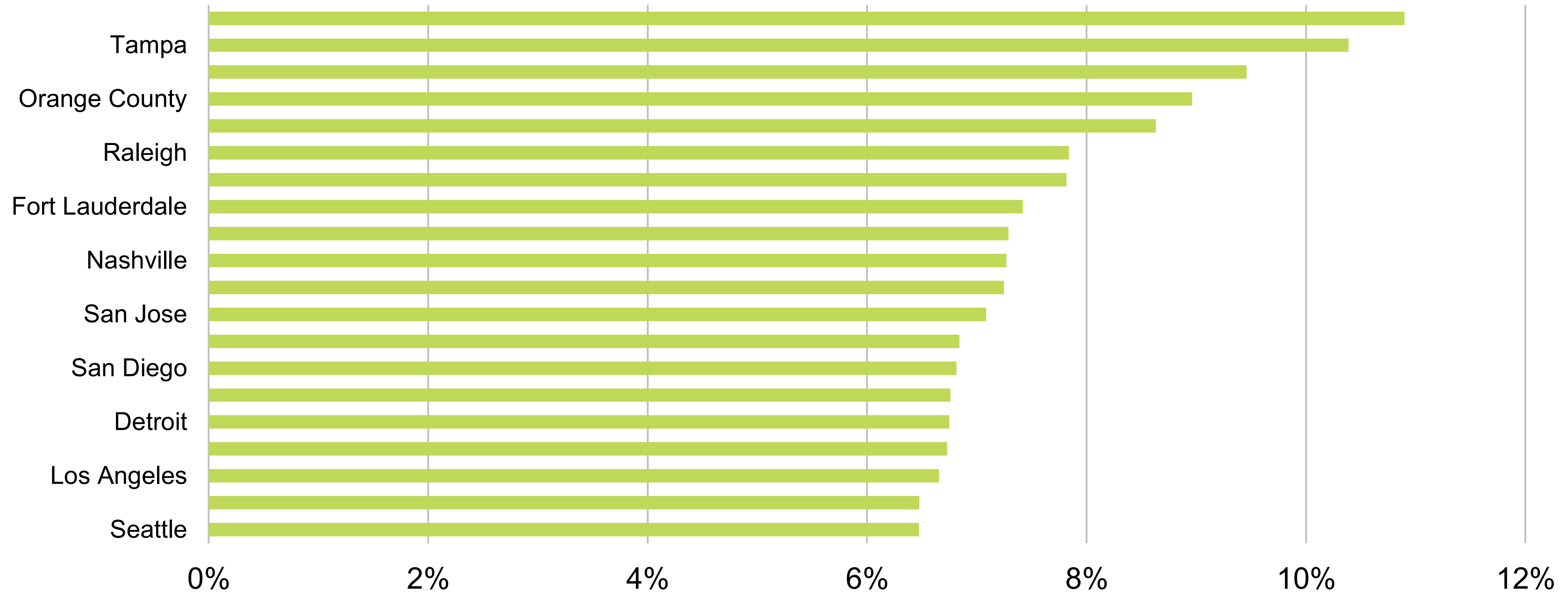
Note: Includes the 25 largest transactions by sq. ft. each quarter for the markets tracked by CBRE Research.
Source: CBRE Research, Q4 2015.

SUNBELT TO LEAD EMPLOYMENT GROWTH

Top 20 Markets for Forecasted Office-Using Employment Growth, 2015-2017



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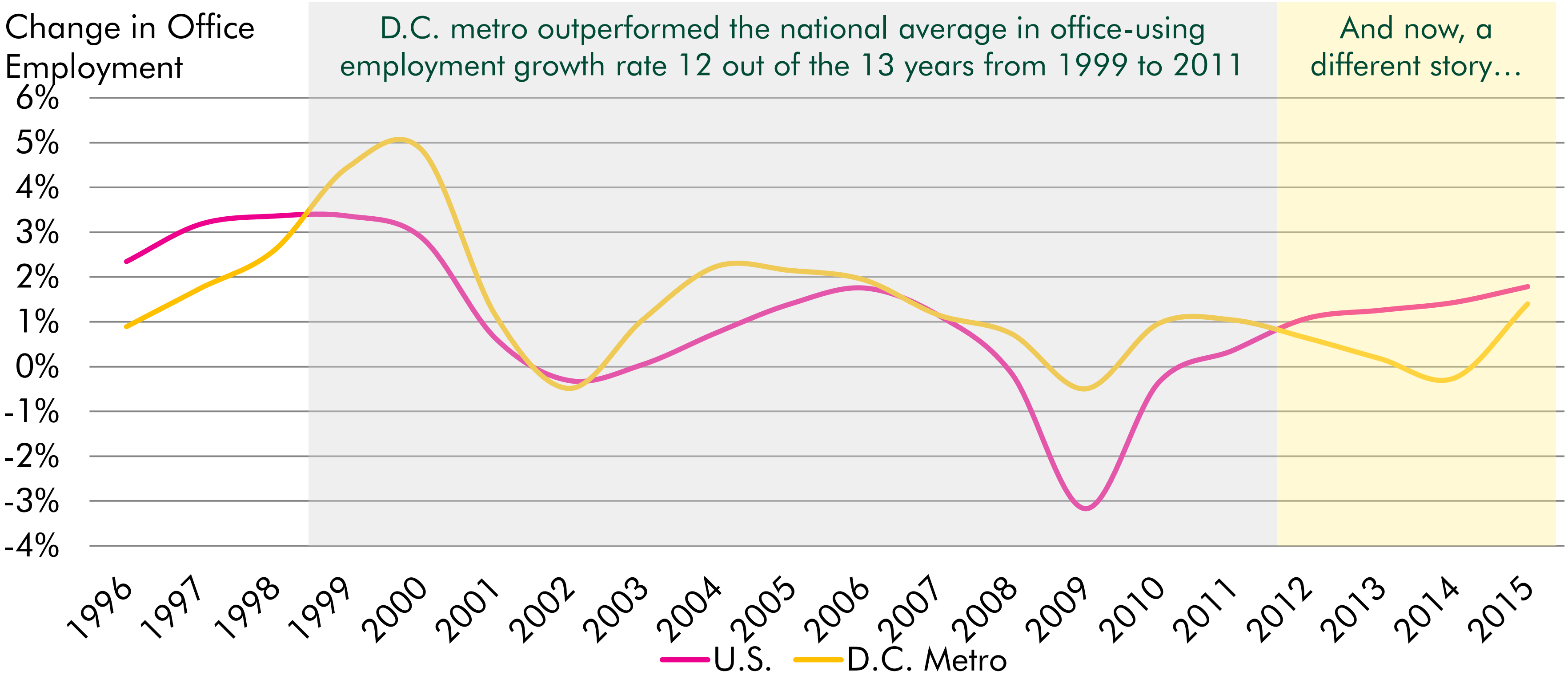
Note: Ranking includes markets with at least 200,000 forecasted office-using jobs in 2017.
Source: CBRE Econometric Advisors, Q4 2015.

DC UNDERPERFORMED US IN JOB GROWTH



REVERSE LOGISTICS

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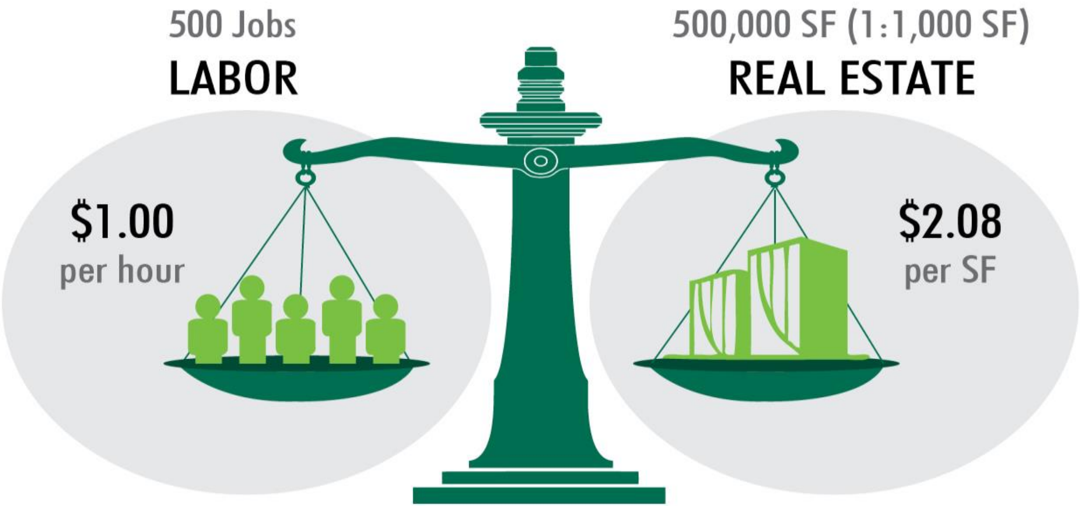
Source: eSource, Schorrs, January 2016.

MINIMUM WAGE IMPACT

The Strategic Cost of Industrial Labor



Source: CBRE Labor Analytics, January 2016.

3. A $1/hour wage increase for 500 jobs = $1.04 million/year, assuming 2,080 hours/employee/year ($1/hour x 500 employees x 2,080 hours/employee/year). A facility that houses 500 employees at 1,000 SF per employee = 500,000 SF ($1.04 million /500,000 SF = $2.08/SF/year price increase)

AGILITY IS THE NEW OMNICHANNEL

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CONCLUSION

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Concurrent Session: PCAOB Issues

Thursday, March 31st
2:45pm – 4pm
Marriott Marquis, Washington DC

Moderator:
Lori Silverstein, VP & Controller, Boston Properties, Inc.

Panelists:
Robert Herz, Former Chair, Financial Accounting Standards Board
Catherine Nance, Sr. Director-Professional Practice, The Center for Audit Quality
Marc Panucci, Partner, PwC
Melanie Pinto, Director-Accounting Policy, Annaly Capital Management, Inc.

Audit Quality Indicators

The Journey and Path Ahead

Center for Audit Quality

Serving Investors, Public Company Auditors & the Markets

Foreword

January 2016

The CAQ is pleased to share recent insights learned from a series of roundtable discussions with audit committee members and other interested stakeholders around the globe to gather their feedback on a potential set of audit quality indicators. This outreach, together with the results from pilot testing of the CAQ's approach, has led to an understanding that audit committee members may benefit from a multidimensional resource that can assist them in gauging the performance of the audit using qualitative and quantitative factors.

As this report documents, we found that determining audit quality is more art than science. It is the conversation that is important; having a dialogue to explore the context and relevance of certain indicators is critical to obtaining a deeper understanding of the quality of a particular audit. We heard that audit committee members desire assistance with their efforts to grasp the more qualitative aspects of the audit, such as the engagement team having the right mindset to bring forth professional skepticism, which is difficult to measure, and is best achieved through dialogue.

We also learned that audit committee members believe this conversation is most impactful in driving actions that improve or maintain audit quality when audit committees have the flexibility to tailor the discussion around the facts and circumstances of their particular audit. The potential components, or indicators, of audit quality, detailed in the CAQ's April 2014 publication, can support or be used to initiate these conversations about auditor performance, but by themselves cannot lead to a holistic understanding of audit quality.

We have learned a great deal on this journey, but much more remains to be done to strengthen our ability to assess audit quality. We invite you to join us as we continue down the path towards this vital goal.

Cindy Fornelli
Executive Director
Center for Audit Quality

Michele Hooper
President and CEO
The Directors' Council
CAQ Governing Board AQI Lead
(2015-Present)

Stephen Chipman
CEO (Retired)
Grant Thornton LLP
Former Governing Board AQI Lead
(2012-2015)

Executive Summary

Audit committees serve an essential role in corporate governance by protecting investors through their oversight of a company's financial reporting process and the audit. The Center for Audit Quality (CAQ) believes that reliable quantitative metrics regarding the audit, commonly referred to as "audit quality indicators" or "AQIs," could be used to better inform audit committees about key matters that may contribute to the quality of an audit. The CAQ developed an approach to communicate AQIs that recognizes the roles and responsibilities of audit committees and reinforces the importance of, and enhances the dialogue around, the auditor's communications with the audit committee. The approach is focused on the communication of engagement-level indicators that can be tailored based on the information needs and interests of a specific audit committee to support its oversight responsibility. Firm-level indicators, which focus on an audit firm's overall strategies and initiatives, can be used to complement these engagement-level indicators. The focus on communication of AQIs to audit committees is appropriate because AQIs:

- **Provide relevant information to audit committees —** AQIs provide greater value to those who have direct oversight responsibilities for the audit.
- **Increase the quality of the dialogue with audit committees —** Audit committees are uniquely positioned to engage in dialogue with the auditor to obtain the context necessary to give meaning to AQIs and potentially take actions that might help maintain or increase audit quality on an engagement.
- **Assist with selection/evaluation of the external auditor —** Given their governance authority and knowledge of the particular circumstances of the audit engagement, audit committees are in a position to act upon the information communicated to make decisions about reappointing the auditor, appointing a new auditor, and selecting a lead engagement partner.

To develop perspectives on the key elements of a quality audit and a sample set of quantitative indicators that provide information about the performance of those elements over time, the CAQ worked with a Stakeholder Advisory Panel composed of investors, audit committee members, former standards-setters, auditors and others. The CAQ and the Panel identified a set of potential AQIs they believed would provide the greatest opportunity to enhance discussions between auditors and audit committees, and the ability of audit committees to fulfill their responsibilities relative to oversight of the audit. In January of 2014, the CAQ assembled a roundtable of audit committee members to get their reactions to these indicators. The set of indicators were amended slightly based on their feedback to make them more risk-based. The CAQ in April 2014 published the CAQ *Approach to Audit Quality Indicators (Approach)*.[1]

In coordination with its member firms, the CAQ subjected the set of potential AQIs to pilot testing. The objective of the pilot testing was to identify potential barriers to auditor preparation and communication of AQIs, and to assess the overall usefulness of the *Approach* to audit committees. Most of the participating audit committees and engagement teams generally expressed overall support for a discussion of AQIs between the audit committee and the engagement team, although feedback on individual AQIs varied.

To continue to evaluate the set of potential AQIs and suggested communication approach, the CAQ convened a series of roundtable discussions with audit committee members around the globe throughout the summer of 2015. The roundtables were designed to spur discussion of whether and how AQIs might assist audit committee members in performing their important audit and financial reporting oversight responsibilities on behalf of investors. Roundtable participants thoughtfully considered the findings from pilot testing and shared their views on the potential benefits and challenges of identifying and developing a set of AQIs. Key findings from the roundtables included the following:

- Desire for information that can assist audit committees in their assessment of the more qualitative aspects of the audit, such as the engagement team having the right mindset to bring forth professional skepticism and auditor judgment, which cannot be adequately captured in a quantitative AQI, and is best achieved through dialogue.
- Recognition that although AQIs can help audit committees oversee the quality of their external audit, the external audit is just one aspect of quality financial reporting.
- Endorsement of a flexible approach that allows an audit committee, working with the external auditor, to tailor or customize the selection and portfolio of AQIs that best suit its specific information needs.
- General support for the concept of AQIs and recognition of their potential value to audit committees' auditor oversight responsibilities, although some participants felt they already have the tools necessary for them to gauge the quality of their audit.
- Agreement that AQIs alone, without context, cannot adequately communicate factors relevant to any particular audit engagement or audit firm.

[1] CAQ *Approach to Audit Quality Indicators*, is available at http://www.thecaq.org/reports-and-publications/caq-approach-to-audit-quality-indicators.

- Agreement that the process of identifying and evaluating AQIs needs to be audit committee-driven and iterative, and will require continuous assessment and refinement in order to meet the changing information needs of audit committees.
- Belief that mandated public disclosure of engagement-level AQIs could lead to unintended consequences and that any disclosures of engagement-level AQI information should be voluntary.

This report is intended to advance consideration of the issues uncovered during these roundtable discussions, pilot testing, and through additional outreach and efforts in recent years on this important topic. While the CAQ has learned a great deal since the launch of its AQI initiative, more remains to be done. For example, because audit committee members are interested in more qualitative information to evaluate audit quality at the engagement level, a potential path forward is to create a tool for audit committees that guides their assessment of both quantitative and qualitative information. Further dialogue and continued collaboration among all stakeholders is needed so that we all can participate in the development of a path forward on AQIs and, potentially, best practices for their use.

Background

In 2012, the CAQ began work to attempt to define and measure audit quality with the goal of determining a set of measures, or framework, from which key stakeholders could communicate and discuss the quality of an audit. Like others around the world, the U.S. public company auditing profession recognized the importance of a common vision and understanding of factors that may contribute to the performance of a quality audit. To inform its efforts, the CAQ convened a Stakeholder Advisory Panel comprising audit committee members, investors, academics, profession representatives and others.[2] An initial roundtable held in January of 2014 with audit committee members helped provide insights on the development of the CAQ's *Approach*.

In developing the *Approach*, the progress of others working on AQIs was considered. The United Kingdom's Financial Reporting Council and the International Auditing and Assurance Standards Board have both sponsored initiatives to help understand and describe AQIs. In identifying potential indicators of quality, the CAQ also evaluated the indicators employed to review quality in other professions and industries, such as the airline, manufacturing, and service industries, and the medical profession. In parallel to the efforts of the CAQ and its member firms, the Public Company Accounting Oversight Board (PCAOB) identified AQIs as a priority in 2013.[3] The CAQ has shared and continues to share with the PCAOB its perspectives regarding the components of audit quality, including potential AQIs to measure those components, as well as the feedback received through pilot testing.[4] While there have been a number of research projects and global initiatives centered on the topic of audit quality in recent years, there remains little consensus on a definition of audit quality, an audit quality framework, and the most relevant indicators of audit quality and how and to whom they should be communicated.

Recognizing the challenges associated with putting words around a specific definition of audit quality, the CAQ instead worked with its Stakeholder Advisory Panel to agree on a framework that describes the elements of audit quality. The elements of audit quality that were included as part of this framework were largely drawn from the PCAOB's quality control standards and other professional standards. The indicators in the *Approach* fall into four principle areas:

1. Firm leadership and tone at the top
2. Engagement team knowledge, experience, and workload
3. Monitoring
4. Auditor reporting

---

2 See the Appendix for a list of Stakeholder Advisory Panel members.

3 PCAOB Briefing Paper, *Discussion – Audit Quality Indicators*, SAG Meeting, May 15–16, 2013. See also, PCAOB's *AQI Update*, SAG Meeting, November 14, 2013.

4 See, for example, the CAQ's letter to Greg Jonas, Director of the PCAOB's Office of Research and Analysis, on May 13, 2013, which is available at http://www.thecaq.org/newsroom/2013/05/13/caq-provides-perspectives-on-understanding-audit-quality-to-pcaob-ahead-of-sag-meeting. See also, the CAQ's comment letter in response to the PCAOB's July 2015 *Concept Release on Audit Quality Indicators*, which was submitted on September 28, 2015, and is available at http://thecaq.org/resources/comment-letters/caq-comment-letter--pcaob-s-concept-release-on-audit-quality-indicators. The PCAOB's Concept Release sought public comment on 28 potential quantitative AQIs, with over 70 illustrative calculations.

As a guiding principle in developing a set of potential AQIs, the CAQ established that each of the indicators should measure an input or output related to an element of this audit quality framework. Other guiding principles used by the CAQ required that the AQIs collectively avoid or minimize unintended negative consequences, and be scalable to audit firms and audit engagements of different types and sizes.

The feedback received during stakeholder outreach efforts led the CAQ to focus primarily on the communication of engagement-level metrics to audit committees — an approach that recognizes the critical role that audit committees play in the oversight of audits on behalf of investors. Consequently, the *Approach* includes a set of potential AQIs that could aid audit committees in their oversight of the audit and potentially enhance discussions between auditors and audit committees.

The CAQ engaged in two separate efforts to assess the usefulness and feasibility of the *Approach* for audit committees. First, the CAQ coordinated with 10 audit firms of various sizes to pilot test these indicators during the 2014 audit cycle. A total of 30 audit engagements participated encompassing a broad range of operations and industries. None of the selected audit engagements were identified to the CAQ and participating audit firms shared the pilot testing results on a confidential basis. During the pilot testing, audit committees were asked for feedback on the usefulness of a number of proposed AQIs in fulfilling their auditor oversight responsibilities.[5] Although the AQIs, on average, were seen as useful by audit committees, some were more relevant to certain audit committees than others. The audit committee members ranked certain AQIs related to engagement team experience and workload as the most useful indicators, including years of industry experience relevant to the audit engagement, years on the engagement, changes in audit hours between years, and audit hours spent on the audit engagement by engagement team members grouped by their seniority in the audit firm. Many audit committee members expressed a preference for flexibility in the approach to discussing AQIs and a desire to be able to tailor the discussion to include those AQIs most relevant to their company and its audit.

Secondly, in the summer of 2015, the CAQ convened four roundtables with audit committee members in London, Chicago, New York, and Singapore to further explore the issues around AQIs. Through these activities, the CAQ gathered the perspectives of audit committee members and information on current practices around the globe on the identification and communication of AQIs.

[5] Some of the AQIs in the *Approach* that were communicated to audit committees overlapped with existing audit committee communications required by professional standards. For example, Auditing Standard (AS) No. 16, *Communications with Audit Committees*, requires that the nature and extent of specialized skills or knowledge needed related to significant risks be communicated to the audit committee (AC). The *Approach* includes metrics to quantify factors related to "specialists and national office personnel involvement by significant risk area."

Major Themes From the Roundtable Discussions

Most participants supported the concept of AQIs and recognized their potential value to audit committees in execution of their auditor oversight responsibilities. However, some of the audit committee members who participated in the roundtables believed they had sufficiently robust audit evaluation and oversight processes without the need for additional AQI information. Participants agreed that deriving value from AQIs would be dependent upon their ability to tailor or customize the selection and portfolio of AQIs that best suit their specific information needs. Participants also agreed that AQIs alone, without context, cannot adequately communicate factors relevant to the audit of any particular engagement or firm. The PCAOB also notes the importance of context in its *Concept Release on Audit Quality Indicators* and emphasizes that for this reason, AQIs cannot be used as benchmarks.[6] Participants stressed that context is integral to the proper understanding of any AQI, which can lead to an enhanced dialogue between the audit engagement team and the audit committee regarding matters that affect audit quality. Using PCAOB inspections reports as an example, participants said they would find them more useful as an indicator of audit quality if it were clear how identified deficiencies relate to the facts and circumstances of their own audits. Such an understanding requires dialogue with the engagement team to understand the nature of the deficiencies identified, how they may or may not relate to the particular audit, and how the engagement team has addressed them as part of their audit plan.

Another example of the importance of context heard during earlier outreach efforts is a scenario in which an engagement team is experiencing higher than expected overtime. This could be caused by many different factors, including, for example, that the engagement team encountered an unforeseen issue that required extra time, or that the team is overburdened. A timely dialogue with the auditor regarding such matters would allow the audit committee to better understand the specific factors driving the measure and to address potential issues with the engagement team and evaluate the reasonableness of any response.

Another common theme that emerged in the roundtable discussions was that, in many cases, the drivers of the quality of an audit are not inherently quantifiable and, as a result, require evaluation of qualitative factors, such as the engagement team having the appropriate mindset to bring forth professional skepticism and requisite auditor judgment. While quantitative AQIs may inform qualitative aspects of the audit, they cannot be a substitute for an audit committee member's judgment of these qualitative aspects. Moreover, many participants pointed out that evaluating audit quality should be a multidimensional process that focuses on more than the external auditor. While recognizing that responsibility for performing an audit rests with external auditors, these participants noted that without a high-quality internal organization — management and internal audit — achieving high-quality financial reporting and the related audit is challenging.

[6] PCAOB Release No. 2015-005, July 1, 2015, p. 7.

Participants agreed that the process of identifying and evaluating AQIs needs to be driven by the audit committee and iterative. It also will require continuous assessment and refinement in order to meet an audit committee's changing information needs.

Generally, participants also believed that any disclosures of engagement-level AQI information should be voluntary, and expressed concern that mandated public disclosure of engagement-level AQIs could lead to unintended consequences in the marketplace. For example, some participants said that publication of engagement-level AQIs could lead to the production of boilerplate, or one-size-fits-all, approaches that would likely change the nature and usefulness of the information in their discussion with the external auditor. These and other key themes are discussed below.

Audit Committees Support the Concept of AQIs

As noted above, there was widespread agreement that audit quality is a function of the competency and effectiveness of the external audit team, and recognition that the same attributes in company management, internal audit, and audit committees also play critical roles in contributing to the quality of financial reporting and the related audit.[7] While a few participants felt they had what they needed, and that the development of AQIs was "a solution in search of a problem," most participants generally agreed that AQIs could enhance audit committee discussions with the auditor about the engagement team's experience and skills and lead to greater understanding of how those attributes contribute to the audit process. Participants also believed that AQIs could help focus discussions on how the engagement team allocates key resources to address and manage potentially serious audit risks, such as using a specialist to audit a significant estimate. High value

> "I particularly liked the range of AQIs that were being suggested for engagement team knowledge experience and workload because those give insights into the capability of the firm to take on the task and some check about whether what was put into the original plan — the assessment of risk and the allocation of resources — has worked out."
>
> *– Chicago Roundtable Participant*

[7] While the roundtable discussions focused on indicators that could help audit committees assess the quality of their external audit, some noted that the external auditor's performance is but one aspect of quality financial reporting, albeit a critical one.

was attributed to AQIs that could help clarify how the audit firm's tone at the top and system of quality control support the engagement team in delivering quality audit outcomes. One audit committee member said that if AQI information was distributed to the audit committee in advance of the meeting, it likely would help the committee ask more insightful questions of the auditor and increase the efficiency and impact of their limited time together.

Several participants offered that AQIs could be another tool for audit committees to use when selecting the external auditor, as some feared the primary consideration too often used by some may be the audit fee. Some audit committee members favored AQIs as a way to provide a framework supporting a deliberate process in reviewing competing audit firm proposals and ultimately choosing a new audit firm or reappointing the incumbent firm, as the case may be, during an audit tender.[8] For example, AQIs on the extent, distribution, and timing of planned audit hours could be gathered from prospective audit firms at the tendering stage. Audit committees could use the information to gain perspective on strategy and timing of work, which would help audit committees evaluate competing auditors' proposals.

> "As with anything of quality, it starts with people. For audit committees, audit quality starts with the lead audit partner — the quality, experience, background, perspective, and philosophy of how they approach client service and working with an audit committee. That's tough to quantify."
>
> *– New York Roundtable Participant*

Some participants viewed AQIs as a potentially useful tool in initiating dialogue with prospective lead engagement partners in anticipation of the current lead engagement partner rotating off the engagement. Many participants said they evaluate a prospective lead engagement partner to determine whether he or she has the right mix of skills and experience to manage audit risk and can set the right tone with the rest of the engagement team in promoting independence, objectivity, and skepticism. While many accepted that AQIs can support this process, they did not believe that analyzing quantitative AQIs alone could replace the audit committee's assessment of the independence, objectivity, and skepticism of partner candidates.

8 Participants thought this would be of growing importance when mandatory audit firm rotation becomes effective in the United Kingdom and other European Union member states in 2016.

“Quality is subjective.”

– London Roundtable Participant

Qualitative Aspects of the Audit Necessary to Inform Quality

Many participants noted that quantitative AQIs can provide a good starting point for a discussion, but by themselves cannot lead to an understanding of those factors that are the actual drivers of audit quality. Participants emphasized the importance of the external auditor's mindset in terms of the engagement team's capacity and propensity to exercise professional skepticism and question and critically assess audit evidence. To participants, the importance of this mindset went hand in hand with those skills associated with a person's emotional intelligence quotient or EQ.[9] According to participants, engagement teams with high EQ display intellectual rigor, and strong communication and influencing skills, and are highly valued for their ability to quickly and effectively resolve matters with management, the audit committee, and their firm's national office, as appropriate.

“An independent professional's skepticism is most important and is also the most immeasurable of any criteria.”

– New York Roundtable Participant

Participants acknowledged that there are AQIs that might contribute to a conversation about the competence and capacity of the engagement team to apply independent judgment and professional skepticism, but they did not believe that relying on these types of AQI data alone would be helpful in assessing such skills, as they are not easily quantified. The participants noted that they can better assess mindset and EQ through conversational discourse with the engagement team, and explained that they would value additional tools to help them consider these important qualities.

Participants agreed that an audit firm's tone at the top serves as an important indicator of the incentives that drive auditors to deliver quality outcomes. Through an audit firm's tone at the top, the leadership emphasizes audit quality and holds itself accountable for the audit firm's system of quality control. Having the proper tone at the top is essential for creating a firm culture that supports professional skepticism and the expression of EQ at the engagement level. It is also something that is difficult to capture in an AQI or set of AQIs. Some participants indicated that they do review audit firms' messaging around their tone at the top and the

[9] Emotional Intelligence Quotient (EQ) is a term created by two researchers — Peter Salavoy and John Mayer — and popularized by Dan Goleman in his 1996 book of the same name. In a workplace, this term refers to the individual's ability to sense, understand and effectively apply the power and acumen of emotions to facilitate high levels of collaboration and productivity.

> “What I depend on first and foremost is the tone at the top — the integrity of the organization.” *– New York Roundtable Participant*

measures meant to capture the effectiveness of such messaging, like employee surveys provided to the audit committee by the engagement team. In their minds, however, these measures fall short of being sufficient indicators of how audit firms incentivize their audit partners and personnel to deliver high quality audits.

Participants offered suggestions on qualitative factors that could serve to more adequately validate a firm’s tone at the top and commitment to audit quality. A recurring suggestion related to how firms structure compensation of audit partners and personnel to reward quality. Having an appropriate “compensation philosophy,” some reasoned, would be one indication that a firm has the right tone at the top. Another suggestion was to include information about the systems in place at the audit firm to strengthen quality control and detect and deter wrongdoing within its own organization.

> “You can’t have audit quality without a quality audit committee, quality management, and quality internal audit. To me, the evaluation of audit quality is more multidimensional than just focusing on those items that relate back to the audit firm and the team.”
>
> *– New York Roundtable Participant*

> “...the quality comes from the entire audit which includes the input, the audit process, as well as the output.”
>
> *– Singapore Roundtable Participant*

Several participants noted that the audit committee also plays a role in setting the right tone that supports and encourages auditors, both internal and external, to maintain a questioning mindset and work effectively with the audit committee and management to address and resolve issues. In pursuit of setting the appropriate tone, some audit committees conduct a system-wide review that includes an assessment of how well the work of internal audit was integrated into the external audit process. Some participants pointed to the fact that the audit committees on which they serve routinely undertake some form of performance self-assessment, which often included a conversation about whether the audit committee’s process for evaluating the previous year’s audit and planning for the current year audit was adequate and complete. This evaluation might be another type of indicator of audit quality. Some participants advocated for the development of additional tools that could guide audit committee self-assessments of not only their oversight of the external audit, but also that of the company’s controllership, internal audit functions, and tone at the top.

Audit Committees Should Drive Process of Using and Reporting on AQIs

> "I think indicators precipitate important conversations, but those conversations need to be tailored to the individual engagements, voluntary, and very qualitative."
>
> *– Chicago Roundtable Participant*

Because audit committees represent investors, most roundtable participants view themselves as the primary audience for AQI information as it relates to a particular company's financial reporting and audit oversight. Participants felt that as audit committee members they are best informed of the circumstances surrounding the audit engagement, and are, therefore, ideally placed to determine which AQIs are relevant to a given audit engagement. Participants also felt that audit committees are best situated to discuss AQI information with the audit engagement team and management to obtain the necessary context that gives significance to AQIs or fluctuations in AQIs over time.

There was agreement among those audit committee members who participated in the pilot testing and those who participated in the roundtables that there is no "right" set of AQIs that could, for every audit engagement, consistently add value and insight to audit committee discussions with the engagement team. This is due in part, they explained, to variations among companies' geographic locations, industries, and scope of operations. An overwhelming majority of roundtable participants agreed that the use and reporting of AQIs should remain voluntary to allow for audit committees to experiment with AQIs and tailor the information to address the unique facts and circumstances of their particular audit. For example, audit committee members who serve on boards of global companies said they would focus on AQIs that helped them evaluate how well the global aspects of the audit are being managed by the audit firm. Participants also believed that mandating the communication or reporting of specific AQIs could overburden audit committees with required or expected communications on matters that may not be relevant to the quality of their particular audit. Some participants expressed that they viewed AQIs as generators of questions for the audit committee to ask of the external auditor, as opposed to serving as sources of useful information about audit quality on their own.

Some participants thought a list of common AQIs that could be widely accepted and understood might elevate the use of AQIs among a greater population of audit committees. Over time, experimentation by audit committees may result in the fine tuning or identification of AQIs or a set of AQIs that are widely accepted as useful in the audit committee's dialogue with the auditor.

"I think we will continue to fine tune these measures or indicators and this will allow us to have a useful dialogue with the auditor."

– Singapore Roundtable Participant

"We ought to be careful not to be too prescriptive because every company is different and every audit is going to be unique."

– New York Roundtable Participant

This also could serve to promote consistency among audit firms in terms of how certain AQIs are calculated and to generate expectations for audit firms to assist in providing the data associated with these AQIs. Firm-level transparency reports or audit quality reports that are made publicly available by some of the audit firms provide an example of some level of consistency of AQI reporting across firms.[10] The CAQ has observed that among those publicly available reports issued by the largest audit firms in the United Kingdom, the United States, the Netherlands, and Australia, examples of similar types of AQIs include measuring revenue splits between audit and non-audit services, the results of externally published inspections, and a qualitative description of investor engagement. Such voluntary reporting allows for comparison of firm-wide AQI data, to the extent that two firms report the same AQIs.[11]

Audit committee members who serve on the boards of multiple companies pointed out that standardization of AQIs at the engagement level would be challenging given the variation among companies' business models, scope of operations, and risk profiles. They observed that choosing which AQIs best fit the facts and circumstances of each audit engagement requires the audit committee to apply judgment. In applying that judgment, participants said they would likely choose different AQIs on which to focus depending on the company, and that AQIs of importance to a company could change from one year's audit to the next. Even in those cases where they would look at the same AQIs across the different companies, the contextual information they would solicit from the external audit team to explain the significance of an AQI or change in that AQI over time likely would be very different. On the other hand, some participants wondered whether a core set of AQIs could be identified as particularly useful to certain types of companies, such as those in certain complex or high risk industries, or for companies with significant operations in many different countries. Others cautioned that standardization of AQIs runs the risk of turning reports of AQI information into boilerplate documents, which in turn could diminish their usefulness to audit committees.

[10] In general, these reports are intended to provide greater transparency into the public company audit process by assisting financial statement users, audit committee members, and other stakeholders in understanding how an audit firm's management and operations support the performance of high quality audits.

[11] Since 2007, the International Organization of Securities Commissions (IOSCO) has been evaluating the role of audit firm transparency reporting in protecting investors and ensuring that markets are fair, efficient and transparent. In November 2015, IOSCO issued a final report on this work which posits that high quality transparency reports issued by audit firms could reinforce audit firm internal policies and practices aimed towards improving audit quality and assist those responsible for selecting a public company auditor by providing information that would enable them to compare firms on the basis of information on a firm's audit quality. See, *Transparency of Firms that Audit Public Companies* (Final Report), available at www.IOSCO.org. See also the CAQ's *Resource on Audit Quality Reporting* (August 2013), which highlights elements of audit quality that audit firms could consider in refining or developing their own reporting regarding their public company audit practice, and which is available at http://www.thecaq.org/docs/audit-committees/caqresourceonauditqualityreporting.pdf?sfvrsn=0.

Potential Unintended Consequences of Public Reporting of AQI Information

Participants acknowledged growing interest from investors for more information about how the work of the audit committee fulfills its responsibilities. In the case of AQI information, participants observed that it is not possible for investors to be privy to the dialogue necessary to bring focus on the significance of AQIs to audit quality at the engagement level. On this basis, many participants believed it would do more harm than good to publicize engagement-level AQI information.

> "This is ultimately a judgment. It's not a math test to see whether or not you got a 90% to have quality."
>
> *– New York Roundtable Participant*

Participants expressed concern that public AQIs could turn into a set of inconsistent and misleading benchmarks or tests. Such metrics, without an accompanying dialogue to provide the appropriate context, could lead the recipient to draw incomplete or uninformed conclusions regarding the presence or lack of audit quality. Also, there could be a tendency to choose a particular set of metrics because they are easily and reliably measured rather than being relevant to audit quality. This could lead to a check-the-box compliance exercise or, worse, a misallocation of resources and overemphasis on managing select metrics to the detriment of a focus on other factors that might be more pertinent to quality performance.

> "It's an evolution, not a revolution."
>
> *– London Roundtable Participant*

Some participants observed that the audit model is also changing in response to technical improvements to audit methodologies and as new, macro and microeconomic risks emerge. For example, audit firms are developing capabilities to incorporate data analytics testing procedures on audit evidence into their audit methodologies, which should increase the efficiency and effectiveness of auditors. Accounting and auditing standards also are evolving to address emerging risks. In light of these factors, some participants posited that the development and required use of a static set of AQIs could serve to reinforce outdated audit methodologies and impede innovation in audits, which over time could risk reducing the overall relevance of the audit, the role of the auditor, and, ultimately, audit quality. To continue to be helpful and not a hindrance, AQIs, they asserted, should be allowed to evolve as well.

Conclusion

By sharing input, feedback, and findings from its multi-year effort to explore AQIs, the CAQ aims to further the dialogue and study of AQIs. This publication is intended to advance that effort. The CAQ anticipates that greater awareness, discussion, and collaboration will lead to the development of a common path forward on AQIs and, potentially, best practices for their use.

> "I am a supporter of audit quality indicators. I believe the project has great merit, and I'm glad to see people out in front of it."
>
> *– New York Roundtable Participant*

The feedback received on the *Approach* through these efforts has reinforced the view that although there is no "right" set of AQIs for every audit engagement, the *Approach* provides a good foundation for further development of tools that could advance the oversight capability of the audit committee with respect to both the quantitative and qualitative aspects of the audit process. Audit committee members expressed an appetite for more qualitative information, as well as guidance on how to use firm-level AQI information already publicly available to enhance the dialogue about their audits. Allowing audit committees to continue to explore AQIs in an audit committee-driven, voluntary environment could facilitate the development of a common principles-based framework that could promote consistency in application of AQI use and reporting while maintaining the flexibility audit committees need to tailor approaches to their specific information needs.

All stakeholders in the financial reporting and audit process can benefit from an understanding of how certain AQIs may correlate with audit quality. For its part, the CAQ will continue to monitor and engage in this exciting and important global dialogue. The CAQ looks forward to the outcome of the PCAOB's project on root cause analysis, which seeks to analyze certain measures of audit quality.[12] The CAQ also will monitor the work of other organizations around the world that have an AQI project on their agenda. The involvement of these organizations and their efforts will continue to be invaluable for driving continued stakeholder interest in identifying AQIs that are both relevant to audit quality and which can be consistently and reliably measured.

[12] PCAOB staff briefing memo, *Initiatives to Improve Audit Quality – Root Cause Analysis, Audit Quality Indicators, and Quality Control Standards*, June 24–25, 2014 SAG meeting.

The CAQ expresses its sincere thanks and gratitude to the roundtable participants, as well as the investors, academics, audit committee members, and audit firm representatives who served on the Stakeholder Advisory Panel, and the participants in the pilot testing. Their generosity with their time — and their valuable insights and perspectives — have helped to advance the discussion on this critical issue. Additionally, the CAQ extends its gratitude and appreciation to the Singapore Institute of Directors and the Singapore Accounting and Corporate Regulatory Authority for their support in organizing the Singapore roundtable. The CAQ will continue its rewarding interaction with these stakeholders as it further explores and studies AQIs.

Appendix:
Stakeholder Advisory Panel and Roundtable Participants

Stakeholder Advisory Panel

Stephen Chipman, Retired Chief Executive Officer, Grant Thornton LLP; Former CAQ Governing Board AQI Lead (2012–2015)

Peggy Foran, Senior Vice President, Chief Governance Officer, and Corporate Secretary, Prudential Financial, Inc.

Arnold Hanish, Audit Committee (AC) Chairman, Omeros Corp.

Michele Hooper, President and CEO, The Directors' Council; AC Chairman, PPG Industries, Inc.; CAQ Governing Board Lead AQI (2015–Present)

Robert H. Herz, Executive in Residence, Columbia Business School

William Kinney, Charles and Elizabeth Prothro Regents Chair in Business, University of Texas at Austin

Charles Noski, AC Chairman, Microsoft Corp. and Avon Products, Inc.

Lynn Paine, Senior Associate Dean, Harvard Business School

Zoe-Vonna Palmrose, Professor of Accounting, University of Washington

Anne Sheehan, Director of Corporate Governance, California State Teachers' Retirement System

Roundtable Participants

London: June 2, 2015

Discussion Moderator:

Mark Jeffries, Economist and Keynote Speaker

Participants:

Mike Ashley, AC Chairman, Barclays

Steve Bailey, Managing Director, Aim Proactive Ltd

Hywel Ball, Managing Partner, EY LLP

Lisanne Barrell, Senior Manager, Deloitte LLP

Wanda Eriksen, AC Member, AXA Winterthur and Meyer Burger

Thorsten Grenz, AC Chairman, Draeger

David Isherwood, Partner, BDO LLP

Shonaid Jemmett-Page, AC Chairman, GKN plc

Nick Land, AC Chairman, Vodafone Group plc

David Lindsell, AC Chairman, Drax Group plc and Premier Oil plc

Gillian Lord, Partner, PwC LLP

Steve Maslin, Partner, Grant Thornton UK LLP

John Ormerod, AC Chairman, ITV plc

Kevin Parry, AC Chairman, Standard Life plc

Richard Pinckard, Partner, KPMG LLP

Eric Tracey, AC Chairman, Findel Plc.

Guy Wilson, AC Chairman, Fresnillo plc

Chicago: June 23, 2015

Discussion Moderator:

Leslie Seidman, Executive Director, Center for Excellence in Financial Reporting, Pace University, Lubin School of Business; Director, Moody's Corp. and FINRA

Participants:

Michelle Applebaum, AC Member, Northwest Pipe

Jeffrey Brown, AC Chairman, Teachers Insurance and Annuity Association

Jennifer Burns, Partner, Deloitte LLP

Howard Carver, AC Member, Assurant Inc., Pinnocal Assurance, and StoneMor Partners

Rodney Chase, AC Chairman, Tesoro

Ruth Ann Gillis, Board Committee Member, Snap-On, Inc. (Audit), KeyCorp (Risk), and Voya Financial (Finance)

David Landsittel, Former Chairman and Former AC Chairman, COSO

Janet Malzone, Midwest Audit Practice Leader, Grant Thornton LLP

Mark Zorko, AC Chairman, MFRI, Inc.

New York: June 29, 2015

Discussion Moderator:

Leslie Seidman, Executive Director, Center for Excellence in Financial Reporting, Pace University, Lubin School of Business; Director, Moody's Corp. and FINRA

Participants:

Joan Amble, AC Member, Brown-Forman Corp. (Chair), Sirius XM Radio (Chair), Booz Allen Hamilton, and Zurich Insurance Group

Raymond J. Bromark, AC Chairman, YRC Worldwide, Inc., CA, Inc. and Tesoro Logistics GP, LLC

J. Frank Brown, Managing Director and COO, General Atlantic

Stephen Chipman, Retired Chief Executive Officer, Grant Thornton LLP; Former CAQ Governing Board AQI Lead (2012–2015)

John Cody, AC Chairman, Gannett

J. Michael Cook, AC Chairman, Comcast

William Ehrhardt, AC Chairman, Oppenheimer Holdings, Inc.

Timothy Flynn, AC Chairman, Walmart

Robert Hagemann, AC Chairman, Zimmer Biomet Holdings and Ryder Systems

Robert Herdman, AC Chairman, Cummins, Inc. and WPX Energy, Inc.

Robert H. Herz, Executive in Residence, Columbia Business School

Michele Hooper, President and CEO, The Directors' Council; AC Chairman, PPG Industries, Inc.; CAQ Governing Board Lead AQI (2015–Present)

Peter Kind, AC Member, Enable Midstream Partners (Chair) and NextEra Energy Partners

Lewis Kramer, AC Chairman, L-3 Communications

Catherine Lego, Board Member, SanDisk Corp. (AC Chair), Lam Research and Fairchild Semiconductor

Douglas L. Maine, Limited Partner and Sr. Advisor, Brown Brothers Harriman & Co.

Charles Noski, AC Chairman, Microsoft Corp. and Avon Products, Inc.

Joseph Perry, AC Member, Dime Community Bancshares

Thomas Presby, AC Chairman, ExamWorks Group, Inc.

Richard Randall, AC Chairman, Steve Madden, Ltd.

Singapore: July 27, 2015

Discussion Moderator:

Willie Cheng, Chairman, Singapore Institute of Directors, and AC Chairman, United Overseas Bank

Special Guest:

Julia Tay, Deputy Chief Executive, Singapore Accounting and Corporate Regulatory Authority

Participants:

Fong Heng Boo, AC Chairman, CapitaRetail China Trust Management Ltd

Euleen Goh, AC Chairman, Capitaland Ltd

Chua Phuay Hee, AC Chairman, Perennial Real Estate Holdings Ltd

Tan Boon Hoo, AC Chairman, Bumitama Agri Ltd

Lee Chiang Huat, AC Chairman, Keppel Reit

Tan Ngiap Joo, AC Chairman, Oversea-Chinese Banking Corp.

Goh Boon Kok, AC Chairman, Pan Asian Holdings Ltd

Soon Tit Koon, AC Chairman, SPH Reit

Kevin Kwok, AC Chairman, Singapore Exchange Ltd

Fang Ai Lian, AC Chairman, Banyan Tree Holdings Ltd

Jenny Lim, AC Chairman, CDL Hospitality Real Estate Investment Trust

Paul Ma, AC Chairman, Keppel Infrastructure Trust

Yap Chee Meng, AC Chairman, Keppel Land Ltd

Bahren Shaari, AC Chairman, Singapore Press Holdings Ltd

Alan Ow Soon Sian, AC Chairman, M1 Ltd

Neo Boon Siong, AC Chairman, Keppel Telecommunications & Transportation Ltd

Bernard Tay, AC Chairman, SIIC Environment Holdings Ltd

Timothy Teo, AC Chairman, Guocoland Ltd

Danny Teoh, AC Chairman, Keppel Corp. Ltd

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Seven Habits of Effective Audit Fee Management

Robert Herz (http://www.complianceweek.com/authors/robert-herz) | December 22, 2015

I suspect it will come not as a surprise to readers of *Compliance Week* involved in public company reporting that external audit fees continue to rise for a majority of Securities and Exchange Commission registrants.

The 2015 Audit Fee Report issued in October by the Financial Executives Research Foundation (FERF) reported that median external audit fees increased by 3 percent, 3.5 percent, and 3.4 percent in 2012, 2013, and 2014, respectively. That outpaces the rise in the producer price index, which rose less than 2 percent in each of these years. Increased audit fees were experienced by a majority of the 7,000-8,000 public companies that report their audit fees in SEC filings.

Increased audit fees can result from a combination of higher hourly rates charged by the audit firm and increases in the hours required to complete an audit. Rising compensation and other costs incurred by audit firms can translate into increases in the hourly rates charged for audits, while higher audit hours reflect increases in audit scope. For example, more than 46 percent of the respondents to the FERF survey said the increase in their 2014 audit fees resulted from acquisitions; 36 percent attributed the increase to other changes in company structure.

Another significant factor cited by survey respondents is the heightened focus by audit firms on internal controls over financial reporting. In its inspection reports of audit firms in recent years, the Public Company Accounting Oversight Board has noted many deficiencies relating to the assessment by auditors of internal controls. Auditors are therefore looking more closely at internal controls.

Nearly 40 percent of respondents to the 2015 FERF survey said audit firms “review of manual controls resulting from PCAOB inspections and other PCAOB issues” was a significant contributor to the rise in audit fees. When I was an auditor, yes, there were situations where we increased our review of manual entity-level controls in key areas, and in areas where the company either did not have automated activity-level controls or we concluded that these could not be relied upon because the company had not instituted sufficiently robust access controls over the automated systems.

Companies can experience many benefits from improving and automating internal controls and the related processes and documentation, including helping better manage and even reduce audit fees. As one company told FERF, "Our external fees have decreased because our internal processes have gotten better."

The FERF study also found that companies that reported ineffective internal controls over financial reporting saw more than twice the increase in their audit fees, compared to companies with effective internal controls: a 6.4 percent increase in 2014 for firms reporting ineffective internal controls, compared to 3.1 percent for others.

Interestingly, although public companies face increased scrutiny of their internal controls, not all have experienced higher audit fees. FERF found that more than 40 percent of public companies reported flat or lower fees in 2014 than in the prior year, and 15 percent of the companies achieved decreases in audit fees for multiple consecutive years.

FERF has begun to explore the reasons why some companies have been able to hold their audit fees flat or reduce them over multiple years, even in the face of significant acquisition activity. While the FERF researchers have not yet completed their investigation of these matters, their findings so far are quite interesting. In interviews with companies that reported decreased audit fees for multiple consecutive years, FERF identified the following seven actions that can make a difference.

Review current processes to identify areas for improvement. One interviewee suggested that immediately after an audit, the internal team takes "inventory" of the audit processes and determines ways that they could be enhanced to address audit inefficiencies. Another interviewee reported that, after carefully considering all key controls, he concluded that the number of these controls be cut nearly in half and still achieve the desired level of coverage. Moreover, by focusing attention on a smaller number of controls, the company was able to improve the quality of control documentation and testing with fewer resources.

Improve internal controls. Interviewees reported that there were improvements in their internal controls resulting from centralization, standardization of work papers, and automation that promoted enhanced consistency of control processes and related documentation. Improving internal control can have a direct effect on the effort and cost of external audits. As Gregory Wilson, former deputy director of the PCAOB Inspection Division, put it, "Show me a company with weak internal controls, and I'll show you an expensive audit."

One of the companies FERF interviewed reduced its audit fees despite multiple acquisitions that doubled its size in recent years not once, but twice. The company's vice president of accounting policy and SOX reported that while the company did not set out to reduce audit fees, this was a byproduct of the focused effort to improve controls in the light of its recent rapid growth through acquisitions and its reconsideration of controls against the 2013 COSO Framework.

Continual communication and collaboration with external auditors. Almost all interviewees suggested that there should be regular and active communication with the external auditor during the audit. This helps identify efficiencies for both the company and the auditor, and it helps ensure that the auditors are provided the information they need on a timely basis.

Centralize the audit footprint. Respondents indicated that an audit of the financial statements of a company with centralized operations could be more efficient and less costly than that of a company with decentralized operations.

Companies also described the importance of centralizing critical information and information systems. One company achieved important efficiencies by replacing three or four different enterprise resource planning systems with a single system that was easily accessible at one location.

Automation. Interviewees suggested that automation has major benefits, especially of time-consuming, error-prone tasks. One company reported using a cloud-based solution to automate internal controls documentation and to manage and execute SOX testing documentation (including evidence of the performance of key controls), certification, and the reporting process. This system also provided the auditors with all the necessary information to review and test the company's controls. Companies also reported benefits from standardizing and automating account reconciliations. Among other benefits, such automated systems allow auditors to view reconciliations on their own without the need to involve company staff.

Overall, significant cost savings and other benefits can arise from automation via reducing the administrative burden and freeing up critical resources to focus more attention on the risks and controls that matter most.

Skilled staff. Not surprisingly, interviewees reported that having well-trained company staff involved with the audit will help reduce audit fees. One interviewee suggested that having an employee with prior audit experience is critical to this effort.

Review audit hours and fees, and don't be afraid to push back. Companies that monitor the hours auditors spend on particular audit areas are in a better position to question the number of hours they were billed for and why these hours were incurred. Companies should not just blindly accept an explanation by their auditors that they had to perform additional audit steps because "the PCAOB says so."

Sound internal controls are critical to financial reporting. Companies can experience many benefits from improving and automating internal controls and the related processes and documentation, including helping better manage and even reduce audit fees. As one company told FERF, "Our external fees have decreased because our internal processes have gotten better."

Related articles

The U.S. Financial Reporting System, Circa 2015: Are We OK? (http://www.complianceweek.com/blogs/robert-herz/the-us-financial-reporting-system-circa-2015-are-we-ok)

NATIONAL ASSOCIATION OF
REAL ESTATE INVESTMENT TRUSTS®

October 31, 2014

Ms. Phoebe W. Brown
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Delivered Electronically

Re: Staff Consultation Paper, *Auditing Estimates and Fair Value Measurements*

Dear Board Members:

This letter is submitted by the National Association of Real Estate Investment Trusts® (NAREIT) in response to the solicitation for public comment by the Public Company Accounting Oversight Board (PCAOB or Board) with respect to the Staff Consultation Paper, *Auditing Estimates and Fair Value Measurements, August 19, 2014* (the Staff Paper).

NAREIT is the worldwide representative voice for real estate investment trusts (REITs) and publicly traded real estate companies with an interest in U.S. real estate and capital markets. NAREIT's members are REITs and other businesses throughout the world that own, operate and finance income-producing real estate, as well as those firms and individuals who advise, study and service those businesses.

REITs are generally deemed to operate as either Equity REITs or Mortgage REITs. Our members that operate as Equity REITs acquire, develop, lease and operate income-producing real estate. Our members that operate as Mortgage REITs finance housing and commercial real estate, by originating mortgages or by purchasing whole loans or mortgage backed securities in the secondary market.

A useful way to look at the REIT industry is to consider an index of stock exchange-listed companies like the FTSE NAREIT All REITs Index, which covers both Equity REITs and Mortgage REITs. This Index contained 209 companies representing an equity market capitalization of $789 billion[1] at September 30, 2014. Of these companies, 169 were Equity REITs representing

[1] http://www.reit.com/sites/default/files/reitwatch/RW1410.pdf at page 21

91.8% of total U.S. listed REIT equity market capitalization (amounting to $724.5 billion). The remainder was 40 publicly traded Mortgage REITs with a combined equity market capitalization of $64.5 billion.

This letter has been developed by a task force of NAREIT members, including members of NAREIT's Best Financial Practices Council. Members of the task force include financial executives of both Equity and Mortgage REITs, representatives of major accounting firms, institutional investors and industry analysts.

NAREIT appreciates the PCAOB's efforts toward improving audit quality since its inception in 2002. However, NAREIT has significant concerns with the Staff Paper as drafted.

Why is a change to the existing audit framework for auditing estimates warranted?

NAREIT is not persuaded that a change to the audit framework for auditing estimates is necessary. In NAREIT's view, a single standard for auditing estimates and fair value measurements is an unworkable solution given the multiple iterations of accounting estimates in U.S. Generally Accepted Accounting Principles (GAAP). Additionally, NAREIT's member companies observe that external auditors currently perform a significant amount of audit work surrounding estimates pursuant to existing audit standards. For example, multiple member companies have indicated that the audit fees for auditing fair value estimates of real estate and auditing purchase price allocations in business acquisitions *exceed* the fees paid to the third party valuation companies that develop the estimates. In NAREIT's view, the suggestions in the Staff Paper would not pass a cost benefit test. The suggestions in the Staff Paper would only expand the work that auditors perform today, with no increase in the reliability or credibility of the audited financial statements. Further, as discussed below, there is no evidence that the existing auditing standards related to auditing estimates fail to detect significant errors in financial statements. In short, NAREIT sees no basis to conclude that increased audit work (and thus audit fees) would provide any measurable benefit.

What is the underlying problem that the Staff Paper is trying to solve?

NAREIT does not believe that the Staff Paper articulates a pervasive problem that would be solved by a change in auditing standards. The Staff Paper seems to be justifying a significant increase in audit work (and cost) based on the number of deficiencies found in the inspections process. While NAREIT acknowledges that PCAOB inspection reports have identified shortcomings in the audit work surrounding estimates, we observe that these criticisms could be caused by a number of factors:

- Auditors are not following the current standards;
- Auditors are performing the required procedures but are not adequately documenting the work that they perform;

- Auditors lack sufficient knowledge with respect to quantitatively sophisticated methods of developing estimates used by their clients or third party specialists and therefore are not capable of designing appropriate audit procedures to test the estimates; or,

- The expectations of the PCAOB inspection teams do not reflect the inherent uncertainties and imprecision that underlies estimates, including estimates of fair value measurements.

NAREIT is not aware of any significant audit failures (with "audit failures" defined as restatements of financial statements) driven by erroneous estimates in recent history that would necessitate standard setting by the PCAOB. NAREIT questions whether the PCAOB's inspection findings in the areas of estimates, including estimates of fair value measurements, are more likely driven by auditor shortcomings relative to existing standards rather than problems with the auditing standards themselves.

As illustrated by FASB Member Larry Smith and former FASB Chairman Robert Herz[2] at the October 2, 2014 PCAOB Standing Advisory Group Meeting, estimates are prevalent throughout financial statements prepared under U.S. GAAP. Further, accounting estimates extend above and beyond fair value measurements and the GAAP hierarchy for fair value measurements that was introduced by FAS 157 *Fair Value Measurements*. Examples of accounting estimates within the real estate industry include: depreciation and amortization, asset impairment, reserves for tenant receivables, accrued expenses, deferred revenues, commitments and contingencies, contingent rental revenue, unrealized gains and losses on derivatives, foreign currency translation adjustments, changes in value for available-for-sale securities, etc. Developing estimates and fair value measurements is not new to the accounting profession. NAREIT fails to see where audits have failed to assess the reasonableness of the financial statements in accordance with U.S. GAAP.

Why should external third parties be considered an extension of management?

NAREIT strongly objects to the portions of the Staff Paper that suggest expanding the scope of audit work in the evaluation of processes and controls when management uses a third party specialist or pricing services. NAREIT continues to believe that the auditor's testing of the accuracy of information provided to the third party is appropriate. Additionally, NAREIT considers the evaluation of information provided by third parties to be sufficient in accordance with current audit literature. However, we disagree with requiring the auditor to "test the information provided by the specialist as if it were produced by the company"[3] or to "evaluate the audit evidence obtained [from the third-party source] as if it were produced by the company.[4]" The idea that either management (in its assessment of the adequacy of the company's internal controls over financial reporting) or the external auditor (in its evaluation of management's assessment) could evaluate third parties' processes and controls is simply not operational. NAREIT notes that existing audit guidance in AU 342.04 *Auditing Accounting*

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[2] http://pcaobus.org/News/Events/Documents/10022014_SAG/Herz_slides.pdf
[3] Staff Paper, page 38, Management's Use of a Specialist
[4] Staff Paper, page 44, Use of Third Parties

Estimates acknowledges that "[a]s estimates are based on subjective as well as objective factors, it may be difficult for management to establish controls over them.[5]" Finally, third party specialists and pricing services are separate entities from the companies that engage them. To assume otherwise is not factual.

By suggesting that the auditor treat third party specialists as part of the entity that they are auditing, the Staff Paper seems to be requiring management to understand and evaluate the operating effectiveness and sufficiency of controls at third party vendors. There are two clear business reasons why companies engage third parties to assist in the development of estimates: (i) the company does not have the requisite expertise or time to perform the work in-house; or (ii) the company's management believes that the use of third parties enhances the objectivity and reliability of its estimates. Requiring management and the auditor to evaluate the third parties' processes and controls as if they were part of the company itself would exacerbate the company's resource constraints in the first scenario and potentially discourage the company's efforts in the second scenario. As indicated earlier, in NAREIT's view, the costs of implementing such audit requirements would far outweigh any incidental benefits.

Isn't an accounting estimate, by its very nature, merely one possibility in a range of reasonable outcomes?

While NAREIT understands the importance of auditing estimates, we have to wonder whether the Staff Paper is attempting to reach a level of precision via the audit process that contradicts the inherent nature of the subject being audited.

Estimates, including fair value measurements, are used extensively in the preparation of real estate entities' financial statements. Preparers, auditors and, most importantly, investors and other users of this financial information understand the imprecision that results from the use of estimates. In the context of financial reporting, management's responsibility is to use its judgment regarding available information in making accounting estimates. AU 342.03 notes that "[m]anagement's judgment is normally based on its knowledge and experience about past and current events and its assumptions about conditions it expects to exist and courses of action it expects to take." The auditor's responsibility is *not* to conclude whether the estimate is right or wrong, but to assess whether management's accounting estimate is *reasonable.* Auditing Standard No. 14 *Evaluating Audit Results* states: "If an accounting estimate is determined in conformity with the relevant requirements of the application financial reporting framework and the amount of the estimate is reasonable, a difference between an estimated amount best supported by the audit evidence and the recorded amount of the accounting estimate ordinarily would not be considered to be a misstatement.[6]"

[5] http://pcaobus.org/standards/auditing/pages/au342.aspx
[6] http://pcaobus.org/Standards/Auditing/Pages/Auditing_Standard_14.aspx

NAREIT's recommendation: Focus on targeted improvements to identified problems

In the event that the PCAOB decides to move forward with some change to existing auditing standards, NAREIT recommends that the PCAOB use a targeted approach instead of wholesale changes to the audit framework for estimates. For example, if there are shortcomings in the use of the work of specialists, the PCAOB might consider focusing on auditing the work of specialists to further evaluate the expertise and/or objectivity of the specialist or auditing the inputs provided by the company to the specialist. Alternatively, if the shortcomings stem from inadequate documentation or insufficient subject matter knowledge, the PCAOB could consider steps that would target those issues.

As a starting point, NAREIT recommends that the PCAOB address how proposed changes to auditing literature would impact the auditor's consideration of materiality. NAREIT observes that the Staff Paper is silent on the assessment of materiality. The intersection of where estimates and materiality meet would appear to be a fundamental starting point for the PCAOB's focus in making targeted improvements to audit literature.

Summary

NAREIT appreciates the PCAOB's staff efforts in their endeavor to further audit quality. However, NAREIT does not believe that the PCAOB has identified the root cause that would necessitate further amendments to auditing standards. While the PCAOB cites fair value as a common area of "significant audit deficiencies[7]", NAREIT fails to see where these deficiencies have translated into restatements of previously reported financial results. Thus, NAREIT questions whether the Staff Paper simply represents rule-making for the sake of rule-making, without a clearly articulated underlying problem. As indicated above, in the event that the PCAOB concludes that further standard setting is required, NAREIT recommends that the Board make targeted improvements to specific sections of audit guidance as opposed to wide-ranging changes to the entire audit framework.

* * *

We thank the PCAOB for the opportunity to comment on the Staff Paper. If you would like to discuss our views in greater detail, please contact George Yungmann, NAREIT's Senior Vice President, Financial Standards, at gyungmann@nareit.com or 1-202-739-9432, or Christopher Drula, NAREIT's Vice President, Financial Standards, at cdrula@nareit.com or 1-202-739-9442.

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[7] Staff Paper, page 3, Introduction

Respectfully submitted,

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NATIONAL ASSOCIATION OF
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December 11, 2013

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Delivered Electronically

Re: PCAOB Rulemaking Docket Matter No. 034

Dear Board Members:

This letter is submitted by the National Association of Real Estate Investment Trusts® (NAREIT) in response to the solicitation for public comment by the Public Company Accounting Oversight Board (PCAOB or Board) with respect to its *Proposed Auditing Standards – The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*, and *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements (PCAOB Release No. 2013-005, August 13, 2013, PCAOB Rulemaking Docket Matter No. 034)* (the Proposal).

NAREIT is the worldwide representative voice for real estate investment trusts (REITs) and publicly traded real estate companies with an interest in U.S. real estate and capital markets. NAREIT's members are REITs and other businesses throughout the world that own, operate and finance income-producing real estate, as well as those firms and individuals who advise, study and service those businesses.

REITs are generally deemed to operate as either Equity REITs or Mortgage REITs. Our members that operate as Equity REITs acquire, develop, lease and operate income-producing real estate. Our members that operate as Mortgage REITs finance housing and commercial real estate, by originating mortgages or by purchasing whole loans or mortgage backed securities in the secondary market.

A useful way to look at the REIT industry is to consider an index of stock exchange-listed companies like the FTSE NAREIT All REITs Index, which covers both Equity REITs and Mortgage REITs. This Index contained 193 companies representing an equity market capitalization of $659.6 billion[1] at September 30, 2013. Of these companies, 154 were Equity REITs representing 90.7% of total U.S. listed REIT equity market capitalization (amounting to $598.5 billion). The remainder, as of September 30, 2013, was 39 publicly traded Mortgage REITs with a combined equity market capitalization of $61.1 billion.

This letter has been developed by a task force of NAREIT members, including members of NAREIT's Best Financial Practices Council. Members of the task force include financial executives of both Equity and Mortgage REITs, representatives of major accounting firms, institutional investors and industry analysts.

NAREIT appreciates the PCAOB's efforts toward improving audit quality since its inception in 2002. NAREIT acknowledges the PCAOB's substantive consideration of the feedback it received on its *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards, Notice of Roundtable, (PCAOB Release No. 2011-003, June 21, 2011, PCAOB Rulemaking Docket Matter No. 34*[2]*)* (the Concept Release) that discussed alternatives for changing the auditor's reporting model. In particular, NAREIT supports the PCAOB's decisions to retain the current pass/fail model of auditor reporting and to reject the requirement for an auditor's discussion and analysis. However, NAREIT does not support a requirement for the auditor to report on "critical audit matters" (as that term is defined in the Proposal). In our view, such a requirement would not meet the PCAOB's objective of providing users of financial statements with additional meaningful information. As discussed further below, it is our view that the PCAOB's proposal for auditor reporting of critical audit matters would largely result in generic disclosures that are duplicative of information that is provided by management while simultaneously increasing audit cost.

NAREIT Comments on Critical Audit Matters

We understand that the PCAOB is trying to add value to the audit report and enhance its decision usefulness by requiring that the auditor identify and discuss critical audit matters as a part of the annual audit report. However, we believe that a requirement to disclose critical audit matters in the audit report would potentially:

- Confuse and mislead users with a piecemeal discussion of audit procedures that readers of the financial statements have no context or basis to understand;

- Introduce situations when the auditor is disclosing sensitive information that is not otherwise required to be disclosed by the issuer;

- Duplicate information already disclosed by the issuer;

[1] http://returns.reit.com/reitwatch/rw1310.pdf at page 21
[2] http://pcaobus.org/Rules/Rulemaking/Docket034/Concept_Release.pdf

- Increase audit fees for, among other things, the senior level time the auditor would incur describing the critical audit matters for purposes of drafting the proposed disclosure and incremental time discussing those matters and the related disclosure with management and the audit committee; and,

- Exacerbate existing time pressures to meet financial reporting deadlines.

Each of these concerns is further discussed below.

Confuse and mislead users with a piecemeal discussion of audit procedures that readers of the financial statements have no context or basis to understand

In reporting critical audit matters, auditors would likely feel compelled to describe the audit procedures they performed, consistent with the examples in the proposal. NAREIT questions whether the substantial majority of financial statement users are likely to understand a discussion of audit procedures. When the auditor discusses its audit process with the audit committee, the auditor has the opportunity to answer questions and provide additional information to the audit committee members, thus limiting the risk of confusion or misunderstanding about the nature and extent of audit procedures performed. Further, when the audit committee and auditor are discussing the audit work in discrete areas, they are doing so in the context of the audit taken as a whole. In this context, there is no potential for confusion about whether the auditor is, in some way, effectively providing a piecemeal opinion on an individual line item within the financial statements.

NAREIT believes that users would likely be confused by the discussion of audit procedures in an audit report not only because they lack an understanding of the audit process as a whole but because they lack the context for the discussion of discrete audit procedures on an individual financial statement line item. We are therefore concerned that the Proposal would widen the existing expectation gap regarding the nature and extent of audit work required by the PCAOB's auditing standards.

Introduce situations when the auditor is disclosing sensitive information that is not otherwise required to be disclosed by the issuer;

One of the examples in the Proposal (Hypothetical Auditing Scenario #3) illustrates a fact pattern in which the auditor discloses a "control deficiency less severe than a material weakness noted in the Company's internal control system."[3] This information is part of the auditor's required communication to the issuer's audit committee, under current PCAOB standards, but there is nothing in securities law that requires public reporting of either significant deficiencies in internal controls or audit adjustments.

[3] http://pcaobus.org/Rules/Rulemaking/Docket034/Release_2013-005_ARM.pdf at page A5-77

The Proposal acknowledges a fact pattern whereby control deficiencies that are not material weaknesses would be disclosed by the auditor. For example, Appendix V of the Proposal states:

> Because a deficiency or deficiencies in the company's internal control over financial reporting could have a significant effect on the conduct of the audit and on the level of difficulty in gathering audit evidence or forming an opinion on the financial statements, an internal control deficiency might be an indicator of a critical audit matter.[4]

This would mean that the auditor would be disclosing sensitive information that is not otherwise required to be reported by the issuer. Furthermore, unlike the existing audit requirement to discuss such matters with the audit committee, the information is being presented to users of financial statements with limited context and no opportunity for the clarifying discussion that occurs during most audit committee meetings.

We strongly believe that an audit firm should not report sensitive information that is not required to be disclosed under existing securities laws and/or generally accepted accounting principles. We believe that existing U.S. securities laws and existing U.S. GAAP are sufficient to provide users with the appropriate amount of information to make investment decisions. Further, the expansion of existing disclosure requirements is the purview and responsibility of the SEC and the FASB. Accordingly, if the PCAOB were to go forward with this Proposal, we believe the auditor should be prohibited from disclosing any information that is not otherwise required to be disclosed by the issuer.

Duplicate information already disclosed by the issuer

We believe that the most difficult, subjective and complex audit matters encountered by the auditor are highly likely to be the critical accounting policies and estimates that the issuer is already disclosing in its Management Discussion and Analysis (MD&A). Given that the sections of MD&A that cover critical accounting policies and estimates provide the reader with management's assessment of the most judgmental aspects of the financial statements, NAREIT questions why the Board would require auditors to duplicate this information. If the PCAOB believes that this existing information is not sufficiently robust or transparent, NAREIT recommends that SEC or the Financial Accounting Standards Board (FASB) evaluate this aspect of financial reporting and provide additional guidance through the comment letter process. Another possibility would be to request that the FASB evaluate these disclosures as part of its Disclosure Framework Project.

Increase audit fees for, among other things, the senior level time the auditor will incur describing the critical audit matters for purposes of drafting the proposed disclosure and incremental time discussing those matters and the related disclosure with management and the audit committee

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[4] http://pcaobus.org/Rules/Rulemaking/Docket034/Release_2013-005_ARM.pdf at page A5-32

NAREIT acknowledges that the current audit standards require the auditor to identify and communicate significant audit matters to the audit committee. However, NAREIT believes that requiring the auditor to report critical audit matters in the audit opinion would lead to increased audit fees. At a minimum, each and every audit engagement team would incur additional senior level time in order to determine the critical audit matters (CAMs) for purposes of drafting the proposed disclosure and discussing both the CAMs and the related disclosure with management and the audit committee.

Further, given the significant degree of subjectivity involved in determining which significant audit matters are "the most critical" and the inevitable second guessing of that determination by audit committees, management, PCAOB inspection teams, SEC staff and litigators, NAREIT anticipates that audit partners would need to consult others in the firm regarding both the selection of CAMs as well as the report language. The added time and related increased risk incurred by the audit firm would directly translate into an unnecessary and avoidable increase in annual audit fees. Further, we believe that there is a risk of inconsistent disclosure of CAMs both within and among the audit firms. We sense that the added disclosure in the audit report would open both audit firms and issuers to increased litigation risk, the cost of which will be passed on to issuers (and thus investors) in the form of increased audit fees.

Exacerbate existing time pressures to meet reporting deadlines

Given the nature of the audit process, auditors are unlikely to be able to conclude definitively on "the most" significant, judgmental or complex audit matters until substantially all the audit work has been completed. That necessarily places the decisions and discussions surrounding CAMs into the very final stages of the audit and just prior to the release of the audited financial statements on Form 10-K. If the Board moves forward with this Proposal, NAREIT foresees the addition of a very time consuming step into the late stages of what is already a tight deadline for many issuers.

In light of time pressures, liability concerns and fee issues, audit firms may feel compelled to develop standardized audit report language for common critical audit matters. Thus, stepping back and looking at the sum total of our concerns, we believe there is a significant risk that the PCAOB's proposal will result in boilerplate, duplicative disclosures that add to the cost of the audit without adding to the information available to users of financial statements.

NAREIT Comments on Auditor Tenure

NAREIT understands that there is some interest amongst financial statement users about auditor tenure. We observe that for many issuers, the tenure of an audit firm can be determined by a review of the issuer's public filings. However, NAREIT does not support the Proposal that auditors report on their tenure because that information, placed in the audit report, infers a direct relationship between auditor tenure and the quality of the audit or the content of the audit report that does not exist. NAREIT is unaware of evidence indicating that auditor tenure has a direct correlation to audit quality.

Perhaps more importantly, NAREIT considers auditor tenure to be a corporate governance matter under the direct purview of the issuer's audit committee only. A statement regarding auditor tenure placed in the audit report would provide no information about how the audit committee assesses the quality of the audit work and determines that a change in auditor is appropriate. It also would provide no information regarding the most recent tendering of the audit. Some users might incorrectly infer that longer auditor tenure indicates that the audit has not been retendered when, in fact, the audit committee's decision to retain the incumbent audit firm was made after an extensive retendering process.

Therefore, NAREIT recommends that information regarding auditor tenure continue to be excluded from the audit report. If users of financial statements believe this information would provide significant value, the SEC should consider adding relevant disclosure requirements to proxy statements that are filed coincident with audit committee reports or in connection with company shareholder ratification of auditor appointments.[5]

NAREIT Comments on Other Information

We do not understand the purpose of expanding the audit report to explicitly address information that is not audited and that is often outside the expertise of an auditor. More importantly, NAREIT believes the proposed language that would be included in the audit report regarding other information would mislead users into believing that the auditor has an authoritative basis to conclude on the sufficiency, accuracy or completeness of the other, unaudited information. This, in turn, would cause auditors to do additional work and invest additional resources into the reading of the unaudited information beyond what may be required by the standard because they would be perceived as being more closely associated with that information. Inevitably, this exercise would increase the cost of the audit as well as the cost of preparing the unaudited information. The result would be more cost to shareholders without additional assurance to those same shareholders.

In NAREIT's view, there is no need to change the existing audit standard related to other information contained in a report that includes audited financial statements. We are unaware of any evidence indicating that auditors are either not meeting their existing (albeit very limited) responsibilities for other information or that users are misinformed about which elements of an SEC filing are audited and which are not. In fact, in its Proposal, the PCAOB notes that "investors generally were not supportive of auditor assurance on other information outside the financial statements."[6] To the extent that the audit committee or external third parties (*e.g.*, underwriters, institutional investors, or analysts) believe it is appropriate to obtain additional assurance on other information included in SEC filings, the PCAOB's existing standards provide auditors with the tools to meet those requests. Accordingly, nothing more is needed.

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[5] In its Proposal, the PCAOB notes that the UK-listed companies are "required to provide information about auditor tenure in a separate section of the annual report" (page A5-16.) The approach used by the UK is consistent with our view that information about auditor tenure, while potentially of interest to investors, is a matter of corporate governance.

[6] http://pcaobus.org/Rules/Rulemaking/Docket034/Release_2013-005_ARM.pdf at page 25

The PCAOB states that

> The required procedures under the proposed other information standard would focus the auditor's attention on the identification of material inconsistencies between other information and the company's audited financial statements and on the identification of material misstatements of fact, based on relevant evidence obtained and conclusions reached during the audit.[7]

NAREIT views these requirements as largely consistent with the existing audit standard which states that the auditor "should read the other information and consider whether such information, or the manner of its presentation, is materially inconsistent with information, or the manner of its presentation appearing in the financial statements."[8] However, the proposed changes to the standard, and the related proposed language in the audit report, suggest that the auditor's responsibility should extend beyond what has been historically required. Specifically, under the Proposal the auditor would be required to state that, "in addition to auditing the financial statements and the Company's internal controls over financial reporting," the auditor would also be required to "evaluate" the other information in the filing, an evaluation that was "based on relevant audit evidence obtained and conclusions reached during the audit." What level of assurance is provided by an "evaluation?" Absent clarification by the PCAOB, users of financial statements could mistakenly perceive the audit firm's work and the level of assurance provided surrounding other information as something substantial, with no meaningful understanding as to the distinction between an "evaluation" and an "audit." This perception gap could have severe ramifications on the investment community as well as the audit profession. Instead of adding more clarity to the audit report and narrowing the expectation gap, we view this Proposal as significantly obfuscating the nature and scope of an audit and dramatically widening the expectation gap.

In NAREIT's view, this aspect of the Proposal is fraught with many issues involving each financial statement users' perspectives, and would likely lead auditors by default to performing a far more significant amount of unnecessary work on other information than under current standards due to the lack of clarity regarding the nature and scope of the auditor's responsibility. This would cause increases in audit fees when there is absolutely no demand or requirement for any type of assurance on this information and could lead to less useful information being provided to investors.

Summary

NAREIT does not believe that the changes recommended by the Proposal with respect to the audit report, disclosure of auditor tenure, and the auditor's responsibility for other information are warranted. These requirements would add costs without improving the quality of the audit. Furthermore, these proposals would be likely to confuse and in some cases even mislead users of

[7] http://pcaobus.org/Rules/Rulemaking/Docket034/Release_2013-005_ARM.pdf at page 7
[8] See AU 550.04

financial statements. Therefore, NAREIT recommends that the PCAOB suspend its efforts on the Proposal, and instead focus its time and resources on improving aspects of the audit procedures that would enhance audit quality so as to provide investors with more confidence that the audited financial statements are, indeed, free of material misstatement.

In the event that the PCAOB decides to move forward with the Proposal, NAREIT recommends that the Board consider conducting robust field testing. In our view, field testing should involve not only the preparer and auditor community, but also representatives from the investment community in order to fully assess both the costs and the benefits of the Proposal. This would provide the Board with evidential matter in evaluating whether the Proposal is operational, whether additional guidance is needed, whether the implementation costs outweigh the perceived benefits, and if the Proposal's objectives could actually be achieved.

* * *

We thank the PCAOB for the opportunity to comment on the Proposal. If you would like to discuss our views in greater detail, please contact George Yungmann, NAREIT's Senior Vice President, Financial Standards, at gyungmann@nareit.com or 1-202-739-9432, or Christopher T. Drula, NAREIT's Vice President, Financial Standards, at cdrula@nareit.com or 1-202-739-9442.

Respectfully submitted,

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NATIONAL ASSOCIATION OF
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August 3, 2015

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Office of the Secretary
PCAOB
1666 K Street, N.W.
Washington, D.C. 20006-2803
comments@pcaobus.org

Delivered Electronically

Re: Staff Consultation Paper No. 2015-01 - *The Auditor's Use of the Work of Specialists*

Dear Board Members:

This letter is submitted by the National Association of Real Estate Investment Trusts® (NAREIT) in response to the solicitation for public comment by the Public Company Accounting Oversight Board (PCAOB or Board) with respect to the Staff Consultation Paper, *The Auditor's Use of the Work of Specialists* (the Staff Paper).

NAREIT is the worldwide representative voice for real estate investment trusts (REITs) and publicly traded real estate companies with an interest in U.S. real estate and capital markets. NAREIT's members are REITs and other businesses throughout the world that own, operate and finance income-producing real estate, as well as those firms and individuals who advise, study and service those businesses.

REITs are generally deemed to operate as either Equity REITs or Mortgage REITs. Our members that operate as Equity REITs acquire, develop, lease and operate income-producing real estate. Our members that operate as Mortgage REITs finance housing and commercial real estate, by originating mortgages or by purchasing whole loans or mortgage backed securities in the secondary market.

A useful way to look at the REIT industry is to consider an index of stock exchange-listed companies like the FTSE NAREIT All REITs Index which covers both Equity REITs and Mortgage REITs. This Index contained 224 companies representing an equity market capitalization of $890 billion at June 30, 2015. Of these companies, 183 were Equity REITs representing 93.5% of total U.S. stock exchange-listed REIT equity market capitalization (amounting to $832 billion)[1]. The remainder, as of June 30, 2015, is represented by 41 stock exchange-listed Mortgage REITs with a combined equity market capitalization of $58 billion.

[1] https://www.reit.com/sites/default/files/reitwatch/RW1507.pdf at page 21.

NAREIT appreciates the PCAOB's efforts toward improving audit quality since its inception in 2002. However, NAREIT has significant concerns with the Staff Paper as drafted. NAREIT's comments are primarily focused on the areas that would impact NAREIT member companies (*i.e.*, use of specialists in valuing investment properties, equity and mortgage-backed securities, and derivative positions.)

Why is a change to the existing audit framework for the auditor's use of specialists warranted?

NAREIT is not persuaded that a change to the audit framework for the auditor's use of specialists is necessary. In NAREIT's view, the expansion of audit requirements for the work of specialists is an unnecessary change given the amount of work performed by auditors today. NAREIT's member companies observe that external auditors currently perform a significant amount of audit work surrounding estimates prepared by specialists pursuant to existing audit standards. For example, multiple member companies have indicated that the audit fees for auditing fair value estimates of real estate and auditing purchase price allocations in business acquisitions *exceed* the fees paid to the third party valuation companies that develop the estimates. In NAREIT's view, the suggestions in the Staff Paper would not pass a cost benefit test. The suggestions in the Staff Paper would only expand the work that auditors perform today, with no increase in the reliability or credibility of the audited financial statements. Further, as discussed below, there is no evidence that the existing auditing standards related to the auditor's use of the work of specialists fail to detect significant errors in financial statements. In short, NAREIT sees no basis to conclude that increased audit work (and thus audit fees) would provide any measurable benefit.

What is the underlying problem that the Staff Paper is trying to solve?

NAREIT does not believe that the Staff Paper articulates a pervasive problem that would be solved by a change in auditing standards. The Staff Paper seems to be justifying a significant increase in audit work (and cost) based on academic research papers and limited circumstances where *existing* audit guidance was not followed by the auditor. Further, NAREIT is not aware of any significant audit failures (with "audit failures" defined as restatements of financial statements) driven by the inappropriate reliance on work performed by a specialist in recent history that would necessitate standard setting by the PCAOB.

Why should external third parties be considered an extension of management?

NAREIT strongly objects to the alternative of expanding the scope of audit work in the evaluation of processes and controls when management uses a third party specialist or pricing services. NAREIT continues to believe that the auditor's evaluation of the objectivity of the specialist and the accuracy of information provided to the third party are appropriate. Additionally, NAREIT considers the existing requirements for both management and auditors to evaluate the information provided by third parties to be sufficient in accordance with current audit literature.

The idea that either management (in its assessment of the adequacy of the company's internal controls over financial reporting) or the external auditor (in its evaluation of management's assessment) could evaluate third parties' processes and controls is simply not operational. NAREIT notes that existing audit guidance in AU 342.04 *Auditing Accounting Estimates* acknowledges that "[a]s estimates are based on subjective as well as objective factors, it may be difficult for management to establish controls over them.[2]" Finally, third party specialists and pricing services are separate entities from the companies that engage them. To assume otherwise is not factual.

By suggesting that the auditor treat third party specialists as part of the entity that they are auditing, the Staff Paper seems to be requiring management to understand and evaluate the operating effectiveness and sufficiency of controls at third party vendors. There are two clear business reasons why companies engage third parties to assist in the development of estimates: (i) the company does not have the requisite expertise or time to perform the work in-house; and (ii) the company's management believes that the use of third parties enhances the objectivity and reliability of its estimates. Requiring management and the auditor to evaluate the third parties' processes and controls as if they were part of the company itself would exacerbate the company's resource constraints in the first scenario and potentially discourage the company's efforts to utilize outside specialists in the second scenario. NAREIT cautions the PCAOB of the potential for the unintended consequence of management deciding not to use outside expertise in order to avoid incremental audit fees.

Summary

NAREIT appreciates the PCAOB's staff efforts in their endeavor to further audit quality. However, NAREIT does not believe that the PCAOB has identified the root cause that would necessitate further amendments to auditing standards. While the PCAOB cites academic research papers and limited examples of where the auditor failed to follow existing auditing standards, NAREIT fails to see the impetus for a change in auditing standards. In the event that the PCAOB decides to move forward with some change to existing auditing standards, NAREIT recommends that the PCAOB use a targeted approach that address the root cause of problems that are identified.

* * *

We thank the PCAOB for the opportunity to comment on the Staff Paper. If you would like to discuss our views in greater detail, please contact George Yungmann, NAREIT's Senior Vice President, Financial Standards, at gyungmann@nareit.com or 1-202-739-9432, or Christopher Drula, NAREIT's Vice President, Financial Standards, at cdrula@nareit.com or 1-202-739-9442.

[2] http://pcaobus.org/standards/auditing/pages/au342.aspx

Respectfully submitted,

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♦ ♦ ♦
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In brief
The latest news in financial reporting

pwc

No. US2015-43
December 18, 2015

At a glance

The PCAOB adopted new rules and related amendments to its auditing standards to require public reporting of the name of the engagement partner and other accounting firms that took part in the audit.

PCAOB adopts final rules to disclose name of partner and others on new form

What happened?

On December 15, 2015, the Public Company Accounting Oversight Board ("PCAOB") adopted new rules and amendments to its auditing standards requiring disclosure of the name of the engagement partner and information about other accounting firms that took part in the audit, including other firms within the same network as the group auditor. This information will be filed with the PCAOB on a new PCAOB form, *Auditor Reporting of Certain Audit Participants* ("Form AP") and will be searchable on the PCAOB's website.

The rules and amendments to the auditing standards require disclosure for all audits of issuers, including employee stock purchase, savings, and similar plans that file annual reports on Form 11-K. At this time, the PCAOB is not extending the Form AP requirements to audits of brokers and dealers unless the broker or dealer is an issuer required to file audited financial statements. Additionally, the PCAOB is recommending the rules and amendments to its auditing standards apply to emerging growth companies, which will be subject to a separate determination by the Securities and Exchange Commission (the "SEC"), pursuant to the JOBS Act.

Disclosure requirements and effective dates

The rules require disclosure of:

- The name of the engagement partner;
- The names, locations, and extent of participation of other accounting firms that took part in the group audit, if their work constituted 5 percent or more of the total group audit hours; and
- The number and aggregate extent of participation of all other accounting firms that took part in the group audit whose individual participation was less than 5 percent of the total group audit hours.

Subject to SEC approval, disclosure of the engagement partner will be required for audit reports issued on or after January 31, 2017 (or three months after SEC approval, whichever is later), while disclosure of information about other accounting firms that took part in the audit will be required for audit reports issued on or after June 30, 2017.

Form AP

The filing deadline for Form AP will be 35 days after the date the auditor's report is first included in a document filed with the SEC, with a shorter filing deadline of 10 days for initial public offerings.

The filing of Form AP is required the first time an audit report is included in a document filed with the SEC. Subsequent inclusion of precisely the same audit report in other documents filed with the SEC does not give rise to a requirement to file another Form AP. Conversely, any changes to the auditor's report, including if it is dual-dated, requires a new Form AP even when no information on the form, other than the date of the report, changes.

For audits of mutual funds, the rules permit one Form AP to be filed in cases where multiple audit opinions are included in the same auditor's report, such as in the case for mutual fund families. If multiple audit opinions included in the same auditor's report involved different engagement partners, a Form AP will be filed for each engagement partner.

Partner identifying number

The final rules require each registered accounting firm to assign a 10-digit partner identifying number to each of its partners serving as the engagement partner on audits of issuers. The number will be assigned to a particular partner and will not be reassigned if the partner retires or otherwise ceases serving as engagement partner on issuer audits conducted by that firm.

Use of estimates

Firms may use a reasonable method to estimate audit hours of other accounting firms participating in the audit.

Why is this important?

It is intended to help the public know the name of the engagement partner and understand how much of the audit was performed by the accounting firm signing the auditor's report and how much was performed by other accounting firms.

What's next?

The PCAOB will formally submit the rules and amendments to its auditing standards to the SEC, and the SEC will consider them for approval through their normal process. PCAOB staff plans to publish guidance in 2016 to assist firms in complying with the reporting requirements of Form AP.

Questions?

PwC clients who have questions about this *In brief* should contact their engagement partner. Engagement teams who have questions should contact the National Professional Services Group (1-973-236-7800).

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No. US2014-16
August 22, 2014

At a glance

The staff of the PCAOB's Office of the Chief Auditor is evaluating whether existing PCAOB standards relating to auditing accounting estimates and fair value measurements can and should be improved.

PCAOB issues staff consultation paper seeking comment on auditing accounting estimates and fair value measurements

What happened?

On August 19, 2014, the Public Company Accounting Oversight Board ("PCAOB") issued for public comment a staff consultation paper on standard-setting activities related to auditing accounting estimates and fair value measurements. The staff consultation paper discusses and solicits comment on certain issues related to auditing accounting estimates and fair value measurements in order to assist the PCAOB staff in evaluating whether the existing PCAOB auditing standards can and should be improved. The PCAOB staff is specifically seeking feedback on: (i) the potential need for changes to the PCAOB's existing auditing standards to better address changes in the financial reporting frameworks related to accounting estimates and fair value measurements, (ii) current audit practices that have evolved to address issues relating to auditing accounting estimates and fair value measurements, (iii) a possible approach to changing existing auditing standards, and the requirements of a potential new standard, and (iv) relevant economic data about potential economic impacts to inform the PCAOB's economic analysis associated with standard setting in this area.

Overview of the approach being considered by the PCAOB staff

Although the PCAOB staff identified a number of alternative approaches that the PCAOB may wish to consider, the PCAOB staff is considering developing a single standard related to auditing accounting estimates and fair value measurements instead of separate standards that exist today. The staff consultation paper discusses that the potential new standard could be designed to:

- Align with the PCAOB's risk assessment standards
- Generally retain the approaches to internal control and substantive testing from the existing standards, but include requirements that apply to both accounting estimates and fair value measurements
- Establish more specific audit requirements related to the use of third parties in developing accounting estimates and fair value measurements, and
- Create a more comprehensive standard related to auditing accounting estimates and fair value measurements to promote greater consistency and effectiveness in application

Use of third parties

A new standard could include the existing requirement related to testing assumptions for fair value measurements developed by a company's specialist, but apply it more broadly to information provided for accounting estimates. As such, if a company uses a specialist to develop an accounting estimate, a new standard could direct the auditor to test that information as if it were produced by the company. In this case, the auditor would be required, as applicable, to evaluate the appropriateness of the methods, test the data used, and evaluate the reasonableness of significant assumptions, with respect to the information provided by the specialist.

Additionally, the PCAOB staff is considering how a potential new standard could address audit evidence obtained from third-party sources, such as pricing services and broker-dealers. Given the differences in how values of financial instruments are derived and obtained, the PCAOB staff is exploring whether a new standard should set forth specific requirements for evaluating information from third-party pricing sources as part of evaluating the reliability and relevance of the evidence. For example, to evaluate reliability, the auditor could take into account the methods used by a third-party in determining fair value and whether the methodology used is in conformity with the applicable financial reporting framework. As it relates to evaluating the relevance, the auditor could determine, among other matters, when there are no transactions either for the asset or liability or comparable assets or liabilities, how the information was developed, including whether the inputs developed represent the assumptions that market participants would use when pricing the asset or liability, if applicable.

Why is this important?

Financial statements and disclosures of most companies include accounting estimates and fair value measurements.

What's next?

Comments on the staff consultation paper are due on November 3, 2014. Additionally, the PCAOB announced it will host a meeting of its Standing Advisory Group ("SAG") on October 2, 2014, in Washington, D.C., to discuss matters related to auditing accounting estimates and fair value measurements. The agenda and meeting logistics will be announced closer to the meeting date.

Questions?

PwC clients who have questions about this *In brief* should contact their engagement partner. Engagement teams who have questions should contact the National Professional Services Group (1-973-236-7800).

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No. US2015-16
June 3, 2015

PCAOB issues staff consultation paper seeking comment on the auditor using the work of specialists

At a glance

The staff of the PCAOB's Office of the Chief Auditor is considering ways to improve the existing PCAOB standards that apply to the auditor using the work of a specialist, including areas related to objectivity and oversight of specialists.

What happened?

On May 28, 2015, the Public Company Accounting Oversight Board ("PCAOB") issued for public comment a staff consultation paper on potential standard-setting activities related to the auditor using the work of specialists. The staff consultation paper discusses the increased use and importance of specialists in recent years due, in part, to the increasing complexity of business transactions reported in a company's financial statements. The staff consultation paper also raises questions about whether PCAOB standards adequately address the auditor's use of the work of an auditor's or a company's specialists, and whether more rigorous standards and specific procedures are needed in this regard to help the auditor respond to the risks of material misstatement in financial statements. The PCAOB staff is seeking feedback on: (i) additional information on current practice, (ii) the potential need for changes, (iii) possible alternatives to address the issues discussed in the staff consultation paper, and (iv) relevant economic data about potential economic impacts to inform the PCAOB's economic analysis associated with standard-setting in this area. The staff consultation paper builds on feedback received on an earlier staff consultation paper related to auditing accounting estimates and fair value measurements.

Overview of the approach being considered by the PCAOB staff

This staff consultation paper describes that the PCAOB staff is considering:

- Requirements to improve the auditor's oversight and review of the work of an auditor's specialist, whether employed or engaged by the auditor, by creating consistent requirements that would apply to any auditor's specialist.
- Requirements to improve the auditor's evaluation of the objectivity of an auditor's specialist, whether employed or engaged by the auditor. Those requirements are based on the independence requirements in Rule 2-01 of Regulation S-X of the Securities and Exchange Commission. An auditor's employed specialist is already required to follow the independence requirements.
- Alternatives that would improve the auditor's evaluation of the work of a company's employed or engaged specialist. The alternatives would require more rigorous procedures than those currently required by PCAOB AU 336, *Using the Work of a Specialist* ("PCAOB AU 336").

Auditor's employed or engaged specialist

Under existing PCAOB standards, an auditor's specialist is either an employee of the audit firm and supervised by the auditor under PCAOB Auditing Standard No. 10, *Supervision of the Audit Engagement*, ("AS No. 10"), or engaged by the audit firm and overseen by the auditor under PCAOB AU 336. Under the alternatives being explored by the PCAOB staff, which include either developing a single standard for using the work of an auditor's specialist or extending the supervision requirements in AS No. 10 to an auditor's engaged specialist, the PCAOB staff would also consider including enhanced requirements for (i) evaluating the knowledge, skill, and objectivity of an auditor's specialist, (ii) informing an auditor's specialist of his or her responsibilities, including by reaching agreement in writing regarding certain matters such as nature, timing, and extent of the work that the auditor's specialist is to perform and the nature and extent of audit documentation the auditor's specialist will provide, and (iii) reviewing the auditor's specialist's work and conclusions including, if an auditor's specialist develops an independent estimate, determining whether the methods are appropriate and significant assumptions are reasonable.

The PCAOB staff is also considering revising requirements that apply to an auditor's determination of whether an auditor's specialist is capable of exercising objective and impartial judgment in his or her work. The alternatives being considered would require a more rigorous evaluation of the business, employment, and financial relationships that may impair the objectivity of an auditor's specialist, including obtaining written information of any relationships and the process used by the specialist to formulate the response.

Auditor's use of a company's specialist

Under existing PCAOB standards, auditors may use the work of a company's employed or engaged specialist to obtain audit evidence. The PCAOB staff is considering two alternatives, including (i) amending the current PCAOB standards, including removing certain provisions that may be considered to limit the extent of the auditor's testing of the specialist's work that is needed to obtain sufficient appropriate audit evidence, or (ii) rescinding the current PCAOB specialists standard. Under either alternative, the PCAOB staff is exploring whether the auditor would be required to evaluate the reasonableness of significant assumptions and appropriateness of methods used by a company's specialist in the same manner as the auditor evaluates information produced by others in the company.

Why is this important?

If the PCAOB staff alternatives are finalized in a PCAOB standard, the incremental effort may be significant for auditors, specialists, and company management, as auditors may need to use their own employed or engaged specialists and not directly use the work of a company specialist as can be done today. As a result, the staff consultation paper is seeking feedback on the likely benefits and costs of a potential new set of requirements.

What's next?

Comments on the staff consultation paper are due no later than July 31, 2015. Additionally, the PCAOB announced it will host a meeting of its Standing Advisory Group on June 18, 2015, in Washington, D.C., to discuss matters related to the auditor's use of the work of specialists. The agenda for this meeting can be found here.

Questions?

PwC clients who have questions about this *In brief* should contact their engagement partner. Engagement teams who have questions should contact the National Professional Services Group (1-973-236-7800).

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No. US2015-22
July 7, 2015

PCAOB seeks comment on potential audit quality indicators

At a glance

The PCAOB is seeking comment on a portfolio of twenty-eight potential quantitative measures (audit quality indicators) that may enhance the dialogue on ways to evaluate audit quality.

What happened?

On July 1, 2015, the Public Company Accounting Oversight Board ("PCAOB") issued a concept release to seek public comment on a group of twenty-eight potential audit quality indicators ("AQIs") and the availability and value of those AQIs to audit committees, audit firms, investors, PCAOB and others. The AQIs are meant to enhance the dialogue on ways to evaluate audit quality. The concept release follows the PCAOB's outreach process through public meeting with its Standing Advisory Group and Investor Advisory Group and receipt of input from others, including the Center for Audit Quality.

The PCAOB developed the AQIs considering three principles: (i) AQIs should be quantitative wherever possible to add consistency of approach and objectivity to minimize subjective judgments, (ii) AQIs should generate data that enable users to pose critical questions, and (iii) AQIs should be used, and function together as a "balanced portfolio", as no single indicator is likely to be determinative of audit quality. The AQIs are designed to operate in an integrated manner and, although quantitative in nature, contextual information is to be provided. The AQIs pertain to three broad categories:

- Audit Professionals — measures relating to availability of resources, competence, and focus (e.g., percentage of hours by significant risk for partners, managers, and staff) of those performing the audit.
- Audit Process — measures relating to an audit firm's tone at the top and leadership, incentives, independence, attention to infrastructure (e.g., investment in audit practice as a percentage of firm revenue), and record of monitoring and remediation of identified matters impacting audit quality.
- Audit Results — measures relating to financial statements (such as the number and impact of restatements and other measures of financial reporting quality), internal control over financial reporting, going concern reporting, communications between auditors and audit committees, and enforcement and litigation.

Most of the AQIs include measures at the engagement and firm level and are further described in the concept release.

The PCAOB observes the nature of AQI data and the method for its distribution will depend on, among other things, the users involved. The PCAOB is considering one or more approaches to assisting in the distribution of the AQI data. For example, it could (i) encourage firms and engagement teams voluntarily to discuss AQI engagement- or firm-level data with audit committees, or to do so publicly, (ii) require audit teams to provide that data to audit committees, (iii) collect and make "combined" AQI data public over time, as a single set of weighted figures for comparable firms, (iv) collate and make public on a firm-by-firm basis AQIs derived from public sources, and (v) consider requiring reporting of the necessary data to the PCAOB so that the PCAOB could make it public, or even require firms to do so directly.

Areas in which feedback is being solicited

Information the PCAOB is seeking feedback, includes:

- The nature of the potential AQIs, including whether there are additional AQIs to consider and if other subgroups should be included (e.g., by office, region, or industry),
- The availability and value of AQIs to various potential users of the information, which includes whether the AQIs should be publicly available,
- How the data from which AQIs are derived might be obtained and distributed,
- Whether audit firms' use of AQIs should be voluntary or mandatory,
- The scope of audits and audit firms that may be subject to AQI reporting, and
- The possibility of phasing-in steps toward AQI reporting and use.

Why is this important?

The PCAOB is considering, among other matters, whether the AQIs will enhance the discussion around audit quality and contribute to the identification of key variables that drive audit quality. In turn, the PCAOB suggests that this will provide another objective measure for audit committees, management and others to further evaluate the performance and stimulate competition based on audit quality among the audit firms.

What's next?

Comments on the concept release are due no later than September 29, 2015. Additionally, the PCAOB will host a public roundtable to discuss views on the concept release on a date to be determined during the fourth quarter of 2015.

Questions?

PwC clients who have questions about this *In brief* should contact their engagement partner. Engagement teams who have questions should contact the National Professional Services Group (1-973-236-7800).

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No. US2015-21
July 7, 2015

SEC considers changes to audit committee disclosure of auditor oversight

What happened?

On July 1, 2015, the SEC published a concept release to solicit public input on possible changes to its audit committee disclosure requirements. The concept release is focused on disclosures relating to the audit committee's oversight of the independent auditor.

At a glance

The SEC is seeking public input on whether investors would benefit from enhanced disclosure relating to the audit committee's oversight of the independent auditor and, if so, what information would be useful.

Current audit committee disclosure requirements

Audit committees play a critical role in protecting the interests of investors, and disclosures about audit committee interactions with the independent auditor promote investor confidence. The majority of the SEC's current audit committee disclosure requirements were adopted in 1999. Since that time, there have been significant changes in audit committee responsibilities, including the 2002 Congressional mandate that the audit committee of a listed issuer be directly responsible for the appointment, compensation, retention, and oversight of the work of the independent auditor.

Current audit committee disclosure requirements (e.g., that the committee has discussed certain required communications with the auditor and has received written communications relating to the auditor's independence) provide some information about the audit committee's role in overseeing the independent auditor. However, the SEC's current rules do not provide insight into how the audit committee executes its responsibilities.

Focus of the concept release

The concept release seeks public input on a number of potential changes to the SEC's audit committee disclosure requirements on topics such as:

- communications between the audit committee and the auditor;
- frequency of meetings between the audit committee and the auditor;
- discussions about the auditor's internal quality review and most recent PCAOB inspection report;
- how the audit committee assesses, promotes, and reinforces the auditor's objectivity and professional skepticism;
- how the audit committee assessed the auditor (including the auditor's independence, objectivity and audit quality) and its rationale for selecting or retaining the auditor;
- whether the audit committee sought proposals for the independent audit and if so, the process the committee undertook and the factors it considered in selecting the auditor;
- policies for an annual shareholder vote on the selection of the auditor, and the audit committee's consideration of the voting results;

- disclosures of certain individuals on the engagement team (e.g., the naming the engagement partner);
- audit committee input in selecting the engagement partner;
- the number of years the auditor has served as the company's independent auditor; and
- information relating to other firms involved in the audit.

Some of these topics (e.g., naming the engagement partner and disclosing auditor tenure) are the subject of on-going projects by the PCAOB. The SEC is also seeking input on those topics so it can evaluate whether the disclosures, if they are important, would be more appropriately placed (or perhaps repeated) in company filings where they can be made in the broader context of the audit committee's oversight of the independent auditor.

Why is this important?

High quality, independent audits are critical to the proper functioning of the capital markets because they give the public confidence in the credibility and reliability of financial statements. Audit committees promote confidence through their oversight of the independent auditors.

In this concept release, the SEC is exploring whether additional disclosure about the audit committee's oversight of the independent auditor could be beneficial to investors, for instance, by providing useful information for making investment decisions or helping inform voting decisions regarding the ratification of auditors and the election of directors who are members of the audit committee.

It is important to note the SEC's current audit committee disclosure rules establish the "floor" for audit committee disclosure, not the "ceiling." Many audit committees have already gone beyond these minimum reporting requirements to provide enhanced disclosures around their independent auditor oversight activities. In November 2013, a group of nationally recognized corporate governance and policy organizations known as the Audit Committee Collaboration published *Enhancing the Audit Committee Report: A Call to Action* to encourage audit committees to voluntarily strengthen their disclosures. The Audit Committee Collaboration recently published its *External Auditor Assessment Tool: A Reference for U.S. Audit Committees* to assist audit committees in evaluating the external auditor. Audit committees may find these resources helpful as they consider their own disclosures.

What's next?

Comments are due within 60 days after the concept release is published in the Federal Register. The SEC will use the input it receives to evaluate whether to propose changes to its rules. The issuance of the concept release is only the first step in the rulemaking process.

Questions?

PwC clients who have questions about this *In brief* should contact their engagement partner. Engagement teams who have questions should contact the National Professional Services Group (1-973-236-7800).

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Concurrent Session: Public Non-listed REITs

Thursday, March 31st
2:45pm – 4pm
Marriott Marquis, Washington DC

Moderator:
Rosemarie Thurston, Partner, Alston & Bird LLP

Panelists:
David Lazarus, Sr. Managing Director, Eastdil Secured
Ross Prindle, Managing Director, Duff & Phelps, LLC
Thomas Sittema, CEO & President, CNL Financial Group

FEDERAL REGISTER

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No. 75 April 20, 2015

Part III

Department of Labor

Employee Benefits Security Administration

29 CFR Parts 2509 and 2510

Definition of the Term "Fiduciary"; Conflict of Interest Rule—Retirement Investment Advice; Proposed Rule

DEPARTMENT OF LABOR

Employee Benefits Security Administration

29 CFR Parts 2509 and 2510

RIN 1210–AB32

Definition of the Term "Fiduciary"; Conflict of Interest Rule—Retirement Investment Advice

AGENCY: Employee Benefits Security Administration, Department of Labor.

ACTION: Notice of proposed rulemaking and withdrawal of previous proposed rule.

SUMMARY: This document contains a proposed regulation defining who is a "fiduciary" of an employee benefit plan under the Employee Retirement Income Security Act of 1974 (ERISA) as a result of giving investment advice to a plan or its participants or beneficiaries. The proposal also applies to the definition of a "fiduciary" of a plan (including an individual retirement account (IRA)) under section 4975 of the Internal Revenue Code of 1986 (Code). If adopted, the proposal would treat persons who provide investment advice or recommendations to an employee benefit plan, plan fiduciary, plan participant or beneficiary, IRA, or IRA owner as fiduciaries under ERISA and the Code in a wider array of advice relationships than the existing ERISA and Code regulations, which would be replaced. The proposed rule, and related exemptions, would increase consumer protection for plan sponsors, fiduciaries, participants, beneficiaries and IRA owners. This document also withdraws a prior proposed regulation published in 2010 (2010 Proposal) concerning this same subject matter. In connection with this proposal, elsewhere in this issue of the **Federal Register**, the Department is proposing new exemptions and amendments to existing exemptions from the prohibited transaction rules applicable to fiduciaries under ERISA and the Code that would allow certain broker-dealers, insurance agents and others that act as investment advice fiduciaries to continue to receive a variety of common forms of compensation that otherwise would be prohibited as conflicts of interest.

DATES: As of April 20, 2015, the proposed rule published October 22, 2010 (75 FR 65263) is withdrawn. Submit written comments on the proposed regulation on or before July 6, 2015.

ADDRESSES: To facilitate the receipt and processing of written comment letters on the proposed regulation, EBSA encourages interested persons to submit their comments electronically. You may submit comments, identified by RIN 1210–AB32, by any of the following methods:

Federal eRulemaking Portal: http://www.regulations.gov. Follow instructions for submitting comments.

Email: e-ORI@dol.gov. Include RIN 1210–AB32 in the subject line of the message.

Mail: Office of Regulations and Interpretations, Employee Benefits Security Administration, Attn: Conflict of Interest Rule, Room N–5655, U.S. Department of Labor, 200 Constitution Avenue NW., Washington, DC 20210.

Hand Delivery/Courier: Office of Regulations and Interpretations, Employee Benefits Security Administration, Attn: Conflict of Interest Rule, Room N–5655, U.S. Department of Labor, 200 Constitution Avenue NW., Washington, DC 20210.

Instructions: All comments received must include the agency name and Regulatory Identifier Number (RIN) for this rulemaking (RIN 1210–AB32). Persons submitting comments electronically are encouraged not to submit paper copies. All comments received will be made available to the public, posted without change to *http://www.regulations.gov* and *http://www.dol.gov/ebsa,* and made available for public inspection at the Public Disclosure Room, N–1513, Employee Benefits Security Administration, U.S. Department of Labor, 200 Constitution Avenue NW., Washington, DC 20210, including any personal information provided.

FOR FURTHER INFORMATION CONTACT:

For Questions Regarding the Proposed Rule: Contact Luisa Grillo-Chope or Fred Wong, Office of Regulations and Interpretations, Employee Benefits Security Administration (EBSA), (202) 693–8825.

For Questions Regarding the Proposed Prohibited Transaction Exemptions: Contact Karen Lloyd, Office of Exemption Determinations, EBSA, 202–693–8824.

For Questions Regarding the Regulatory Impact Analysis: Contact G. Christopher Cosby, Office of Policy and Research, EBSA, 202–693–8425. (These are not toll-free numbers).

SUPPLEMENTARY INFORMATION:

I. Executive Summary

A. Purpose of the Regulatory Action

Under ERISA and the Code, a person is a fiduciary to a plan or IRA to the extent that he or she engages in specified plan activities, including rendering "investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan . . ." ERISA safeguards plan participants by imposing trust law standards of care and undivided loyalty on plan fiduciaries, and by holding fiduciaries accountable when they breach those obligations. In addition, fiduciaries to plans and IRAs are not permitted to engage in "prohibited transactions," which pose special dangers to the security of retirement, health, and other benefit plans because of fiduciaries' conflicts of interest with respect to the transactions. Under this regulatory structure, fiduciary status and responsibilities are central to protecting the public interest in the integrity of retirement and other important benefits, many of which are tax-favored.

In 1975, the Department issued regulations that significantly narrowed the breadth of the statutory definition of fiduciary investment advice by creating a five-part test that must, in each instance, be satisfied before a person can be treated as a fiduciary adviser. This regulatory definition applies to both ERISA and the Code. The Department created the test in a very different context, prior to the existence of participant-directed 401(k) plans, widespread investments in IRAs, and the now commonplace rollover of plan assets from fiduciary-protected plans to IRAs. Today, as a result of the five-part test, many investment professionals, consultants, and advisers [1] have no obligation to adhere to ERISA's fiduciary standards or to the prohibited transaction rules, despite the critical role they play in guiding plan and IRA investments. Under ERISA and the Code, if these advisers are not fiduciaries, they may operate with conflicts of interest that they need not disclose and have limited liability under federal pension law for any harms resulting from the advice they provide. Non-fiduciaries may give imprudent and disloyal advice; steer plans and IRA owners to investments based on their own, rather than their customers' financial interests; and act on conflicts of interest in ways that would be prohibited if the same persons were fiduciaries. In light of the breadth and intent of ERISA and the Code's statutory

[1] By using the term "adviser," the Department does not intend to limit its use to investment advisers registered under the Investment Advisers Act of 1940 or under state law. For example, as used herein, an adviser can be an individual or entity who can be, among other things, a representative of a registered investment adviser, a bank or similar financial institution, an insurance company, or a broker-dealer.

definition, the growth of participant-directed investment arrangements and IRAs, and the need for plans and IRA owners to seek out and rely on sophisticated financial advisers to make critical investment decisions in an increasingly complex financial marketplace, the Department believes it is appropriate to revisit its 1975 regulatory definition as well as the Code's virtually identical regulation. With this regulatory action, the Department proposes to replace the 1975 regulations with a definition of fiduciary investment advice that better reflects the broad scope of the statutory text and its purposes and better protects plans, participants, beneficiaries, and IRA owners from conflicts of interest, imprudence, and disloyalty.

The Department has also sought to preserve beneficial business models for delivery of investment advice by separately proposing new exemptions from ERISA's prohibited transaction rules that would broadly permit firms to continue common fee and compensation practices, as long as they are willing to adhere to basic standards aimed at ensuring that their advice is in the best interest of their customers. Rather than create a highly prescriptive set of transaction-specific exemptions, the Department instead is proposing a set of exemptions that flexibly accommodate a wide range of current business practices, while minimizing the harmful impact of conflicts of interest on the quality of advice.

In particular, the Department is proposing a new exemption (the "Best Interest Contract Exemption") that would provide conditional relief for common compensation, such as commissions and revenue sharing, that an adviser and the adviser's employing firm might receive in connection with investment advice to retail retirement investors.[2] In order to protect the interests of plans, participants and beneficiaries, and IRA owners, the exemption requires the firm and the adviser to contractually acknowledge fiduciary status, commit to adhere to basic standards of impartial conduct, adopt policies and procedures reasonably designed to minimize the harmful impact of conflicts of interest, and disclose basic information on their conflicts of interest and on the cost of their advice. Central to the exemption is the adviser and firm's agreement to meet fundamental obligations of fair dealing and fiduciary conduct—to give advice that is in the customer's best interest; avoid misleading statements; receive no more than reasonable compensation; and comply with applicable federal and state laws governing advice. This principles-based approach aligns the adviser's interests with those of the plan participant or IRA owner, while leaving the adviser and employing firm with the flexibility and discretion necessary to determine how best to satisfy these basic standards in light of the unique attributes of their business. The Department is similarly proposing to amend existing exemptions for a wide range of fiduciary advisers to ensure adherence to these basic standards of fiduciary conduct. In addition, the Department is proposing a new exemption for "principal transactions" in which advisers sell certain debt securities to plans and IRAs out of their own inventory, as well as an amendment to an existing exemption that would permit advisers to receive compensation for extending credit to plans or IRAs to avoid failed securities transactions. In addition to the Best Interest Contract Exemption, the Department is also seeking public comment on whether it should issue a separate streamlined exemption that would allow advisers to receive otherwise prohibited compensation in connection with plan, participant and beneficiary accounts, and IRA investments in certain high-quality low-fee investments, subject to fewer conditions. This is discussed in greater detail in the **Federal Register** notice related to the proposed Best Interest Contract Exemption.

This broad regulatory package aims to enable advisers and their firms to give advice that is in the best interest of their customers, without disrupting common compensation arrangements under conditions designed to ensure the adviser is acting in the best interest of the advice recipient. The proposed new exemptions and amendments to existing exemptions are published elsewhere in today's edition of the **Federal Register**.

B. Summary of the Major Provisions of the Proposed Rule

The proposed rule clarifies and rationalizes the definition of fiduciary investment advice subject to specific carve-outs for particular types of communications that are best understood as non-fiduciary in nature. Under the definition, a person renders investment advice by (1) providing investment or investment management recommendations or appraisals to an employee benefit plan, a plan fiduciary, participant or beneficiary, or an IRA owner or fiduciary, and (2) either (a) acknowledging the fiduciary nature of the advice, or (b) acting pursuant to an agreement, arrangement, or understanding with the advice recipient that the advice is individualized to, or specifically directed to, the recipient for consideration in making investment or management decisions regarding plan assets. When such advice is provided for a fee or other compensation, direct or indirect, the person giving the advice is a fiduciary.

Although the new general definition of investment advice avoids the weaknesses of the current regulation, standing alone it could sweep in some relationships that are not appropriately regarded as fiduciary in nature and that the Department does not believe Congress intended to cover as fiduciary relationships. Accordingly, the proposed regulation includes a number of specific carve-outs to the general definition. For example, the regulation draws an important distinction between fiduciary investment advice and non-fiduciary investment or retirement education. Similarly, under the "seller's carve-out,"[3] the proposal would not treat as fiduciary advice recommendations made to a plan in an arm's length transaction where there is generally no expectation of fiduciary investment advice, provided that the carve-out's specific conditions are met. In addition, the proposal includes specific carve-outs for advice rendered by employees of the plan sponsor, platform providers, and persons who offer or enter into swaps or security-based swaps with plans. All of the rule's carve-outs are subject to conditions designed to draw an appropriate line between fiduciary and non-fiduciary communications, consistent with the text and purpose of the statutory provisions.

Finally, in addition to the new proposal in this Notice, the Department is simultaneously proposing a new Best Interest Contract Exemption, revising other exemptions from the prohibited transaction rules of ERISA and the Code and is exploring through a request for comments the concept of an additional low-fee exemption.

[2] For purposes of the exemption, retail investors include (1) the participants and beneficiaries of participant-directed plans, (2) IRA owners, and (3) the sponsors (including employees, officers, or directors thereof) of non participant-directed plans with fewer than 100 participants to the extent the sponsors (including employees, officers, or directors thereof) act as a fiduciary with respect to plan investment decisions.

[3] Although referred to herein as the "seller's carve-out," we note that the carve-out provided in paragraph (b)(1)(i) of the proposal is not limited to sales and would apply to incidental advice provided in connection with an arm's length sale, purchase, loan, or bilateral contract between a plan investor with financial expertise and the adviser.

C. Gains to Investors and Compliance Costs

When the Department promulgated the 1975 rule, 401(k) plans did not exist, IRAs had only just been authorized, and the majority of retirement plan assets were managed by professionals, rather than directed by individual investors. Today, individual retirement investors have much greater responsibility for directing their own investments, but they seldom have the training or specialized expertise necessary to prudently manage retirement assets on their own. As a result, they often depend on investment advice for guidance on how to manage their savings to achieve a secure retirement. In the current marketplace for retirement investment advice, however, advisers commonly have direct and substantial conflicts of interest, which encourage investment recommendations that generate higher fees for the advisers at the expense of their customers and often result in lower returns for customers even before fees.

A wide body of economic evidence supports a finding that the impact of these conflicts of interest on retirement investment outcomes is large and, from the perspective of advice recipients, negative. As detailed in the Department's Regulatory Impact Analysis (available at *www.dol.gov/ebsa/pdf/conflictsofinterestria.pdf*), the supporting evidence includes, among other things, statistical analyses of conflicted investment channels, experimental studies, government reports documenting abuse, and basic economic theory on the dangers posed by conflicts of interest and by the asymmetries of information and expertise that characterize interactions between ordinary retirement investors and conflicted advisers. This evidence takes into account existing protections under ERISA as well as other federal and state laws. A review of this data, which consistently points to substantial failures in the market for retirement advice, suggests that IRA holders receiving conflicted investment advice can expect their investments to underperform by an average of 100 basis points per year over the next 20 years. The underperformance associated with conflicts of interest—in the mutual funds segment alone—could cost IRA investors more than $210 billion over the next 10 years and nearly $500 billion over the next 20 years. Some studies suggest that the underperformance of broker-sold mutual funds may be even higher than 100 basis points, possibly due to loads that are taken off the top and/or poor timing of broker sold investments. If the true underperformance of broker-sold funds is 200 basis points, IRA mutual fund holders could suffer from underperformance amounting to $430 billion over 10 years and nearly $1 trillion across the next 20 years. While the estimates based on the mutual fund market are large, the total market impact could be much larger. Insurance products, Exchange Traded Funds (ETFs), individual stocks and bonds, and other products are all sold by agents and brokers with conflicts of interest.

The Department expects the proposal would deliver large gains for retirement investors. Because of data constraints, only some of these gains can be quantified with confidence. Focusing only on how load shares paid to brokers affect the size of loads paid by IRA investors holding load funds and the returns they achieve, the Department estimates the proposal would deliver to IRA investors gains of between $40 billion and $44 billion over 10 years and between $88 billion and $100 billion over 20 years. These estimates assume that the rule would eliminate (rather than just reduce) underperformance associated with the practice of incentivizing broker recommendations through variable front-end-load sharing; if the rule's effectiveness in this area is substantially below 100 percent, these estimates may overstate these particular gains to investors in the front-load mutual fund segment of the IRA market. The Department nonetheless believes that these gains alone would far exceed the proposal's compliance cost. For example, if only 75 percent of anticipated gains were realized, the quantified subset of such gains—specific to the front-load mutual fund segment of the IRA market—would amount to between $30 billion and $33 billion over 10 years. If only 50 percent were realized, this subset of expected gains would total between $20 billion and $22 billion over 10 years, or several times the proposal's estimated compliance cost of $2.4 billion to 5.7 billion over the same 10 years. These gain estimates also exclude additional potential gains to investors resulting from reducing or eliminating the effects of conflicts in financial products other than front-end-load mutual funds. The Department invites input that would make it possible to quantify the magnitude of the rule's effectiveness and of any additional, not-yet-quantified gains for investors.

These estimates account for only a fraction of potential conflicts, associated losses, and affected retirement assets. The total gains to IRA investors attributable to the rule may be much higher than these quantified gains alone for several reasons. The Department expects the proposal to yield large, additional gains for IRA investors, including potential reductions in excessive trading and associated transaction costs and timing errors (such as might be associated with return chasing), improvements in the performance of IRA investments other than front-load mutual funds, and improvements in the performance of defined contribution (DC) plan investments. As noted above, under current rules, adviser conflicts could cost IRA investors as much as $410 billion over 10 years and $1 trillion over 20 years, so the potential additional gains to IRA investors from this proposal could be very large.

The following accounting table summarizes the Department's conclusions:

TABLE 1—PARTIAL GAINS TO INVESTORS AND COMPLIANCE COSTS ACCOUNTING TABLE

Category	Primary estimate	Low estimate	High estimate	Year dollar	Discount rate (9%)	Period covered
Partial Gains to Investors						
Annualized, Monetized ($millions/year)	$4,243	$3,830		2015	7	2017–2026
	$5,170	4,666		2015	3	2017–2026

TABLE 1—PARTIAL GAINS TO INVESTORS AND COMPLIANCE COSTS ACCOUNTING TABLE—Continued

Category	Primary estimate	Low estimate	High estimate	Year dollar	Discount rate (9%)	Period covered
Notes: The proposal is expected to deliver large gains for retirement investors. Because of limitations of the literature and other available evidence, only some of these gains can be quantified. The estimates in this table focus only on how load shares paid to brokers affect the size of loads IRA investors holding load funds pay and the returns they achieve. These estimates assume that the rule will eliminate (rather than just reduce) underperformance associated with the practice of incentivizing broker recommendations through variable front-end-load sharing. If, however, the rule's effectiveness in reducing underperformance is substantially below 100 percent, these estimates may overstate these particular gains to investors in the front-end-load mutual fund segment of the IRA market. However, these estimates account for only a fraction of potential conflicts, associated losses, and affected retirement assets. The total gains to IRA investors attributable to the rule may be higher than the quantified gains alone for several reasons. For example, the proposal is expected to yield additional gains for IRA investors, including potential reductions in excessive trading and associated transaction costs and timing errors (such as might be associated with return chasing), improvements in the performance of IRA investments other than front-load mutual funds, and improvements in the performance of DC plan investments. The partial-gains-to-investors estimates include both economic efficiency benefits and transfers from the financial services industry to IRA holders. The partial gains estimates are discounted to December 31, 2015.						
Compliance Costs						
Annualized, Monetized ($millions/year)	$348 328		$706 664	2015 2015	7 3	2016–2025 2016–2025
Notes: The compliance costs of the current proposal including the cost of compliance reviews, comprehensive compliance and supervisory system changes, policies and procedures and training programs updates, insurance increases, disclosure preparation and distribution, and some costs of changes in other business practices. Compliance costs incurred by mutual funds or other asset providers have not been estimated.						
Insurance Premium Transfers						
Annualized Monetized ($millions/year)	$63 63			2015 2015	7 3	2016–2025 2016–2025
From/To	From: Service providers facing increased insurance premiums due to increased liability risk			To: Plans, participants, beneficiaries, and IRA investors through the payment of recoveries—funded from a portion of the increased insurance premiums		

OMB Circular A–4 requires the presentation of a social welfare accounting table that summarizes a regulation's benefits, costs and transfers (monetized, where possible). A summary of this type would differ from and expand upon Table I in several ways:

• In the language of social welfare economics as reflected in Circular A–4, investor gains comprise two parts: Social welfare "benefits" attributable to improvements in economic efficiency and "transfers" of welfare to retirement investors from the financial services industry. Due to limitations of the literature and other available evidence, the investor gains estimates presented in Table I have not been broken down into benefits and transfer components, but making the distinction between these categories of impacts is key for a social welfare accounting statement.

• The estimates in Table I reflect only a subset of the gains to investors resulting from the rule, but may overstate this subset. As noted in Table I, the Department's estimates of partial gains to investors reflect an assumption that the rule will eliminate, rather than just reduce, underperformance associated with the practice of incentivizing broker recommendations through variable front-end-load sharing. If, however, the rule's effectiveness is substantially below 100 percent, these estimates would overstate these partial gains to investors in the front-load mutual fund segment of the IRA market. The estimates in Table I also exclude additional potential gains to investors resulting from reducing or eliminating the effects of conflicts in financial products other than front-end-load mutual funds in the IRA market, and all potential gains to investors in the plan market. The Department invites input that would make it possible to quantify the magnitude of the rule's effectiveness and of any additional, not-yet-quantified gains for investors.

• Generally, the gains to investors consist of multiple parts: Transfers to IRA investors from advisers and others in the supply chain, benefits to the overall economy from a shift in the allocation of investment dollars to projects that have higher returns, and resource savings associated with, for example, reductions in excessive turnover and wasteful and unsuccessful efforts to outperform the market. Some of these gains are partially quantified in Table I. Also, the estimates in Table I assume the gains to investors arise gradually as the fraction of wealth invested based on conflicted investment advice slowly declines over time based on historical patterns of asset turnover. However, the estimates do not account for potential transition costs associated with a shift of investments to higher-performing vehicles. These transition costs have not been quantified due to lack of granularity in the literature or availability of other evidence on both the portion of investor gains that consists of resource savings, as opposed to transfers, and the amount of transitional cost that would be incurred per unit of resource savings.

• Other categories of costs not yet quantified include compliance costs incurred by mutual funds or other asset providers. Enforcement costs or other costs borne by the government are also not quantified.

The Department requests detailed comment, data, and analysis on all of the issues outlined above for incorporation into the social welfare analysis at the finalization stage of the rulemaking process.

For a detailed discussion of the gains to investors and compliance costs of the current proposal, please see Section J. Regulatory Impact Analysis, below.

II. Overview

A. Rulemaking Background

The market for retirement advice has changed dramatically since the Department first promulgated the 1975 regulation. Individuals, rather than large employers and professional money managers, have become increasingly responsible for managing retirement assets as IRAs and participant-directed plans, such as 401(k) plans, have supplanted defined benefit pensions. At the same time, the variety and complexity of financial products have increased, widening the information gap between advisers and their clients. Plan fiduciaries, plan participants and IRA investors must often rely on experts for advice, but are unable to assess the quality of the expert's advice or effectively guard against the adviser's conflicts of interest. This challenge is especially true of small retail investors who typically do not have financial expertise and can ill-afford lower returns to their retirement savings caused by conflicts. As baby boomers retire, they are increasingly moving money from ERISA-covered plans, where their employer has both the incentive and the fiduciary duty to facilitate sound investment choices, to IRAs where both good and bad investment choices are myriad and advice that is conflicted is commonplace. Such "rollovers" will total more than $2 trillion over the next 5 years. These trends were not apparent when the Department promulgated the 1975 rule. At that time, 401(k) plans did not yet exist and IRAs had only just been authorized. These changes in the marketplace, as well as the Department's experience with the rule since 1975, support the Department's efforts to reevaluate and revise the rule through a public process of notice and comment rulemaking.

On October 22, 2010, the Department published a proposed rule in the **Federal Register** (75 FR 65263) (2010 Proposal) proposing to amend 29 CFR 2510.3–21(c) (40 FR 50843, Oct. 31, 1975), which defines when a person renders investment advice to an employee benefit plan, and consequently acts as a fiduciary under ERISA section 3(21)(A)(ii) (29 U.S.C. 1002(21)(A)(ii)). In response to this proposal, the Department received over 300 comment letters. A public hearing on the 2010 Proposal was held in Washington, DC on March 1 and 2, 2011, at which 38 speakers testified. The transcript of the hearing was made available for additional public comment and the Department received over 60 additional comment letters. In addition, the Department has held many meetings with interested parties.

A number of commenters urged consideration of other means to attain the objectives of the 2010 Proposal and of additional analysis of the proposal's expected costs and benefits. In light of these comments and because of the significance of this rule, the Department decided to issue a new proposed regulation. On September 19, 2011 the Department announced that it would withdraw the 2010 Proposal and propose a new rule defining the term "fiduciary" for purposes of section 3(21)(A)(ii) of ERISA. This document fulfills that announcement in publishing both a new proposed regulation and withdrawing the 2010 Proposal. Consistent with the President's Executive Orders 12866 and 13563, extending the rulemaking process will give the public a full opportunity to evaluate and comment on the revised proposal and updated economic analysis. In addition, we are simultaneously publishing proposed new and amended exemptions from ERISA and the Code's prohibited transaction rules designed to allow certain broker-dealers, insurance agents and others that act as investment advice fiduciaries to nevertheless continue to receive common forms of compensation that would otherwise be prohibited, subject to appropriate safeguards. The existing class exemptions will otherwise remain in place, affording flexibility to fiduciaries who currently use the exemptions or who wish to use the exemptions in the future. The proposed new regulatory package takes into account robust public comment and input and represents a substantial change from the 2010 Proposal, balancing long overdue consumer protections with flexibility for the industry in order to minimize disruptions to current business models.

In crafting the current regulatory package, the Department has benefitted from the views and perspectives expressed in public comments to the 2010 Proposal. For example, the Department has responded to concerns about the impact of the prohibited transaction rules on the marketplace for retail advice by proposing a broad package of exemptions that are intended to ensure that advisers and their firms make recommendations that are in the best interest of plan participants and IRA owners, without disrupting common fee arrangements. In response to commenters, the Department has also determined not to include, as fiduciary in nature, appraisals or valuations of employer securities provided to ESOPs or to certain collective investment funds holding assets of plan investors. On a more technical point, the Department also followed recommendations that it not automatically assign fiduciary status to investment advisers under the Advisers Act, but instead follow an entirely functional approach to fiduciary status. In light of public comments, the new proposal also makes a number of other changes to the regulatory proposal. For example, the Department has addressed concerns that it could be misread to extend fiduciary status to persons that prepare newsletters, television commentaries, or conference speeches that contain recommendations made to the general public. Similarly, the rule makes clear that fiduciary status does not extend to internal company personnel who give advice on behalf of their plan sponsor as part of their duties, but receive no compensation beyond their salary for the provision of advice. The Department is appreciative of the comments it received to the 2010 Proposal, and more fully discusses a number of the comments that influenced change in the sections that follow. In addition, the Department is eager to receive comments on the new proposal in general, and requests public comment on a number of specific aspects of the package as indicated below.

The following discussion summarizes the 2010 Proposal, describes some of the concerns and issues raised by commenters, and explains the new proposed regulation, which is published with this notice.

B. The Statute and Existing Regulation

ERISA (or the "Act") is a comprehensive statute designed to protect the interests of plan participants and beneficiaries, the integrity of employee benefit plans, and the security of retirement, health, and other critical benefits. The broad public interest in ERISA-covered plans is reflected in the Act's imposition of stringent fiduciary responsibilities on parties engaging in important plan activities, as well as in the tax-favored status of plan assets and investments. One of the chief ways in which ERISA protects employee benefit plans is by requiring that plan fiduciaries comply with fundamental obligations rooted in the law of trusts. In particular, plan fiduciaries must manage plan assets prudently and with undivided loyalty to the plans and their participants and beneficiaries.[4] In addition, they must refrain from

[4] ERISA section 404(a).

engaging in "prohibited transactions," which the Act does not permit because of the dangers to the interests of the plan and IRA posed by the transactions.[5] When fiduciaries violate ERISA's fiduciary duties or the prohibited transaction rules, they may be held personally liable for any losses to the investor resulting from the breach.[6] In addition, violations of the prohibited transaction rules are subject to excise taxes under the Code.

The Code also protects individuals who save for retirement through tax-favored accounts that are not generally covered by ERISA, such as IRAs, through a more limited regulation of fiduciary conduct. Although ERISA's general fiduciary obligations of prudence and loyalty do not govern the fiduciaries of IRAs and other plans not covered by ERISA, these fiduciaries are subject to the prohibited transaction rules of the Code. In this context, however, the sole statutory sanction for engaging in the illegal transactions is the assessment of an excise tax enforced by the Internal Revenue Service (IRS). Thus, unlike participants in plans covered by Title I of ERISA, IRA owners do not have a statutory right to bring suit against fiduciaries under ERISA for violation of the prohibited transaction rules and fiduciaries are not personally liable to IRA owners for the losses caused by their misconduct.

Under this statutory framework, the determination of who is a "fiduciary" is of central importance. Many of ERISA's and the Code's protections, duties, and liabilities hinge on fiduciary status. In relevant part, section 3(21)(A) of ERISA provides that a person is a fiduciary with respect to a plan to the extent he or she (i) exercises any discretionary authority or discretionary control with respect to management of such plan or exercises any authority or control with respect to management or disposition of its assets; (ii) renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan, or has any authority or responsibility to do so; or, (iii) has any discretionary authority or discretionary responsibility in the administration of such plan. Section 4975(e)(3) of the IRC identically defines "fiduciary" for purposes of the prohibited transaction rules set forth in Code section 4975.

The statutory definition contained in section 3(21)(A) deliberately casts a wide net in assigning fiduciary responsibility with respect to plan assets. Thus, "any authority or control" over plan assets is sufficient to confer fiduciary status, and any person who renders "investment advice for a fee or other compensation, direct or indirect" is an investment advice fiduciary, regardless of whether they have direct control over the plan's assets, and regardless of their status as an investment adviser and/or broker under the federal securities laws. The statutory definition and associated fiduciary responsibilities were enacted to ensure that plans can depend on persons who provide investment advice for a fee to make recommendations that are prudent, loyal, and untainted by conflicts of interest. In the absence of fiduciary status, persons who provide investment advice would neither be subject to ERISA's fundamental fiduciary standards, nor accountable under ERISA or the Code for imprudent, disloyal, or tainted advice, no matter how egregious the misconduct or how substantial the losses. Plans, individual participants and beneficiaries, and IRA owners often are not financial experts and consequently must rely on professional advice to make critical investment decisions. The statutory definition, prohibitions on conflicts of interest, and core fiduciary obligations of prudence and loyalty, all reflect Congress' recognition in 1974 of the fundamental importance of such advice to protect savers' retirement nest eggs. In the years since then, the significance of financial advice has become still greater with increased reliance on participant-directed plans and self-directed IRAs for the provision of retirement benefits.

In 1975, the Department issued a regulation, at 29 CFR 2510.3–21(c) defining the circumstances under which a person is treated as providing "investment advice" to an employee benefit plan within the meaning of section 3(21)(A)(ii) of ERISA (the "1975 regulation"), and the Department of the Treasury issued a virtually identical regulation under the Code.[7] The regulation narrowed the scope of the statutory definition of fiduciary investment advice by creating a five-part test that must be satisfied before a person can be treated as rendering investment advice for a fee. Under the regulation, for advice to constitute "investment advice," an adviser who is not a fiduciary under another provision of the statute must—(1) render advice as to the value of securities or other property, or make recommendations as to the advisability of investing in, purchasing or selling securities or other property (2) on a regular basis (3) pursuant to a mutual agreement, arrangement or understanding, with the plan or a plan fiduciary that (4) the advice will serve as a primary basis for investment decisions with respect to plan assets, and that (5) the advice will be individualized based on the particular needs of the plan or IRA. The regulation provides that an adviser is a fiduciary with respect to any particular instance of advice only if he or she meets each and every element of the five-part test with respect to the particular advice recipient or plan at issue.

As the marketplace for financial services has developed in the years since 1975, the five-part test may now undermine, rather than promote, the statutes' text and purposes. The narrowness of the 1975 regulation allows advisers, brokers, consultants and valuation firms to play a central role in shaping plan and IRA investments, without ensuring the accountability that Congress intended for persons having such influence and responsibility. Even when plan sponsors, participants, beneficiaries, and IRA owners clearly rely on paid advisers for impartial guidance, the regulation allows many advisers to avoid fiduciary status and disregard ERISA's fiduciary obligations of care and prohibitions on disloyal and conflicted transactions. As a consequence, these advisers can steer customers to investments based on their own self-interest (*e.g.*, products that generate higher fees for the adviser even if there are identical lower-fee products available), give imprudent advice, and engage in transactions that would otherwise not be permitted by ERISA and the Code without fear of accountability under either ERISA or the Code.

Instead of ensuring that trusted advisers give prudent and unbiased advice in accordance with fiduciary norms, the current regulation erects a multi-part series of technical impediments to fiduciary responsibility. The Department is concerned that the specific elements of the five-part test—which are not found in the text of the Act or Code—now work to frustrate statutory goals and defeat advice recipients' legitimate expectations. In

[5] ERISA section 406. The Act also prohibits certain transactions between a plan and a "party in interest."

[6] ERISA section 409; *see also* ERISA section 405.

[7] See 26 CFR 54.4975–9(c), which interprets Code section 4975(e)(3). 40 FR 50840 (Oct. 31, 1975). Under section 102 of Reorganization Plan No. 4 of 1978, the authority of the Secretary of the Treasury to interpret section 4975 of the Code has been transferred, with certain exceptions not here relevant, to the Secretary of Labor. References in this document to sections of ERISA should be read to refer also to the corresponding sections of the Code.

light of the importance of the proper management of plan and IRA assets, it is critical that the regulation defining investment advice draws appropriate distinctions between the sorts of advice relationships that should be treated as fiduciary in nature and those that should not. In practice, the current regulation appears not to do so. Instead, the lines drawn by the five-part test frequently permit evasion of fiduciary status and responsibility in ways that undermine the statutory text and purposes.

One example of the five-part test's shortcomings is the requirement that advice be furnished on a "regular basis." As a result of the requirement, if a small plan hires an investment professional or appraiser on a one-time basis for an investment recommendation or valuation opinion on a large, complex investment, the adviser has no fiduciary obligation to the plan under ERISA. Even if the plan is considering investing all or substantially all of the plan's assets, lacks the specialized expertise necessary to evaluate the complex transaction on its own, and the consultant fully understands the plan's dependence on his professional judgment, the consultant is not a fiduciary because he does not advise the plan on a "regular basis." The plan could be investing hundreds of millions of dollars in plan assets, and it could be the most critical investment decision the plan ever makes, but the adviser would have no fiduciary responsibility under the 1975 regulation. While a consultant who regularly makes less significant investment recommendations to the plan would be a fiduciary if he satisfies the other four prongs of the regulatory test, the one-time consultant on an enormous transaction has no fiduciary responsibility.

In such cases, the "regular basis" requirement, which is not found in the text of ERISA or the Code, fails to draw a sensible line between fiduciary and non-fiduciary conduct, and undermines the law's protective purposes. A specific example is the one-time purchase of a group annuity to cover all of the benefits promised to substantially all of a plan's participants for the rest of their lives when a defined benefit plan terminates or a plan's expenditure of hundreds of millions of dollars on a single real estate transaction with the assistance of a financial adviser hired for purposes of that one transaction. Despite the clear importance of the decisions and the clear reliance on paid advisers, the advisers would not be plan fiduciaries. On a smaller scale that is still immensely important for the affected individual, the "regular basis" requirement also deprives individual participants and IRA owners of statutory protection when they seek specialized advice on a one-time basis, even if the advice concerns the investment of all or substantially all of the assets held in their account (*e.g.*, as in the case of an annuity purchase or a roll-over from a plan to an IRA or from one IRA to another).

Under the five-part test, fiduciary status can also be defeated by arguing that the parties did not have a *mutual* agreement, arrangement, or understanding that the advice would serve as a *primary basis* for investment decisions. Investment professionals in today's marketplace frequently market retirement investment services in ways that clearly suggest the provision of tailored or individualized advice, while at the same time disclaiming in fine print the requisite "mutual" understanding that the advice will be used as a primary basis for investment decisions.

Similarly, there appears to be a widespread belief among broker-dealers that they are not fiduciaries with respect to plans or IRAs because they do not hold themselves out as registered investment advisers, even though they often market their services as financial or retirement planners. The import of such disclaimers—and of the fine legal distinctions between brokers and registered investment advisers—is often completely lost on plan participants and IRA owners who receive investment advice. As shown in a study conducted by the RAND Institute for Civil Justice for the Securities and Exchange Commission (SEC), consumers often do not read the legal documents and do not understand the difference between brokers and registered investment advisers particularly when brokers adopt such titles as "financial adviser" and "financial manager." [8]

Even in the absence of boilerplate fine print disclaimers, however, it is far from evident how the "primary basis" element of the five-part test promotes the statutory text or purposes of ERISA and the Code. If, for example, a plan hires multiple specialized advisers for an especially complex transaction, it should be able to rely upon all of the consultants' advice, regardless of whether one could characterize any particular consultant's advice as primary, secondary, or tertiary. Presumably, paid consultants make recommendations—and retirement investors pay for them—with the hope or expectation that the recommendations could, in fact, be relied upon in making important decisions. When a plan, participant, beneficiary, or IRA owner directly or indirectly pays for advice upon which it can rely, there appears to be little statutory basis for drawing distinctions based on a subjective characterization of the advice as "primary," "secondary," or other.

In other respects, the current regulatory definition could also benefit from clarification. For example, a number of parties have argued that the regulation, as currently drafted, does not encompass advice as to the selection of money managers or mutual funds. Similarly, they have argued that the regulation does not cover advice given to the managers of pooled investment vehicles that hold plan assets contributed by many plans, as opposed to advice given to particular plans. Parties have even argued that advice was insufficiently "individualized" to fall within the scope of the regulation because the advice provider had failed to prudently consider the "particular needs of the plan," notwithstanding the fact that both the advice provider and the plan agreed that individualized advice based on the plan's needs would be provided, and the adviser actually made specific investment recommendations to the plan. Although the Department disagrees with each of these interpretations of the current regulation, the arguments nevertheless suggest that clarifying regulatory text could be helpful.

Changes in the financial marketplace have enlarged the gap between the 1975 regulation's effect and the Congressional intent of the statutory definition. The greatest change is the predominance of individual account plans, many of which require participants to make investment decisions for their own accounts. In 1975, private-sector defined benefit pensions—mostly large, professionally managed funds—covered over 27 million active participants and held assets totaling almost $186 billion. This compared with just 11 million active participants in individual account defined contribution plans with assets of just $74 billion.[9] Moreover, the great majority of defined contribution plans at that time were professionally

[8] Angela A. Hung, Noreen Clancy, Jeff Dominitz, Eric Talley, Claude Berrebi, Farrukh Suvankulov, *Investor and Industry Perspectives on Investment Advisers and Broker-Dealers*, RAND Institute for Civil Justice, commissioned by the U.S. Securities and Exchange Commission, 2008, at *http://www.sec.gov/news/press/2008/2008-1_randiabdreport.pdf*

[9] U.S. Department of Labor, *Private Pension Plan Bulletin Historical Tables and Graphs*, (Dec. 2014), at *http://www.dol.gov/ebsa/pdf/historicaltables.pdf*.

managed, not participant-directed. In 1975, 401(k) plans did not yet exist and IRAs had just been authorized as part of ERISA's enactment the prior year. In contrast, by 2012 defined benefit plans covered just under 16 million active participants, while individual account-based defined contribution plans covered over 68 million active participants— including 63 million participants in 401(k)-type plans that are participant-directed.[10]

With this transformation, plan participants, beneficiaries and IRA owners have become major consumers of investment advice that is paid for directly or indirectly. By 2012, 97 percent of 401(k) participants were responsible for directing the investment of all or part of their own account, up from 86 percent as recently as 1999.[11] Also, in 2013, more than 34 million households owned IRAs.[12]

Many of the consultants and advisers who provide investment-related advice and recommendations receive compensation from the financial institutions whose investment products they recommend. This gives the consultants and advisers a strong bias, conscious or unconscious, to favor investments that provide them greater compensation rather than those that may be most appropriate for the participants. Unless they are fiduciaries, however, these consultants and advisers are free under ERISA and the Code, not only to receive such conflicted compensation, but also to act on their conflicts of interest to the detriment of their customers. In addition, plans, participants, beneficiaries, and IRA owners now have a much greater variety of investments to choose from, creating a greater need for expert advice. Consolidation of the financial services industry and innovations in compensation arrangements have multiplied the opportunities for self-dealing and reduced the transparency of fees.

The absence of adequate fiduciary protections and safeguards is especially problematic in light of the growth of participant-directed plans and self-directed IRAs; the gap in expertise and information between advisers and the customers who depend upon them for guidance; and the advisers' significant conflicts of interest.

When Congress enacted ERISA in 1974, it made a judgment that plan advisers should be subject to ERISA's fiduciary regime and that plan participants, beneficiaries and IRA owners should be protected from conflicted transactions by the prohibited transaction rules. More fundamentally, however, the statutory language was designed to cover a much broader category of persons who provide fiduciary investment advice based on their functions and to limit their ability to engage in self-dealing and other conflicts of interest than is currently reflected in the five-part test. While many advisers are committed to providing high-quality advice and always put their customers' best interests first, the 1975 regulation makes it far too easy for advisers in today's marketplace not to do so and to avoid fiduciary responsibility even when they clearly purport to give individualized advice and to act in the client's best interest, rather than their own.

C. The 2010 Proposal

In 2010, the Department proposed a new regulation that would have replaced the five-part test with a new definition of what counted as fiduciary investment advice for a fee. At that time, the Department did not propose any new prohibited transaction exemptions and acknowledged uncertainty regarding whether existing exemptions would be available, but specifically invited comments on whether new or amended exemptions should be proposed. The proposal also provided carve-outs for conduct that would not result in fiduciary status. The general definition included the following types of advice: (1) Appraisals or fairness opinions concerning the value of securities or other property; (2) recommendations as to the advisability of investing in, purchasing, holding or selling securities or other property; and (3) recommendations as to the management of securities or other property. Reflecting the Department's longstanding interpretation of the 1975 regulations, the 2010 Proposal made clear that investment advice under the proposal includes advice provided to plan participants, beneficiaries and IRA owners as well as to plan fiduciaries.

Under the 2010 Proposal, a paid adviser would have been treated as a fiduciary if the adviser provided one of the above types of advice and either: (1) Represented that he or she was acting as an ERISA fiduciary; (2) was already an ERISA fiduciary to the plan by virtue of having control over the management or disposition of plan assets, or by having discretionary authority over the administration of the plan; (3) was already an investment adviser under the Investment Advisers Act of 1940 (Advisers Act); or (4) provided the advice pursuant to an agreement or understanding that the advice may be considered in connection with plan investment or asset management decisions and would be individualized to the needs of the plan, plan participant or beneficiary, or IRA owner. The 2010 Proposal also provided that, for purposes of the fiduciary definition, relevant fees included any direct or indirect fees received by the adviser or an affiliate from any source. Direct fees are payments made by the advice recipient to the adviser including transaction-based fees, such as brokerage, mutual fund or insurance sales commissions. Indirect fees are payments to the adviser from any source other than the advice recipient such as revenue sharing payments from a mutual fund.

The 2010 Proposal included specific carve-outs for the following actions that the Department believed should not result in fiduciary status. In particular, a person would not have become a fiduciary by—

1. Providing recommendations as a seller or purchaser with interests adverse to the plan, its participants, or IRA owners, if the advice recipient reasonably should have known that the adviser was not providing impartial investment advice and the adviser had not acknowledged fiduciary status.

2. Providing investment education information and materials in connection with an individual account plan.

3. Marketing or making available a menu of investment alternatives that a plan fiduciary could choose from, and providing general financial information to assist in selecting and monitoring those investments, if these activities include a written disclosure that the adviser was not providing impartial investment advice.

4. Preparing reports necessary to comply with ERISA, the Code, or regulations or forms issued thereunder, unless the report valued assets that lack a generally recognized market, or served as a basis for making plan distributions.

The 2010 Proposal applied to the definition of an "investment advice fiduciary" in section 4975(e)(3)(B) of the Code as well as to the parallel ERISA definition. These provisions apply to both certain ERISA covered plans, and certain non-ERISA plans such as individual retirement accounts.

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[10] U.S. Department of Labor, *Private Pension Plan Bulletin Abstract of 2012 Form 5500 Annual Reports*, (Jan. 2015), at *http://www.dol.gov/ebsa/PDF/2012pensionplanbulletin.PDF*.

[11] U.S. Department of Labor, *Private Pension Plan Bulletin Abstract of 1999 Form 5500 Annual Reports*, Number 12, Summer 2004 (Apr. 2008), at *http://www.dol.gov/ebsa/PDF/1999pensionplanbulletin.PDF*.

[12] Brien, Michael J., and Constantijn W.A. Panis. Analysis of Financial Asset Holdings of Households on the United States: 2013 Update. Advanced Analytic Consulting Group and Deloitte, Report Prepared for the U.S. Department of Labor, 2014.

In the preamble to the 2010 Proposal, the Department also noted that it had previously interpreted the 1975 regulation as providing that a recommendation to a plan participant on how to invest the proceeds of a contemplated plan distribution was not fiduciary investment advice. Advisory Opinion 2005–23A (Dec. 7, 2005). The Department specifically asked for comments as to whether the final rule should include such recommendations as fiduciary advice.

The 2010 Proposal prompted a large number of comments and a vigorous debate. As noted above, the Department made special efforts to encourage the regulated community's participation in this rulemaking. In addition to an extended comment period, the Department held a two-day public hearing. Additional time for comments was allowed following the hearing and publication of the hearing transcript on the Department's Web site and Department representatives held numerous meetings with interested parties. Many of the comments concerned the Department's conclusions regarding the likely economic impact of the proposal, if adopted. A number of commenters urged the Department to undertake additional analysis of expected costs and benefits particularly with regard to the 2010 Proposal's coverage of IRAs. After consideration of these comments and in light of the significance of this rulemaking to the retirement plan service provider industry, plan sponsors and participants, beneficiaries and IRA owners, the Department decided to take more time for review and to issue a new proposed regulation for comment.

D. The New Proposal

The new proposed rule makes many revisions to the 2010 Proposal, although it also retains aspects of that proposal's essential framework. The new proposal broadly updates the definition of fiduciary investment advice, and also provides a series of carve-outs from the fiduciary investment advice definition for communications that should not be viewed as fiduciary in nature. The definition generally covers the following categories of advice: (1) Investment recommendations, (2) investment management recommendations, (3) appraisals of investments, or (4) recommendations of persons to provide investment advice for a fee or to manage plan assets. Persons who provide such advice fall within the general definition of a fiduciary if they either (a) represent that they are acting as a fiduciary under ERISA or the Code or (b) provide the advice pursuant to an agreement, arrangement, or understanding that the advice is individualized or specifically directed to the recipient for consideration in making investment or investment management decisions regarding plan assets.

The new proposal includes several carve-outs for persons who do not represent that they are acting as ERISA fiduciaries, some of which were included in some form in the 2010 Proposal but many of which were not. Subject to specified conditions, these carve-outs cover—

(1) Statements or recommendations made to a "large plan investor with financial expertise" by a counterparty acting in an arm's length transaction;

(2) offers or recommendations to plan fiduciaries of ERISA plans to enter into a swap or security-based swap that is regulated under the Securities Exchange Act or the Commodity Exchange Act;

(3) statements or recommendations provided to a plan fiduciary of an ERISA plan by an employee of the plan sponsor if the employee receives no fee beyond his or her normal compensation;

(4) marketing or making available a platform of investment alternatives to be selected by a plan fiduciary for an ERISA participant-directed individual account plan;

(5) the identification of investment alternatives that meet objective criteria specified by a plan fiduciary of an ERISA plan or the provision of objective financial data to such fiduciary;

(6) the provision of an appraisal, fairness opinion or a statement of value to an ESOP regarding employer securities, to a collective investment vehicle holding plan assets, or to a plan for meeting reporting and disclosure requirements; and

(7) information and materials that constitute "investment education" or "retirement education."

The new proposal applies the same definition of "investment advice" to the definition of "fiduciary" in section 4975(e)(3) of the Code and thus applies to investment advice rendered to IRAs. "Plan" is defined in the new proposal to mean any employee benefit plan described in section 3(3) of the Act and any plan described in section 4975(e)(1)(A) of the Code. For ease of reference in this proposal, the term "IRA" has been inclusively defined to mean any account described in Code section 4975(e)(1)(B) through (F), such as a true individual retirement account described under Code section 408(a) and a health savings account described in section 223(d) of the Code.[13]

Many of the differences between the new proposal and the 2010 Proposal reflect the input of commenters on the 2010 Proposal as part of the public notice and comment process. For example, some commenters argued that the 2010 Proposal swept too broadly by making investment recommendations fiduciary in nature simply because the adviser was a plan fiduciary for purposes unconnected with the advice or an investment adviser under the Advisers Act. In their view, such status-based criteria were in tension with the Act's functional approach to fiduciary status and would have resulted in unwarranted and unintended compliance issues and costs. Other commenters objected to the lack of a requirement for these status-based categories that the advice be individualized to the needs of the advice recipient. The new proposal incorporates these suggestions: An adviser's status as an investment adviser under the Advisers Act or as an ERISA fiduciary for reasons unrelated to advice are no longer factors in the definition. In addition, unless the adviser represents that he or she is a fiduciary with respect to advice, the advice must be provided pursuant to an agreement, arrangement, or understanding that the advice is individualized or specifically directed to the recipient to be treated as fiduciary advice.

Furthermore, the carve-outs that treat certain conduct as non-fiduciary in nature have been modified, clarified, and expanded in response to comments. For example, the carve-out for certain valuations from the definition of fiduciary investment advice has been modified and expanded. Under the 2010 Proposal, appraisals and valuations for compliance with certain reporting and disclosure requirements were not treated as fiduciary advice. The new proposal additionally provides a carve-out from fiduciary treatment for appraisal and fairness opinions for ESOPs regarding employer securities. Although, the Department remains concerned about valuation advice concerning an ESOP's purchase of employer stock and about a plan's reliance on that advice, the Department has concluded that the concerns regarding valuations of closely held employer stock in ESOP transactions raise unique issues that are more

[13] As discussed below in Section E. Coverage of IRAs and Other Non-ERISA Plans, in recognition of differences among the various types of non-ERISA plan arrangements described in Code section 4975(e)(1)(B) through (F), the Department solicits comments on whether it is appropriate for the regulation to cover the full range of these arrangements. These non-ERISA plan arrangements are tax favored vehicles under the Code like IRAs, but are not intended for retirement savings.

appropriately addressed in a separate regulatory initiative. Additionally, the carve-out for valuations conducted for reporting and disclosure purposes has been expanded to include reporting and disclosure obligations outside of ERISA and the Code, and is applicable to both ERISA plans and IRAs. Many other modifications to the other carve-outs from fiduciary status, as well as new carve-outs and prohibited transaction exemptions, are described below in Section IV—"The Provisions of the New Proposal."

III. Coordination With Other Federal Agencies

Many comments to the 2010 rulemaking emphasized the need to harmonize the Department's efforts with rulemaking activities under the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. Law No. 111–203, 124 Stat. 1376 (2010), (Dodd-Frank Act), in particular, the Security and Exchange Commission's (SEC) standards of care for providing investment advice and the Commodity Futures Trading Commission's (CFTC) business conduct standards for swap dealers. While the 2010 Proposal discussed statutes over which the SEC and CFTC have jurisdiction, it did not specifically describe inter-agency coordination efforts. In addition, commenters questioned the adequacy of coordination with other agencies regarding IRA products and services. They argued that subjecting SEC-regulated investment advisers and broker-dealers to a special set of ERISA rules for plans and IRAs could lead to additional costs and complexities for individuals who may have several different types of accounts at the same financial institution some of which may be subject only to the SEC rules, and others of which may be subject to both SEC rules and new regulatory requirements under ERISA.

In the course of developing the new proposal and the related proposed prohibited transaction exemptions, the Department has consulted with staff of the SEC and other regulators on an ongoing basis regarding whether the proposals would subject investment advisers and broker-dealers who provide investment advice to requirements that create an undue compliance burden or conflict with their obligations under other federal laws. As part of this consultative process, SEC staff has provided technical assistance and information with respect to retail investors, the marketplace for investment advice and coordinating, to the extent possible, the agencies' separate regulatory provisions and responsibilities. As the Department moves forward with this project in accordance with the specific provisions of ERISA and the Code, it will continue to consult with staff of the SEC and other regulators on its proposals and their impact on retail investors and other regulatory regimes. One result of these discussions, particularly with staff of the CFTC and SEC, is the new provision at paragraph (b)(1)(ii) of the proposed regulations concerning counterparty transactions with swap dealers, major swap participants, security-based swap dealers, and major security-based swap participants. Under the terms of that paragraph, such persons would not be treated as ERISA fiduciaries merely because, when acting as counterparties to swap or security-based swap transactions, they give information and perform actions required for compliance with the requirements of the business conduct standards of the Dodd-Frank Act and its implementing regulations.

In pursuing these consultations, the Department has aimed to coordinate and minimize conflicting or duplicative provisions between ERISA, the Code and federal securities laws, to the extent possible. However, the governing statutes do not permit the Department to make the obligations of fiduciary investment advisers under ERISA and the Code identical to the duties of advice providers under the securities laws. ERISA and the Code establish consumer protections for some investment advice that does not fall within the ambit of federal securities laws, and vice versa. Even if each of the relevant agencies were to adopt an identical definition of "fiduciary", the legal consequences of the fiduciary designation would vary between agencies because of differences in the specific duties and remedies established by the different federal laws at issue. ERISA and the Code place special emphasis on the elimination or mitigation of conflicts of interest and adherence to substantive standards of conduct, as reflected in the prohibited transaction rules and ERISA's standards of fiduciary conduct. The specific duties imposed on fiduciaries by ERISA and the Code stem from legislative judgments on the best way to protect the public interest in tax-preferred benefit arrangements that are critical to workers' financial and physical health. The Department has taken great care to honor ERISA and the Code's specific text and purposes.

At the same time, the Department has worked hard to understand the impact of the proposed rule on firms subject to the securities laws and other federal laws, and to take the effects of those laws into account so as to appropriately calibrate the impact of the rule on those firms. The proposed regulation reflects these efforts. In the Department's view, it neither undermines, nor contradicts, the provisions or purposes of the securities laws, but instead works in harmony with them. The Department has coordinated—and will continue to coordinate—its efforts with other federal agencies to ensure that the various legal regimes are harmonized to the fullest extent possible.

The Department has also consulted with the Department of the Treasury and the IRS, particularly on the subject of IRAs. Although the Department has responsibility for issuing regulations and prohibited transaction exemptions under section 4975 of the Code, which applies to IRAs, the IRS maintains general responsibility for enforcing the tax laws. The IRS' responsibilities extend to the imposition of excise taxes on fiduciaries who participate in prohibited transactions.[14] As a result, the Department and the IRS share responsibility for combating self-dealing by fiduciary investment advisers to tax-qualified plans and IRAs. Paragraph (e) of the proposed regulation, in particular, recognizes this jurisdictional intersection.

When the Department announced that it would issue a new proposal, it stated that it would consider proposing new and/or amended prohibited transaction exemptions to address the concerns of commenters about the broader scope of the fiduciary definition and its impact on the fee practices of brokers and other advisers. Commenters had expressed concern about whether longstanding exemptions granted by the Department allowing advisers, despite their fiduciary status under ERISA, to receive commissions in connection with mutual funds, securities and insurance products would remain applicable under the new rule. As explained more fully below, the Department is simultaneously publishing in the notice section of today's **Federal Register** proposed prohibited transaction class exemptions to address these concerns. The Department believes that existing exemptions and these new proposed exemptions would preserve the ability to engage in common fee arrangements, while protecting plan participants, beneficiaries and IRA owners from abusive practices that may result from conflicts of interest.

The terms of these new exemptions are discussed in more detail below and in the preambles to the proposed

[14] Reorganization Plan No. 4 of 1978.

exemptions. While the exemptions differ in terms and coverage, each imposes a "best interest" standard on fiduciary investment advisers. Thus, for example, the Best Interest Contract Exemption requires the investment advice fiduciary and associated financial institution to expressly agree to provide advice that is in the "best interest" of the advice recipient. As proposed, the best interest standard is intended to mirror the duties of prudence and loyalty, as applied in the context of fiduciary investment advice under sections 404(a)(1)(A) and (B) of ERISA. Thus, the "best interest" standard is rooted in the longstanding trust-law duties of prudence and loyalty adopted in section 404 of ERISA and in the cases interpreting those standards.

Accordingly, the Best Interest Contract Exemption provides:

> Investment advice is in the "Best Interest" of the Retirement Investor when the Adviser and Financial Institution providing the advice act with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person would exercise based on the investment objectives, risk tolerance, financial circumstances and needs of the Retirement Investor, without regard to the financial or other interests of the Adviser, Financial Institution, any Affiliate, Related Entity, or other party.

This "best interest" standard is not intended to add to or expand the ERISA section 404 standards of prudence and loyalty as they apply to the provision of investment advice to ERISA covered plans. Advisers to ERISA-covered plans are already required to adhere to the fundamental standards of prudence and loyalty, and can be held accountable for violations of the standards. Rather, the primary impact of the "best interest" standard is on the IRA market. Under the Code, advisers to IRAs are subject only to the prohibited transaction rules. Incorporating the best interest standard in the proposed Best Interest Contract Exemption effectively requires advisers to comply with these basic fiduciary standards as a condition of engaging in transactions that would otherwise be prohibited because of the conflicts of interest they create. Additionally, the exemption ensures that IRA owners and investors have a contract-based claim to hold their fiduciary advisers accountable if they violate these basic obligations of prudence and loyalty. As under current law, no private right of action under ERISA is available to IRA owners.

IV. The Provisions of the New Proposal

The new proposal would amend the definition of investment advice in 29 CFR 2510.3–21 (1975) of the regulation to replace the restrictive five-part test with a new definition that better comports with the statutory language in ERISA and the Code.[15] As explained below, the proposal accomplishes this by first describing the kinds of communications and relationships that would generally constitute fiduciary investment advice if the adviser receives a fee or other compensation. Rather than add additional elements that must be met in all instances, as under the current regulation, the proposal describes several specific types of advice or communications that would not be treated as investment advice. In the Department's view, this structure is faithful to the remedial purpose of the statute, but avoids burdening activities that do not implicate relationships of trust and expectations of impartiality.

A. Categories of Advice or Recommendations

Paragraph (a)(1) of the proposal sets forth the following types of advice, which, when provided in exchange for a fee or other compensation, whether directly or indirectly, and given under circumstances described in paragraph (a)(2), would be "investment advice" unless one of the carve-outs in paragraph (b) applies. The listed types of advice are—

(i) A recommendation as to the advisability of acquiring, holding, disposing of or exchanging securities or other property, including a recommendation to take a distribution of benefits or a recommendation as to the investment of securities or other property to be rolled over or otherwise distributed from the plan or IRA;

(ii) A recommendation as to the management of securities or other property, including recommendations as to the management of securities or other property to be rolled over or otherwise distributed from the plan or IRA;

(iii) An appraisal, fairness opinion, or similar statement whether verbal or written concerning the value of securities or other property if provided in connection with a specific transaction or transactions involving the acquisition, disposition, or exchange, of such securities or other property by the plan or IRA; or

(iv) A recommendation of a person who is also going to receive a fee or other compensation to provide any of the types of advice described in paragraphs (i) through (iii) above.

Except for the prong of the definition concerning appraisals and valuations discussed below, the proposal is structured so that communications must constitute a "recommendation" to fall within the scope of fiduciary investment advice. In that regard, as stated earlier in Section III concerning coordination with other Federal Agencies, the Department has consulted with staff of other agencies with rulemaking authority over investment advisers and broker-dealers. FINRA Policy Statement 01–23 sets forth guidelines to assist brokers in evaluating whether a particular communication could be viewed as a recommendation, thereby triggering application of FINRA's Rule 2111 that requires that a firm or associated person have a reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer.[16] Although the regulatory context for the FINRA guidance is somewhat different, the Department believes that it provides useful standards and guideposts for distinguishing investment education from investment advice under ERISA. Accordingly, the Department specifically solicits comments on whether it should adopt some or all of the standards developed by FINRA in defining communications that rise to the level of a recommendation for purposes of distinguishing between investment education and investment advice under ERISA.

Additionally, as paragraph (d) of the proposal makes clear, the regulation does not treat the mere execution of a securities transaction at the direction of

[15] For purposes of readability, this proposed rulemaking republishes 29 CFR 2510.3–21 in its entirety, as revised, rather than only the specific amendments to this section. See 29 CFR 2510.3–21(d)—Execution of securities transactions.

[16] See also FINRA's Regulatory Notice 11–02, 12–25 and 12–55. Regulatory Notice 11–02 includes the following discussion:

> For instance, a communication's content, context and presentation are important aspects of the inquiry. The determination of whether a "recommendation" has been made, moreover, is an objective rather than subjective inquiry. An important factor in this regard is whether—given its content, context and manner of presentation—a particular communication from a firm or associated person to a customer reasonably would be viewed as a suggestion that the customer take action or refrain from taking action regarding a security or investment strategy. In addition, the more individually tailored the communication is to a particular customer or customers about a specific security or investment strategy, the more likely the communication will be viewed as a recommendation. Furthermore, a series of actions that may not constitute recommendations when viewed individually may amount to a recommendation when considered in the aggregate. It also makes no difference whether the communication was initiated by a person or a computer software program. These guiding principles, together with numerous litigated decisions and the facts and circumstances of any particular case, inform the determination of whether the communication is a recommendation for purposes of FINRA's suitability rule.

a plan or IRA owner as fiduciary activity. This paragraph remains unchanged from the 1975 regulation other than to update references to the proposal's structure. The definition's scope remains limited to advice relationships, as delineated in its text and does not impact merely administrative or ministerial activities necessary for a plan or IRA's functioning. It also does not apply to order taking where no advice is provided.

(1) Recommendations To Distribute Plan Assets

Paragraph (a)(1)(i) specifically includes recommendations concerning the investment of securities to be rolled over or otherwise distributed from the plan or IRA. Noting the Department's position in Advisory Opinion 2005–23A that it is not fiduciary advice to make a recommendation as to distribution options even if that is accompanied by a recommendation as to where the distribution would be invested, (Dec. 7, 2005), the 2010 Proposal did not include this type of advice, but the Department requested comments on whether it should be included in a final regulation. Some commenters stated that exclusion of this advice from the final rule would fail to protect participant accounts from conflicted advice in connection with one of the most significant financial decisions that participants make concerning retirement savings. Other commenters argued that including this advice would give rise to prohibited transactions that could disrupt the routine process that occurs when a worker leaves a job, contacts a financial services firm for help rolling over a 401(k) balance, and the firm explains the investments it offers and the benefits of a rollover.

The proposed regulation, if finalized, would supersede Advisory Opinion 2005–23A. Thus, recommendations to take distributions (and thereby withdraw assets from existing plan or IRA investments or roll over into a plan or IRA) or to entrust plan or IRA assets to particular money managers, advisers, or investments would fall within the scope of covered advice. However, as the proposal's text makes clear, one does not act as a fiduciary merely by providing participants with information about plan or IRA distribution options, including the consequences associated with the available types of benefit distributions. In this regard, the new proposal draws an important distinction between fiduciary investment advice and non-fiduciary investment information and educational materials. The Department believes that the proposal's treatment of such non-fiduciary educational and informational materials adequately covers the common types of distribution-related information that participants find useful, including information relating to annuitizations and other forms of lifetime income payment options, but welcomes input on other types of information that would help clarify the line between advice and education in this context.

(2) Recommendations as to the Management of Plan Investments

The preamble to the 2010 Proposal stated that the "management of securities or other property" would include advice and recommendations as to the exercise of rights appurtenant to shares of stock (*e.g.*, voting proxies). 75 FR 65266 (Oct. 22, 2010). The Department has long viewed the exercise of ownership rights as a fiduciary responsibility because of its material effect on plan investment goals. 29 CFR 2509.08–2 (2008). Consequently, individualized or specifically directed advice and recommendations on the exercise of proxy or other ownership rights are appropriately treated as fiduciary in nature. Accordingly, the proposed regulation's provision on advice regarding the management of securities or other property would continue to cover individualized advice or recommendations as to proxy voting and the management of retirement assets in paragraph (a)(1)(ii).

We received comments on the 2010 proposal seeking some clarification regarding its application to certain practices. In this regard, it is the Department's view that guidelines or other information on voting policies for proxies that are provided to a broad class of investors without regard to a client's individual interests or investment policy, and which are not directed or presented as a recommended policy for the plan or IRA to adopt, would not rise to the level of fiduciary investment advice under the proposal. Additionally, a recommendation addressed to all shareholders in a proxy statement would not result in fiduciary status on the part of the issuer of the statement or the person who distributes the proxy statement. These positions are clarified in the proposed regulation.

(3) Appraisals

The new proposal, like the current regulation which includes "advice as to the value of securities or other property," continues to cover certain appraisals and valuation reports. However, it is considerably more focused than the 2010 Proposal. Responding to comments, the proposal in paragraph (a)(1)(iii) covers only appraisals, fairness opinions, or similar statements that relate to a particular transaction. The Department also expanded the 2010 Proposal's carve-out for general reports or statements of value provided to satisfy required reporting and disclosure rules under ERISA or the Code. The carve-out in the 2010 proposal covered general reports or statements of value that merely reflected the value of an investment of a plan or a participant or beneficiary, and provided for purposes of compliance with the reporting and disclosure requirements of ERISA, the Code, and the regulations, forms and schedules issued thereunder, unless the reports involved assets for which there was not a generally recognized market and served as a basis on which a plan could make distributions to plan participants and beneficiaries. The carve-out was broadened in this proposal to includes valuations provided solely for purposes of compliance with the reporting and disclosure provisions under the Act, the Code, and the regulations, forms and schedules issued thereunder, or any applicable reporting or disclosure requirement under a Federal or state law, or rule or regulation or self-regulatory organization (*e.g.*, FINRA) without regard to the type of asset involved. In this manner, the new proposal focuses on instances where the plan or IRA owner is looking to the appraiser for advice on the market value of an asset that the investor is considering to acquire, dispose, or exchange. In many cases the most important investment advice that an investor receives is advice as to how much it can or should pay for hard-to-value assets. In response to comments, the proposal also contains an entirely new carve-out at paragraph (b)(5)(ii) specifically addressing valuations or appraisals provided to an investment fund (*e.g.*, collective investment fund or pooled separate account) holding assets of various investors in addition to at least one plan or IRA. Also, as mentioned, the Department has decided not to extend fiduciary coverage to valuations or appraisals for ESOPs relating to employer securities at this time because the Department has concluded that its concerns in this space raise unique issues that are more appropriately addressed in a separate regulatory initiative. The proposal's carve-outs do not apply, however, if the provider of the valuation represents or acknowledges that it is acting as a fiduciary with respect to the advice.

Some representatives of the appraisal industry submitted comments on the 2010 Proposal arguing that ERISA's fiduciary duty to act solely in the interest of the plan and its participants and beneficiaries is inconsistent with the duty of appraisers to provide objective, independent value determinations. The Department disagrees. A biased or inaccurate appraisal does not help a plan, a participant or a beneficiary make prudent investment decisions. Like other forms of investment advice, an appraisal is a tool for plan fiduciaries, participants, beneficiaries, and IRA owners to use in deciding what price to pay for assets and whether to accept or decline proposed transactions. An appraiser complies with his or her obligations as an appraiser—and as a loyal fiduciary—by giving plan fiduciaries or participants an impartial and accurate assessment of the value of an asset in accordance with appraisers' professional standard of care. Nothing in ERISA or this regulation should be read as compelling an appraiser to slant valuation opinions to reflect what the plan wishes the asset were worth rather than what it is really worth. As stated in the preamble to the 2010 Proposal, the Department would expect a fiduciary appraiser's determination of value to be unbiased, fair and objective and to be made in good faith based on a prudent investigation under the prevailing circumstances then known to the appraiser. In the Department's view, these fiduciary standards are fully consistent with professional standards, such as the Uniform Standards of Professional Appraisal Practice (USPAP).[17]

(4) Recommendations of a Person To Provide Investment Advice or Management Services

The proposal would treat recommendations on the selection of investment managers or advisers as fiduciary investment advice. In the Department's view, the current regulation already covers such advice. The proposal simply revises the regulation's text to remove any possible ambiguity. The Department believes that such advice should be treated as fiduciary in nature if provided under the circumstances in paragraph (a)(1)(iv) and for direct or indirect compensation. Covered advice would include recommendations of persons to perform asset management services or to make investment recommendations. Advice as to the identity of the person entrusted with investment authority over retirement assets is often critical to the proper management and investment of those assets. On the other hand, general advice as to the types of qualitative and quantitative criteria to consider in hiring an investment manager would not rise to the level of a recommendation of a person to manage plan investments nor would a trade journal's endorsement of an investment manager. Similarly, the proposed regulation would not cover recommendations of administrative service providers, property managers, or other service providers who do not provide investment services.

B. The Circumstances Under Which Advice Is Provided

As provided in paragraph (a)(2) of the proposal, unless a carve-out applies, a category of advice listed in the proposal would constitute "investment advice" if the person providing the advice, either directly or indirectly (*e.g.,* through or together with any affiliate)—

(i) Represents or acknowledges that it is acting as a fiduciary within the meaning of the Act or Code with respect to the advice described in paragraph (a)(1); or

(ii) Renders the advice pursuant to a written or verbal agreement, arrangement or understanding that the advice is individualized to, or that such advice is specifically directed to, the advice recipient for consideration in making investment or management decisions with respect to securities or other property of the plan or IRA.

Under paragraph (a)(2)(i), advisers who claim fiduciary status under ERISA or the Code in providing advice would be taken at their word. They may not later argue that the advice was not fiduciary in nature. Nor may they rely upon the carve-outs described in paragraph (b) on the scope of the definition of fiduciary investment advice.

The 2010 Proposal provided that investment recommendations provided by an investment adviser under the Advisers Act would, in the absence of a carve-out, automatically be treated as investment advice. In response to comments, the new proposal drops this provision. Thus, the proposal avoids making such persons fiduciaries based solely on their or an affiliate's status as an investment adviser under the Advisers Act. Instead, their fiduciary status would be determined by reference to the same functional test that applies to all persons under the regulation.

Paragraph (a)(2)(ii) of the proposal avoids treating recommendations made to the general public, or to no one in particular, as investment advice and thus addresses concerns that the general circulation of newsletters, television talk show commentary, or remarks in speeches and presentations at financial industry educational conferences would result in the person being treated as a fiduciary. This paragraph requires an agreement, arrangement, or understanding that advice is directed to, a specific recipient for consideration in making investment decisions. The parties need not have a meeting of the minds on the extent to which the advice recipient will actually rely on the advice, but they must agree or understand that the advice is individualized or specifically directed to the particular advice recipient for consideration in making investment decisions. In this respect, paragraph (a)(2)(ii) differs significantly from its counterpart in the 2010 Proposal. In particular, and in response to comments, the proposal does not require that advice be individualized to the needs of the plan, participant or beneficiary or IRA owner if the advice is specifically directed to such recipient. Under the proposal, advisers could not specifically direct investment recommendations to individual persons, but then deny fiduciary responsibility on the basis that they did not, in fact, consider the advice recipient's individual needs or intend that the recipient base investment decisions on their recommendations. Nor could they continue the practice of advertising advice or counseling that is one-on-one or that a reasonable person would believe would be tailored to their individual needs and then disclaim that the recommendations are fiduciary investment advice in boilerplate language in the advertisement or in the paperwork provided to the client.

Like the 2010 Proposal, and unlike the 1975 regulation, the new proposal does not require that advice be provided on a regular basis. Investment advice that meets the requirements of the proposal, even if provided only once, can be critical to important investment decisions. If the adviser received a direct or indirect fee in connection with its advice, the advice recipients should reasonably expect adherence to fiduciary standards on the same terms as other retirement investors who get

[17] A number of commenters also pointed to such professional standards as alternatives to fiduciary treatment under ERISA. While the Department believes that such professional standards are fully consistent with the fiduciary duties, the rights, remedies and sanctions under both ERISA and the Code importantly turn on fiduciary status, and advice on the value of an asset is often the most critical investment advice a plan receives. As a result, treating appraisals as fiduciary advice provides an additional layer of protection for consumers without conflicting with the duties of appraisers.

recommendations from the adviser on a more routine basis.

C. Carve-Outs From the General Definition

The Department recognizes that in many circumstances, plan fiduciaries, participants, beneficiaries, and IRA owners may receive recommendations or appraisals that, notwithstanding the general definition set forth in paragraph (a) of the proposal, should not be treated as fiduciary investment advice. Accordingly, paragraph (b) contains a number of specific carve-outs from the scope of the general definition. The carve-out at paragraph (b)(5) of the proposal concerning financial reports and valuations was discussed above in connection with appraisals. The carve-out in paragraph (b)(5)(iii) covers communications to a plan, a plan fiduciary, a plan participant or beneficiary, an IRA or IRA owner solely for purposes of compliance with the reporting and disclosure provisions under the Act, the Code, and the regulations, forms and schedules issued thereunder, or any applicable reporting or disclosure requirement under a Federal or state law, rule or regulation or self-regulatory organization rule or regulation. The carve-out in paragraph (b)(6) covers education. The other carve-outs are limited to communications with plans and plan fiduciaries and do not cover communications to participants, beneficiaries or IRA owners. These more limited carve-outs are described more fully below. In each instance, the proposed carve-outs are for communications that the Department believes Congress did not intend to cover as fiduciary "investment advice" and that parties would not ordinarily view as communications characterized by a relationship of trust or impartiality. None of the carve-outs apply where the adviser represents or acknowledges that it is acting as a fiduciary under ERISA with respect to the advice.

(1) Seller's and Swap Carve-Outs

(a) The "Seller's Carve-Out" [18]

Paragraph (b)(1)(i) of the proposed regulation provides a carve-out from the general definition for incidental advice provided in connection with an arm's length sale, purchase, loan, or bilateral contract between an expert plan investor and the adviser. It also applies in connection with an offer to enter into such a transaction or when the person providing the advice is acting as a representative, such as an agent, for the plan's counterparty. This carve-out is subject to the following conditions.

First, the person must provide advice to an ERISA plan fiduciary who is independent of such person and who exercises authority or control respecting the management or disposition of the plan's assets, with respect to an arm's length sale, purchase, loan or bilateral contract between the plan and the counterparty, or with respect to a proposal to enter into such a sale, purchase, loan or bilateral contract.

Second, either of two alternative sets of conditions must be met. Under alternative one, prior to providing any recommendation with respect to the transaction, such person:

(1) Obtains a written representation from the plan fiduciary that he/she is a fiduciary who exercises authority or control with respect to the management or disposition of the employee benefit plan's assets (as described in section 3(21)(A)(i) of the Act), that the employee benefit plan has 100 or more participants covered under the plan, and that the fiduciary will not rely on the person to act in the best interests of the plan, to provide impartial investment advice, or to give advice in a fiduciary capacity;

(2) fairly informs the plan fiduciary of the existence and nature of the person's financial interests in the transaction;

(3) does not receive a fee or other compensation directly from the plan, or plan fiduciary, for the provision of investment advice in connection with the transaction (this does not preclude a person from receiving a fee or compensation for other services);

(4) knows or reasonably believes that the independent plan fiduciary has sufficient expertise to evaluate the transaction and to determine whether the transaction is prudent and in the best interest of the plan participants (such person may rely on written representations from the plan or the plan fiduciary to satisfy this condition).

The second alternative applies if the person knows or reasonably believes that the independent plan fiduciary has responsibility for managing at least $100 million in employee benefit plan assets (for purposes of this condition, when dealing with an individual employee benefit plan, a person may rely on the information on the most recent Form 5500 Annual Return/Report filed by the plan to determine the value of plan assets, and, in the case of an independent fiduciary acting as an asset manager for multiple employee benefit plans, a person may rely on representations from the independent plan fiduciary regarding the value of employee benefit plan assets under management). In that circumstance, the adviser need not obtain written representations from its counterparty to avail itself of the carve-out, but must fairly inform the independent plan fiduciary that the adviser is not undertaking to provide impartial investment advice, or to give advice in a fiduciary capacity; and cannot receive a fee or other compensation directly from the plan, or plan fiduciary, for the provision of investment advice in connection with the transaction. In that circumstance, the adviser must also reasonably believe that the independent plan fiduciary has sufficient expertise to prudently evaluate the transaction.

The overall purpose of this carve-out is to avoid imposing ERISA fiduciary obligations on sales pitches that are part of arm's length transactions where neither side assumes that the counterparty to the plan is acting as an impartial trusted adviser, but the seller is making representations about the value and benefits of proposed deals. Under appropriate circumstances, reflected in the conditions to this carve-out, these counterparties to the plan do not suggest that they are an impartial fiduciary and plans do not expect a relationship of undivided loyalty or trust. Both sides of such transactions understand that they are acting at arm's length, and neither party expects that recommendations will necessarily be based on the buyer's best interests. In such a sales transaction, the buyer understands that it is buying an investment product, not advice about whether it is a good product, from a seller who has opposing financial interests. The seller's invitation to buy the product is understood as a sales pitch, not a recommendation. Also, a representative for the plan's counterparty, such as a broker, in such a transaction, would be able to use the carve-out if the conditions are met.

Although the 2010 Proposal also had a carve-out for sellers and other counterparties, the carve-out in the new proposal is significantly different. The changes are designed to ensure that the carve-out appropriately distinguishes incidental advice as part of an arm's length transactions with no expectation of trust or acting in the customer's best interest, from those instances of advice where customers may be expecting unbiased investment advice that is in their best interest. For example, the seller's carve-out is unavailable to an adviser if the plan directly pays a fee for investment advice. If a plan expressly

[18] Although the preamble uses the shorthand expression "seller's carve-out," we note that the carve-out provided in paragraph (b)(1)(i) of the proposal is not limited to sales but rather would apply to incidental advice provided in connection with an arm's length sale, purchase, loan, or bilateral contract between a plan investor with financial expertise and an adviser.

pays a fee for advice, the essence of the relationship is advisory, and the statute clearly contemplates fiduciary status. Thus, a service provider may not charge the plan a direct fee to act as an adviser, and then disclaim responsibility as a fiduciary adviser by asserting that he or she is merely an arm's length counterparty.

Commenters on the 2010 Proposal differed on whether the carve-out should apply to transactions involving plan participants, beneficiaries or IRA owners. After carefully considering the issue and the public comments, the Department does not believe such a carve-out can or should be crafted to cover recommendations to retail investors, including small plans, IRA owners and plan participants and beneficiaries. As a rule, investment recommendations to such retail customers do not fit the "arm's length" characteristics that the seller's carve-out is designed to preserve. Recommendations to retail investors and small plan providers are routinely presented as advice, consulting, or financial planning services. In the securities markets, brokers' suitability obligations generally require a significant degree of individualization. Research has shown that disclaimers are ineffective in alerting retail investors to the potential costs imposed by conflicts of interest, or the fact that advice is not necessarily in their best interest, and may even exacerbate these costs.[19] Most retail investors and many small plan sponsors are not financial experts, are unaware of the magnitude and impact of conflicts of interest, and are unable effectively to assess the quality of the advice they receive. IRA owners are especially at risk because they lack the protection of having a menu of investment options chosen by a plan fiduciary who is charged to protect the interests of the IRA owner. Similarly, small plan sponsors are typically experts in the day-to-day business of running an operating company, not in managing financial investments for others. In this retail market, a seller's carve-out would run the risk of creating a loophole that would result in the rule failing to improve consumer protections by permitting the same type of boilerplate disclaimers that some advisers now use to avoid fiduciary status under the current "five-part test" regulation. Persons making investment recommendations should be required to put the interests of the investors they serve ahead of their own. The Department has addressed legitimate concerns about preserving existing fee practices and minimizing market disruptions through proposed prohibited transaction exemptions detailed below, rather than through a blanket carve-out from fiduciary status.

Moreover, excluding retail investors from the seller's carve-out is consistent with recent congressional action, the Pension Protection Act of 2006 (PPA). Specifically, the PPA created a new statutory exemption that allows fiduciaries giving investment advice to individuals (pension plan participants, beneficiaries and IRA owners) to receive compensation from investment vehicles that they recommend in certain circumstances. 29 U.S.C. 1108(b)(14); 26 U.S.C. 4975(d)(17). Recognizing the risks presented when advisers receive fees from the investments they recommend to individuals, Congress placed important constraints on such advice arrangements that are calculated to limit the potential for abuse and self-dealing, including requirements for fee-leveling or the use of independently certified computer models. The Department has issued regulations implementing this provision at 29 CFR 2550.408g–1 and 408g–2. Including retail investors in the seller's carve-out would undermine the protections for retail investors that Congress required under this PPA provision.

Although the seller's carve-out may not be available in the retail market, the proposal is intended to ensure that small plan fiduciaries, plan participants, beneficiaries and IRA owners would be able to obtain essential information regarding important decisions they make regarding their investments without the providers of that information crossing the line into fiduciary status. Under the platform provider carve-out under paragraph (b)(3), platform providers (*i.e.,* persons that provide access to securities or other property through a platform or similar mechanism) and persons that help plan fiduciaries select or monitor investment alternatives for their plans can perform those services without incurring fiduciary status. Similarly, under the investment education carve-out of paragraph (b)(6), general plan information, financial, investment and retirement information, and information and education regarding asset allocation models would all be available to a plan, plan fiduciary, participant, beneficiary or IRA owner and would not constitute the provision of investment advice, irrespective of who receives that information. The Department invites comments on whether the proposed seller's carve-out should be available for advice given directly to plan participants, beneficiaries, and IRA owners. Further, the Department invites comments on the scope of the seller's carve-out and whether the plan size limitation of 100 plan participants and 100 million dollar asset requirement in the proposal are appropriate conditions or whether other conditions would be more appropriate proxies for identifying persons with sufficient investment-related expertise to be included in a seller's carve-out.[20] The Department is also interested in whether existing and proposed prohibited transaction exemptions eliminate or mitigate the need for any seller's carve-out.

(b) Swap and Security-Based Swap Transactions

Paragraph (b)(1)(ii) of the proposal specifically addresses advice and other communications by counterparties in connection with certain swap or security-based swap transactions under the Commodity Exchange Act or the Securities Exchange Act. This broad class of financial transactions is defined and regulated under amendments to the Commodity Exchange Act and the Securities Exchange Act by the Dodd-Frank Act. Section 4s(h) of the Commodity Exchange Act (7 U.S.C. 6s(h)), and section 15F of the Securities

[19] Loewenstein, George, Daylian Cain, Sunita Sah, *The Limits of Transparence: Pitfalls and Potential of Disclosing Conflicts of Interest,* American Economic Review: Papers and Proceedings 101, no. 3 (2011).

[20] The proposed thresholds of 100 or more participants and assets of $100 million are consistent with thresholds used for similar purposes under existing rules and practices. For example, administrators of plans with 100 or more participants, unlike smaller plans, generally are required to report to the Department details on the identity, function, and compensation of their services providers; file a schedule of assets held for investments; and submit audit reports to the Department. Smaller plans are not subject to these same filing requirements that are imposed on large plans. The vast majority of plans with fewer than 100 participants have 10 or less participants. They are much more similar to individual retail investors than to large financially sophisticated institutional investors, who employ lawyers and have the time and expertise to scrutinize advice they receive for bias. Similarly, Congress established a $100 million asset threshold in enacting the PPA statutory cross-trading exemption under ERISA section 408(b)(19). In the transactions covered by 408(b)(19), an investment manager has discretion with respect to separate client accounts that are on opposite sides of the trade. The cross trade can create efficiencies for both clients, but it also gives rise to a prohibited transaction under ERISA § 406(b)(2) because the adviser or manager is "representing" both sides of the transaction and, therefore, has a conflict of interest. The exemption generally allows an investment manager to effect cash purchases and sales of securities for which market quotations are readily available between large sophisticated plans with at least $100 million in assets and another account under management by the investment manager, subject to certain conditions. In this context, the $100 million threshold serves as a proxy for identifying institutional fiduciaries that can be expected to have the expertise to protect their own interests in the conflicted transaction.

Exchange Act of 1934 (15 U.S.C. 78o–10(h) establishes similar business conduct standards for dealers and major participants in swaps or security-based swaps. Special rules apply for transactions involving "special entities," a term that includes employee benefit plans under ERISA, but not IRAs and other non-ERISA plans.

In outline, paragraph (b)(1)(ii) of the proposal would allow swap dealers, security-based swap dealers, major swap participants and security-based major swap participants who make recommendations to plans to avoid becoming ERISA investment advice fiduciaries when acting as counterparties to a swap or security-based swap transaction. Under the swap carve out, if the person providing recommendations is a swap dealer or security-based swap dealer, it must not be acting as an adviser to the plan, within the meaning of the applicable business conduct standards regulations of the CFTC or the SEC. In addition, before providing any recommendations with respect to the transaction, the person providing recommendations must obtain a written representation from the independent plan fiduciary, that the fiduciary will not rely on recommendations provided by the person.

Under the Commodity Exchange Act, swap dealers or major swap participants that act as counterparties to ERISA plans, must have a reasonable basis to believe that the plans have independent representatives who are fiduciaries under ERISA. 7 U.S.C. 6s(h)(5). Similar requirements apply for security-based swap transactions. 15 U.S.C 78o–10(h)(4) and (5). The CFTC has issued a final rule to implement these requirements and the SEC has issued a proposed rule that would cover security-based swaps. 17 CFR 23.400 to 23.451 (2012).

Paragraph (b)(1)(ii) reflects the Department's coordination of its efforts with staff of the SEC and CFTC, and is intended to provide a clear road-map for swap counterparties to avoid ERISA fiduciary status in arm's length transactions with plans. The provision addresses commenters' concerns that the conduct required for compliance with the Dodd-Frank Act's business conduct standards could constitute fiduciary investment advice under ERISA even in connection with arm's length transactions with plans that are separately represented by independent fiduciaries who are not looking to their counterparties for disinterested advice. If that were the case, swaps and security-based swaps with plans would often constitute prohibited transactions under ERISA. Commenters also argued that their obligations under the business conduct standards could effectively preclude them from relying on the carve-out for counterparties in the 2010 Proposal. Although the Department does not agree that the carve-out in the 2010 Proposal would have been unavailable to plan's swap counterparty (see letter dated April 28, 2011, to CFTC Chairman Gary Gensler from EBSA's Assistant Secretary Phyllis Borzi), the separate proposed carve-out for swap and security-based swap transactions in the proposal should avoid any uncertainty.[21] The Department will continue to coordinate its efforts with staff of the SEC and CFTC to ensure that any final regulation is consistent with the agencies' work in connection with the Dodd-Frank Act's business conduct standards.

(2) Employees of the Plan Sponsor

The proposal at paragraph (b)(2) provides that employees of a plan sponsor of an ERISA plan would not be treated as investment advice fiduciaries with respect to advice they provide to the fiduciaries of the sponsor's plan as long as they receive no compensation for the advice beyond their normal compensation as employees of the plan sponsor. This carve-out from the scope of the fiduciary investment advice definition recognizes that internal employees, such as members of a company's human resources department, routinely develop reports and recommendations for investment committees and other named fiduciaries of the sponsors' plans, without acting as paid fiduciary advisers. The carve-out responds to and addresses the concerns of commenters who said that these personnel should not be treated as fiduciaries because their advice is largely incidental to their duties on behalf of the plan sponsor and they receive no compensation for these advice-related functions.

(3) Platform Providers/Selection and Monitoring Assistance

The carve-out at paragraph (b)(3) of the proposal is directed to service providers, such as recordkeepers and third party administrators, that offer a "platform" or selection of investment vehicles to participant-directed individual account plans under ERISA. Under the terms of the carve-out, the plan fiduciaries must choose the specific investment alternatives that will be made available to participants for investing their individual accounts. The carve-out merely makes clear that persons would not act as investment advice fiduciaries simply by marketing or making available such investment vehicles, without regard to the individualized needs of the plan or its participants and beneficiaries, as long as they disclose in writing that they are not undertaking to provide impartial investment advice or to give advice in a fiduciary capacity.

Similarly, a separate provision at paragraph (b)(4) carves out certain common activities that platform providers may carry out to assist plan fiduciaries in selecting and monitoring the investment alternatives that they make available to plan participants. Under paragraph (b)(4), merely identifying offered investment alternatives meeting objective criteria specified by the plan fiduciary or providing objective financial data regarding available alternatives to the plan fiduciary would not cause a platform provider to be a fiduciary investment adviser. These two carve-outs are clarifying modifications to the corresponding provisions of the 2010 Proposal. They address certain common practices that have developed with the growth of participant-directed individual account plans and recognize circumstances where the platform provider and the plan fiduciary clearly understand that the provider has financial or other relationships with the offered investments and is not purporting to provide impartial investment advice. It also accommodates the fact that platform providers often provide general financial information that falls short of constituting actual investment advice or recommendations, such as information on the historic performance of asset classes and of the investments available through the provider. The carve-outs also reflect the Department's agreement with commenters that a platform provider who merely identifies investment alternatives using objective third-party criteria (*e.g.*, expense ratios, fund size, or asset type specified by the plan fiduciary) to assist in selecting and monitoring investment alternatives should not be considered to be rendering investment advice.

While recognizing the utility of the provisions in paragraphs (b)(3) and (b)(4) for the effective and efficient operation of plans by plan sponsors, plan fiduciaries and plan service providers, the Department reiterates its longstanding view, recently codified in 29 CFR 2550.404a–5(f) and 2550.404c–1(d)(2)(iv) (2010), that a fiduciary is always responsible for prudently selecting and monitoring providers of services to the plan or designated

[21] *http://www.dol.gov/ebsa/pdf/cftc20110428.pdf.*

investment alternatives offered under the plan.

Several commenters also asked the Department to clarify that the platform provider carve-out is available in the 403(b) plan marketplace. In the Department's view, a 403(b) plan that is subject to Title I of ERISA would be an individual account plan within the meaning of ERISA section 3(34) of the Act for purposes of the proposed regulation, so the platform provider carve-out would be available with respect to such plans.

Other commenters asked that the platform provider provision be generally extended to apply to IRAs. In the IRA context, however, there typically is no separate independent "plan fiduciary" who interacts with the platform provider to protect the interests of the account owners. As a result, it is much more difficult to conclude that the transaction is truly arm's length or to draw a bright line between fiduciary and non-fiduciary communications on investment options. Consequently, the proposed regulation declines to extend application of this carve-out to IRAs and other non-ERISA plans. As the Department continues its work on this regulatory project, however, it requests specific comment as to the types of platforms and options that may be offered to IRA owners, how they may be similar to or different from platforms offered in connection with participant-directed individual account plans, and whether it would be appropriate for service providers not to be treated as fiduciaries under this carve-out when marketing such platforms to IRA owners. We also invite comments, alternatively, on whether the scope of this carve-out should be limited to large plans, similar to the scope of the "Seller's Carve-out" discussed above.

As a corollary to the proposal's restriction of the applicability of the platform provider carve-out to only ERISA plans, the selection and monitoring assistance carve-out is similarly not available in the IRA and other non-ERISA plans context. Commenters on the platform provider restriction are encouraged to offer their views on the effect of this restriction in the non-ERISA plan marketplace.

(4) Investment Education

Paragraph (b)(6) of the proposed regulation is similar to a carve-out in the 2010 Proposal for the provision of investment education information and materials within the meaning of an earlier Interpretive Bulletin issued by the Department in 1996. 29 CFR 2509.96–1 (IB 96–1). Paragraph (b)(6) incorporates much of IB 96–1's operative text, but with the important exceptions explained below. Paragraph (b)(6) of the proposed regulation, if finalized, would supersede IB 96–1. Consistent with IB 96–1, paragraph (b)(6) makes clear that furnishing or making available the specified categories of information and materials to a plan, plan fiduciary, participant, beneficiary or IRA owner will not constitute the rendering of investment advice, irrespective of who provides the information (*e.g.*, plan sponsor, fiduciary or service provider), the frequency with which the information is shared, the form in which the information and materials are provided (*e.g.*, on an individual or group basis, in writing or orally, via a call center, or by way of video or computer software), or whether an identified category of information and materials is furnished or made available alone or in combination with other categories of investment or retirement information and materials identified in paragraph (b)(6), or the type of plan or IRA involved. As a departure from IB 96–1, a new condition of the carve-out for investment education is that the information and materials not include advice or recommendations as to specific investment products, specific investment managers, or the value of particular securities or other property. The paragraph reflects the Department's view that the statutory reference to "investment advice" is not meant to encompass general investment information and educational materials, but rather is targeted at more specific recommendations and advice on the investment of plan and IRA assets.

Similar to IB 96–1, paragraph (b)(6) of the proposed regulation divides investment education information and materials into four general categories: (i) Plan information; (ii) general financial, investment and retirement information; (iii) asset allocation models; and (iv) interactive investment materials. The proposed regulation in paragraph (b)(6)(v) also adopts the provision from IB 96–1 stating that there may be other examples of information, materials and educational services which, if furnished, would not constitute investment advice or recommendations within the meaning of the proposed regulation and that no inference should be drawn regarding materials or information which are not specifically included in paragraph (b)(6)(i) through (iv).

Although paragraph (b)(6) incorporates most of the relevant text of IB 96–1, there are important changes. One change from IB 96–1 is that paragraph (b)(6) makes clear that the distinction between non-fiduciary education and fiduciary advice applies equally to information provided to plan fiduciaries as well as information provided to plan participants and beneficiaries and IRA owners, and that it applies equally to participant-directed plans and other plans. In addition, the provision applies without regard to whether the information is provided by a plan sponsor, fiduciary, or service provider.

Based on public input received in connection with its joint examination of lifetime income issues with the Department of the Treasury, the Department is persuaded that additional guidance may help improve retirement security by facilitating the provision of information and education relating to retirement needs that extend beyond a participant's or beneficiary's date of retirement. Accordingly, paragraph (b)(6) of the proposal includes specific language to make clear that the provision of certain general information that helps an individual assess and understand retirement income needs past retirement and associated risks (*e.g.*, longevity and inflation risk), or explains general methods for the individual to manage those risks both within and outside the plan, would not result in fiduciary status under the proposal.[22]

[22] Although the proposal would formally remove IB 96–1 from the CFR, the Department notes that paragraph (e) of IB 96–1 provides generalized guidance under section 405 and 404(c) of ERISA with respect to the selection by employers and plan fiduciaries of investment educators and the lack of responsibility of employers and fiduciaries with respect to investment educators selected by participants. Specifically, paragraph (e) states:

As with any designation of a service provider to a plan, the designation of a person(s) to provide investment educational services or investment advice to plan participants and beneficiaries is an exercise of discretionary authority or control with respect to management of the plan; therefore, persons making the designation must act prudently and solely in the interest of the plan participants and beneficiaries, both in making the designation(s) and in continuing such designation(s). See ERISA sections 3(21)(A)(i) and 404(a), 29 U.S.C. 1002 (21)(A)(i) and 1104(a). In addition, the designation of an investment advisor to serve as a fiduciary may give rise to co-fiduciary liability if the person making and continuing such designation in doing so fails to act prudently and solely in the interest of plan participants and beneficiaries; or knowingly participates in, conceals or fails to make reasonable efforts to correct a known breach by the investment advisor. See ERISA section 405(a), 29 U.S.C. 1105(a). The Department notes, however, that, in the context of an ERISA section 404(c) plan, neither the designation of a person to provide education nor the designation of a fiduciary to provide investment advice to participants and beneficiaries would, in itself, give rise to fiduciary liability for loss, or with respect to any breach of part 4 of title I of ERISA, that is the direct and necessary result of a participant's or beneficiary's exercise of independent control. 29 CFR 2550.404c–1(d). The Department also notes that a plan sponsor or

As noted, another change is that the Department is not incorporating the provisions at paragraph (d)(3)(iii) and (4)(iv) of IB 96–1. Those provisions of IB 96–1 permit the use of asset allocation models that refer to specific investment products available under the plan or IRA, as long as those references to specific products are accompanied by a statement that other investment alternatives having similar risk and return characteristics may be available. Based on its experience with the IB 96–1 since publication, as well as views expressed by commenters to the 2010 Proposal, the Department now believes that, even when accompanied by a statement as to the availability of other investment alternatives, these types of specific asset allocations that identify specific investment alternatives function as tailored, individualized investment recommendations, and can effectively steer recipients to particular investments, but without adequate protections against potential abuse.[23]

In particular, the Department agrees with those commenters to the 2010 Proposal who argued that cautionary disclosures to participants, beneficiaries, and IRA owners may have limited effectiveness in alerting them to the merit and wisdom of evaluating investment alternatives not used in the model. In practice, asset allocation models concerning hypothetical individuals, and interactive materials which arrive at specific investment products and plan alternatives, can be indistinguishable to the average retirement investor from individualized recommendations, regardless of caveats. Accordingly, paragraphs (b)(6)(iii) and (iv) relating to asset allocation models and interactive investment materials preclude the identification of specific investment alternatives available under the plan or IRA in order for the materials described in those paragraphs to be considered investment education. Thus, for example, we would not treat an asset allocation model as mere education if it called for a certain percentage of the investor's assets to be invested in large cap mutual funds, and accompanied that proposed allocation with the identity of a specific fund or provider. In that circumstance, the adviser has made a specific investment recommendation that should be treated as fiduciary advice and adhere to fiduciary standards. Further, materials that identify specific plan investment alternatives also appear to fall within the definition of "recommendation" in paragraph (f)(1) of the proposal, and could result in fiduciary status on the part of a provider if the other provisions of the proposal are met. The Department believes that effective and useful asset allocation education materials can be prepared and delivered to participants and IRA owners without including specific investment products and alternatives available under the plan. The Department understands that not incorporating the provisions of IB 96–1 at paragraph (d)(3)(iii) and (4)(iv) into the proposal represents a significant change in the information and materials that may constitute investment education. Accordingly, the Department invites comments on whether this change is appropriate.[24]

D. Fee or Other Compensation

A necessary element of fiduciary status under section 3(21)(A)(ii) of ERISA is that the investment advice be for a "fee or other compensation, direct or indirect." Consistent with the statute, paragraph (f)(6) of the proposed regulation defines this phrase to mean any fee or compensation for the advice received by the advice provider (or by an affiliate) from any source and any fee or compensation incident to the transaction in which the investment advice has been rendered or will be rendered. It further provides that the term "fee or compensation" includes, but is not limited to, brokerage fees, mutual fund sales, and insurance sales commissions.

Paragraph (c)(3) of the 2010 Proposal used similar language, but it also provided that the term included fees and compensation based on multiple transactions involving different parties. Commenters found this provision confusing and it does not appear in the new proposal. The provision was intended to confirm the Department's position that fees charged on a so-called "omnibus" basis (*e.g.*, compensation paid based on business placed or retained that includes plan or IRA business) would constitute fees and compensation for purposes of the rule.

Direct or indirect compensation also includes any compensation received by affiliates of the adviser that is connected to the transaction in which the advice was provided. For example, when a fiduciary adviser recommends that a participant or IRA owner invest in a mutual fund, it is not unusual for an affiliated adviser to the mutual fund to receive a fee. The receipt by the affiliate of advisory fees from the mutual fund is indirect compensation in connection with the rendering of investment advice to the participant.

Some commenters additionally suggested that call center employees should not be treated as investment advice fiduciaries where they are not specifically paid to provide investment advice and their compensation does not change based on their communications with participants and beneficiaries. The carve-out from the fiduciary investment advice definition for investment education provides guidelines under which call center staff and other employees providing similar investor assistance services may avoid fiduciary status. However, commenters stated that a specific carve-out for such call centers would provide a greater level of certainty so as not to inhibit mutual funds, insurance companies, broker-dealers, recordkeepers and other financial service providers from continuing to make such assistance available to participants and beneficiaries in 401(k) and similar participant-directed plans. In the Department's view, such a carve-out would be inappropriate. The fiduciary definition is intended to apply broadly to all persons who engage in the activities set forth in the regulation, regardless of job title or position, or whether the advice is rendered in person, in writing or by phone. If, in the performance of their jobs, call center employees make specific investment recommendations to plan participants or IRA owners under the circumstances

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fiduciary would have no fiduciary responsibility or liability with respect to the actions of a third party selected by a participant or beneficiary to provide education or investment advice where the plan sponsor or fiduciary neither selects nor endorses the educator or advisor, nor otherwise makes arrangements with the educator or advisor to provide such services.

Unlike the remainder of the IB, this text does not belong in the investment advice regulation. Also, the principles articulated in paragraph (e) are generally understood and accepted such that retaining the paragraph as a stand-alone IB does not appear necessary or appropriate.

[23] When the Department issued IB 96–1, it expressed concern that service providers could effectively steer participants to a specific investment alternative by identifying only one particular fund available under the plan in connection with an asset allocation model. As a result, where it was possible to do so, the Department encouraged service providers to identify other investment alternatives within an asset class as part of a model. Ultimately, however, when asset allocation models and interactive investment materials identified any specific investment alternative available under the plan, the Department required an accompanying statement both indicating that other investment alternatives having similar risk and return characteristics may be available under the plan and identifying where information on those investment alternatives could be obtained. 61 FR 29586, 29587 (June 11, 1996).

[24] As indicated earlier in this Notice, the Department believes that FINRA's guidance in this area may provide useful standards and guideposts for distinguishing investment education from investment advice under ERISA. The Department specifically solicits comments on the discussion in FINRA's "Frequently Asked Questions, FINRA Rule 2111 (Suitability)" of the term "recommendation" in the context of asset allocation models and general investment strategies.

described in the proposal, it is appropriate to treat them, and possibly their employers, as fiduciaries unless they meet the conditions of one of the carve-outs set forth above.

E. Coverage of IRAs and Other Non-ERISA Plans

Certain provisions of Title I of ERISA, 29 U.S.C. 1001–1108, such as those relating to participation, benefit accrual, and prohibited transactions also appear in the Code. This parallel structure ensures that the relevant provisions apply to all tax-qualified plans, including IRAs. With regard to prohibited transactions, the Title I provisions generally authorize recovery of losses from, and imposition of civil penalties on, the responsible plan fiduciaries, while the Code provisions impose excise taxes on persons engaging in the prohibited transactions. The definition of fiduciary with respect to a plan is the same in section 4975(e)(3)(B) of the IRC as the definition in section 3(21)(A)(ii) of ERISA, 29 U.S.C. 1002(21)(A)(ii), and the Department's 1975 regulation defining fiduciary investment advice is virtually identical to regulations that define the term "fiduciary" under the Code. 26 CFR 54.4975–9(c) (1975).

To rationalize the administration and interpretation of dual provisions under ERISA and the Code, Reorganization Plan No. 4 of 1978 divided the interpretive and rulemaking authority for these provisions between the Secretaries of Labor and of the Treasury, so that, in general, the agency with responsibility for a given provision of Title I of ERISA would also have responsibility for the corresponding provision in the Code. Among the sections transferred to the Department were the prohibited transaction provisions and the definition of a fiduciary in both Title I of ERISA and in the Code. ERISA's prohibited transaction rules, 29 U.S.C. 1106–1108, apply to ERISA-covered plans, and the Code's corresponding prohibited transaction rules, 26 U.S.C. 4975(c), apply both to ERISA-covered pension plans that are tax-qualified pension plans, as well as other tax-advantaged arrangements, such as IRAs, that are not subject to the fiduciary responsibility and prohibited transaction rules in ERISA.[25]

Given this statutory structure, and the dual nature of the 1975 regulation, the proposal would apply to both the definition of "fiduciary" in section 3(21)(A)(ii) of ERISA and the definition's counterpart in section 4975(e)(3)(B) of the Code. As a result, it applies to persons who give investment advice to IRAs. In this respect, the new proposal is the same as the 2010 Proposal.

Many comments on the 2010 Proposal concerned its impact on IRAs and questioned whether the Department had adequately considered possible negative impacts. Some commenters were especially concerned that application of the new rule could disrupt existing brokerage arrangements that they believe are beneficial to customers. In particular, brokers often receive revenue sharing, 12b–1 fees, and other compensation from the parties whose investment products they recommend. If the brokers were treated as fiduciaries, the receipt of such fees could violate the Code's prohibited transaction rules, unless eligible for a prohibited transaction exemption. According to these commenters, the disruption of such current fee arrangements could result in a reduced level of assistance to investors, higher up-front fees, and less investment advice, particularly to investors with small accounts. In addition, some commenters expressed skepticism that the imposition of fiduciary standards would result in improved advice and questioned the view that current compensation arrangements could cause sub-optimal advice. Additionally, commenters stressed the need for coordination between the Department and other regulatory agencies, such as the SEC, CFTC, and Treasury.

As discussed above, to better align the regulatory definition of fiduciary with the statutory provisions and underlying Congressional goals, the Department is proposing a definition of a fiduciary investment advice that would encompass investment recommendations that are individualized or specifically directed to plans, participants, beneficiaries or IRA owners, if the adviser receives a direct or indirect fee. Neither the relevant statutory provisions, nor the current regulation, draw a distinction between brokers and other advisers or carve brokers out of the scope of the fiduciary provisions of ERISA and of the Code. The relevant statutory provisions, and accordingly the proposed regulation, establish a functional test based on the service provider's actions, rather than the provider's title (*e.g.,* broker or registered investment adviser). If one engages in specified activities, such as the provision of investment advice for a direct or indirect fee, the person engaging in those activities is a fiduciary, irrespective of labels. Moreover, the statutory definition of fiduciary advice is identical under both ERISA and the Code. There is no indication that the definition should vary between plans and IRAs.

In light of this statutory framework, the Department does not believe it would be appropriate to carve out a special rule for IRAs, or for brokers or others who make specific investment recommendations to IRA owners or to other participants in non-ERISA plans for direct or indirect fees. When Congress enacted ERISA and the corresponding Code provisions, it chose to impose fiduciary status on persons who provide investment advice to plans, participants, beneficiaries and IRA owners, and to specifically prohibit a wide variety of transactions in which the fiduciary has financial interests that potentially conflict with the fiduciary's obligation to the plan or IRA. It did not provide a special carve-out for brokers or IRAs, and the Department does not believe it would be appropriate to write such a carve-out into the regulation implementing the statutory definition.

Indeed, brokers who give investment advice to IRA owners or plan participants, and who otherwise meet the terms of the current five-part test, are already fiduciaries under the existing fiduciary regulation. If, for example, a broker regularly advises an individual IRA owner on specific investments, the IRA owner routinely follows the recommendations, and both parties understand that the IRA owner relies upon the broker's advice, the broker is almost certainly a fiduciary. In such circumstances, the broker is already subject to the excise tax on prohibited transactions if he or she receives fees from a third party in connection with recommendations to invest IRA assets in the third party's investment products, unless the broker satisfies the conditions of a prohibited transaction exemption that covers the particular fees. Indeed, broker-dealers today can provide fiduciary investment advice by complying with prohibited transaction exemptions that permit the receipt of commission-based compensation for the sale of mutual funds and other securities. Moreover, both ERISA and the Code were amended as part of the PPA to include a new prohibited transaction exemption that applies to investment advice in both the plan and IRA context. The PPA exemption clearly reflects the longstanding concern under ERISA and the Code about the dangers posed by conflicts of interest, and the need for appropriate safeguards in both the plan and IRA markets. Under the terms of the

[25] The Secretary of Labor also was transferred authority to grant administrative exemptions from the prohibited transaction provisions of the Code.

exemption, the investment recommendations must either result from the application of an unbiased and independently certified computer program or the fiduciary's fees must be level (*i.e.*, the fiduciary's compensation cannot vary based on his or her particular investment recommendations).

Moreover, as discussed in the regulatory impact analysis below, there is substantial evidence to support the statutory concern about conflicts of interest. As the analysis reflects, unmitigated conflicts can cause significant harm to investors. The available evidence supports a finding that the negative impacts are present and often times large. The proposal would curtail the harms to investors from such conflicts and thus deliver significant benefits to plan participants and IRA owners. Plans, plan participants, beneficiaries and IRA owners would all benefit from advice that is impartial and puts their interests first. Moreover, broker-dealer interactions with plan fiduciaries, participants, and IRA owners present some of the most obvious conflict of interest problems in this area. Accordingly, in the Department's view, broker-dealers that provide investment advice should be subject to fiduciary duties to mitigate conflicts of interest and increase investor protections.

Some commenters additionally suggested that the application of special fiduciary rules in the retail investment market to IRA accounts, but not savings outside of tax-preferred retirement accounts, is inappropriate and could lead to confusion among investors and service providers. The distinction between IRAs and other retail accounts, however, is a direct result of a statutory structure that draws a sensible distinction between tax-favored IRAs and other retail investment accounts. The Code itself treats IRAs differently, bestowing uniquely favorable tax treatment on such accounts and prohibiting self-dealing by persons providing investment advice for a fee. In these respects, and in light of the special public interest in retirement security, IRAs are more like plans than like other retail accounts. Indeed, as noted above, the vast majority of IRA assets today are attributable to rollovers from plans.[26] In addition, IRA owners may be at even greater risk from conflicted advice than plan participants. Unlike ERISA plan participants, IRA owners do not have the benefit of an independent plan fiduciary to represent their interests in selecting a menu of investment options or structuring advice arrangements. They cannot sue fiduciary advisers under ERISA for losses arising from fiduciary breaches, nor can the Department sue on their behalf. Compared to participants with ERISA plan accounts, IRA owners often have larger account balances and are more likely to be elderly. Thus, limiting the harms to IRA investors resulting from conflicts of interest of advisers is at least as important as protecting ERISA plans and plan participants from such harms.

The Department believes that it is important to address the concerns of brokers and others providing investment advice to IRA owners about undue disruptions to current fee arrangements, but also believes that such concerns are best resolved within a fiduciary framework, rather than by simply relieving advisers from fiduciary responsibility. As previously discussed, the proposed regulation permits investment professionals to provide important financial information and education, without acting as fiduciaries or being subject to the prohibited transaction rules. Moreover, ERISA and the Code create a flexible process that enables the Department to grant class and individual exemptions from the prohibited transaction rules for fee practices that it determines are beneficial to plan participants and IRA owners. For example, existing prohibited transaction exemptions already allow brokers who provide fiduciary advice to receive commissions generating conflicts of interest for trading the types of securities and funds that make up the large majority of IRA assets today. In addition, simultaneous with the publication of this proposed regulation, the Department is publishing new exemption proposals that would permit common fee practices, while at the same time protecting plan participants, beneficiaries and IRA owners from abuse and conflicts of interest. As noted above, in contrast with many previously adopted PTE exemptions that are transaction-specific, the Best Interest Contract PTE described below reflects a more flexible approach that accommodates a wide range of current business practices while minimizing the impact of conflicts of interest and ensuring that plans and IRAs receive investment recommendations that are in their best interests.

As discussed, the Department received extensive comment on the application of the 2010 Proposal's provisions to IRAs, but comments regarding other non-ERISA plans such as Health Savings Accounts (HSAs), Archer Medical Savings Accounts and Coverdell Education Savings Accounts were less prolific. The Department notes that these accounts are given tax preferences as are IRAs. Further, some of the accounts, such as HSAs, can be used as long term savings accounts for retiree health care expenses. These types of accounts also are expressly defined by Code section 4975(e)(1) as plans that are subject to the Code's prohibited transaction rules. Thus, although they generally may hold fewer assets and may exist for shorter durations than IRAs, the owners of these accounts or the persons for whom these accounts were established are entitled to receive the same protections from conflicted investment advice as IRA owners. Accordingly, these accounts are included in the scope of covered plans in paragraph (f)(2) of the new proposal. However, the Department solicits specific comment as to whether it is appropriate to cover and treat these plans under the proposed regulation in a manner similar to IRAs as to both coverage and applicable carve-outs.

F. Administrative Prohibited Transaction Exemptions

In addition to the new proposal in this Notice, the Department is also proposing, elsewhere in this edition of the **Federal Register**, certain administrative class exemptions from the prohibited transaction provisions of ERISA (29 U.S.C. 1106), and the Code (26 U.S.C. 4975(c)(1)) as well as proposed amendments to previously adopted exemptions. The proposed exemptions and amendments would allow, subject to appropriate safeguards, certain broker-dealers, insurance agents and others that act as investment advice fiduciaries to nevertheless continue to receive a variety of forms of compensation that would otherwise violate prohibited transaction rules and trigger excise taxes. The proposed exemptions would supplement statutory exemptions at 29 U.S.C. 1108 and 26 U.S.C. 4975(d), and previously adopted class exemptions.

Investment advice fiduciaries to plans and plan participants must meet ERISA's standards of prudence and loyalty to their plan customers. Such fiduciaries also face taxes, remedies and other sanctions for engaging in certain transactions, such as self-dealing with plan assets or receiving payments from third parties in connection with plan transactions, unless the transactions are permitted by an exemption from ERISA's and the Code's prohibited transaction rules. IRA fiduciaries do not

[26] Peter Brady, Sarah Holden, and Erin Shon, *The U.S. Retirement Market, 2009*, Investment Company Institute, Research Fundamentals, Vol. 19, No. 3, May 2010, *at http://www.ici.org/pdf/fm-v19n3.pdf.*

have the same general fiduciary obligations of prudence and loyalty under the statute, but they too must adhere to the prohibited transaction rules or they must pay an excise tax. The prohibited transaction rules help ensure that investment advice provided to plan participants and IRA owners is not driven by the adviser's financial self-interest.

Proposed Best Interest Contract Exemption (Best Interest Contract PTE)

The proposed Best Interest Contract PTE would provide broad and flexible relief from the prohibited transaction restrictions on certain compensation received by investment advice fiduciaries as a result of a plan's or IRA's purchase, sale or holding of specifically identified investments. The conditions of the exemption are generally principles-based rather than prescriptive and require, in particular, that advice be provided in the best interest of the plan or IRA. This exemption was developed partly in response to comments received that suggested such an approach. It is a significant departure from existing exemptions, examples of which are discussed below, which are limited to much narrower categories of investments under more prescriptive and less flexible and adaptable conditions.

The proposed Best Interest Contract PTE was developed to promote the provision of investment advice that is in the best interest of retail investors, such as plan participants and beneficiaries, IRA owners, and small plans. The proposed exemption would apply to compensation received by individual investment advice fiduciaries (including individual advisers [27] and firms that employ or otherwise contract with such individuals) as well as their affiliates and related entities, that is provided in connection with the purchase, sale or holding of certain assets by the plans, participants and beneficiaries, and IRAs. In order to protect the interests of these investors, the exemption requires the firm and the adviser to contractually acknowledge fiduciary status, commit to adhere to basic standards of impartial conduct, warrant that they will comply with applicable federal and state laws governing advice and that they have adopted policies and procedures reasonably designed to mitigate any harmful impact of conflicts of interest, and disclose basic information on their conflicts of interest and on the cost of their advice. The standards of impartial conduct to which the adviser and firm must commit are basic obligations of fair dealing and fiduciary conduct to which the Department believes advisers and firms often informally commit—to give advice that is in the customer's best interest; avoid misleading statements; and receive no more than reasonable compensation. This standards-based approach aligns the adviser's interests with those of the plan or IRA customer, while leaving the adviser and employing firm the flexibility and discretion necessary to determine how best to satisfy these basic standards in light of the unique attributes of their business.

As an additional protection for retail investors, the exemption would not apply if the contract contains exculpatory provisions disclaiming or otherwise limiting liability of the adviser or financial institution for violation of the contract's terms. Adopting the approach taken by FINRA, the contract could require the parties to arbitrate individual claims, but it could not limit the rights of the plan, participant, beneficiary, or IRA owner to bring or participate in a class action against the adviser or financial institution.

Additional conditions would apply to firms that limit the products that their advisers can recommend based on the receipt of third party payments or the proprietary nature of the products (*i.e.*, products offered or managed by the firm or its affiliates) or for other reasons. The conditions require, among other things, that such firms provide notice of the limitations to plans, participants and beneficiaries and IRA owners, as well as make a written finding that the limitations do not prevent advisers from providing advice in those investors' best interest.

Finally, certain notice and data collection requirements would apply to all firms relying on the exemption. Specifically, firms would be required to notify the Department in advance of doing so, and they would have to maintain certain data, and make it available to the Department upon request, to help evaluate the effectiveness of the exemption in safeguarding the interests of plan and IRA investors.

The Department's intent in crafting the Best Interest Contract PTE is to permit common compensation structures that create conflicts of interest, while minimizing the costs imposed on investors by such conflicts. The exemption is designed both to impose broad fiduciary standards of conduct on advisers and financial institutions, and to give them sufficient flexibility to accommodate a wide range of business practices and compensation structures that currently exist or that may develop in the future.

The Department is also considering an additional streamlined exemption that would apply to compensation received in connection with investments by plans, participants and beneficiaries, and IRA owners, in certain high-quality, low-fee investments, subject to fewer conditions than in the proposed Best Interest Contract PTE. If properly crafted, the streamlined exemption could achieve important goals of minimizing compliance burdens for advisers and financial institutions when they offer investment products with little potential for material conflicts of interest. The Department is not proposing text for such a streamlined exemption due to the difficulty in operationalizing this concept. However the Department is eager to receive comments on whether such an exemption would be worthwhile and, as part of the notice proposing the Best Interest Contract PTE, is soliciting comments on a number of issues relating to the design of a streamlined exemption.

Proposed Principal Transaction Exemption (Principal Transaction PTE)

Broker-dealers and other advisers commonly sell debt securities out of their own inventory to plans, participants and beneficiaries and IRA owners in a type of transaction known as a "principal transaction." Fiduciaries trigger taxes, remedies and other legal sanctions when they engage in such activities, unless they qualify for an exemption from the prohibited transaction rules. These principal transactions raise issues similar to those addressed in the Best Interest Contract PTE, but also raise unique concerns because the conflicts of interest are particularly acute. In these transactions, the adviser sells the security directly from its own inventory, and may be able to dictate the price that the plan, participant or beneficiary, or IRA owner pays.

Because of the prevalence of the practice in the market for fixed income securities, the Department has proposed a separate Principal Transactions PTE that would permit principal transactions in certain debt securities between a plan or IRA owner and an investment advice fiduciary, under certain circumstances.

[27] By using the term "adviser," the Department does not intend to limit the exemption to investment advisers registered under the Investment Advisers Act of 1940; under the exemption an adviser is individual who can be a representative of a registered investment adviser, a bank or similar financial institution, an insurance company, or a broker-dealer.

The Principal Transaction PTE would include all of the contract requirements of the Best Interest Contract PTE. In addition, however, it would include specific conditions related to the price of the debt security involved in the transaction. The adviser would have to obtain two price quotes from unaffiliated counterparties for the same or a similar security, and the transaction would have to occur at a price at least as favorable to the plan or IRA as the two price quotes. Additionally, the adviser would have to disclose the amount of compensation and profit (sometimes referred to as a "mark up" or "mark down") that it expects to receive on the transaction.

Amendments to Existing PTEs

In addition to the Best Interest Contract PTE and the Principal Transaction PTE, the Department is also proposing elsewhere in the **Federal Register** amendments to certain existing PTEs.

Prohibited Transaction Exemption 86–128

Prohibited Transaction Exemption (PTE) 86–128 [28] currently allows an investment advice fiduciary to cause the recipient plan or IRA to pay the investment advice fiduciary or its affiliate a fee for effecting or executing securities transactions as agent. To prevent churning, the exemption does not apply if such transactions are excessive in either amount or frequency. The exemption also allows the investment advice fiduciary to act as an agent for both the plan and the other party to the transaction (*i.e.,* the buyer and the seller of securities) and receive a reasonable fee. To use the exemption, the fiduciary cannot be a plan administrator or employer, unless all profits earned by these parties are returned to the plan. The conditions of the exemption require that a plan fiduciary independent of the investment advice fiduciary receive certain disclosures and authorize the transaction. In addition, the independent fiduciary must receive confirmations and an annual "portfolio turnover ratio" demonstrating the amount of turnover in the account during that year. These conditions are not presently applicable to transactions involving IRAs.

The Department is proposing to amend PTE 86–128 to require all fiduciaries relying on the exemption to adhere to the same impartial conduct standards required in the Best Interest Contract PTE. At the same time, the proposed amendment would eliminate relief for investment advice fiduciaries to IRA owners; instead they would be required to rely on the Best Interest Contract PTE for an exemption for such compensation. In the Department's view, the provisions in the Best Interest Contract Exemption better address the interests of IRAs with respect to transactions otherwise covered by PTE 86–128 and, unlike plan participants and beneficiaries, there is no separate plan fiduciary in the IRA market to review and authorize the transaction. Investment advice fiduciaries to plans would remain eligible for relief under the exemption, as would investment managers with full investment discretion over the investments of plans and IRA owners, but they would be required to comply with all the protective conditions, described above. Finally, the Department is proposing that PTE 86–128 extend to a new covered transaction, for fiduciaries who sell mutual fund shares out of their own inventory (*i.e.,* acting as principals, rather than agents) to plans and IRAs and to receive commissions for doing so. This transaction is currently the subject of another exemption, PTE 75–1, Part II(2) (discussed below) that the Department is proposing to revoke.

Several changes are proposed with respect to PTE 75–1, a multi-part exemption for securities transactions involving broker dealers and banks, and plans and IRAs.[29] Part I(b) and (c) currently provide relief for certain non-fiduciary services to plans and IRAs. The Department is proposing to revoke these provisions, and require persons seeking to engage in such transactions to rely instead on the existing statutory exemptions provided in ERISA section 408(b)(2) and Code section 4975(d)(2), and the Department's implementing regulations at 29 CFR 2550.408b–2. The Department believes the conditions of the statutory exemptions are more appropriate for the provision of these services.

PTE 75–1, Part II(2), currently provides relief for fiduciaries selling mutual fund shares to plans and IRAs in a principal transaction to receive commissions. PTE 75–1, Part II(2) currently provides relief for fiduciaries to receive commissions for selling mutual fund shares to plans and IRAs in a principal transaction. As described above, the Department is proposing to provide relief for these types of transactions in PTE 86–128, and so is proposing to revoke PTE 75–1, Part II(2), in its entirety. As discussed in more detail in the notice of proposed amendment/revocation, the Department believes the conditions of PTE 86–128 are more appropriate for these transactions.

PTE 75–1, Part V, currently permits broker-dealers to extend credit to a plan or IRA in connection with the purchase or sale of securities. The exemption does not permit broker-dealers that are fiduciaries to receive compensation when doing so. The Department is proposing to amend PTE 75–1, Part V, to permit investment advice fiduciaries to receive compensation for lending money or otherwise extending credit, but only for the limited purpose of avoiding a failed securities transaction.

Prohibited Transaction Exemption 84–24

PTE 84–24 [30] covers transactions involving mutual fund shares, or insurance or annuity contracts, sold to plans or IRA investors by pension consultants, insurance agents, brokers, and mutual fund principal underwriters who are fiduciaries as a result of advice they give in connection with these transactions. The exemption allows these investment advice fiduciaries to receive a sales commission with respect to products purchased by plans or IRA investors. The exemption is limited to sales commissions that are reasonable under the circumstances. The investment advice fiduciary must provide disclosure of the amount of the commission and other terms of the transaction to an independent fiduciary of the plan or IRA, and obtain approval for the transaction. To use this exemption, the investment advice fiduciary may not have certain roles with respect to the plan or IRA such as trustee, plan administrator, fiduciary with written authorization to manage the plan's assets and employers. However it is available to investment advice fiduciaries regardless of whether they expressly acknowledge their fiduciary status or are simply functional or "inadvertent" fiduciaries that have not expressly agreed to act as fiduciary advisers, provided there is no written authorization granting them discretion to acquire or dispose of the assets of the plan or IRA.

[28] Class Exemption for Securities Transactions Involving Employee Benefit Plans and Broker-Dealers, 51 FR 41686 (Nov. 18, 1986), amended at 67 FR 64137 (Oct. 17, 2002).

[29] Exemptions from Prohibitions Respecting Certain Classes of Transactions Involving Employee Benefit Plans and Certain Broker-Dealers, Reporting Dealers and Banks, 40 FR 50845 (Oct. 31, 1975), as amended at 71 FR 5883 (Feb. 3, 2006).

[30] Class Exemption for Certain Transactions Involving Insurance Agents and Brokers, Pension Consultants, Insurance Companies, Investment Companies and Investment Company Principal Underwriters, 49 FR 13208 (Apr. 3, 1984), amended at 71 FR 5887 (Feb. 3, 2006).

The Department is proposing to amend PTE 84–24 to require all fiduciaries relying on the exemption to adhere to the same impartial conduct standards required in the Best Interest Contract Exemption. At the same time, the proposed amendment would revoke PTE 84–24 in part so that investment advice fiduciaries to IRA owners would not be able to rely on PTE 84–24 with respect to (1) transactions involving variable annuity contracts and other annuity contracts that constitute securities under federal securities laws, and (2) transactions involving the purchase of mutual fund shares. Investment advice fiduciaries to IRA owners would instead be required to rely on the Best Interest Contract Exemption for most common forms of compensation received in connection with these transactions. The Department believes that investment advice transactions involving annuity contracts that are treated as securities and transactions involving the purchase of mutual fund shares should occur under the conditions of the Best Interest Contract Exemption due to the similarity of these investments, including their distribution channels and disclosure obligations, to other investments covered in the Best Interest Contract Exemption. Investment advice fiduciaries to ERISA plans would remain eligible for relief under the exemption with respect to transactions involving all insurance and annuity contracts and mutual fund shares and the receipt of commissions allowable under that exemption. Investment advice fiduciaries to IRAs could still receive commissions for transactions involving non-securities insurance and annuity contracts, but they would be required to comply with all the protective conditions, described above.

Finally, the Department is proposing amendments to certain other existing class exemptions to require adherence to the impartial conduct standards required in the Best Interest Contract PTE. Specifically, PTEs 75–1, Part III, 75–1, Part IV, 77–4, 80–83, and 83–1, would be amended. These existing class exemptions will otherwise remain in place, affording flexibility to fiduciaries who currently use the exemptions or who wish to use the exemptions in the future.

The proposed dates on which the new exemptions and amendments to existing exemptions would be effective are summarized below.

G. The Provision of Professional Services Other Than Investment Advice

Several commenters asserted that it was unclear whether investment advice under the scope of the 2010 Proposal would include the provision of information and plan services that traditionally have been performed in a non-fiduciary capacity. For example, they requested that the proposal be revised to make clear that actuaries, accountants, and attorneys, who have historically not been treated as ERISA fiduciaries for plan clients, would not become fiduciary investment advisers by reason of providing actuarial, accounting and legal services. They said that if individuals providing these services were classified as fiduciaries, the associated costs would almost certainly increase because of the need to account for their new potential fiduciary liability. This was not the intent of the 2010 proposal.

The new proposal clarifies that attorneys, accountants, and actuaries would not be treated as fiduciaries merely because they provide such professional assistance in connection with a particular investment transaction. Only when these professionals act outside their normal roles and recommend specific investments or render valuation opinions in connection with particular investment transactions, would they be subject to the proposed fiduciary definition.

Similarly, the new proposal does not alter the principle articulated in ERISA Interpretive Bulletin 75–8, D–2 at 29 CFR 2509.75–8 (1975). Under the bulletin, the plan sponsor's human resources personnel or plan service providers who have no power to make decisions as to plan policy, interpretations, practices or procedures, but who perform purely administrative functions for an employee benefit plan, within a framework of policies, interpretations, rules, practices and procedures made by other persons, are not fiduciaries with respect to the plan.

H. Effective Date; Applicability Date

Final Rule

Commenters on the 2010 Proposal asked the Department to provide sufficient time for orderly and efficient compliance, and to make it clear that the final rule would not apply in connection with advice provided before the effective date of the final rule. Many commenters also expressed concern with the provision in the Department's 2010 Proposal that the final regulation and class exemptions would be effective 90 days after their publication in the **Federal Register**. Some commenters suggested that these effective dates should be extended to as much as 12 months or longer following publication of the new rule to allow service providers sufficient time to make necessary changes in business practices, recordkeeping, communication materials, sales processes, compensation arrangements, and related agreements, as well as the time necessary to obtain and adjust to any additional individual or class exemptions. Several said that applicability of any changes in the 1975 regulation should be no earlier than two years after the promulgation of a final regulation. Other commenters thought that the effective dates in the 2010 proposal were reasonable and asked that the final rules should go into effect promptly in order to reduce ongoing harms to savers.

In response to these concerns, the Department has revised the date by which the final rule would apply. Specifically, the final rule would be effective 60 days after publication in the **Federal Register** and the requirements of the final rule would generally become applicable eight months after publication of a final rule, with the potential exceptions noted below. This modification is intended to balance the concerns raised by commenters about the need for prompt action with concerns raised about the cost and burden associated with transitioning current and future contracts or arrangements to satisfy the requirements of the final rule and any accompanying prohibited transaction exemptions.

Administrative Prohibited Transaction Exemptions

The Department proposes to make the Best Interest Contract Exemption, if granted, available on the final rule's applicability date, *i.e.,* eight months after publication of a final rule. Further, the department proposes that the other new and revised PTEs that it is proposing go into effect as of the final rule's applicability date.[31]

For those fiduciary investment advisers who choose to avail themselves of the Best Interest Contract Exemption, the Department recognizes that compliance with certain requirements of the new exemption may be difficult within the eight-month timeframe. The Department therefore is soliciting comments on whether to delay the application of certain requirements of the Best Interest Contract Exemption for several months (for example, certain data collection requirements), thereby enabling firms and advisers to benefit from the Best Interest Contract Exemption without meeting all the

[31] See the notices with respect to these proposals, published elsewhere in this issue of the **Federal Register**.

requirements for a limited period of time. Although the Department does not believe that a general delay in the application of the exemption's requirements is warranted, it recognizes that a short-term delay of some requirements may be appropriate and may not compromise the overall protections created by the proposed rule and exemptions. As discussed in more detail in the Notice proposing the Best Interest Contract Exemption published elsewhere in this issue of the **Federal Register**, the Department requests comments on this approach.

I. Public Hearing

The Department plans to hold an administrative hearing within 30 days of the close of the comment period. As with the 2010 Proposal, the Department will ensure ample opportunity for public comment by reopening the record following the hearing and publication of the hearing transcript. Specific information regarding the date, location and submission of requests to testify will be published in a notice in the **Federal Register**.

J. Regulatory Impact Analysis

Under Executive Order 12866, "significant" regulatory actions are subject to the requirements of the Executive Order and review by the Office of Management and Budget (OMB). Section 3(f) of the executive order defines a "significant regulatory action" as an action that is likely to result in a rule (1) having an annual effect on the economy of $100 million or more, or adversely and materially affecting a sector of the economy, productivity, competition, jobs, the environment, public health or safety, or State, local or tribal governments or communities (also referred to as "economically significant"); (2) creating serious inconsistency or otherwise interfering with an action taken or planned by another agency; (3) materially altering the budgetary impacts of entitlement grants, user fees, or loan programs or the rights and obligations of recipients thereof; or (4) raising novel legal or policy issues arising out of legal mandates, the President's priorities, or the principles set forth in the Executive Order. OMB has determined that this proposed rule is economically significant within the meaning of section 3(f)(1) of the Executive Order, because it would be likely to have an effect on the economy of $100 million in at least one year. Accordingly, OMB has reviewed the rule pursuant to the Executive Order.

The Department's complete Regulatory Impact Analysis is available at *www.dol.gov/ebsa/pdf/conflictsofinterestria.pdf*. It is summarized below.

Tax-preferred retirement savings, in the form of private-sector, employer-sponsored retirement plans, such as 401(k) plans ("plans"), and Individual Retirement Accounts ("IRAs"), are critical to the retirement security of most U.S. workers. Investment professionals play a major role in guiding their investment decisions. However, these professional advisers often are compensated in ways that create conflicts of interest, which can bias the investment advice they render and erode plan and IRA investment results. In order to limit or mitigate conflicts of interest and thereby improve retirement security, the Department of Labor ("the Department") is proposing to attach fiduciary status to more of the advice rendered to plan officials, participants, and beneficiaries (plan investors) and IRA investors.

Since the Department issued its 1975 rule, the retirement savings market has changed profoundly. Financial products are increasingly varied and complex. Individuals, rather than large employers, are increasingly responsible for their investment decisions as IRAs and 401(k)-type defined contribution plans have supplanted defined benefit pensions as the primary means of providing retirement security. Plan and IRA investors often lack investment expertise and must rely on experts—but are unable to assess the quality of the expert's advice or police its conflicts of interest. Most have no idea how "advisers" are compensated for selling them products. Many are bewildered by complex choices that require substantial financial literacy and welcome "free" advice. The risks are growing as baby boomers retire and move money from plans, where their employer has both the incentive and the fiduciary duty to facilitate sound investment choices, to IRAs, where both good and bad investment choices are myriad and most advice is conflicted. These "rollovers" are expected to approach $2.5 trillion over the next 5 years.[32] These rollovers, which will be one-time and not "on a regular basis" and thus not covered by the 1975 standard, will be the most important financial decisions that many consumers make in their lifetime. An ERISA plan investor who rolls her retirement savings into an IRA could lose 12 to 24 percent of the value of her savings over 30 years of retirement by accepting advice from a conflicted financial advisor.[33] Timely regulatory action to redress advisers' conflicts is warranted to avert such losses.

In the retail IRA marketplace, growing consumer demand for personalized advice, together with competition from online discount brokerage firms, has pushed brokers to offer more comprehensive guidance services rather than just transaction support. Unfortunately, their traditional compensation sources—such as brokerage commissions, revenue shared by mutual funds and funds' asset managers, and mark-ups on bonds sold from their own inventory—can introduce acute conflicts of interest. Brokers and others advising IRA investors are often able to calibrate their business practices to steer around the narrow 1975 rule and thereby avoid fiduciary status and prohibited transactions for accepting conflict-laden compensation. Many brokers market retirement investment services in ways that clearly suggest the provision of tailored or individualized advice, while at the same time relying on the 1975 rule to disclaim any fiduciary responsibility in the fine print of contracts and marketing materials. Thus, at the same time that marketing materials may characterize the financial adviser's relationship with the customer as one-on-one, personalized, and based on the client's best interest, footnotes and legal boilerplate disclaim the requisite mutual agreement, arrangement, or understanding that the advice is individualized or should serve as a primary basis for investment decisions. What is presented to an IRA investor as trusted advice is often paid for by a financial product vendor in the form of a sales commission or shelf-space fee, without adequate counter-balancing consumer protections that are designed to ensure that the advice is in the investor's best interest. In another variant of the same problem, brokers and others provide apparently tailored advice to customers under the guise of general education to avoid triggering fiduciary status and responsibility.

[32] Cerulli Associates, "Retirement Markets 2014: Sizing Opportunities in Private and Public Retirement Plans," 2014.

[33] For example, an ERISA plan investor who rolls $200,000 into an IRA, earns a 6% nominal rate of return with 3% inflation, and aims to spend down her savings in 30 years, would be able to consume $10,204 per year for the 30 year period. A similar investor whose assets underperform by 1 or 2 percentage points per year would only be able to consume $8,930 or $7,750 per year, respectively, in each of the 30 years. The 1 to 2 percentage point underperformance comes from a careful review of a large and growing body of literature which consistently points to a substantial failure of the market for retirement advice. The literature is discussed in the Department's complete Regulatory Impact Analysis (available at *www.dol.gov/ebsa/pdf/conflictsofinterestria.pdf*).

Likewise in the plan market, pension consultants and advisers that plan sponsors rely on to guide their decisions often avoid fiduciary status under the five-part test and are conflicted. For example, if a plan hires an investment professional or appraiser on a one-time basis for an investment recommendation on a large, complex investment, the adviser has no fiduciary obligation to the plan under ERISA. Even if the plan official, who lacks the specialized expertise necessary to evaluate the complex transaction on his or her own, invests all or substantially all of the plan's assets in reliance on the consultant's professional judgment, the consultant is not a fiduciary because he or she does not advise the plan on a "regular basis" and therefore may stand to profit from the plan's investment due to a conflict of interest that could affect the consultant's best judgment. Too much has changed since 1975, and too many investment decisions are made as one-time decisions and not advice on a regular basis for the five-part test to be a meaningful safeguard any longer.

The proposed definition of fiduciary investment advice included in this NPRM generally covers specific recommendations on investments, investment management, the selection of persons to provide investment advice or management, and appraisals in connection with investment decisions. Persons who provide such advice would fall within the proposed regulation's ambit if they either (a) represent that they are acting as an ERISA fiduciary or (b) make investment recommendations pursuant to an agreement, arrangement, or understanding that the advice is individualized or specifically directed to the recipient for consideration in making investment or investment management decisions regarding plan or IRA assets.

The current proposal specifically includes as fiduciary investment advice recommendations concerning the investment of assets that are rolled over or otherwise distributed from a plan. This would supersede guidance the Department provided in a 2005 advisory opinion,[34] which concluded that such recommendations did not constitute fiduciary advice. However, the current proposal provides that an adviser does not act as a fiduciary merely by providing plan investors with information about plan distribution options, including the tax consequences associated with the available types of benefit distributions.

The current proposal adopts what the Department intends to be a balanced approach to prohibited transaction exemptions. The proposal narrows and attaches new protective conditions to some existing PTEs. At the same time it includes some new PTEs with broad but targeted combined scope and strong protective conditions. These elements of the proposal reflect the Department's effort to ensure that advice is impartial while avoiding larger and costlier than necessary disruptions to existing business arrangements or constraints on future innovation.

In developing the current proposal, the Department conducted an in-depth economic assessment of the market for retirement investment advice. As further discussed below, the Department found that conflicted advice is widespread, causing serious harm to plan and IRA investors, and that disclosing conflicts alone would fail to adequately mitigate the conflicts or remedy the harm. By extending fiduciary status to more providers of advice and providing broad but targeted and protective PTEs, the Department believes the current proposal would mitigate conflicts, support consumer choice, and deliver substantial gains for retirement investors and economic benefits that more than justify its costs.

Advisers' conflicts take a variety of forms and can bias their advice in a variety of ways. For example, advisers often are paid more for selling some mutual funds than others, and to execute larger and more frequent trades of mutual fund shares or other securities. Broker-dealers reap price spreads from principal transactions, so advisers may be encouraged to recommend larger and more frequent trades. These and other adviser compensation arrangements introduce direct and serious conflicts of interest between advisers and retirement investors. Advisers often are paid a great deal more if they recommend investments and transactions that are highly profitable to the financial industry, even if they are not in investors' best interests. These financial incentives can and do bias the advisers' recommendations.

Following such biased advice can inflict losses on investors in several ways. They may choose more expensive and/or poorer performing investments. They may trade too much and thereby incur excessive transaction costs, and they may incur more costly timing errors, which are a common consequence of chasing returns.

A wide body of economic evidence, reviewed in the Department's full Regulatory Impact Analysis (available at *www.dol.gov/ebsa/pdf/conflictsofinterestria.pdf*), supports a finding that the impact of these conflicts of interest on investment outcomes is large and negative. The supporting evidence includes, among other things, statistical analyses of conflicted investment channels, experimental studies, government reports documenting abuse, and economic theory on the dangers posed by conflicts of interest and by the asymmetries of information and expertise that characterize interactions between ordinary retirement investors and conflicted advisers. A review of this data, which consistently points to a substantial failure of the market for retirement advice, suggests that IRA holders receiving conflicted investment advice can expect their investments to underperform by an average of 100 basis points per year over the next 20 years. The underperformance associated with conflicts of interest—in the mutual funds segment alone—could cost IRA investors more than $210 billion over the next 10 years and nearly $500 over the next 20 years. Some studies suggest that the underperformance of broker-sold mutual funds may be even higher than 100 basis points. If the true underperformance of broker-sold funds is 200 basis points, IRA mutual fund holders could suffer from underperformance amounting to $430 billion over 10 years and nearly $1 trillion across the next 20 years. While the estimates based on the mutual fund market are large, the total market impact could be much larger. Insurance products, Exchange Traded Funds (ETFs), individual stocks and bonds, and other products are all sold by brokers with conflicts of interest.

Disclosure alone has proven ineffective to mitigate conflicts in advice. Extensive research has demonstrated that most investors have little understanding of their advisers' conflicts, and little awareness of what they are paying via indirect channels for the conflicted advice. Even if they understand the scope of the advisers' conflicts, most consumers generally cannot distinguish good advice, or even good investment results, from bad. The same gap in expertise that makes investment advice necessary frequently also prevents investors from recognizing bad advice or understanding advisers' disclosures. Recent research suggests that even if disclosure about conflicts could be made simple and clear, it would be ineffective—or even harmful.[35]

[34] DOL Advisory Opinion 2005–23A (Dec. 7, 2005).

[35] See Loewenstein *et al.*, (2011) for a summary of some relevant literature.

Excessive fees and substandard investment performance in DC plans or IRAs, which can result when advisers' conflicts bias their advice, erode benefit security. This proposal aims to ensure that advice is impartial, thereby rooting out excessive fees and substandard performance otherwise attributable to advisers' conflicts, producing gains for retirement investors. Delivering these gains would entail compliance costs—namely, the cost incurred by new fiduciary advisers to avoid the prohibited transaction rules and/or satisfy relevant PTE conditions. The Department expects investor gains would be very large relative to compliance costs, and therefore believes this proposal is economically justified and sound.

Because of limitations of the literature and other evidence, only some of these gains can be quantified with confidence. Focusing only on how load shares paid to brokers affect the size of loads IRA investors holding front-end load funds pay and the returns they achieve, we estimate the proposal would deliver to IRA investors gains of between $40 billion and $44 billion over 10 years and between $88 and $100 billion over 20 years. These estimates assume that the rule will eliminate (rather than just reduce) underperformance associated with the practice of incentivizing broker recommendations through variable front-end-load sharing; if the rule's effectiveness in this area is substantially below 100 percent, these estimates may overstate these particular gains to investors in the front-load mutual fund segment of the IRA market. The Department nonetheless believes that these gains alone would far exceed the proposal's compliance cost which are estimated to be between $2.4 billion and $5.7 billion over 10 years, mostly reflecting the cost incurred by new fiduciary advisers to satisfy relevant PTE conditions (these costs are also front-loaded and will be less in subsequent years). For example, if only 75 percent of the potential gains were realized in the subset of the market that was analyzed (the front-load mutual fund segment of the IRA market), the gains would amount to between $30 billion and $33 billion over 10 years. If only 50 percent were realized, the expected gains in this subset of the market would total between $20 billion and $22 billion over 10 years, still several times the proposal's estimated compliance cost

These estimates account for only a fraction of potential conflicts, associated losses, and affected retirement assets. The total gains to IRA investors attributable to the rule may be much higher than these quantified gains alone. The Department expects the proposal to yield large, additional gains for IRA investors, including improvements in the performance of IRA investments other than front-load mutual funds and potential reductions in excessive trading and associated transaction costs and timing errors (such as might be associated with return chasing). As noted above, under current rules, adviser conflicts could cost IRA investors as much as $410 billion over 10 years and $1 trillion over 20 years, so the potential additional gains to IRA investors from this proposal could be very large.

Just as with IRAs, there is evidence that conflicts of interest in the investment advice market also erode plan assets. For example, the U.S. Government Accountability Office (GAO) found that defined benefit pension plans using consultants with undisclosed conflicts of interest earned 1.3 percentage points per year less than other plans.[36] Other GAO reports point out how adviser conflicts may cause plan participants to roll plan assets into IRAs that charge high fees or 401(k) plan officials to include expensive or underperforming funds in investment menus.[37] A number of academic studies find that 401(k) plan investment options underperform the market,[38] and at least one study attributes such underperformance to excessive reliance on funds that are proprietary to plan service providers who may be providing investment advice to plan officials that choose the investment options.[39]

The Department expects the current proposal's positive effects to extend well beyond improved investment results for retirement investors. The IRA and plan markets for fiduciary advice and other services may become more efficient as a result of more transparent pricing and greater certainty about the fiduciary status of advisers and about the impartiality of their advice. There may be benefits from the increased flexibility that the current proposal's PTEs would provide with respect to fiduciary investment advice currently falling within the ambit of the 1975 rule. The current proposal's defined boundaries between fiduciary advice, education, and sales activity directed at large plans, may bring greater clarity to the IRA and plan services markets. Innovation in new advice business models, including technology-driven models, may be accelerated, and nudged away from conflicts and toward transparency, thereby promoting healthy competition in the fiduciary advice market.

A major expected positive effect of the current proposal in the plan advice market is improved compliance and associated improved security of plan assets and benefits. Clarity about advisers' fiduciary status would strengthen EBSA's enforcement activities resulting in fuller and faster correction, and stronger deterrence, of ERISA violations.

In conclusion, the Department believes that the current proposal would mitigate adviser conflicts and thereby improve plan and IRA investment results, while avoiding greater than necessary disruption of existing business practices and would deliver large gains to retirement investors and a variety of other economic benefits, which would more than justify its costs.

K. Initial Regulatory Flexibility Analysis

The Regulatory Flexibility Act (5 U.S.C. 601 *et seq.*) (RFA) imposes certain requirements with respect to Federal rules that are subject to the notice and comment requirements of section 553(b) of the Administrative Procedure Act (5 U.S.C. 551 *et seq.*) and which are likely to have a significant economic impact on a substantial number of small entities. Unless an agency determines that a proposal is not likely to have a significant economic impact on a substantial number of small entities, section 603 of the RFA requires the agency to present an initial regulatory flexibility analysis (IRFA) of the proposed rule. The Department's IRFA of the proposed rule is provided below.

The Department believes that amending the current regulation by broadening the scope of service providers, regardless of size, that would be considered fiduciaries would enhance the Department's ability to redress service provider abuses that currently exist in the plan service provider market, such as undisclosed fees, misrepresentation of compensation arrangements, and biased appraisals of the value of plan investments.

The Department's complete Initial Regulatory Flexibility Analysis is available at *www.dol.gov/ebsa/pdf/conflictsofinterestria.pdf.* It is summarized below.

The Department believes that the proposal would provide benefits to small plans and their related small employers and IRA holders, and impose costs on small service providers

[36] GAO Report, Publication No. GAO–09–503T, 2009.

[37] GAO Report, Publication No. GAO–11–119, 2011.

[38] See *e.g.* Elton *et al.* (2013).

[39] See Pool *et al.* (2014).

providing investment advice to ERISA plans, ERISA plan participants and IRA holders. Small service providers affected by this rule are defined to include broker-dealers, registered investment advisers, consultants, appraisers, and others providing investment advice to small ERISA plans and IRA that have less than $38.5 million in revenue.

The Department anticipates that broker-dealers would experience the largest impact from the proposed rule and associated proposed exemptions. Registered investment advisers and other ERISA plan service providers would experience less of a burden from the rule. The Department assumes that firms would utilize whichever PTEs would be most cost effective for their business models. Regardless of which PTEs they use, small affected entities would incur costs associated with developing and implementing new compliance policies and procedures to minimize conflicts of interest; creating and distributing new disclosures; maintaining additional compliance records; familiarizing and training staff on new requirements; and obtaining additional liability insurance.

As discussed previously, the Department estimated the costs of implementing new compliance policies and procedures, training staff, and creating disclosures for small broker-dealers. The Department estimates that small broker-dealers could expend on average approximately $53,000 in the first year and $21,000 in subsequent years; small registered investment advisers would spend approximately $5,300 in the first year and $500 in subsequent years; and small service providers would spend approximately $5,300 in the first year and $500 in subsequent years. The estimated cost for small broker-dealers is believed to be an overestimate, especially for the smallest firms as they are believed to have on average simpler arrangements and they may have relationships with larger firms that help with compliance, thus lowering their costs. Additionally, broker-dealers and service providers would incur an expense of about $300 in additional liability insurance premiums for each representative or other individual who would now be considered a fiduciary. Of this expense, $150 is estimated to be paid to the insuring firms and the other $150 is estimated to be paid out as compensation to those harmed, which is counted as a transfer. Any disclosures produced by affected entities would cost, on average, about $1.53 in the first year and about $1.15 in subsequent years. These per-representative and per-disclosure costs are not expected to disproportionately affect small entities.

Although the PTEs allow firms to maintain their existing business models, some small affected entities may determine that it is more cost effective to shift business models. In this scenario, some BDs might incur the costs of switching to becoming RIAs, including training, testing, and licensing costs, at a cost of approximately $5,600 per representative.

Some small service providers may find that the increased costs associated with ERISA fiduciary status outweigh the benefit of continuing to service the ERISA plan market or the IRA market. The Department does not believe that this outcome would be widespread or that it would result in a diminution of the amount or quality of advice available to small or other retirement savers. It is also possible that the economic impact of the rule on small entities would not be as significant as it would be for large entities, because anecdotal evidence indicates that some small entities do not have as many business arrangements that give rise to conflicts of interest. Therefore, they would not be confronted with the same costs to restructure transactions that would be faced by large entities.

L. Paperwork Reduction Act

As part of its continuing effort to reduce paperwork and respondent burden, the Department of Labor conducts a preclearance consultation program to provide the general public and Federal agencies with an opportunity to comment on proposed and continuing collections of information in accordance with the Paperwork Reduction Act of 1995 (PRA) (44 U.S.C. 3506(c)(2)(A)). This helps to ensure that the public understands the Department's collection instructions; respondents can provide the requested data in the desired format; reporting burden (time and financial resources) is minimized; collection instruments are clearly understood; and the Department can properly assess the impact of collection requirements on respondents.

Currently, the Department is soliciting comments concerning the proposed information collection requests (ICRs) included in the "carve-outs" section of its proposal to amend its 1975 rule that defines when a person who provides investment advice to an employee benefit plan becomes an ERISA fiduciary. A copy of the ICRs may be obtained by contacting the PRA addressee shown below or at *http://www.RegInfo.gov.*

The Department has submitted a copy of the Conflict of Interest Proposed Rule Carveout Disclosure Requirements to the Office of Management and Budget (OMB) in accordance with 44 U.S.C. 3507(d) for review of its information collections. The Department and OMB are particularly interested in comments that:

• Evaluate whether the collection of information is necessary for the proper performance of the functions of the agency, including whether the information would have practical utility;

• Evaluate the accuracy of the agency's estimate of the burden of the collection of information, including the validity of the methodology and assumptions used;

• Enhance the quality, utility, and clarity of the information to be collected; and

• Minimize the burden of the collection of information on those who are to respond, including through the use of appropriate automated, electronic, mechanical, or other technological collection techniques or other forms of information technology, *e.g.*, permitting electronic submission of responses.

Comments should be sent to the Office of Information and Regulatory Affairs, Office of Management and Budget, Room 10235, New Executive Office Building, Washington, DC 20503; Attention: Desk Officer for the Employee Benefits Security Administration. OMB requests that comments be received within 30 days of publication of the Proposed Investment Advice Initiative to ensure their consideration.

PRA Addressee: Address requests for copies of the ICR to G. Christopher Cosby, Office of Policy and Research, U.S. Department of Labor, Employee Benefits Security Administration, 200 Constitution Avenue NW., Room N–5718, Washington, DC 20210. Telephone (202) 693–8410; Fax: (202) 219–5333. These are not toll-free numbers. ICRs submitted to OMB also are available at *http://www.RegInfo.gov.*

As discussed in detail above, Paragraph (b)(1)(i) of the proposed regulation provides a carve-out to the general definition for advice provided in connection with an arm's length sale, purchase, loan, or bilateral contract between a sophisticated plan investor, which has 100 or more plan participants, and the adviser ("seller's carve-out"). It also applies in connection with an offer to enter into such a transaction or when the person providing the advice is acting as an agent or appraiser for the plan's counterparty. In order to rely on this carve-out, the person must provide advice to a plan fiduciary who is independent of such person and who exercises authority or control respecting the management or disposition of the plan's assets, with respect to an arm's length sale, purchase, loan or bilateral contract between the plan and the counterparty, or with respect to a proposal to enter into such a sale, purchase, loan or bilateral contract.

The seller's carve-out applies if certain conditions are met. Among these conditions are the following: The adviser must obtain a written representation from the plan fiduciary that (1) the plan fiduciary is a fiduciary who exercises authority or control respecting the management or disposition of the employee benefit plan's assets (as described in section 3(21)(A)(i) of the Act), (2) that the employee benefit plan has 100 or more participants covered under the plan, and that (3) the fiduciary will not rely on the person to act in the best interests of the plan, to provide impartial investment advice, or to give advice in a fiduciary capacity.

Paragraph (b)(3) of the proposed regulation provides a carve-out making clear that persons who merely market and make available, securities or other property through a platform or similar mechanism to an employee benefit plan without regard to the individualized needs of the plan, its participants, or beneficiaries do not act as investment advice fiduciaries. This carve-out applies if the person discloses in writing to the plan fiduciary that the person is not undertaking to provide impartial investment advice or to give advice in a fiduciary capacity.

Paragraph (b)(6) of the proposal makes clear that furnishing and providing certain specified investment educational information and materials (including certain investment allocation models and interactive plan materials) to a plan, plan fiduciary, participant, beneficiary or IRA owner would not constitute the rendering of investment advice if certain conditions are met. One of the conditions is that the asset allocation models or interactive materials must explain all material facts and assumptions on which the models and materials are based and include a statement indicating that, in applying particular asset allocation models to their individual situations, participants, beneficiaries, or IRA owners should consider their other assets, income, and investments in addition to their interests in the plan or IRA to the extent they are not taken into account in the model or estimate.

The seller's carve-out written representation, platform provider carve-out disclosure, and the education carve-out disclosures for asset allocation models and interactive investment materials are information collection requests (ICRs) subject to the Paperwork Reduction Act. The Department has made the following assumptions in order to establish a reasonable estimate of the paperwork burden associated with these ICRs:

- Approximately 43,000 plans would utilize the seller's carve-out;
- Approximately 1,800 service providers would utilize the platform provider carve-out;
- Approximately 2,800 financial institutions would utilize the education carve-out;
- Plans and advisers using the seller's carve-out are entities with financial expertise and would distribute substantially all of the disclosures electronically via means already used in their normal course of business and the costs arising from electronic distribution would be negligible;
- Service providers using the platform provider carve-out already maintain contracts with their customers as a regular and customary business practice and the materials costs arising from inserting the platform provider carve-out into the existing contracts would be negligible;
- Materials costs arising from inserting the required education carve-out disclosure into existing models and interactive materials would be negligible;
- Advisers would use existing in-house resources to prepare the disclosures; and
- The tasks associated with the ICRs would be performed by clerical personnel at an hourly rate of $30.42 and legal professionals at an hourly rate of $129.94.[40]

The Department estimates that each plan would require one hour of legal professional time and 30 minutes of clerical time to produce the seller's carve-out representation. Therefore, the seller's carve-out representation would result in approximately 43,000 hours of legal time at an equivalent cost of approximately $5.6 million. It would also result in approximately 21,000 hours of clerical time at an equivalent cost of approximately $653,000. In total, the burden associated with the seller's carve-out representation is approximately 64,000 hours at an equivalent cost of $6.2 million.

The Department estimates that each service provider using the platform provider carve-out would require ten minutes of legal professional time to draft the needed disclosure. Therefore, the platform provider carve-out disclosure would result in approximately 300 hours of legal time at an equivalent cost of approximately $39,000.

The Department estimates that each financial institution using the education carve-out would require twenty minutes of legal professional time to draft the disclosure. Therefore, this carve-out disclosure would result in approximately 900 hours of legal time at an equivalent cost of approximately $121,000.

In total, the hour burden for the representation and disclosures required by the carve-outs is approximately 66,000 hours at an equivalent cost of $6.4 million.

Because the Department assumes that all disclosures would be distributed electronically or require small amounts of space to include in existing materials, the Department has not associated any cost burden with these ICRs.

These paperwork burden estimates are summarized as follows:

Type of Review: New collection (Request for new OMB Control Number).

Agency: Employee Benefits Security Administration, Department of Labor.

Title: Conflict of Interest Proposed Rule Carveout Disclosure Requirements.

OMB Control Number: 1210—NEW.

Affected Public: Business or other for-profit.

Estimated Number of Respondents: 47,532.

Estimated Number of Annual Responses: 47,532.

Frequency of Response: When engaging in excepted transaction.

Estimated Total Annual Burden Hours: 65,631 hours.

Estimated Total Annual Burden Cost: $0.

M. Congressional Review Act

The proposed rule is subject to the Congressional Review Act provisions of the Small Business Regulatory Enforcement Fairness Act of 1996 (5 U.S.C. 801 *et seq.*) and, if finalized,

[40] The Department's estimated 2015 hourly labor rates include wages, other benefits, and overhead are calculated as follows: Mean wage from the 2013 National Occupational Employment Survey (April 2014, Bureau of Labor Statistics *http://www.bls.gov/news.release/pdf/ocwage.pdf*); wages as a percent of total compensation from the Employer Cost for Employee Compensation (June 2014, Bureau of Labor Statistics *http://www.bls.gov/news.release/ecec.t02.htm*); overhead as a multiple of compensation is assumed to be 25 percent of total compensation for paraprofessionals, 20 percent of compensation for clerical, and 35 percent of compensation for professional; annual inflation assumed to be 2.3 percent annual growth of total labor cost since 2013 (Employment Costs Index data for private industry, September 2014 *http://www.bls.gov/news.release/eci.nr0.htm*).

would be transmitted to Congress and the Comptroller General for review. The proposed rule is a "major rule" as that term is defined in 5 U.S.C. 804, because it is likely to result in an annual effect on the economy of $100 million or more.

N. Unfunded Mandates Reform Act

Title II of the Unfunded Mandates Reform Act of 1995 (Pub. L. 104–4) requires each Federal agency to prepare a written statement assessing the effects of any Federal mandate in a proposed or final agency rule that may result in an expenditure of $100 million or more (adjusted annually for inflation with the base year 1995) in any one year by State, local, and tribal governments, in the aggregate, or by the private sector. Such a mandate is deemed to be a "significant regulatory action." The current proposal is expected to have such an impact on the private sector, and the Department therefore hereby provides such an assessment.

The Department is issuing the current proposal under ERISA section 3(21)(A)(ii) (29 U.S.C. 1002(21)(a)(ii)).[41] The Department is charged with interpreting the ERISA and Code provisions that attach fiduciary status to anyone who is paid to provide investment advice to plan or IRA investors. The current proposal would update and supersede the 1975 rule[42] that currently interprets these statutory provisions.

The Department assessed the anticipated benefits and costs of the current proposal pursuant to Executive Order 12866 in the Regulatory Impact Analysis for the current proposal and concluded that its benefits would justify its costs. The Department's complete Regulatory Impact Analysis is available at *www.dol.gov/ebsa/pdf/conflictsofinterestria.pdf.* To summarize, the current proposals' material benefits and costs generally would be confined to the private sector, where plans and IRA investors would, in the Department's estimation, benefit on net, partly at the expense of their fiduciary advisers and upstream financial service and product producers. The Department itself would benefit from increased efficiency in its enforcement activity. The public and overall US economy would benefit from increased compliance with ERISA and the Code and confidence in advisers, as well as from more efficient allocation of investment capital, and gains to investors.

The current proposal is not expected to have any material economic impacts on State, local or tribal governments, or on health, safety, or the natural environment. The North American Securities Administrators Association commented in support of the Department's 2010 proposal.[43]

O. Federalism Statement

Executive Order 13132 (August 4, 1999) outlines fundamental principles of federalism, and requires the adherence to specific criteria by Federal agencies in the process of their formulation and implementation of policies that have substantial direct effects on the States, the relationship between the national government and States, or on the distribution of power and responsibilities among the various levels of government. This proposed rule does not have federalism implications because it has no substantial direct effect on the States, on the relationship between the national government and the States, or on the distribution of power and responsibilities among the various levels of government. Section 514 of ERISA provides, with certain exceptions specifically enumerated, that the provisions of Titles I and IV of ERISA supersede any and all laws of the States as they relate to any employee benefit plan covered under ERISA. The requirements implemented in the proposed rule do not alter the fundamental reporting and disclosure requirements of the statute with respect to employee benefit plans, and as such have no implications for the States or the relationship or distribution of power between the national government and the States.

Statutory Authority

This regulation is proposed pursuant to the authority in section 505 of ERISA (Pub. L. 93–406, 88 Stat. 894; 29 U.S.C. 1135) and section 102 of Plan No. 4 of 1978 (43 FR 47713, October 17, 1978), effective December 31, 1978 (44 FR 1065, January 3, 1979), 3 CFR 1978 Comp. 332, and under Secretary of Labor's Order No. 1–2011, 77 FR 1088 (Jan. 9, 2012).

Withdrawal of Proposed Regulation

Paragraph (c) of the proposed regulation relating to the definition of fiduciary (proposed 29 CFR 2510.3(21)) that was published in the **Federal Register** on October 20, 2010 (75 FR 65263) is hereby withdrawn.

List of Subjects in 29 CFR Parts 2509 and 2510

Employee benefit plans, Employee Retirement Income Security Act, Pensions, Plan assets.

For the reasons set forth in the preamble, the Department is proposing to amend parts 2509 and 2510 of subchapters A and B of Chapter XXV of Title 29 of the Code of Federal Regulations as follows:

SUBCHAPTER A—GENERAL

PART 2509—INTERPRETIVE BULLETINS RELATING TO THE EMPLOYEE RETIREMENT INCOME SECURITY ACT OF 1974

■ 1. The authority citation for part 2509 continues to read as follows:

Authority: 29 U.S.C. 1135. Secretary of Labor's Order 1–2011, 77 FR 1088 (Jan. 9, 2012). Sections 2509.75–10 and 2509.75–2 issued under 29 U.S.C. 1052, 1053, 1054. Sec. 2509.75–5 also issued under 29 U.S.C. 1002. Sec. 2509.95–1 also issued under sec. 625, Pub. L. 109–280, 120 Stat. 780.

§ 2509.96–1 [Removed]

■ 2. Remove § 2509.96–1.

SUBCHAPTER B—DEFINITIONS AND COVERAGE UNDER THE EMPLOYEE RETIREMENT INCOME SECURITY ACT OF 1974

PART 2510—DEFINITIONS OF TERMS USED IN SUBCHAPTERS C, D, E, F, AND G OF THIS CHAPTER

■ 3. The authority citation for part 2510 is revised to read as follows:

Authority: 29 U.S.C. 1002(2), 1002(21), 1002(37), 1002(38), 1002(40), 1031, and 1135; Secretary of Labor's Order 1–2011, 77 FR 1088; Secs. 2510.3–21, 2510.3–101 and 2510.3–102 also issued under Sec. 102 of Reorganization Plan No. 4 of 1978, 5 U.S.C. App. 237. Section 2510.3–38 also issued under Pub. L. 105–72, Sec. 1(b), 111 Stat. 1457 (1997).

■ 4. Revise § 2510.3–21 to read as follows:

§ 2510.3–21 Definition of "Fiduciary."

(a) *Investment advice.* For purposes of section 3(21)(A)(ii) of the Employee Retirement Income Security Act of 1974 (Act) and section 4975(e)(3)(B) of the Internal Revenue Code (Code), except as provided in paragraph (b) of this section, a person renders investment advice with respect to moneys or other property of a plan or IRA described in paragraph (f)(2) of this section if—

(1) Such person provides, directly to a plan, plan fiduciary, plan participant or beneficiary, IRA, or IRA owner the

[41] Under section 102 of the Reorganization Plan No. 4 of 1978, the authority of the Secretary of the Treasury to interpret section 4975 of the Code has been transferred, with exceptions not relevant here, to the Secretary of Labor.

[42] 29 CFR 2510.3–21(c).

[43] Available at *http://www.dol.gov/ebsa/pdf/1210-AB32-PH007.pdf.*

following types of advice in exchange for a fee or other compensation, whether direct or indirect:

(i) A recommendation as to the advisability of acquiring, holding, disposing or exchanging securities or other property, including a recommendation to take a distribution of benefits or a recommendation as to the investment of securities or other property to be rolled over or otherwise distributed from the plan or IRA;

(ii) A recommendation as to the management of securities or other property, including recommendations as to the management of securities or other property to be rolled over or otherwise distributed from the plan or IRA;

(iii) An appraisal, fairness opinion, or similar statement whether verbal or written concerning the value of securities or other property if provided in connection with a specific transaction or transactions involving the acquisition, disposition, or exchange, of such securities or other property by the plan or IRA;

(iv) A recommendation of a person who is also going to receive a fee or other compensation for providing any of the types of advice described in paragraphs (i) through (iii); and

(2) Such person, either directly or indirectly (*e.g.,* through or together with any affiliate),—

(i) Represents or acknowledges that it is acting as a fiduciary within the meaning of the Act with respect to the advice described in paragraph (a)(1) of this section; or

(ii) Renders the advice pursuant to a written or verbal agreement, arrangement or understanding that the advice is individualized to, or that such advice is specifically directed to, the advice recipient for consideration in making investment or management decisions with respect to securities or other property of the plan or IRA.

(b) *Carve-outs—investment advice.* Except for persons described in paragraph (a)(2)(i) of this section, the rendering of advice or other communications in conformance with a carve-out set forth in paragraph (b)(1) through (6) of this section shall not cause the person who renders the advice to be treated as a fiduciary under paragraph (a) of this section.

(1) *Counterparties to the plan*—(i) *Counterparty transaction with plan fiduciary with financial expertise.* (A) In such person's capacity as a counterparty (or representative of a counterparty) to an employee benefit plan (as described in section 3(3) of the Act), the person provides advice to a plan fiduciary who is independent of such person and who exercises authority or control with respect to the management or disposition of the plan's assets, with respect to an arm's length sale, purchase, loan or bilateral contract between the plan and the counterparty, or with respect to a proposal to enter into such a sale, purchase, loan or bilateral contract, if, prior to providing any recommendation with respect to the transaction, such person satisfies the requirements of either paragraph (b)(1)(i)(B) or (C) of this section.

(B) Such person—

(*1*) Obtains a written representation from the independent plan fiduciary that the independent fiduciary exercises authority or control with respect to the management or disposition of the employee benefit plan's assets (as described in section 3(21)(A)(i) of the Act), that the employee benefit plan has 100 or more participants covered under the plan, and that the independent fiduciary will not rely on the person to act in the best interests of the plan, to provide impartial investment advice, or to give advice in a fiduciary capacity;

(*2*) Fairly informs the independent plan fiduciary of the existence and nature of the person's financial interests in the transaction;

(*3*) Does not receive a fee or other compensation directly from the plan, or plan fiduciary, for the provision of investment advice (as opposed to other services) in connection with the transaction; and

(*4*) Knows or reasonably believes that the independent plan fiduciary has sufficient expertise to evaluate the transaction and to determine whether the transaction is prudent and in the best interest of the plan participants (the person may rely on written representations from the plan or the plan fiduciary to satisfy this subsection (b)(1)(i)(B)(*4*)).

(C) Such person—

(*1*) Knows or reasonably believes that the independent plan fiduciary has responsibility for managing at least $100 million in employee benefit plan assets (for purposes of this paragraph (b)(1)(i)(C), when dealing with an individual employee benefit plan, a person may rely on the information on the most recent Form 5500 Annual Return/Report filed for the plan to determine the value and, in the case of an independent fiduciary acting as an asset manager for multiple employee benefit plans, a person may rely on representations from the independent plan fiduciary regarding the value of employee benefit plan assets under management);

(*2*) Fairly informs the independent plan fiduciary that the person is not undertaking to provide impartial investment advice, or to give advice in a fiduciary capacity; and

(*3*) Does not receive a fee or other compensation directly from the plan, or plan fiduciary, for the provision of investment advice (as opposed to other services) in connection with the transaction.

(ii) *Swap and security-based swap transactions.* The person is a counterparty to an employee benefit plan (as described in section 3(3) of the Act) in connection with a swap or security-based swap, as defined in section 1(a) of the Commodity Exchange Act (7 U.S.C. 1(a) and section 3(a) of the Securities Exchange Act (15 U.S.C. 78c(a)), if—

(A) The plan is represented by a fiduciary independent of the person;

(B) The person is a swap dealer, security-based swap dealer, major swap participant, or major security-based swap participant;

(C) The person (if a swap dealer or security-based swap dealer), is not acting as an advisor to the plan (within the meaning of section 4s(h) of the Commodity Exchange Act or section 15F(h) of the Securities Exchange Act of 1934) in connection with the transaction; and

(D) In advance of providing any recommendations with respect to the transaction, the person obtains a written representation from the independent plan fiduciary, that the fiduciary will not rely on recommendations provided by the person.

(2) *Employees.* In his or her capacity as an employee of any employer or employee organization sponsoring the employee benefit plan (as described in section 3(3) of the Act), the person provides the advice to a plan fiduciary, and he or she receives no fee or other compensation, direct or indirect, in connection with the advice beyond the employee's normal compensation for work performed for the employer or employee organization.

(3) *Platform providers.* The person merely markets and makes available to an employee benefit plan (as described in section 3(3) of the Act), without regard to the individualized needs of the plan, its participants, or beneficiaries, securities or other property through a platform or similar mechanism from which a plan fiduciary may select or monitor investment alternatives, including qualified default investment alternatives, into which plan participants or beneficiaries may direct the investment of assets held in, or contributed to, their individual accounts, if the person discloses in writing to the plan fiduciary that the person is not undertaking to provide

impartial investment advice or to give advice in a fiduciary capacity.

(4) *Selection and monitoring assistance.* In connection with the activities described in paragraph (b)(3) of this section with respect to an employee benefit plan (as described in section 3(3) of the Act), the person—

(i) Merely identifies investment alternatives that meet objective criteria specified by the plan fiduciary (*e.g.,* stated parameters concerning expense ratios, size of fund, type of asset, credit quality); or

(ii) Merely provides objective financial data and comparisons with independent benchmarks to the plan fiduciary.

(5) *Financial reports and valuations.* The person provides an appraisal, fairness opinion, or statement of value to—

(i) An employee stock ownership plan (as defined in section 407(d)(6) of the Act) regarding employer securities (as defined section 407(d)(5) of the Act);

(ii) An investment fund, such as a collective investment fund or pooled separate account, in which more than one unaffiliated plan has an investment, or which holds plan assets of more than one unaffiliated plan under 29 CFR 2510.3–101; or

(iii) A plan, a plan fiduciary, a plan participant or beneficiary, an IRA or IRA owner solely for purposes of compliance with the reporting and disclosure provisions under the Act, the Code, and the regulations, forms and schedules issued thereunder, or any applicable reporting or disclosure requirement under a Federal or state law, rule or regulation or self-regulatory organization rule or regulation.

(6) *Investment education.* The person furnishes or makes available any of the following categories of investment-related information and materials described in paragraphs (b)(6)(i) through (iv) of this section to a plan, plan fiduciary, participant or beneficiary, IRA or IRA owner irrespective of who provides or makes available the information and materials (*e.g.,* plan sponsor, fiduciary or service provider), the frequency with which the information and materials are provided, the form in which the information and materials are provided (*e.g.,* on an individual or group basis, in writing or orally, or via call center, video or computer software), or whether an identified category of information and materials is furnished or made available alone or in combination with other categories of information and materials identified in paragraphs (b)(6)(i) through (iv), provided that the information and materials do not include (standing alone or in combination with other materials) recommendations with respect to specific investment products or specific plan or IRA alternatives, or recommendations on investment, management, or value of a particular security or securities, or other property.

(i) *Plan information.* Information and materials that, without reference to the appropriateness of any individual investment alternative or any individual benefit distribution option for the plan or IRA, or a particular participant or beneficiary or IRA owner, describe the terms or operation of the plan or IRA, inform a plan fiduciary, participant, beneficiary, or IRA owner about the benefits of plan or IRA participation, the benefits of increasing plan or IRA contributions, the impact of preretirement withdrawals on retirement income, retirement income needs, varying forms of distributions, including rollovers, annuitization and other forms of lifetime income payment options (*e.g.,* immediate annuity, deferred annuity, or incremental purchase of deferred annuity), advantages, disadvantages and risks of different forms of distributions, or describe investment objectives and philosophies, risk and return characteristics, historical return information or related prospectuses of investment alternatives under the plan or IRA.

(ii) *General financial, investment and retirement information.* Information and materials on financial, investment and retirement matters that do not address specific investment products, specific plan or IRA alternatives or distribution options available to the plan or IRA or to participants, beneficiaries and IRA owners, or specific alternatives or services offered outside the plan or IRA, and inform the plan fiduciary, participant or beneficiary, or IRA owner about—

(A) General financial and investment concepts, such as risk and return, diversification, dollar cost averaging, compounded return, and tax deferred investment;

(B) Historic differences in rates of return between different asset classes (*e.g.,* equities, bonds, or cash) based on standard market indices;

(C) Effects of inflation;

(D) Estimating future retirement income needs;

(E) Determining investment time horizons;

(F) Assessing risk tolerance;

(G) Retirement-related risks (*e.g.,* longevity risks, market/interest rates, inflation, health care and other expenses); and

(H) General methods and strategies for managing assets in retirement (*e.g.,* systematic withdrawal payments, annuitization, guaranteed minimum withdrawal benefits), including those offered outside the plan or IRA.

(iii) *Asset allocation models.* Information and materials (*e.g.,* pie charts, graphs, or case studies) that provide a plan fiduciary, participant or beneficiary, or IRA owner with models of asset allocation portfolios of hypothetical individuals with different time horizons (which may extend beyond an individual's retirement date) and risk profiles, where—

(A) Such models are based on generally accepted investments theories that take into account the historic returns of different asset classes (*e.g.,* equities, bonds, or cash) over defined periods of time;

(B) All material facts and assumptions on which such models are based (*e.g.,* retirement ages, life expectancies, income levels, financial resources, replacement income ratios, inflation rates, and rates of return) accompany the models;

(C) Such models do not include or identify any specific investment product or specific alternative available under the plan or IRA; and

(D) The asset allocation models are accompanied by a statement indicating that, in applying particular asset allocation models to their individual situations, participants, beneficiaries, or IRA owners should consider their other assets, income, and investments (*e.g.,* equity in a home, Social Security benefits, individual retirement plan investments, savings accounts and interests in other qualified and non-qualified plans) in addition to their interests in the plan or IRA, to the extent those items are not taken into account in the model or estimate.

(iv) *Interactive investment materials.* Questionnaires, worksheets, software, and similar materials which provide a plan fiduciary, participant or beneficiary, or IRA owners the means to estimate future retirement income needs and assess the impact of different asset allocations on retirement income; questionnaires, worksheets, software and similar materials which allow a plan fiduciary, participant or beneficiary, or IRA owners to evaluate distribution options, products or vehicles by providing information under paragraphs (b)(6)(i) and (ii) of this section; questionnaires, worksheets, software, and similar materials that provide a plan fiduciary, participant or beneficiary, or IRA owner the means to estimate a retirement income stream that could be generated by an actual or hypothetical account balance, where—

(A) Such materials are based on generally accepted investment theories that take into account the historic returns of different asset classes (*e.g.*, equities, bonds, or cash) over defined periods of time;

(B) There is an objective correlation between the asset allocations generated by the materials and the information and data supplied by the participant, beneficiary or IRA owner;

(C) There is an objective correlation between the income stream generated by the materials and the information and data supplied by the participant, beneficiary or IRA owner;

(D) All material facts and assumptions (*e.g.*, retirement ages, life expectancies, income levels, financial resources, replacement income ratios, inflation rates, rates of return and other features and rates specific to income annuities or systematic withdrawal plan) that may affect a participant's, beneficiary's or IRA owner's assessment of the different asset allocations or different income streams accompany the materials or are specified by the participant, beneficiary or IRA owner;

(E) The materials do not include or identify any specific investment alternative available or distribution option available under the plan or IRA, unless such alternative or option is specified by the participant, beneficiary or IRA owner; and

(F) The materials either take into account other assets, income and investments (*e.g.*, equity in a home, Social Security benefits, individual retirement account/annuity investments, savings accounts, and interests in other qualified and non-qualified plans) or are accompanied by a statement indicating that, in applying particular asset allocations to their individual situations, or in assessing the adequacy of an estimated income stream, participants, beneficiaries or IRA owners should consider their other assets, income, and investments in addition to their interests in the plan or IRA.

(v) The information and materials described in paragraphs (b)(6)(i) through (iv) of this section represent examples of the type of information and materials that may be furnished to participants, beneficiaries and IRA owners without such information and materials constituting investment advice. Determinations as to whether the provision of any information, materials or educational services not described herein constitutes the rendering of investment advice must be made by reference to the criteria set forth in paragraph (a) of this section.

(c) *Scope of fiduciary duty—investment advice.* A person who is a fiduciary with respect to an employee benefit plan or IRA by reason of rendering investment advice (as defined in paragraph (a) of this section) for a fee or other compensation, direct or indirect, with respect to any securities or other property of such plan, or having any authority or responsibility to do so, shall not be deemed to be a fiduciary regarding any assets of the plan or IRA with respect to which such person does not have any discretionary authority, discretionary control or discretionary responsibility, does not exercise any authority or control, does not render investment advice (as defined in paragraph (a)(1) of this section) for a fee or other compensation, and does not have any authority or responsibility to render such investment advice, provided that nothing in this paragraph shall be deemed to:

(1) Exempt such person from the provisions of section 405(a) of the Act concerning liability for fiduciary breaches by other fiduciaries with respect to any assets of the plan; or

(2) Exclude such person from the definition of the term "party in interest" (as set forth in section 3(14)(B) of the Act or "disqualified person" as set forth in section 4975(e)(2) of the Code) with respect to a plan.

(d) *Execution of securities transactions.* (1) A person who is a broker or dealer registered under the Securities Exchange Act of 1934, a reporting dealer who makes primary markets in securities of the United States Government or of an agency of the United States Government and reports daily to the Federal Reserve Bank of New York its positions with respect to such securities and borrowings thereon, or a bank supervised by the United States or a State, shall not be deemed to be a fiduciary, within the meaning of section 3(21)(A) of the Act or section 4975(e)(3)(B) of the Code, with respect to an employee benefit plan or IRA solely because such person executes transactions for the purchase or sale of securities on behalf of such plan in the ordinary course of its business as a broker, dealer, or bank, pursuant to instructions of a fiduciary with respect to such plan or IRA, if:

(i) Neither the fiduciary nor any affiliate of such fiduciary is such broker, dealer, or bank; and

(ii) The instructions specify:

(A) The security to be purchased or sold;

(B) A price range within which such security is to be purchased or sold, or, if such security is issued by an open-end investment company registered under the Investment Company Act of 1940 (15 U.S.C. 80a–1, *et seq.*), a price which is determined in accordance with Rule 22c1 under the Investment Company Act of 1940 (17 CFR270.22c1);

(C) A time span during which such security may be purchased or sold (not to exceed five business days); and

(D) The minimum or maximum quantity of such security which may be purchased or sold within such price range, or, in the case of a security issued by an open-end investment company registered under the Investment Company Act of 1940, the minimum or maximum quantity of such security which may be purchased or sold, or the value of such security in dollar amount which may be purchased or sold, at the price referred to in paragraph (d)(1)(ii)(B) of this section.

(2) A person who is a broker-dealer, reporting dealer, or bank which is a fiduciary with respect to an employee benefit plan or IRA solely by reason of the possession or exercise of discretionary authority or discretionary control in the management of the plan or IRA, or the management or disposition of plan or IRA assets in connection with the execution of a transaction or transactions for the purchase or sale of securities on behalf of such plan or IRA which fails to comply with the provisions of paragraph (d)(1) of this section, shall not be deemed to be a fiduciary regarding any assets of the plan or IRA with respect to which such broker-dealer, reporting dealer or bank does not have any discretionary authority, discretionary control or discretionary responsibility, does not exercise any authority or control, does not render investment advice (as defined in paragraph (a) of this section) for a fee or other compensation, and does not have any authority or responsibility to render such investment advice, provided that nothing in this paragraph shall be deemed to:

(i) Exempt such broker-dealer, reporting dealer, or bank from the provisions of section 405(a) of the Act concerning liability for fiduciary breaches by other fiduciaries with respect to any assets of the plan; or

(ii) Exclude such broker-dealer, reporting dealer, or bank from the definition of the term party in interest (as set forth in section 3(14)(B) of the Act) or disqualified person 4975(e)(2) of the Code with respect to any assets of the plan or IRA.

(e) *Internal Revenue Code.* Section 4975(e)(3) of the Code contains provisions parallel to section 3(21)(A) of the Act which define the term "fiduciary" for purposes of the prohibited transaction provisions in Code section 4975. Effective December 31, 1978, section 102 of the Reorganization Plan No. 4 of 1978, 5 U.S.C. App. 237 transferred the authority of the Secretary of the Treasury to promulgate regulations of the type published herein to the Secretary of Labor. All references herein to section 3(21)(A) of the Act should be read to include reference to the parallel provisions of section 4975(e)(3) of the Code. Furthermore, the provisions of this section shall apply for purposes of the application of Code section 4975 with respect to any plan described in Code section 4975(e)(1).

(f) *Definitions.* For purposes of this section—

(1) "Recommendation" means a communication that, based on its content, context, and presentation, would reasonably be viewed as a suggestion that the advice recipient engage in or refrain from taking a particular course of action.

(2)(i) "Plan" means any employee benefit plan described in section 3(3) of the Act and any plan described in section 4975(e)(1)(A) of the Code, and

(ii) "IRA" means any trust, account or annuity described in Code section 4975(e)(1)(B) through (F), including, for example, an individual retirement account described in section 408(a) of the Code and a health savings account described in section 223(d) of the Code.

(3) "Plan participant" means for a plan described in section 3(3) of the Act, a person described in section 3(7) of the Act.

(4) "IRA owner" means with respect to an IRA either the person who is the owner of the IRA or the person for whose benefit the IRA was established.

(5) "Plan fiduciary" means a person described in section (3)(21) of the Act and 4975(e)(3) of the Code.

(6) "Fee or other compensation, direct or indirect" for purposes of this section and section 3(21)(A)(ii) of the Act, means any fee or compensation for the advice received by the person (or by an affiliate) from any source and any fee or compensation incident to the transaction in which the investment advice has been rendered or will be rendered. The term fee or other compensation includes, for example, brokerage fees, mutual fund and insurance sales commissions.

(7) "Affiliate" includes: Any person directly or indirectly, through one or more intermediaries, controlling, controlled by, or under common control with such person; any officer, director, partner, employee or relative (as defined in section 3(15) of the Act) of such person; and any corporation or partnership of which such person is an officer, director or partner.

(8) "Control" for purposes of paragraph (f)(7) of this section means the power to exercise a controlling influence over the management or policies of a person other than an individual.

Signed at Washington, DC, this 14th day of April, 2015.

Phyllis C. Borzi,

Assistant Secretary, Employee Benefits Security Administration, Department of Labor.

[FR Doc. 2015–08831 Filed 4–15–15; 11:15 am]

BILLING CODE 4510–29–P

DEPARTMENT OF LABOR

Employee Benefits Security Administration

29 CFR Part 2550

[Application No. D–11712]

ZRIN 1210–ZA25

Proposed Best Interest Contract Exemption

AGENCY: Employee Benefits Security Administration (EBSA), U.S. Department of Labor.

ACTION: Notice of Proposed Class Exemption.

SUMMARY: This document contains a notice of pendency before the U.S. Department of Labor of a proposed exemption from certain prohibited transactions provisions of the Employee Retirement Income Security Act of 1974 (ERISA) and the Internal Revenue Code (the Code). The provisions at issue generally prohibit fiduciaries with respect to employee benefit plans and individual retirement accounts (IRAs) from engaging in self-dealing and receiving compensation from third parties in connection with transactions involving the plans and IRAs. The exemption proposed in this notice would allow entities such as broker-dealers and insurance agents that are fiduciaries by reason of the provision of investment advice to receive such compensation when plan participants and beneficiaries, IRA owners, and certain small plans purchase, hold or sell certain investment products in accordance with the fiduciaries' advice, under protective conditions to safeguard the interests of the plans, participants and beneficiaries, and IRA owners. The proposed exemption would affect participants and beneficiaries of plans, IRA owners and fiduciaries with respect to such plans and IRAs.

DATES: *Comments:* Written comments concerning the proposed class exemption must be received by the Department on or before July 6, 2015.

Applicability: The Department proposes to make this exemption available eight months after publication of the final exemption in the **Federal Register**. We request comment below on whether the applicability date of certain conditions should be delayed.

ADDRESSES: All written comments concerning the proposed class exemption should be sent to the Office of Exemption Determinations by any of the following methods, identified by ZRIN: 1210–ZA25:

Federal eRulemaking Portal: http://www.regulations.gov at Docket ID number: EBSA–2014–0016. Follow the instructions for submitting comments.

Email to: e-OED@dol.gov.

Fax to: (202) 693–8474.

Mail: Office of Exemption Determinations, Employee Benefits Security Administration, (Attention: D–11712), U.S. Department of Labor, 200 Constitution Avenue NW., Suite 400, Washington DC 20210.

Hand Delivery/Courier: Office of Exemption Determinations, Employee Benefits Security Administration, (Attention: D–11712), U.S. Department of Labor, 122 C St. NW., Suite 400, Washington DC 20001.

Instructions. All comments must be received by the end of the comment period. The comments received will be available for public inspection in the Public Disclosure Room of the Employee Benefits Security Administration, U.S. Department of Labor, Room N–1513, 200 Constitution Avenue NW., Washington, DC 20210. Comments will also be available online at *www.regulations.gov,* at Docket ID number: EBSA–2014–0016 and *www.dol.gov/ebsa,* at no charge.

Warning: All comments will be made available to the public. Do not include any personally identifiable information (such as Social Security number, name, address, or other contact information) or confidential business information that you do not want publicly disclosed. All comments may be posted on the Internet and can be retrieved by most Internet search engines.

FOR FURTHER INFORMATION CONTACT: Karen E. Lloyd or Brian L. Shiker, Office of Exemption Determinations, Employee Benefits Security Administration, U.S. Department of Labor (202) 693–8824 (this is not a toll-free number).

Historical PNLR Liquidity Events and Potential Liquidity Candidates

Historical PNLR Liquidity Events

Company	Property Type	Total Cap ($B)	Date of Inception	Completed Capital Raise(s)	Closed Liquidity Event	Liquidity Event	Initial Offer Price	Implied Cap Rate	Annualized Total Return
Landmark Apartment Trust	Multifamily	$1.9	Jul-06	Aug-12	Jan-16	Acquired by Starwood Capital Group and Milestone Apartments REIT	$10.00	6.7%	2.9%
Industrial Income Trust	Industrial	$4.6	Dec-09	Jul-13	Nov-15	Acquired by Global Logistic Properties	$10.00	5.6%	7.5%
Chambers Street Properties	Net Lease (Off. / Indust.)	$3.3	Oct-06	Jan-12	Dec-15	Acquired by Gramercy Property Trust	$10.00	7.8%	1.9%
Cole Corporate Income Trust	Net Lease (Off. / Indust.)	$3.1	Feb-11	Nov-13	Jan-15	Acquired by Select Income REIT	$10.00	5.8%	7.7%
Griffin-American Healthcare REIT II	Healthcare / Diversified	$4.0	Aug-09	Oct-13	Dec-14	Acquired by NorthStar Realty Finance Corp.	$10.00	6.4%	10.9%
American Realty Capital Healthcare Trust, Inc.	Healthcare / Diversified	$2.6	Feb-11	Apr-13	Jan-15	Acquired by Ventas, Inc.	$10.00	6.0%	11.6%
Inland Diversified Real Estate Trust	Shopping Centers	$2.1	Aug-09	Aug-12	Jul-14	Merged with Kite Realty Group	$10.00	6.6%	7.1%
Cole Real Estate Investments, Inc.	Net Lease (Retail)	$11.3	Oct-08	Apr-12	Feb-14	Merged with American Realty Capital Properties, Inc.	$10.00	6.3%	16.6%
Corporate Property Associates 16 - Global Inc	Net Lease (Diversified)	$4.0	Dec-03	Dec-06	Jan-14	Merged with W.P. Carey	$10.00	7.7%	7.8%
American Realty Capital Trust IV	Net Lease (Retail)	$3.0	Jun-12	Apr-13	Jan-14	Merged with American Realty Capital Properties, Inc.	$25.00	6.4%	15.8%
Cole Credit Property Trust II, Inc.	Net Lease (Retail)	$3.7	Jun-05	Jan-09	Jul-13	Merged with Spirit Realty Capital	$10.00	6.5%	5.8%
American Realty Capital Trust III	Net Lease (Retail)	$2.7	Mar-11	Sep-12	Feb-13	Reverse Merger with American Realty Capital Properties, Inc.	$10.00	5.9%	26.6%
Apple REIT Six Inc	Hotel	$1.2	Jan-04	Mar-06	May-13	Acquired by BRE Select Hotels Corp (Blackstone)	$11.00	7.3%	7.6%
American Realty Capital Trust, Inc.	Net Lease (Retail)	$3.0	Jan-08	Jul-11	Jan-13	Merged with Realty Income Corp.	$10.00	6.0%	13.9%
Corporate Property Associates 15 Inc	Net Lease (Diversified)	$2.7	Nov-01	Aug-03	Sep-12	Merger with W.P. Carey and REIT conversion	$9.92	8.3%	8.3%

Source: Public company filings, Stanger Report, SNL Financial, Green Street Advisors.

Historical PNLR Liquidity Events (cont.)

Company	Property Type	Total Cap ($B)	Date of Inception	Completed Capital Raise(s)	Closed Liquidity Event	Liquidity Event	Initial Offer Price	Implied Cap Rate	Annualized Total Return
Corporate Property Associates 14, Inc.	Net Lease (Diversified)	$1.5	Dec-97	Nov-01	May-11	Merged with Corporate Property Associates 16 - Global, Inc.	$10.00	8.8%	8.6%
CNL Hotels & Resorts, Inc.	Hotels	$6.6	Jul-97	Mar-04	Apr-07	Acquired by MS Resort Holdings, LLC (Morgan Stanley RE)	$20.00	NA	7.6%
Inland Retail Real Estate Trust, Inc.	Shopping Centers	$5.9	Feb-99	Apr-03	Feb-07	Acquired by Developers Diversified Realty Corp	$10.00	NA	13.4%
CNL Retirement Properties, Inc.	Healthcare / Senior Housing	$5.2	Sep-98	Mar-06	Oct-06	Acquired by Healthcare Property Investors, Inc. (now HCP)	$10.00	6.8%	13.6%
Cornerstone Realty Income Trust, Inc.	Multifamily	$1.5	Jan-93	Oct-96	Apr-05	Merged with Colonial Properties Trust, Inc.	$11.00	NA	6.1%
CNL Restaurant Properties, Inc.	Net Lease (Restaurant)	$1.3	Apr-95	Jan-99	Feb-05	With CNL Income Funds, merged with U.S. Restaurant Properties, Inc.	$20.00	8.2%	1.4%
Columbia Property Trust	Office	$5.0	Dec-03	Aug-10	Oct-13	Listed with $234 mm tender (CXP)	$40.00	7.8%	(1.6%)
Cole Real Estate Investments, Inc.	Net Lease (Retail)	$8.6	Oct-08	Apr-12	Jun-13	Listed with $250 mm tender (COLE)	$10.00	6.9%	6.0%
Chambers Street	Net Lease (Off. / Indust.)	$3.0	Oct-06	Jan-12	May-13	Listed with $125 mm tender (CSG)	$10.00	5.7%	6.3%
Healthcare Trust of America, Inc.	Healthcare	$2.5	Sep-06	Feb-11	Jun-12	Listed with $150 mm tender (HTA)	$10.00	6.4%	7.3%
Retail Properties of America	Shopping Centers	$6.0	Sep-03	Sep-05	Apr-12	Listed with $293 mm offering (RPAI)	$25.00	8.4%	(7.4%)
American Realty Capital Trust, Inc.	Net Lease (Retail)	$2.1	Jan-08	Jul-11	Mar-12	Listed with $220 mm tender (ARCT) - later sold to Realty Income	$10.00	7.2%	9.3%
Piedmont Office Realty Trust	Office	$4.4	Jan-98	Dec-03	Feb-10	Listed with $200 mm offering (PDM)	$25.14	9.3%	3.3%
DCT Industrial Trust Inc.	Industrial	$3.0	Jul-02	Jan-06	Dec-06	Listed with $200 mm offering (DCT)	$10.00	5.3%	12.8%
Inland Real Estate Corporation	Shopping Centers	$1.3	Oct-94	Dec-98	Jun-04	Listed (IRC)	$10.00	8.7%	10.0%

Source: Public company filings, Stanger Report, SNL Financial, Green Street Advisors.

PNLR Liquidity Candidates

Entity Profiles

InvenTrust Properties (1)

- **Sector Focus**: Retail
- **Target Raise**: NA
- **Raise To Date**: $6.2 B
- **Advisor**: Inland

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- **Sector Focus**: Office / Industrial / Retail
- **Target Raise**: $2.9 B
- **Raise To Date**: $3.2 B
- **Advisor**: W.P. Carey

Cole Credit Property Trust IV

- **Sector Focus:** Net Lease / Retail
- **Target Raise:** $2.5 B
- **Raise To Date:** $3.0 B
- **Advisor:** Cole Capital

HinesREIT

- **Sector Focus:** Office
- **Target Raise:** $2.2 B
- **Raise To Date:** $2.2 B
- **Advisor:** Hines

American Realty Capital Healthcare Trust II, Inc.

- **Sector Focus:** Healthcare
- **Target Raise:** $2.3 B
- **Raise To Date:** $2.3 B
- **Advisor:** American Realty Capital

Source: Company filings, Stanger Report. (1) Formerly known as Inland American.

PNLR Liquidity Candidates (cont.)

Entity Profiles

GRIFFIN-AMERICAN HEALTHCARE REIT III

- **Sector Focus**: Healthcare
- **Target Raise**: $1.3 B
- **Raise To Date**: $1.9 B
- **Advisor**: Griffin & American

PHILLIPS EDISON GROCERY CENTER REIT I (1)

- **Sector Focus**: Retail
- **Target Raise**: $1.5 B
- **Raise To Date**: $1.8 B
- **Advisor**: Philips Edison & Company

CARTERVALIDUS MISSION CRITICAL REIT

- **Sector Focus**: Data Center / Healthcare
- **Target Raise**: $1.7 B
- **Raise To Date**: $1.8 B
- **Advisor**: Carter Validus

CNL® Healthcare Trust

- **Sector Focus**: Healthcare
- **Target Raise**: $3.0 B
- **Raise To Date**: $1.4 B
- **Advisor**: CNL Financial

NorthStar REAL ESTATE INCOME TRUST

- **Sector Focus**: Office / Multifamily / Hotel / Retail / Industrial
- **Target Raise**: $1.1 B
- **Raise To Date**: $1.2 B
- **Advisor**: NorthStar

Source: Company filings, Stanger Report. (1) Terminated advisory agreement with American Realty Capital year-end 2014.

PNLR Liquidity Candidates (cont.)

Entity Profiles

KBS Real Estate Investment Trust II

- **Sector Focus**: Office / Industrial
- **Target Raise**: $2.8 B
- **Raise To Date**: $1.0 B
- **Advisor**: KBS

Griffin Capital Essential Asset REIT

- **Sector Focus**: Office / Industrial
- **Target Raise**: $1.2 B
- **Raise To Date**: $1.0 B
- **Advisor**: Griffin Capital

Steadfast Income REIT

- **Sector Focus**: Multifamily
- **Target Raise**: $1.5 B
- **Raise To Date**: $0.8 B
- **Advisor**: Steadfast

AR Capital American Realty Capital New York City REIT

- **Sector Focus**: Office / Retail
- **Target Raise**: $0.8 B
- **Raise To Date**: $0.7 B
- **Advisor**: American Realty Capital

Source: Company filings, Stanger Report.

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REITS: BUILDING DIVIDENDS AND DIVERSIFICATION®

July 21, 2015

VIA Email: *e-ORI@dol.gov and e-OED@dol.gov*

Office of Regulations and Interpretations
Office of Exemption Determinations
Employee Benefits Security Administration
U.S. Department of Labor
200 Constitution Ave., NW
Washington, DC 20210

Re: Definition of the Term "Fiduciary" (RIN 1210-AB32);
Best Interest Contract Exemption (ZRIN 1210-ZA25)

Ladies and Gentlemen:

Thank you for the opportunity to review the Department's regulatory package expanding the definition of fiduciary investment advice and preventing conflicts of interest in advice provided to ERISA-covered retirement plans and Individual Retirement Accounts ("IRAs").

We share the Department's goal of improving the quality of investment advice provided to plans, plan participants and IRA owners. Retirement investors should receive advice in their best interests. We believe that this goal is best achieved without limiting retirement investors' access to the full range of investment products and services available to plans and IRAs.

One of the legal obligations of a prudent investment fiduciary is to diversify investments within the investment portfolio, taking into account the role various asset classes play within the portfolio's investment strategy.[1] Preserving the ability of retirement plan investors and their advisors to construct portfolios from a wide array of asset classes, including a broad range of real estate investments, is vitally important to proper diversification

About REITs:

REITs were established by Congress in 1960 to enable all Americans to enjoy the benefits of investment in real estate. There are two main types of REITs, generally referred to as equity REITs and mortgage REITs. Equity REITs invest in "bricks and mortar" real estate by acquiring leasable space in properties, such as apartments, shopping malls, office buildings, and other properties, and collecting rents from their tenants. Mortgage REITs primarily invest in

[1] *See* ERISA §404(a)(1)(C) and 29 CFR §2550.404a-1(b).

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mortgages and mortgage-backed securities, providing financing for residential and commercial properties. More than 2 million single-family homes are estimated to be currently financed by mortgages owned by mortgage REITs.

REITs in the United States may be public companies whose securities are registered with the Securities and Exchange Commission (SEC) and listed on a stock exchange (so-called Listed REITs); public companies whose securities are registered with the SEC, but which are not listed on a stock exchange (so-called, "Public Non-Listed REITS" or PNLRs); or private companies[2]. At the end of June 2015, 327 REITs were registered with the SEC, and 229 of these REITs were Listed REITs on U.S. stock exchanges, primarily the New York Stock Exchange (NYSE).

Like Listed REITs, PNLRs own, manage and lease investment-grade, income-producing commercial real estate in nearly all property sectors. PNLRs are subject to the same IRS requirements that a Listed REIT must meet, including distributing all of their taxable income to shareholders annually to be subject to just one level of taxation. In addition, PNLRs are required to make regular SEC disclosures, including quarterly and yearly financial reports. All of these PNLR filings are publicly available through the SEC's EDGAR database. PNLRs are primarily sold by broker-dealers registered with and regulated by the SEC, the Financial Industry Regulatory Association (FINRA), and the relevant state securities regulatory authorities.

About NAREIT:

The National Association of Real Estate Investment Trusts ("NAREIT") is the worldwide voice for REITs and real estate companies with interests in U.S. real estate and capital markets. NAREIT's members are REITs and other real estate businesses throughout the world that own, operate and finance commercial and residential real estate.

PNLRs participate at NAREIT through the Public Non-Listed REIT Council (the "PNLR Council"), which consists of 44 NAREIT PNLR corporate members. The mission of the PNLR Council is to advise NAREIT's Executive Board on matters of interest and importance to PNLRs.

NAREIT's PNLR Council has carefully reviewed the proposed regulation redefining fiduciary investment advice under ERISA §3(21)(A)(ii) (the "Proposal"),[3] and the new proposed prohibited transaction class exemption, the

[2] Private REITs are not traded on stock exchanges or registered with the SEC. They are regulated by the SEC, and are sold to accredited investors under Regulation D and to qualified institutional buyers (QIBs) under Rule 144A.

[3] 80 Fed. Reg. 21,928 (Apr. 20, 2015).

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Best Interest Contract Exemption (the "BIC Exemption"),[4] and has developed the attached comment letter for submission and consideration by the Department.

NAREIT and its PNLR Council look forward to working with the Department as it continues its work on this important regulatory project, and we would be pleased to answer any questions the Department may have.

Please feel free to contact me if you would like to discuss our positions in greater detail.

Respectfully submitted,

Steven A. Wechsler
President & CEO

[4] Id at 21,960.

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July 21, 2015

VIA Email: *e-ORI@dol.gov and e-OED@dol.gov*

Office of Regulations and Interpretations
Office of Exemption Determinations
Employee Benefits Security Administration
U.S. Department of Labor
200 Constitution Ave., NW
Washington, DC 20210

Re: Definition of the Term "Fiduciary" (RIN 1210-AB32);
Best Interest Contract Exemption (ZRIN 1210-ZA25)

Ladies and Gentlemen:

The Public Non-Listed REIT Council (PNLR Council) of the National Association of Real Estate Investment Trusts (NAREIT) submits the following comment with respect to the Department's regulatory package redefining fiduciary investment advice. Specifically, we submit comments on the proposed regulation (the Proposal)[1] redefining the term "fiduciary" with respect to investment advice under ERISA §3(21)(A)(ii), and the proposed prohibited transaction class exemption "Best Interest Contract Exemption" (the BIC Exemption).[2] The PNLR Council appreciates the opportunity to comment on these very important regulatory initiatives.

The PNLR Council supports the Department's goal of ensuring that financial advisors put the best interests of retirement plans, plan participants and IRA owners first. We agree that it is prudent and reasonable to update the 40 year-old fiduciary advice definition in the current regulation, given the significant changes that have occurred in retirement savings since 1975.

However, we have a number of specific concerns about the negative effect the Proposal and the BIC Exemption would have on the availability of investments, like Public Non-Listed REITs (PNLRs), used by IRA owners and participants to diversify their retirement portfolios. In addition to our specific comments below, we want to associate ourselves with, and formally endorse, the comment letters filed by the Investment Program Association and the U.S. Chamber of Commerce. These letters raise important concerns on this issue and many others that the Department should consider during its development of any final rule.

About PNLRs

PNLRs are public companies whose securities are registered with the SEC, though not listed on a stock exchange. PNLRs own, manage and lease investment-grade, income-producing commercial real estate in nearly all property sectors. PNLRs are subject to IRS requirements that include distributing all of their taxable income to shareholders annually in order to be subject to just one level of taxation, and must make regular SEC disclosures, including quarterly and yearly

[1] 80 Fed. Reg. 21,928 (Apr. 20, 2015).
[2] Id at 21,960.

financial reports, which are publicly available through the SEC's EDGAR database. Interests in a PNLR are public offerings, exchanged primarily through broker-dealers registered with and regulated by the SEC, the Financial Industry Regulatory Association ("FINRA"), and the relevant state securities regulatory authorities.

PNLRs help build diversified portfolios for retirement plan investors. Typically paying meaningful dividends due to the IRS REIT distribution requirements, PNLRs also provide the potential for moderate, long-term capital appreciation. As the leases, rents, properties and other underlying investments have tended to be responsive to inflation, PNLRs generally offer the potential for some protection from inflation risks. Further, PNLRs potentially provide an additional source of portfolio diversification because their investment returns reflect the performance of income-producing real estate, which typically has been only moderately correlated with the returns of other assets over long investment horizons.

As with mutual funds or any other pooled investment, there are a variety of fees charged in connection with PNLRs that are reflected in net returns and clearly disclosed in the prospectus, which is publicly available from the SEC. These fees will become even more transparent to PNLR shareholders when FINRA Regulatory Notice 15-02 comes into effect next year.

Specific Concerns with the Proposal and BIC Exemption

The PNLR Council is concerned that as currently written, the Proposal and the BIC Exemption would prevent many IRA owners and plan participants from having access to investments, like PNLRs, that can play an important role in diversifying retirement investment portfolios.[3] We are particularly concerned with the BIC Exemption's definition of "assets" in Sec. VIII(c)[4] of the proposed exemption. In this definition, the Department lists only certain types of investments, and PNLRs are not on the list. Investments not on the list cannot be the subject of advice provided in connection with the exemption. As a result, many advisors would be effectively prohibited from being able to discuss PNLRs at all, no matter how much doing so might be in the best interests of their clients.

This inability to discuss PNLRs would be particularly harmful if the advisor provides an investment analysis and recommendations for a client's total portfolio and the client owns shares in PNLRs outside of his or her retirement accounts. For example, advisors would be effectively unable to advise clients to use such assets inside retirement accounts, preventing them, for example, from taking into account tax efficiency in investing. Placing such limitations on the information, analysis and recommendations of investment advisers in such circumstances would inevitably compromise the ensuing advice and would depart from "best practices" dictating that assessments and recommendations be based on comprehensive information about the investors'

[3] The Investment Program Association estimates that nearly half of the PNLRs owned by retail investors are held in IRAs, although plan participants may hold PNLRs through a brokerage window.
[4] 80 Fed. Reg. 21,987 (Apr. 20, 2015).

assets and accounts."[5] Such information limits could also conflict with other regulatory requirements applicable to advisers.[6]

It is a decidedly odd result that a regulation intended to prevent conflicts that could cause an advisor to act against your best interest would actually prohibit an advisor from acting in your best interest. Further, the asset definition does not provide any additional conflict protection to IRA owners and participants. We believe the Department should not attempt to restrict the type of investments about which IRA owners or participants may receive advice, or attempt to restrict investments by IRA owners and participants that are otherwise permitted by law.

- **The Definition of Assets Should Be Removed from the BIC Exemption**

A close review of the Department's rationale for including the definition of assets, as well as the practical effects of the definition in operation, lead us to ask that the Department remove the definition from the BIC Exemption entirely. It serves only to limit investment and advice options for IRA owners and participants, while offering them no additional benefits.

The Asset Definition Provides No Additional Protection from Advisor Conflicts

The BIC Exemption's asset definition provides no additional protection against conflicts beyond those already provided by the Proposal and the BIC Exemption conduct and compensation conditions. Instead, the asset definition simply would limit the types of investments IRA owners and plan participants would be advised to make.

The Proposal would impose a general level-fee requirement on advisors by defining them to be fiduciaries for the purposes of the prohibited transaction rules. Under this general rule, advisors to plan participants and IRAs could have no financial incentive to recommend one investment over another. The BIC Exemption also would prohibit advisors from receiving compensation that would affect their advice. While the BIC Exemption would be a limited exception to the prohibited transaction rules, it generally would not allow the advisor to receive differential compensation.[7] According to Section II(d)(4), the advisor could not receive compensation incenting him or her to act against the best interest of the IRA owner or participant, and may not

[5] *See, e.g.*, "Questions Advisers Should Ask While Establishing or Reviewing Their Compliance Programs," SEC, May 2006, available at https://www.sec.gov/info/cco/adviser_compliance_questions.htm, last accessed July 19, 2015, (SEC registered investment advisers should "maintain *current and complete* information regarding each client's financial and family circumstances, investment objectives and restrictions, and risk tolerance.." and this information should be the basis for "…provid[ing]clients suitable investment advice."); FINRA Rule 2090 (Know Your Customer**)** (requiring a broker to seek to obtain and consider all relevant customer-specific information when making a recommendation); and FINRA Rule 2111 (Suitability) (requiring brokers to exercise "reasonable diligence" to ascertain the customer's investment profile prior to making a recommendation).

[6] *See, e.g.*, 31 U.S.C. §§ 5311-5330 (Bank Secrecy Act), and associated regulations 31 C.F.R. §§ 1023 et seq., and FINRA Rule 3310 (Anti-Money Laundering Compliance Program).

[7] While the BIC Exemption might permit a rollover to take place despite the fact that the advisor typically receives a higher proportional fee in an IRA than in a plan, the differential compensation in such a rollover is due to the structural differences in cost between a retail IRA and an institutionally-priced plan.

receive differential compensation unless it is in connection with a "neutral factor" that presents no conflict.[8]

Removing the asset definition from the BIC Exemption would not diminish the Department's efforts to reduce conflicts in any way.

The Asset Definition would be Contrary to the Intent of the BIC Exemption, ERISA's History, and the Practical Realities of Retirement Investing

The structure of the asset definition—its narrow application only to specifically identified assets—would be exactly contrary to the Department's stated intentions in crafting the exemption. In the Preamble to the BIC Exemption, the Department writes, "Rather than create a set of highly prescriptive transaction-specific exemptions…the proposed exemption would flexibly accommodate a wide range of current business practices…The Department has [taken] a standards-based approach…"[9] In other words, the Department's intent was to permit flexibility in the execution of principles that protect participants and IRA owners from conflicted advisors.

The Asset Definition, by contrast, would apply rigidly with no flexibility—an asset is either on the list, or not. Given the significance of the asset definition in limiting the scope of the exemption, the change in approach makes a material difference in the application of the exemption.

This list-based approach also contradicts ERISA's legislative and regulatory history. Plans and IRAs are permitted wide latitude under the law to invest in vehicles they deem prudent and appropriate—indeed, other than prohibited transaction restrictions that prevent the plan sponsor or IRA owner from inappropriately using the plan or IRA to benefit themselves, the few prohibitions on investments for plans and IRAs, pertain to certain "collectibles" and special rules for precious metals.[10] Other than these restrictions, virtually any asset class is permissible as a potential investment under ERISA.

The Department historically has rejected investment category limitations, instead focusing on the prudent selection and monitoring of such investments. Rather than telling plans what they could invest in, the Department instead issued guidance and regulations governing the investment decision process. In adopting its regulations governing the prudent investment process, the Department wrote that it,"…does not consider it appropriate to include in the regulation any list of investments, classes of investments, or investment techniques…no such list could be complete; moreover, the Department does not intent to create or suggest a 'legal list' of investments for plan fiduciaries."[11] The Department should retain this approach in the BIC Exemption and rely on the fiduciary process employed by advisors to IRA owners and participants to determine which investments should be considered for any individual's account.

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[8] 80 Fed. Reg. 21,984 (Apr. 20, 2015).
[9] Id. at 21,961
[10] *See,* 26 USC §408(m).
[11] 44 Fed. Reg. 31,639 (June 1, 1979).

Finally, as the Department explained in its rejection of a “legal list” of investments in 1979, no list could ever be complete. If the Department in any final exemption provides an asset definition that includes a specific list, it would be fixed as of that point in time. No new investments would be eligible for the BIC exemption absent a separate regulatory approval granted on a case-by-case basis. This would result in a rule and an exemption that would not adapt to an evolving marketplace, and an ever-growing number of IRA owners and participants would not be exposed to these investment opportunities arising after the adoption of the exemption.

For all of these reasons, we ask the Department to remove the asset definition from any final exemption. It would not provide any additional conflict protection to IRA owners and plan participants, but it would result in additional costs through reduced access to investment advice. In effect, the Department would be substituting its own judgment, on a one-size-fits-all basis, regarding which investment categories are appropriate for individual retirement investors, for the professional, impartial, and individualized decisions of financial advisors. The universe of individual retirement investors encompasses a diverse pool of Americans with a range of retirement needs and investment requirements, whose retirement needs are best served by considered financial advice. A contrary result disserves the statutory purpose of ERISA, to facilitate the retirement savings of all Americans.

- **If the Definition of Assets is Retained, PNLRs Should Be Added to the List**

In the Preamble to the BIC Exemption, the Department explained that the asset definition included those assets it determined were “commonly purchased”[12] by retirement plans and IRAs. The Department did not provide much additional insight into how it concluded which investments were “commonly” utilized, but suggested the listed assets should contribute to a “basic diversified portfolio” with investments that are “relatively transparent and liquid,” but it did not require a “ready market price” for inclusion.[13] We believe that PNLRs meet these criteria, and request that they be added to the asset definition.

<u>Commonly Purchased</u>

Large numbers of Americans are now invested in PNLRs, including thousands now held in IRA accounts. More than $15.6 billion was invested in in PNLRs in 2014,[14]and as indicated previously the Investment Program Association estimates that roughly half of PNLR investments are through IRAs. Investors have invested an additional $8.7 billion to date in 2015.[15] While we recognize that there may be other retirement plan investments that are more common than PNLRs, these numbers demonstrate that they are a common investment for a large number of IRA owners.

[12] 80 Fed. Reg. 21,968 (Apr. 20, 2015).
[13] Id.
[14] *The Stanger Report* ™ (Winter 2015).
[15] *The Stanger Report* ™ (Summer 2015).

Contribution to a Basic Diversified Portfolio

As the Department notes, diversification is a basic legal obligation of a prudent investment fiduciary, taking into account the role various asset classes play within the portfolio's investment strategy.[16] PNLRs can play an important role in basic diversification as they offer access to a portfolio of real estate assets that typically are not closely correlated with fixed income or equity markets, and that can offer potential inflation protection. The dividends required of PNLRs can also offer assistance in meeting cash flow requirements in various investments.

Relatively Transparent and Liquid

PNLRs are transparent public companies registered with the SEC and providing annual and quarterly reporting. In public offerings, PNLRs provide a prospectus describing the fees, risks, investment strategies and other material information for advisors and investors to make informed decisions. While they are not traded on an exchange, and thus do not have a daily market price, PNLRs are not illiquid—the terms and conditions under which distributions are made are clearly disclosed, as are any redemption fees or other charges. We note that other investments on the "approved" asset list are not traded on an exchange and have redemption fees or other restrictions applicable to investments—these features apparently do not disqualify an investment from inclusion as an eligible asset.

- **The Existing Arrangement or "Grandfather" Clause in the BIC Exemption Is Too Limited and Does Not Apply to Assets Not Covered by the Exemption, Including PNLRs. The Effective Date of the General Rule Should Be Amended to Apply Prospectively to New or Renewed Advice Arrangements, Leaving Existing Arrangements in Place Until Their Normal Expiration.**

The Department suggests that the new fiduciary definition and its associated exemptions would take effect eight months following the publication of the final rule in the Federal Register. Without a transition rule, this would result in tens of millions of existing advice arrangements having to be fundamentally reformed on a single day. Unfortunately, the only transition rule provided by the Department is in Section VII(b)(3) of the BIC Exemption, which would permit only certain eligible existing arrangements to continue, and only up to the point that additional advice would be provided after the effective date. If additional advice would be provided, the existing arrangement would have to be modified. This approach to the effective date is fundamentally flawed.

First, PNLRs and other investments not on the "legal list" of assets set forth in the BIC Exemption would be ineligible for even this limited transition rule. There is no logical rationale for a transition rule that discriminates among various asset categories, all of which were lawful prior to the effective date. Such a rule would result in the anomalous outcome that even within the same account, certain assets would be allowed to remain under the prior arrangement (at least until additional advice is provided) while other assets would immediately force account holders to negotiate a different advice arrangement. This is another example of why the asset limitations

[16] *See* ERISA §404(a)(1)(C) and 29 CFR §2550.404a-1(b).

under the BIC Exemption should be removed—they affect the entire structure of the exemption in ways unrelated to the goal of preventing conflicted advice to account holders.

Additional deleterious collateral consequences would follow from this limited transition rule. Permitting existing arrangements to stand only until such point that additional advice is provided would deny IRA owners and participants the benefit of the original bargain they made for advisory services, and create obvious disincentives to advisers to provide further advice. Many IRA owners have paid an up-front fee for advice to be provided in the future. Compelling the dissolution of such arrangements would deny account holders the benefit of the advice they have already paid for, and force the reformation of previously lawful contracts under then prevailing market conditions (favorable or otherwise). We question whether the Department has the legal authority to force two private parties who entered into a valid and legal contract for services to dissolve the contract to the detriment of the IRA owner or participant.

Accordingly, we ask the Department to adopt the following clear and straightforward "grandfather rule" applicable to all account assets acquired prior to the effective date of any final rule. With respect to new advice arrangements entered into on or after the effective date, the new regulatory standards would apply. With respect to existing advice arrangements entered into prior to the effective date —including assets acquired pursuant to such previous arrangements—the previous regulatory standards governing these arrangements would remain in effect, unless or until, they would be terminated or renewed by the parties. To do otherwise would violate common sense principles of due process respecting the rights of private parties to make and keep contracts legally entered into.

We further request that this effective date language be included in the general rule, not in the BIC Exemption. The asset definition in the BIC Exemption is linked to the "grandfather" clause, giving rise to the anomalous result that the same account could include assets that are "grandfathered" and assets that are not, further illustrating the unworkability of the BIC Exemption asset list.

In proposing the grandfather rule above, we acknowledge the difficulties posed in attempting to devise a fair BIC Exemption transition rule applicable to existing account assets acquired pursuant previous lawful arrangements. We respectfully submit that this, too, points to the impracticability of any rule prescribing "legal assets" in this manner and furthers supports our earlier arguments that this asset list should be eliminated altogether.

- **Conclusion**

We believe IRA owners and plan participants would be best served by removing the asset definition in the BIC Exemption. This would ensure they get individualized advice from financial advisors to determine what is in their individual best interests, rather than having the Department make that decision for IRA owners and plan participants. If the Department decides to retain the asset definition, we urge the Department to add PNLRs to that list.

The PNLR Council looks forward to working with the Department as it continues its efforts on this important regulatory project. We would be pleased to answer any questions the Department may have regarding PNLRs or REITs generally.

We appreciate your consideration of our comments, and please feel free to contact me if you would like to discuss our positions in greater detail.

Respectfully submitted,

Executive Committee
NAREIT PNLR Council

CHAIR:

Daniel L. Goodwin
Chairman and CEO, The Inland Real Estate Group, Inc.

Robert S. Aisner
CEO, Behringer

Sherri W. Schugart
Senior Managing Director/CEO,
Hines Interests Limited Partnership

William M. Kahane
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CEO, Griffin Capital Corporation

Charles J. Schreiber
CEO, KBS Realty Advisors

Thomas K. Sittema
CEO, CNL Financial Group

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of
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REITs:
Building
Dividends
and
Diversification®

September 24, 2015

Submitted Electronically – e-ORI@dol.gov and e-OED@dol.gov

Office of Regulations and Interpretations
Office of Exemption Determinations
Employee Benefits Security Administration
U.S. Department of Labor
200 Constitution Ave., NW
Washington, DC 20210

Re: Definition of the Term "Fiduciary" (RIN 1210-AB32);
Best Interest Contract Exemption (ZRIN 1210-ZA25)

Ladies and Gentlemen:

We appreciate the opportunity to offer additional comments regarding the Department's regulatory package expanding the definition of fiduciary investment advice and preventing conflicts of interest in advice provided to ERISA-covered retirement plans and Individual Retirement Accounts ("IRAs").

The extensive comments received by the Department and the four days of public hearings on the proposed rule and the accompanying prohibited transaction exemptions demonstrated the significant public interest in these issues. This interest is quite appropriate given the Department's goal of changing the way investment advice is provided to all ERISA-covered retirement plans and to all Individual Retirement Accounts ("IRAs"), representing many trillions of dollars in retirement savings. These public hearings also served to highlight the fact that there are many discrete items of discussion within the broader package, some of which are quite controversial.

As we previously wrote[1], NAREIT shares the Department's goal of improving the quality of investment advice provided to plans, plan participants and IRA owners, and of ensuring such advice is in their best interests. However, we remain very concerned that the Department must achieve this goal without limiting retirement investors' access to the full range of investment products and services available to plans and IRAs.

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[1] See, letter from the Executive Committee of the Public Non-listed REIT Council of the National Association of Real Estate Investment Trusts (NAREIT), July 21, 2015 to the Department of Labor *available at*. http://www.dol.gov/ebsa/regs/cmt-1210-AB32-2.html

As a number of witnesses testified during the public hearings, retirement investors must be able to diversify their holdings across a broad spectrum of risks as part of a prudent retirement portfolio. Further, each plan, each participant, and each IRA owner has individualized retirement needs and objectives. Consequently, the Department's regulatory efforts must ensure that advisors to these plans, participants, and IRA owners are able to discuss all available investment alternatives, not just selected asset types. Those alternatives must include a broad range of real estate investments to allow advisors to act in the best interest of retirement investors.

About NAREIT:

The National Association of Real Estate Investment Trusts ("NAREIT") is the worldwide voice for REITs and real estate companies with interests in U.S. real estate and capital markets. NAREIT's members are REITs and other real estate businesses throughout the world that own, operate and finance commercial and residential real estate. Public Non-Listed REITS ("PNLR") participate at NAREIT through the Public Non-Listed REIT Council (the "PNLR Council"), which consists of 42 NAREIT PNLR corporate members. The mission of the PNLR Council is to advise NAREIT's Executive Board on matters of interest and importance to PNLRs.

NAREIT's PNLR Council has reviewed the public comments filed in July and the testimony presented at the August hearings, and has developed the attached additional comment letter for submission and consideration by the Department.

NAREIT and its PNLR Council look forward to working with the Department as it works on developing a final rule and final prohibited transaction class exemptions, and we would be pleased to answer any questions the Department may have.

Please feel free to contact me if you would like to discuss our positions in greater detail.

Respectfully submitted,

Steven A. Wechsler
President & CEO

September 24, 2015

Submitted Electronically – [e-ORI@dol.gov and e-OED@dol.gov](mailto:e-ORI@dol.gov)

Office of Regulations and Interpretations
Office of Exemption Determinations
Employee Benefits Security Administration
U.S. Department of Labor
200 Constitution Ave., NW
Washington, DC 20210

Re: Definition of the Term "Fiduciary" (RIN 1210-AB32);
Best Interest Contract Exemption (ZRIN 1210-ZA25)

Ladies and Gentlemen:

The Public Non-Listed REIT Council ("PNLR Council") of the National Association of Real Estate Investment Trusts ("NAREIT") appreciates the opportunity to submit these additional comments following the public hearings on the Department's regulatory efforts to redefine fiduciary investment advice provided to ERISA plans, plan participants and beneficiaries, and IRA owners. Specifically, we submit additional comments on the proposed regulation (the "Proposal")[1] redefining the term "fiduciary" with respect to investment advice under ERISA §3(21)(A)(ii), and the proposed prohibited transaction class exemption "Best Interest Contract Exemption" (the "BIC Exemption").[2]

<u>About PNLRs:</u>

As we discussed in our July 21, 2015 letter to the Department[3], PNLRs are valuable investment options for many investors and are commonly found in IRA portfolios. They are public companies whose securities are registered with the SEC, though not listed on a stock exchange. PNLRs are subject to IRS requirements that include distributing all of their taxable income to shareholders annually in order to be subject to just one level of taxation, and must make regular SEC disclosures, including quarterly and yearly financial reports, which are publicly available through the SEC's EDGAR database. As with mutual funds or any other pooled investment, there are a variety of fees charged in connection with PNLRs that are reflected in net returns and clearly disclosed in the prospectus, which is publicly available from the SEC. These fees will become even more transparent to PNLR shareholders when FINRA Regulatory Notice 15-02 comes into effect next year.

Overview:

As we explained in our July 21, 2015 comment letter, the PNLR Council supports the goals behind the Department's regulatory efforts. We agree that retirement investors should receive advice that is in their best interest—the needs of the participant or IRA owner should come first.

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[1] 80 Fed. Reg. 21,928 (Apr. 20, 2015).
[2] Id at 21,960.
[3] See, letter from the Executive Committee of the Public Non-listed REIT Council of the National Association of Real Estate Investment Trusts (NAREIT), July 21, 2015 to the Department of Labor *available at* http://www.dol.gov/ebsa/regs/cmt-1210-AB32-2.html.

In fact, it is precisely because of our strong belief in this core principle that we are again writing to ask the Department to remove the limited definition of "asset" in the Best Interest Contract Exemption (the "BIC Exemption"). The practical effect of the limited list of assets in the definition is to prevent advisors from putting the participant or IRA owner first—an advisor using the BIC Exemption is simply not allowed to discuss assets not on the list, no matter how much those assets are in the best interest of the participant. This outcome is inconsistent with the Department's purpose in proposing the rule.

The BIC Exemption Should Allow Advisors to Provide Individualized Advice in the Best Interest of Investors Planning for Retirement:

The Department received extensive comments on this regulatory package, and heard testimony from witnesses for four full days at the recent administrative hearings. This public interest is due to a basic but crucial fact—the Department's decisions will have significant consequences on the adequacy of the retirement savings of America's workers. We reviewed many of these comments, and followed the testimony presented at the hearings, particularly as they related to the BIC Exemption.

This review suggests a contradiction between the Department's policy goals and the effect of the BIC Exemption. The purpose of the regulatory package is to ensure retirement investors get quality, impartial, individualized advice from financial professionals. The Proposal and the BIC Exemption are both designed to do this by removing conflicts of interest. Yet the list of "approved" assets in the BIC Exemption prevents those same advisors from giving quality, impartial, individualized advice about any asset not on the list. Regardless of the individual circumstances of the IRA owner, her impartial advisor cannot discuss an asset not on the Department's one-size-fits-all list of assets if the advisor is using the BIC Exemption.

Obviously, each retirement investor has different needs, different retirement objectives, and different types of personal assets outside of retirement accounts—all of this must be taken into account when an advisor makes an investment recommendation. Advice in the retirement investor's best interest is individualized, and an investment right for one person may not be right for another. Logically then, it doesn't make sense for the Department to exclude entire asset classes from advice available to tens of millions of retirement investors, especially when doing so adds no additional protection from conflicts of interest.

The BIC Exemption Must Be Redrafted to Avoid Negative Consequences for Participants and IRA Owners:

In an exchange regarding the BIC Exemption asset list between a hearing witness and a Department official, the official suggested that the asset list didn't prevent an advisor from giving advice on any asset so long as that advice occurred outside of the BIC Exemption.[4] While this is technically true, it does not address the fundamental problem. The BIC Exemption will likely be necessary for a large number of plan transactions. For example, the BIC Exemption will likely be necessary for advisors assisting plan participants with IRA rollovers. It is also

[4] Raw transcript of testimony presented on August 11, 2015, at 638, accessed on September 21, 2015 at http://www.dol.gov/ebsa/pdf/1210-AB32-2-HearingTranscript2.pdf.

likely that the BIC Exemption could become a preferred compliance method for advisors operating under the new rules to address other situations. Consequently, our concerns regarding the asset list underscore a fundamental flaw in the structure of the BIC Exemption and the entire regulatory package.

For all of these reasons, the PNLR Council continues to believe that the Department must address this issue in the final rule. As written, the Proposal and the BIC Exemption would have a negative effect on the availability of quality investments, like PNLRs, used by IRA owners and participants to diversify their retirement portfolios.

- **Remove the List from the Asset Definition**

Our preferred solution to the problem would be to amend the BIC Exemption definition of assets in Sec. VIII(c)[5] to remove the list entirely. It serves only to limit investment and advice options for IRA owners and participants, while offering them no additional benefits.

As discussed above and in our July 21, 2015 comment letter, the Proposal and the BIC Exemption already prohibit conflicts of interest—the asset list provides no additional protection against conflicts. Further, the structure of the asset list is contrary to the purpose of the BIC Exemption, which was to "…flexibly accommodate a wide range of current business practices…" through a principles-based exemption.[6] The asset list is anything but flexible—it is a bright line dividing assets into those that can and can't be discussed, regardless of their merits to any particular individual.

Finally, as we highlighted in our previous letter, the Department historically has rejected investment asset class limits, writing, "no such list could be complete…"[7] This is a very good point—an asset list in BIC would be fixed as of that point in time. No new investments would be eligible for the BIC exemption absent a separate regulatory approval granted on a case-by-case basis.

- **Other Alternatives**

If the Department will not remove the asset list from the BIC Exemption, we ask that the definition be modified to permit important investments like PNLRs that help IRA owners achieve diversified portfolios composed of asset classes with relatively uncorrelated risks and returns.

One solution would be to add PNLRs to the list of assets in the definition. As we discussed in our July 21, 2015 comment letter, we believe PNLRs meet the criteria identified in the Preamble to the BIC Exemption that investments be "commonly purchased"[8] by retirement plans and IRAs, and contribute to a "basic diversified portfolio" with investments that are "relatively transparent and liquid" even if there is no "ready market price."[9]

[5] 80 Fed. Reg. 21,987 (Apr. 20, 2015).
[6] Id. at 21,961
[7] 44 Fed. Reg. 31,639 (June 1, 1979).
[8] 80 Fed. Reg. 21,968 (Apr. 20, 2015).
[9] Id.

We also urge the Department to consider the promising approach proposed by the Investment Program Association ("IPA") in its September 24, 2015 comment letter, which sets forth an expanded set of Policies and Procedures applicable solely to retirement plan investments in "Public Products" (including PNLRs). We would welcome the opportunity to discuss these ideas further with the Department.

The Proposal and the BIC Exemption Need a Reasonable Transition Rule:

As the Department heard from a number of witnesses in the hearings, the transition rule for the Proposal and the BIC Exemption does not work as proposed. The Department suggests that the new fiduciary definition and its associated exemptions would take effect eight months following the publication of the final rule in the Federal Register. Without a transition rule, this would result in tens of millions of existing advice arrangements having to be fundamentally reformed on a single day. Unfortunately, the only transition rule provided by the Department is in Section VII(b)(3) of the BIC Exemption, which would permit only certain eligible existing arrangements to continue, and only up to the point that additional advice would be provided after the effective date. If additional advice would be provided, the existing arrangement would have to be modified. The PNLR Council initially raised this in its July 21, 2015 comment letter and our review of the hearing testimony has reinforced our view that the Proposal's approach to the effective date is fundamentally flawed in a number of ways.

First, the asset definition would affect the BIC Exemption transition rule; PNLRs and other investments not on the "legal list" of assets set forth in the BIC Exemption would be ineligible. Thus, the same IRA account might have assets to which the transition rule applies, and assets to which it does not. Further, the Proposal would disrupt legal contracts entered into voluntarily by willing parties under the prior rule—it is questionable whether the Department can disrupt these otherwise valid contracts.

Accordingly, we reiterate our request that the Department adopt the following clear and straightforward transition rule: With respect to new advice arrangements entered into on or after the effective date, the new regulatory standards would apply. With respect to existing advice arrangements entered into prior to the effective date —including assets acquired pursuant to such previous arrangements—the previous regulatory standards governing these arrangements would remain in effect until they are terminated or renewed by the parties.

We further request that this effective date language be included in the general rule, not in the BIC Exemption only, so that this sensible approach is generally applicable.

Conclusion:

We continue to believe IRA owners and plan participants would be best served by removing the asset list from the asset definition in the BIC Exemption. This would ensure advisors are able to act in their client's individualized best interest, rather than having the Department make that decision for IRA owners and plan participants. We also urge the Department to adopt a clear, straightforward and traditional transition rule permitting contractual arrangements agreed to prior to the effective date to be governed by the regulatory standards in place at that time.

The PNLR Council looks forward to working with the Department, and we would be pleased to answer any questions the Department may have regarding PNLRs or REITs generally.

Thank you for your consideration of our comments, and please feel free to contact me if you would like to discuss our positions in greater detail.

Respectfully submitted,

Executive Committee
NAREIT PNLR Council

CHAIR:

Daniel L. Goodwin
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CEO, CNL Financial Group

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Public Non-Listed REITs

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FINRA Regulatory Notice 15-02

The SEC approved amendments to NASD Rule 2340 (Customer Account Statements) to modify the requirements relating to the inclusion of per share estimated values for public non-listed real estate investment trust (REIT) securities on account statements.

The amendments becomes effective on April 11, 2016.

Salient rule changes that will affect disclosure and practice are as follows:

- FINRA proposes two methodologies under which reported values are to be presumed reliable and included on customer account statements: (1) Net Investment, and (2) Independent Valuation.

- Net Investment may be used no longer than 2 years plus 150 days after breaking escrow. Net Investment is defined as the gross operating share price less selling commissions & organizational offering expenses.

- Guidance on valuation methodology and practice is referenced in FINRA 15-02 to the Investment Program Association (IPA) guidance on the valuation of public non-listed REITs

Valuation – Best Practices & IPA Guidelines

- Objectives of the IPA Guidelines are as follows:
  - ✓ Promote improved uniformity and consistency of valuation techniques by public non-listed REITs (“PNLRs”);
  - ✓ Establish standards with respect to the timing of implementation and reporting of estimated valuations and enhance the disclosure of valuations and of the methodology used to develop such valuations;
  - ✓ Enhance public confidence in the PNLR industry by improving the transparency of valuations of PNLRs;
  - ✓ Provide information useful to assist fiduciaries of tax qualified pension, stock-bonus or profit-sharing plans,
  - ✓ Assist broker/dealers and registered investment advisors who require valuation information for client account statement reporting, due diligence reviews, and for ongoing monitoring of investment performance; and

Valuation – Best Practices & IPA Guidelines

The term “Valuation” as used herein refers to an estimated value per share reported by the PNLR distinct from the offering price of the PNLR’s security.

- Basis of Valuations- Valuation of PNLR securities be based upon the PNLR’s net asset value per share (“NAV Per Share”).

- NAV Valuation Definition

  - ✓ Net Asset Value: *The fair value of real estate, real estate-related investments and all other assets less the fair value of total liabilities.*

  - ✓ Fair value: The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

Valuation – Best Practices & IPA Guidelines

- Independence of Valuations & Management of Process - Establishment of a Valuation Committee comprised of independent directors responsible for oversight of the valuation process.

    - ✓ Engage third party valuation firms - ensure that valuation performed is in accordance with USPAP as well as certified by MAI members of the Appraisal Institute
    - ✓ Enterprise Value and/or Portfolio Premium is NOT to be considered
    - ✓ Review and approve the proposed valuation process and methodology to be used to determine the valuation
    - ✓ Review the reasonableness of the valuation or range of values resulting from the process
    - ✓ Recommend the final proposed Valuation for approval by the board of directors.

Valuation – Best Practices & IPA Guidelines

- As Of Valuation Date(s) and Frequency of Valuations

  ✓ Once Valuations commence, in accordance with 15-02 the IPA recommends that Valuations be produced at least annually thereafter (15-02 also promulgates annual valuation at a minimum)

  ✓ IPA guidelines state that valuations are to be completed by an independent third-party every 2 years or may be performed by the Company or its advisor in the intervening years, provided the PNLR engages a qualified third-party valuation expert to provide assistance in and confirmation of the valuation process and resulting valuation. (In reality, most have had independent appraisals completed as it has better optics with broker-dealer community.)

Valuation – Best Practices & IPA Guidelines

- Reporting of Valuations & Recommended Disclosure

  ✓ The IPA recommends that: (i) per share valuations be reported in public filings and in annual reports sent to investors; and (ii) such reporting be accompanied by disclosure text sufficient to allow broker-dealers to provide information on customer account statements consistent with the requirements of FINRA Rule 2340 and for Stakeholders to understand the nature and quality of the valuation. **<u>The IPA also recommends that the NL REIT disclose its valuation policies and, to the extent practicable given the specificity of its investment portfolio, valuation procedures including the anticipated role of third-party valuation experts, in its prospectus or other offering materials filed with the SEC.</u>**

  ✓ The IPA also recommends that PNLRs either maintain a written Valuation Policy which can be provided to broker-dealer due diligence personnel and other selected Stakeholders in accordance with policies established by the PNLR

Valuation – Best Practices & IPA Guidelines

Each PNLR is encouraged to consider the applicability of including the following items in summary disclosures relating to the valuation:

- ✓ the process by which the valuations were conducted;
- ✓ the roles of the Valuation Committee, the PNLR's management and advisor, and third-parties involved in the process;
- ✓ the identification of the third-party valuation expert(s) their qualifications;
- ✓ the process by which independent external valuation services are conducted and their relationship to internal valuations, if any;
- ✓ the frequency of valuations, the date of the valuation being reported, and the age of the data utilized for the Valuation;
- ✓ general description of the methodology used to value the PNLR's real estate and real estate-related investments;

Valuation – Best Practices & IPA Guidelines

Each PNLR is encouraged to consider the applicability of including the following items in summary disclosures relating to the valuation:

- ✓ description of the key valuation assumptions and any specific valuation parameters utilized, including but not limited to: (i) the weighted average and range, as applicable to the valuation method(s) used, of going-in and terminal capitalization rates, discount rates, and per unit values; and (ii) the holding period utilized;
- ✓ a statement of valuation sensitivity reflecting the impact on the estimated per share valuation of a 5% change in average discount rates in the case of discounted cash flow analysis or a 5% change in going-in capitalization rates in the case of direct capitalization analysis;
- ✓ general overview of procedures used to value debt and other balance sheet assets and liabilities and;
- ✓ general overview of procedures used to determine allocations of the PNLR's gross equity value among various classes of securities holders or unitholders, the PNLR's management/advisor and other minority interest holders;

Valuation – Best Practices & IPA Guidelines

- ✓ disclosure of the limitations inherent in any estimated valuation and any specific limitations and qualifications relating to the Valuation disclosed by the PNLR.
- ✓ disclosure that the Valuation has been performed in accordance with the Investment Program Association Practice Guideline 2013-01, Valuations of Public Non-Listed REITs.
- ✓ disclosure concerning potential conflicts of interest with respect to the engagement of third-party valuation expert

Valuation – Best Practices & IPA Guidelines

- **Accessibility of Non-Public Valuation Information for Broker-Dealer Confidential Use In Connection with Due Diligence**

✓ The IPA recommends that PNLR's allow reasonable access by broker-dealer personnel or designated due diligence representatives or consultants ("Due Diligence Representatives") to review supporting materials related to the valuation and deemed relevant to evaluating the nature and quality of the valuation, subject to the following provisions:

  ➢ the broker-dealer and its Due Diligence Representatives enter into mutually satisfactory non-disclosure agreements with the PNLR and the valuation expert;

  ➢ the broker-dealer and/or its Due Diligence Representatives acknowledge their observance of the proscriptions on use and communication of nonpublic information as set forth in SEC Regulation FD; and

  ➢ the broker-dealer and/or its due diligence representatives agree that PNLR representatives be given the opportunity to participate in any discussions between the broker-dealer or its due diligence representatives and the independent valuation expert(s) concerning the valuation process and results.

Investor Alerts and Bulletins

Investor Bulletin: Non-traded REITs

Aug. 31, 2015

The SEC's Office of Investor Education and Advocacy is issuing this bulletin to educate investors about investing in non-traded REITs.

What are REITs?

A *REIT*, or real estate investment trust, is a company that owns – and typically operates – income-producing real estate or real estate-related assets. The income-producing real estate assets owned by a REIT may include real assets (*e.g.*, an apartment or commercial building) or real estate-related debt (*e.g.*, mortgages). Most REITs specialize in a single type of real estate – for example, apartment communities. There are retail REITs, office REITs, residential REITs, healthcare REITs and industrial REITs, to name a few.

What is the difference between publicly traded REITs and non-traded REITs?

Publicly traded REITs (also called *exchange-traded REITs*) are registered with the SEC, file regular reports with the SEC and are listed on an exchange such as the NYSE or NASDAQ. As with stocks listed on an exchange, you can buy and sell a publicly traded REIT with relative ease. An investment in publicly traded REITs is typically a liquid investment. Similarly, you can easily assess the value of the publicly traded REIT by noting the share price at which the REIT is trading on the exchange.

In contrast, there are also ***non-traded REITs*** that are registered with the SEC, file regular reports with the SEC, but are ***not*** listed on an exchange and are ***not*** publicly traded. An investment in a non-traded REIT poses risks different than an investment in a publicly traded REIT.

Some risks of non-traded REITs to consider before investing

- ***Lack of liquidity.*** Non-traded REITs are illiquid investments, which mean that they cannot be sold readily in the market. Instead, investors generally must wait until the non-traded REIT lists its shares on an exchange or liquidates its assets to achieve liquidity. These liquidity events, however, might not occur until more than 10 years after your investment.

  Non-traded REITs usually offer investors' opportunities to redeem their shares early but these share redemption programs are typically subject to significant limitations and may be discontinued at the discretion of the REIT without notice. Redemption programs also may require that shares be redeemed at a discount, meaning investors lose part of their investment if they redeem their shares.

  For these reasons, investors with short time horizons or who may need to sell an asset to raise money quickly may not be able to do so with shares of a non-traded REIT.

- ***High fees.*** Non-traded REITs typically charge high upfront fees to compensate a firm or individual selling the investment and to lower their offering and organizational costs. ***These fees can represent up to 15 percent of the offering price, which lowers the value and return of your investment and leaves less money for the REIT to invest.*** In addition to the high upfront fees, non-traded REITs may have significant transaction costs, such as property acquisition fees and asset management fees.

> ***Check your broker or investment adviser.*** Whether working with a broker or an investment adviser, it is important to check that they are registered with the SEC or a state securities regulator. ***If the person is not registered, it could be a red flag for fraud.*** You can find out if someone is registered and obtain information about the person by visiting the SEC's Investment Adviser Public Disclosure (IAPD) website or FINRA's BrokerCheck website. You can also check with your state securities regulator about the person soliciting your investment.

- ***Distributions may come from principal.*** Investors may be attracted to non-traded REITs by their high distributions, which may be referred to as dividend yields, compared to other investment options, including publicly traded REITs. However, the initial distributions may not represent earnings from operations since non-traded REITs often declare these distributions prior to acquiring significant assets. Investors should consider the total return of a non-traded REIT – capital appreciation plus distributions – instead of focusing exclusively on the high distributions. ***Non-traded REITs may use offering proceeds, which includes the money you invested, and borrowings to pay distributions. This practice reduces the value of the shares and reduces the cash available to the REIT to purchase real estate assets***.

- ***Lack of share value transparency.*** Because non-traded REITs are not publicly traded, there is no market price readily available. Consequently, it can be difficult to determine the value of a share of a non-traded REIT or the performance of your investment. In addition, any share valuation will be based on periodic or annual appraisals of the properties owned by the non-traded REIT, and therefore may not be accurate or timely. ***As a result, you may not be able to assess the value or performance of your non-traded REIT investment for significant time periods.***

- ***Conflicts of interest.*** Non-traded REITs are typically externally managed – meaning the REITs do not have their own employees. ***As noted above, the external manager may be paid significant transaction fees by the REIT for services that may not necessarily align with the interests of shareholders, such as fees based on the amount of property acquisitions and assets under management.*** In addition, the external manager may manage or be affiliated with other companies that may compete with the REIT in which you are invested or that are paid by the REIT for services provided, such as property management or leasing fees.

Where can I get information about a non-traded REIT?

When offered an opportunity to invest in a non-traded REIT, your financial professional should provide you with a copy of a *prospectus* for the investment. The prospectus is the offering document describing the REIT's investment strategy, offering terms, risks and other information that you should consider when deciding whether to invest. There may also be *supplements* to the prospectus detailing changes since the original date of the prospectus. ***You should carefully review the prospectus and any prospectus supplements before making any investment decision.*** The prospectus and any supplements can also be found through the SEC's EDGAR database usually identified as a "424B3" filing.

Non-traded REITs that are registered with the SEC also must regularly file quarterly and annual reports detailing the financial results of the non-traded REIT. These reports can be found on the SEC's EDGAR database and are identified as a Form 10-Q for a quarterly report and a Form 10-K for an annual report. Forms 8-K may also be filed in connection with the occurrence of certain events that require disclosure. ***You should carefully review these reports before investing.***

Chart comparing REIT types

	Publicly traded REITs	**Non-traded REITs**
Overview	REITs that file with the SEC and whose shares trade on national stock exchanges.	REITs that file with the SEC but who shares do not trade on national stock exchanges.
Liquidity	Shares are listed and traded, like any publicly traded stock, on major stock exchanges. Most are NYSE listed.	Shares are not traded on public stoc exchanges. Redemption programs fc shares vary by company and are lim Generally a minimum holding period investment exists. Investor exit strat generally linked to a required liquidat after some period of time (often 10 years) or, instead, the listing of the stock on a national stock exchange such time.
Transaction costs	Brokerage costs the same as for buying or selling any other publicly traded stock.	Typically, fees of 10-15 percent of th investment are charged for broker-de commissions and other up-front cost Ongoing management fees and expenses also are typical. Back-end fees may be charged.
Management	Typically self-advised and self-managed.	Typically externally advised and managed.

Minimum investment amount	One share.	Typically $1,000 - $2,500.
Performance measurement	Numerous independent performance benchmarks available for tracking listed REIT industry. Wide range of analyst reports available to the public.	No independent source of performan data available.

Source: National Association of Real Estate Investment Trusts (NAREIT)

Private REITs. In addition to publicly traded REITs and non-traded REITs, there are also *private REITs*. Similar to non-traded REITs, private REITs are not listed making them hard to value and trade. Private REITs also do not regularly file disclosure reports with the SEC possibly making it difficult for you to keep informed of your investment. Instead, private REIT offerings are private placements and rely on an exemption from the obligation to register with the SEC. Investors are typically limited to accredited investors.

Additional Information

See FINRA's investor alert about non-traded REITs for more information.

For more information about REITs generally, see our Investor Bulletin.

For information about how fees impact your investment, see our Investor Bulletin.

To learn about how to research your investment professional, see our Investor Bulletin.

For our Investment Adviser Public Disclosure (IAPD) website, visit adviserinfo.sec.gov.

For FINRA's BrokerCheck, visit brokercheck.finra.org.

To locate contact information for your state securities regulator, visit nasaa.org.

For information on how to search for company documents, such as Forms 8-K, in the SEC's EDGAR database, see Using EDGAR - Researching Public Companies.

For another resource for using EDGAR, see Researching Public Companies Through EDGAR: A Guide for Investors.

For more information about private placement, see our Investor Bulletin.

For more information about accredited investors, see our Investor Bulletin.

For additional investor educational information, visit the SEC's website for individual investors, Investor.gov.

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Modified: Aug. 31, 2015

REIT Wise®

NAREIT's Law, Accounting & Finance Conference

March 30 - April 1

2016

T. Sittema

March 30-April 1, 2016

Product Structures

Multi-Share Class Overview

Multi-Share Class Fund

Class A

- Higher price per share
- Higher upfront fee
- Higher current income from distributions

Class T

- Lower price per share
- Lower upfront fee
- Annual distribution fee ("trail") lowers distributions

A Share Fee Structure (Example)

10% Upfront Load

Financial Advisor
7.0% Total Day 1

Dealer Manager
3.0% Total Day 1

Reallowance to Broker Dealer

T Share Fee Structure (Example)

Upfront Load

Based on Gross Proceeds; Paid on Day 1

4.75%

As Filed

Financial Advisor (FA): 2.00%

Dealer Manager Fee: 2.75%

Ongoing Annual Distribution and Stockholder Servicing Fees (“*Trail Fee*”)

Based on POP; Accrued Daily and Paid Quarterly

(Totals to ~5% of Gross Proceeds)

\+ **1.0% annual fee** | **1.0% annual fee** | **1.0% annual fee** | **1.0% annual fee** | **1.0% annual fee** =

5.0% years 1-5

We will pay the annual distribution and stockholder servicing fees to our dealer manager, which may allow up to all or a portion of the annual distribution and stockholder servicing fee to the broker-dealer who sold the Class T shares.

Maximum Load (“Cap”)

Based on Gross Proceeds

9.75%

I Share Fee Structure (Example)

0% Upfront Load

Load Structure

0.50% annual fee	0.50% annual fee	0.50% annual fee	0.50% annual fee	0.50% annual fee	0.50% annual fee

Paid to Sponsor

Platform Fee

Accounting for Trail fees

Ongoing Annual Distribution & Stockholder Servicing Fees ("trail")

NO AUTHORITATIVE GUIDANCE	No **authoritative guidance** for Ongoing Annual Distribution & Stockholder Servicing Fees
GUIDELINE 16-01	IPA Practice **Guideline 16-01** "IPA 16-01" provides industry position for its members
ACCRUAL OF TRAIL OVER TIME	IPA 16-01 supports **accrual of trail over time** as services are performed (not when shares are sold)
ACCOUNTING POLICY ELECTION	IPA 16-01 supports **"offering cost" or "expense"** treatment of trail as both are accepted practices

Ongoing Annual Distribution & Stockholder Servicing Fees (continued)

- IPA encouraged members to **work with their respective auditors** to determine accounting treatment

- **Facts and circumstances** of each dealer manager agreement will impact accounting treatment

- Some IPA members include a **risk factor** regarding diversity of accounting methods and the total trail if fully earned and paid

Accounting Policy Election

OPTION A – Equity (no full accrual)

- Record services provided by Dealer Manager as offering costs (contra equity)
- Recognize liability for ongoing services when services are performed (accrue liability over time)

OPTION B – Expense (no full accrual)

- Record services provided by Dealer Manager as expense (disclose if addback for MFFO)
- Recognize liability for ongoing services when services are performed (accrue liability over time)

General Session: Privatization Primer – Re-learning the Lessons from the 2005-2007 Cycle

Friday, April 1st
9:30am – 10:45am
Marriott Marquis, Washington DC

Moderator:
Alex Rubin, Managing Director, Moelis & Company

Panelists:
Dirk Aulabaugh, Managing Director-Consulting & Advisory, Green Street Advisors
Adam Emmerich, Partner, Wachtell, Lipton, Rosen & Katz
Jonathan Klassen, EVP & General Counsel, BioMed Realty Trust, Inc.
Ann McCormick, former EVP, General Counsel & Secretary, Home Properties, Inc.

REIT Wise®

NAREIT's Law, Accounting & Finance Conference

March 30 - April 1

2016

Privatization Panel

March 30-April 1, 2016

U.S. REIT M&A Transactions Since 2000

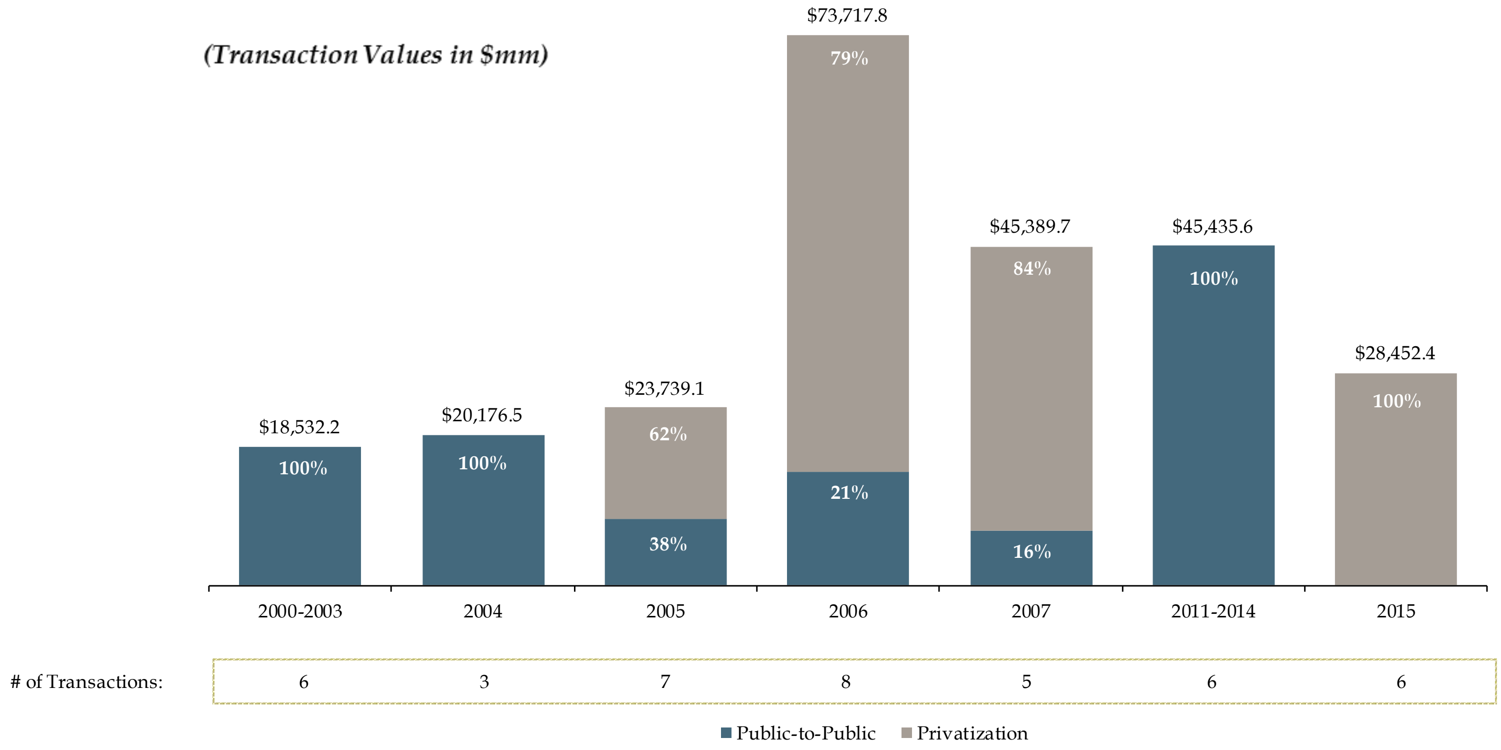
(Over $1bn)

Date Announced	Target	Acquiror	Type	Property Type	Transaction Value ($mm)	Purchase Consideration	% Stock	Premium to Share Price	Premium to NAV	Premium to Enterprise Value
10/16/15	Campus Crest Communities	Harrison Street Real Estate Capital	Privatization	Student	$1,824.9	Cash	-	23.8%	NA	8.5%
10/08/15	BioMed Realty Trust, Inc.	Blackstone Group	Privatization	Lab Space	$8,324.9	Cash	-	20.3%	2.2%	11.2%
09/08/15	Strategic Hotels and Resorts	Blackstone Group	Privatization	Hotel	6,137.9	Cash	-	9.9%	(1.7%)	6.3%
06/22/15	Home Properties	Lone Star Funds	Privatization	Apartment	7,780.9	Cash	-	9.2%	(6.0%)	5.9%
04/22/15	Associated Estates	Brookfield Asset Mangement	Privatization	Apartment	2,521.6	Cash	-	18.7%	8.5%	11.7%
04/10/15	Excel Trust	Blackstone Group	Privatization	Strip Center	1,862.3	Cash	-	14.5%	5.7%	7.5%
10/31/14	Aviv REIT	Omega Healthcare	Public-to-public	Health Care	2,985.1	Stock	100.0%	17.0%	57.1%	11.5%
09/16/14	Glimcher	Washington Prime Group	Public-to-public	Mall	4,421.2	Combination	26.8%	32.9%	(6.0%)	13.2%
12/19/13	BRE Properties	Essex	Public-to-public	Apartment	6,424.2	Combination	73.0%	17.7%	(3.0%)	11.2%
06/03/13	Colonial Properties	Mid America	Public-to-public	Apartment	4,424.9	Stock	100.0%	10.8%	(0.1%)	5.5%
02/28/11	Nationwide Health Properties	Ventas	Public-to-public	Health Care	7,488.1	Stock	100.0%	16.1%	53.6%	11.8%
01/31/11	ProLogis	AMB	Public-to-public	Industrial	19,692.2	Stock	100.0%	1.2%	18.5%	0.5%
05/29/07	Archstone-Smith	Tishman, Lehman, and BofA	Privatization	Apartment	22,261.0	Cash	-	18.8%	3.0%	12.2%
05/22/07	Crescent Real Estate	Morgan Stanley Real Estate	Privatization	Office	6,638.0	Cash	-	8.8%	(16.3%)	3.6%
03/13/07	Spirit Finance Corp	Macquarie and Kaupthing Bank	Privatization	Net Lease	3,090.6	Cash	-	11.6%	31.8%	5.1%
02/27/07	New Plan Excel	Centro Properties Group	Privatization	Strip Center	6,021.6	Cash	-	10.4%	30.0%	5.9%
01/17/07	Mills Corporation	Simon; Farallon Capital Mgmt	Public-to-public	Mall	7,378.4	Cash	-	42.1%	17.4%	7.1%
11/19/06	Equity Office Properties	Blackstone Group	Privatization	Office	39,330.1	Cash	-	23.7%	22.7%	12.3%
08/03/06	Reckson Associates	SL Green	Public-to-public	Office	6,006.6	Combination	26.9%	(1.1%)	4.8%	(0.7%)
07/10/06	Pan Pacific	Kimco	Public-to-public	Strip Center	4,073.6	Combination	14.3%	(0.2%)	3.7%	(0.1%)
07/09/06	Heritage Property	Centro Properties and Watt Commercial Properties	Privatization	Strip Center	3,385.5	Cash	-	2.2%	(6.7%)	1.1%
06/05/06	Trizec Properties	BPO and Blackstone Group	Privatization	Office	7,629.5	Cash	-	21.3%	7.4%	11.9%
03/07/06	Shurgard	Public Storage	Public-to-public	Self Storage	5,077.4	Stock	100.0%	1.3%	13.2%	0.8%
03/06/06	Carramerica Realty	Blackstone Group	Privatization	Office	5,471.2	Cash	-	8.9%	4.1%	4.5%
02/21/06	Meristar Hospitality	Blackstone Group	Privatization	Hotel	2,744.0	Cash	-	5.2%	(0.5%)	1.7%
12/22/05	Arden Realty	GE Real Estate	Privatization	Office	4,905.1	Cash	-	(3.1%)	10.4%	(2.0%)
12/19/05	Town & Country	MSRE and Onex Real Estate	Privatization	Apartment	1,374.9	Cash	-	32.7%	24.7%	16.9%
12/07/05	CenterPoint Properties	CALPERS and LaSalle	Privatization	Industrial	3,521.0	Cash	-	9.6%	57.5%	6.7%
10/24/05	AMLI Residential Properties	MSRE Prime Property Fund	Privatization	Apartment	2,196.8	Cash	-	23.2%	2.0%	11.4%
10/03/05	Prentiss Properties	Brandywine	Public-to-public	Office	3,698.6	Cash	-	5.7%	4.6%	3.2%
06/07/05	Gables Residential	ING Clarion Partners	Privatization	Apartment	2,800.7	Cash	-	14.5%	1.2%	7.0%
06/06/05	Catellus	ProLogis	Public-to-public	Industrial	5,242.1	Combination	65.0%	15.5%	30.4%	10.1%
10/25/04	Cornerstone Realty Income	Colonial Properties	Public-to-public	Apartment	1,471.5	Stock	100.0%	4.9%	24.0%	2.1%
08/20/04	Rouse	General Growth	Public-to-public	Mall	13,695.3	Cash	-	32.2%	42.9%	14.4%
06/21/04	Chelsea	Simon	Public-to-public	Premium Outlet	5,009.7	Combination	46.2%	13.5%	53.1%	9.2%
05/14/03	Crown America	Pennsylvania REIT	Public-to-public	Mall	1,304.5	Stock	100.0%	(5.7%)	9.0%	(1.7%)
10/03/02	JDN Realty	DDR Corp	Public-to-public	Strip Center	1,045.0	Stock	100.0%	(7.0%)	NA	(6.5%)
03/04/02	JP Realty	General Growth	Public-to-public	Strip Center	1,136.5	Cash	-	7.6%	24.3%	3.3%
05/04/01	Charles E. Smith Residential	Archstone	Public-to-public	Apartment	3,528.3	Stock	100.0%	10.7%	12.3%	6.3%
02/23/01	Spieker Properties	Equity Office Properties	Public-to-public	Office	6,973.1	Combination	76.6%	9.7%	4.5%	6.0%
02/11/00	Cornerstone	Equity Office Properties	Public-to-public	Office	4,544.8	Combination	55.0%	21.0%	5.9%	11.7%
	Total Transactions: [41]		**Mean**		$6,230.3			12.9%	14.1%	6.5%
			Median		4,544.8			10.8%	7.4%	6.3%

Source: Green Street Advisors, Company Filings

U.S. REIT M&A Transactions Since 2000

(Over $1bn) (Cont'd)

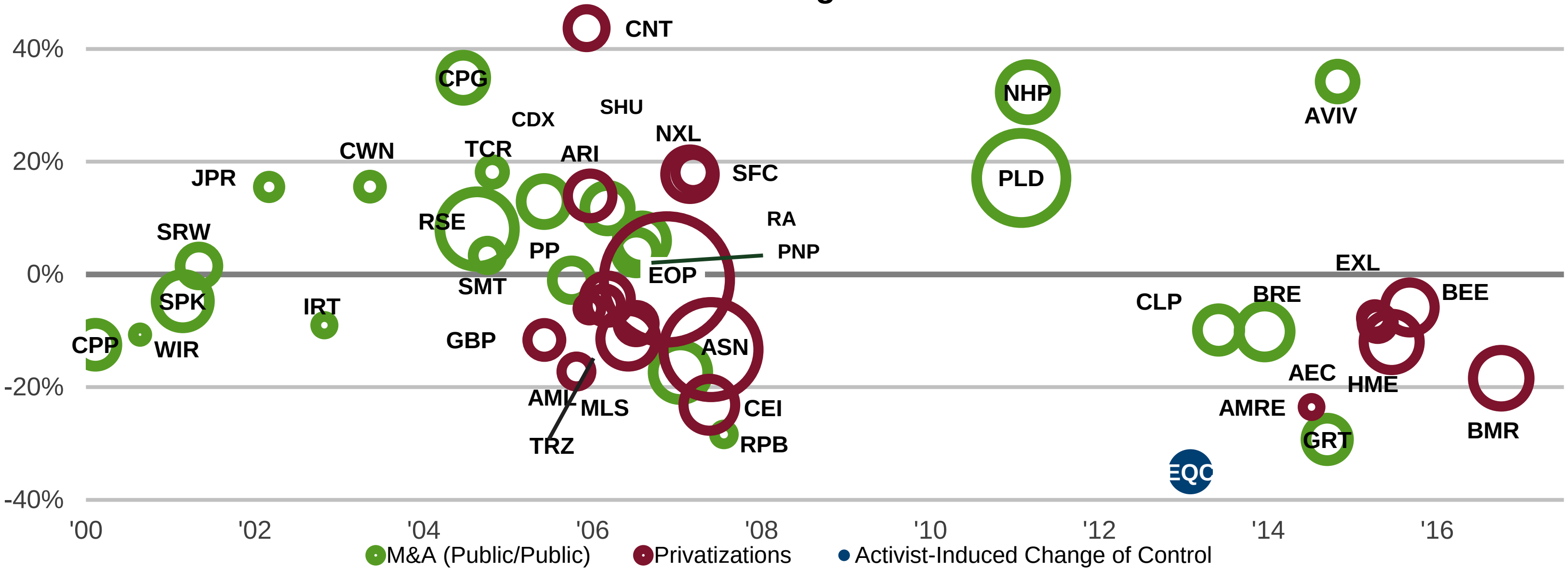


Source: Green Street Advisors, Company Filings

M&A Volume

- Thirty-two REIT M&A deals[1] occurred from '00 through mid-'07. Only seven were executed between mid-'07 and '14. Since the beginning of 2015, there have been five deals, and large NAV discounts for most REITs will continue to promote additional M&A chatter.

NAV Premium of Target Prior to Deal

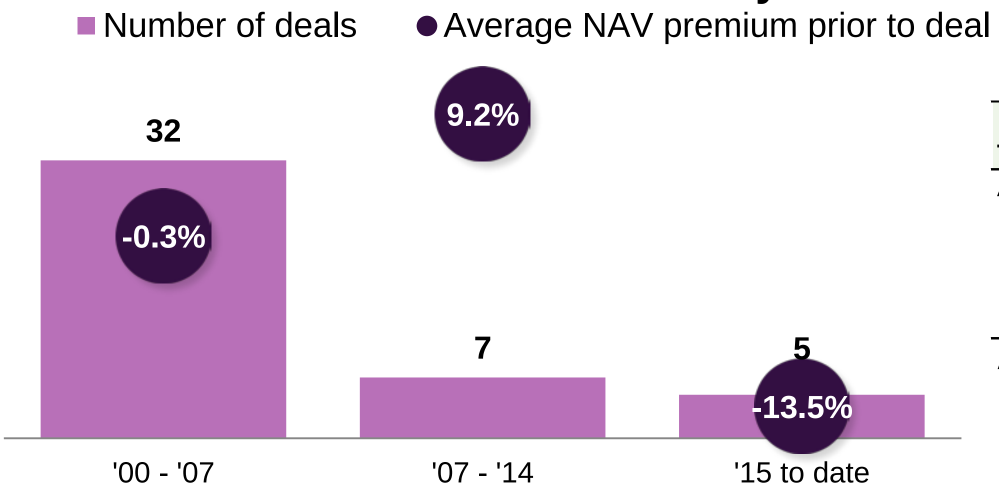


1. Deals include target companies that are tracked, either formally or informally, by Green Street Advisors.

Pricing Over Time

- During the M&A wave of ’00-’07, acquired companies were trading at ~NAV on average when suitors came along. From ’08-’14, public-to-public deals involving targeted companies trading at NAV premiums became common. Since ’15, the average deal has priced near NAV while the REITs traded at substantial discounts.

Deal Volume & NAV Premiums by Period



Recent Deals

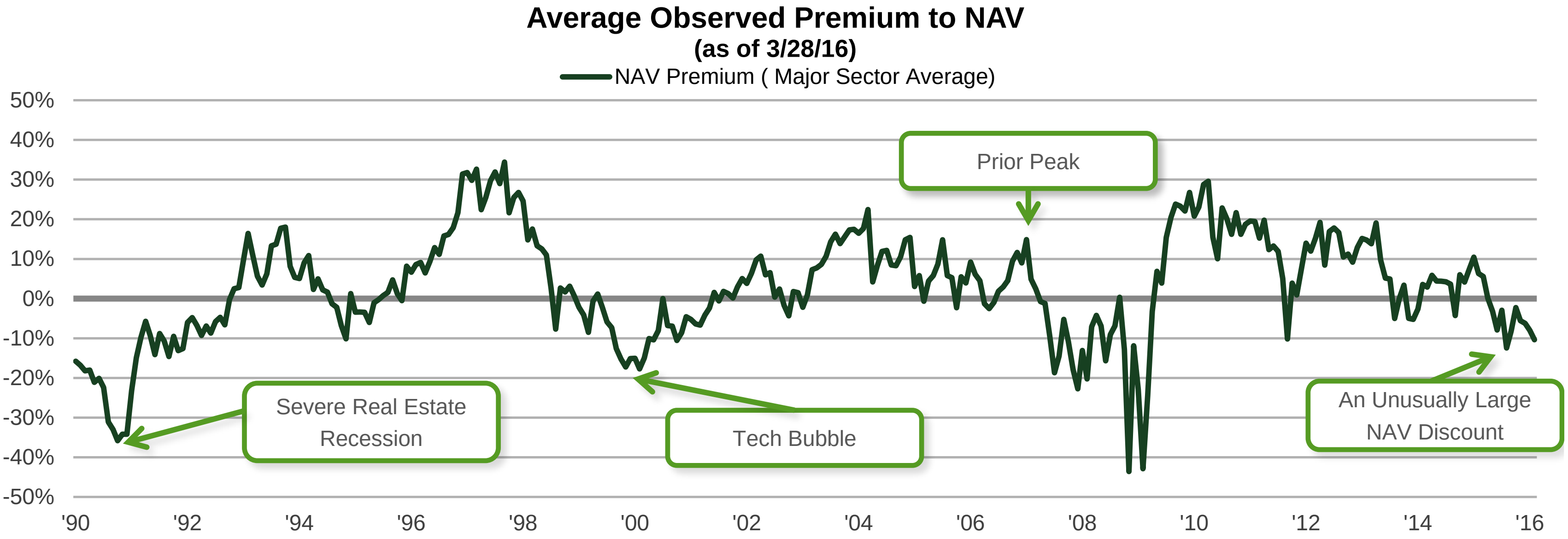
Target	Public Price	NAV	Deal Price	Prem. to Share Price	Deal NAV Premium
AEC	$24.22	$26.50	$28.75	18.7%	8.5%
EXL	$13.84	$15.00	$15.85	14.5%	5.7%
HME	$68.87	$80.00	$75.23	9.2%	-6.0%
BEE	$12.97	$14.50	$14.25	9.9%	-1.7%
BMR	$19.74	$23.25	$23.75	20.3%	2.2%
Avg[1]				***13.9%***	***(0.4%)***

Source: Green Street Advisors

1. Weighted average by deal size.

Relative Pricing

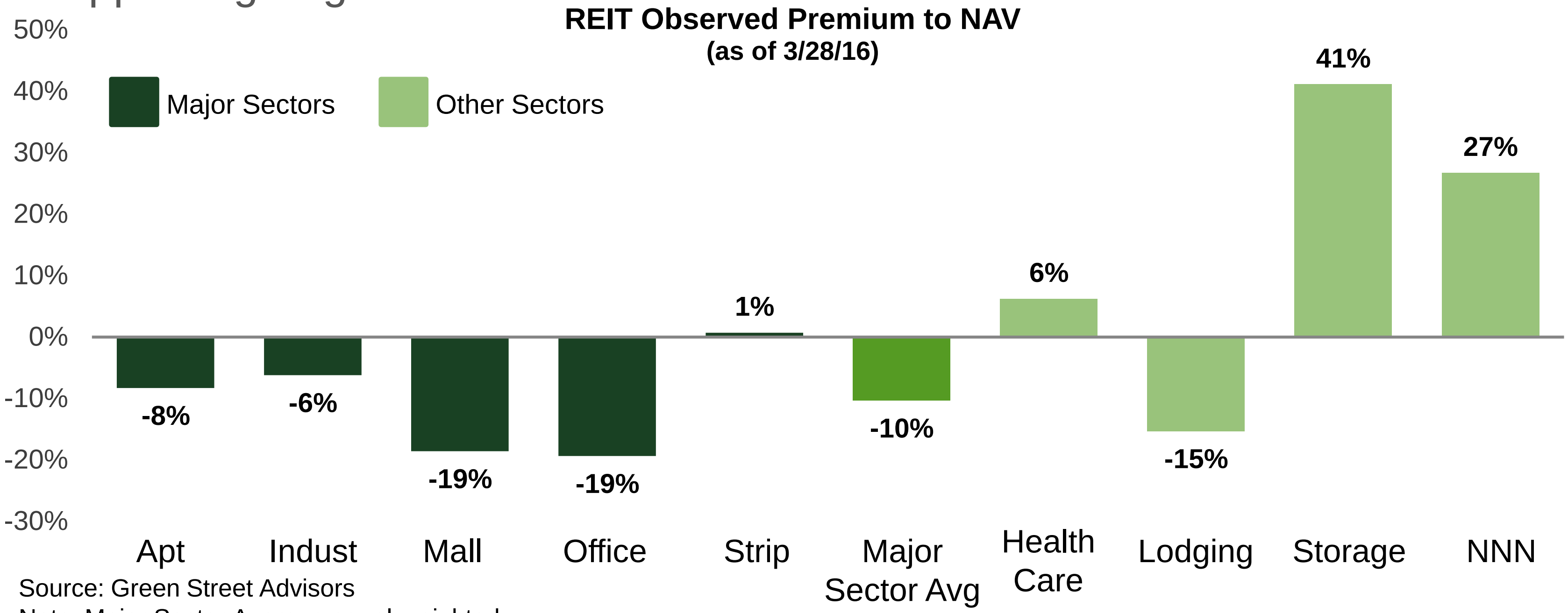
- On average, REITs trade near NAV. But at certain times, they trade at large premiums and discounts. The current discount is unusually wide. Commercial real estate can clearly be acquired more cheaply on Wall Street than on Main Street given current REIT share prices.



Source: Green Street Advisors

Potential Targets

- The average REIT in each of the major property sectors is now trading at a double-digit NAV discount. With a large pool of capital committed to buying U.S. real estate, REITs trading at sizable NAV discounts should represent appealing targets.



Source: Green Street Advisors
Note: Major Sector Average equal-weighted.

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January 7, 2016

REIT and Real Estate M&A in 2016

Following are some of the key trends we are following as we enter 2016, while keeping a weather eye on macro market turmoil:

1. M&A activity should continue at a steady pace, with a number of public-to-private and public-to-public REIT mergers already in the works.

2. We are not expecting an avalanche of REIT buyouts a la 2006-7, but many of the same drivers are apparent, as we noted last October in Taking REITs Private – The Playbook is Back in Play, and a number of significant transactions are likely.

3. Hostile transactions remain viable in the REIT world, and we expect the same factors – including institutional investor and activist support – that have led to current record-high levels across all industries to result in more hostile REIT acquisitions.

4. Succession planning and executive compensation will continue to be a major focus for boards, especially given the "maturation" of a significant number of management teams and changed equity market and interest rate environments.

5. While tax-free REIT spinoffs by real estate-rich corporations are no longer possible, we expect the trend to unlock real estate value to continue (albeit at a slower pace) utilizing taxable spins, sale-leasebacks, rights offerings, joint ventures and other structures, particularly in distress situations or where NOLs are available.

6. REIT-REIT spin-offs and spins of REITs' taxable subsidiaries can still be done tax free, and are expected to continue.

7. Activists are reworking their REIT playbooks to factor in the new REIT legislation and interest rate environment, but they aren't going anywhere. Dedicated funds for activism have never been more of a force, nor has institutional investor support. One of the key challenges for targeted companies will be both maintaining focus on the business, and being thoughtful about the merits of activists' suggestions and how best to respond.

8. Congress' FIRPTA relief should increase already robust deal volume from foreign investors, particularly as investors in stumbling or slowing-growth economies seek safe havens.

9. Interest by U.S. REITs in non-U.S. acquisitions is mixed, with divergent views in different sectors and companies. The debate is likely to continue and we don't expect volume to grow dramatically.

10. The dislocation in the non-traded REIT sector could lead to increased deal activity, but may also complicate migration into the public markets given due diligence concerns.

11. Ripple effects of e-commerce continue to reshape a number of property types, driving up cap rates in some sectors and continuing to drive industrial, data center and cell tower REIT expansion. Clearly, this is just the beginning.

Adam O. Emmerich Robin Panovka

October 18, 2015

Taking REITs Private – The Playbook is Back in Play

With many REITs now trading at meaningful discounts to their net asset value, we are already seeing signs of an increase in REIT buyouts. Many of the drivers of the $100 billion-plus of public-to-private REIT M&A transactions that preceded the financial crisis are apparent again, including higher valuations in the private real estate markets than in the public REIT markets, highly liquid private markets that facilitate wholesale-to-retail executions, debt that is still both cheap and plentiful for certain transactions, large pools of low-cost private equity seeking deals (and willing to accept low cap rates), and a sizeable pipeline of REITs and REIT executives who are seeking a graceful exit. More recent trends such as the increasing interest of sovereign wealth funds and other sources of international capital in the U.S. real estate sector may also drive future REIT privatizations.

In recent months we have dusted off our public-to-private playbook, including some of the lessons from the last privatization wave:

1. **Market Checks**. Boards of REITs considering a going-private transaction (or a sale of any kind) should bear in mind that while a pre-market check is not always required as a legal matter – particularly in Maryland, where many REITs are incorporated – the decision of how to conduct a sale process and on what basis to strike a deal is probably the most intensely reviewed decision a board can make. Even when there is no explicit pre- or post-signing market-check or shopping period when selling a public REIT, the sale of every non-controlled public company will include a market test, if only through the absence of preclusive lock-up arrangements. Boards should carefully consider the alternatives – pre-signing full auction, limited auction, accepting a preemptive bid with a subsequent market check, go-shops, low break-fee deals (sometimes viewed as an auction with a floor), full-on accepting a blockbuster bid with a standard fiduciary out and break-fee, or combinations and variations on these options – and determine which course is most likely to enhance shareholder value under the relevant circumstances. Boards should also consider, in evaluating their options, how to best communicate the rationale for their chosen strategy to shareholders in order to facilitate shareholder approval. Courts in both Maryland and Delaware will generally respect the board's decision if an appropriate process was followed (including, as noted below, with regard to any conflicts of interest) and is demonstrable from the record.

2. **Executive Compensation and Retention**. It is often important to private equity buyers to retain some or all of the target REIT's senior management. In constructing the best approval process for employment arrangements with the buyer, or retention arrangements with the target, entered into prior to the signing or closing of a transaction, it is important to distinguish between those situations where there is a management conflict of interest necessitating a special committee (discussed below) and routine retention arrangements, which may be approved by the target board or compensation committee in the ordinary course. Employment agreements between executives and a buyer negotiated after the major deal terms have been agreed and which do not affect the price to be paid to shareholders are common and perfectly acceptable, even if executed prior to or simultaneously with the definitive deal documents. From the buyer's standpoint these agreements should be carefully crafted to create the best possible alignment between the buyer and the executives, both on the downside (by requiring a rollover of significant equity and/or a cash investment) and on the upside (through promote structures and other compensation mechanisms). Equity compensation arrangements in a REIT which has been taken private typically will be more heavily weighted than when the REIT was public toward performance-based vesting and payout, and less toward being earned solely based on continued service. On the sell side, consideration should be given to ensuring that any management arrangements are compatible with the fiduciary-out or market-check aspects of a deal.

3. **Change of Control Employment Arrangements**. All public companies, including REITS, can and should address "change of control" protections well in advance of any potential transaction, before deal pressures mount, in order to create an environment that is best suited to maximizing shareholder value and retaining executive loyalty and focus when they are needed most. Properly-structured change of control protections are both legal and proper and serve to align the interests of key decision makers with the interests of shareholders. It is not in the interests of public REITs or their shareholders for senior management to have an incentive to avoid shareholder value-creating transactions out of a fear of the impact of those transactions on their own financial situation, or to prefer a transaction involving the opportunity of continued employment over one – perhaps better for shareholders – in which there is no ongoing role for management. However, boards should also be aware of the scrutiny that shareholder advisory groups and activist investors give to change of control employment arrangements which provide for excessive severance, "single-trigger" payments (i.e., those made upon a change of control, irrespective of continued employment), or benefits which are, at the moment, out of public favor generally (such as gross-up payments relating to the "golden parachute" excise tax), and consider how best to balance these concerns with the needs of the company.

4. **Special Considerations for UPREIT Transactions**. Acquisitions involving UPREITs present their own unique set of challenges that can make or break the deal. Tax protection agreements (designed to perpetuate a contributing operating partnership unitholder's tax deferral by requiring tax gross-ups if the contributed property is sold), and more general unitholder protections enshrined in the operating partnership's governing documents, can frustrate plans to "slice and dice" the acquired portfolio through rapid sale of some or all of the assets. Careful thought must be given both to any unitholder voting, notice, or consent rights that might be triggered by the acquisition and to the form of consideration to be offered in the transaction to unitholders who prefer to extend their tax deferral by rolling over their equity rather than taking the cash consideration offered to REIT shareholders. In private equity acquisitions, there is no surviving public equity, so the flexibility and protections previously available through conversion of operating partnership units into stock or its cash equivalent often must be replaced with a security that satisfies the unitholders needs. For example, unitholders may be offered a fixed-return preferred security or combination consideration including a mixture of cash and preferred securities. Issues to consider include the yield, windows for puts and calls, voting rights (if any), and continuing tax protection arrangements (no sale or refinancing of certain assets, the ability to guarantee debt, etc.). Along the same lines, if executives and other employees hold equity compensation awards in the form of operating partnership units which are profits interests for tax purposes (commonly known as "LTIP Units"), care must be taken to preserve the favorable tax attributes of those awards for the holders.

5. **The CEO, the Board, Special Committees**. Any sale process should be overseen by the board, which should provide management with direction as to any process or potential process. In most circumstances it is proper for the CEO or other senior management to explore whether there are attractive private equity options, among others, that the board should consider, but management should take care not to get out over their skis (as demonstrated by some spectacular recent flameouts). Whenever a buyer seeks to retain some or all of the target REIT's senior management, it will be essential to ensure that critical decisions – including the method of sale, selection of bidders, deal protections, access to due diligence materials, and negotiation of the price and other deal terms – fully involve unconflicted directors. In situations going beyond a straightforward desire by the buyer to retain current senior management (for instance when a management team or affiliated stockholder or unitholder seeks out a private equity buyer to submit a joint bid to acquire the company, or in other circumstances presenting more complicated or extensive conflicts), the best way to address the conflict may be to establish a special committee. In situations where directors are also operating partnership unitholders, the board should consider any possible differing interests as between unitholders and shareholders. When a special committee is formed, it should be firmly in control of the process, retain the services of independent legal and financial advisors, and have a clearly defined role, the ability to negotiate independently, and the power to say no. The best way to address conflicts will always depend on the

circumstances, however, and care should be taken not to reflexively establish formalistic special committees or otherwise implement drastic measures that end up hurting the process by, for example, depriving the board and bidders of critical access to key executives and their base of knowledge and experience or creating the impression of conflict where it does not truly exist.

6. **Club Deals**. Successful club deals require careful management of a number of buy-side complications, particularly the danger of a club bid being dragged down by its weakest member; defections by renegade club members; lack of alignment with regard to bidding, operating or exit strategies; and excessively complex or impractical governance and bidding arrangements. On the sell-side, careful thought should be given to allowing clubbing with the board's consent, recognizing that, depending on the circumstances, the size of the deal and field of potential acquirors, a club prohibition could hurt as much or more than it helps.

7. **Debt and Equity Bridges**. The conditionality of bridge and other financing commitments should be carefully scrutinized by the selling board and the private equity buyer, and should inform negotiations around reverse break fees (discussed below). The goal, of course, is to eliminate any daylight between the closing conditions in the merger agreement and the financing commitments. In light of the strong bargaining power of private equity borrowers and the favorable debt markets, market MACs, diligence conditions and the usual extensive list of contingencies in lender forms can often be eliminated.

8. **Reverse Break Fees and Capped Guarantees**. Reverse break-up fees and caps on guarantees provided by private equity firms are fairly standard in public-to-private REIT deals which typically involve reverse termination fees, or liquidated damages provisions, of roughly 7 - 10% of overall transaction value. In some ways, these provisions represent a regression to traditional real estate deposits and liquidated damages provisions, but they tend to be far more complicated in operation. Recent reverse break fees have been asymmetrical, exceeding (often substantially) the termination fees payable by the target. From the selling board's perspective, careful thought should be given to the odds and consequences of a failed deal and the limited recourse available in such circumstances. The reputation and track record of the private equity shop will be relevant, as will be the conditionality of the buyer's financing commitment.

9. **Strategic v. Financial**. In an auction context, careful consideration should be given to including the right mix of potential bidders to maximize value. Strategic bidders often will have different views of value than financial bidders, since they may be able to capitalize on synergies not otherwise available to financial bidders or because an acquisition fulfills a strategic need or, conversely, because of constraints on their ability to utilize cheap leverage and concerns about dilution. These considerations need to be weighed against concerns with providing confidential information to a competitor and the fact that strategic bidders sometimes need a longer time to conduct diligence and decide on a process.

10. **Litigation**. Nearly every REIT deal now attracts shareholder litigation and take-private transactions are an especially attractive target for the stockholder plaintiffs' bar. What this means is that a selling board's actions, including its decisions with respect to all the issues outlined above, are likely to face post-signing scrutiny in court. Careful and well-documented board and committee processes are therefore critical in these deals, because they allow bidders, sellers and trustees to minimize the costs and risks of litigation and in many cases obtain favorable settlements or early dismissal when the inevitable lawsuits materialize.

Adam O. Emmerich
Jodi J. Schwartz
Michael J. Segal
Robin Panovka
William Savitt
Matthew R. MacDonald

Concurrent Session: REIT Tax Issues When You Arrive at Work

Friday, April 1st
11am – 12:15pm
Marriott Marquis, Washington DC

Moderator:
Carol Bradshaw, SVP-Tax, Westfield Corporation

Panelists:
Joshua Cox, VP-Tax, Tanger Factory Outlet Centers, Inc.
Mark Patterson, VP-Taxation, Duke Realty Corporation
Charles Temkin, Director, Deloitte LLP

Updated Earnings and Profits Rules for REITs

To qualify as a real estate investment trust ("REIT"), an entity, among other things, must make a minimum "dividend" distribution to its shareholders. REITs generally can deduct these dividends for corporate-level income tax purposes. Since 1960, unique rules modified a REIT's earnings and profits ("E&P") determination so that sufficient E&P existed to support the treatment of distributions as "dividends," allowing the REIT to satisfy its distribution requirement while lowering corporate-level tax. This article explains how the Protecting Americans from Tax Hikes Act of 2015 (the "PATH Act") amended these modification rules to eliminate potential double taxation of "deemed" E&P to REIT shareholders, but why the PATH Act also created—or highlighted—other ambiguities.

February 15, 2016

by Armando Giannese, Federal Tax, and David Lee, Washington National Tax

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Overview

On December 18, 2015, the PATH Act was enacted as part of Pub. Law 114-113, the "Consolidated Appropriations Act, 2016." The new law includes many significant changes to the REIT rules, such as favorable treatment under the Foreign Investment in Real Property Tax Act ("FIRPTA") regime for investments in U.S. real estate through REITs. The new law also modifies the unique REIT E&P rules designed to provide REITs with sufficient E&P to support the dividend distribution requirement by eliminating the potential double taxation to shareholders of the "deemed" E&P. For many REITs, the revised and simplified rules will require minimal efforts to follow. However, for others, guidance from the IRS may be needed to coordinate the interplay between a REIT's E&P determination and certain other provisions.

This article first discusses the E&P operating rules prior to the enactment of the PATH Act. It then reviews the revised provisions that are effective for tax years beginning after December 31, 2015, and the effects that presumably were intended. Finally, the article highlights potential uncertainties that may require further clarifications or guidance from the IRS.

REIT E&P Rules Prior to PATH Act

Generally, a dividend is a distribution of property by a corporation to its shareholders out of the corporation's accumulated E&P or current E&P,[1] and a REIT and its shareholders are subject to the tax rules applicable to a domestic corporation.[2] For various reasons, a corporation's taxable income and E&P for a given year may differ. For example, a corporation is required to use longer cost recovery periods in computing depreciation in determining its E&P and cannot reduce its current E&P following the energy efficient commercial buildings provision.[3] Furthermore, an expense that is not allowed as a deduction in computing taxable income (i.e., permanently disallowed) usually is reflected in E&P except when the Code specifically provides otherwise.[4] Finally, a corporation's E&P is reduced by a loss recognized on the sale or disposition of property even though the loss is not allowed as a deduction (or may be deferred until capital gains are recognized) by the operation of section 267 or 1211 (e.g., net capital loss).[5]

A REIT is a tax-efficient vehicle for owning and operating real estate because, while it is taxed as a corporation, it can avoid corporate-level tax on its taxable income by claiming a deduction for dividends paid to its shareholders.[6] To qualify and maintain status as a REIT, the entity must, among other things, distribute generally 90 percent of its "ordinary" taxable income in the form of "dividends."[7] Thus, absent special rules, a REIT may lack E&P to treat distributions as dividends, and thus, may fail to meet this distribution requirement or incur corporate-level tax because of

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1 Section 316(a).

2 Section 1.856-1(e).

3 Section 312(k)(3).

4 Rev. Rul. 71-165, 1971-1 C.B. 111, stated "[a]n expense of an accrual basis corporation that under the Code is never an allowable deduction in computing taxable income usually is reflected in earnings and profits in the year to which it is attributable, except where the Code specifically provides that the corporation's earnings and profits shall not be reduced by any amount which is not allowable as a deduction in computing its taxable income."

5 Section 1.312-7(b)(1).

6 Section 857(b)(1) and (2).

7 Specifically, pursuant to section 857(a)(1), a REIT must make distributions that qualify for a dividends paid deduction (without regard to capital gain dividends) equal to at least the sum of 90 percent of the REIT taxable income for the tax year (determined without regard to the deduction for dividends paid and by excluding any net capital gain), and 90 percent of the excess of the net income from foreclosure property over the tax imposed on such income, minus any "excess noncash income."

Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended (the "Code") or the applicable regulations promulgated pursuant to the Code (the "regulations").

the disparity between its taxable income and E&P. To this end, prior to the enactment of the PATH Act, a REIT's determination of E&P was subject to the following rules:

- Section 857(d)(1)–A REIT's current E&P is not reduced by any amount that is not allowable in computing its taxable income for such taxable year.
- Section 562(e)–For purposes of computing the dividends paid deduction, a REIT's current E&P is increased by the total amount of gain (if any) on the sale or exchange of real property by the REIT during such taxable year.

The following illustrates how these rules have been applied.

Example 1

A REIT acquires a single residential apartment building for $1,000 and computes depreciation over 27.5 years and 40 years, respectively, for taxable income and E&P purposes. The REIT distributes all its available cash every year and has no accumulated E&P at the beginning of Year 30, which suggests that its shareholders have recognized dividend income based on smaller annual E&P depreciation deductions. The REIT distributes $90 to its shareholders in Year 30, has a pre-depreciation taxable income of $90 for Year 30, and computes its depreciation for taxable income and E&P purposes to be $0 and $25, respectively. Under former section 857(d)(1), the excess E&P depreciation of $25 for Year 30 would not be allowable in determining Year 30's taxable income because it was claimed in prior years, so such amount could not reduce REIT's current E&P for Year 30, resulting in a current E&P balance of $90. Accordingly, the REIT would be able to claim a dividends paid deduction of $90 to eliminate its taxable income. However, notwithstanding that in this example REIT's shareholders have already recognized dividend income based on smaller E&P depreciation deductions and have not benefited from larger tax depreciation deductions in prior years, the shareholders would recognize dividend income of $90 reflecting the "deemed" E&P of $25.

Example 2

Continuing with the example above, the REIT sells the building for $1,000 in Year 31 and computes its gain for taxable income and E&P purposes as $1,000 and $750, respectively, ignoring the mid-month convention. The

REIT has no accumulated E&P at the beginning of Year 31, has no other activities in Year 31, and distributes $1,000 to its shareholders. Under former section 562(e), the REIT would treat its tax gain of $1,000 as its E&P gain for purposes of determining the dividends paid deduction. Accordingly, the REIT could claim a dividends paid deduction of $1,000 to eliminate its taxable income, and its shareholders would recognize dividend income of only $750 (because the modification under former section 562(e) was only for purposes of determining the dividends paid deduction).

It is worth noting that, while Congress crafted these provisions to allow REITs to have sufficient E&P for purposes of satisfying the minimum distribution requirement or avoiding corporate-level tax,[8] the above modifications were not always effective. For example, certain income items that are treated differently between taxable income and E&P were not captured under a literal reading of former section 857(d)(1) and required private letter rulings from the IRS. In Private Letter Rulings 201537020 and 201503010, the IRS relied on the legislative history accompanying the Tax Reform Act of 1986, which amended former section 857(d)(1),[9] to treat a REIT as having sufficient E&P

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[8] For example, Congress included section 562(e) as part of the Technical Corrections Act of 1982, and the accompanying legislative history explained "[w]here the amount of taxable gain from the sale or disposition of real property is greater than the current or accumulated earnings and profits because of the different recovery periods used for computing taxable income and earnings and profits, the real estate investment trust may not have sufficient earnings and profits to pay enough dividends to meet the 95-percent test [currently a 90-percent test] or to avoid taxation of all income from the sale or other disposition of the real property through dividend distributions to its shareholders." See S. Rep. No. 97-592, 97th Cong., 2d Sess. (1982).

[9] Prior to 1986, section 857(d) read "[t]he earnings and profits of a real estate investment trust for any taxable year (but not its accumulated earnings and profits) shall not be reduced by any amount which is not allowable *as a deduction* in computing its taxable income for such taxable year." [Emphasis added] As part of the legislative process of the Tax Reform Act of 1986, the Senate proposed and passed amendments to (1) delete the phrase "as a deduction" and (2) to insert a new provision providing that a REIT's current E&P would not be less than its REIT taxable income before the dividends paid deduction. S. Rep. 99-313, 99th Cong., 2d Sess. (May 29, 1986). In conference, the Senate's amendment to delete the phrase "as a deduction" from section 857(d) was adopted. However, the addition to ensure REIT's current E&P would in no event be less than its REIT taxable income before the dividends paid deduction was not adopted "since the conferees believe that this provision is a restatement of present law." H.R. Conf. Rep. No. 99-841, at 218 (1986).

notwithstanding that the REIT's positive section 481(a) adjustment for taxable income purposes was greater than the amount for E&P purposes.

REIT E&P Rules under the PATH Act

To address the potential double taxation of "deemed" E&P under former section 857(d)(1), the PATH Act provides a somewhat circuitous solution. It first modifies section 857(d)(1), so that current E&P is not reduced for amounts that have not been allowable for computing taxable income in the current "*or*" prior taxable years. For purposes of the dividends paid deduction, new section 857(d)(5) cross-references amended section 562(e)(1) for special rules, which then applies section 857(d)(1) without regard to the provision relating to prior taxable years. The net result is that, for purposes of the dividends paid deduction, section 857(d)(1) (as modified by section 562(e)(1)(B)) would prevent a current year reduction of E&P for amounts that are attributable to prior year taxable income deductions.

As amended, the determination rules are now as follows:

- Section 857(d)(1)–A REIT's current E&P is not reduced by any amount that
  - (A) Is not allowable in computing its taxable income for such taxable year, and
  - (B) Was not allowable in computing its taxable income for any prior taxable year.
- Section 562(e)(1)--For purposes of computing the dividends paid deduction,
  - (A) REIT's current E&P is increased by the amount of gain (if any) on the sale or exchange of real property that is taken into account in determining the taxable income for such taxable year, and
  - (B) Section 857(d)(1) is applied without regard to section 857(d)(1)(B).

Amounts subject to amended section 857(d)(1) continue to include items that are permanently disallowed in determining taxable income, such as nondeductible penalties and disallowed entertainment expenses.

Amended section 857(d)(1) also applies to amounts that would ordinarily reduce E&P, but the deduction for which might be deferred to a future year for taxable income purposes, such as a net capital loss or a disallowed section 163(j) interest.[10] However, for purposes of determining the taxability of distributions to shareholders (i.e., Form 1099-DIV), this change means that an item—such as the excess of E&P depreciation over tax depreciation in later years due to the use of different recovery periods—is no longer subject to amended section 857(d)(1). This means the normal current year E&P adjustments (negative), which in fact are attributable to prior year taxable income deductions, would be permitted. This reduces the amount of current year distributions that would otherwise be taxable as dividends to shareholders.

On the other hand, for determining the dividends paid deduction (and not for Form 1099-DIV), such excess amount cannot reduce the REIT's current E&P pursuant to amended section 562(e)(1)(B). Thus, under Example 1 above, the REIT would have sufficient E&P (i.e., $90) to support a dividends paid deduction large enough to offset its current taxable income, but the shareholder would recognize a smaller amount of dividend income (i.e., Form 1099-DIV of $65), to the extent that all prior year E&P was previously distributed as taxable dividends.

Uncertainties under the PATH Act

While the amendment appears to accomplish the apparent objective of eliminating the potential double taxation of the "deemed" E&P, it also raises questions over how certain provisions that are affected by E&P, such as the January dividend, the throwback dividend, and the consent dividend, should operate under the new determination rules.

Relevant to a REIT, the term "deduction for dividends paid" includes generally the sum of the dividends paid during the tax year and consent dividend for the tax year.[11] For this purpose, dividends paid by a REIT during the year following a relevant year may be included. For example, under section 857(b)(9) (or the so-called January dividend), any dividend declared by a REIT in October, November, or December of any calendar year and payable to shareholders of record on a specified date in one of

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[10] Section 1.163(j)-1(e) provides "[t]he disallowance and carryforward of a deduction for interest expense under this section shall not affect whether or when such interest expense reduces earnings and profits of the payor corporation."

[11] Sections 857(b)(2)(B), 561, and 562.

those months is deemed paid by the REIT on December 31 of that calendar year if the dividend is paid during January of the following calendar year. This special timing rule also treats shareholders as receiving the dividend on December 31. Further, section 858 (or the throwback dividend) provides that a REIT may elect to treat a dividend declared before the return due date (including extension) for a relevant year and distributed in the 12-month period following the relevant year as being paid during the relevant year. However, contrary to the January dividend, the elected amount is treated as being received by shareholders in the distribution year. Because of this timing difference (i.e., deducted by a REIT earlier than recognized as income by shareholders), Congress passed section 4981, under which a REIT is subject to a four-percent excise tax if it relies on the throwback dividend generally for more than 15 percent of its ordinary income.[12] Finally, pursuant to section 565(a) (or the consent dividend), a REIT's common shareholder(s) may elect to treat as a dividend the amount specified in such election (i.e., a hypothetical distribution deemed occurring on December 31).[13]

Consistent with the term "dividend" (rather than "distribution") being used in the statute for these provisions, the income tax regulations specifically limit the application of a throwback dividend and a consent dividend to the E&P of the relevant tax year. For example, section 1.858-1(b)(2) provides in part that a REIT can elect a throwback dividend "to the extent that the earnings and profits of the taxable year (computed with the application of sections 857(d) and 1.857-7) exceed the total amount of distributions out of such earnings and profits actually made during the taxable year." Thus, if a REIT has taxable income and E&P of $100,000 for Year 1, distributes $85,000 in Year 1, and elects on its Year 1 return to treat $40,000 paid in Year 2 as a dividend paid during Year 1 pursuant to

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[12] Pursuant to section 4981, a REIT is subject to a tax equal to generally four percent of the excess of the required distribution over the sum of (1) the amounts actually distributed during the calendar year, (2) retained amounts on which income tax is paid, and (3) the excess of dividends paid deductions over REIT taxable income before such deductions of prior years. For this purpose, the required distribution is the sum of (1) 85 percent of its ordinary income, (2) 95 percent of its capital gain net income, and (3) any prior-year undistributed income.

[13] Section 1.565-3(a) provides in part that "[t]he amount of the consent dividend... shall be considered, for all purposes of the Code, as if it were distributed in money by the corporation to the shareholder on the last day of the taxable year of the corporation, received by the shareholder on such day, and immediately contributed by the shareholder as paid-in capital to the corporation on such day."

section 858, the election is valid only to the extent of $15,000.[14] Similarly, for a consent dividend, section 1.565-2(c)(1) treats an elected amount as effective not exceeding "the amounts which would constitute a dividend (as defined in section 316) if the corporation had distributed the total specified amounts in money to shareholders on the last day of the taxable year of the corporation."

Considering that a REIT now may have two different current E&P amounts (i.e., section 857(d)(1) vs. section 562(e)(1)), the threshold question then is: Which E&P amount serves as the limitation for these purposes (including the January dividend)?[15]

Pursuant to section 1.565-1(b)(1), a consent dividend election is made on Form 972, *Consent of Shareholder To Include Specific Amount in Gross Income*. If the amount so elected is limited to only the amount that a consent shareholder will include in its gross income, the use of a consent dividend may not be possible in certain circumstances. For example, assume that the REIT in Example 1 above intends to rely solely on the consent dividend (rather than the actual distribution of cash). If the amount specified on Form 972 cannot exceed $65 (i.e., the E&P determined for Form 1099-DIV), the REIT would fail to satisfy the minimum distribution requirement. It should be noted that section 1.565-2(c)(1) provides if only a portion of the specified amount would constitute a dividend (i.e., due to insufficient E&P), then only a corresponding portion of each specified amount is treated as a consent dividend. Thus, can common stockholders of the REIT under Example 1 above specify $90 on Form 972 but recognize only $65 as dividend income on their tax returns?[16]

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[14] See Example 2 of section 1.858-1(d).

[15] Technically, except in the case of a sale of property, the special E&P adjustments are all made pursuant to section 857(d)(1). The application of section 857(d)(1) is then modified by section 562(e)(1)(B) for purposes of the dividends paid deduction. For simplicity, we refer to the two different E&P calculations as made pursuant to section 857(d)(1) for shareholder purposes, or section 562(e)(1) for dividends paid deduction purposes.

[16] The example under section 1.565-2(c)(2) provides:

> The X Corporation, a corporation described in §1.565-(a)(1) or (2), which makes its income tax returns on the calendar year basis, has only one class of stock outstanding, owned in equal amounts by A and B. It makes no distributions during the taxable year 1987. Its earnings and profits for the calendar year 1987 amount to $8,000, there being at the beginning of such year no accumulated earnings or profits. A and B execute proper consents to include $5,000 each in their gross income as a dividend received by them on December 31, 1987. The sum of the amounts

With respect to the January dividend and throwback dividend, it is possible that a distribution that may not qualify as a January dividend, because of the application of section 857(d)(1), may be eligible for the throwback dividend election. Thus, which E&P determination controls may be more complex and may require further coordination as illustrated below:

Example 3

Continuing with Example 1 above, and for Year 30 and Year 31, the REIT's current E&P is $90 and $65, respectively, as determined under amended sections 562(e)(1) and 857(d)(1). The REIT has no accumulated E&P at the beginning of Year 30 and makes quarterly distributions of $22.50 each in Year 30 and Year 31. The REIT declares the 4th quarter distribution of $22.50 in December of Year 30 and Year 31 and pays such amount in January of Year 31 and Year 32.

	Year 30	Year 31	Year 32
REIT taxable income before the dividends paid deduction	90	90	
E&P - section 562(e)(1)	90	90	
E&P - section 857(d)(1)	65	65	
Declared			
March	22.5	22.5	
June	22.5	22.5	
September	22.5	22.5	
December	22.5	22.5	
Paid			
January		22.5	22.5
April	22.5	22.5	
July	22.5	22.5	
October	22.5	22.5	
	67.5	90	22.5

specified in the consents executed by A and B is $10,000, but if $10,000 had actually been distributed by the X corporation on December 31, 1987, only $8,000 would have constituted a dividend under section 316(a). The amount which could be considered as consent dividends in computing the dividends paid deduction for purposes of the accumulated earnings tax is limited to $8,000, or $4,000 of the $5,000 specified in each consent. The remaining $1,000 in each consent is disregarded for all tax purposes.

Option #1

If, for purposes of section 857(b)(9), E&P is determined under section 857(d)(1) and not modified by section 562(e)(1)(B), (i.e., $65, E&P for shareholder purposes), then the distribution in January may not be treated as relating back to December 31, as there is insufficient E&P to treat it as a dividend. On the other hand, an argument may be made that, for purposes of section 858, the relevant E&P calculation for the prior year should be that which is made for corporate-level purposes (i.e., the section 562(e)(1) calculation), rather than shareholder-level purposes (i.e., section 857(d)(1)), since section 858 only carries back the corporate-level dividend paid deduction to the prior year.[17] Under this approach, the relevant E&P calculation is $90 for Year 30, which would permit the REIT to fully offset its taxable income using a throwback dividend election. However, such election could subject the REIT to an excise tax of $0.36 (i.e., 85% of $90 minus $67.5 times 4%), since the REIT would fail to distribute at least 85 percent of its ordinary taxable income during Year 30 for purposes of the excise tax. That said, for purposes of the excise tax, a REIT generally can include the excess of its prior-year dividend distributions over its prior-year taxable income for purposes of satisfying its current-year required distribution.[18] Thus, the REIT in this example may not have such excise tax exposure. However, for a REIT that has acquired depreciable property in a carryover basis transaction with higher E&P basis and that has no prior-year over-distributions, it may be subject to an excise tax.

Option #2

Alternatively, if the REIT is permitted to use the E&P calculation under section 562(e)(1) (i.e., $90) for purposes of applying section 857(b)(9) to the January dividend, then the REIT would have sufficient distributions made in Year 30 (i.e., no risk of the four-percent excise tax) to offset its taxable income. However, because the REIT would have total distributions of $90 but current E&P of $65 for Form 1099-DIV purposes, a portion of every such distribution would be reported as a non-dividend distribution

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[17] Section 1.858-1(a) provides, in part, "[u]nder section 858, a real estate investment trust may elect to treat certain dividends that are distributed within a specified period after the close of a taxable year as having been paid during the taxable year," and "[t]he dividend is taken into account *in determining the deduction for dividends paid* for the taxable year in which it is treated as paid." [Emphasis added]

[18] That is, treat as prior year "overdistributions." Section 4981(c)(2).

for purposes of Form 1099-DIV.[19] It should be noted that, if the REIT believes Option #2 is the better alternative, it would not make a throwback dividend election with respect to the amount paid in January, which could lead to insufficient "dividend" distributions for the year if the IRS disagrees with such view.

For a REIT, the E&P determination is critical because it affects not only its shareholders, but also its minimum distribution requirement and the imposition of corporate-level tax. The amended rules should help avoid double taxation of "deemed" E&P to shareholders. Hopefully, as more REITs start applying these new rules to their own situations, uncertainties can be identified and addressed to minimize risks and simplify the already complicated REIT rules.

***What's News in Tax* is a publication from the Washington National Tax practice of KPMG LLP ("KPMG") that contains thoughtful analysis of new developments and practical, relevant discussions of existing rules and recurring tax issues.**

[19] Section 1.316-2(b) provides that if distributions made during the year consist only of money and exceed the earnings and profits of such year, then that proportion of each distribution that the total of the earnings and profits of the year bears to the total distributions made during the year shall be regarded as out of the earnings and profits of that year.

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Non-Customary Services Furnished By Taxable REIT Subsidiaries

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Non-Customary Services Furnished By Taxable REIT Subsidiaries

By Paul W. Decker, David H. Kaplan, and Ameek Ashok Ponda

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In this report, the authors argue that real estate investment trust revenues from tenants for non-customary services provided by taxable REIT subsidiaries constitute rents from real property under section 856(d) regardless of whether the services are billed to tenants separately or as part of a bundled charge.

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I. Introduction

The typical real estate investment trust is a taxpayer, otherwise taxable as a regular C corporation, that continuously complies with numerous, stringent requirements under the code and Treasury regulations, such as the following:

- its share ownership must be sufficiently diversified such that the REIT is neither closely held nor 10 percent-or-more affiliated with its tenants;
- its assets must be principally real property or related to real property leasing, with the possibility of investing in the portfolio securities of other issuers being very limited;
- its gross income must be principally rental revenues and fees for related services, with the balance of any gross income being principally composed of passive investment income such as interest, dividends, and capital gains;
- its subsidiaries, assets, and operations must be properly divided among disregarded entities and partnerships on one hand, and section 856(l) taxable REIT subsidiaries (TRSs) on the other; and
- its distributions to shareholders must be meticulously in sync with its underlying organic documents, pro rata within each class of outstanding shares, and sufficiently large and timely to contemporaneously (or nearly contemporaneously) distribute to shareholders all of its taxable income and any accumulated earnings and profits inherited from regular C corporations.[1]

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[1]*See generally* sections 561, 562, 565, 856-860, and 4981. Meeting these numerous, stringent standards requires a REIT to have the right ownership, assets, income streams, and distribution amounts, all accompanied by continuous monitoring. But even so, the financial and tax press contain some shrill voices opposed to the recent (and likely transitory) phenomenon of so-called REIT conversions, with "REIT nativist" commentators decrying any taxpayer or type of real estate being treated as REIT-compliant if it did not come over on the "REIT Mayflower," *i.e.*, either by being a company originally set up as a REIT or investing in a property type held by REITs since 1960. *See, e.g.*, Bradley T. Borden, "Rethinking the Tax-Revenue Effect of REIT Taxation," 17 *Fla. T. Rev.* 527, 530 (2015) ("The comparison of REIT spinoffs to [transactions that potentially harm the fisc] borders on misplaced hysteria."); Richard M. Nugent, "REIT Spinoffs: Passive REITs, Active Businesses," *Tax Notes*, Mar. 23, 2015, p. 1513, at p. 1514 ("Traditional REIT spinoffs are fairly well supported by current law and [the] common criticisms of these transactions generally miss the mark."); Nugent, "REIT Spinoffs: Passive REITs, Active Businesses, Part 2," *Tax Notes*, Mar. 30, 2015, p. 1635, at p. 1648 ("Some have suggested

(Footnote continued on next page.)

In general, a REIT pays no regular corporate income tax because it receives a deduction for taxable income distributed to its shareholders;[2] however, REITs still pay entity-level income and excise taxes in several circumstances designed to protect the integrity of the corporate income tax base.[3] More important, a REIT's distribution of its taxable income to shareholders will generally be treated as ordinary dividend income (or sometimes as capital gain dividend income)[4] that is subject to far more fulsome taxation at the shareholder level than the dividends paid to shareholders by non-REITs.[5]

As demonstrated by the requirements above, a REIT's primary function under the code is to hold and lease real property for occupancy. As with all landlords, REITs must also provide a variety of related services to their tenants. The extent to which a REIT's revenues from those tenant services qualify for purposes of the 75 percent and 95

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restricting only the spinoff element of REIT spinoffs. It is unclear what purpose that ban would serve, because REIT spinoffs typically satisfy all the policy and technical requirements of section 355.''). More sober voices, including Treasury and the IRS, recognize that the standards for what constitute real estate have remained essentially unchanged over time, even though the particular types of real estate crucial to the national and global economy will (and should) evolve. For example, the preamble to the proposed REIT real property regulations, REG-150760-13, states that Treasury and the IRS ''view these proposed regulations as a clarification of the existing definition of real property and not as a modification that will cause a significant reclassification of property.'' 79 F.R. 27508, 27510 (May 14, 2014). The preamble makes clear that the definition of real property was never as plain vanilla as the REIT nativists contend, citing published and private rulings dating back to 1969, which for all practical purposes is the dawn of the REIT statute:

> The IRS issued revenue rulings between 1969 and 1975 addressing whether certain assets qualify as real property for purposes of section 856. Specifically, the published rulings describe assets such as railroad properties, mobile home units permanently installed in a planned community, air rights over real property, interests in mortgage loans secured by total energy systems, and mortgage loans secured by microwave transmission property, and the rulings address whether the assets qualify as either real property or interests in real property under section 856. Since these published rulings were issued, REITs have sought to invest in various types of assets that are not directly addressed by the regulations or the published rulings, and have asked for and received letter rulings from the IRS addressing certain of these assets.

Id. at 27508 (footnotes omitted).

Practitioners commended the proposed regulations for their conformity with existing precedent and their articulation of a workable legal standard. *See*, *e.g.*, comments by the National Association of Real Estate Investment Trusts (NAREIT) on proposed REIT regulations (Aug. 12, 2014); comments by Ameek Ashok Ponda on proposed REIT regulations (Aug. 11, 2014). Indeed, some 55 years ago, REITs may have owned factories to house manufacturing tenants, whereas today a REIT is more likely to own data centers that house technology tenants whose equipment form the backbone of Internet and cloud commerce. *Compare* H.R. Rep. No. 86-2020, at 4 (1960) (stating that REITs can alleviate shortages of private capital ''for individual homes, apartment houses, office buildings, factories, and hotels'') *with* prop. reg. section 1.856-10(g), Example 6 (concluding that a data center's core building systems are real property). For a discussion of some of the more esoteric aspects of REIT conversions, see Ponda, ''How Much Gain Would a REIT Defer if a REIT Could Defer Gain?'' *Tax Notes*, June 4, 2012, p. 1249.

[2]*See generally* sections 561, 562(a), 562(c), 562(e), 565, 857(b)(1)-(3), 857(b)(9), 858, and 860.

[3]*See generally* sections 55(a) (tax on alternative minimum tax items); 337(d)(1) and 1374 (tax on reorganization or liquidation of a C corporation cannot be circumvented through use of REITs); 856(c)(7) (tax on asset test failure remediation); 856(g)(5) (tax on miscellaneous remediation); 857(b)(1)-(3) (tax on income not distributed to shareholders); 857(b)(4) (tax on income from foreclosure property); 857(b)(5) (tax on income test failure remediation); 857(b)(6) (tax on prohibited transactions, such as dealer property gains); 857(b)(7) (tax on misallocations or mispricing involving a TRS); 860 (interest and additions to tax for deficiency dividends); and 4981 (excise tax on delayed distributions to shareholders). Also applicable are reg. sections 1.337(d)-7 (tax on recognized built-in gains inherited from C corporations) and 1.857-11 (interest charge on delayed distributions to shareholders). Further, a REIT's TRSs are regular C corporations under the code, subject to the same corporate income taxes on their income as all other C corporations. *See* sections 11, 163(j), 856(l), and 857(b)(7).

[4]*See* section 857(b)(3).

[5]For example, a REIT's dividend to its shareholders generally cannot qualify for the preferential tax rates on qualified dividend income for noncorporate taxpayers (sections 1(h)(11)(D)(iii) and 857(c)(2)); cannot qualify for the dividends received deduction for corporate taxpayers (sections 243(d)(3) and 857(c)(1)); can be subject to tax as unrelated business taxable income (section 856(h)(3)(C)); can be subject to tax as income effectively connected with a U.S. trade or business (sections 897(h) and 1445(e)(6)-(7); reg. section 1.1445-8; Ponda, ''Foreign Pension Plans Investing in Shares of a U.S. REIT,'' *Tax Notes*, Mar. 24, 1997, p. 1593); and can qualify only under restricted circumstances for the otherwise generally applicable treaty-based reductions in U.S. withholding and income taxes on dividends paid to non-U.S. shareholders (Ponda, *id.*; 2006 U.S. model income tax treaty (Nov. 15, 2006), art. 10, para. 4, at 16-17). *See also* Borden, *supra* note 1, at 579-589 (concerns that REIT conversions damage the fisc are grossly exaggerated, given that over a variety of realistic assumptions regarding shareholder composition and corporate payout ratios, the erosion in the corporate income tax base is generally offset by the higher tax rates (and higher taxes) on the REIT's dividends to its shareholders; thus, REIT conversions generally have only a modest, insignificant net effect on total revenues of the fisc and in some cases may even have a positive impact on those revenues). Moreover, a REIT cannot pass foreign tax credits and similar tax attributes through to its shareholders (unlike a partnership or limited liability company taxed under subchapter K), meaning that the REIT structure can result in those tax attributes being lost forever (section 702; Ponda, ''REITs Abroad,'' in Practising Law Institute's *Tax Strategies for Corporate Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Financings, Reorganizations & Restructurings* (2006-2008), para. I(F); *cf.* section 853 (regulated investment company passthrough of FTCs, but no analogous provision for REITs in sections 856-860)).

percent REIT gross income qualification tests of section 856(c)(2) and (3)[6] has been revisited many times since REITs were introduced in 1960, with each visit by Congress producing more expansive qualification. As discussed below, two intertwined and critical inquiries have generally been at the crux of each iteration of congressional expansion: (1) Is the service customarily provided by similarly situated landlords to similarly situated tenants, and (2) who is the service provider?

The advent of affiliated TRSs as providers of non-customary services to REIT tenants introduced a novel structural paradigm for addressing those critical inquiries. It was also a watershed moment in the effectiveness of the REIT statute[7] and the full realization of the REIT model of real estate ownership and operation.[8] By approaching both critical inquiries in a new way, the TRS structure created the foundation for asking and resolving a third critical question that did not arise under prior law: For purposes of the 75 percent and 95 percent REIT gross income qualification tests, how should a REIT's gross income from tenants for non-customary services supplied through TRSs be treated?

[6]*See supra* text accompanying note 1, and in particular the third bullet point there. The 75 percent REIT gross income qualification test of section 856(c)(3) mandates that 75 percent of the REIT's gross income consist of rental revenues and fees for related services (as well as a few other elements of income consistent with that classification), and the 95 percent REIT gross income qualification test of section 856(c)(2) mandates that 95 percent of the REIT's gross income consist of income qualifying under the 75 percent REIT gross income test plus passive investment income such as interest, dividends, and capital gains.

[7]*See* NAREIT, "REIT Industry Timeline: Celebrating 50 Years of REITs and NAREIT," *available at* http://www.reit.com/timeline/timeline.php.

[8]The REIT model of real estate ownership and operation has many advantages, including providing access to the real estate market for smaller investors, providing investor liquidity, reducing leverage, and generating investor income. As 2013 economics Nobel Prize winner Robert Shiller of Yale University said:

> REITs were created by law in 1960 to democratize the real estate market and make it possible for a broad base of investors to participate in this huge asset class. That was absolutely the right thing to do, because portfolio theory tells us people should diversify across major asset classes, and real estate is one of them.

NAREIT, "The REIT Story," *available at* https://www.reit.com/sites/default/files/media/PDFs/The-Reit-Story.pdf. Another prominent real estate economist, Timothy Riddiough of the University of Wisconsin, found that a "well-structured real estate securitization market," to which REITs contribute, moderates "construction boom and bust tendencies" and thus generates "positive spillover benefits to the economy at large." *Id.*

Although this question was both posed and resolved favorably by Rev. Rul. 2002-38,[9] which concluded that the gross income constitutes section 856(d) rents from real property,[10] the ruling's analysis and conclusions are extremely subtle and become clear only after examining the evolution of the REIT statute. To illuminate the full application of Rev. Rul. 2002-38, this report explains and analyzes the treatment of REIT revenues from tenants for services provided to those tenants by a REIT's TRS (1) in cases in which those revenues do not represent section 856(d)(1)(B) charges for services customarily furnished or rendered in connection with the rental of real property[11] and (2) regardless of whether the services are billed to tenants separately or as part of a bundled charge.[12] For purposes of

[9]2002-2 C.B. 4.

[10]Section 856(d) rents from real property satisfy both the 95 percent REIT gross income qualification test and the 75 percent REIT gross income qualification test. *See* section 856(c)(2)(C) and (c)(3)(A).

[11]Section 856(d)(1)(B). *See also* reg. section 1.856-4(b)(1), which states:

> The term "rents from real property", for purposes of paragraphs (2) and (3) of section 856(c), includes charges for services customarily furnished or rendered in connection with the rental of real property, whether or not the charges are separately stated. Services furnished to the tenants of a particular building will be considered as customary if, in the geographic market in which the building is located, tenants in buildings which are of a similar class (such as luxury apartment buildings) are customarily provided with the service. . . . To qualify as a service customarily furnished, the service must be furnished or rendered to the tenants of the [REIT] or, primarily for the convenience or benefit of the tenant, to the guests, customers, or subtenants of the tenant.

In this report, we refer to the standard created by Congress in section 856(d)(1)(B), as implemented by reg. section 1.856-4(b)(1), as the "section 856(d)(1)(B) standard." The section 856(d)(1)(B) standard and its use of the term "customary" is not coterminous with the use of "customary" under reg. section 1.512(b)-1(c)(5) (described *infra* in notes 47-51 and their accompanying text), in which the term has been interpreted in a slightly more limited fashion. *See infra* notes 49, 51, and 57. For purposes of this report, the section 856(d)(1)(B) standard will be used throughout, unless the discussion or context specifically references section 512(b)(3) and reg. section 1.512(b)-1(c)(5) (referred to in this report as the "section 512(b)(3) standard").

[12]The IRS recently opened a regulations project regarding "clarifying the definition of income in section 856(c)(3) for purposes of the [REIT] qualification tests." Treasury, "2014-2015 Priority Guidance Plan," at 12, item 11 (Aug. 26, 2014). During a NAREIT conference on March 31, 2015, a branch chief noted that the IRS was "looking at all of the different aspects of REIT income testing. There's a lot in there. It's a lot more complex than what is real property." Amy S. Elliott, "REIT Industry Stressed Over Preferential Dividend Ruling," *Tax Notes*, Apr. 6, 2015, p. 58. This report illustrates that complexity and provides an analysis consistent with the code and prior guidance. We recommend that the conclusions of Rev. Rul. 2002-38, as articulated and explicated in this report, be preserved in any future regulations that touch on the topic.

this report, the term "subject revenues" refers to a REIT's section 61 gross income from all revenues for TRS-provided non-customary services, whether the associated charges to tenants are itemized separately or part of an overall bundled charge to tenants.[13]

II. The REIT World Before TRSs

A. The 1960 Standard

When REITs were created in 1960, Congress excluded from the definition of rents from real property amounts when the REIT directly furnished or rendered services to the tenants or managed the property.[14] Thus, initially, Congress did not want REITs to provide services to their tenants directly. Instead, as a practical matter, the statute permitted a REIT to provide those services only through an independent contractor.[15]

To implement the law, regulations first proposed in 1961 stated that all REIT income attributable to tenant services (and, through guilt by association, apparently all income from a property where the REIT performed tenant services) did not constitute rents from real property. Accordingly, a REIT could not perform those services without running afoul of the REIT gross income tests, and any fees for those services had to be included in the income of an independent contractor rather than the REIT.[16] However, the final regulations issued in 1962, T.D. 6598,[17] "extensively revised the proposed regulations on the issue of 'independent contractor'" and introduced the concept of "customarily provided services" to the REIT lexicon.[18] They retained the proposed regulations' requirement that all services provided by a REIT landlord to its tenants be provided through an independent contractor, but they created two separate regimes for those services: one for services for which no separate charge was made (limited to customarily provided services)[19] and one for all services for which a separate charge was made (including customarily provided services with a separate charge *and* all non-customarily provided services).[20] The combination of the 1960 code and the 1962 final regulations is referred to in this report as "the 1960 standard."

The 1960 standard made a slight bow to commercial reality by treating the full amount received by a REIT landlord from its tenant as rents from real property in the case of customary services for which no separate charge was made.[21] However, a REIT was still required to furnish those services through an independent contractor, and the facilities through an which those services were furnished were required to be maintained and operated by an independent contractor[22] that had to be "adequately compensated" by the REIT.[23] Meanwhile,

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[13]As Rev. Rul. 2002-38 makes abundantly clear, in a typical commercial setting, the REIT itself bills and collects for subject revenues, and accordingly the REIT itself has section 61 gross income for those amounts, which is the starting point for REIT 75 percent and 95 percent gross income testing under section 856(c)(2) and -(3), according to reg. section 1.856-2(c)(1).

[14]H. Rep. No. 86-2020 (June 28, 1960). *See* former section 856(d)(3) (1960).

[15]*Id.*

[16]Prop. reg. section 1.856-4(b)(3)(i) (Jan. 19, 1961). To be precise, this proposed regulation provided that "certain amounts, although received or accrued for the use of, or the right to use, real property of the [REIT], will not be includible as 'rents for real property' for the purposes of the gross income requirements," including:

> any amount received or accrued, directly or indirectly, with respect to any real property if the [REIT] furnishes or renders services to the tenants of such property, or manages or operates such property, other than through an independent contractor from whom the [REIT] itself does not derive or receive any income. . . . If any services are performed for tenants, such services must be performed by, and the charges therefor (whether such charges are separately stated or included in the amount paid as rent) must be included in the income of, an independent contractor. . . . Thus, the [REIT] must not receive any income which is attributable to the services performed for the tenants of the [REIT] by an independent contractor.

Thus, the amount that the REIT landlord would have to pay the independent contractor would have to at least equal the amount that the REIT received from the tenants for the services (or the amount it was deemed to receive, in the case of bundled service charges). Apparently, if the REIT retained even a penny of services income, the entire amount of rent that it received (including for basic occupancy) would fail to qualify as rents from real property. However, then as now, normal commercial practice required landlords to provide services to tenants. *See infra* text accompanying note 28. As a result, a contemporary commentator noted that "more time was devoted to the concept of 'independent contractor' at the hearings [on] the [proposed] regulations than to all the other problems combined." Theodore Lynn, "Real Estate Investment Trusts: Problems and Prospects," 31 *Fordham L. Rev.* 73, 90 (1962).

[17]27 F.R. 4089 (Apr. 28, 1962).

[18]Lynn, *supra* note 16, at 91.

[19]Former reg. section 1.856-4(b)(3)(i)(*b*) (1962). New subdivision (*b*) was titled "Customary Services for Which No Separate Charge Is Made."

[20]Former reg. section 1.856-4(b)(3)(i)(*c*) (1962). New subdivision (*c*) was titled "Services for Which a Separate Charge Is Made."

[21]Former reg. section 1.856-4(b)(3)(i)(*b*) (1962). This result was achieved by stating in new subdivision (*b*) (but not in (*c*)) that:

> for purposes of [the REIT provisions], an amount will not be disqualified as "rent" if services, such as are usually or customarily furnished or rendered in connection with the mere rental of real property, are furnished or rendered to tenants of the property through an independent contractor.

[22]*Id.*

[23]Former reg. section 1.856-4(b)(3)(i)(*d*) (1962). The term "adequately compensated" was given a lengthy definition that

(Footnote continued on next page.)

services for which a separate charge was made, regardless of whether the services were customary or non-customary, required the independent contractor to bear the cost of the services and to receive and retain the entire amount of the separate charge.[24] The 1962 final regulations enumerated services that may be customary and services that were usually non-customary,[25] although it provided no means of discerning if or when the services were to be considered customary.

Although the 1962 final regulations were a substantial improvement over the 1961 proposed regulations, the 1960 standard's shortcomings remained obvious to many. As a former commissioner of internal revenue noted at the time regarding the new regime, "Favorable tax treatment does not assure favorable investment."[26] He believed that the most difficult aspect of the 1960 standard was the relationship between the REIT and the independent contractor.[27] Another commentator of the time expressed the problem succinctly:

> The emphasis on the distinction between active and passive income probably devolved from the fact that mutual funds have only passive income; yet the ownership of securities differs substantially from that of real estate. Ownership of real estate today is hopelessly encumbered with management functions, as well as the duty to provide certain incidental services, and these management functions and services result in income, "active" income no less. Needless to say, it is often "good management" and the incidental services which make one multiple-occupancy building more desirable (and hence more valuable) than another.[28]

A third commentator noted that the "independent contractor concept, so vague in theory, may become chaos in practice."[29] Congress kept revisiting tenant services and the independent contractor/REIT relationship over the next 40 years to bring order to the chaos.

B. The 1976 Revisions

The weaknesses of the 1960 standard, including the differentiated treatment between customary services bundled in the rental charge versus customary services for which a separate charge was made, did not permit the REIT format to be a useful vehicle for real estate ownership and investment, defeating the very purpose of the statute.[30] In 1976 Congress made a first attempt to address those weaknesses. The Tax Reform Act of 1976 (P.L. 94-455) provided that rents from real property included "charges for services customarily furnished or rendered in connection with the rental of real property, whether or not such charges are separately stated."[31] It also set standards regarding when services provided by a landlord to a tenant should be considered customary.[32] In explaining those changes, the Senate report stated:

> Under present law, amounts received by a REIT for services rendered to tenants, where no separate charge is made, will qualify for the

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can be summarized as a requirement that the independent contractor receive fair market value for its services.

[24]Former reg. section 1.856-4(b)(3)(i)(*c*) (1962). This requirement was broken into two parts. For non-customary services:

> The cost of such services must be borne by the independent contractor, a separate charge must be made therefor, and the amount thereof must be received and retained by the independent contractor; no amount attributable to such services shall be included in the gross income of the [REIT].

And for customary services:

> If a separate charge is made for the customary services described in (b) of this subdivision, such charge must be made, and the amount thereof must be received and retained, by the independent contractor rather than by the [REIT].

[25]*See* former reg. section 1.856-4(b)(3)(i)(*b*)-(*c*) (1962).

[26]Mortimer Caplin, "Foreword," 48 *Va. L. Rev.* 1007, 1009 (1962).

[27]*Id.*

[28]J.B. Riggs Parker, "REIT Trustees and the 'Independent Contractor,'" 48 *Va. L. Rev.* 1048, 1051 (1962). This commentator

(Footnote continued in next column.)

also examined the 1960 standard and found it wanting because the REIT itself was merely an aggregation of individual properties requiring the management and services that the 1960 standard forbade the REIT from supplying directly:

> The apparent conclusion is that only a true *uncontrolled, unsupervised* "agency law" type of independent contractor will qualify under the REIT tax provisions. . . . The REIT trustees are, in effect, *required by the Code* to delegate to a real estate management company the duty of managing individual properties and providing services to the tenants of such properties if such services are necessary or desirable and proper, and to *relinquish control* over the real estate management company in the performance of those management functions. . . . [The regulation] seems to assume that the distinction between the REIT trustee's fiduciary duty to manage the "trust itself" and managing or "operating the property" of the trust is obvious. Such an assumption appears to be at least an oversimplification. What is the "trust itself" other than an agglomeration of properties which must be individually managed? [Emphasis in original.]

Id. at 1053-1054.

[29]Lynn, *supra* note 16, at 92.

[30]A Goldman Sachs report from 1996 stated that only 10 REITs of any real size existed during the 1960s but that those REITs had "miniscule" portfolios of real property when compared with other property owners. *See* Ralph L. Block, *Investing in REITs: Real Estate Investment Trusts* 110-111 (2006) (quoting the report's finding that REIT industry-wide real estate investments in the 1960s amounted to slightly more than $200 million).

[31]Section 856(d)(1)(B), which is still in effect today.

[32]*See supra* text accompanying note 25.

> 75-percent and 95-percent source tests if the services are customary and are furnished by an independent contractor. However, if a separate charge is made for customary services furnished by an independent contractor, the income tax regulations take the position that the amount of the charge must be received and retained by the independent contractor and not by the REIT. This restriction on separate charges for customarily furnished services does not follow normal commercial practice. Consequently, the committee amendment and House bill provide that amounts received by a REIT as charges for services customarily furnished or rendered in connection with the rental of real property will be treated as rents from real property whether or not the charges are separately stated.[33]

At the same time, TRA 1976 created a standard for determining the circumstances under which services should be considered customary for section 856(d) purposes:

> The committee intends that, with respect to any particular building, services provided to tenants should be regarded as customary if, in the geographic market within which the building is located, tenants in buildings which are of a similar class (for example, luxury apartment buildings) are customarily provided with the service.[34]

Thus, TRA 1976 followed normal commercial practice and overturned the artificial differentiation in the 1960 standard between bundled customary services and separately stated customary services. Accordingly, after TRA 1976 all amounts received by a REIT for customary services constituted rents from real property under section 856(d)(1)(B), regardless of whether a separate charge or an allocation was made. However, the prohibition on a REIT providing services directly instead of through an independent contractor remained in the code.[35]

In response to TRA 1976, the IRS revised the regulations governing section 856(d) rents from real property.[36] In the revised regulations, all services (whether customary or non-customary) still had to be provided through an independent contractor,[37] but a REIT could now treat any amounts received from tenants from the provision of customary services as rents from real property (whether those services were bundled with the rent or separately stated).[38] A new regulation addressing the treatment of independent contractors was put in place to address the rendering of non-customary services, which was substantially similar to the provision in the 1960 standard.[39] Under this new regulation, the only way a REIT landlord could deliver non-customary services to its tenants was to meet each of the following six requirements of the code and Treasury regulations:

[33]S. Rep. No. 94-938, at 473-474 (June 10, 1976).

[34]*Id.* As part of its customary services analysis in TRA 1976, the legislative history also stated that the submetering of electricity (and, by extension, other utilities) by a REIT landlord should be considered a customary service. For the long-standing definition of submetering, see Morway Picket, "The Legal Status of the Submeterer of Electric Current," 37 *Col. L. Rev.* 227 (1937) ("Submetering is the term applied to the remetering and resale of public utility services, purchased by the building owners through a master meter at wholesale rate, to their tenants at retail rates."). Before TRA 1976 it was unclear how submetering should be treated by a REIT landlord. It was clear that the provision of utilities by a landlord was a customary service for a tax-exempt landlord under the section 512(b)(3) standard. *See*, *e.g.*, Rev. Rul. 69-178, 1969-1 C.B. 158 (the rental of a meeting hall where only usual and customary services — but including all utilities — were provided by the landlord-generated rents from real property for a tax-exempt entity). But in the 1960 standard, submetering was listed under "services for which a separate charge is made," a provision that included both separately charged customary services and all non-customary services. *See* former reg. section 1.856-4(b)(3)(i)(*c*) (1962). In Rev. Rul. 75-340, 1975-2 C.B. 270, the IRS implied that submetering was a non-customary service, differentiating between the situation where "a separate charge is made for a usual or customary service" and the situation "where electric current is purchased by the [REIT] and then sold to tenants at a price in excess of the purchase price (for example, submetered)." After TRA 1976, however, the IRS abandoned this implied nuance.

[35]*See* former section 856(d)(2)(C) (1976):

> For purposes of paragraphs (2) and (3) of subsection (c), the term "rents from real property" does not include . . . any amount received or accrued, directly or indirectly, with respect to any real or personal property if the [REIT] furnishes or renders services to the tenants of such property, or manages or operates such property, other than through an independent contractor from whom the [REIT] itself does not derive or receive any income.

Even with TRA 1976's improvements to the REIT structure, the public equity market capitalization of the REIT industry was smaller at the end of 1979 than it had been at the end of 1972. *See* Block, *supra* note 30, at 113.

[36]The IRS proposed new regulations on July 7, 1978, and finalized them with only minor, inconsequential changes in T.D. 7767, 46 F.R. 11282 (Feb. 6, 1981). In a key revision, the TRA 1976 standard adopted by Congress for determining which services should be considered customary (see *supra* text accompanying note 34) replaced the enumerated lists of customary and non-customary services in the 1960 standard. The version of reg. section 1.856-4(b)(1) that was adopted as part of T.D. 7767 is still in effect today.

[37]*See*, *e.g.*, reg. section 1.856-4(b)(1): "The service must be furnished through an independent contractor from which the [REIT] does not derive or receive any income."

[38]*Id. See supra* text accompanying note 31.

[39]*See infra* note 42.

- the REIT and the independent contractor had to be less than 35 percent affiliated;[40]
- the REIT could not earn interest, dividend, rental, or other income from the independent contractor;[41]
- the charges for the services had to be separately stated;
- the service revenues had to be collected by the independent contractor;
- the service revenues had to be retained by the independent contractor; and
- the independent contractor had to be adequately compensated.[42]

These six independent contractor rules were split in applicability: the first two applied to all services provided by independent contractors, whereas the last four applied only to the provision of noncustomary services by the independent contractor. Yet, even after all the useful changes made by TRA 1976, there was still the fundamental problem of the 1960 structure for both customary and noncustomary services: a REIT was required to "relinquish control" over the services to an "uncontrolled, unsupervised" agent.[43]

C. The 1986 Revisions

Congress returned to the REIT provisions a decade later, in the Tax Reform Act of 1986 (P.L. 99-514). Again, a main focus was the REIT's inability to control the services provided to tenants. TRA 1986 was the first legislation to provide that a REIT could actively provide services to tenants without using an independent contractor. As the 1986 blue book put it:

> The Congress believed that [the] requirements of present law, that are intended to assure that the REIT is more a passive entity than one engaged in an active trade or business, may be overly restrictive and should be liberalized consistent with maintaining the essential passivity of the REIT. Congress believed that REITs should be permitted to perform certain services in connection with the rental of real property without being required to use an independent contractor (to assure that rents from such property are considered to qualify as "rent from real property"). The Congress believed that the same standard should be applied to REITs for the purpose of determining whether amounts being received are from the passive rental of real property or from an active trade or business, that is applied to tax-exempt entities in determining whether amounts are treated as income from an "unrelated trade or business."[44]

This liberalization was implemented by TRA 1986, which added a new exception to former section 856(d)(2)[45] to treat as qualifying rents from real property "any amount if such amount would be excluded from unrelated business taxable income under section 512(b)(3) if received by an organization described in section 511(a)(2)."[46] The new exception explicitly made reg. section 1.512(b)-1(c)(5) and the section 512(b)(3) a standard part of the REIT rules.[47] Accordingly, the test used by the IRS exempt organizations group to determine

[40]*See* section 856(d)(3).

[41]*See infra* note 42. *See also* section 856(d)(7)(C)(i).

[42]*See* reg. section 1.856-4(b)(5)(i):

No amount . . . qualifies as "rents from real property" if the [REIT] furnishes or renders services to the tenants of the property . . . other than through an independent contractor from whom the [REIT] itself does not derive or receive any income. . . . To the extent that services (other than those customarily furnished or rendered in connection with the rental of real property) are rendered to the tenants of the property by the independent contractor, the cost of the services must be borne by the independent contractor, a separate charge must be made for the services, the amount of the separate charge must be received and retained by the independent contractor, and the independent contractor must be adequately compensated for the services.

[43]*See supra* note 28.

[44]Joint Committee on Taxation, "General Explanation of the Tax Reform Act of 1986," at 391 (1986 blue book).

[45]*See supra* note 35.

[46]Former section 856(d)(2) (last sentence) (1986), reformulated in 1997 as section 856(d)(7)(C)(ii), which is still in effect today. As Rev. Rul. 98-60, 1998-2 C.B. 751, makes clear, section 856(d)(7)(C)(ii) and its incorporated section 512(b)(3) standard are not concerned with a too-literal application of the statutory "would be [as] if" wording, but instead create an outright exemption for any property-related services that a tax-exempt organization may perform without being in receipt of unrelated business taxable income.

[47]When Congress originally created the rules governing UBTI for some nonprofits, it left to the regulations most of the tough choices regarding real estate rental and services income. *See, e.g.*, S. Rep. No. 81-2375 (1950) (noting that some types of investment income "have long been recognized as a proper source of revenue for educational and charitable organizations and trusts"). Reg. section 1.512(b)-1(c)(2), included in T.D. 6301, 23 F.R. 5192 (July 9, 1958), provided the first real guidance for those nonprofits regarding the treatment of investment income from rental real estate and services — and, with the exception of a few minor, insignificant changes (including the substitution of the term "rents from real property" for the term "rentals from real estate" and its later renumbering as reg. section 1.512(b)-1(c)(5)), this same regulation has provided the standard for nonprofits to use in differentiating UBTI from nontaxable rents from real property for more than 55 years. A variant of the section 512(b)(3) standard is also used in other areas of the code and regulations. *See, e.g.*, the self-employment regulations, reg. section 1.1402(a)-4(c)(1)-(2) (titled, respectively, "No services rendered for occupants" and "Services rendered for occupants").

whether services performed for a tenant of a nonprofit organization give rise to rents from real property under the section 512(b)(3) standard became the standard for services that a REIT could perform directly for its tenants without needing to use an independent contractor. The plain, unambiguous language[48] of reg. section 1.512(b)-1(c)(5) sets out a two-prong test[49]:

> For purposes of this paragraph, payments for the use or occupancy of rooms and other space where services are also rendered to the occupant [do] not constitute rent from real property. Generally, services are considered rendered to the occupant *if* they are provided primarily for his convenience *and* are other than those usually or customarily rendered in connection with the rental of rooms or other space for occupancy only.[50] [Emphasis added.]

Accordingly, clearing either prong of the above test would mean that the particular service is not considered rendered to the occupant, and the associated payments would therefore not be disqualified from section 512(b)(3) rents from real property.

Thus, by incorporating the section 512(b)(3) standard, TRA 1986 permitted REITs (for the first time) to directly render customary services to tenants without using an independent contractor and to include the amounts received for those services in section 856(d) rents from real property. If the section 512(b)(3) standard (and thus, as a practical matter, also the section 856(d)(1)(B) standard)[51] were satisfied, *all* revenues from the provision of those services qualified as rents from real property, regardless of whether they were bundled or separately stated under section 856(d)(1)(B) and regardless of whether they were provided at cost or at a markup over cost.[52]

For example, the archetypal service performed by a landlord, and explicitly noted as a customary service in the 1960 standard, is the provision of

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[48]As the Supreme Court has repeatedly confirmed, the ''plain meaning rule'' of statutory construction means that the plain meaning of a statute or regulation ''must prevail.'' *Atlantic Mutual Insurance v. Commissioner*, 523 U.S. 382, 387 (1998). *See, e.g.*, *Gitlitz v. Commissioner*, 531 U.S. 206, 219-220 (2001) (holding that the plain meaning of the code permitted S corporation shareholders to deduct previously suspended losses).

[49]Both the IRS and the courts have interpreted reg. section 1.512(b)-1(c)(5) as containing a two-prong test. *See, e.g.*, Internal Revenue Manual section 7.27.6.7.4.5, ''Rendering of Personal Services,'' which, similar to, and using wording almost identical to, reg. section 1.512(b)-1(c)(5), shows two prongs as separate requirements introduced by an ''if'' and connected by the conjunction ''and'':

> 1. Payment for the use or occupancy of rooms or other space where services are also rendered to the occupant does not constitute rent from real property. . . .
>
> 2. Generally, services are considered rendered to the occupant *if* they are primarily for his/her convenience *and* are different from those usually or customarily rendered in connection with the rental of rooms or space for occupancy only. [Emphasis added.]

See also Ocean Pines Association, Inc. v. Commissioner, 135 T.C. 276, 287 (2010):

> But the test in the regulation for determining whether the services are rendered to the occupant (and therefore disqualify the organization from using the rental exception) is not whether the services provided are substantial, but whether the services are (1) ''primarily'' for the ''convenience'' of the occupant and (2) are ''other than those usually or customarily rendered in connection with the rental of rooms or other space for occupancy only.''

IRS private letter rulings have also noted the two-prong test. *See, e.g.*, LTR 200241050 (requested ruling 7) (''Even if the Service determines that the marketing and promotional activities related to the Property fail to meet the *two-prong test* of section 1.512(b)-1(c)(5) of the Income Tax Regulations'' (emphasis added).).

[50]The regulations do not explain further what is meant by ''provided primarily for [the tenant's] convenience.'' On closer inspection, some services that might seem oriented to tenant convenience are in fact more closely related to property-wide safety and security. *See, e.g.*, LTR 9014022, in which an apartment REIT:

(Footnote continued in next column.)

> will continue a longstanding practice of changing light bulbs in certain built-in light fixtures located in particular apartments. These fixtures constitute valuable and integral components of the apartment properties and the Company's policy of insisting that light bulbs (which are paid for by the tenant) in these fixtures be removed and replaced only by management personnel is designed to reduce breakage of these valuable fixtures.

See also LTR 8914048 (apartment REIT may ''install and/or remove air conditioning units during a tenant's lease term as is also usual and customary. In connection with the installment and removal of such units [the REIT] may charge a small fee'').

[51]In theory, this exception for section 512(b)(3) in former section 856(d)(2) (now in section 856(d)(7)(C)(ii)) did not mean that any service qualifying under the section 512(b)(3) standard automatically satisfied the section 856(d)(1)(B) standard, but in practice this is so. *Cf.* LTR 200101012 (holding that the provision of Internet, telephone, cable television, security services, and computer room facilities in some apartment complexes is exempt under section 512(b)(3) (and also under the section 856(d)(1)(B) standard), but the provision of private shuttle bus services for tenants of the apartment complexes is exempt only under the section 856(d)(1)(B) standard enumerated in section 856(d)(7)(C)(i)). In words often attributed to Yogi Berra: ''In theory there is no difference between theory and practice. In practice there is.''

[52]For example, on submetering of utilities, LTR 200148074 and LTR 200147058 both clearly state that the landlord ''will retain the difference between the price it charges its tenants and the amount it owes the utility provider for the Utility Services, which may result in a profit to the'' landlord and conclude that:

> any income derived by the [landlord] in connection with the provision of electricity, water, sewer and gas service is not service income, but is includable in ''rents from real property'' within the meaning of section 512(b)(3) of the Code, whether or not the charges for electricity, water, sewer or gas service are separately stated or are incorporated into the tenant's rental obligations.

utilities.[53] Under TRA 1986, REITs could now provide utility services directly without any involvement from an independent contractor.[54] Accordingly, REITs could now be engaged in the active trade or business of providing customary services satisfying the section 512(b)(3) standard to tenants. In response to TRA 1986, the IRS published a ruling appropriately changing its position about REIT involvement in a trade or business.[55]

Of course, REITs could also continue to provide customary services through independent contractors and continue to treat the amounts received for those services as rents from real property.[56] In effect, TRA 1986 created a middle ground for REIT tenant services that satisfy the section 856(d)(1)(B) standard but not the section 512(b)(3) standard. Those middle ground services could not be performed by the REIT directly but could be performed by an independent contractor under an arrangement with the REIT that had to satisfy the first two (but not necessarily the last four) independent contractor rules discussed in Section II.B.[57] However, TRA 1986 did not affect the treatment of non-customary services provided by a REIT to its tenants. Those still had to be performed by an independent contractor under an arrangement that satisfied all six rules in reg. section 1.856-4(b)(5)(i), meaning that a REIT was still required to relinquish control over some of its customary services and all of its non-customary services to an uncontrolled, unsupervised agent.[58]

III. The Advent of TRSs

After almost 40 years of REITs being handicapped in attracting and competing for tenants, the REIT Modernization Act of 1999 (RMA) finally removed the barrier that prevented REIT landlords from being able to control and supervise the offering of non-customary services to their tenants. The RMA was included in the Ticket to Work and Work Incentives Improvement Act of 1999 (P.L. 106-170) and became effective January 1, 2001. It created a new type of REIT subsidiary, the section 856(l) TRS, that would be permitted to perform non-customary services for tenants that otherwise would have to be done by one or more independent contractors. The tradeoff was that unlike other REIT subsidiaries (but like an independent contractor), a TRS would be fully taxable. When introducing the RMA in the House, then-Rep. Bill Thomas, the principal sponsor of the act, said:

> Our legislation would allow REITs to create taxable subsidiaries that would be allowed to

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[53]*See supra* note 34. Reg. section 1.512(b)-1(c)(5) specifies that "the furnishing of heat and light" is a service that clears the two-prong test, even though at some level furnishing a utility is for the benefit of the tenant and in theory does not pass the first prong of the section 512(b)(3) standard — yet, it is considered so basic to the rental relationship that it has been designated as the archetypical good service that satisfies reg. section 1.512(b)-1(c)(5). *See, e.g.*, Rev. Rul. 69-178; LTR 199952084 (ruling in favor of a REIT when "the telecommunication services provided to tenants of the Properties are similar to the provision of services by public utilities and are essential for business communications and information transmission"). *Cf.* reg. section 1.856-4(b)(1) ("The furnishing of water, heat, light, and air-conditioning . . . are examples of services which are customarily furnished to" tenants); prop. reg. section 1.856-10(d)(3)(iii)(D) (performance of "a utility-like function" supports real property treatment).

[54]*See supra* text accompanying note 47.

[55]*See supra* text accompanying note 44. In Rev. Rul. 2001-29, 2001-1 C.B. 1348, the IRS acknowledged the impact of the TRA 1986 change:

> Consequently, as a result of the 1986 amendment, a REIT is permitted to perform activities that can constitute active and substantial management and operational functions with respect to rental activity that produces income qualifying as rents from real property under section 856(d).
>
> * * *
>
> A REIT can be engaged in the active conduct of a trade or business within the meaning of section 355(b) solely by virtue of functions with respect to rental activity that produces income qualifying as rents from real property within the meaning of section 856(d).

[56]As the 1986 blue book, *supra* note 44, at 395, clearly explained: "The Act does not alter the provision of prior law under which amounts received by a REIT are treated as rents from real property if the REIT provides customarily furnished services to its tenants through an independent contractor."

For a general background on customary services performed by REITs under these code provisions and their associated regulations (including reg. section 1.856-4(b)(1)), see, *e.g.*, Peter J. Genz, "REIT Customary Services Issues," 2007 *ABATAX-CLE* 0928051 (Sept. 6, 2007), updated Feb. 20, 2015 (manuscript in possession of the authors).

[57]*See, e.g.*, Rev. Rul. 2004-24, 2004-1 C.B. 550 ("The definition of rents from real property in section 856(d), which applies to REITs, differs significantly in scope and structure from the definition of rents from real property under section 512(b)(3), which applies to exempt organizations."); LTR 200101012 (holding that the provision of Internet, telephone, cable television, security services, and computer room facilities in some apartment complexes are exempt under section 512(b)(3) (which, as described *supra* at text accompanying note 51, is as a practical matter encompassed by the section 856(d)(1)(B) standard), but the provision of private shuttle bus services for tenants of the apartment complexes meets only the section 856(d)(1)(B) standard). *See also* LTR 200008036, LTR 9642027, and LTR 9316024 (involving various transportation services apparently provided to tenants under the section 856(d)(1)(B) standard but not the section 512(b)(3) standard, although the facts and exposition are not entirely clear). Significantly, according to reg. section 1.856-4(b)(5)(i), these middle-ground services need to meet only the first two, but not all six, of the independent contractor requirements enumerated in Section II.B. *See supra* text accompanying notes 40-42.

[58]*See supra* note 28.

perform noncustomary services to REIT tenants without disqualifying the rents a REIT collects from tenants, that is, performance of these services would no longer trigger a technical violation of the REIT rules.[59]

In his introductory remarks for the RMA in the Senate, then-Sen. Connie Mack concurred:

> As a result [of the customary services rule], REITs increasingly have been unable to compete with privately-held partnerships and other more exclusive forms of ownership. Today, the rules prevent REITs from offering the same types of customer services as their competitors, even as such services are becoming more central to marketing efforts.
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> * * *
>
> Certainly, this is not consistent with what Congress intended when it created REITs, and when it modified the REIT rules over the years. In keeping with the Congressional mandate to provide a sensible and effective way for the average investor to benefit from ownership of income-producing real estate, REITs should be able to provide *a range of services* through taxable subsidiaries.[60] [Emphasis added.]

The Senate report noted the control issue that existed under the independent contractor regime, stating:

> Certain kinds of activities that relate to the REIT's real estate investments should be permitted to be performed *under the control of the REIT*, through the establishment of a "taxable REIT subsidiary" where there are rules that limit the amount of the subsidiary's income that can be reduced through transactions with the REIT.[61] [Emphasis added.]

Thus, with the introduction of TRSs, REITs could finally compete for tenants with other, more flexible types of landlords without first involving an uncontrolled and unsupervised agent.[62] But with the advent of TRSs creating a novel structural paradigm for tenant services by permitting for the first time a REIT-controlled entity to be the provider for noncustomary services, the TRS structure created the foundation for asking and resolving an entirely new third question: Do subject revenues qualify as section 856(d) rents from real property?[63]

In the figure, subject revenues compose the outermost ring, which is shaded green (for unbundled service charges) and orange (for bundled service charges). The inner circle consists of charges for services that qualify as usual and customary under both reg. sections 1.512(b)-1(c)(5) (the section 512(b)(3) standard) and 1.856-4(b)(1) (the section 856(d)(1)(B) standard), while the middle ring consists of charges for services that qualify as customary only under reg. section 1.856-4(b)(1) (only the

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[59]145 *Cong. Rec.* E795 (Apr. 28, 1999).

[60]145 *Cong. Rec.* S5377 (May 14, 1999).

[61]S. Rep. No. 106-201, at 57 (Oct. 6, 1999). The Clinton administration also agreed with this change, as shown in its proposed 2000 budget:

> Many of the businesses performed by the REIT subsidiaries are natural outgrowths of a REIT's traditional operations, such as third-party management and development businesses. While it is inappropriate for the earnings from these non-REIT businesses to be sheltered through a REIT, it also is counter-intuitive to prevent these entities from taking advantage of their evolving experiences and expanding into areas where their expertise may be of significant value.

Treasury, "Explanation of the REIT-Related Items in the Fiscal Year 2000 Budget" (Feb. 1, 1999). The administration's caveat was satisfied in the enacted legislation in two ways: (1) the TRS vehicle created to render non-customary services is fully taxable, so all of its revenue is fully exposed to federal income tax;

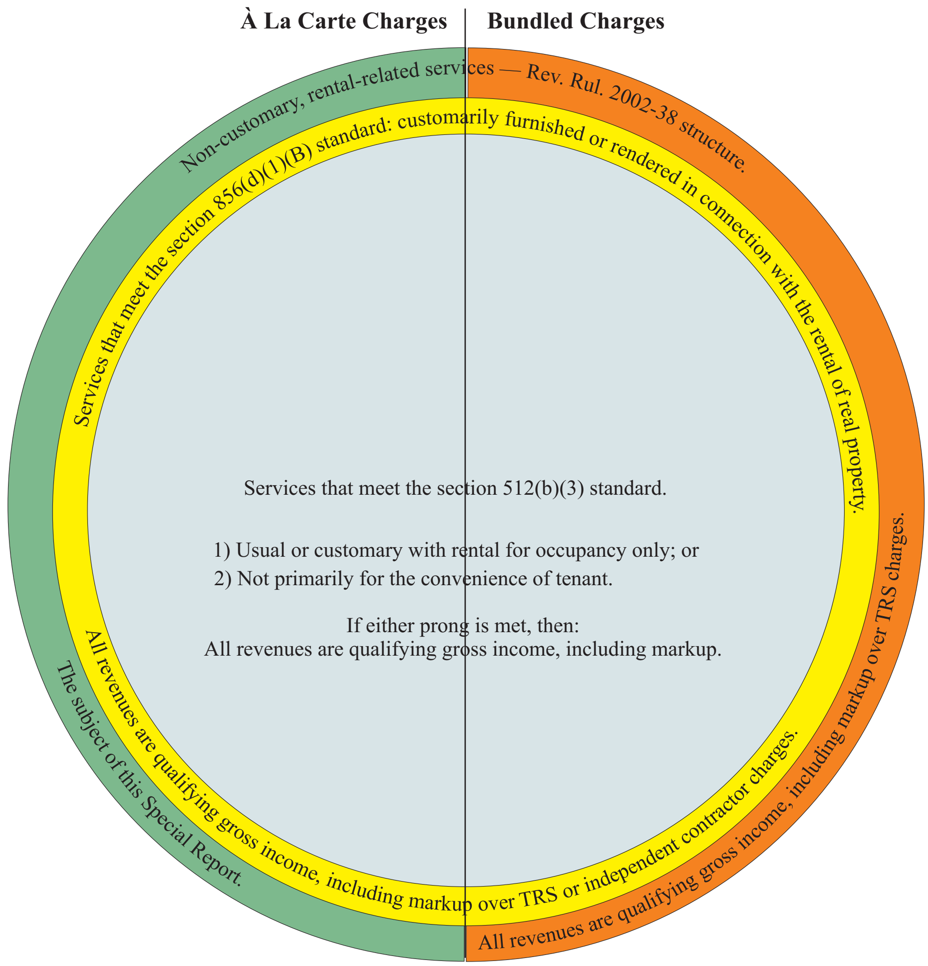
(Footnote continued in next column.)

and (2) improper allocations of revenues between the REIT and its TRS could trigger the 100 percent "redetermined rents" penalty tax discussed in Section IV.B *infra*.

[62]*See supra* note 28. In general, a TRS may engage in any manner of business activity, regardless of whether it is related to the provision of services to REIT tenants, except that section 856(l)(3) prohibits a TRS from operating or managing a lodging facility or a healthcare facility (as well as providing specific franchise or license rights for those facilities). This prohibition concerns day-to-day management and operations, not the type of supervisory functions described in reg. section 1.856-4(b)(5)(ii) and LTR 7930040. *See, e.g.*, LTR 201232032; *see also* section 856(d)(7)(A), (d)(8)(B) (second sentence), (d)(9)(A), (d)(9)(B), and (d)(9)(E). Further, a REIT's investment in the equity and debt of its TRSs, together with other nonqualifying assets, generally cannot exceed 25 percent of the REIT's total assets. *See* section 856(c)(4)(A) (25 percent limit as the mathematical complement of the 75 percent REIT asset test requirement) and section (c)(4)(B)(ii) (direct limit of 25 percent on securities of TRSs); and text accompanying note 1 (in particular the second and fourth bullet points there). For these purposes, however, a REIT's investment in TRS debt securities, to the extent secured by mortgages on real property, or a REIT's investment in TRS equity or debt securities, to the extent and for the duration qualifying as a temporary investment of new capital, will qualify as a real estate asset that counts toward the 75 percent REIT asset test requirement and is therefore not a security subjected to the 25 percent limit. *See* section 856(c)(4)(A), (c)(4)(B), (c)(5)(B), and (c)(5)(D); reg. section 1.856-3(c) ("The term 'securities' does not include 'interests in real property' or 'real estate assets' as those terms are defined in section 856 and" reg. section 1.856-3); LTR 201503010, LTR 201431020, LTR 201315007, LTR 201129007, LTR 200705001, and LTR 200630010 (debt securities of a TRS adequately secured by real estate are not securities for purposes of section 856(c)(4)(B)(ii)); and LTR 9342021 (long-term investment can qualify as a temporary investment of new capital for a temporary duration).

[63]*See supra* text accompanying notes 6-13.

Services at REIT-Owned Properties



section 856(d)(1)(B) standard).[64] Both inner circle and middle ring services have been acknowledged since TRA 1976 and TRA 1986 to represent section 856(d) rents from real property, whether bundled with the rent or separately charged. But what about subject revenues? If collected by the REIT, do they also represent rents from real property? Does it matter if they are bundled or separately charged? Should it matter?

The treatment of subject revenues from bundled services charges was answered clearly by Rev. Rul. 2002-38.[65] As discussed in Section IV.C below, when analyzing a fact pattern that involved bundled charges for a non-customary housekeeping service, Rev. Rul. 2002-38 concluded that the entire amount received by the REIT (including the bundled service charges for non-customary services) constituted rents from real property and were thus subject to any required redetermination of rents under section 857(b)(7). However, some have posited a distinction, similar to the 1960 standard,[66] between bundled subject revenues versus separately stated subject revenues, whereby separately stated subject revenues collected by a REIT might not represent section 856(d) rents from real property.

IV. Subject Revenues as Qualifying Rents

There are at least six interconnected and mutually reinforcing reasons why subject revenues (whether bundled or separately stated) constitute section 856(d) rents from real property.

A. Congressional Intent

As shown below, Congress intended that all subject revenues be treated as section 856(d) rents

[64] *See supra* note 57.
[65] *See supra* note 9.
[66] *See supra* text accompanying notes 19-24.

from real property. The RMA itself does not distinguish between separately stated versus bundled subject revenues, so the legislative history must be examined to see if that differentiation was intended.

The principal sources of legislative history regarding the treatment of TRS activities are the Senate report for the RMA and the 2000 blue book, the latter of which says:

> A taxable REIT subsidiary can engage in certain business activities that under prior law could disqualify the REIT because, but for the provision, the taxable REIT subsidiary's activities and relationship with the REIT would have prevented certain income from qualifying as rents from real property. Specifically, the subsidiary can provide services to tenants of REIT property (even if such services were not considered services customarily furnished in connection with the rental of real property [under the section 856(d)(1)(B) standard]), and can manage or operate properties, generally for third parties, without causing *amounts received or accrued* directly or indirectly *by the REIT for such activities* to fail to be treated as rents from real property.[67] [Emphasis added.]

In parsing the above legislative intent, three points stand out. First, the legislative history uses the phrase "amounts received or accrued" rather than "rents received or accrued," which implies that *all amounts* received by a REIT, including amounts for non-customary services, are intended to be included in rents from real property. That is, the legislative intent is clearly to include all of a REIT's receipts or accruals, not just charges for occupancy and customary services. Second, the term "such activities" specifically refers to services provided to tenants of REIT property that give rise to subject revenues, which again makes clear that subject revenues are encompassed by the legislative intent. Third, the legislative history makes no distinction between subject revenues that are separately stated versus those that are bundled with basic rent or customary services charges, and Congress has never created that distinction. (In fact, with TRA 1976, Congress overturned the distinction that the IRS created in the 1960 standard.[68]) Accordingly, there is no basis in the legislative history to distinguish between separately stated versus bundled subject revenues.

While the above legislative history uses double negatives ("without causing [subject revenues] to fail to be treated" as section 856(d) rents from real property), the rule that it created is in fact meant as an affirmative rule, particularly when read in the context of how tenant services were treated before the RMA[69]: Subject revenues *are* section 856(d) rents from real property. As explained below, this affirmative rule is confirmed by the structure of section 857(b)(7) and by Rev. Rul. 2002-38.

B. The Section 857(b)(7) Structure

As shown below, the statutory structure of the section 857(b)(7) 100 percent penalty tax is predicated on, and only consistent with, treating subject revenues as rents from real property. With the advent of TRSs as providers of services to REIT tenants, Congress gave the IRS a powerful new antiabuse tool: section 857(b)(7) (reproduced in the Appendix, *infra* Section VI), which was designed to prevent REITs from profiting through the misallocation of revenue or profit in arrangements involving their TRSs.[70] Added to the code by the RMA,[71] section 857(b)(7) provides for a 100 percent penalty tax that can be imposed only on redetermined rents, redetermined deductions, and excess interest, each as defined in section 857(b)(7). Redetermined rents are defined to include only section 856(d) rents from real property.[72] When the penalty tax is applied, it supersedes the application of section 482 remedies,[73] because it is a more powerful tool. However, this tool can be applied only to amounts that constitute section 856(d) rents from real property in the first place. Thus, for the entire legislative structure of penalties to work as intended for TRS-provided services, subject revenues must constitute rents from real property.

[67]JCT, "General Explanation of Tax Legislation Enacted in the 106th Congress," JCS-2-01, at 70 (Apr. 19, 2001) (2000 blue book); *see also* S. Rep. No. 106-201, at 59 (Oct. 6, 1999) (using identical language to the 2000 blue book except for verb tenses and a typo).

[68]*See supra* Section II.

[69]*See supra* Section II.

[70]*See supra* note 61.

[71]The wording of section 857(b)(7) in the RMA was corrected by a technical corrections bill (fixing a nit in section 857(b)(7)(B)(ii) that referenced paragraph "(7)(C)(i)" instead of "(7)(C)(ii)") before the January 1, 2001, effective date of the TRS provisions. *See* Consolidated Appropriations Act of 2001 (P.L. 106-554), Appendix G (H.R. 5662), section 311(b). The corrected wording, which represents the wording of this provision as of January 1, 2001, is used in the Appendix, *infra* Section VI.

[72]*See* section 857(b)(7)(B)(i). That redetermined rents must first be section 856(d) rents from real property has been true throughout the entire existence of section 857(b)(7), as amended from time to time. The section 857(b)(7) concepts of redetermined deductions and excess interest are limited to deductions by the TRS for payments to the REIT; by definition, they cannot cover a REIT's undercompensation of its TRS for services provided by the TRS to REIT tenants, because only redetermined rents can do that. *See* section 857(b)(7)(C)-(D).

[73]*See* section 857(b)(7)(E).

The above point is particularly obvious in light of former section 857(b)(7)(B)(ii), which was deleted in a 2004 legislative change but was still in effect when Rev. Rul. 2002-38 was issued.[74] Former section 857(b)(7)(B)(ii) exempted services described within section 856(d)(1)(B) or section 512(b)(3) from the then reach of the 100 percent penalty tax. Sections 856(d)(1)(B) and 512(b)(3) cover all customarily provided services performed by REITs or their TRSs. Thus, under the statutory structure initially created by the RMA, if section 857(b)(7) redetermined rents did not apply to subject revenues, the provision would have applied to nothing at all because former section 857(b)(7)(B)(ii) exempted everything that satisfied the section 856(d)(1)(B) standard.[75]

Accordingly, an interpretation under which subject revenues were not rents from real property would have rendered the section 857(b)(7) redetermined rents provision entirely superfluous. One of the few universally accepted canons of statutory construction is that any interpretation that renders a statutory term as surplusage or a nullity is strongly disfavored.[76] In sum, subject revenues must have been section 856(d) rents from real property; otherwise, section 857(b) redetermined rents as initially created by the RMA would be surplusage. The later amendment to section 857(b)(7) has not affected the original intent to include subject revenues within section 856(d) rents from real property and thus within the reach of the section 857(b)(7) 100 percent penalty tax.[77]

Further, former section 857(b)(7)(B)(v) (current section 857(b)(7)(B)(iv)) specifically excluded some separately charged services from the reach of the 100 percent penalty tax on redetermined rents. If separately charged subject revenues were not intended by the RMA to be included in section 856(d) rents from real property, this exclusion would have been mere surplusage because *all* separately charged subject revenues would have been excluded from the reach of section 857(b)(7) as not being section 856(d) rents from real property in the first place. That is, such a view of separately charged subject revenues would render former section 857(b)(7)(B)(v) a nullity and thus is incorrect.[78] Accordingly, former section 857(b)(7)(B)(v) illustrates that Congress intended separately charged subject revenues, and not just bundled subject revenues, to constitute section 856(d) rents from real property under the RMA.

In sum, without applying section 857(b)(7) and its 100 percent penalty tax to subject revenues (whether bundled or separately stated), there would have been no purpose for section 857(b)(7) redetermined rents after the RMA. Because section 857(b)(7)(B)(i) applies only to section 856(d) rents from real property, subject revenues must have been intended to constitute rents from real property. Further — and again, to avoid interpretations that render statutory terms as surplusage or nullities — the fact that only some separately charged subject revenues are specifically excluded from the reach of section 857(b)(7)(B)(i) means that Congress intended that separately charged subject revenues generally (as well as bundled subject revenues) constitute section 856(d) rents from real property.

C. Rev. Rul. 2002-38

Rev. Rul. 2002-38 confirms that subject revenues, including unbundled subject revenues, are treated as rents from real property. Rev. Rul. 2002-38 analyzes an apartment REIT that provides noncustomary housekeeping services to its tenants through a wholly owned TRS that administers and

[74]As the 2004 legislative history indicates, the deletion of former section 857(b)(7)(B)(ii) was intended to eliminate the "free pass" given to payments made by a REIT to its TRS for customary services and instead subject those payments to the rigor of section 857(b)(7). *See* H. Rep. No. 108-755, at 333 (Oct. 7, 2004).

[75]*See supra* Section III, particularly the figure.

[76]*See*, *e.g.*, *Duncan v. Walker*, 533 U.S. 167, 174 (2001) (refusing to adopt a construction of a statute that would leave a statutory term "insignificant, if not wholly superfluous"); *Williams v. Taylor*, 529 U.S. 362, 404 (2000) (describing this rule as a "cardinal principle of statutory construction"); *United States v. Menasche*, 348 U.S. 528, 538-539 (1955) ("It is our duty 'to give effect, if possible, to every clause and word of a statute'" (quoting *Montclair v. Ramsdell*, 107 U.S. 147, 152 (1883)).); *Market Co. v. Hoffman*, 101 U.S. 112, 115 (1879) ("As early as in Bacon's Abridgment, sec. 2, it was said that 'a statute ought, upon the whole, to be so construed that, if it can be prevented, no clause, sentence, or word shall be superfluous, void, or insignificant.'"); and *BLAK Investments v. Commissioner*, 133 T.C. 431 (2009) (quoting *Menasche*). The IRS has adopted this doctrine in its own interpretations. *See* TAM 9637008 (rejecting an interpretation of section 58(h) that would leave section 56(b) as "statutory deadwood"); and TAM 8940005 (rejecting an interpretation of reg. section 1.864-4(c)(2)(ii) that would make the word "otherwise" in reg. section 1.864-4(c)(2)(ii)(c) meaningless).

Moreover, because former section 857(b)(7)(B)(ii) was corrected in 2000 (see *supra* note 71), the very next year after it was added to the code by the RMA, section 857(b)(7) redetermined rents would most likely have been entirely deleted at that point, not revised, were it intended to be a nullity. Therefore, section 857(b)(7) redetermined rents must have been intended to apply to subject revenues.

[77]Although the 2004 amendment that deleted former clause (ii) commensurately expanded the scope of section 857(b)(7) redetermined rents, that amendment did not alter the RMA treatment of subject revenues. As Section IV.B clearly illustrates, subject revenues were originally intended by Congress to come within the ambit of redetermined rents, and to do so they had to have been section 856(d) rents from real property in the first place. *See supra* note 74.

[78]*See supra* note 76.

manages the services and bears all the related costs. The housekeeping services are bundled as part of the monthly rent charge to tenants, and the REIT pays the TRS for providing the services to the REIT's tenants. In Situation 1, the REIT pays the TRS 160 percent of the cost of the services. In Situation 2, the REIT pays the TRS only 125 percent of the cost of the services, which is stipulated to be less than the arm's-length transfer price under section 482. Rev. Rul. 2002-38 concludes that all the subject revenues in both situations — even when the TRS is undercompensated by the REIT in Situation 2 — constitute section 856(d) rents from real property.

In analyzing this extreme fact pattern of bundled charges,[79] Rev. Rul. 2002-38 concludes as an intermediate step that the non-customary housekeeping services performed by the TRS "do not give rise to impermissible tenant service income and thus do not cause any portion of the rents[80] received by [the REIT] to fail to qualify as rents from real property under section 856(d)."[81]

But the legal exposition and analysis do not end there. Rev. Rul. 2002-38 adds in the very next line: "As rents from real property, those rents[82] are subject to being treated as redetermined rents under section 857(b)(7)(B)(i)."[83] This is important because, by definition, redetermination under section 857(b)(7)(B)(i) can be performed only for amounts that first constitute section 856(d) rents from real property.[84] Thus, the remainder of the analysis and the conclusions in Rev. Rul. 2002-38 are predicated on a determination that all the amounts received by the REIT (which included both occupancy charges and services charges, bundled together as "rents") constitute section 856(d) rents from real property. That is, Rev. Rul. 2002-38 both explicitly and implicitly concluded that the appropriate treatment of the subject revenues was as section 856(d) rents from real property. In short, the genius of Rev. Rul. 2002-38 is that for subject revenues, it both creates a workable rule for REIT gross income testing[85] and imposes the discipline of the section 857(b)(7) 100 percent penalty tax,[86] all as Congress and the statutory structure intended.

Some have wondered whether Rev. Rul. 2002-38 might have come to a different conclusion if subject revenues had been separately stated as opposed to bundled with occupancy charges. For several reasons, that would not have been the case. First, nothing in the legislative history or structure of the RMA indicates that result. In fact, those authorities suggest the opposite: that all subject revenues, whether bundled or unbundled, constitute section 856(d) rents from real property.

Second, the scenarios considered in Rev. Rul. 2002-38 were meant to be the hardest, most extreme situations possible. The facts of the revenue ruling represent an explicit rejection of the older independent contractor requirements of reg. section 1.856-4(b)(5) for non-customary services and thus demonstrate the utility and flexibility of a TRS as a provider of non-customary services to REIT tenants.[87] Necessarily then, simpler and easier facts, including compliance with the old independent

[79]*See infra* text accompanying notes 87-88. The fact pattern in Rev. Rul. 2002-38 was "extreme" because of its intentional contrast to the six requirements of the prior independent contractor regime for non-customary services, one of those prior requirements being that service fees be separately stated. *See supra* text accompanying notes 39-43.

[80]Rev. Rul. 2002-38 used the word "rents" in this instance to include the service charges bundled therein in the facts of the revenue ruling (which states that "no service charges are separately stated from the tenants' rents"). 2002-2 C.B. 4, 5. As shown in Sections III and IV.A above, the legislative history is clear that all amounts received by the REIT, including amounts for services such as subject revenues, are also properly covered by the RMA.

[81]Rev. Rul. 2002-38, 2002-2 C.B. 4, 5.

[82]*See supra* note 80.

[83]*See supra* note 81.

[84]*See supra* Section IV.B.

[85]*See infra* Section IV.D.

[86]*See supra* Section IV.B.

[87]As discussed in Section II, before the creation of the TRS regime, the six independent contractor requirements represented the only way for a REIT to provide tenants services that could not meet the section 856(d)(1)(B) standard. That is, these six requirements applied to both halves of the outer ring in the figure of Section III. To demonstrate the utility and flexibility of TRSs as providers of non-customary services, Rev. Rul. 2002-38 recited extreme, expansive facts to reject each of the six independent contractor (IK) requirements as having any application to TRS arrangements:

Under the IK Regime:	Rev. Rul. 2002-38 Facts:
• The REIT and the independent contractor (IK) must have been less than 35 percent affiliated.	• The REIT and the TRS were 100 percent affiliated, well beyond the 35 percent threshold.
• The REIT could not earn interest, dividend, rental or other income from the IK.	• The REIT expected to earn dividends and rent from its TRS.
• The charges for the services had to be separately stated.	• There was no separate charge to tenants for the housekeeping services.
• The service revenues had to be collected by the IK.	• Revenues for the TRS services (which happened to be part of the bundled charge) were collected from the tenants by the REIT, and the existence and role of the TRS were opaque to the tenant.

(Footnote continued on next page.)

contractor rule of separately stated charges, are subsumed into the conclusion of Rev. Rul. 2002-38.[88] The IRS has apparently concluded in at least two private letter rulings that subject revenues are section 856(d) rents from real property.[89] Although both cases involved bundled subject revenues, the same conclusion would apply to unbundled subject revenues. To suggest that the liberation from separately stated charges in Rev. Rul. 2002-38 has somehow become a requirement to use bundled charges is to misread Rev. Rul. 2002-38 and get its intent backwards.

D. Industry Practice

As shown below, the treatment of subject revenues as section 856(d) rents from real property faithfully and fairly applies the REIT gross income tests, and treating subject revenues in this fashion is critical to many traditional public REITs. Consistent with the critical commentary regarding the 1960 standard, REITs today use their TRSs as a control point for property access and the provision of services to REIT tenants. Many activities that require widespread access through the landlord's property (including over and under the rented space of other REIT tenants) are now performed by TRSs for the orderly leasing and maintenance of the property, not primarily for the convenience of the tenant.[90] Otherwise, giving an independent party that access would create safety and security vulnerabilities for the other tenants of the property.[91] Also, the performance of non-customary services by a TRS of a REIT landlord increases the tenants' clout and comfort regarding the quality and reliability of service. This occurs because the REIT (unlike an

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Under the IK Regime:	Rev. Rul. 2002-38 Facts:
• The service revenues had to be retained by the IK.	• Revenues for the TRS services collected by the REIT from the tenants (which happened to be part of the bundled charge) were not paid over to the TRS, but instead the REIT hired the TRS under a subcontract and paid the TRS for its services based on an intercompany contractual arrangement.
• The IK had to be adequately compensated.	• In the first of the two situations, the TRS may not have been adequately compensated by the REIT, and in the second of the two situations, the TRS definitely was not adequately compensated by the REIT.

As this comparison demonstrates, the facts of Rev. Rul. 2002-38 are consciously liberated from the six independent contractor requirements, creating a system in which the separate existence of the TRS could remain opaque to REIT tenants, as the existence and use of subsidiaries already could be for non-REIT landlords. In the RMA, Congress intended its new TRS legislation to produce those benefits for REITs. *See supra* Sections III and IV.A, and in particular text accompanying notes 60, 67, and 69.

[88]This reading of Rev. Rul. 2002-38 is confirmed by the following passage from the text of the published ruling, which shows that the bundled charges were intended to make the underlying facts harder, not easier:

> In *Situations 1* and *2*, charges to the tenants for the housekeeping services are not separately stated from the rents that the tenants pay to *R* for the use of their apartments. As a result, the amounts of the rents reflect the availability and use of those services. In other words, *R* receives greater rental payments than it would have received if the services had not been provided to its tenants. However, the structure of the 100 percent tax on redetermined rents indicates that Congress did not intend the lack of a separately stated service charge, by itself, to cause services to be treated as rendered by a REIT, rather than its TRS.

2002-2, C.B. 4, 5. From this passage, it is clear that Rev. Rul. 2002-38 is focused on the substance of the arrangement (*viz.*, that the rents therein included fees for services) rather than the form of the arrangement (*viz.*, that somehow the mere act of bundling service fees with rents transmutes service fees into rents).

[89]*See* LTR 201317001 and LTR 201320007. These two private letter rulings indicate that some of the services provided by prison REITs under their tenant contracts and through their TRSs are outside the section 856(d)(1)(B) standard (*e.g.*, in LTR 201317001's description of halfway houses: "A few of the halfway houses employ a psychologist, but generally no other medical care is available onsite. One halfway house employs a nurse who provides basic medical services"). Despite that, all subject revenues in these private letter rulings are held to be section 856(d) rents from real property (to quote, each of the rulings states that "the *entire contract fee* will be treated as 'rents from real property' within the meaning of section 856(d)" (emphasis added)). *See also* LTR 201503010 (storage REIT's "related services"). By contrast, to our knowledge, there is not a single published or private letter ruling that concludes that subject revenues do not qualify as section 856(d) rents from real property. If there were, that would be expressly contrary to the structure of the statute, the legislative intent of the RMA, and Rev. Rul. 2002-38.

[90]*Cf.* reg. section 1.512(b)-1(c)(5) (first prong), *supra* text accompanying notes 49-51.

[91]Given the heightened security demands that tenants have placed on landlords (particularly after September 11, 2001, and in general when permitting access to confidential business-critical systems), REITs would prefer to use their own TRSs to provide any services that do not meet the section 856(d)(1)(B) standard, rather than rely on independent contractors to perform these sensitive roles. *Cf.* LTR 9014022 and LTR 8914048, *supra* note 50.

independent contractor) has an extensive lease relationship with the tenant, which it wants to protect. That gives the tenant significant commercial leverage if problems arise.

The correct interpretation of Rev. Rul. 2002-38 — namely, that subject revenues are section 856(d) rents from real property — is heavily relied on by many public REITs across a variety of real estate property sectors. The following is a non-exhaustive list of common situations in which public REITs treat subject revenues as rents from real property and might otherwise fail the 95 percent REIT gross income qualification test of section 856(c)(2):

- office REITs with separate charges for building amenities such as fitness center memberships and personal trainers, conference center and reception area catering, carwashes, shuttle services, daycare services, and subsidized cafeterias;
- apartment REITs with separate charges for amenities such as housekeeping services, pet care services, daycare services, dry cleaning services, and concierge services;
- shopping mall REITs with separate charges for advertising services and promotional services; and
- self-storage REITs with separate charges for pickup, packing, and delivery services, and for inspection and disposal services.

Further, the above interpretation of Rev. Rul. 2002-38 is not being abused by public REITs to ''hype'' their qualifying gross income and therefore more easily pass the REIT gross income tests. That interpretation is being used because it is the correct interpretation. This point is best illustrated by a realistic example. Suppose a public REIT has the following items of gross income under section 61 and reg. section 1.856-2(c)(1):

- $98 million of qualifying rent from occupancy charges and from charges such as utilities that are clearly covered by section 856(d)(1)(B);
- $2 million of revenue that is definitely nonqualifying because it is outside section 856(c)(2) altogether — for example, third-party management fees or the like; and
- at most $7 million of subject revenues.

If the subject revenues were merely excluded from REIT gross income testing altogether (say, under section 856(c)(5)(J)(i)), the REIT's gross income test percentage would be equal to 98 percent (98/(98+2)), and it would pass the 95 percent REIT gross income qualification test of section 856(c)(2). By contrast, if the subject revenues are properly included as rents from real property under Rev. Rul. 2002-38,[92] the REIT's gross income percentage would be equal to 98.13 percent ((98+7)/(98+2+7)), which is only immaterially higher.[93] The truly unfair outcome here would be to treat the subject revenues as section 61 nonqualifying income, whereby the REIT's gross income test percentage would equal only 91.6 percent (98/(98+2+7)), and the REIT would not pass the 95 percent REIT gross income qualification test of section 856(c)(2). That interpretation would reduce or even block the use of TRSs, which would contradict the express intent of Congress when it created the TRS structure in the RMA.

E. Section 856(c)(5)(J)(ii)

The lack of an explicit rule of inclusion for subject revenues in the RMA was offset by the later addition of section 856(c)(5)(J)(ii), which grants the IRS authority to designate otherwise nonqualifying items of income or gain as qualifying income under section 856(c)(2) or (3). When section 856(d) was reformulated under TRA 1976, section 856(d)(1) and (2) then served a clear purpose, as noted in their titles: ''Amounts included'' for section 856(d)(1) and ''Amounts excluded'' for section 856(d)(2).[94]

It is true but irrelevant that an explicit inclusion for subject revenues was not drafted into section 856(d)(1) as part of the RMA.[95] What is relevant is that Rev. Rul. 2002-38 incorporates the intended

[92]The correct interpretation of Rev. Rul. 2002-38 is tantamount to a rule of inclusion for subject revenues under section 856(c)(5)(J)(ii). Given that there is already a prescribed treatment for subject revenues under Rev. Rul. 2002-38, it would be inappropriate and confusing to fashion a new exclusion rule for the same under section 856(c)(5)(J)(i). Moreover, a ruling under section 856(c)(5)(J)(i) would remove subject revenues from the ambit of section 856(d) rents from real property and thus from the reach of the section 857(b)(7) 100 percent penalty tax. As explained in Sections IV.A-C, that was not the intent of Congress or the IRS and would result in inappropriate and incorrect conclusions.

[93]This numerical example shows that in practical terms and real-world cases, there is very little difference between the Rev. Rul. 2002-38 approach to subject revenues and an alternative approach under section 856(c)(5)(J)(i). ''Hyping'' qualifying revenue is not a concern: Mathematically, compliance with the 95 percent REIT gross income qualification test is anchored by the $2 million of nonqualifying revenue, and it matters little whether the denominator is $100 million or $107 million; that is, the REIT's so-called 5 percent bad basket (which is the mathematical complement of the 95 percent REIT gross income qualification test of section 856(c)(2)) has everything to do with the $2 million and very little to do with the $100 million or $107 million, which is as it should be.

[94]*See* TRA 1976.

[95]Because the RMA did so much and had so little legislative history, some rough patches were inevitable. To see another example of rough patches in the RMA concerning the TRS provisions, see Paul W. Decker, Ponda, and Jonathan Stein, ''Toward a Workable Definition of REIT Healthcare Facility,'' *Tax Notes*, Dec. 5, 2011, p. 1231.

inclusion rule from the legislative history: Subject revenues are in fact intended to be section 856(d) rents from real property — both to assist in compliance with the 95 percent REIT gross income qualification test of section 856(c)(2) and to make sense of the 100 percent penalty tax of section 857(b)(7), all in accordance with the legislative intent of the RMA — and in fact Rev. Rul. 2002-38 accomplishes this despite the lack of an explicit inclusion in section 856(d)(1). Perhaps Rev. Rul. 2002-38 was purposefully subtle in its reasoning and conclusions because of the lack of an explicit inclusion for subject revenues in section 856(d)(1).

Today, however, because of the 2008 addition of the IRS's clear authority to include those amounts as qualifying income under section 856(c)(5)(J)(ii), the published conclusion of Rev. Rul. 2002-38 rests on unquestionably solid ground.

F. No Contrary Authority

There is no contrary published authority that would indicate or compel a different conclusion. Although the absence of negative authority is not definitive proof of the positive, it shows that no authority in over a decade has interpreted any of the primary legal authorities — the structure of the statute, the legislative history of the RMA, or Rev. Rul. 2002-38 — in a way that reaches a conclusion different from the one presented in this report. As noted above, both bundled and separately stated subject revenues are common among public REITs, which interpret this provision in the same manner as discussed in this report.

For example, LTR 201334033 involves a situation in which the REIT "expects to collect all, or nearly all, of the amounts owing from tenants," including amounts for TRS-provided services that "may not be customary services within the meaning of [reg. section] 1.856-4(b)(1)," and some services provided by the TRSs to tenants "may be listed as separate line items on invoices to tenants."[96] There is no published authority that indicates or compels a conclusion that subject revenues *are not* section 856(d) rents from real property, and the reasons presented in this report compel a conclusion that subject revenues *are* section 856(d) rents from real property.[97]

[96]That is, for the taxpayer in LTR 201334033, the TRS-provided services may be outside the section 856(d)(1)(B) standard and may be separately itemized and thus give rise to separately stated subject revenues.

[97]As we discuss in *supra* note 12, we recommend that these conclusions, which are consistent with the code and with prior guidance, be preserved in any future regulations.

V. Conclusion

As this report illustrates, subject revenues, whether separately stated or bundled, constitute section 856(d) rents from real property for the following reasons:

1. according to the legislative history of the RMA, Congress intended that all subject revenues be treated as rents from real property;
2. the statutory structure of the section 857(b)(7) 100 percent penalty tax is predicated on, and consistent only with, treating all subject revenues as rents from real property;
3. Rev. Rul. 2002-38 confirms that subject revenues are treated as rents from real property, and that conclusion applies equally to separately stated subject revenues;
4. the treatment of all subject revenues as rents from real property faithfully and fairly applies the REIT gross income tests, and treating subject revenues this way is critical to many traditional public REITs;
5. the lack of an explicit rule of inclusion for subject revenues in the RMA is offset by the later addition of section 856(c)(5)(J)(ii); and
6. we are unaware of any contrary authority that would indicate or compel a different conclusion.

Accordingly, subject revenues constitute section 856(d) rents from real property, regardless of whether they are billed to tenants separately or as part of a bundled charge.

VI. Appendix

Section 857(b) (2001)

(7) Income from redetermined rents, redetermined deductions, and excess interest.

(A) Imposition of tax. There is hereby imposed for each taxable year of the real estate investment trust a tax equal to 100 percent of redetermined rents, redetermined deductions, and excess interest.

(B) Redetermined rents.

(i) In general. The term "redetermined rents" means rents from real property (as defined in section 856(d)) the amount of which would (but for subparagraph (E)) be reduced on distribution, apportionment, or allocation under section 482 to clearly reflect income as a result of services furnished or rendered by a taxable REIT subsidiary of the real estate investment trust to a tenant of such trust.

(ii) Exception for certain amounts. Clause (i) shall not apply to amounts received directly or indirectly by a real estate investment trust —

(I) for services furnished or rendered by a taxable REIT subsidiary that are described in paragraph (1)(B) of section 856(d), or

(II) from a taxable REIT subsidiary that are described in paragraph (7)(C)(ii) of such section.

(iii) Exception for de minimis amounts. Clause (i) shall not apply to amounts described in section 856(d)(7)(A) with respect to a property to the extent such amounts do not exceed the one percent threshold described in section 856(d)(7)(B) with respect to such property.

(iv) Exception for comparably priced services. Clause (i) shall not apply to any service rendered by a taxable REIT subsidiary of a real estate investment trust to a tenant of such trust if —

(I) such subsidiary renders a significant amount of similar services to persons other than such trust and tenants of such trust who are unrelated (within the meaning of section 856(d)(8)(F)) to such subsidiary, trust, and tenants, but

(II) only to the extent the charge for such service so rendered is substantially comparable to the charge for the similar services rendered to persons referred to in subclause (I).

(v) Exception for certain separately charged services. Clause (i) shall not apply to any service rendered by a taxable REIT subsidiary of a real estate investment trust to a tenant of such trust if —

(I) the rents paid to the trust by tenants (leasing at least 25 percent of the net leasable space in the trust's property) who are not receiving such service from such subsidiary are substantially comparable to the rents paid by tenants leasing comparable space who are receiving such service from such subsidiary, and

(II) the charge for such service from such subsidiary is separately stated.

(vi) Exception for certain services based on subsidiary's income from the services. Clause (i) shall not apply to any service rendered by a taxable REIT subsidiary of a real estate investment trust to a tenant of such trust if the gross income of such subsidiary from such service is not less than 150 percent of such subsidiary's direct cost in furnishing or rendering the service.

(vii) Exceptions granted by Secretary. The Secretary may waive the tax otherwise imposed by subparagraph (A) if the trust establishes to the satisfaction of the Secretary that rents charged to tenants were established on an arms' length basis even though a taxable REIT subsidiary of the trust provided services to such tenants.

(C) Redetermined deductions. The term ''redetermined deductions'' means deductions (other than redetermined rents) of a taxable REIT subsidiary of a real estate investment trust if the amount of such deductions would (but for subparagraph (E)) be decreased on distribution, apportionment, or allocation under section 482 to clearly reflect income as between such subsidiary and such trust.

(D) Excess interest. The term ''excess interest'' means any deductions for interest payments by a taxable REIT subsidiary of a real estate investment trust to such trust to the extent that the interest payments are in excess of a rate that is commercially reasonable.

(E) Coordination with section 482. The imposition of tax under subparagraph (A) shall be in lieu of any distribution, apportionment, or allocation under section 482.

(F) Regulatory authority. The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this paragraph. Until the Secretary prescribes such regulations, real estate investment trusts and their taxable REIT subsidiaries may base their allocations on any reasonable method.

One Hundred Fourteenth Congress of the United States of America

AT THE FIRST SESSION

Begun and held at the City of Washington on Tuesday, the sixth day of January, two thousand and fifteen

An Act

Making appropriations for military construction, the Department of Veterans Affairs, and related agencies for the fiscal year ending September 30, 2016, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE.

This Act may be cited as the "Consolidated Appropriations Act, 2016".

SEC. 2. TABLE OF CONTENTS.

The table of contents of this Act is as follows:

SEC. 3. REFERENCES.

Except as expressly provided otherwise, any reference to “this Act” contained in any division of this Act shall be treated as referring only to the provisions of that division.

SEC. 4. EXPLANATORY STATEMENT.

The explanatory statement regarding this Act, printed in the House of Representatives section of the Congressional Record on or about December 17, 2015 by the Chairman of the Committee on Appropriations of the House, shall have the same effect with respect to the allocation of funds and implementation of divisions A through L of this Act as if it were a joint explanatory statement of a committee of conference.

SEC. 5. STATEMENT OF APPROPRIATIONS.

The following sums in this Act are appropriated, out of any money in the Treasury not otherwise appropriated, for the fiscal year ending September 30, 2016.

SEC. 6. AVAILABILITY OF FUNDS.

Each amount designated in this Act by the Congress for Overseas Contingency Operations/Global War on Terrorism pursuant to section 251(b)(2)(A)(ii) of the Balanced Budget and Emergency Deficit Control Act of 1985 shall be available (or rescinded, if applicable) only if the President subsequently so designates all such amounts and transmits such designations to the Congress.

SEC. 7. TECHNICAL ALLOWANCE FOR ESTIMATING DIFFERENCES.

If, for fiscal year 2016, new budget authority provided in appropriations Acts exceeds the discretionary spending limit for any category set forth in section 251(c) of the Balanced Budget and Emergency Deficit Control Act of 1985 due to estimating differences with the Congressional Budget Office, an adjustment to the discretionary spending limit in such category for fiscal year 2016 shall be made by the Director of the Office of Management and Budget in the amount of the excess but the total of all such adjustments shall not exceed 0.2 percent of the sum of the adjusted discretionary spending limits for all categories for that fiscal year.

SEC. 8. CORRECTIONS.

The Continuing Appropriations Act, 2016 (Public Law 114–53) is amended—

(1) by changing the long title so as to read: “Making continuing appropriations for the fiscal year ending September 30, 2016, and for other purposes.”;

(2) by inserting after the enacting clause (before section 1) the following: “**DIVISION A—TSA OFFICE OF INSPECTION ACCOUNTABILITY ACT OF 2015**”;

"(3) in the case of property placed in service after December 31, 2020, and before January 1, 2022, 22 percent.".

(b) EFFECTIVE DATE.—The amendments made by this section shall take effect on January 1, 2017.

SEC. 305. TREATMENT OF TRANSPORTATION COSTS OF INDEPENDENT REFINERS.

(a) IN GENERAL.—Paragraph (3) of section 199(c) of the Internal Revenue Code of 1986 is amended by adding at the end the following new subparagraph:

"(C) TRANSPORTATION COSTS OF INDEPENDENT REFINERS.—

"(i) IN GENERAL.—In the case of any taxpayer who is in the trade or business of refining crude oil and who is not a major integrated oil company (as defined in section 167(h)(5)(B), determined without regard to clause (iii) thereof) for the taxable year, in computing oil related qualified production activities income under subsection (d)(9)(B), the amount allocated to domestic production gross receipts under paragraph (1)(B) for costs related to the transportation of oil shall be 25 percent of the amount properly allocable under such paragraph (determined without regard to this subparagraph).

"(ii) TERMINATION.—Clause (i) shall not apply to any taxable year beginning after December 31, 2021.".

(b) EFFECTIVE DATE.—The amendment made by this section shall apply to taxable years beginning after December 31, 2015.

DIVISION Q—PROTECTING AMERICANS FROM TAX HIKES ACT OF 2015

SECTION 1. SHORT TITLE, ETC.

(a) SHORT TITLE.—This division may be cited as the "Protecting Americans from Tax Hikes Act of 2015".

(b) AMENDMENT OF 1986 CODE.—Except as otherwise expressly provided, whenever in this division an amendment or repeal is expressed in terms of an amendment to, or repeal of, a section or other provision, the reference shall be considered to be made to a section or other provision of the Internal Revenue Code of 1986.

(c) TABLE OF CONTENTS.—The table of contents for this division is as follows:

SEC. 314. REPEAL OF PREFERENTIAL DIVIDEND RULE FOR PUBLICLY OFFERED REITS.

(a) IN GENERAL.—Section 562(c) is amended by inserting "or a publicly offered REIT" after "a publicly offered regulated investment company (as defined in section 67(c)(2)(B))".

(b) PUBLICLY OFFERED REIT.—Section 562(c), as amended by subsection (a), is amended—

(1) by striking "Except in the case of" and inserting the following:

"(1) IN GENERAL.—Except in the case of", and

(2) by adding at the end the following new paragraph:

"(2) PUBLICLY OFFERED REIT.—For purposes of this subsection, the term 'publicly offered REIT' means a real estate investment trust which is required to file annual and periodic reports with the Securities and Exchange Commission under the Securities Exchange Act of 1934.".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to distributions in taxable years beginning after December 31, 2014.

SEC. 315. AUTHORITY FOR ALTERNATIVE REMEDIES TO ADDRESS CERTAIN REIT DISTRIBUTION FAILURES.

(a) IN GENERAL.—Subsection (e) of section 562 is amended—

(1) by striking "In the case of a real estate investment trust" and inserting the following:

"(1) DETERMINATION OF EARNINGS AND PROFITS FOR PURPOSES OF DIVIDENDS PAID DEDUCTION.—In the case of a real estate investment trust", and

(2) by adding at the end the following new paragraph:

"(2) AUTHORITY TO PROVIDE ALTERNATIVE REMEDIES FOR CERTAIN FAILURES.—In the case of a failure of a distribution by a real estate investment trust to comply with the requirements of subsection (c), the Secretary may provide an appropriate remedy to cure such failure in lieu of not considering the distribution to be a dividend for purposes of computing the dividends paid deduction if—

"(A) the Secretary determines that such failure is inadvertent or is due to reasonable cause and not due to willful neglect, or

"(B) such failure is of a type of failure which the Secretary has identified for purposes of this paragraph as being described in subparagraph (A).".

(b) EFFECTIVE DATE.—The amendments made by this section shall apply to distributions in taxable years beginning after December 31, 2015.

SEC. 316. LIMITATIONS ON DESIGNATION OF DIVIDENDS BY REITS.

(a) IN GENERAL.—Section 857 is amended by redesignating subsection (g) as subsection (h) and by inserting after subsection (f) the following new subsection:

"(g) LIMITATIONS ON DESIGNATION OF DIVIDENDS.—

"(1) OVERALL LIMITATION.—The aggregate amount of dividends designated by a real estate investment trust under subsections (b)(3)(C) and (c)(2)(A) with respect to any taxable year may not exceed the dividends paid by such trust with respect to such year. For purposes of the preceding sentence, dividends to in subclause (I) if such position were ordinary property,

any income of such trust from any position referred to in subclause (I) and from any transaction referred to in subclause (III) (including gain from the termination of any such position or transaction) shall not constitute gross income under paragraphs (2) and (3) to the extent that such transaction hedges such position.".

(b) IDENTIFICATION REQUIREMENTS.—

(1) IN GENERAL.—Subparagraph (G) of section 856(c)(5), as amended by subsection (a), is amended by striking "and" at the end of clause (ii), by striking the period at the end of clause (iii) and inserting ", and", and by adding at the end the following new clause:

"(iv) clauses (i), (ii), and (iii) shall not apply with respect to any transaction unless such transaction satisfies the identification requirement described in section 1221(a)(7) (determined after taking into account any curative provisions provided under the regulations referred to therein).".

(2) CONFORMING AMENDMENTS.—Subparagraph (G) of section 856(c)(5) is amended—

(A) by striking "which is clearly identified pursuant to section 1221(a)(7)" in clause (i), and

(B) by striking ", but only if such transaction is clearly identified as such before the close of the day on which it was acquired, originated, or entered into (or such other time as the Secretary may prescribe)" in clause (ii).

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 2015.

SEC. 320. MODIFICATION OF REIT EARNINGS AND PROFITS CALCULATION TO AVOID DUPLICATE TAXATION.

(a) EARNINGS AND PROFITS NOT INCREASED BY AMOUNTS ALLOWED IN COMPUTING TAXABLE INCOME IN PRIOR YEARS.—Section 857(d) is amended—

(1) by amending paragraph (1) to read as follows:

"(1) IN GENERAL.—The earnings and profits of a real estate investment trust for any taxable year (but not its accumulated earnings) shall not be reduced by any amount which—

"(A) is not allowable in computing its taxable income for such taxable year, and

"(B) was not allowable in computing its taxable income for any prior taxable year.", and

(2) by adding at the end the following new paragraphs:

"(4) REAL ESTATE INVESTMENT TRUST.—For purposes of this subsection, the term 'real estate investment trust' includes a domestic corporation, trust, or association which is a real estate investment trust determined without regard to the requirements of subsection (a).

"(5) SPECIAL RULES FOR DETERMINING EARNINGS AND PROFITS FOR PURPOSES OF THE DEDUCTION FOR DIVIDENDS PAID.—For special rules for determining the earnings and profits of a real estate investment trust for purposes of the deduction for dividends paid, see section 562(e)(1).".

(b) EXCEPTION FOR PURPOSES OF DETERMINING DIVIDENDS PAID DEDUCTION.—Section 562(e)(1), as amended by the preceding provisions of this Act, is amended by striking "deduction, the earnings" and all that follows and inserting the following: "deduction—

"(A) the earnings and profits of such trust for any taxable year (but not its accumulated earnings) shall be increased by the amount of gain (if any) on the sale or exchange of real property which is taken into account in determining the taxable income of such trust for such taxable year (and not otherwise taken into account in determining such earnings and profits), and

"(B) section 857(d)(1) shall be applied without regard to subparagraph (B) thereof.".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 2015.

SEC. 321. TREATMENT OF CERTAIN SERVICES PROVIDED BY TAXABLE REIT SUBSIDIARIES.

(a) TAXABLE REIT SUBSIDIARIES TREATED IN SAME MANNER AS INDEPENDENT CONTRACTORS FOR CERTAIN PURPOSES.—

(1) MARKETING AND DEVELOPMENT EXPENSES UNDER RENTAL PROPERTY SAFE HARBOR.—Clause (v) of section 857(b)(6)(C) is amended by inserting "or a taxable REIT subsidiary" before the period at the end.

(2) MARKETING EXPENSES UNDER TIMBER SAFE HARBOR.—Clause (v) of section 857(b)(6)(D) is amended by striking ", in the case of a sale on or before the termination date,".

(3) FORECLOSURE PROPERTY GRACE PERIOD.—Subparagraph (C) of section 856(e)(4) is amended by inserting "or through a taxable REIT subsidiary" after "receive any income".

(b) TAX ON REDETERMINED TRS SERVICE INCOME.—

(1) IN GENERAL.—Subparagraph (A) of section 857(b)(7) is amended by striking "and excess interest" and inserting "excess interest, and redetermined TRS service income".

(2) REDETERMINED TRS SERVICE INCOME.—Paragraph (7) of section 857(b) is amended by redesignating subparagraphs (E) and (F) as subparagraphs (F) and (G), respectively, and inserting after subparagraph (D) the following new subparagraph:

"(E) REDETERMINED TRS SERVICE INCOME.—

"(i) IN GENERAL.—The term 'redetermined TRS service income' means gross income of a taxable REIT subsidiary of a real estate investment trust attributable to services provided to, or on behalf of, such trust (less deductions properly allocable thereto) to the extent the amount of such income (less such deductions) would (but for subparagraph (F)) be increased on distribution, apportionment, or allocation under section 482.

"(ii) COORDINATION WITH REDETERMINED RENTS.—Clause (i) shall not apply with respect to gross income attributable to services furnished or rendered to a tenant of the real estate investment trust (or to deductions properly allocable thereto).".

(3) CONFORMING AMENDMENTS.—Subparagraphs (B)(i) and (C) of section 857(b)(7) are each amended by striking "subparagraph (E)" and inserting "subparagraph (F)".

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2016

REIT Tax Issues When You Arrive at Work

March 30-April 1, 2016

REIT Tax Issues When You Arrive at Work Panelists

- Mark Patterson, Duke Realty
- Charlie Temkin, Deloitte
- Josh Cox, Tanger Outlets
- Carol Bradshaw, Westfield

REIT Tax Issues When You Arrive at Work

- Tax Automation
- ITSI & Rev. Rul. 2002-38
- 1033(g)(3) in Non-billboard REITs
- Managing Taxable Income Using Repair Regs; Sec. 1031
- E&P Impact: Capital losses, Accelerated depr. post-PATH Act

Tax Automation

- Top Five Complaints about Tax Automation (or lack thereof)
- ?
- ?
- ?
- ?
- ?

Tax Automation

- Survey says!
  - 1) Cost
  - 2) Executive support/buy-in/prioritizing
  - 3) Finding software savvy tax talent
  - 4) Maintenance
  - 5) Customization/proprietary solutions

Asset Test

Asset Item	REIT Share	75% Test	25% Test	25% TRS Test	5% Test
Accounts Receivable, Net	31,755,648	30,881,528	874,120	-	-
Accrued Straight-Line Rents	182,808,790	182,808,790	-	-	-
Buildings, Net	9,314,595,872	9,314,468,541	127,331	-	-
Cash and Cash Equivalents	50,200,777	50,200,777	-	-	-
Construction in Progress	489,491,881	489,491,881	-	-	-
Deferred Financing Costs, Net	36,986,333	2,967	36,983,365	-	-
Goodwill	28,185,855	28,185,855	-	-	-
Investments in Subsidiaries	134,355,872	(4,792,930)	139,148,802	139,148,802	-
Land	2,792,076,090	2,792,076,090	-	-	-
Other Assets, Escrow Deposits, N/R - Net	615,734,771	394,528,035	221,206,736	1,427,084	20,572,716
Other Deferred Costs, Net	528,207,797	514,015,728	14,192,069	-	-
Other Receivables, Net	15,387,525	7,643,582	7,743,943	-	-
Tenant Improvements, Net	982,277,272	982,277,272	-	-	-
Total	**15,202,064,483**	**14,781,788,118**	**420,276,365**	**140,575,885**	**20,572,716**
REIT Asset Test Percentages		**97.2354%**	**2.7646%**	**0.9247%**	**0.1353%**

Income Test

Income Item	REIT Share	95% Test	75% Test
Base Rents	813,395,689	813,395,689	813,395,689
Construction Mgmt. and Dev. Fees	9,151,665	-	-
Dividend Income	380,290	380,290	380,290
Expense Reimbursement	255,364,085	255,364,085	255,364,085
Gain from Property Sales	546,888,748	546,888,748	546,888,748
Gain From Stock Sale	652,719	652,719	-
Interest Income	12,966,946	12,966,946	-
Other Income	6,631,698	-	-
Property Mgmt., Maint. and Leasing	22,011,127	-	-
Tenant Finish Reimbursed Fees	3,310,944	3,310,944	3,310,944
Total	**1,670,753,910**	**1,632,959,420**	**1,619,339,755**
REIT Income Test Percentages		**97.7379%**	**96.9227%**

Tax Balance Sheet

Description	Book	Book Adj.	Adj. Book	Tax Adj.	Tax
Total Assets	53,276,762.48	188,781.26	53,465,543.74	1,715,145.34	55,180,689.08
				-	
Total Liabilities	(43,190,195.32)	(188,781.26)	(43,378,976.58)	45,963.90	(43,333,012.68)
Total Capital	(10,086,567.16)	-	(10,086,567.16)	(1,761,109.24)	(11,847,676.40)
Total Liabilities & Capital	(53,276,762.48)	(188,781.26)	(53,465,543.74)	(1,715,145.34)	(55,180,689.08)

Tax Income Statement

Income Item	Book	Book Adj.	Adj. Book	Tax Adj.	Tax	E&P Adj.	E&P
Total Rental Income	8,926,527.75	1,768.05	8,928,295.80	58,969.21	8,987,265.01	-	8,987,265.01
Total Service Income	(85,956.42)	85,956.42	-	-	-	-	-
Total Other Income	4,613.86	(4,497.05)	116.81	-	116.81	-	116.81
Total Operating Expenses	(636,499.36)	-	(636,499.36)	(368.23)	(636,867.59)	-	(636,867.59)
Total Amortization	(57,921.42)	-	(57,921.42)	(2,222.25)	(60,143.67)	-	(60,143.67)
Total Depreciation	(304,068.75)	-	(304,068.75)	188,733.53	(115,335.22)	(97,744.46)	(213,079.68)
Total Other Expenses	7,956.51	2,729.00	10,685.51	(12,076.20)	(1,390.69)	-	(1,390.69)
Total	**7,854,652.17**	**85,956.42**	**7,940,608.59**	**233,036.06**	**8,173,644.65**	**(97,744.46)**	**8,075,900.19**

Benefits

- Realize annual cost savings (an annuity)
  - Some apps run for 7-10 years without updates
  - Tax preparation time for $1 Billion JV reduced by 80 to 90%
- Building blocks (unit record)
- Scalability
  - Can handle unlimited number of JVs
  - Blackstone sale

Benefits (continued)

- Benefits to other departments
  - Asset strategy roadmap
  - Equity compensation
  - GAAP depreciation
- Not tied to any single 3rd party provider
  - Conversion costs
  - Flexibility

Benefits (continued)

- Spot issues/trends earlier (interim reviews)
- Eliminate transposition/polarity/excel formula errors
- Create better audit trail (extreme detail)
- Standardized results (next man up)
- Fosters better work morale (less overtime)

Future Tax Automation

- Integrated/modular based solutions
- Platform independent solution
  - Abstraction layer(s)
- Cloud computing
  - Data encryption
  - Multi-factor authentication

Primary Data Accumulation

- General Ledger data sources (e.g., CTI, Timberline, Yardi)
- Fixed Asset data sources (e.g., BNA, FAS)
- Automate data retrieval
- Summarize results
- Reconcile results to financial statements/reports

Secondary Data Sources

- True tax locations
- Budgeted/projected information
- Expected sales/exchanges
- Managed property systems
- Purchase card systems

Tax Books

- Tax chart of accounts
- Tax versus legal entity accounting
- Tax and book ownership differences
- Account mapping of trial balance to tax report headers
- Account mapping to tax returns

Adjusting Journal Entries

- Identify tax sensitive accounts/subaccounts
- Automate standard adjusting journal entries from CTI, FAS, etc.
- Differentiate between types of adjusting journal entries
- Manual adjusting journal entries
- Archive adjusting journal entries each year

Standard Adjusting Journal Entries

- Book to tax depreciation differences
- Book to tax property sale differences
- Prepaid rents
- Bad debt expense
- Other as identified in G/L

Reporting

- Identify relevant worksheets
- Collaborate on worksheet format
- Automate basic calculations (totals/subtotals)
- Automate diagnostics
- Allow for tax workbook updating

Assorted ITSI Issues

- The main steps in addressing ITSI
- Treatment of income from noncustomary services performed by TRS

Assorted ITSI Issues

- Restaurant, café, food services
  - If this is customary in the geographic area for comparable properties, which is frequently the case, can a REIT use an IK? Does the REIT receive any net profits or have to pay for any net losses—i.e., the IK gets a management fee and no exposure? Do the profits and losses get reflected on the REIT's books? Could the tax on prohibited transactions apply?
  - Can the REIT lease the facilities to an operator at below-market rent, assuming that the facilities do not need any additional subsidy beyond the discount on the rent? Apparently so. See PLR 199917039 (*See* NAREIT Compendium Memorandum 1999-9).

Assorted ITSI Issues

- Restaurant, café, food services
  - If the REIT engages its TRS to provide the food service, and the TRS hires the IK, do the operations on the facility go on the IK's books, the TRS's books, or the REIT's books? If the REIT pays the TRS a premium on top of any anticipated fees to the IK and overall subsidy, and the REIT is not entitled to any share of profits if there are any, are the operations then on the TRS's books? Does the TRS need to have employees of its own, since it will be relying on the IK? Does the REIT have to charge the TRS any rent?

Assorted ITSI Issues

- Restaurant, café, food services
  - Note that if the TRS is paid less than an arm's length amount, the REIT will be liable to a 100% penalty on the shortfall, either because there is redetermined rent or because it is redetermined TRS service income (added by the PATH Act).
  - What is a reasonable rate? There is a 150%-of-expenses safe harbor for redetermined rent; did someone forget the safe harbor for redetermined TRS service income?

Assorted ITSI Issues

- Gyms/sports facilities
  - Easy if unattended facilities with workout machines and little else. See, e.g., PLR 200101012 (unattended fitness center); PLR 9510030 (same).
  - One step up is facilities that are unattended, except that there are classes provided by personal trainers. PLR 9646027 (fitness instruction provided by IKs) *(See* NAREIT Compendium Memorandum 1996-20*).* Is there a risk in using individuals as IKs?

Assorted ITSI Issues

- Gyms/sports facilities
  - Frequently so upscale that unclear if customary, with both significant personal services (classes, personal trainers) and retail sales. It is therefore more common to involve a TRS.
  - Similar issues to food services.

Assorted ITSI Issues

- Strictly speaking, not ITSI, but related: if the REIT receives income from a noncustomary service provided by a TRS, is the income rent from real property?
  - Income from a customary service is rent, whether or not separately stated. Section 856(d)(1)(B).
  - Rev. Rul. 2002-38 (*See* NAREIT Compendium Memorandum 2002-3) concluded that where the charges for a noncustomary service are not separately stated, the rent is, in its entirety, rents from real property. Is it significant whether the charge for the service is or is not separately stated?
  - P. Decker, D. Kaplan, and A. Ponda, "Non-customary Services Furnished by Taxable REIT Subsidiaries," Tax Notes Today (July 28, 2015).

Sec. 1033(g)(3) is not just for Lamar & CBS Outdoor

- Legislative history of 1033(g)
- Advertising as REIT qualifying income is not new
- Billboard structures as real estate is not new
- Implementation
- UBTI considerations

Sec. 1033(g)(3) is not just for Lamar & CBS Outdoor

- Legislative history of 1033(g)(3)
- Highway Beautification Act of 1965 - LBJ and Lady Bird Johnson
- This legislation called for the control of outdoor advertising along the nation's highways. Condemnation and removal of advertising billboards that don't comply with the standards is one way to enforce compliance with the law.
- Highway Beautification Act anticipated billboards would be characterized as real property for purposes of this rule. By 1976 a number of courts had concluded that billboards were personal property and not eligible for exchange treatment.

Sec. 1033(g)(3) is not just for Lamar & CBS Outdoor

- Tax Reform Act of 1976

- In response to the court cases and billboard lobby, Congress enacted Code section 1033(g)(3) allowing a taxpayer to elect to treat its “outdoor advertising displays” as real property. This applies to Chapter 1 of the Code which includes the REIT provisions and UBTI provisions.

- 1033(g)(3)(C) - The term “outdoor advertising display” is defined as a rigidly assembled sign, display, or device permanently affixed to the ground or permanently attached to a building or other inherently permanent structure constituting, or used for the display of, a commercial or other advertisement to the public.

Sec. 1033(g)(3) is not just for Lamar & CBS Outdoor

- Opportunities for non-billboard REITs
  - Any REIT with road frontage that wants to erect billboards: Timber, Farmland, Prison, Student housing, Industrial, Retail
  - Office REITs that add permanent signs on sides of buildings
  - Signs on building walls inside and out in shopping centers
  - Strip center retail REITs

Sec. 1033(g)(3) is not just for Lamar & CBS Outdoor

- Leasing of advertising space by REITs is not new
  - PLR 8830076, the Service ruled that the income derived by the REIT from its proposed leasing advertising space in shopping center common areas would qualify as rents from real property
  - PLR 9808011 *(See* NAREIT Compendium Memorandum 1998-5), the Service ruled that the REIT's share of amounts "received pursuant to tenant and licensee arrangements with respect to … space on mall directories and other locations at the retail projects for the placement of advertisements will qualify as 'rents from real property' under section 856(d)

Billboards - Eligibility

- Permanency of Structures
  - May be properly classified as real property
  - Asset class 00.3 vs 57.1
  - Is 1033(g) election necessary? Consider if leasing sign structure as well as other components not typically classified as real property.
- Sign Structures Eligible for Sec.1033(g) election
  - PLR 201450004 Sign structures leased to unrelated 3rd party for FMV rent
    - Sign structures inherently permanent
    - Ancillary housing structures/sign assets are dedicated and integral parts of sign structures, i.e. parts of the outdoor advertising display since necessary to make sign function and therefore the Sec. 1033(g) election applies to these assets as well.

Billboards – Property Depreciation

- 1033 (g) Election
  - Change in use rules seem to indicate no tax accounting method change in year election is made
  - See Reg. Sec. 1.168(i)-4(d) through (f)
  - PLR 200041027 & PLR 201450001
    - Generally, if sign structures/outdoor advertising displays already classified as land improvements under asset classes 00.3 or 57.1, then election has no impact on depreciation method or life
    - If some or all of the sign structure assets classified as tangible personal property (and depreciated accordingly), the change of classification to real property constitutes a change in use of the property and not a change in method of accounting

Billboards – Digital Boards

- The 2014-2015 “Billboard” PLRs state that “certain Qualified Outdoor Advertising Displays allow for multiple Rental Agreements to be in place at one time.”
  - Use of the defined term “Qualified Outdoor Advertising Displays” from IRC 1033(g)(3) means the taxpayer is treating the digital board as well as the structure to which it is affixed as real property.
  - The digital board must be attached to the structure in a way intended to remain for the duration of its useful life.
  - As real property, the digital board must be depreciated as real property, not personal property.

Billboards – Short Term Rentals

- Recent Billboard REIT PLRs address short term rentals as small part of billboard revenue
  - 201522002 (*See* NAREIT Tax Report 2015-8)
    - Specifies that the portion of its revenue attributable to such short-term Rental Agreements will not be material
  - 201431020 (*See* NAREIT Tax Report 2014-27)
    - Specifies short term rentals are approximately 3% of total revenues from billboards
  - 201431018 (*See* NAREIT Tax Report 2014-26)
    - specifies short term rentals of x weeks are approximately 2% of total revenues from billboards
- Consider the standard industry contract duration for advertising

Billboards – Election Statement

- Sample 1033 (g) Election

Election to Treat Outdoor Advertising Displays as Real Property

Pursuant to Code Sec. 1033(g)(3)

Pursuant to Reg. Sec. 1.1033(g)-1, TAXPAYER hereby elects, beginning with the taxable year ending 12/31/20xx, that outdoor advertising displays owned by taxpayer be treated as real property in accordance with the provisions of Code Sec. 1033(g). TAXPAYER has not elected to expense under Code Section 179(a) any part of the cost of the above mentioned advertising displays.

Billboards - ITSI

- PLR 201143011 (*See* NAREIT Tax Report 2011-34) REIT leased sign structures, rent did not include payments for non-customary services
  - Some rent based on gross receipts, which such receipts only included those from customary services
  - Non customary services such as installation services provided by TRS (Rev. Rul. 2002-38)
- PLR 201204006 (*See* NAREIT Tax Report 2012-2)
  - Sign Superstructures constituted real property and therefore so did use rights
  - License fees considered similar to rental payments required under a lease and therefore consider rents from real property
  - Installation services provided by independent contractors represented by taxpayer as customary in geographic market

Billboards – UBTI

- Gross advertising income is defined in Reg. 1.512(a)–1(f)(3) as all amounts derived from the unrelated advertising activities of the exempt organization.
- IRC Sec. 1033(g)(3) applies for all purposes of Chapter 1 of the Code
- UBTI rulings re revenue from short term contracts is rent from real property:
  - Rev Rul 69-178, TAM 199924059 & PLR 200222030
    - Short term rentals of space are rental income for purposes of IRC Sec. 512(b)(3)
- Payments for occupancy of space where services are also rendered to the occupant are not rents from real property per Reg. Sec. 1.512(b) – 1(c)(5)
- Personal property included in the lease may not exceed 10% of the total value per Reg. Sec. 1.512(b) – 1(c)(2)
- Use a lease form and not a license form of agreement

Managing Taxable Income

- Communication with senior management
- Like kind exchanges
- Tangible property regulations

Managing Taxable Income

- Questions to Consider
  - Is your 90% test under pressure?
  - Will you have enough dividend to cover taxable income?
  - Do you have a plan for tax department communication with senior management and/or the Board of Directors regarding:
    - Dividend rate increases
    - Special dividend payments
- Recommendation: Develop a formal plan and present to CFO and other senior management to gain buy in and educate
  - Pinpoint key dates during year where dividend planning/updates are on the agenda

Managing Taxable Income Con't.

- Like Kind Exchange
  - Deferring gain may not always be the best strategy.
  - Questions to Consider
    - Are we currently estimating return of capital distributions for the year?
    - How large is the gain and therefore how large is the potential distribution required?
    - Are there any other losses or deductions that can be taken in the current tax year to offset the gain?

Managing Taxable Income Con't.

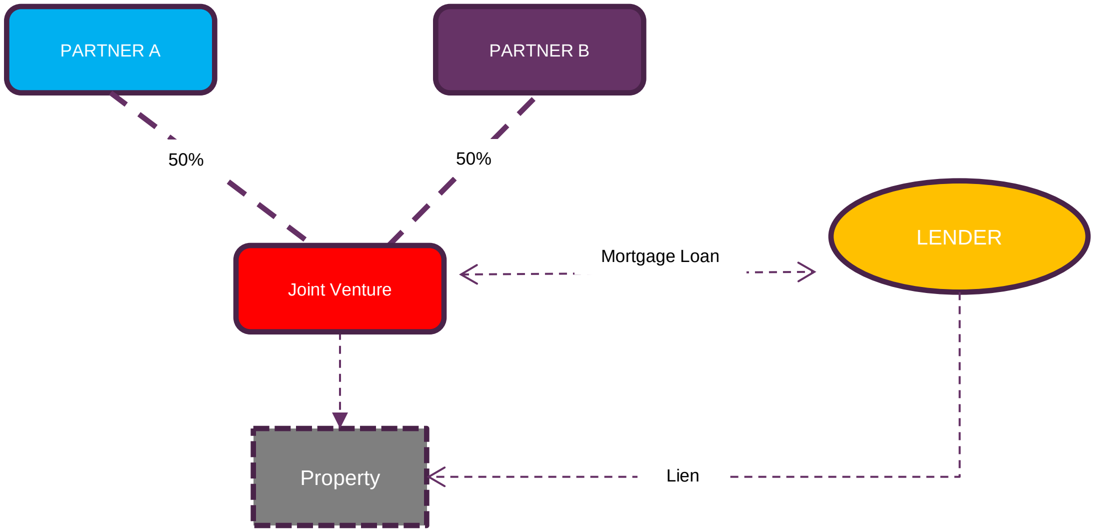
- Like Kind Exchange
  - Questions
    - Is there visible replacement property?
    - How will gain deferral/lack of gain deferral impact my shareholders/unitholders?
    - Can the company afford lost depreciation deductions in the future?
    - Are there any state tax implications that should be considered?

Managing Taxable Income Con't.

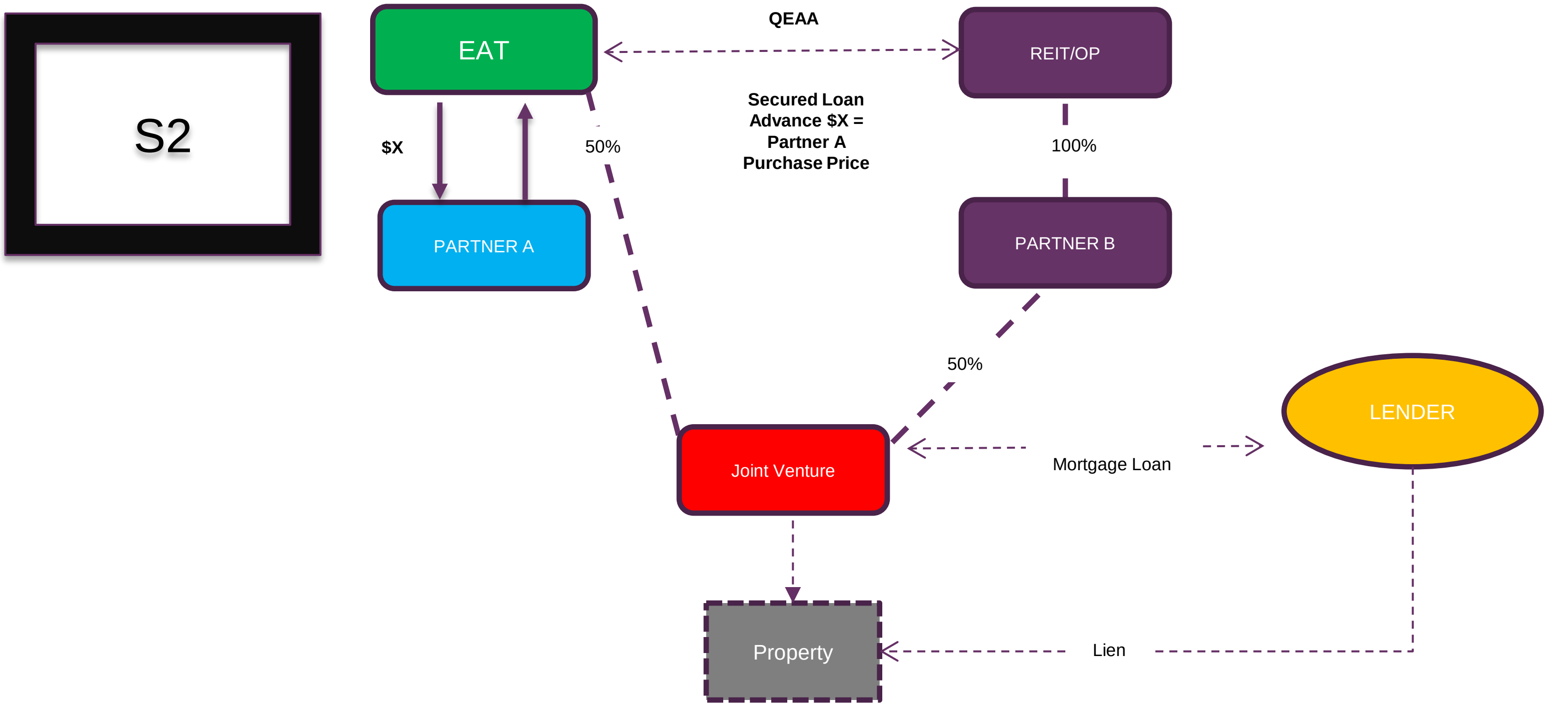
- Like Kind Exchange
  - Using an Exchange Accommodator Titleholder (EAT) to unencumber property
    - To defer 100% of gain on sale, replacement property must equal or exceed both the relinquished property FMV and taxpayer's net equity in the property
    - In some instances, an EAT can be used to purchase encumbered replacement property and facilitate a debt paydown or payoff prior to the taxpayer's purchase of the replacement property
    - Potentially useful in JV partner buyouts where there is property level debt (see following step charts S1 – S5 for example)

Managing Taxable Income Con't.

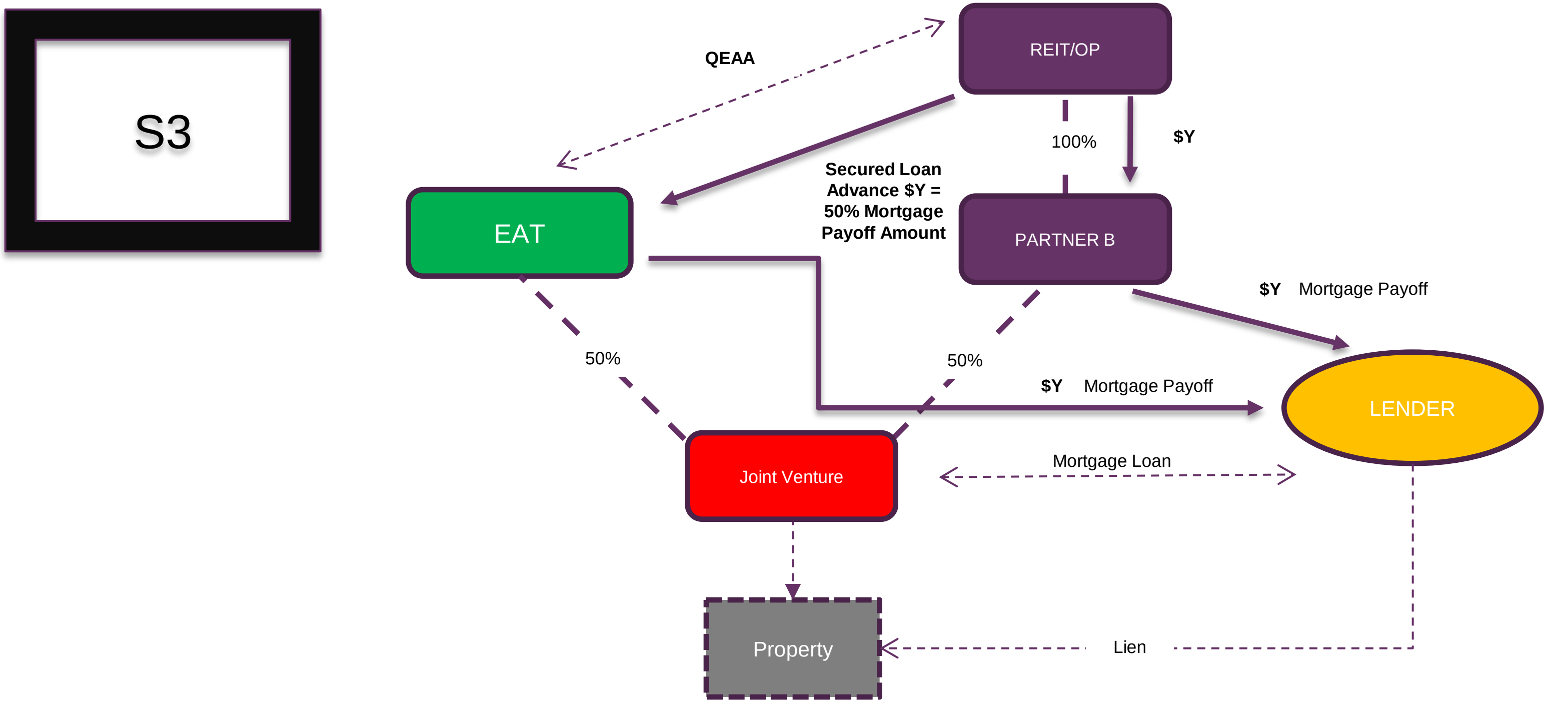
S1
Current
Structure



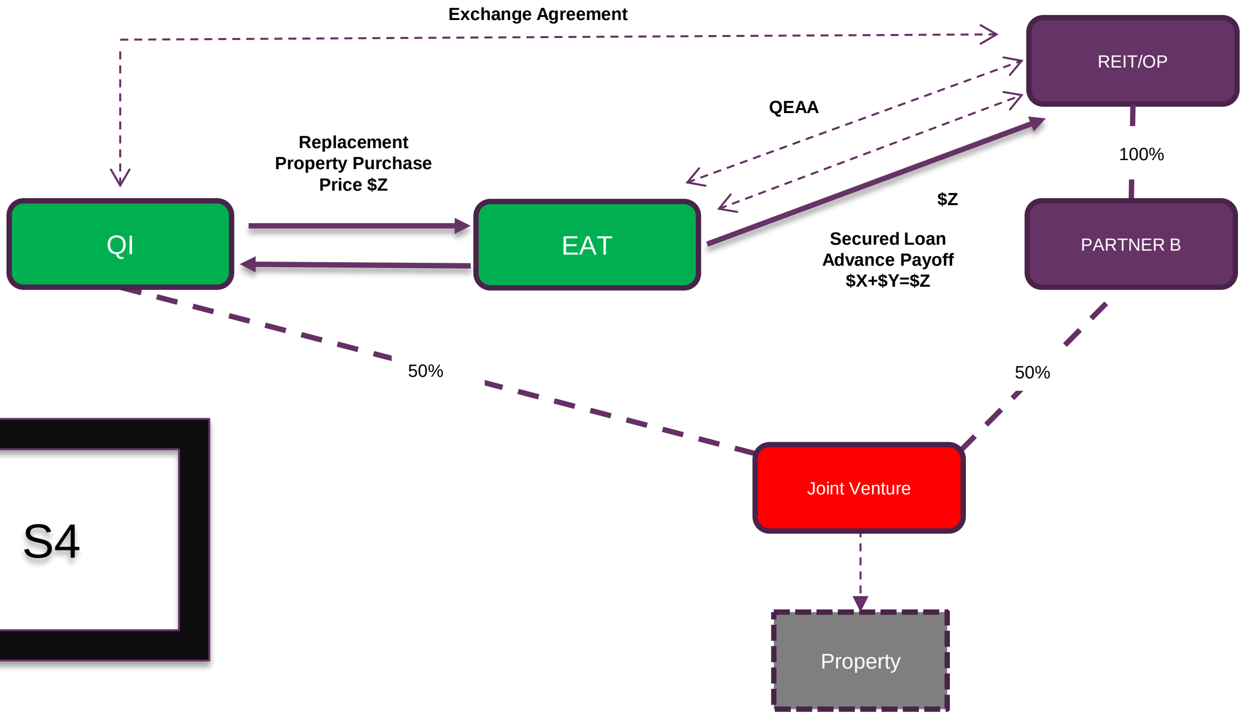
Managing Taxable Income Con’t.



Managing Taxable Income Con't.

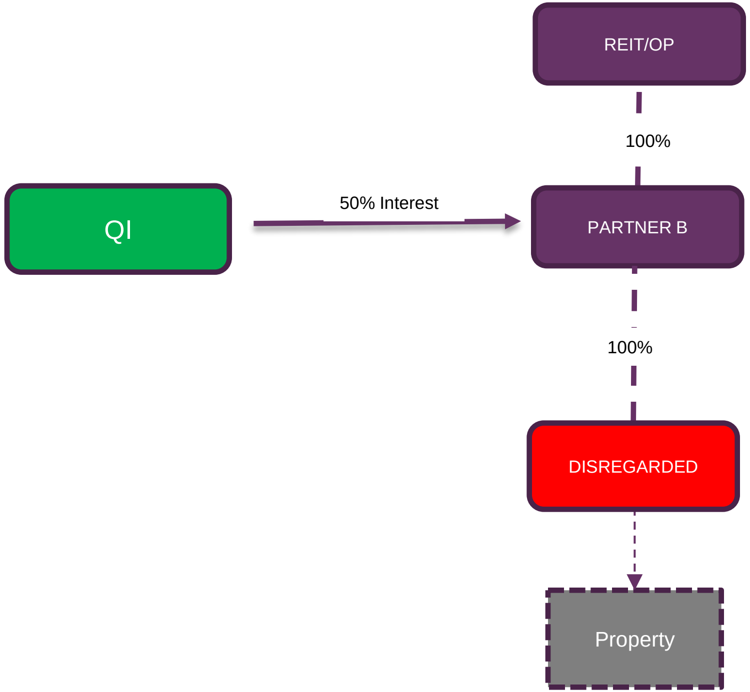


Managing Taxable Income Con’t.



S4

Managing Taxable Income Con't.



S5

Managing Taxable Income Con't.

- Like Kind Exchange
  - Option for Extending the 180 day window
    - Lease structure in which properties are constructed and/or acquired pursuant to an operating lease and the assets are later acquired by the taxpayer from the lessor to use as replacement property
    - Requires a financing partner willing to invest capital into the project and agreeable to lease terms conducive to facilitating a LKE
      - Interest only payments during construction period
      - Purchase option at cost
      - No obligation to purchase, can remain in lease
    - Purchase Option allows taxpayer to time purchase to match LKE needs
    - Can potentially extend parking period up to 2 years

Managing Taxable Income Con't.

- Making the Most of the Tangible Property Regulations
  - Tenant Allowance expensing - Regs 1.162-4(a); Automatic change #184; Rev Proc 2015-13 Sec 5.01(1)
    - Disposition rules can impact deductibility - 1.263(a)-3(k)
    - Interplay with Section 110 – Regs 1.263(a)-3(f)(3)(i)
    - "2nd Generation" allowances – Regs 1.162-4, 1.263(a)-1(a)(1)
    - Consider the impact of previous method changes and IRS adjustments
    - Industry Issue Resolution for Retail and Restaurant taxpayers (Rev. Proc. 2015-56) provides a safe harbor for treating a portion of remodel/refresh costs as currently deductible

Managing Taxable Income Con't.

- Additional Tenant Allowance Opportunities
  - QLI Method Change – (from 39 to 15 year lives) - Automatic Change # 7 - Impermissible to permissible method - 1.446-1(e)(2)(ii)(d)(2)(i)
  - Lease Incentive Review – Automatic Change # 7 - Impermissible to permissible method - 1.446-1(e)(2)(ii)(d)(2)(i)
  - LHI Review for Personal property - take shorter lived depreciation based on property for QLI's at centers - (change from 39 to 7 or 5 year life) - Automatic Change #199; Regs - 1.167(a)-4(a)

Managing Taxable Income Con't.

- Making the Most of the Tangible Property Regulations
  - Election to follow GAAP and forego otherwise deductible repairs
    - Year by year analysis/election
    - Reg. Section 1.263(a)-3(n)
    - Made with timely filed tax return
  - Consider if made a previous method change to deduct repair and maintenance costs under Reg. Section 1.262-4.

Managing Taxable Income Con't.

- Sample Election

Section 1.263(a)-3(n) Election

For the Tax Year Ended: 12/31/20XX

[Taxpayer] is electing to capitalize repair and maintenance costs under § 1.263(a)-3(n) of the Final Repair Regulations (T.D. 9636) for the taxable year that began January 1, 20XX and ended December 31, 20XX.

[Taxpayer] is electing to treat any amounts paid for repairs and maintenance that are capitalized on the taxpayer's books and records as improvements to tangible property and began to depreciate the cost of such improvements when they were placed in service.

Managing Taxable Income Con't.

- Other Opportunities to Consider
  - Prepaid Payment Liability Acceleration
    - Automatic Change # 78
    - Reg. Section 1.263(a)-4(f), "12 month rule"
    - Insurance, software maintenance contracts, warranty contracts, annual dues
    - Year 1 481(a) adjustment and then favorable/unfavorable fluctuates depending on increasing/decreasing rates and periods to which payment relates

Managing Taxable Income Con't.

- Other Opportunities Continued
  - Timing of Incurring Real Property Taxes (and other taxes)
    - Rev. Proc. 2015-14 Automatic Change # 43
    - Utilize the recurring item exception to accelerate property tax deductions under 461(h)(3) and Reg. Sec. 1.461-5(b)(1)
    - Change from deducting ratably over period to which tax relates, typically following GAAP, to deducting:
      - In the year that all events have occurred to establish the liability
      - The amount of the liability can be determined with reasonable accuracy
      - Economic Performance occurs on or before the earlier of the date the taxpayer files a timely return (including extensions), or September 15th
    - Great for companies with property in NY, CA, CT, MI, NH, MD… among others

Managing Taxable Income Con't.

- Other Opportunities Continued
  - 467 Rental Agreements
    - Automatic Change #136
    - Possibility to defer prepaid rents pursuant to Reg. Sec. 1.467-1(d)(2)(iii)
    - Check with your lease accounting team regarding the ability to run queries in your general ledger/lease accounting software
    - Taxpayer only receives limited audit protection in the case of disqualified leasebacks and long-term agreements described in Reg. Sec. 1.467-(3)(b)
    - See also Rev. Proc. 2011-14, Section 20.01

The PATH Act Changes to E&P

- PATH Act changes to E&P rules for
  - REIT’s DPD
  - Shareholders’ treatment of distributions
  - Clarification of other provisions that reference E&P
- Capital loss carryover issues
- § 163(j)
- E&P after a preferential dividend

The PATH Act Changes to E&P

- Determination of E&P for purposes of determining the DPD largely the same
  - Under revised § 562(e)(1), E&P for any taxable year (but not accumulated E&P) is increased by the amount of gain on the sale of real property taken into account during the year (and not otherwise taken into account).
  - This is very similar to prior law, except that it does not require that the sale itself occur during the year, and so this would apply to installment sales.

The PATH Act Changes to E&P

- Determination of E&P for purposes of determining the DPD largely the same
  - In addition, § 857(d)(1)(A), which is the same as prior § 857(d)(1), is also applied.
  - Therefore, a REIT is entitled to receive a DPD for distributions corresponding to gains on the sale of real property and other income of the REIT, both as determined for income tax purposes, even though the gain as determined for E&P purposes would be lower or amounts not allowable for income tax purposes would otherwise have reduced E&P.

The PATH Act Changes to E&P and Capital Losses

- Determination of E&P for § § 301 and 316 purposes—i.e., shareholder treatment of distributions as dividends or returns of capital
  - § 857(d)(1)(A) applies as just described, unless it is also the case that the amounts not allowable for income tax purposes in the current taxable year were allowable in a prior year, in which case § 857(d)(1)(B) cancels § 857(d)(1)(A).

The PATH Act Changes to E&P and Capital Losses

- Determination of E&P for § § 301 and 316 purposes—i.e., shareholder treatment of distributions as dividends or returns of capital
  - To restate this in something that more closely resembles English, if there is a deduction for E&P purposes in the present year that does not correspond to a deduction for regular income tax purposes in the current year, but does correspond to a deduction for regular income tax purposes in a prior year, then the deduction reduces current year E&P.

The PATH Act Changes to E&P and Capital Losses

- Determination of E&P for § § 301 and 316 purposes—i.e., shareholder treatment of distributions as dividends or returns of capital
  - The technical explanation to the PATH Act makes clear that new rules were intended to permit a REIT to get the DPD it needs to zero out taxable income, but without subjecting its shareholders to double taxation. Prior law permitted the REIT to get the DPD, but at the cost of the shareholders having to treat the additional E&P as increasing the amount of the dividend as well.

The PATH Act Changes to E&P and Capital Losses

- Determination of E&P for purposes of applying other REIT rules:
  - Section 857(b)(9)
  - Section 858
  - Section 565
  - Section 4981
- *See* A. Giannese and D. Lee, "PATH Act Updates Earnings and Profits Rules for REITs," 41 Daily Tax Report J-1 (March 2, 2016).

The PATH Act Changes to E&P and Capital Losses

- Problem with items like capital losses or interest limited by § 163(j), where there is a full E&P reduction in the item occurs, but where the deduction is allowable (if at all) in a later year.
  - For the treatment of capital losses, see Rev. Rul. 76-299, 1976-2 CB 211.
  - In the year the item occurs, the REIT can get a DPD under § § 562(e)(1) and 857(d)(1)(A) for its full taxable income, even though E&P would otherwise be reduced by the item. The shareholders, however, do not appear to get any benefit from § 857(d)(1)(B), since there was no deduction in an earlier year. Consequently, they are taxed on the full amount of the distribution as a dividend.

The PATH Act Changes to E&P and Capital Losses

- Problem with items like capital losses or interest limited by § 163(j), where there is a full E&P reduction in the item occurs, but where the deduction is allowable (if at all) in a later year.
  - In the year when the deduction becomes available (e.g., there were capital losses in an earlier year, and they were carried forward to reduce capital gain in the current year), the deduction does not reduce current E&P. Consequently, if the REIT does not limit its distribution to its taxable income as determined by taking into account the now-available deduction, the shareholders will be taxable to the extent of the full current year E&P.

The PATH Act Changes to E&P and Capital Losses

- Problem with items like capital losses or interest limited by § 163(j), where there is a full E&P reduction in the item occurs, but where the deduction is allowable (if at all) in a later year.
  - The best fix would appear to require legislation to change § 857(d)(1)(B) so that it would apply whether the item was taken into account for income tax purposes in a prior year or could be taken into account in a later year. That way, the E&P for determining the DPD in the first year would be increased, but not the E&P for determining shareholder dividends.

The PATH Act Changes to E&P and Capital Losses

- Problem with items like capital losses or interest limited by § 163(j), where there is a full E&P reduction in the item occurs, but where the deduction is allowable (if at all) in a later year.
  - Failing a legislative remedy, the existing regulations should be revised. At present, Treas. Reg. § 1.857-7(b) provides that if the REIT takes advantage of § 857(d)(1), and distributes the full amount of its taxable income, the accumulated E&P of the subsequent year will not reflect the reduction of E&P in the earlier year.

The PATH Act Changes to E&P and Capital Losses

- Problem with items like capital losses or interest limited by § 163(j), where there is a full E&P reduction in the item occurs, but where the deduction is allowable (if at all) in a later year.
  - The mechanism for reaching this result is that the distribution corresponding to the excess of the actual distribution over the actual E&P (that is, without applying the § 857(d)(1) limitation) is treated as a return of paid-in capital. An odd result, both because paid-in capital is not a tax concept and because the shareholders are treated for tax purposes as getting a dividend, not a return of capital.

The PATH Act Changes to E&P and Capital Losses

- Problem with items like capital losses or interest limited by § 163(j), where there is a full E&P reduction in the item occurs, but where the deduction is allowable (if at all) in a later year.
  - Even if the regulation were amended so that the earlier reduction in E&P reduced accumulated E&P, that would be only occasionally helpful, because dividend treatment is determined initially based upon current year E&P, which would not be affected.

Preferential Dividends

- Following a preferential dividend, does E&P remain so that it is possible for the REIT to get a DPD for a nonpreferential dividend (either during the same year, through a § 858 carryback, or through a § 860 deficiency dividend)?
  - In PLR 200729021 (*See* NAREIT Compendium Memorandum 2007-24), the Service ruled that a preferential dividend does not reduce E&P, on the rationale that under § 858(d)(1), deductions not allowable in computing a REIT's taxable income do not reduce current E&P. A good result, but this approach raises questions as to the proper treatment of the preferential dividend by the shareholders. The Service has indicated that they would not now issue a ruling to this effect.
  - In PLR 201503010 (*See* NAREIT Tax Report 2015-2) and PLR 201537020 (*See* NAREIT Tax Report 2015-32), the Service ruled that, in the case of a § 481(a) adjustment relating to depreciation, even if the § 481(a) exceeded the correlative E&P adjustment, there would be enough E&P for the REIT to get a DPD to offset the adjustment. The rationale, based on the legislative history of the TRA of 1986, was that Congress indicated its belief that this is how the REIT rules operate. Any such dividend would appear to be treated as a dividend both for DPD purposes and by the shareholders.

Concurrent Session: REIT Taxes All Around Us

Thursday, March 31st
2:45pm – 4pm
Marriott Marquis, Washington DC

Moderator:
Brian Wood, SVP & Chief Tax Officer, Ventas, Inc.

Panelists:
Michael Brody, Partner, Latham & Watkins
David Lee, Partner, KPMG LLP
Kathy Miller, SVP-Financial Services & Tax, Regency Centers Corporation
Andrew Needham, Partner, Cravath, Swaine & Moore

REITWise 2016 – REIT Taxes All Around Us

REIT Investments in Non-Controlled Partnerships

Sample Provision[1]

ARTICLE I
REIT PROTECTION PROVISIONS.

Section 1.1 Generally.

The Members acknowledge and agree that the REIT Member is an Affiliate of REIT Parent and that REIT Parent is a real estate investment trust for U.S. federal income tax purposes (a "REIT") and is therefore subject to the requirements set forth in Code Sections 856 through 859. Notwithstanding anything herein to the contrary, each Member acknowledges and agrees that, for so long as REIT Parent (which term also refers to any successor to REIT Parent, whether by merger or otherwise, that also is intended to qualify as a REIT) directly or indirectly owns interests in the Company, through REIT Member or otherwise, it is intended that the Company and each Subsidiary shall be operated in such a manner so that REIT Parent may continue to so qualify as a REIT and avoid U.S. federal income and excise tax liability to the extent permitted under the Code. The Company shall, promptly upon the request of REIT Member, make available to REIT Member all data and information in the possession of the Company which is determined by REIT Member to be necessary or helpful to (1) determine the tax treatment of REIT Parent, or (2) monitor REIT Parent's compliance with the requirements relating to the status of REIT Parent as a REIT. In the event of any conflict or inconsistency between the terms of this Article I and any other provision of this Agreement, the terms of this Article I shall control.

Section 1.2 Covenants.

Notwithstanding anything in the Agreement to the contrary, the Members acknowledge and agree that neither the Company nor any Subsidiary shall, without the prior written consent of REIT Member:

(A) own assets other than interests in real property, furniture, fixtures, equipment and intangible property associated with such real property, cash, bank time deposits, interests in money market accounts or receivables which arise in the ordinary course of its rental business, such as for rent from occupancy of space;

(B) directly or indirectly acquire (whether by purchase, contribution, distribution, operation of law, or otherwise) or own any equity interest in any corporation, partnership, limited

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1 This provision may not be appropriate for any particular joint venture. The provision used for any joint venture should be drafted to address the specific circumstances.

liability company, trust, or other entity, except in the case of interests in money market accounts or in an entity that is either (1) disregarded as separate from the Company for U.S. federal income tax purposes or (2) with the prior written consent of REIT Member not to be unreasonably withheld, treated as a partnership for U.S. federal income tax purposes (subject to the condition that such disregarded entity or partnership shall have agreed to be bound by the entirety of this Article I);

(C) directly or indirectly acquire (whether by purchase, contribution, distribution, operation of law, or otherwise), own, or originate any loan or debt instrument, or consent to any modification, alteration, or amendment of any of the same; provided that this Section 1.2(C) shall not restrict the Company's ownership of bank time deposits or interests in money market accounts;

(D) directly or indirectly derive income in any taxable year other than rent from occupancy of real property and associated personal property, interest income from bank time deposits or money market accounts, or gain from sale of properties that satisfy the requirements of the prohibited transaction safe harbor set forth in Section 857(b)(6)(C) of the Code with respect to REIT Parent, [to the extent such income would exceed X percent (X%) of the total gross income of the Company for such year];

(E) enter into any lease of space for a term of less than thirty (30) days;

(F) directly or indirectly enter into any lease with a Person (A) that is a corporation for U.S. federal income tax purposes, if REIT Parent would be considered to own (x) ten percent (10%) or more of the total value of shares of all classes of stock of such Person or (y) stock of such Person possessing ten percent (10%) or more of the total combined voting power of all classes of stock of such Person entitled to vote, or (B) that is an entity that is not a corporation for U.S. federal income tax purposes, if REIT Parent would be considered to own an interest of ten percent (10%) or more in the assets or net profits of such Person, with ownership by REIT Parent in either case determined taking into account the rules for constructive ownership described in Section 318(a) of the Code, as modified by Section 856(d)(5) of the Code (a "Related Party Tenant");

(G) directly or indirectly enter into any lease which provides for rent based on any Person's net income or profits;

(H) directly or indirectly permit any sublease or license of any portion of any Property if either (A) the rent or other amounts to be paid by the proposed subtenant or licensee thereunder would be based, in whole or in part, on the income or profits derived by such proposed subtenant or licensee from the property, or (B) the sublessee or licensee, as the case may be, would be a Related Party Tenant;

(I) directly or indirectly permit any assignment of a lease (or sublease or license) of all or any portion of any Property if either (A) any amounts to be paid by the proposed assignee thereunder to the assignor would be based, in whole or in part, on the income or profits derived by such proposed subtenant or licensee from any property, or (B) the assignee would be a Related Party Tenant;

(J) enter into any lease which provides for the rental of personal property, except a lease which provides for the rental of both personal property and real property and in which the rent attributable to such personal property for the taxable year does not exceed [ten percent (10%)] of the total rent for the taxable year attributable to both the real and personal property leased under, or in connection with, such lease (as determined pursuant to Code Section 856(d)(1));

(K) directly or indirectly derive in any year, “impermissible tenant service income” (as defined under Code Section 856(d)(7)) with respect to any property, which exceeds [0.8%] of all income received or accrued during such taxable year from such property;

(L) provide services or amenities at any Property that are (i) not customarily provided to tenants of comparable properties in the same geographic area, unless such services or amenities are provided by an entity that is a “taxable REIT subsidiary” (as defined in Section 856(l) of the Code) with respect to REIT Parent (a “TRS”), or (ii) primarily for the convenience of the tenant, unless such services or amenities are provided either by an entity that (A) is a TRS or (B) qualifies as an “independent contractor” (within the meaning of Section 856(d)(3) of the Code) with respect to REIT Parent and from which REIT Parent does not directly or indirectly derive any income;

(M) fail to [use commercially reasonable efforts to] cause the Company to make distributions to Members so that the annual distributions paid to REIT Member are an amount equal to or greater than the amount of taxable income derived by REIT Member from the Company for each taxable year;

(N) elect to be taxed as, or take any other action or position the effect or import of which would be that the Company, any Subsidiary, or any of their subsidiaries is or would be treated as, other than a partnership or disregarded entity for U.S. federal income tax purposes;

(O) take any other action, if the Company or any Subsidiary is informed in writing by REIT Member in the exercise of REIT Member’s reasonable judgment, that such action could cause REIT Parent to lose its qualification as a REIT; or[2]

(P) commit to do any of the foregoing.

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2 Due to its uncertainty, the REIT may need to offer to indemnify the other partner for any losses associated with the use of this provision.

REIT Wise®

NAREIT's Law, Accounting & Finance Conference

March 30 - April 1

2016

REIT Taxes All Around Us

March 31, 2016

REIT Taxes All Around Us

Moderator: Brian Wood, SVP & Chief Tax Officer, Ventas, Inc.

Panelists: Michael Brody, Partner, Latham & Watkins

David Lee, Partner, KPMG LLP

Kathy Miller, SVP, Regency Centers Corporation

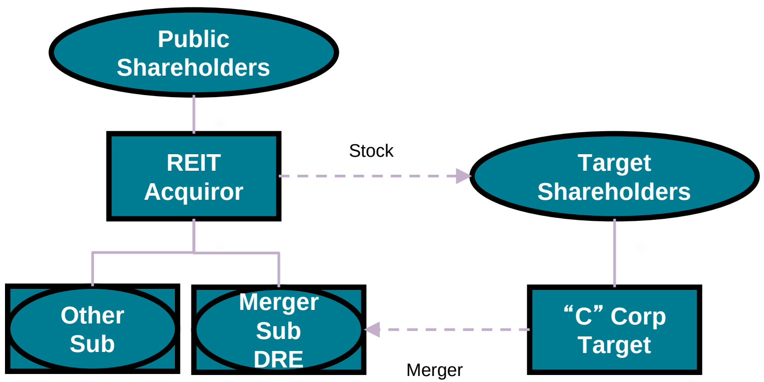
Andrew Needham, Partner, Cravath, Swaine & Moore

REIT’s Acquisition of a C Corporation

REIT’s Acquisition of a C Corporation

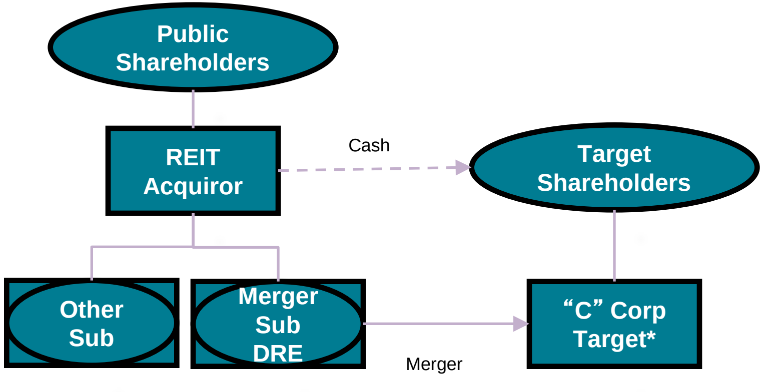
- Many REIT-able assets (e.g., infrastructure, healthcare, etc.) may potentially be separated from operations and acquired via carve-out transactions.
- Tax-exempt and foreign investors may sometimes favor ownership and operation of REIT-able assets in leveraged “C” blockers and may be exempt from U.S. tax on sales of “blocker” shares.
- A REIT is likely a longer term investor and can wait out the recognition period on “converted” assets (now being reduced to 5 years under the PATH Act).
- Recent transactions in data-center, healthcare, communications towers, record storage, office, etc.
- Common structures
  - Forward subsidiary merger (stock)
  - Reverse subsidiary merger (stock or cash)
  - Cash purchase

Potential Structure - Forward Sub Merger (Stock)



- Section 1.368-2(b)(1)(iii) - Example 2 - Merger of a target corporation into a disregarded entity in exchange for stock of the owner - This transaction could qualify as a statutory merger or consolidation for purposes of section 368(a)(1)(A) if other requirements are satisfied.
- Intended to be non-recognition to both Target and its shareholders; carryover-basis transaction and non-REIT E&P.
  - If recognition, see Rev. Rul. 69-6 (deemed sale of assets by Target).

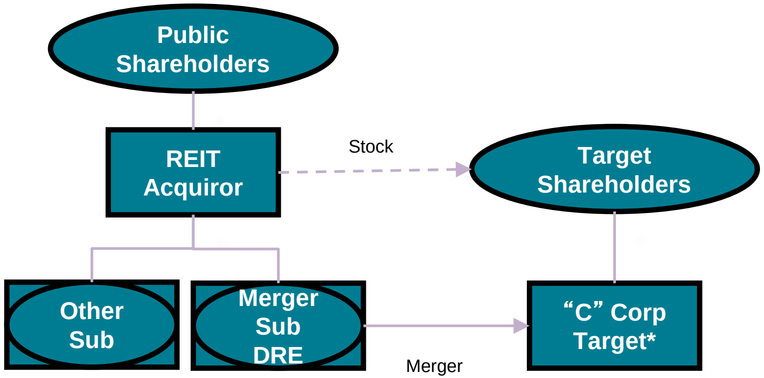
Potential Structure - Reverse Sub Merger (Cash)



*Target becomes a QRS (unless making TRS election) and is deemed liquidated into Acquiror REIT

- Rev. Rul. 90-95 (Situation 2) - P acquired all of the stock of T in a reverse cash merger and promptly liquidated T by merging T upstream into P. The ruling held that the transaction was properly treated as a taxable stock purchase followed by a tax free section 332 liquidation, and not as a taxable purchase of T's assets by P under the Kimbell-Diamond case.
- Target becoming a QRS and deemed liquidated into Acquiror REIT; carryover-basis transaction and non-REIT E&P.

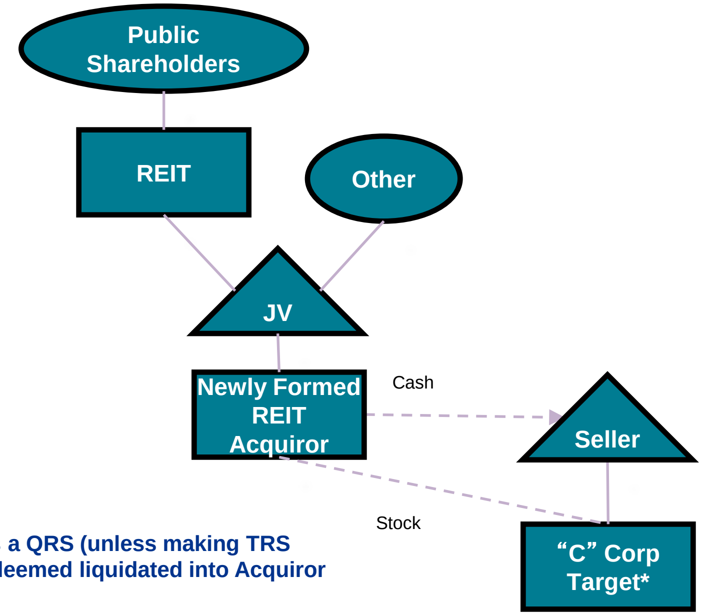
Potential Structure - Reverse Sub Merger (Stock)



***Target becomes a QRS (unless making TRS election) and is deemed liquidated into Acquiror REIT**

- Section 1.368-2(b)(1)(iii) - Example 6 - Merger of a disregarded entity into a corporation - The transaction cannot qualify as a statutory merger or consolidation for purposes of section 368(a)(1)(A).
- However, can this qualify as a stock-for-assets reorganization of section 368(a)(1)(C) – Target transferred its assets to Acquiror in exchange for Acquiror voting stock and then distributing such stock to Target shareholders in liquidation?
- Target becoming a QRS and deemed liquidated into Acquiror REIT; carryover-basis transaction and non-REIT E&P.

Potential Structure – Cash Purchase



***Target becomes a QRS (unless making TRS election) and is deemed liquidated into Acquiror REIT**

- Taxable sale of Target stock
- Target becoming a QRS and deemed liquidated into Acquiror REIT; carryover-basis transaction and non-REIT E&P.

Why Should We Care?

- A REIT must comply with specific asset-holding and income-source requirements.
- A REIT must distribute 90 percent of its “ordinary” taxable income and is taxed on any undistributed taxable income.
- A REIT must not have any non-REIT E&P at a year end.
- A REIT is subject to corporate level tax on net built-in gain recognized (during the recognition period) on assets acquired from a “C” corporation in a carryover-basis transaction.
- A REIT is subject to a 100-percent tax on prohibited transactions.
- A “C” corporation is subject to corporate level tax on its taxable income, including income recognized as the result of being acquired by a REIT.

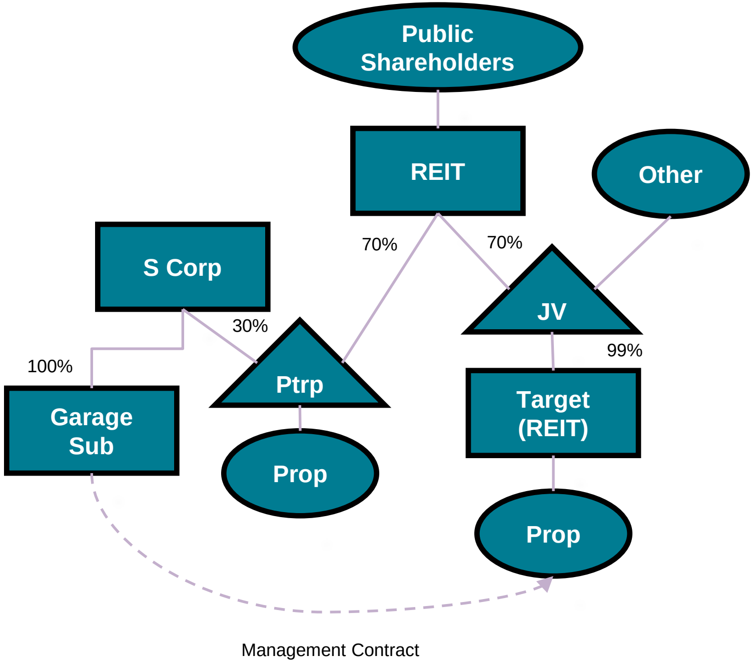
Tax Considerations - Asset & Income

- Typical property acquisition due diligence (e.g., lease vs. management contract; lease vs. financing; lease review; related tenants; TRS limited rental; cross-checking tenants/IKs; customary determination; impermissible tenant services; garage's predominate-use documentation; TRS election and service agreements; cost reimbursements; etc.)
- Review of acquired assets (e.g., intangibles; non-tenant receivables; section 467 loans; partner loan in connection with a defaulted capital contribution; mezzanine loan with bad boy carve-outs; other securities; etc.)
- Corporate (e.g., investments in corporate or partnership subsidiaries; beneficiary interest in trusts; pure preferred equity investments; guaranteed payments; identification of qualified derivative instruments; 481(a) adjustments; etc.)

Tax Considerations – Distribution Requirement

- For a taxable stock transaction, can Acquiror REIT preserve its ability to obtain FMV basis with respect to Target's assets by converting Target to a REIT, and waiting out the recognition period under section 1374?
  - After the recognition period has expired, Target may be liquidated in a taxable transaction (i.e., recognizing a gain on the distributed property under section 336(a) and may claim a deduction for dividend paid based on the liquidation distribution under section 562(b)(1)(B) to eliminate section 336(a) gain.
- What are the risks of maintaining a subsidiary REIT? E.g., inadvertent/foot faults, ownership attrition and related tenants/IKs, etc.

Tax Considerations – Distribution Requirement (continued)



- Ownership attribution risk?
  - REIT's charter typically contains excess share provisions to ensure REIT compliance.
  - Can such provisions be effective to prevent Target (REIT) from having a disqualified IK?
  - Pursuant to modified section 318(a)(3)(A) and then 318(a)(3)(C), Garage Sub would be deemed to own Target and not qualify as an IK.

Tax Considerations - Non-REIT E&P

- What if the determined and distributed amount is low? - Section 1.857-11(c) directs REITs to section 852(e) (procedures similar to deficiency dividend) for non-REIT E&P.
- What is the risk of a pre-transaction distribution by Target being re-characterized as part of the stock purchase price?
  - Rev. Rul. 75-493 held that a cash amount to a sole shareholder prior to the sale of the stock was a dividend, where the buyer had no legal obligation to purchase the stock upon the declaration and payment of the dividend.
  - Waterman Steamship Corp. v. Commissioner, 430 F.2d 1185 (5th Cir. 1970) and TSN Liquidating Corp., Inc. v. United States, 624 F.2d 1328 (5th Cir. 1980)
  - PLR 9717036 - The IRS respected the pre-sale distribution (including the issuance of promissory notes if cash reserves are insufficient) because "the Notes will be paid with cash from the continuing operations of Target and the Subsidiaries or from loans against their assets, and not from the assets of [the buyer REIT]."

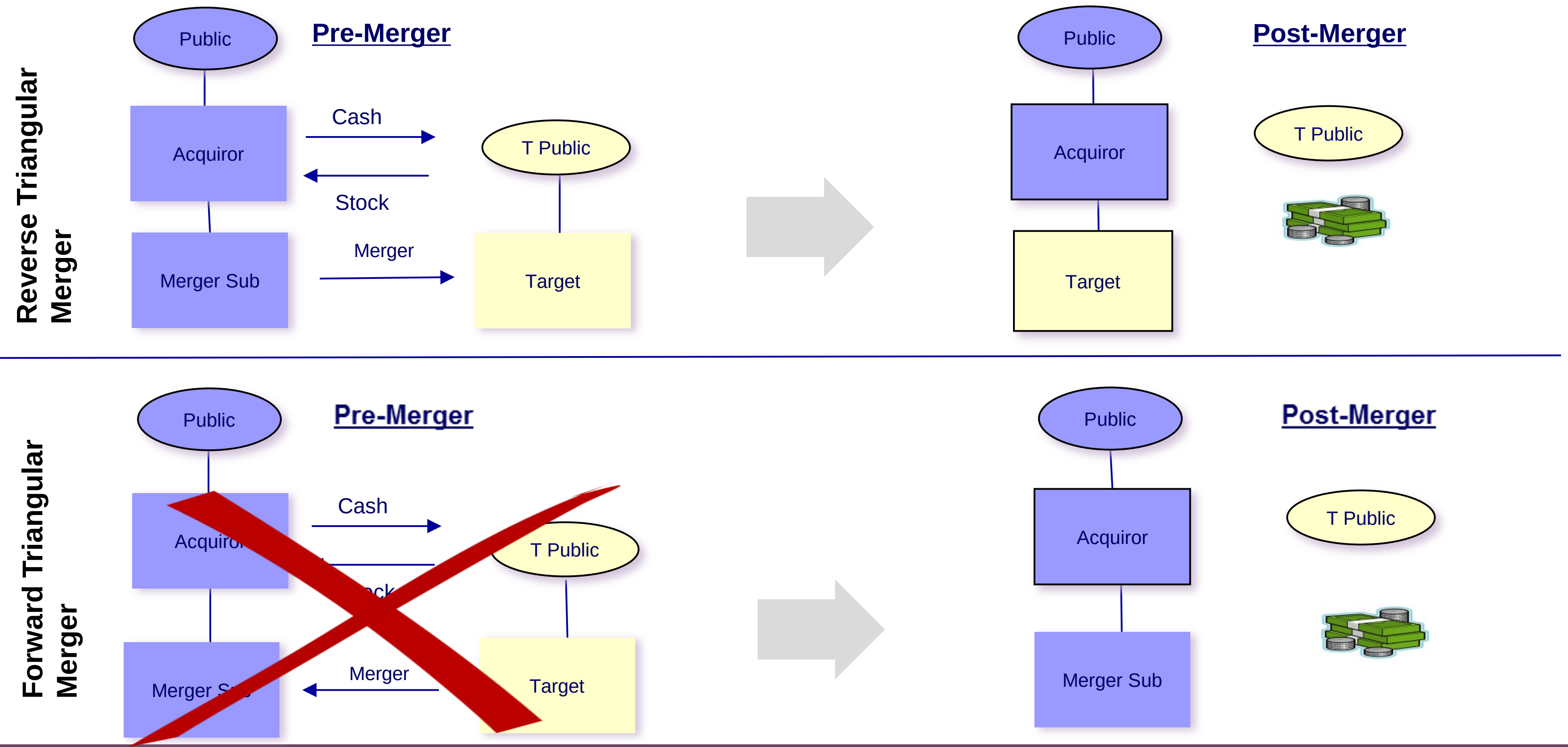
Tax Considerations - Income Tax Exposures

- If consolidated group, Target's excess loss account (akin to negative basis; to recapture P's negative adjustments with respect to S stock to the extent the negative adjustments exceed P's basis in the stock)
- Built-in gain
- Sale of unwanted assets and prohibited transactions
- If Target claims to be a QRS of another REIT, can it have any income tax exposures?
- If intended to be a reorganization, is Target an undiversified investment company?

REIT-to-REIT M&A

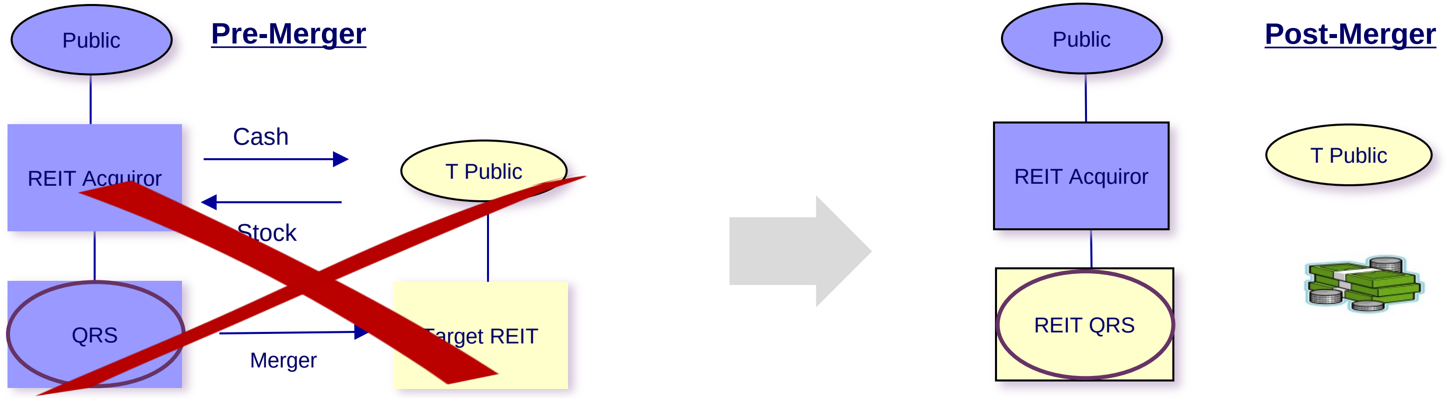
Taxable Deals

Triangular Mergers – T is Not a REIT

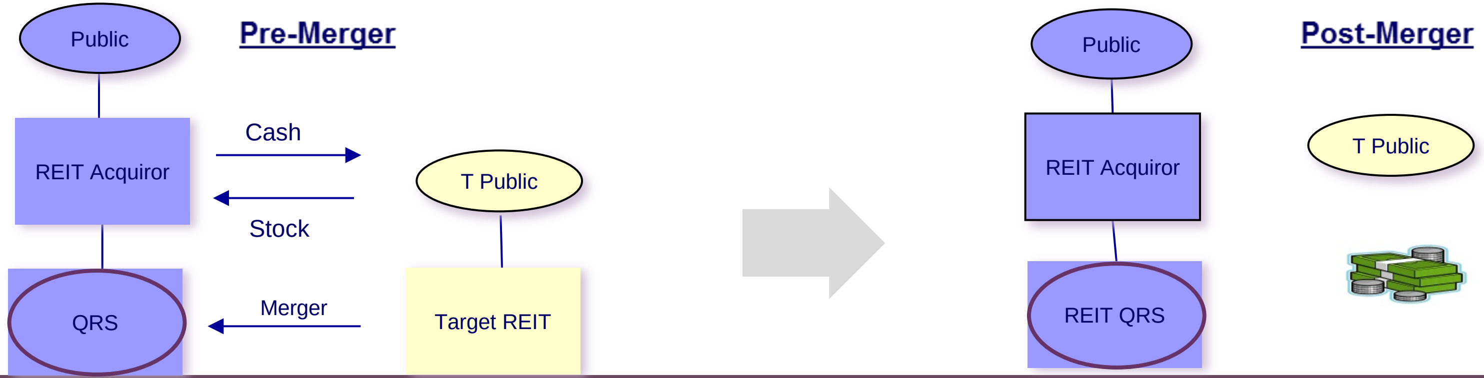


Triangular Mergers – T is a REIT

Reverse Triangular Merger

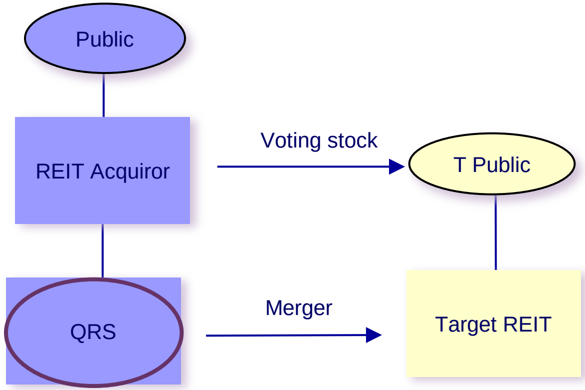


Forward Triangular Merger

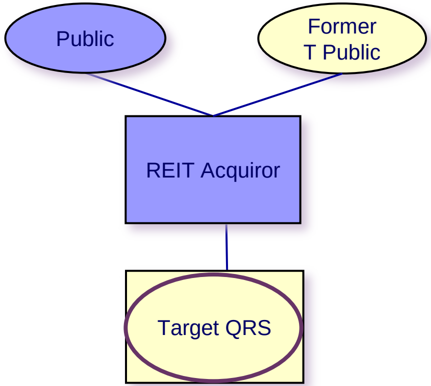


Reverse Subsidiary Merger: A2E, B or C?

Pre-Merger



Post-Merger



To qualify as a reorganization under § 368(a)(2)(E), the consideration in a reverse subsidiary merger must consist of at least 80% voting stock (i.e., ≤ 20% boot).

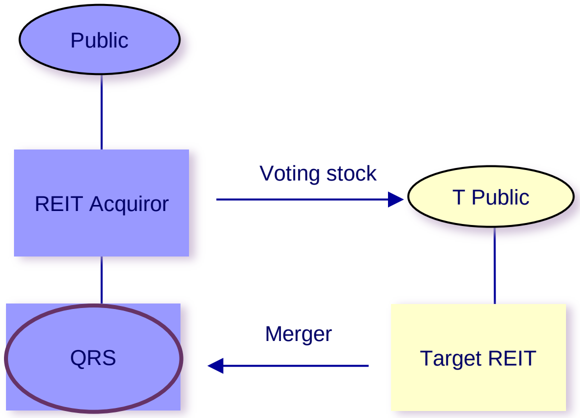
Because the merger subsidiary is a QRS and the target REIT will become a QRS, the merger cannot qualify as a reorganization under § 368(a)(2)(E) (or § 368(a)(1)(B)).

Because the target REIT is deemed to liquidate after the merger, the merger qualifies as a reorganization under § 368(a)(1)(C) (Rev. Rul. 67-274)

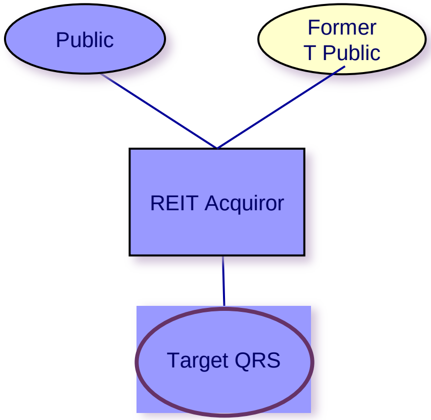
If the merger consideration had included any boot, it would generally be treated as a fully taxable stock purchase followed by a liquidation (Rev. Rul. 90-95)

Forward Subsidiary Merger: A2D or A?

Pre-Merger



Post-Merger



To qualify as a reorganization under § 368(a)(2)(D), the consideration in a forward subsidiary merger must consist of at least <u>40%</u> stock (<u>i.e.</u>, ≤ 60% boot).

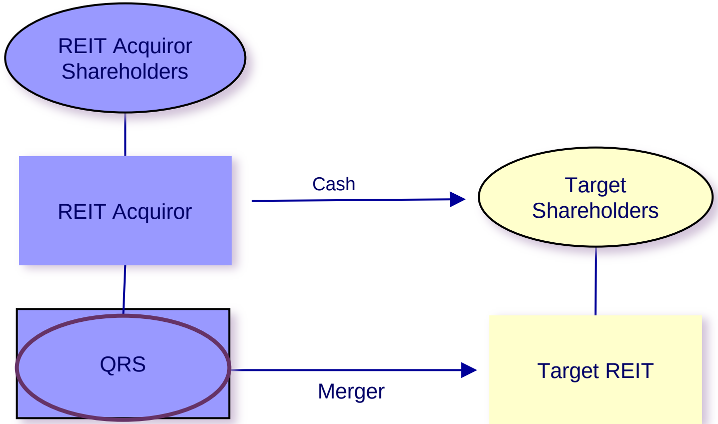
Because the merger subsidiary is a QRS and the target REIT will <u>become</u> a QRS, the merger cannot qualify as a reorganization under § 368(a)(2)(D).

Because the target REIT is deemed to merge directly into the acquiring REIT, the merger should qualify as a reorganization under § 368(a)(1)(A).

If more than 60% of the merger consideration is cash or other property, the merger will be treated as a taxable sale of assets followed by a liquidation. (Rev. Rul. 69-6)

Achieving a Basis Step-Up in a Cash Merger

Reverse Subsidiary Merger?



Tax Result:

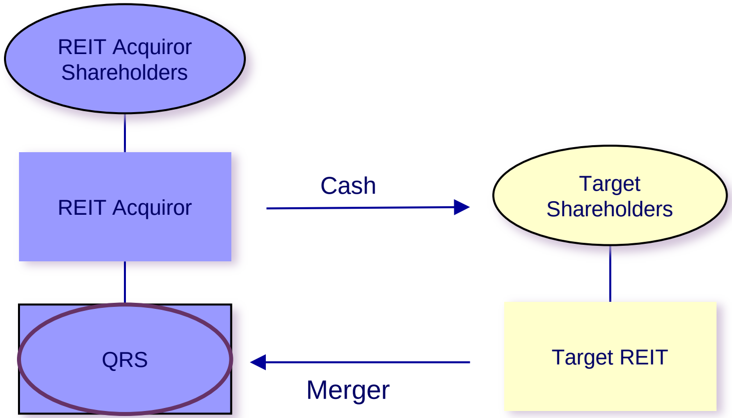
Because the merger subsidiary is a QRS, the merger is treated as a qualified stock purchase by the acquiring REIT.

Because it will become a QRS after the merger, the target REIT will be deemed to transfer its assets and liabilities to the acquiring REIT in a § 332 liquidation.

1. No Basis Step Up
2. Tax at shareholder level
3. What about FIRPTA?

Achieving a Basis Step-Up in a Cash Merger

Forward Subsidiary Merger?



In a forward subsidiary merger, the target recognizes gain in a deemed sale of assets followed by a liquidation. (Rev. Rul. 69-6)

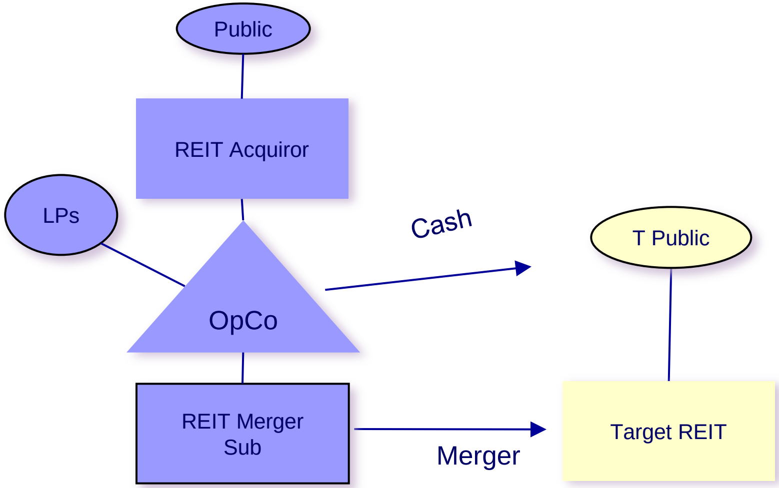
If the target is a REIT, the liquidating distribution should qualify for the dividends paid deduction (DPD) under § 562(b).

Tax Result:

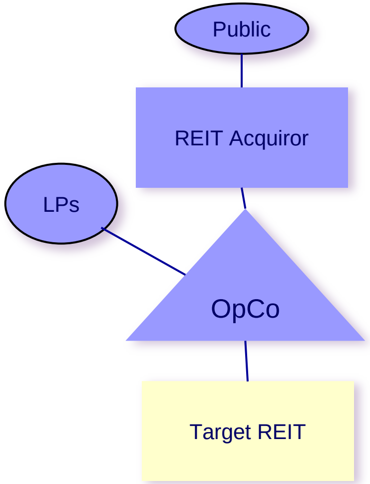
1. Taxable Sale of Assets
2. DPD Shelters the Gain
3. Full Basis Step Up
4. Capital Gain to Shareholders
5. What about FIRPTA?

Reverse Subsidiary Merger with a Partnership

Pre-Merger



Post-Merger



Because Opco (rather than the REIT parent) owns the Target REIT after the merger, the liquidation of the Target REIT is taxable.

Although the Target recognizes § 311 gain in the liquidation, the gain is sheltered by the DPD.

Opco recognizes no gain b/c it has a FMV basis in the Target stock.

Tax Result:

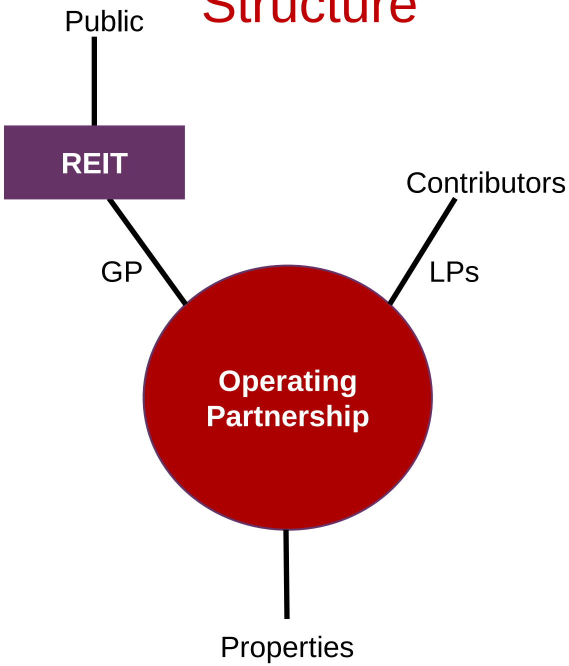
1. Full Basis Step Up
2. No Add'l Tax to Public
3. Avoids FIRPTA?

Operating Partnership
M&A Transactions

What is an UPREIT and Why Contribute to It?

- In a typical REIT IPO, a sponsor creates a new UPREIT structure, including a REIT parent and an OP subsidiary.
- The OP acquires the sponsor's management business and properties through a series of merger or contribution transactions, referred to as a roll-up.
- Participants in the roll-up receive cash, OP units or REIT shares.

Typical UPREIT Structure



Why Use an UPREIT?

- A transfer of property to a REIT in exchange for its shares would be fully taxable to the transferor in most cases.
- The UPREIT structure allows for property contributions to the OP in exchange for OP units on a tax-deferred basis.
- One REIT share and one OP unit each represent an undivided and equal slice of a single pool of assets (i.e., the assets owned by the OP), so there is economic fungibility.
- REIT shares and OP units are typically entitled to identical distributions.
- An OP Unitholder has the right to put some or all of its OP units to the OP in exchange for cash based on the current REIT stock price.
- Alternatively, the REIT has the right to acquire the OP units in exchange for REIT shares on a one-for-one basis.
- The redemption or exchange is taxable.

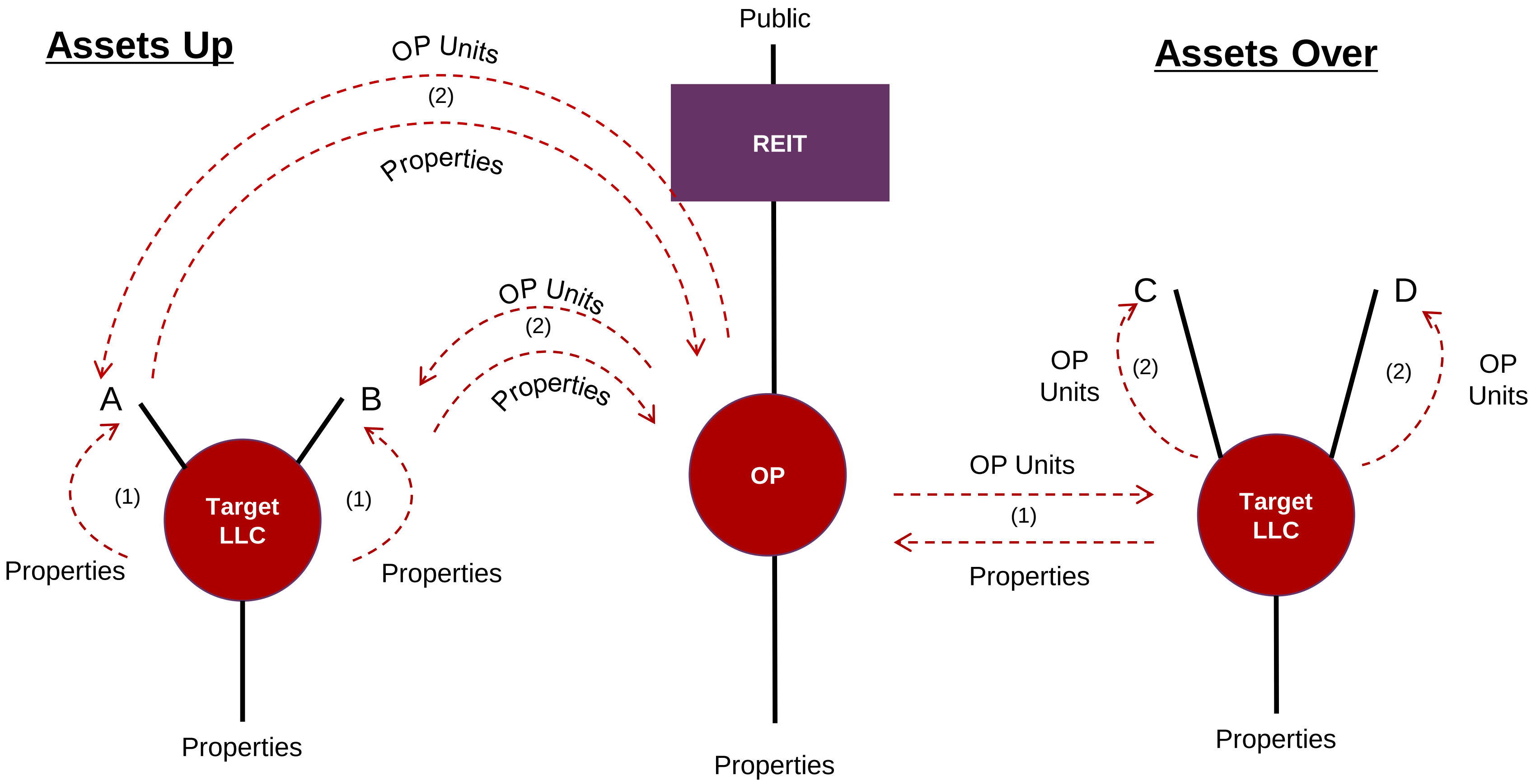
Merger and Contribution Issues

- The merger and contribution issues discussed in these slides may arise in:
  - Private contributions of property or partnership interests in exchange for OP units.
  - Merger and acquisition transactions between two UPREITs or DOWN REITs.
  - A REIT’s acquisition of a C corporation, followed by the REIT’s contribution of the assets of the corporation to its OP.

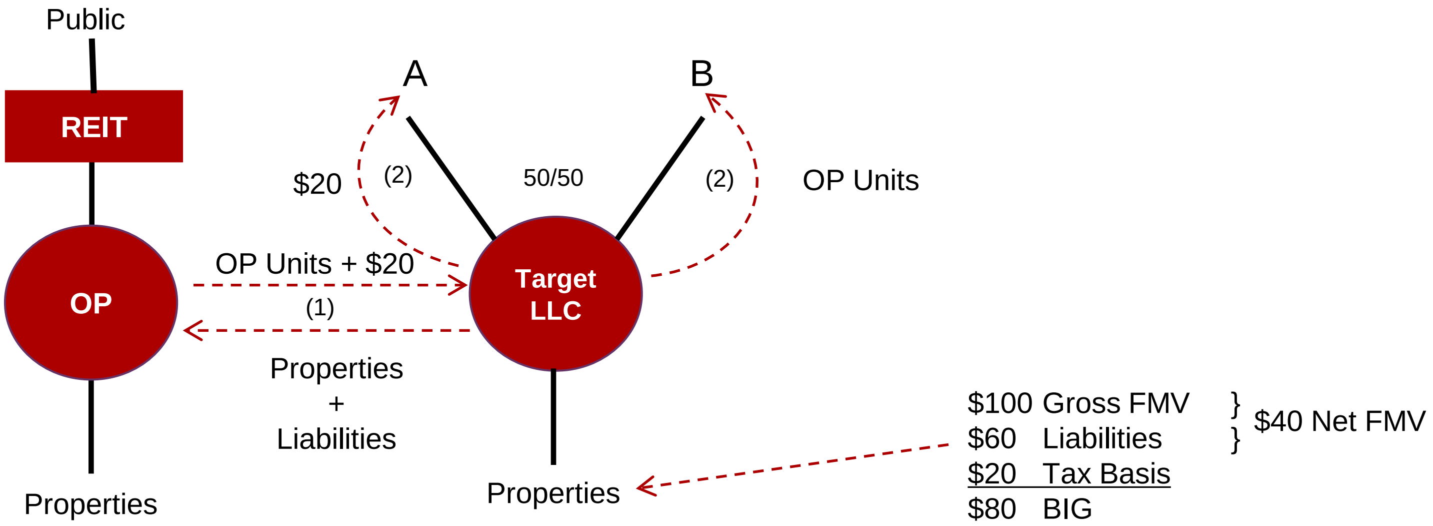
Partnership Mergers

- Code and Treasury Regulations do not define partnership mergers.
- Working Definition – Transaction in which:
  - Assets/liabilities of a target partnership are transferred to acquiring partnership.
  - At least one partner in the target partnership becomes a partner in the acquiring partnership.
  - Target partnership ceases to exist for Federal income tax purposes.
- TR § 1.708-1(c)(1) determines the direction of the merger (i.e., which partnership survives)
  - The resulting partnership is the continuation of any merging partnership whose partners own more than 50% of the capital and profits in the resulting partnership.
  - If the above could be more than one partnership, it's the partnership which contributed the most net assets.
  - The direction of the merger under these rules may differ from the direction taken in form.
- The direction of the merger may affect the need to make tax elections, and the tax consequences of the merger (e.g., the applicability of § 704(c) and the mixing-bowl rules).
- TR § 1.708-1(c)(3) determines the form of the merger.

UPREIT: Form of Merger

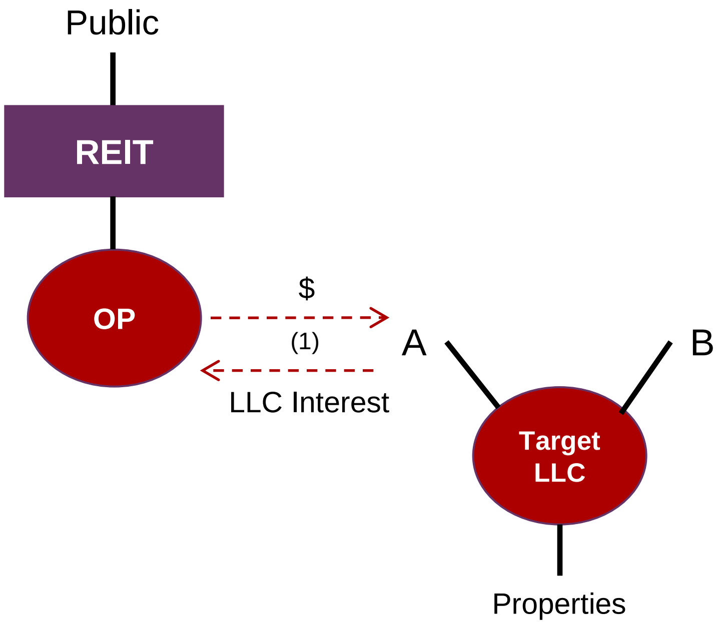


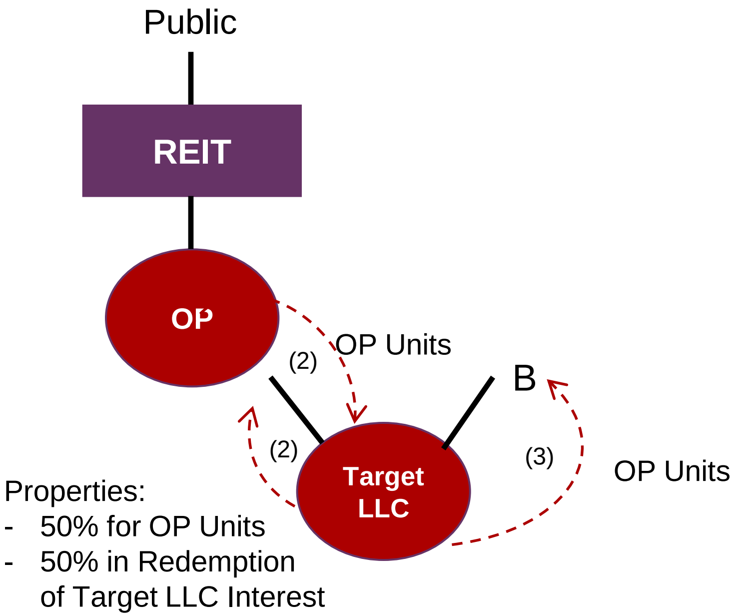
Simple UPREIT Contribution Example: Assets over Merger



- Cash causes Target LLC to recognize $40 [$80 BIG x 50%] of gain.
- Gain would be allocated $20 (50%) to A and $20 (50%) to B, even though B received no cash.
- B could recognize additional gain due to a reduction in liabilities (discussed later).

Simple UPREIT Contribution Example: Deemed Sale Election – TR § 1.708-1(c)(4)

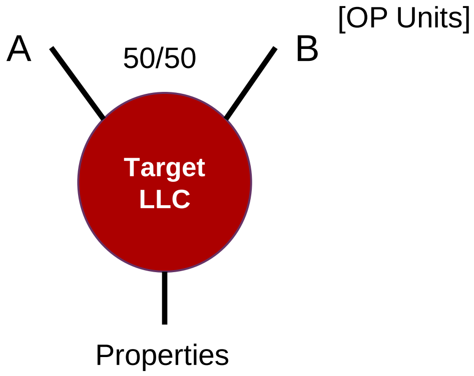




- Avoids gain recognition to B because no cash is received by Target LLC.
- Deemed sale election must be made with A's consent given prior to or contemporaneous with the transaction.

Simple UPREIT Contribution Example: Gain from Deemed Cash Distributions

- Partnership liabilities are allocated to its partners.
- A reduction in a partner's share of partnership liabilities is treated as a cash distribution.
- B received OP units and expects tax deferral.
- Suppose B's share of OP liabilities is $5:
  - $30 Target LLC liabilities - $5 OP liabilities = $25 deemed cash distribution
  - $25 distribution - $10 tax basis = $15 gain recognition
- Treasury Regulations provide alternatives for debt allocations.
- B may be able to increase non-recourse debt allocation from OP (reducing its gain) with a more favorable alternative for non-recourse liabilities or by a guarantee of OP debt.
- If B also guaranteed $15 of OP debt, it would not recognize gain.



$100 Gross FMV
$60 Liabilities
<u>$20 Tax Basis</u>

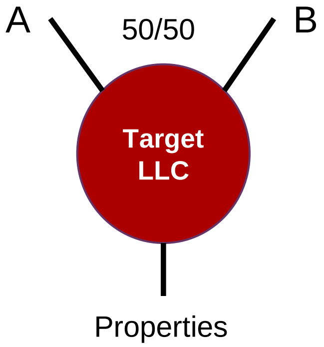
Assume A + B each have:
- $10 tax basis in LLC interest
- $30 share of LLC liabilities

Simple UPREIT Contribution Example: Other Ways to Recognize Gain on Contributions

- At-Risk Rules
  - Will recognize gain to extent of prior losses if negative amount at-risk.
  - Rules operate similar to tax basis rules, but there are differences.
- Disguised Sale Rules
  - A partnership's distribution of cash or other property to a partner within 2 years of a property contribution are presumed to be a sale of the property to the partnership.
  - A contrary position requires that the facts/circumstances "clearly establish" that the transfers do not constitute a sale, and requires tax return disclosure.
  - Applicable to deemed distributions of cash resulting from a reduction of liabilities other than "qualified liabilities," and in limited circumstances, a reduction of "qualified liabilities."
- Mixing-Bowl Rules – May apply if a partner contributed property to Target LLC in the prior 7 years.

Simple UPREIT Contribution Example: Sale of Contributed Property - § 704(c) Issues

- B received OP units and expects tax deferral.
- If OP sells the former Target LLC property, gain attributable to B's share of the $80 BIG ($40, subject to adjustments) is specially allocated back to B.
- B may be subject to substantial tax without a commensurate cash distribution.
- Any gain in excess of B's share of the BIG is generally allocated to all partners.



$100 Gross FMV
$20 Tax Basis
$80 BIG

Simple UPREIT Contribution Example: Tax Matters Agreement

- Debt Allocation - May require OP to make a tax indemnity payment to contributing partner if OP fails to use agreed upon method of allocating non-recourse debt or to make OP liabilities available for guarantee.
- Sale Limit - May require OP to make a tax indemnity payment to contributing partner if OP sells contributed property in a taxable transaction.
- Allocations - May require the OP to make use of a particular 704(c) method (e.g., the “traditional method”) to account for the difference between the book (or contribution) value of the contributed property and its tax basis.
  - Issues potentially subject to heavy negotiation include:
  - Number of properties subject to the sale limit.
  - The duration of the sale limit and debt assurances.
  - Risk profile restrictions on the debt to be guaranteed.
  - The remedy for a violation of the restrictions:
    - Full tax obligation versus time value of money.
    - Gross up for tax on the indemnity payment.

UPREIT Contributions
Tax Deferred Receipt of Cash or REIT Shares

- A contributor’s receipt of cash or REIT shares from the OP will generally be taxable, but there are limited exceptions allowing for the receipt of cash on a tax deferred basis.
  - CapEx - If the contributors have made capital expenditures with respect to the contributed property during the 2 years preceding the contribution date, the contributors may be permitted to receive cash from the OP on a tax-deferred basis to the extent of some or all of such capital expenditures.
  - Debt Financed Distribution - A cash distribution may be structured as a debt financed distribution (i.e., a distribution of the proceeds of a new loan made to the OP). Generally requires that the contributors guarantee such loan (among other requirements).
  - Loan - It may also be possible for the OP to loan cash to the contributors, secured by their OP units (and, most likely, recourse to the contributors).

UPREIT Contributions Conclusion

- A contribution of property to an OP may be an attractive alternative for property owners seeing to dispose of their property. It may allow the contributors to -
  - Diversify their investment, acquiring OP interests with common, preferred or other economic rights,
  - Obtain increased liquidity and transparency as to value, and
  - Receive a limited amount of cash or loan proceeds.
- The contributors in most cases should be able to accomplish the outcome described above on a tax efficient basis.
- Similar issues arise in the context of an UPREIT merger and acquisition transaction.

Can a REIT be a market leader with customary services?

Can a REIT be a market leader with customary services?

- Generally speaking, a REIT cannot be a market leader with customary services because a REIT’s realization of impermissible tenant service income may cause a failure to meet the income tests, and significant uncertainties may exist with respect to the “customary” determination.

- However, a REIT may evaluate the potential effects of offering cutting-edge services on its ability to satisfy the income tests and follow strictly a set of pre-established procedures to prevent adverse effects, including the appropriate use of its taxable REIT subsidiary.

Why “Customary” Matters

- A REIT must derives 75% and 95% of its gross income (subject to certain adjustments) from statutorily defined sources, including rents from real property.
- Rents from real property are generally amounts received for the use of, or the right to use, real property and include charges (whether separately stated or not) for services customarily furnished in connection with the rental of real property.
- However, rents from real property do not include impermissible tenant service income (ITSI).
  - If ITSI exceeds 1% of gross amounts received from property, then ITSI includes all such amounts (i.e., all rents are tainted).
  - Impermissible tenant service income (ITSI) means with respect to any real or personal property, any amount received by a REIT (i) for services furnished or rendered by the REIT to tenants of the property, or (ii) for managing or operating the property.

Why “Customary” Matters (continued)

- ITSI exceptions
  - Unrelated business taxable income (UBTI) exception – REIT may directly perform services that are not primarily for the tenant’s convenience <u>and</u> are usually or customarily rendered in connection with the rental of rooms or other space for occupancy only, e.g., furnishing of heat and light, the cleaning of public entrances, exits, stairways, and lobbies, the collection of trash… [Different from geographic market determination]
  - Independent contractor (IK)/taxable REIT subsidiary (TRS) exception - Services or management provided through an IK from whom the REIT does not derive income, or through TRS are not considered furnished by the REIT.
    - The use of an IK for noncustomary services is subject to the separate charge requirement, i.e., the cost of the services must be borne by the IK; a separate charge must be made for the services and received and retained by the IK; and the IK must be adequately compensated for the services.

Why “Customary” Matters (continued)

- In summary, a REIT risks of failing the income tests, if
  - It realizes ITSI, which itself is nonqualifying income but could also taint property’s otherwise qualifying rents, because
    - It uses its employees or a nonqualifying IK for noncustomary services, or
    - It uses an IK for noncustomary services but keeps the separate charges.
  - It realizes too much income attributable to noncustomary services even if it uses its taxable REIT subsidiary.

Services – Customary Determination

- "Services furnished to the tenants of a particular building will be considered as customary if, in the geographic market in which the building is located, tenants in buildings which are of a similar class (such as luxury apartment buildings) are customarily provided with the service." [See § 1.856-4(b)(1)]

- Uncertainties exist with respect to the determination of "geographic market," "similar class," and "customarily provided".
  - Some questions – How is the geographic market defined? What are buildings of a similar class? How many such buildings must offer the service in question for it to be considered customary? What is the service? How about "the only property in town"?

Geographic Market

- Transfer pricing – section 1.482-1(d)(4)(ii)(A) - "any geographic area in which the economic conditions for the relevant product or service are substantially the same."
- GCM 39726 – for section 482 purposes – "an area in which sellers compete and around which there exist economic barriers that significantly impede the entry of new competitors" and "[t]he physical boundaries… cannot be precisely drawn at any given point in time."
- In Re/Max Int'l, Inc. v. Realty One, Inc. (an antitrust case), 173 F.3d 995, the Court of Appeals for the Sixth Circuit stated:
  - "Although [a geographic market or an area of effective competition] is not subject to definition by metes and bounds, it is the locale in which consumers of a product or service can turn for alternative sources of supply. Obviously, at the outer edges of a bona fide geographic market, buyers may be able to cross into other territory for their supply of a product or service; however, this fact alone does not require a rejection of the claimed market." [Citation omitted]

Use of Taxable REIT Subsidiary

- Congress enacted the TRS provisions to, among other things, provide tenant services to remain competitive “that might not be considered customary because they are relatively new or ‘cutting-edge’,” and “simplify such rental operations since uncertainty whether a particular service provided by a subsidiary is ‘customary’ will not affect the parent's qualification as a REIT.”
- Rev. Rul. 2002-38 – a REIT pays its TRS to provide noncustomary housekeeping services to tenants. The REIT does not separately state charges to tenants for the services. Thus, a portion of the amounts received by the REIT from tenants represents an amount received for services provided by the TRS. TRS employees perform all of the services and TRS pays all of the costs of providing the services. The TRS also rents space from the REIT for carrying out its services to tenants.
  - The ruling held that the services provided to the REIT's tenants are considered to be rendered by the TRS, rather than the REIT. Accordingly, the services do not give rise to ITSI and do not cause any portion of the rents received by the REIT to fail to qualify as rents from real property.

Use of Taxable REIT Subsidiary (continued)

- Rev. Rul. 2002-38 stated “[a]ll relevant facts and circumstances must be considered in determining the provider of the services for [ITSI] purpose.”
- Many REITs have their employees housed one place and shared among affiliates (i.e., TRS may have no employees of its own). Thus, the use of a TRS for tenant services typically involves issues, such as
  - Is TRS respected as a tax entity? Are employees performing activities on behalf of TRS or REIT? If REIT assigns rights and obligations to TRS to avoid separately-stated noncustomary service income, is such assignment effective?
  - Note – Rev. Rul. 2002-38 does not suggest that the TRS has entered into contracts with tenants for the housekeeping services.
  - Considerations - doctrines of corporate identity and anticipatory assignment of income. [Transfer pricing being discussed elsewhere.]

Doctrine of Corporate Identity

- In *Moline Properties v. Commissioner*, 319 U.S. 436 (1943), the U.S. Supreme Court discussed:
  - “Whether the purpose be to gain an advantage under the law of the state of incorporation… or to serve the creator's personal or undisclosed convenience, so long as that purpose is the equivalent of business activity or is followed by the carrying on of business by the corporation, the corporation remains a separate taxable entity.”
- *National Carbide Corp. v. Commissioner*, 336 U.S. 422 (1949) - “when a corporation carries on business activity the fact that the owner retains direction of its affairs down to the minutest detail, provides all of its assets and takes all of its profits can make no difference tax-wise.”
- In short, it does not take much for TRS to be respected as a tax entity.

Anticipatory Assignment of Income Doctrine

- The U.S. Supreme Court in *Lucas v. Earl*, 281 U.S. 111 (1930), stated:
  - “There is no doubt that the statute could tax salaries to those who earned them and provide that the tax could not be escaped by anticipatory arrangements and contracts however skillfully devised to prevent the salary when paid from vesting even for a second in the man who earned it. That seems to us the import of the statute…”
- In *Iowa Bridge Co. v. Commissioner*, 39 F.2d 777 (8th Cir. 1930), the taxpayer, a corporation, entered into certain contracts for the construction of certain bridges. Subsequently, the taxpayer’s stockholders adopted a resolution selling, assigning, and transferring to the corporation’s president, who was also the major stockholder of the taxpayer, certain contracts and parts of the bridge contracts for which the work had not been completed. Then, all correspondence relative to the bridge construction and the performance of the contract work conducted in and under the president’s trade-name. No formal notice of assignment was given to the surety companies nor customers of the contracts.

Anticipatory Assignment of Income Doctrine (continued)

- *Iowa Bridge Co*. – The court reasoned:
  - “Unless expressly prohibited by statute, all ordinary business contracts, which are not necessarily personal in character, are assignable… There was nothing in the nature of these contracts which required the personal services of either of the contracting parties, and it appears from the stipulation that contracts of this character were frequently sublet... There was clearly a novation. The contracts were performed by the assignee and the performance thereof was accepted by the contracting parties.”
- The court rejected the decision of the Board of Tax Appeals that contracting profits were the profits of Iowa Bridge Company.

Anticipatory Assignment of Income Doctrine (continued)

- In *Alan M. Mantell, Executor v. Commissioner*, T.C. Memo. 1993-420, the taxpayer entered into an agreement to receive a fee for his involvement with a development project, including raising capital, supervising the collection of sums due to the project from the investors, and an operating deficit guarantee. Subsequently, the taxpayer formed A. Mantell, Inc. and assigned the agreement to A. Mantell, Inc., including obligations and rights to income. The taxpayer informed the project coordinator orally of the assignment of the obligations but never received a release from these obligations. To perform its obligation under the assumption agreement, A. Mantell, Inc., on its own letterhead, wrote letters to the investors who were in default to obtain collection of the funds, monitored the collection process in general, and regularly corresponded with the investors on every payment date. The Tax Court discussed:
  - "… the principles of *Lucas v. Earl*, supra, are not applicable where the income is derived from the assumption of a fully assignable bilateral contract obligation to be performed by the assignee, is not for personal services, did not represent fees for income earned prior to assignment, and was accrued by a corporation that served a legitimate business purpose…"

Anticipatory Assignment of Income Doctrine (continued)

- To avoid ITSI, it is imperative that the TRS be respected as the provider of the services (e.g., with available resources to furnish the services and corporate formality being followed).
  - Define in a TRS Service Agreement the specific services to be furnished before such services being actually rendered to service recipients
  - Make resources available to the TRS via employee sharing agreement, lease or ownership of property required for the services, contract with 3rd– party service providers, etc.
  - Maintain books and records consistent with the TRS Service Agreement (including employee costs)

REIT Investments in Non-Controlled Partnerships

REIT Investments in Partnerships

- REIT Qualification Requirements - To qualify as a REIT, a corporation must meet a number of asset and income tests, and distribution requirements.
- Partnership Look-Through - TR § 1.856-3(g) provides that if a REIT is a partner in a partnership -
  - The REIT will be deemed to own its proportionate share of each of the assets of the partnership, and
  - The REIT will be deemed to be entitled to the income of the partnership attributable to such share.
- Monitoring - As a result, a REIT must monitor the assets and income of a partnership* in which it invests to the same extent as its own assets and income.

* References to a partnership include an LLC that is taxed as a partnership.

Control of the Partnership

- No-Control - If a REIT does not, or may not always, control the partnership (e.g., as general partner*), it needs the partnership agreement to restrict the partnership's activities to REIT-acceptable activities.
- Control - Even if a REIT does control the partnership, it is good practice to include a similar provision (although perhaps less specific), so that it's clear the REIT may use its power to control the partnership in a REIT acceptable fashion, even if it's contrary to the interests of its non-REIT partners.
- LP Duties - Unless the partnership agreement states otherwise, a general partner may owe default fiduciary duties (loyalty, care) to limited partners.

* Or managing member of an LLC

REIT Compliance Issues: REIT Income Tests

- General Limitation
  - The partnership should produce income that will qualify under REIT income tests.
  - Depending on the business of the partnership, the agreement could require that at least 95% of the partnership’s income be “rents from real property” to the REIT partner, or otherwise be qualifying income.
- More Specific Rent Limitations -
  - Rent not based on income or profits.
  - Tenant Services
    - Not permitted to the extent they produce impermissible tenant service income (ITSI), or possibly more than 1% ITSI with respect to any property.
    - Must be customary in the geographic area, unless provided by a taxable REIT subsidiary (TRS).
    - Must not be primarily for the convenience of the tenants, unless provided by an independent contractor (IK) from whom the REIT derives no income or a TRS.
  - Personal property - Limited to 15% of the leased property.
  - No related party tenants with respect to the REIT partner.

REIT Compliance Issues:
REIT Income Tests – Service Issues

- Service Issues - Suppose the REIT's partner wants the partnership to provide non-customary services to tenants.
  - Use of TRS - Partnership could form a subsidiary TRS to provide such services, but the REIT's partner may not like the tax cost associated with using a TRS.
  - Use of Services Partnership - REIT and its partner could form a second partnership (the service partnership) to provide the services.
    - REIT partner could participate through a TRS
    - Rev. Rul. 2003-86 concludes that the use of this structure to provide non-customary services will not cause rent to fail to qualify as "rents from real property" where –
      - JV partner participates through a corporation which is an IK from whom REIT derives no income; and
      - The tenants separately contract with the service partnership for the provision of services.

REIT Compliance Issues: Asset Tests

- REIT Asset Tests
  - General Limitation
    - The partnership should own assets that will qualify under REIT asset tests.
    - Depending on the business of the partnership, these tests could require that at least 75% of the partnership's assets be real estate assets, cash or ordinary course receivables.
  - More Specific Asset Test Limitations –
    - Equity - No equity interests in other entities, except
      - Interests in disregarded entity subsidiaries or partnerships, in each case which are subject to the same REIT restrictions.
      - Money market investments.
    - Loans - No loans, or possibly no loans other than loans adequately secured by real property.

REIT Compliance Issues: Distribution Requirements and Information Rights

- REIT Distribution Requirements
  - Annual Distributions - Require partnership to make annual distributions so that the REIT partner's share of such distributions is at least equal to the REIT partner's allocable share of taxable income from the partnership.
- Information Rights
  - The agreement should provide the REIT partner with the right to obtain information from the partnership which will allow the REIT partner to monitor its qualification and taxation as a REIT.

Prohibited Transactions Tax Issues

- Prohibited Transactions Tax - 100% on dealer sales.
- Partnership Look Through - TR § 1.856-3(g) provides that if a REIT is a partner in a partnership that holds property primarily for sale to customers in the ordinary course of its trade or business, then the REIT will be treated as holding its proportionate share of such property primarily for the same purpose.
- Type of Sale - Prohibited transactions tax issues could arise because the partnership sells its property, or because the REIT sells its interest in the partnership (including pursuant to a buy-sell arrangement between partners).
- Limitation
  - Ideally, require that any partnership property sales, or triggering of the buy-sell arrangement, must satisfy the prohibited transactions tax safe-harbor with respect to the REIT partner.
  - Not always possible to include this provision, in which case the REIT partner may need to be the buyer, not the seller.

Buy – Sell Arrangements

- Pricing - Need to make sure pricing is fair, and that the non-REIT partner may not manipulate the pricing mechanics.
  - Typical Buy-Sell - Assume on a deadlock (or other events), a partner (the electing partner) may set a value for the partnership, and the other partner (the responding partner) may elect to either sell its partnership interest to the electing partner, or buy the electing partner's partnership interest, in each case, based on the value set by the electing partner.
  - Manipulation - If the responding partner is the REIT, and the electing partner is aware the REIT does not want to be a seller (e.g., due to prohibited transactions tax issues), the electing partner may set an unreasonably high price, expecting to be a seller.
  - Appraisal - Use of an appraisal mechanism to determine value of the partnership may be preferable, to avoid this risk.

Buy – Sell Arrangements

- Single Tax Basis - Under Rev. Rul. 84-53, a partner only has one tax basis in its partnership interest, even if portions of its partnership interest were acquired at different times and prices.
- Separate Entity - If the REIT partner may resell the acquired interest (e.g., it bought because it was concerned about prohibited transaction issues, or because it thought the price was favorable), the REIT may want to purchase the interest through a separate entity to preserve the higher tax basis in that partnership interest.
- TRS - If the REIT expects to promptly resell the interest, it may want to purchase the interest through a TRS to eliminate the risk of a prohibited transactions tax on the sale of the interest.

Single Property Issues

- Example –
  - The partnership owns many properties, but only one will be sold.
  - The REIT is concerned about gain recognition or prohibited transactions tax issues, so it elects to purchase the property.
- Purchase from Partnership - If REIT buys the property from the partnership, a portion of the gain on sale would be allocated back to the REIT, and could still raise prohibited transaction issues, or at least increase the REIT's income and distribution requirement.
- Alternative
  - The agreement could provide that the property (or interests in the LLC that owns the property) will be distributed to the partners, and the REIT will purchase the other partner's interest in the property (or such LLC).
  - This should avoid the recognition of gain with respect to the REIT's share of the property.

REIT Status Catch-All

- Traps – There may be situations that were not anticipated, but which could adversely affect REIT status.
- Example – Partnership invests in securities of an issuer which also issued debt to the REIT, intended to qualify as straight-debt.
  - REIT's deemed ownership of the partnership's securities could cause the REIT's debt to fail the straight-debt safe-harbor. § 856(m)(2)(C).
- Example – Partnership derives income from a party which is an IK of the REIT, and from whom the REIT may derive no income.
  - Could taint the rental income at the REIT properties where the independent contractor provides services. § 856(d)(7)(C)(i).
- Catch-All - The partnership agreement could provide that the partnership is not permitted to take any other action which could jeopardize the REIT's qualification as such.
  - May require written notice from the REIT partner.
  - Due to its potentially broad application, REIT may need to offer an indemnity to its partner for any losses arising from the use of this provision.

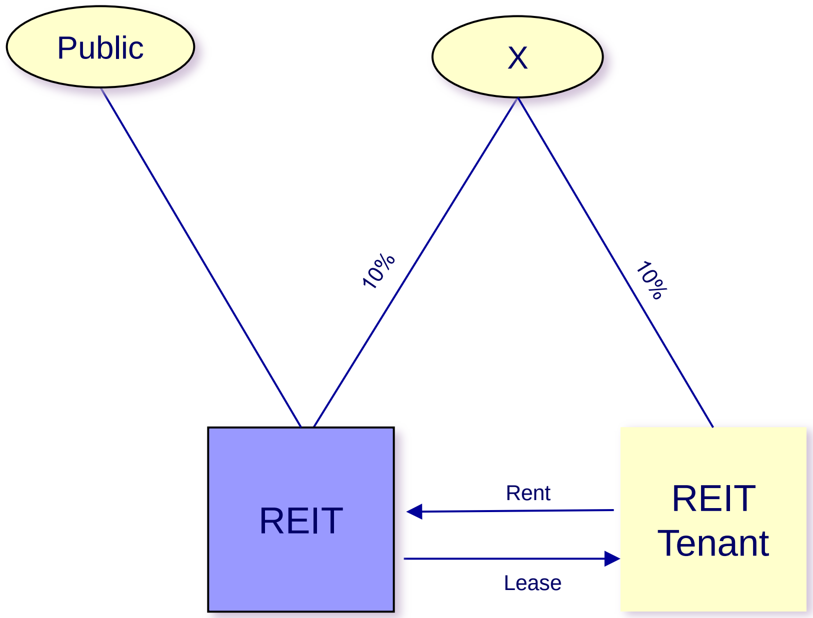
Charter Restrictions

Why Charter Restrictions?

- to facilitate compliance with Five or Fewer rule
- to facilitate compliance with 100 shareholder rule
- to minimize risk of related party rent
- to qualify foreign holders for FIRPTA relief under "domestically controlled" exception
- to minimize risk of UBTI to pension fund shareholders

Most REITs Prohibit Stock Ownership in Excess of 9.8%

- prevents violations of Five or Fewer rule
  - 9.8% x 5 < 50%
- avoids related party rent
  - related party rent does not qualify as “rents from real property” to a REIT
  - if a REIT owns 10% or more of the stock of a tenant, the rent from such tenant is related party rent
  - a REIT is deemed to own stock of any tenant held by a 10% or greater shareholder



Not Rent from Real Property!

What Happens to the “Excess Shares”?

- share ownership in excess of 9.8% triggers “excess share” provisions of charter
- under most REIT charters, the excess shares are transferred to a trust
  - REIT appoints a charity as the trust beneficiary
  - no voting rights or dividends to offending shareholder
- trustee sells shares on the market and retains any profits
  - offending shareholder receives lesser of original purchase price or sales proceeds

Charter Amendment vs Poison Pills

- Although most REITs impose these restrictions by charter, some adopt shareholder rights plans (i.e, a poison pill).
- Unlike most charter restrictions, a shareholder rights plan does not void, nullify or deny economic rights to the transferred shares; it penalizes the violator by economic dilution.
- A REIT with a shareholder rights plan must rely on *the in terrorem* effect of the pill to avoid violations of REIT ownership limitations.

Impact on REIT				
	Shareholder Approval?	**Quick to Implement?**	**Tax Impact on REIT if Violated**	**Enforceable?**
Charter Amendment	Yes	No (in most cases)	Excess share purchase treated as if it never occurred	Not against shareholders who voted against amendment
Poison Pill	No	Yes	•Related party rent? •Five or fewer? •100 shareholder? •Domestically-controlled?	Generally enforceable for future stock acquisitions; existing shareholders usually grandfathered

Concurrent Session: SEC Legal Issues

Thursday, March 31st
2:45pm – 4pm
Marriott Marquis, Washington DC

Moderator:
Michael McTiernan, Partner, Hogan Lovells LLP

Panelists:
Sonia Barros, Assistant Director-Division of Corporation Finance, Securities and Exchange Commission
Judith Fryer, Shareholder, Greenberg Traurig, LLP
Jeffrey Miller, SVP, General Counsel & Secretary, Highwoods Properties, Inc.
David Roberts, Partner, Goodwin Procter LLP

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March 30 - April 1 2016

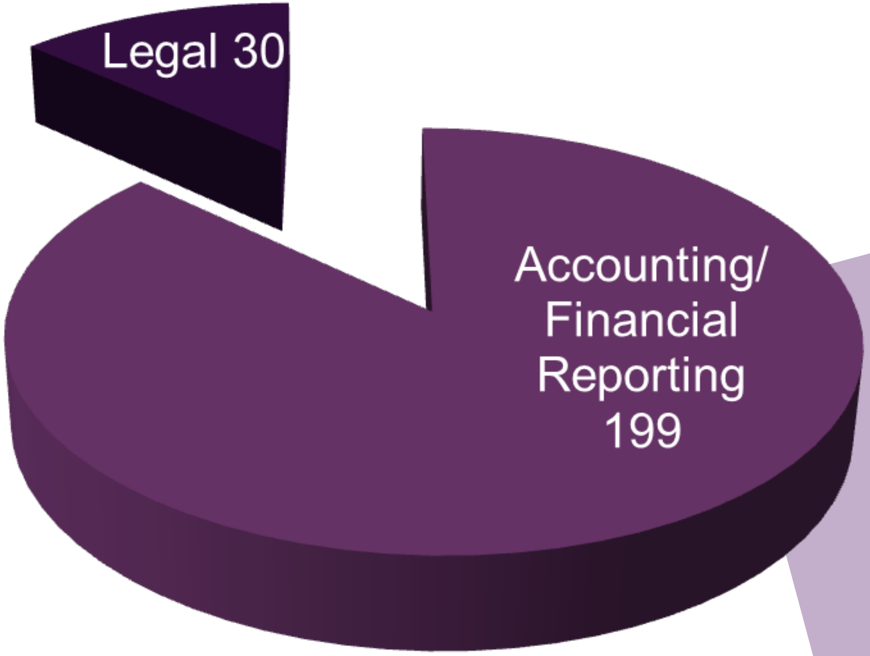
Analysis of 2015 SEC Comment Letters On Form 10-Ks Filed by REITs

Michael McTiernan, Partner
Hogan Lovells US LLP

Scope of Survey

- Reviewed Comment letters issued March 1, 2015 to September 30, 2015 on Form 10-Ks Filed in 2015
- Limited to Traded REITs (Equity and Mortgage)
- Review Covered 91 Letters and 229 comments

General Types of Comments



Summary of Legal Comments

- Most Frequent Topic of Comments:
  - Property Operating Metrics:
    - average rents
    - Occupancy
    - geographic/tenant diversification
- Other Topics:
  - Related Party Transactions
  - Certifications

Summary of Accounting/Financial Reporting Comments

- Most Frequent Topics of Comments:
  - Non-GAAP Measures
  - MD&A
    - results of operations
    - liquidity and capital resources
- Other Topics:
  - Significant Accounting Policies
  - Fair Value

Summary of Non-GAAP Comments

- Most Frequent Topics of Non-GAAP Comments:
  - Labeling issues—primarily clarifying whether FFO includes amounts allocable to unitholders
  - Questioning whether a particular Non-GAAP measure not disclosed in 10-K is a “key performance indicator” or “key liquidity indicator” that should be disclosed in MD&A
  - Failure to comply with Item 10(e) requirements
  - When FFO is identified as “NAREIT FFO”, questioning whether certain adjustments are consistent with the NAREIT definition

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Supreme Court Guidance on Opinions in Registration Statements

From the Experts

Robert A. Horowitz, Steven M. Malina and Brian D. Straw

Faced with the new test enunciated by the U.S. Supreme Court this year in Omnicare v. Laborers District Council Construction Industry Pension Fund, corporate securities lawyers will have to make extremely difficult and subjective decisions when it comes to advising their clients whether to disclose opinions in registration statements and, if so, whether the opinions might be considered materially misleading if not accompanied by disclosure of facts that might contradict the opinion.

The case arose out of a registration statement Omnicare filed in connection with its 2005 stock offering. Two sentences expressed the company's opinion concerning its compliance with the law:

- "We believe our contract arrangements with other health care providers, our pharmaceutical suppliers and our pharmacy practice are in compliance with applicable federal and state laws."
- "We believe that our contracts with pharmaceutical manufacturers are legally and economically valid arrangements that bring value to the health care system and the patients that we serve."

The company's opinion turned out to be wrong. Several years after Omnicare filed the registration statement, the federal government commenced a civil False Claims Act suit alleging that its receipt of payments from drug manufacturers violated anti-kickback laws. Citing these suits, certain pension funds that purchased stock in Omnicare's public offering sued the company and certain directors and officers under Section 11, alleging that the company's statement of opinion about its legal compliance was false and misleading.

The district court granted Omnicare's motion to dismiss, holding that a statement of opinion is not actionable unless it was "subjectively false," i.e., the speaker did not honestly hold the opinion at the time. The U.S. Court of Appeals for the Sixth Circuit reversed, holding it sufficient for the pension funds to allege that the stated belief was "objectively false" as evidenced by the fact that it turned out to be false, regardless of whether the funds alleged that anyone at Omnicare disbelieved the opinion. The Supreme Court granted Omnicare's writ of certiorari to consider when statements of opinion are actionable under Section 11 of the Act.

The Court disagreed with both the district court and the Sixth Circuit. It announced a new test for determining whether a statement of opinion in a registration statement may give rise to liability for a material omission:

"[I]f a registration statement omits material facts about the issuer's inquiry into or knowledge concerning a statement of opinion, and if those facts conflict with what a reasonable investor would take from the statement itself, the § 11's omissions clause creates liability."

The Court stressed that a statement of opinion is not necessarily misleading merely because the issuer is aware of particular facts that cut against the opinion. Only if the withheld facts would lead a reasonable investor to disregard the stated opinion would the issuer be liable for failing to disclose those facts.

The Court then went on to discuss the plaintiff's burden to plead a Section 11 violation based upon a statement of opinion that omits to state material facts that cut against the opinion:

"The investor must identify particular (and material) facts going to the basis for the issuer's opinion—facts about the inquiry the issuer did or did not conduct or the knowledge it did or did not have—whose omission makes the opinion statement at issue misleading to a reasonable person reading the statement fairly and in context. . . That is no small task for an investor."

The difficulty in applying the Supreme Court's test is exemplified by the Omnicare facts with which the district court will have to deal on remand. Omnicare's opinions that it was in compliance with applicable federal and state law were accompanied by caveats. Omnicare cited several state-initiated enforcement actions against pharmaceutical manufacturers for offering payments to pharmacies that dispensed their products, and then cautioned that future interpretation and application of the laws relating to such rebates might be inconsistent with its current interpretation. Omnicare also noted that the federal government had expressed "significant concerns" about some manufacturers' rebates to pharmacies. However, Omnicare failed to disclose that an attorney warned that one of Omnicare's contracts presented a "heightened risk of legal exposure" under anti-kickback rules.

Faced with the warning, what should Omnicare have done? Expressed its opinion as it did without any reference to the warning? Expressed its opinion, but disclosed the attorney's warning as a third caveat? Refrained from expressing its opinion?

In light of the new test, if a company chooses to express an opinion in a registration statement, its corporate securities attorney must inquire as to the basis for the opinion and all facts that might undermine the opinion in any way, and then advise the company whether a reasonable investor might consider those facts to be material. How will that play out in practice?

After Omnicare, is the corporate securities lawyer supposed to advise his client that any time an attorney raises an issue that creates doubt as to the opinion expressed, the company must disclose the otherwise privileged communication? The Supreme Court addressed an easy example: the fact that an issuer did not disclose that a single junior attorney expressed doubts about a practice's legality when six of his more senior colleagues gave a stamp of approval would not make the opinion that the issuer is in legal compliance misleading.

But what if the attorney who expressed doubts about a practice's legality is outside counsel who specializes in the compliance issue at hand, but in-house counsel and the business folks conclude the practice is legal? Is the fact that outside counsel raised an issue a material fact that must be disclosed? If so, what would the disclosure look like? Perhaps: "We believe we are in compliance with federal and state regulations. Our outside counsel raised an issue concerning our compliance and we considered the concern he raised, but we continue to believe we are in compliance." Even if such a disclosure were otherwise realistic, disclosure of otherwise privileged communications is fraught with obvious dangers.

For those issuers concluding from this uncertainty that the better course might be not to consult an attorney before expressing the opinion, the Supreme Court anticipated that conclusion and knocked it down. The Court noted an issuer that states it believes its conduct is lawful without disclosing it did not consult counsel would be making a misleading statement actionable under Section 11. As Omnicare argued to the Supreme Court, the new test might simply cause companies not to express opinions in their registration statements.

While issuers can breathe a sigh of relief as a result of the Court's rejection of the Sixth Circuit's view that issuers can be held liable under Section 11 for sincerely held opinions that turn out to be false, the Supreme Court's decision creates enormous uncertainties as to when an issuer can safely state an opinion and what facts it would need to disclose to protect itself from Section 11 claims should its opinions prove to be false.

Fortunately, the Court made clear that reasonable investors should not expect every fact known to an issuer to support its opinions, and that such statements should be read in light of all its surrounding text, including hedges and disclaimers. Nevertheless, the prudent course for an issuer may be to refrain from offering any opinions, a result that would not be welcomed by investors and is not necessarily consistent with the disclosure-based regulatory regime underlying the '33 Act.

Robert A. Horowitz is co-chair of the securities litigation practice and a shareholder in the financial and regulatory compliance practice at Greenberg Traurig. Steven M. Malina is a shareholder in the securities litigation practice and financial services litigation practice at the firm. Brian D. Straw is an associate in the litigation practice at the firm.

Deloitte.

SEC Comment Letters — Including Industry Insights
What "Edgar" Told Us

Ninth Edition
October 2015

Deloitte.

To our clients, colleagues, and other friends:

We are frequently asked to provide our perspective on the topics the SEC staff focuses on in its comment letters to registrants. The ninth edition of *SEC Comment Letters — Including Industry Insights: What "Edgar" Told Us* offers such perspective. In addition to extracts of letters and links to relevant related resources, it contains analysis of staff comments to help registrants understand trends and improve their financial statements and disclosures.

Over the past year, the SEC staff has continued to address most topics discussed in our eighth edition, and it remains focused on the clarity of registrants' disclosures. This ninth edition reflects current SEC comments on registrants' financial statements and other aspects of their filings and includes the following appendixes: (1) Appendix A, which lists comment letter trends discussed in our eighth edition that no longer represent recent trends; (2) Appendix B, which gives a glimpse into the SEC staff's review and comment letter process; (3) Appendix C, which discusses best practices for managing unresolved SEC comments; (4) Appendix D, which provides helpful tips on searching the SEC's EDGAR database for comment letters; (5) Appendix E, which lists the titles (or links to titles) of the standards referred to in this publication; and (6) Appendix F, which defines the abbreviations we used.

Our ninth edition captures developments on relevant financial reporting topics through the date of publication. The SEC and its staff will continue to provide registrants with information that is pertinent to their filings by means of rulemaking and written interpretive guidance as well as speeches delivered at various forums, of which the AICPA Conference is a prime example. Deloitte's US GAAP Plus Web site is a resource you can use to keep current on the SEC's latest activities related to financial reporting matters — including the SEC staff's participation at the next AICPA Conference, which is scheduled for December 9–11, 2015, and will be discussed in an upcoming issue of our *Heads Up* newsletter.

We hope you find our ninth edition of this publication — and other publications on US GAAP Plus — useful resources as you prepare your annual reports and plan for the upcoming year.

In keeping with recent SEC staff remarks about how registrants can make their disclosures more effective, we encourage you to consider materiality, relevance, and redundancy as you assess whether to provide additional disclosures or enhance existing ones.

As always, we encourage you to contact us for additional information and assistance, and we welcome your feedback.

Sincerely,

Rob — Christine

Rob Comerford
Accounting Services

Christine Davine
SEC Services

Contents

Acknowledgments

This ninth edition of *SEC Comment Letters — Including Industry Insights: What "Edgar" Told Us* would not have been possible without the significant contributions of the Accounting Services, Audit and Assurance Services, and SEC Services departments and the industry specialists at Deloitte & Touche LLP. Specifically, we wish to thank Lisa Mitrovich for the insights and dedication that she brings to this publication each year, as well as Jeff Naumann and Deloitte's Disclosure Analytics team for the insight into comment letter trend statistics that they provided this year. In addition, we are grateful to Ana Zelic for her tireless contributions and the many late nights that she dedicated to managing the development of this publication. We would also like to thank Teri Asarito, Geri Driscoll, David Eisenberg, Michael Lorenzo, Jeanine Pagliaro, and Lora Spickler-Alot for delivering the first-class editorial and production effort that we have come to rely on for all of Deloitte's financial reporting publications. Special thanks go to Derek Gillespie for supervising the overall development of this ninth edition with his trademark enthusiasm, creativity, and dedication. Finally, we want to acknowledge Joe DiLeo, whose supervision of past editions of this publication provided the foundation on which we have built this year's edition.

Executive Summary

As we approach the start of the 2015 annual reporting cycle, it seems natural to look back at the strategic priorities of the SEC over the past 12 months.

Since Mary Jo White took the helm of the SEC in April 2013 as its 31st chairman, the aggressive pursuit of investor protection has been a key focus of the Commission. The SEC recently announced that in its fiscal year ended September 2015, it filed 807 enforcement actions and obtained orders totaling approximately $4.2 billion in disgorgements and penalties. Further, as technology and business practices have continued to evolve, the SEC's Division of Enforcement has increased its focus on cybersecurity. For example, the SEC recently announced the settlement of a cybersecurity case against an investment adviser that had failed to establish the required cybersecurity policies and procedures before a breach.

Convergence of U.S. GAAP and IFRSs is another topic of interest for the SEC — particularly its Office of the Chief Accountant headed by James Schnurr, who continues to monitor this as well as the progress the FASB and the IASB are making in identifying and addressing implementation issues related to the new converged revenue standard. While the chief accountant seems generally pleased with the progress toward implementation that has been achieved to date, it appears from his remarks at the 2015 AICPA Banking Conference that he is focusing on the role of industry groups in the implementation process. Regarding whether and, if so, how to incorporate IFRSs in the U.S. financial reporting system, Mr. Schnurr has publicly stated that in the foreseeable future, continued collaboration between the boards seems to be the most realistic path forward.

The Division of Corporation Finance (the "Division") has been busy undertaking its own priorities over the past year. In the period leading up to the five-year anniversary of the Dodd-Frank Act, the Division continued to help the SEC fulfill its responsibilities under the Act's mandatory rulemaking provisions. For example, the SEC issued (1) a proposed rule[1] that would require disclosure of the relationship between executive compensation paid by a registrant and the registrant's financial performance ("pay versus performance") and (2) a proposed rule[2] that would require registrants to adopt clawback policies on executive compensation. The SEC also issued a final rule[3] on pay ratio disclosure that requires a registrant to disclose the ratio of the compensation of its CEO to the median compensation of its employees.

In addition, the Division facilitated the SEC's issuance of a concept release[4] in July 2015 that requested input on audit committee disclosure requirements with a focus on audit committees' oversight of independent auditors. The Division has also been working on the SEC's "disclosure effectiveness project,"[5] which began in earnest in December 2013 and resulted in the September 2015 issuance of a release[6] that requests public comment on the effectiveness of the financial disclosure requirements in Regulation S-X that apply to certain entities other than the registrant.[7]

Further, the Division continues to help the SEC meet its responsibilities under the Sarbanes-Oxley Act to review registrants at least once every three years. In this ninth edition of our publication, we, in turn, continue our tradition of highlighting trends in SEC staff comments by analyzing comments issued by the staff over the past year.

1 SEC Proposed Rule Release No. 34-74835, *Pay Versus Performance*.

2 SEC Proposed Rule Release No. 33-9861, *Listing Standards for Recovery of Erroneously Awarded Compensation*.

3 SEC Final Rule Release No. 33-9877, *Pay Ratio Disclosure*.

4 SEC Release No. 33-9862, *Possible Revisions to Audit Committee Disclosures*.

5 For additional information, see Deloitte's August 26, 2014, *Heads Up*.

6 SEC Release No. 33-9929, *Request for Comment on the Effectiveness of Financial Disclosures About Entities Other Than the Registrant*.

7 For additional information, see Deloitte's October 6, 2015, *Heads Up*.

The table below summarizes comment letter trends in the 12-month periods ended July 31, 2015, and July 31, 2014:[8]

Topic	12 Months Ended July 31, 2015				12 Months Ended July 31, 2014		
	Number of 10-K and 10-Q Reviews With Comment Letters That Include a Comment on Topic	Percentage of All Comment Letter–Yielding 10-K and 10-Q Reviews That Include a Comment on Topic	Rank	Change in Rank From Prior Year	Number of 10-K and 10-Q Reviews With Comment Letters That Include a Comment on Topic	Percentage of All Comment Letter–Yielding 10-K and 10-Q Reviews That Include a Comment on Topic	Rank
MD&A:[9]			1	—			1
• Results of operations	379	23%			516	23%	
• Liquidity issues	187	11%			336	15%	
• Critical accounting policies and estimates	147	9%			248	11%	
Fair value measurement and estimates	358	22%	2	—	544	25%	2
Revenue recognition	246	15%	3	↑ 1	318	14%	4
Non-GAAP measures	235	14%	4	↑ 2	277	13%	6
Signatures, exhibits, and agreements	205	12%	5	↓ 2	370	17%	3
Income taxes	184	11%	6	↓ 1	291	13%	5
Segment reporting	164	10%	7	↑ 3	219	10%	10
Acquisitions, mergers, and business combinations	162	10%	8	↓ 1	254	12%	7
Property, plant, and equipment; intangible assets; and goodwill	146	9%	9	↓ 1	244	11%	8
Debt, warrants, and equity securities	134	8%	10	↑ 1	218	10%	11

In the 12 months ended July 31, 2015, there was a sharp decline from the previous 12-month period in the number of registrants that received a comment letter as a result of the SEC staff's review of Form 10-K and Form 10-Q filings. That significant decline is reflected in the reduced number of Form 10-K and Form 10-Q reviews that yielded comment letters that include a comment related to one of the top 10 topics noted in the table above.

As the table indicates, MD&A is again the leading source of SEC staff comments, many of which reflect the staff's continuing sentiment that registrants should "tell their story" in MD&A to allow investors to see the company "through the eyes of management." In reviewing registrants' analysis and disclosure of results of operations, the staff has continued to focus on encouraging registrants to (1) disclose known trends or uncertainties, (2) quantify components of overall changes in financial statement line items, and (3) enhance their analysis of the underlying factors that cause such changes.

8 Comment letter trend information in the table was derived from data provided by Audit Analytics.

9 Statistics related to three MD&A subtopics are noted below.

Highlights of comment letters issued over the past year also include:

- *Fair value* — The SEC staff continues to ask registrants about (1) valuation techniques and inputs used to determine fair value, (2) sensitivity of Level 3 measurements, (3) categorization of assets and liabilities in the fair value hierarchy, and (4) the use of third-party pricing services.
- *Revenue recognition* — Although many preparers are focused on the forthcoming revenue recognition standard, application of the current standard continues to draw the staff's attention. Revenue recognition issues addressed in comment letters include (1) the completeness and consistency of disclosures about revenue recognition policies, (2) accounting for multiple-element arrangements, and (3) principal-versus-agent analysis (i.e., gross versus net reporting).
- *Non-GAAP financial measures and key metrics* — Staff comments on non-GAAP financial measures and key metrics have focused on asking registrants to (1) explain why such measures and metrics are useful to investors, (2) reconcile non-GAAP financial measures to the appropriate GAAP measures and avoid attaching "undue prominence" to the non-GAAP measures, and (3) explain how key metrics are calculated and describe how a key metric is related to current or future results of operations.
- *Income taxes* — The SEC staff remains focused on (1) the potential tax and liquidity ramifications related to the repatriation of foreign earnings, (2) valuation allowances, (3) rate reconciliation, and (4) unrecognized tax benefits.
- *Segment reporting* — The staff continues to ask registrants about (1) the identification of the chief operating decision maker (CODM); (2) the identification of operating segments; and (3) the analysis supporting the aggregation of operating segments, including consideration of qualitative factors (e.g., similar products and customers).
- *Business combinations* — M&A activity has remained high over the past couple of years, and so has the number of related SEC comments. Like past SEC staff comments on business combinations, recent ones have centered on (1) purchase price allocation, (2) contingent consideration, (3) bargain purchases, and (4) disclosures.

Many of the recent comment letter trends noted above and current industry-specific trends[10] are likely to continue in the coming year. In addition, while it is difficult to predict what new comment letter trends are on the horizon, history tells us that new trends are often prompted by events such as (1) the enactment of new rules and (2) changes in economic cycles and trends:

- *New rules* — Whether they are accounting- or reporting-related, new rules typically make for a comment letter–rich environment as registrants work through accounting and system implementation issues and familiarize themselves with the new requirements. Accordingly, since U.S. GAAP guidance on consolidation is once again in flux, an uptick in related comments is likely in the coming year.
- *Changes in economic cycles and trends* — As the economy fluctuates between periods of contraction and expansion and other economic trends develop on a global or regional basis, tension is placed on different accounting and reporting rules. Given the current state of play, we may see an increase in SEC staff comments related to (1) the release of loan allowances and DTAs (timing and amount) and (2) requests for additional disclosures when a registrant's results of operations are significantly affected by depressed commodity prices or hyperinflationary currencies.

[10] For a discussion of comment letter trends related to particular industries, see Industry-Specific Topics below.

Financial Statement Accounting and Disclosure Topics

Business Combinations

Purchase Price Allocation

Example of an SEC Comment

In regard to your preliminary purchase price allocation . . . , please provide further supporting disclosure for each purchase price adjustment to each tangible and intangible asset acquired and liability assumed. This disclosure should explain in greater detail what the adjustment represents and how the increase or decrease was determined, including a brief explanation of the factors and assumptions involved in the calculation. For example, please disclose and explain how you determined the increase in property, plant and equipment, franchises and customer relationships.

The SEC staff frequently asks registrants how they have assigned amounts to assets acquired and liabilities assumed in business combinations. In particular, the staff asks registrants that have recorded a significant amount of goodwill why they have not attributed value to identifiable intangible assets. The staff also compares disclosures provided in press releases, the business section, and MD&A to the purchase price allocation in the financial statements. For example, the SEC staff may ask why a registrant did not recognize a customer-related intangible asset if it discloses in MD&A that it acquired customers in a business combination. In addition, the SEC staff may ask detailed questions about (1) how a registrant determined that intangible assets would have finite or indefinite useful lives; (2) the useful lives of identified intangible assets determined to have finite useful lives; and (3) material revisions to the initial accounting for a business combination, including what significant assumptions have changed to support a revision to the value of intangible assets.

Contingent Consideration

Example of an SEC Comment

Please note that ASC 805-30-50-1(c) requires a description of contingent consideration arrangements in the financial statements including the basis for determining the amount of any payments. Also, disclosure of the changes in the range of outcomes and reasons for those changes is required to be disclosed in accordance with ASC 805-30-50-4. Given these disclosure requirements, please provide draft disclosure to be included in future filings to disclose both the nature and terms of the contingent consideration arrangement including the metrics which must be achieved for payments to occur, and the nature and timing of the changes in facts and circumstances that resulted in your reversal of the previously recorded expense for future incentive payments of $[X] during the fourth quarter of the fiscal year ended February 1, 2014. As part of your revised disclosure, please also explain why your determination that the financial metrics would not be achieved did not occur until the fourth quarter of your fiscal year ended February 1, 2014.

The SEC staff often asks registrants to provide additional disclosures about the nature and terms of a contingent consideration arrangement and the conditions that must be met for the arrangement to become payable. Since ASC 805 requires entities to recognize contingent consideration at fair value as of the acquisition date, the staff may ask registrants to disclose how they determined the fair value of the contingent consideration. In addition, the staff may ask whether the change in the fair value of contingent consideration should be reflected as a retrospective adjustment to the amount of goodwill (i.e., if the adjustment is due to new information obtained during the measurement period about facts or circumstances that existed as of the acquisition date) or in current earnings under ASC 805-10-25-13 through 25-19 and ASC 805-10-30-3. The staff may also ask for disclosure of the total amount of contingent consideration that could become payable under the terms of the arrangement.

Bargain Purchases

Example of an SEC Comment

Please fully explain to us how you determined the fair value of the property, plant and equipment you acquired from [Company A]. Please specifically address why the gain on bargain purchase you recognized was so significant relative to the purchase price. Please also address if you have performed any subsequent impairment analysis for the assets you acquired and, if applicable, tell us the significant assumptions you used.

When a registrant recognizes a gain related to a bargain purchase, the SEC staff will typically issue comments on how the registrant determined and reassessed the purchase price allocation. A gain from a bargain purchase occurs when the net of the acquisition-date fair value of the identifiable assets acquired and the liabilities assumed is greater than the sum of the acquisition-date fair value of (1) the consideration transferred,[1] (2) the noncontrolling interest in the acquiree, and (3) any equity interests previously held by the acquirer. Before recognizing the gain, a registrant is required to perform a reassessment of the bargain purchase gain by verifying that all assets acquired and liabilities assumed were properly identified. The SEC staff has asked registrants to (1) explain their process, (2) provide the results of the reassessment, and (3) disclose that a reassessment was performed. In addition, the staff has inquired about whether any subsequent impairment analyses for the assets acquired have been performed.

Disclosures

Example of an SEC Comment

Please revise [the notes] to disclose the amounts of revenue and earnings of [Company A] and [Company B] since the acquisition date which have been included in the consolidated income statement for the reporting period in which the acquisitions occurred. Also, please revise to disclose the revenue and earnings of the combined entity for the current reporting period as though the acquisition date for all business combinations that occurred during the period had been as of the beginning of the annual reporting period. Comparable information for the prior annual period should also be presented as if these acquisitions had occurred at the beginning of the comparable prior annual reporting period. Refer to the disclosure requirements outlined in ASC 805-10-50-2(h).

The SEC staff has commented when a registrant fails to provide pro forma disclosures under ASC 805-10-50 about the effects of an acquisition as of the beginning of a reporting period. ASC 805-10-50-2(h)(3) states that the disclosure requirements for comparative financial statements are as follows:

> [F]or a calendar year-end entity, disclosures would be provided for a business combination that occurs in 20X2, as if it occurred on January 1, 20X1. Such disclosures would not be revised if 20X2 is presented for comparative purposes with the 20X3 financial statements (even if 20X2 is the earliest period presented).

In accordance with ASC 805-10-50, registrants must also disclose the nature and amount of material, nonrecurring pro forma adjustments directly attributable to the business combinations that are recognized in the reported pro forma information.

If certain criteria are met (e.g., if a significant business combination has occurred or is probable), registrants may also be required to (1) comply with Regulation S-X, Rule 3-05, and (2) provide pro forma financial information that complies with Regulation S-X, Article 11, in a registration statement, proxy statement, or Form 8-K. For additional information, see the SEC Reporting section.

[1] Certain share-based payment awards are not measured at fair value.

The SEC staff has also asked registrants:

- Whether an acquisition meets the definition of a business under ASC 805-10-20.
- To indicate which specific elements related to their use of the acquisition method of accounting are not yet complete and why they have not been finalized.
- To identify and disclose the income statement classification of acquisition-related costs they incurred (e.g., due diligence fees, legal fees).
- Whether individually immaterial acquisitions are collectively material, which would require them to disclose certain information.
- Whether a transaction is considered to be an acquisition of an entity under common control.

Other Deloitte Resources

September 30, 2015, *Heads Up*, "FASB Simplifies the Accounting for Measurement-Period Adjustments."

Consolidation

ASC 810 provides guidance on entities that are subject to consolidation under either the voting interest entity model or the variable interest entity (VIE) model. Recent SEC comments on this topic have focused primarily on the VIE model. For example, such comments have addressed:

- The consolidation conclusions reached under the VIE model, including those related to:
  - The determination of whether an entity is a VIE.
  - The determination of whether the reporting entity is the primary beneficiary of a VIE (including reassessment of whether the reporting entity continues to be the primary beneficiary).
- Presentation of assets and liabilities of consolidated VIEs.

Determining Whether an Entity Is a VIE and Whether the Reporting Entity Is a VIE's Primary Beneficiary

Examples of SEC Comments

- Please provide us with your detailed analysis of the accounting model and the authoritative accounting guidance you considered in your conclusion to consolidate [the legal entity]. Tell us whether [the legal entity] is subject to the consolidation guidance related to variable interest entities and what consideration was given to the guidance in ASC 810-10-15-14(b)(1). If it is subject to this guidance, explain how you determined that you have the characteristics of a controlling financial interest per ASC 810-10-25-38A.
- You disclosed that at December 31, 2013, you consolidated an investment in [an] LLC where you were determined to be the primary beneficiary due to a related party affiliation. At June 30, 2014, you were no longer considered the primary beneficiary of this LLC and therefore deconsolidated this LLC in accordance with ASC 810. Please tell us how you determined that it was appropriate to deconsolidate this LLC. Please also tell us how you accounted for this deconsolidation and tell us whether you recognized a gain or loss in net income attributable to the parent. Refer to ASC 810-10-40.
- We note that during the year ended December 31, 2013 and the subsequent quarterly period ended March 31, 2014, amendments of existing operating agreements governing certain properties resulted in you gaining control of these properties. Please tell us and describe the pre-existing terms and the changes that were made to these operating agreements. In addition, please cite the specific authoritative guidance within [ASC 810] relied upon that resulted in the change from equity method to consolidation treatment.

To determine whether it is required to consolidate another entity, a reporting entity must evaluate whether the other entity is a VIE under ASC 810-10 and, if so, whether the reporting entity is the VIE's primary beneficiary.[1] To be the primary beneficiary of a VIE and, therefore, the party that is required to consolidate it, the reporting entity must have (1) the power to direct the activities of the VIE that most significantly affect the VIE's economic performance and (2) the obligation to absorb losses of, or the right to receive benefits from, the VIE that could potentially be significant to the VIE.[2] Given that the SEC staff continues to focus on consolidation conclusions under ASC 810-10, it often asks registrants to (1) explain their involvement with, and the structure of, VIEs; (2) provide detailed support for their conclusions about whether an entity is a VIE (including the consolidation model they ultimately used); (3) discuss the basis for their determination of whether they are the primary beneficiary of a VIE; and (4) discuss any events affecting their previous consolidation conclusion (e.g., events that result in deconsolidation).

[1] The comment letter trends discussed in this section are applicable to consolidation analyses that do not qualify for the deferral under ASU 2010-10 and are subject to the consolidation guidance in ASC 810-10 as amended by ASU 2009-17.

[2] Registrants should consider whether consolidating a VIE meets the significance thresholds for reporting under Item 2.01 of Form 8-K and Rule 3-05 of Regulation S-X. For additional information about Rule 3-05, see the SEC Reporting section.

Presentation of Assets and Liabilities of Consolidated VIEs

Example of an SEC Comment

We note that you separately present the assets and liabilities held by variable interest entities on your balance sheet. In future filings, please recast your balance sheet to present the consolidated totals for each line item required by Rule 5-02 of Regulation S-X. Please note that you may state parenthetically after each line item the amount that relates to consolidated VIEs, or you may include a table following the consolidated balance sheets to present assets and liabilities of consolidated VIEs that have been included in the preceding balance sheet.

SEC staff comments have addressed the reporting entity's presentation of assets and liabilities of consolidated VIEs. When presenting assets, liabilities, and noncontrolling interests of a consolidated VIE, a reporting entity should present those items in the consolidated financial statements as if the basis for consolidating the VIE had been voting interests. ASC 810-10-45-25 requires a reporting entity to present on the face of the statement of financial position the (1) "[a]ssets of a consolidated [VIE] that can be used only to settle obligations of the consolidated VIE" and (2) "[l]iabilities of a consolidated VIE for which creditors (or beneficial interest holders) do not have recourse to the general credit of the primary beneficiary." A reporting entity must also satisfy the requirements related to (1) the elimination of intra-entity balances and transactions and (2) other matters discussed in ASC 810-10-45.

Other Deloitte Resources

- May 26, 2015, *Heads Up*, "FASB Amends Its Consolidation Model."
- December 15, 2014, *Heads Up*, "Highlights of the 2014 AICPA Conference on Current SEC and PCAOB Developments."

Contingencies

Because registrants' contingency disclosures have improved, the SEC staff has commented on this topic less frequently than in prior years. However, the staff continues to monitor registrants' contingency disclosures, and it comments when such disclosures do not comply with U.S. GAAP or SEC rules and regulations.

The staff has continued to comment on:

- Lack of specificity regarding the nature of the matter.
- Lack of quantification of amounts accrued, if any, and possible loss or range of loss (or disclosure about why such an estimate cannot be made).
- Lack of disclosure or insufficient detail about what triggered a significant current-period accrual for a contingency when no loss or a significantly lower amount was accrued in prior periods.
- Insufficient detail about judgments and assumptions underlying significant accruals.
- Insufficient detail about (and untimely reporting of) new developments related to loss contingencies and the effect of such developments on current and future periods.
- Inconsistency among disclosures in the footnotes, in other sections of the filing (e.g., risk factors and legal proceedings), and outside the filing (e.g., in press releases and earnings calls). In addition, if different registrants are parties to a claim, the SEC staff may also review the counterparty's filings and comment if the information is not consistent.
- Use of unclear language in disclosures (e.g., not using terms that are consistent with accounting literature, such as "probable" or "reasonably possible") and failure to consider the disclosure requirements in ASC 450, SAB Topic 5.Y, and Regulation S-K, Item 103.
- Lack of disclosure of an accounting policy related to accounting for legal costs (when material) and uncertainties in loss contingency recoveries, including (1) whether ranges of reasonably possible losses are disclosed gross or net of anticipated recoveries from third parties, (2) risks regarding the collectibility of anticipated recoveries, and (3) the accounting policy for uncertain recoveries.

Loss Contingencies

Examples of SEC Comments

- We note [your assertion] that "given the uncertainty of litigation combined with the fact that such matters are each in their very preliminary stages[,]" you cannot provide the "range of potential losses." Please supplementally explain to us the procedures you undertake on a quarterly basis to attempt to develop a range of reasonably possible loss for disclosure and tell us the specific factors that are causing the inability to estimate a range for each material matter. We recognize that there are a number of uncertainties and potential outcomes associated with loss contingencies. Nonetheless, an effort should be made to develop estimates for purposes of disclosure, including determining which of the potential outcomes are reasonably possible and what the reasonably possible range of losses would be for those reasonably possible outcomes.

  Additionally, ASC 450 does not use the term "potential"; therefore, in future filings please provide disclosure relative to reasonably possible losses.
- You state that "At this time, no assessment can be made as to the likely outcome of these lawsuits or whether the outcome will be material to the Company." We do not believe that this disclosure meets the requirements of ASC 450-20-50-3 and 50-4. Please provide us proposed disclosure to be included in future periodic reports for all legal proceedings to include an estimate of the possible loss or range of loss or a statement that such an estimate cannot be made for loss contingencies that are at least reasonably possible but not accrued, either because it is not probable that a loss has been incurred or the amount of loss cannot be reasonably estimated.

The SEC staff often asks about estimates of reasonably possible losses or comments when a registrant omits disclosure of a loss or range of losses because its estimates lack "precision and confidence." If an estimate of the loss or range of losses cannot be made, the staff expects registrants to (1) disclose, in accordance with ASC 450-20-50-4, that such an estimate cannot be made and (2) demonstrate that they at least attempted to estimate the loss or range of losses before concluding that an estimate cannot be made. In such cases, the staff has commented that registrants should disclose the specific factors that limited their ability to reasonably estimate the loss or range of losses and has asked about registrants' quarterly procedures related to such estimates. The specific factors disclosed should be specific to the loss contingency in question and could include representations that (1) claims do not specify an amount of damages, (2) there are a large number of plaintiffs, or (3) the case is in its early stages.

Many comments from the SEC staff have focused on comparing current-year disclosures with those in prior-year filings. Staff questions commonly include (1) whether additional reasonably possible losses have been incurred since the initial disclosure of a reasonably possible loss, (2) why the accrual amount for the current year is different from that reported in previous filings, and (3) whether there are any changes in facts and circumstances that may affect the accrual amount. Further, if a registrant discusses a potential contingency in its earnings calls, the SEC staff is likely to seek more information about the contingency and to inquire about whether the related disclosures are appropriate. The SEC staff encourages registrants to clearly disclose the "full story" regarding their loss contingencies because recognition of such contingencies requires a high degree of professional judgment. Further, the staff has noted that disclosures related to loss contingencies should be continually evaluated over time as facts and circumstances change.

The SEC staff may also ask about (1) the basis for a registrant's accrual (e.g., factors supporting an accrual, such as trends in claims received and rejected), (2) the timing of a loss contingency's recognition, and (3) disclosure of a loss contingency. In addition, when a material settlement is disclosed during the period, the staff may review prior-period disclosures to determine whether such disclosures were appropriate (i.e., whether the registrant should have provided early-warning disclosures about the possibility of incurring or settling a loss in future periods to help users understand these risks and how they could potentially affect the financial statements) or whether an accrual should have been recognized in a prior period. See the Management's Discussion and Analysis section for additional information about early-warning disclosures.

Litigation Contingencies

Example of an SEC Comment

We note your disclosure . . . regarding the [merger] litigation that the company believes the claims in the Illinois and Delaware actions are without merit. Your introductory disclosure regarding litigation . . . quantifies the accrued aggregate liability for pending legal matters, but does not address reasonably possible losses in excess of amounts accrued. If there is at least a reasonable possibility that a loss exceeding amounts already recognized may have been incurred, you must either disclose an estimate of the additional loss or range of loss that is reasonably possible, or state that such an estimate cannot be made. Such disclosure may be provided in the aggregate. Please tell us how your disclosures comply with paragraphs 50-3 through 50-5 of ASC 450-20-50 and SAB Topic [5.Y].

The SEC staff often asks registrants to expand their disclosures about litigation contingencies. If a registrant discloses that the impact of pending or threatened litigation is not expected to be material to its financial statements, the staff is likely to request that the registrant disclose the estimated loss or range of reasonably possible losses in excess of amounts accrued in accordance with ASC 450-20-50-4(b) and SAB Topic 5.Y.[1]

In addition to complying with ASC 450, public entities must separately meet the requirements of Regulation S-K, Item 103, when disclosing litigation matters because while those requirements are similar to the requirements of ASC 450, they are not identical. Also, to address concerns related to a registrant's contention that providing too much information may be detrimental to efforts to litigate or settle matters, the SEC staff has indicated that registrants do not need to separately disclose each asserted claim; rather, they may aggregate asserted claims in a logical manner as long as the disclosure complies with ASC 450.

[1] Specifically, the interpretive response to Question 2 of SAB Topic 5.Y indicates that "a statement that the contingency is not expected to be material does not satisfy the requirements of FASB ASC Topic 450 if there is at least a reasonable possibility that a loss exceeding amounts already recognized may have been incurred and the amount of that additional loss would be material to a decision to buy or sell the registrant's securities. In that case, the registrant must either (a) disclose the estimated additional loss, or range of loss, that is reasonably possible, or (b) state that such an estimate cannot be made."

Debt

Restrictions

Example of an SEC Comment

We note your disclosure . . . that credit facilities of certain subsidiaries include financial covenants. Please tell us whether these covenants and/or any other third party or regulatory restrictions on your subsidiaries or investments accounted for by the equity method restrict the ability to transfer funds to you in the form of loans, advances or cash dividends without consent. If so, please tell us: (i) the amount of restricted net assets of consolidated subsidiaries and your equity in the undistributed earnings of investments accounted for by the equity method as of the most recent balance sheet date and how you computed the amount; (ii) your consideration of providing the disclosures required by Rule 4-08(e)(3)(i) and (ii) of Regulation S-X; and (iii) your consideration of providing the condensed financial information prescribed by Rule 12-04 of Regulation S-X in accordance with Rule 5-04 of Regulation S-X.

When the transfer of assets (cash or other funds) to the parent company/registrant from its subsidiary (or subsidiaries) or equity method investee is materially restricted, limited, or in need of a third party's approval, Regulation S-X, Rules 4-08(e), 5-04, and 12-04, may require:

- Footnote disclosure of the restriction or limitation (Rule 4-08(e)).
- Presentation of condensed parent-company financial data in a financial statement schedule (i.e., Schedule I).
- Both footnote and Schedule I disclosures.

Rule 4-08(e) disclosures are intended to inform investors of restrictions on a registrant's ability to pay dividends or transfer funds within a consolidated group. Such restrictions may result from a contractual agreement (e.g., a debt agreement) or a regulatory body. Without appropriate disclosures of such restrictions, an investor may presume that the registrant (at the parent or subsidiary level) has more discretion to transfer funds or pay cash dividends than is actually the case.

If Rule 4-08(e) applies, registrants must disclose in the notes to the financial statements a description of "the most significant restrictions, other than as reported under [Rule 4-08(d)], on the payment of dividends by the registrant, indicating their sources, their pertinent provisions, and the amount of retained earnings or net income restricted or free of restrictions."

Disclosure is also required under Rule 4-08(e)(3) if the total restricted net assets of subsidiaries, plus the parent's equity in the undistributed earnings of 50 percent or less owned entities, exceed 25 percent of consolidated net assets. SAB Topic 6.K provides further guidance on determining the restricted net assets of subsidiaries. Disclosures required under Rule 4-08(e)(3) include:

- The "nature of any restrictions on the ability of consolidated subsidiaries and unconsolidated subsidiaries to transfer funds to the registrant in the form of cash dividends, loans or advances."
- Separate disclosure of "the amounts of such restricted net assets for unconsolidated subsidiaries and consolidated subsidiaries as of the end of the most recently completed fiscal year."

In addition, to give investors separate information about the parent company, registrants are required under Rule 5-04 to file Schedule I "when the restricted net assets [of the registrant's] consolidated subsidiaries exceed 25 percent of consolidated net assets as of the end of the most recently completed fiscal year."

The calculations under Rule 4-08(e) are different from those under Rule 5-04, which governs Schedule I, so registrants must perform both tests to determine what is required. If Schedule I is required, footnote disclosures under Rule 4-08(e) are also required. However, if Rule 4-08(e) disclosures are required, Schedule I may not be required. In addition, a registrant's filing of Schedule I does not necessarily mean that the registrant has satisfied the disclosure requirements of Rule 4-08(e), which are separate and distinct.

Refinancing

Example of an SEC Comment

Please provide us your analysis under ASC 470-50-40 supporting your conclusion that the January 23, 2014 second amendment to the credit agreement was a modification and not an extinguishment.

The SEC staff's comments on refinancings have focused on registrants' (1) conclusions about whether debt refinancing transactions should be accounted for as debt extinguishments under ASC 470-50 and (2) disclosures about the significant components of the gains or losses recorded on a debt extinguishment and how registrants calculated the components.

Financial Covenant Disclosures

Example of an SEC Comment

We note you received a waiver from the Lender for non-compliance with a financial covenant and the lender modified various financial covenants relating to fiscal 2014. We further note your disclosure . . . that states the Credit Agreement requires maximum levels of cash usage and minimum levels of liquidity, as defined, and provides for increased liquidity levels if operating results are not achieved. It appears to us that your Credit Agreement is a material agreement, that the covenants are material terms of the Credit Agreement and that information about the covenants would be material to an investor's understanding of the Company's financial condition and liquidity. Please describe to us the nature of the waiver received from the Lender to cure non-compliance with the financial covenant. In addition, please provide us with draft disclosure of the following information to be included in future filings:

- The material terms of the debt covenants, including quantification of the amount or limit required for compliance with any financial covenants as compared to your actual results.
- The likelihood of failing a financial covenant or obtaining a waiver in the future.
- The actual or reasonably likely effects of compliance or non-compliance with the covenants on the Company's financial condition and liquidity.

It is important for a registrant to consider providing disclosures about covenant compliance in MD&A to illustrate its financial condition and liquidity. These disclosures may include a discussion of (1) the terms of the most severe covenants and how the registrant has complied with those covenants, (2) waivers obtained from lenders and the likelihood of failing a covenant or obtaining a waiver in the future, and (3) the impact of noncompliance on the registrant's financial condition and liquidity. In addition, a registrant may present a table that compares its most material actual debt covenant ratios as of the latest balance sheet date with the minimum and maximum amounts permitted under debt agreements. Such transparent disclosures will enable investors to better understand the risk of future covenant noncompliance by the registrant.

For additional discussion on liquidity, see the Management's Discussion and Analysis section.

Classification as Debt or Equity

Under ASC 480, certain financial instruments that embody an obligation of the issuer should be accounted for as liabilities even if their legal form is that of equity or they involve obligations to repurchase or issue the entity's equity shares. In addition, the guidance in ASC 480-10-S99-3A states that "ASR 268 requires preferred securities that are redeemable for cash or other assets to be classified outside of permanent equity if they are redeemable (1) at a fixed or determinable price on a fixed or determinable date, (2) at the option of the holder, or (3) upon the occurrence of an event that is not solely within the control of the issuer." ASC 480-10-S99-3A also notes the SEC staff's belief that ASR 268 can be applied analogously to other redeemable instruments.

Consequently, the SEC staff frequently asks registrants with redeemable securities — including registrants undergoing IPO transactions — to support the basis for their classification of such securities as either debt or equity. In addition, the staff often asks registrants about the accounting for conversion features in convertible instruments, including convertible preferred securities.

See the Noncontrolling Interests section for more information about redeemable NCIs. See the Financial Instruments section for considerations related to embedded conversion features.

Other Deloitte Resources

June 18, 2015, *Heads Up*, "FASB Simplifies Guidance on Presentation of Debt Issuance Costs."

Discontinued Operations, Assets Held for Sale, and Restructuring Charges

Discontinued Operations and Assets Held for Sale

Examples of SEC Comments

- We note the disclosure that as part of a strategic repositioning and refocusing of [Company A], a decision was made to sell [Facility A and Facility B] in 2013. In light of the fact that [Facility B has] not been sold as of December 31, 2014 and you expect a final determination for [Facility B] to occur in 2015, whereby [Company A] is currently weighing all of its disposal options, please tell us why [Company A] continues to believe that the fixed assets are appropriately classified as held for sale and the results of operations classified in discontinued operations as of December 31, 2014. Please tell us the specific considerations given to ASC 360-10-45-9 through ASC 360-10-45-11 in concluding that the assets continue to meet the held for sale criteria as of December 31, 2014.
- With reference to ASC 205-20-45-1, please tell us why your expected sale of [Component A] is not reflected as held for sale and discontinued operations. In this regard, we note . . . that you entered into a definitive agreement in December 2014 and the sale is expected to close in the first half of 2015 pending receipt of customary regulatory approvals. See also ASC 360-10-45-9.

The SEC staff continues to ask registrants whether the operations they have disposed of should be accounted for as discontinued operations. The staff may challenge whether the operations are a "component of an entity" under ASC 205-20. Specifically, it may ask whether the operations and cash flows "can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity."

Whether components qualify as discontinued operations must be carefully considered.[1] Further, the staff has asked registrants to discuss whether assets meet the held-for-sale criteria in ASC 360 and to explain how they considered the related required disclosures. The staff may inquire about items such as:

- The timeline of events leading to an asset sale.
- The factors used to determine whether to present assets held for sale separately on the balance sheet.
- Sales agreements and how they affected the determination of whether particular assets should be classified as held for sale.

The SEC staff may also question the appropriateness and timeliness of a registrant's impairment tests when assets or components (1) are disposed of, (2) are discontinued, or (3) appear misclassified on the basis of other information in the filing. For example, the staff may ask whether assets that the registrant was expected to sell or dispose of were tested for impairment in prior periods or subject to an impairment charge in the current period (i.e., classified as held for use and thus not recorded at net realizable value). See the Impairments of Goodwill and Other Long-Lived Assets and Management's Discussion and Analysis sections for further discussion of long-lived-asset impairment testing and early-warning disclosures, respectively.

The SEC staff has also asked registrants about why they did not disclose the gain or loss on a sale after disposition.[2]

[1] See ASC 205-20-45.

[2] Before its amendment by ASU 2014-08, ASC 205-20-45-3 provided that gains or losses on disposal transactions "shall be disclosed either on the face of the income statement or in the notes to financial statements."

Restructuring Charges

Example of an SEC Comment

In your February 24, 2015 earnings call, your CEO indicated that you implemented approximately $[X] in cost reduction actions, including [an X]% head count reduction to your global workforce. You disclose . . . that you implemented a number of cost reduction actions during the quarter, including the planned closure of a manufacturing facility in [Location A]. Please describe to us the nature and extent of any workforce reduction actions undertaken during the year ended December 31, 2014 and the quarter ended March 31, 2015 and tell us how you considered providing the disclosures required by ASC 420-10-50.

The SEC staff has inquired about corporate reorganizations and restructurings and registrants' disclosures about such activities. Comments primarily stem from workforce reductions and facility closures.
In accordance with ASC 420-10-50-1, registrants should disclose specific information in "notes to financial statements that include the period in which an exit or disposal activity is initiated and any subsequent period until the activity is completed." Such information would include a description of the exit or disposal activity, its expected completion date, where in the income statement the amounts are presented, and quantitative information about each major type of cost associated with the activity and about each reportable segment. Further, in accordance with ASC 420-10-50-1(e), when "a liability for a cost associated with the activity is not recognized because fair value cannot be reasonably estimated," registrants should disclose "that fact and the reasons why." The SEC staff has also directed registrants to comply with the guidance in SAB Topic 5.P.4 on disclosures related to material restructuring activities.

Earnings per Share

Two-Class Method

> **Example of an SEC Comment**
>
> We note from your disclosure . . . that recipients of restricted stock receive all dividends with respect to the shares, whether or not the shares have vested. Please tell us whether you consider the restricted stock to be participating securities that would be included in your computation of earnings per share under the two-class method. Refer to ASC 260-10-45-61A.

Under ASC 260-10-45-59A, the two-class method applies to the following securities:

> a. Securities that may participate in dividends with common stocks according to a predetermined formula (for example, two for one) with, at times, an upper limit on the extent of participation (for example, up to, but not beyond, a specified amount per share)
>
> b. A class of common stock with different dividend rates from those of another class of common stock but without prior or senior rights.

When a filing indicates that the registrant has two classes of common stock (or one class of common stock and participating securities) that have been treated as a single class in the calculation of EPS, the SEC staff often asks whether application of the two-class method in the computation of EPS under ASC 260-10-45-59A through 45-70 is required.

The SEC staff may ask a registrant to substantiate the method used to calculate EPS (e.g., the two-class method or the if-converted method), and it may request additional information or disclosures about each of the registrant's classes of common stock, preferred stock, and common-stock equivalents (such as convertible securities, warrants, or options).

Further, the SEC staff expects that a registrant with two classes of common stock will present both basic and diluted EPS for each class regardless of whether either class has conversion rights. See the Financial Instruments section for more information about conversion features.

In assessing registrants' conclusions related to the two-class method, the SEC staff has focused on understanding the terms of arrangements, including (1) classes and types of common (or preferred) stock, (2) such stock's dividend rates, and (3) the rights and privileges associated with each class (or type) of stock. When a registrant has preferred shares, the SEC staff may seek to determine whether the preferred stockholders have contractual rights to share in profits and losses of the registrant beyond the stated dividend rate. Similarly, the SEC staff may ask registrants about the dividend rights of restricted stock unit awards or other share-based payment awards and how those rights are considered in the calculation of EPS.

EPS Disclosures

> **Example of an SEC Comment**
>
> We note your diluted [EPS] reflect the potential reduction in EPS using the treasury stock method to reflect the impact of common stock equivalents if stock options, [stock appreciation rights,] and warrants were exercised. Related to your reconciliation of basic and diluted EPS computations . . . , please confirm that you will disaggregate the dilutive [effect] of these share based awards by the award type (e.g., options, warrants, etc.) in future filings similar to the illustration provided in ASC 260-10-55-51 and [55-52].

The SEC staff may comment on whether a registrant has met the requirements of ASC 260-10-50-1, under which an entity must disclose all of the following for each period in which an income statement is presented:

> a. A reconciliation of the numerators and the denominators of the basic and diluted per-share computations for income from continuing operations. . . .
>
> b. The effect that has been given to preferred dividends in arriving at income available to common stockholders in computing basic EPS.
>
> c. Securities . . . that could potentially dilute basic EPS in the future that were not included in the computation of diluted EPS because to do so would have been antidilutive for the period(s) presented.

In addition, the SEC staff may ask registrants to elaborate on their calculation of EPS by disclosing:

- How unvested shares, unvested share units, unvested restricted share units, and performance shares are treated in basic and diluted EPS.
- Whether unvested share-based payment awards that contain nonforfeitable rights to dividends or dividend equivalents (paid or unpaid) are treated as participating securities and factored into the calculation of EPS.
- The nature of incentive distribution rights.

Fair Value

Valuation Techniques and Inputs

Examples of SEC Comments

- [P]lease provide us, for each "class" of level 2 fixed maturity securities, the valuation technique(s) and inputs used in your fair value measurement. To the extent that you use more than one technique in a class, tell us:
  - [T]he extent to which you use each technique for the class;
  - [W]hat determines when each technique is used in the class; and
  - [T]he inputs for each technique in the class.
- Please tell us, and revise future filings, to include the disclosure requirements of ASC 820-10-50-2.bbb, specifically quantitative information about the significant unobservable inputs used in the fair value measurement for fair value measurements categorized within Level 3 of the fair value hierarchy for impaired loans and other real estate owned. Refer to ASC 820-10-55-103 for a proposed template for disclosing this information in future filings.

The SEC staff has requested more specific information from registrants related to valuation techniques and inputs used in fair value measurements. Registrants should consider how the fair value disclosure requirements in ASC 820-10-50 apply to their recurring and nonrecurring fair value measurements. More specifically, registrants should provide information about (1) the methods and techniques used to determine fair value and (2) the inputs to those models.

Under ASC 820-10-50-2(bbb), entities are required to disclose quantitative information about the significant unobservable inputs used in Level 3 fair value measurements. Although this provision contains no explicit guidance on the types of quantitative information an entity should disclose, the example in ASC 820-10-55-103 illustrates quantitative information an entity "might disclose" to meet the requirement in ASC 820-10-50-2(bbb). According to the example, such information includes the entity's valuation technique, its significant unobservable inputs, and the range and weighted average of those inputs.

Some may have interpreted from the example in ASC 820-10-55-103 that an entity is not required to disclose the weighted average of significant unobservable inputs used in a Level 3 fair value measurement. However, the SEC staff may inquire about weighted averages when registrants do not disclose them.[1] The staff has suggested that if a weighted average would not be meaningful, a registrant could instead present qualitative information about the distribution of the range of values. Ideally, such qualitative disclosures would address each significant input and describe the reason for the wide range, the drivers of dispersion (e.g., a particular position or instrument type), and data point concentrations within the range.

Sensitivity of Level 3 Measurements

Example of an SEC Comment

You disclose the significant unobservable inputs used in developing the fair value of your warrants which are classified as a Level 3 measurement. Given that your warrants carried at fair value are a critical accounting policy, please revise your future filings to address the sensitivity disclosures required by ASC 820-10-50-2(g).

[1] Such inquiries are consistent with SEC staff remarks at the 2012 AICPA Conference. For more information about the conference, see Deloitte's December 11, 2012, *Heads Up*.

The SEC staff continues to comment when a registrant omits disclosures about the sensitivity of Level 3 measurements and may ask for disclosures about changes in significant unobservable inputs to be more granular and transparent. In addition, the staff has noted that it may be helpful for registrants to discuss the specific inputs that changed in the sensitivity analysis and the effect of changing those significant unobservable inputs.

Fair Value Hierarchy

> **Example of an SEC Comment**
>
> We note your disclosure . . . that you estimate the fair value of your "non-centrally cleared" interest rate swaps using inputs from counterparty and third-party pricing models to estimate the net present value of the future cash flows. We further note that these assets and liabilities are classified within Level 2 of the fair value hierarchy. Please provide us with additional details to support your Level 2 classification.

The SEC staff has asked registrants for additional information that supports their categorization of assets and liabilities in the fair value hierarchy. In addition, when assets or liabilities are transferred between levels in the fair value hierarchy, the staff has requested expanded disclosures to explain the amounts of any transfers, the reasons for those transfers, and the registrant's policy for determining when transfers between levels are deemed to have occurred.

Use of Third-Party Pricing Services

> **Example of an SEC Comment**
>
> We note that you use third-party pricing services to determine the fair value of your investments in [available-for-sale] securities. Please revise your future filings to disclose if you adjust prices obtained from pricing services and if so, the underlying reason for the adjustment and methods used to determine the adjustment. Please also revise to describe the procedures you perform to validate the valuations received from such third-party pricing services. Please refer to ASC 820-10-50-2(bbb) for further guidance.

The SEC staff continues to ask registrants to describe the procedures they perform to validate fair value measurements obtained from third-party pricing services. The staff has also asked registrants to clarify when and how often they use adjusted rather than unadjusted quoted market prices and to disclose why prices obtained from pricing services and securities dealers were adjusted. If multiple quotes were obtained, the SEC staff may request information about how the registrant determined the ultimate value used in the financial statements.

Financial Instruments

Because of the complexity associated with determining whether certain financial instruments should be accounted for as derivatives, debt instruments, or equity, SEC staff comments related to financial instruments have focused on (1) accounting for embedded derivatives in hybrid instruments,[1] (2) classification of warrants on a company's own stock, and (3) identification and calculation of beneficial conversion features (BCFs).

Embedded Derivatives in Hybrid Financial Instruments

Examples of SEC Comments

- It appears the exchangeable senior notes issued in August 2014 contain redemption features. Provide us your analysis that supports your conclusion that none of the redemption features are required to be bifurcated in accordance with ASC 815-15. Specifically address whether the debt involves a substantial discount in accordance with ASC 815-15-25-40 through [25-43].
- We note your disclosure that the 1.25% Notes contain an embedded cash conversion option and that you have determined that this option is a derivative financial instrument that is required to be separated from the notes. Please provide us with the details of your analysis in determining that this conversion option should be accounted for separately as a derivative and refer to the specific accounting literature you relied on.

The SEC staff continues to focus on whether registrants have reached appropriate accounting conclusions regarding whether embedded features in hybrid instruments should be bifurcated from the host contract. ASC 815-15-25 provides guidance on whether an embedded feature (e.g., a put option embedded in a company's preferred stock) should be separated from the host contract and accounted for as a stand-alone derivative instrument in accordance with ASC 815-10. If it is determined that an embedded feature is not clearly and closely related to the host contract, the embedded feature may need to be bifurcated from the host contract depending on whether certain other criteria are met and whether the embedded feature qualifies for any scope exceptions. For example, if the features in a hybrid instrument are predominantly debt-like, the entity would conclude that the host contract is more akin to debt; in such a case, an equity-like feature (e.g., a conversion option) would not be considered clearly and closely related to a debt host. Given the complexity involved in determining whether a host contract is debt-like or equity-like, registrants can expect the SEC staff to continue asking about the terms and features of convertible instruments to determine whether the registrant has (1) properly determined the nature of the host contract and (2) accounted for embedded features as stand-alone financial instruments when necessary. After adopting the guidance in ASU 2014-16, registrants should consider the ASU's disclosure requirements when making disclosures about the nature of the host contract.

Classification of Warrants on a Company's Own Stock

Example of an SEC Comment

Please tell us why the warrants you sold in this transaction are properly classified in equity and reference for us the authoritative literature you relied upon to support your accounting. In your response, specifically tell us how the strike price of these warrants can be adjusted and why these adjustments do not trigger derivative accounting.

[1] The ASC Master Glossary defines a hybrid instrument as a "contract that embodies both an embedded derivative and a host contract."

If certain criteria are met, warrants issued in connection with debt and equity offerings are accounted for on a separate basis (i.e., as freestanding financial instruments[2]). Under U.S. GAAP, an issuer of a stock purchase warrant is required to first determine whether the warrant should be classified as a liability under ASC 480. If the warrant is not classified as a liability under ASC 480, liability classification may still result under ASC 815. Specifically, the warrant's classification as either a liability or equity may hinge on whether the instrument meets the definition of a derivative and qualifies for any scope exceptions under ASC 815-10-15. When a warrant is accounted for as a freestanding financial instrument, the manner in which offering proceeds are allocated to the issued instrument and to the warrant depends on whether the warrant is classified as an equity instrument or as a liability instrument. Consequently, the SEC staff has asked registrants to explain the basis for their determination of how warrants should be classified, including the application of relevant accounting literature.

Identification and Calculation of BCFs

Examples of SEC Comments

- Please submit the analyses you performed in determining whether these classes of preferred shares contain [BCFs].
- Please tell us how you calculated the [BCF] you recorded in connection with the issuance of [convertible shares]. Further, please provide to us your accounting analysis which supports recognizing the BCF as a non-cash distribution that is recognized ratably from the issuance date through the conversion date in equity.

The SEC staff frequently comments on the recognition and calculation of BCFs. ASC 470-20 requires the issuer of a convertible security to measure the amount of any embedded BCF at the intrinsic value of the embedded conversion option, which is computed on the basis of the effective conversion price (i.e., the issuer computes the intrinsic value of the embedded conversion option by multiplying (1) the amount by which the fair value of the common stock or other securities into which the security is convertible exceeds the effective conversion price by (2) the number of shares into which the security is convertible). Accordingly, registrants can expect the SEC staff to ask how they calculated the value of a BCF that was recorded in connection with the issuance of a hybrid financial instrument. In addition, the SEC staff frequently asks registrants to provide the accounting analysis that supports the BCF calculation.

[2] The ASC Master Glossary defines a freestanding financial instrument as a financial instrument that either (1) "is entered into separately and apart from any of the entity's other financial instruments or equity transactions" or (2) "is entered into in conjunction with some other transaction and is legally detachable and separately exercisable."

Financial Statement Classification, Including Other Comprehensive Income

The SEC staff frequently comments on registrants' classification of items in the financial statements, namely on whether their balance sheets, income statements, statements of cash flows, and statements of comprehensive income comply with the requirements of Regulation S-X and U.S. GAAP.

Balance Sheet Classification

Separate Presentation

> **Example of an SEC Comment**
>
> We note that "Other accrued expenses" comprises more than 13% of total current liabilities as of November 30, 2014. Please tell us what consideration you gave to separately presenting any individual items within this category that were in excess of 5% of total current liabilities pursuant to Regulation S-X Rule 5-02(20).

In accordance with Regulation S-X, Rule 5-02, commercial and industrial registrants should state separately on the face of the balance sheet or in a note to the financial statements (1) other current assets and other current liabilities in excess of 5 percent of total current assets and total current liabilities, respectively, and (2) other noncurrent assets and other noncurrent liabilities in excess of 5 percent of total assets and total liabilities, respectively. Consequently, the SEC staff may ask a registrant to confirm whether the reported balances of other current assets and other current liabilities (or other noncurrent assets and other noncurrent liabilities) include any items in excess of 5 percent of total current assets and total current liabilities (or total assets and total liabilities). If the registrant confirms that any such items are included, the SEC staff will ask the registrant to state those items individually on the face of the balance sheet or in the notes.

Restricted Cash

> **Example of an SEC Comment**
>
> Please refer to Rule 5-02 of Regulation S-X and tell us how you considered presenting or disclosing restricted cash associated with the company's participation in programs administrated by the Department of Education and Department of Defense.

Rule 5-02 includes a provision requiring commercial and industrial registrants to (1) separately disclose cash and cash items that are subject to restrictions on withdrawal or usage and (2) describe the provisions of those restrictions in a note to the financial statements. Consequently, the SEC staff has issued comments asking registrants to explain how they considered presenting or disclosing restricted cash in accordance with Rule 5-02.

Income Statement Classification

The SEC staff has commented on registrants' compliance with the technical requirements of Regulation S-X, Rule 5-03, which lists the captions and details that commercial and industrial registrants must present in their income statements. For example, the SEC staff has asked registrants to explain why they have excluded certain line items required by Rule 5-03 from the face of their income statements. In addition, the SEC staff has reminded registrants that when alternative classifications are permissible, they should disclose their policies and apply them consistently in accordance with ASC 235-10.

Separate Presentation

> **Example of an SEC Comment**
>
> To the extent that Other expenses remains material to the income statement, please consider disaggregating its components on the face of the statement or in a note to the financial statements.

Among the requirements of Rule 5-03 is separate presentation of certain material (1) other operating costs and expenses and (2) other general expenses. The SEC staff frequently comments when registrants present material amounts in "other expenses" (or similarly phrased line items) and, in certain instances, has asked registrants to consider disaggregating the components of such line items on the face of the income statement or in the notes to the financial statements.

Further, the SEC staff has focused on the distinction between product and service revenue. Under Rule 5-03, if product or service revenue is greater than 10 percent of total revenue, disclosure of such component is required as a separate line item on the face of the income statement, and costs and expenses related to the product or service revenue should be presented in the same manner. Accordingly, registrants that combined the presentation of product and service revenue when such revenue met the separate presentation threshold have received SEC staff comments directing them to revise their consolidated statement of operations.

Cost of Sales

> **Example of an SEC Comment**
>
> We note that you present a subtotal for gross profit on your consolidated statements of income and that this profit measure reflects revenues less the cost of food and retail merchandise sold, which you label as "Cost of goods sold." We note that costs of goods sold does not reflect certain costs of goods and services such as labor, benefits, rent, depreciation, and amortization, among others. Please tell us the basis for your determination of the types of costs included in cost of goods sold and your consideration of S-X Rule 5-03.2, S-K Item 302, and SAB Topic 11.B.

The SEC staff often asks registrants to disclose the types of expenses that are included in or excluded from the cost-of-sales line item. For example, the SEC staff has issued comments to registrants that did not allocate depreciation and amortization to cost of sales. SAB Topic 11.B states, in part:

> If cost of sales or operating expenses exclude charges for depreciation, depletion and amortization of property, plant and equipment, the description of the line item should read somewhat as follows: "Cost of goods sold (exclusive of items shown separately below)" or "Cost of goods sold (exclusive of depreciation shown separately below)." [D]epreciation, depletion and amortization should not be positioned in the income statement in a manner which results in reporting a figure for income before depreciation.

Most of the SEC staff's comments on this matter have stemmed from registrants' lack of awareness or incorrect application of the guidance in SAB Topic 11.B, particularly their inappropriate reporting of an amount for gross profit before depreciation and amortization.

Operating Versus Nonoperating Income

> **Example of an SEC Comment**
>
> We note that you classified the net gain of $[X] from the sale of your microphone product line within non-operating income. We also note that the microphone product line was not considered to be a component of the company. Please tell us why you classified the amount as non-operating income and not within operating income. Include a discussion of your consideration of FASB ASC 360-10-45-5.

The SEC staff has commented about items that registrants have included in, or excluded from, operating income. Under Rule 5-03, a subtotal line item for operating income is not required on the face of the income statement. However, if a registrant presents a subtotal for operating income, it should generally present the following items (which are sometimes incorrectly excluded) in operating income:

- Gains or losses on asset sales.
- Litigation settlements.
- Insurance proceeds.
- Restructuring charges.

The following items should generally be excluded from operating income (but are sometimes incorrectly included):

- Dividends.
- Interest on securities.
- Profits on securities (net of losses).
- Interest and amortization of debt discount and expense.
- Earnings from equity method investments (or unconsolidated affiliates).
- Noncontrolling interest in income of consolidated subsidiaries.

Cash Flow Statement Classification

Category Classification

> **Example of an SEC Comment**
>
> We note you classified dividends received from your banking subsidiary of $[X] in 2014, $[X] in 2013, and $[X] in 2012 as cash flows from investing activities. Please tell us why you classified these cash inflows to the parent company as investing cash flows as opposed to operating cash flows. Please refer to ASC 230-10-45-16(b) for specific guidance on how to classify dividends received on a statement of cash flows.

Many of the SEC staff's comments are related to misclassification among the three cash flow categories: operating, investing, and financing. ASC 230 distinguishes between returns **of** investment, which should be classified as inflows from investing activities (see ASC 230-10-45-12(b)), and returns **on** investment, which should be classified as inflows from operating activities (see ASC 230-10-45-16(b)). Under ASC 230-10-45-16(b), cash inflows from operating activities include "[c]ash receipts from returns on loans, other debt instruments of other entities, and equity securities — interest and dividends."

At the 2014 AICPA Conference, the SEC staff noted that it has observed an increased number of classification errors in registrants' statements of cash flows. Further, such errors are generally not attributable to complex fact patterns. The SEC staff identified various actions that registrants could take when preparing the statement of cash flows to potentially reduce the likelihood of errors, including:

- Evaluating the completeness and accuracy of the information collected for preparation of the statement.
- Standardizing and automating required reports and other information.
- Separately considering the effect of nonrecurring transactions in the statement.
- Preparing the statement earlier to allow for adequate review.
- Selecting employees that have the appropriate expertise to prepare the statement of cash flows and providing them with sufficient training on the accounting requirements related to the statement.
- Incorporating risk assessment and monitoring controls in addition to control activities.

For information about SEC staff comments on how registrants' errors could affect their conclusions about DC&P and ICFR, see the Disclosure Controls and Procedures and Internal Control Over Financial Reporting sections.

Net Versus Gross Presentation

Example of an SEC Comment

Please note that borrowings and payments on your revolving credit facility should be recorded on a gross basis in the statement of cash flows unless the original maturity of the borrowings is three months or less. Refer to ASC 230-10-45-9 and advise us why the borrowings and payments were not reflected on a gross basis.

The SEC staff may challenge whether it is appropriate to report the net amount of certain cash receipts and cash payments on the face of the statement of cash flows. ASC 230-10-45-7 through 45-9 state that although reporting gross cash receipts and cash payments provides more relevant information, financial statement users sometimes may not need gross reporting to understand certain activities. The SEC staff may ask a registrant to revise the presentation or to explain (in accordance with ASC 230) why it is appropriate to report certain cash flows on a net basis rather than on a gross basis.

Comprehensive Income — Disclosure

Examples of SEC Comments

- Please tell us your consideration of disclosing in the notes to the financial statements the gross changes, along with the related tax expense or benefit, of each classification of other comprehensive income. Refer to ASC 220-10-45-12 and [ASC] 220-10-45-17.
- Please provide the disclosures required by ASU 2013-02 related to amounts reclassified out of accumulated other comprehensive income or tell us why this authoritative literature does not apply to you.

Entities are required to report components of comprehensive income in either (1) a continuous statement of comprehensive income or (2) two separate but consecutive statements.

The SEC staff has commented when registrants have not provided information required by ASC 220 (ASU 2013-02) about the amounts reclassified out of accumulated OCI. For example, the staff frequently reminds registrants to "present the amount of income tax expense or benefit allocated to each component of other comprehensive income, including reclassification adjustments," for each reporting period either on the face of the statement where those items are presented or in the footnotes.

Foreign Currency

Quantification of Foreign Currency Adjustments

Example of an SEC Comment

Throughout MD&A, you indicate that results were negatively impacted by the effects of foreign currency translation. Please expand your discussion to quantify the impact of foreign currency translation on each segment, where applicable. Please also discuss any trends related to foreign currency currently impacting your results of operations and indicate whether they are expected to continue (i.e. whether currency has strengthened or weakened from period to period).

The SEC staff's comments on quantitative disclosures related to foreign currency adjustments reflect published staff views[1] on the topic, under which registrants should:

- "[R]eview management's discussion and analysis and the notes to financial statements to ensure that disclosures are sufficient to inform investors of the nature and extent of the currency risks to which the registrant is exposed and to explain the effects of changes in exchange rates on its financial statements."
- Describe in their MD&A "any material effects of changes in currency exchange rates on reported revenues, costs, and business practices and plans."
- Identify "the currencies of the environments in which material business operations are conducted [when] exposures are material."
- "[Q]uantify the extent to which material trends in amounts are attributable to changes in the value of the reporting currency relative to the functional currency of the underlying operations [and analyze] any materially different trends in operations or liquidity that would be apparent if reported in the functional currency."

The foreign operations of many registrants may be subject to material risks and uncertainties that should be disclosed, including those related to the foreign jurisdiction's political environment, its business climate, currency, and taxation. The effects on a registrant's consolidated operations of an adverse event related to these risks may be disproportionate relative to the size of the registrant's foreign operations. Therefore, the registrant's segment information or MD&A may need to describe the trends, risks, and uncertainties related to its operations in individual countries or geographic areas and possibly supplement such disclosures with disaggregated financial information about those operations.

A registrant's assessment of whether it needs to provide disaggregated financial information about its foreign operations in its MD&A would need to take into account more than just the percentage of consolidated revenues, net income, or assets contributed by foreign operations. The registrant also should consider how the foreign operations might affect the consolidated entity's liquidity. For example, a foreign operation that holds significant liquid assets may have an exposure to exchange-rate fluctuations or restrictions that could affect the registrant's overall liquidity.

Accounting and Disclosure Considerations Related to Venezuelan Operations

The SEC staff continues to focus on accounting and disclosure considerations related to the foreign currency exchange environment in Venezuela. Business operations in Venezuela may give rise to accounting questions about (1) which exchange rate is appropriate for remeasurement and (2) whether such operations should be deconsolidated or considered impaired. For additional accounting and disclosure considerations related to the foreign currency exchange environment in Venezuela, see (1) the October 2, 2015, Deloitte Accounting Journal entry and (2) Deloitte's Financial Reporting Alerts 15-1,[2] 14-5,[3] and 14-1.[4]

1 Division of Corporation Finance: Frequently Requested Accounting and Financial Reporting Interpretations and Guidance, Section II.J.

2 Financial Reporting Alert 15-1, "Foreign Currency Exchange Accounting Implications of Recent Government Actions in Venezuela."

3 Financial Reporting Alert 14-5, "Consolidation and Disclosure Considerations Related to Venezuelan Operations."

4 Financial Reporting Alert 14-1, "Foreign Currency Exchange Accounting Implications of Recent Government Actions in Venezuela."

Impairments of Goodwill and Other Long-Lived Assets

Goodwill

Disclosures

Example of an SEC Comment

We note your disclosure . . . that the fair value of [Reporting Unit A] substantially exceeded the related carrying value as of your annual assessment in the fourth quarter of fiscal 2014. We also note that operating income of [Reporting Unit A] declined [X]%, from $[X] million to $[X] million, during fiscal year 2014 primarily as a result of a decrease in gross margin rates and increases in buying, distribution and occupancy costs and depreciation expense. Please provide the following:

- [T]he percentage by which [Reporting Unit A]´s fair value exceeded its carrying value as of June 26, 2014;
- [A]n explanation of how the decline in operating income that occurred during fiscal year 2014 was considered in your goodwill impairment analysis. Please specifically address the fact that the lower gross margin rate was mainly attributable to higher promotional markdowns, which resulted from increased promotional activity required to sell through seasonal merchandise; and
- [W]hether you believe the continued decline in [Reporting Unit A]'s operating income through the quarter ending October 25, 2014 puts it at risk for potential impairment of its related goodwill as of October 25, 2014.

Section 9510 of the FRM discusses the SEC staff's views on when goodwill impairment disclosures in the critical accounting estimates section of MD&A are appropriate and the extent of such disclosures. The SEC staff has commented on a registrant's compliance with the disclosure requirements in Regulation S-K, Item 303(a)(3)(ii), to discuss a known uncertainty — specifically, to disclose the potential for a material impairment charge — in light of potential impairment triggers. The staff has noted that it may use these disclosures to assess whether a registrant's goodwill impairment analysis is reasonable or whether the registrant should have performed an interim goodwill impairment analysis.

While registrants often provide the appropriate disclosures before incurring an impairment charge, the SEC staff has noted instances in which registrants did not disclose the specific events and circumstances that led to the charge in the period of impairment. After performing an interim impairment test, a registrant should consider disclosing (1) that it performed the test, (2) the event that triggered the test, and (3) the test result regardless of whether goodwill was determined to be impaired. Further, registrants should avoid attributing an impairment charge to general factors such as "soft market conditions" or expected reductions in sales price or sales volume. Instead, the disclosures should discuss (1) why the changes occurred, (2) why the change in forecasts or results occurred in the particular period of the impairment charge, and (3) what known developments or other doubts could affect the reporting unit's fair value estimate.

Reporting Units

Example of an SEC Comment

Please revise [your critical accounting policy discussion of goodwill and other intangible assets as follows]:

- Clarify the number of reporting units identified for impairment testing and how they were determined (e.g., operating segments or components) and how goodwill is assigned to reporting units;
- If you aggregate more than one component into a single reporting unit, provide the specific facts and circumstances supporting a conclusion that aggregation is appropriate;
- Clarify whether the optional qualitative assessment was performed for any reporting units;
- Please disclose whether or not your reporting units' fair value is substantially in excess of [their carrying value]. To the extent that any of your reporting units have estimated fair values that are not substantially in excess of the carrying value and to the extent that goodwill for these reporting units, in the aggregate or individually, if impaired, could materially impact your operating results, please provide the following disclosures for each of these reporting units:
    - Identify the reporting unit;
    - The percentage by which fair value exceeds the carrying value as of the most recent step-one test;
    - The amount of goodwill;
    - A description of the assumptions that drive the estimated fair value;
    - A discussion of the uncertainty associated with the key assumptions; and
    - A discussion of any potential events and/or circumstances that could have a negative effect on the estimated fair value.

The SEC staff continues to comment on asset grouping for goodwill impairment testing (e.g., the identification and composition of reporting units), especially when a registrant does not clearly state that it tests goodwill at the reporting-unit level or when changes appear to have been made to a registrant's reportable segments (e.g., as the result of a reorganization or acquisition). Given the interaction between the guidance on reporting units in ASC 350-20 and the guidance on operating segments in ASC 280, the staff may also ask questions to better understand (1) how the reporting units were identified; (2) how many reporting units were identified; (3) how the reporting units align with the registrant's segment reporting; (4) whether and, if so, how the registrant aggregated reporting units to perform goodwill impairment testing; and (5) how the fair value of the reporting units was determined. For additional information about the identification and aggregation of operating segments, see the Segment Reporting section.

Interim Impairment Tests

Example of an SEC Comment

We note your goodwill impairment charge of $[X] recorded in the fourth quarter of 2014 as a result of your annual goodwill impairment test. Please tell us whether you performed an interim goodwill test as a result of a triggering event described in ASC 350-20-35-3C. If an interim impairment test was performed, please tell us the triggering event that caused the evaluation, the results of the impairment test and the percentage that fair value exceeded carrying value for each of your reporting units. If no interim impairment test was completed, please confirm that there were no triggering events described in ASC 350-20-35-3C and explain in detail why each factor did not trigger an interim impairment test. Please be specific when explaining the factor in ASC 350-20-35-3C(d). Refer to 350-20-35-30.

ASC 350-20 requires entities to test goodwill for impairment annually and also between annual tests if facts and circumstances indicate that goodwill may be impaired. The SEC staff has asked registrants about negative trends that could trigger the requirement to test for impairment between annual tests and often asks them to describe the events leading up to the recording of an impairment charge, including how circumstances changed from prior quarters and from when the registrant had performed its previous annual goodwill impairment test. The SEC staff may also request an explanation of how the impairment had not been reasonably foreseen during management's prior-period assessments. Specifically, the staff may question why management did not identify an impairment during a previous quarter.

Other Long-Lived Assets

Example of an SEC Comment

We note that in the second quarter 2014 earnings conference call you stated that you plan to close [X] stores with a majority of the closures occurring in the fourth quarter of 2014. In light of the planned closures, please tell us if you have tested the related long-lived assets for impairment and reviewed their depreciation estimates, as of August 2, 2014. See ASC 360-10-35-21 and 35-22. If so tell us the outcome of your evaluations. If you have not [recorded an impairment] or revised depreciation estimates for these assets, please tell us your accounting basis for not doing so. We have reviewed your policy for impairment testing; however, it does not appear to address long-lived assets associated with planned store closings.

In its comments on impairments of long-lived assets, the SEC staff may ask a registrant that is recording, or is at risk of recording, impairment charges to either disclose or inform the SEC staff about the following:

- The adequacy and frequency of the registrant's asset impairment tests, including the date of its most recent test.
- The factors or indicators (or both) used by management to evaluate whether the carrying value of other long-lived assets may not be recoverable.
- The methods and assumptions used in impairment tests, including how assumptions compare to recent operating performance, the amount of uncertainty associated with the assumptions, and the sensitivity of the estimate of fair value of the assets to changes in the assumptions.
- The timing of the impairment, especially if events that could result in an impairment had occurred in periods before the registrant recorded the impairment. In these circumstances, the SEC staff may ask registrants to justify why the impairment was not recorded in the previous period.
- The types of events that could result in impairments.
- In the critical accounting policies section of MD&A, the registrant's process for assessing impairments.
- The facts and circumstances that led to the impairments, along with a reminder that a registrant may be required to disclose in MD&A risks and uncertainties associated with the recoverability of assets in the periods before an impairment charge is recorded. For example, even if an impairment charge is not required, a reassessment of the useful life over which depreciation or amortization is being recognized may be appropriate.

Other Deloitte Resources

- March 20, 2014, *Heads Up*, "Highlights of the 'SEC Speaks in 2014' Conference."
- December 16, 2013, *Heads Up*, "Highlights of the 2013 AICPA Conference on Current SEC and PCAOB Developments."
- May 2012, *Qualitative Goodwill Impairment Assessment — A Roadmap to Applying the Guidance in ASU 2011-08*.

Income Taxes

The SEC staff's comments about income taxes continue to focus on (1) the potential tax and liquidity ramifications related to the repatriation of foreign earnings, (2) valuation allowances, (3) rate reconciliation, and (4) unrecognized tax benefits.

Further, the staff continues to ask registrants to provide early-warning disclosures to help financial statement users understand these items and how they potentially affect the financial statements. For additional information about early-warning disclosures, see the Management's Discussion and Analysis section.

At the 2014 AICPA Conference, the staff stated that boilerplate language should be avoided with respect to income tax disclosures within MD&A and that approaches more conducive to effective disclosure would include:

- Using the income tax rate reconciliation as a starting point and describing the details of the material items.
- Discussing significant foreign jurisdictions, including statutory rates, effective rates, and the current and future impact of reconciling items.
- Providing meaningful disclosures about known trends and uncertainties, including expectations regarding the countries where registrants operate.

Repatriation of Foreign Earnings and Liquidity Ramifications

Example of an SEC Comment

You disclose that during fiscal 2014, 2013 and 2012, you provided for U.S. and non-U.S. income and withholding taxes in the amount of $[X], $[X] and $[X], respectively, on earnings that were or are intended to be repatriated. You further indicate that, in general, the remaining earnings of your subsidiaries are considered to be permanently reinvested and that you have approximately $[X] of undistributed earnings that are considered to be permanently reinvested. Please quantify the amounts repatriated for each period presented and tell us the facts and circumstances for repatriating your subsidiaries earnings. Substantiate how your assertion that the remaining portion will be permanently reinvested meets the indefinite reinvestment criteria in ASC 740-30-25. In this regard, since you did or intend to repatriate earnings in each of the periods presented and indicated the related tax amounts for each of those periods, please tell us why your assertion that it is not practicable to determine the cumulative amount of tax liability that would arise if these earnings were remitted is reasonable.

In accordance with ASC 740, when the earnings of a foreign subsidiary are indefinitely reinvested, registrants should disclose the nature and amount of the temporary difference for which no deferred tax liability (DTL) has been recognized as well as the changes in circumstances that could render the temporary difference taxable. In addition, registrants should disclose either (1) the amount of the unrecorded DTL related to that temporary difference or (2) a statement that determining that liability is not practicable.

Registrants may need to repatriate cash from foreign subsidiaries. ASC 740-30-25-19 states that "[i]f circumstances change and it becomes apparent that some or all of the undistributed earnings of a subsidiary will be remitted in the foreseeable future but income taxes have not been recognized by the parent entity, [the parent entity] shall accrue as an expense of the current period income taxes attributable to that remittance."

The SEC staff continues to (1) ask for additional information when registrants claim that it is not practicable to determine the amount of unrecognized DTL and (2) request that registrants expand disclosures in MD&A about their indefinitely reinvested foreign earnings. In addition, the staff has indicated that it evaluates such an assertion by taking into account registrants' potential liquidity needs and the availability of funds in U.S. and foreign jurisdictions. Recently, the staff has focused on situations in which registrants have repatriated a portion of their foreign earnings but continue to assert that the remaining earnings are considered to be permanently invested.

Disclosures in an MD&A liquidity analysis should include:

- The amount of cash and short-term investments held by foreign subsidiaries that would not be available to fund domestic operations unless the funds were repatriated.
- A statement that the company would need to accrue and pay taxes if the funds are repatriated.
- If true, a statement that the company does not intend to repatriate those funds.

Valuation Allowances

Examples of SEC Comments

- We note . . . that during 2014, you released $[X] of the valuation allowance that existed at the beginning of the year. We further note that you considered your income from operations and reduction in interest expense as a result of refinancings as positive evidence supporting this release. Given that you have three years of cumulative losses from pre-tax income, please help us better understand how you determined it was appropriate to release the valuation allowance during 2014. Your response should tell us how you weighted all of the positive and negative evidence, including your consideration of the extent to which it can be objectively verified, in reaching the conclusion to reverse the valuation allowance. Refer to paragraphs 30-21 through 30-23 of ASC 740-10-30.
- Given your recurring losses before income taxes, please disclose in future filings the nature of the deferred tax assets that have not been offset by a valuation allowance and how you determined they would be realized. Please also disclose the following:
  - The nature of the positive and negative evidence you considered, how that evidence was weighted, and how that evidence led you to determine it was not appropriate to record a valuation allowance on the remaining deferred tax assets;
  - The amount of any pre-tax income you need to generate to realize the deferred tax assets;
  - The anticipated future trends included in any projections of future taxable income; and
  - State, if true, that the deferred tax liabilities you are relying on in your assessment of the realizability of your deferred tax assets will reverse in the same period and jurisdiction and are of the same character as the temporary differences giving rise to the deferred tax assets.

ASC 740-10-30-5(e) requires entities to reduce deferred tax assets (DTAs) by "a valuation allowance if, based on the weight of available evidence, it is more likely than not (a likelihood of more than 50 percent) that some portion or all of the [DTAs] will not be realized. The valuation allowance shall be sufficient to reduce the [DTA] to the amount that is more likely than not to be realized." ASC 740-10-30-16 through 30-23 provide additional guidance. In light of this guidance, the SEC staff has commented when registrants' filings indicate that no valuation allowance has been recorded, or when it seems that the valuation allowance recorded is insufficient. More recently, the staff has asked registrants about reversals of, or other changes in, their valuation allowances.

The staff has reminded registrants that in assessing the realizability of DTAs, they should consider cumulative losses in recent years to be significant negative evidence and that to avoid recognizing a valuation allowance, they would need to overcome such evidence with significant objective and verifiable positive evidence.

The SEC staff has indicated that factors for registrants to consider in making a determination about whether they should reverse a previously recognized valuation allowance would include:

- The magnitude and duration of past losses.
- The magnitude and duration of current profitability.
- Changes in the above two factors that drove losses in the past and those currently driving profitability.

Further, the staff has noted that registrants should bear in mind that the goal of the assessment is to determine whether sufficient positive evidence outweighs existing negative evidence. The staff has emphasized the importance of evidence that is objectively verifiable and has noted that such evidence carries more weight than evidence that is not. In addition, registrants should (1) assess the sustainability of profits in jurisdictions in which an entity was previously in a cumulative loss position and (2) consider their track record of accurately forecasting future financial results. Doubts about the sustainability of profitability in a period of economic uncertainty may give rise to evidence that would carry less weight in a valuation allowance assessment. Likewise, a registrant's poor track record of accurately forecasting future results would also result in future profit projections that may be very uncertain and should carry less weight in the overall assessment.

The SEC staff has also pointed out that registrants' disclosures should include a discussion of the specific factors or reasons that led to a reversal of a valuation allowance to effectively answer the question, why now? Such disclosures would include a comprehensive analysis of all available positive and negative evidence and how the registrant weighed each piece of evidence in its assessment. In addition, the SEC staff has reminded registrants that the same disclosures would be expected when there is significant negative evidence and a registrant concludes that a valuation allowance is necessary.

Rate Reconciliation

Examples of SEC Comments

- We note your tax benefit from non-U.S. net earnings as depicted in the tax reconciliation table. Please discuss and disclose in your MD&A the identities of specific jurisdictions that materially affect your effective tax rate (currently, [X]%), the tax rates and incentives in those specific jurisdictions, earnings within those jurisdictions and information about the effects of such foreign jurisdictions (e.g., magnitude, mix), including but not limited to [Country A], on the current and future effective tax rate.
- We note the foreign tax rate differential is significantly lower than the federal statutory rate in the income tax rate reconciliation. In light of the significantly lower impact of taxes imposed on foreign earnings to your operating results, in future filings please explain in MD&A the relationship between foreign pre-tax income and the foreign effective tax rate in greater detail. We refer you to Section III.B of SEC Release 33-8350. Please provide us with your proposed revised disclosure.

In accordance with ASC 740 and Regulation S-X, Rule 4-08(h)(2), registrants must disclose a reconciliation that uses percentages or dollar amounts of income tax expense or benefit attributable to continuing operations with the amount that would have resulted from applying domestic federal statutory tax rates (the regular rate, not the alternative minimum tax rate) to pretax income from continuing operations.

Further, registrants should disclose the estimated amount and the nature of each significant reconciling item. ASC 740-10-50 does not define "significant." However, Rule 4-08(h) states that public entities should disclose (on an individual basis) all reconciling items that constitute 5 percent or more of the computed amount (i.e., income before tax multiplied by the applicable domestic federal statutory tax rate). Reconciling items may be aggregated in the disclosure if they are individually less than 5 percent of the computed amount.

The SEC staff has noted the following issues related to registrants' tax rate reconciliation disclosures:

- Labels related to reconciling items were unclear, and disclosures about material reconciling items did not adequately describe the underlying nature of these items.
- For material reconciling items related to foreign tax jurisdictions, registrants did not disclose in MD&A (1) each material foreign jurisdiction and its tax rate and (2) how each jurisdiction affects the amount in the tax rate reconciliation.
- Registrants have inappropriately aggregated material reconciling items that are greater than 5 percent of the amount they calculated by multiplying the pretax income by the statutory tax rate.
- Amounts reflected in the tax rate reconciliation were inconsistent with related amounts disclosed elsewhere in a registrant's filing.
- Corrections of errors were inappropriately reflected as changes in estimates.

Unrecognized Tax Benefits

Example of an SEC Comment

We note [an $X] increase in unrecognized tax benefits related to additions for prior year tax positions. Please describe for us in greater detail the significant components of this increase in unrecognized tax benefits. Please also describe whether this increase relates to the tax audit by the [Country A] tax authorities . . . . In this regard, please tell us how you have concluded that no other major jurisdictions outside the U.S. are required to be disclosed under FASB ASC 740-10-50-15(e).

Under ASC 740-10-25-6, entities cannot recognize a tax benefit related to a tax position unless it is "more likely than not" that tax authorities will sustain the tax position solely on technical merits. The tax benefit recognized is measured as the largest amount of the tax benefit that is more than 50 percent likely to be realized. The difference between a tax position taken or expected to be taken in a tax return and the benefit recognized and measured under ASC 740-10 is referred to as an "unrecognized tax benefit." Generally, if the unrecognized tax benefit would be settled by offsetting it with an available loss or tax credit carryforward in the same jurisdiction, it should be netted against the related DTA. Otherwise, the amount of the unrecognized tax benefit is presented as a liability in the statement of financial position. The SEC staff has commented when registrants omit disclosures required under ASC 740-10-50-15 and 50-15A about unrecognized tax benefits, which include a tabular reconciliation of such benefits.

In addition, the SEC staff may ask registrants about their conclusions regarding disclosures about reasonably possible changes in unrecognized tax benefits. Because the guidance on the acceptable level of aggregation of information for these disclosures is not prescriptive and permits judgment, the SEC staff evaluates a registrant's level of disclosure on a case-by-case basis.

Examples of what registrants should disclose under ASC 740-10-50-15(d) include:

- Information related to scheduled expiration of the tax position's statute of limitations. A registrant should disclose this information if (1) the statute of limitations is scheduled to expire within 12 months of the financial statement's date and (2) management believes it is reasonably possible that the statute's expiration will cause the total amounts of unrecognized tax benefits to significantly increase or decrease.
- Significant unrecognized tax benefits for tax positions that the registrant believes will be effectively settled within 12 months in accordance with ASC 740-10-25-9.

Other Deloitte Resources

January 2015, *A Roadmap to Accounting for Income Taxes*.

Leases

Lease Classification

Examples of SEC Comments

- We note your disclosure that during fiscal 2014 you entered into [X] agreements covered under a master lease agreement to lease back the equipment. Please provide us with your analysis of the guidance in ASC 840-10-25-1 supporting your classification of these as operating leases, including your consideration of the renewal option and transfer of ownership at the end of the lease term.
- [T]ell us how you determine that the exercise of a bargain renewal option is reasonably assured, including whether you consider historical experience in determining such exercises. Further, quantify for us the number of leases in your portfolio that have bargain renewal options. In your response, tell us the accounting literature relied upon and the basis for your conclusions.

The lease classification criteria in ASC 840-10-25-1 are based on the concept that a lease that transfers substantially all of the benefits and risks incident to the ownership of property should be accounted for (1) as the acquisition of an asset and the incurrence of an obligation by the lessee and (2) as a sale or financing by the lessor. All other leases should be accounted for as operating leases. The evaluation of the four lease classification criteria in ASC 840-10-25-1 and the subsequent conclusion about whether to classify a particular lease as an operating lease or a capital lease can have material effects on an entity's financial statements and disclosures. A lessee recognizes a capital lease as an asset and obligation on its balance sheet. Operating leases, on the other hand, are not recognized on the balance sheet but result in charges to expense by the lessee (reported as income by the lessor) over the lease term.

The SEC staff has asked registrants to further explain their considerations of the lease classification criteria. Many of the comments have focused on criteria (a) and (b) of ASC 840-10-25-1, which are related to transfer of ownership by the end of the lease term and bargain purchase options, respectively. If a lease transfers title to the lessee by the end of the lease term or shortly thereafter for no additional consideration or for nominal consideration, the lease would be classified by the lessee as a capital lease. Further, if the lease contains a bargain purchase option, it also would be classified by the lessee as a capital lease. Determining whether a purchase option is a bargain requires judgment (e.g., determining whether the exercise price is sufficiently lower than the expected fair value of the asset at the date of exercise to make exercise of the option reasonably assured), and there are no bright lines in this regard. The SEC staff may ask questions related to how the registrant determined that a bargain purchase option is reasonably assured or, in turn, how the registrant determined that it has not met the bargain purchase option criteria.

Sale-and-Leaseback Transactions Involving Fixed-Price Renewal Options

In the past, the SEC staff has commented on how registrants considered fixed-price renewal options in evaluating whether a real estate transaction qualifies for sale-and-leaseback accounting. A fixed-price renewal option in a leaseback may preclude a real estate transfer from qualifying for sale accounting (in which case, the real estate would remain on the seller's books and be treated as a financing arrangement). Renewal options that cover substantially all of the useful life of the real estate and enable the seller-lessee to participate in the appreciation of the underlying property (i.e., through favorable rental rates) are a prohibited form of continuing involvement.

Although comments have focused on fixed-price renewal options, the SEC staff may ask about any renewal terms that allow the seller-lessee to participate in increases in the value of the underlying real estate, including fixed base rents during the renewal period that a registrant calculates by using an inflationary index to adjust the current base rents. While these are not technically fixed-price renewals, they do have the potential to give the seller-lessee upside participation to the extent that market rates for rents exceed the rate of inflation.

Materiality

Example of an SEC Comment

We note that you concluded that the errors related to deferred tax assets were immaterial to the previously reported amounts contained in your periodic reports. Please tell us the following concerning these errors:

- Explain to us in greater detail the nature of the errors and how they were determined and remediated;
- Tell us if there was any impact on the evaluation of your disclosure controls and procedures and your conclusion on Internal Control over Financial Reporting; and
- Provide us with your SAB 99 materiality analysis beginning with the initial time period in which the errors were detected, addressing how you concluded that these errors were immaterial to the previously reported amounts contained in your periodic reports.

Registrants perform materiality analyses to determine the impact of identified misstatements on their (1) financial statements and (2) previous conclusions about ICFR and DC&P.

ASC 250-10-45-27 provides guidance on materiality determinations related to the correction of errors, and SAB Topics 1.M (SAB 99) and 1.N (SAB 108) contain the SEC staff's guidance on assessing the materiality of misstatements identified as part of the audit process or during the preparation of financial statements.

SAB Topic 1.M indicates that a "matter is 'material' if there is a substantial likelihood that a reasonable person would consider it important." The definition of materiality is based on FASB Concepts Statement 2[1] and on legal precedent in interpretations of the federal securities laws. The SEC staff has noted that in Supreme Court cases, the Court has followed precedent regarding materiality — namely, that the materiality requirement is met when there is a "substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."

SAB Topic 1.M also indicates that registrants should consider (1) each misstatement individually and (2) the aggregate effect of all misstatements. SAB Topic 1.N provides guidance on how a registrant should consider the effects of prior-year misstatements when quantifying misstatements in current-year financial statements.

To understand registrants' materiality assessments and conclusions, the SEC staff frequently asks registrants about the nature of an error, the quantitative and qualitative factors that registrants considered, and an error's impact on their conclusions about (1) the effectiveness of their ICFR and DC&P and (2) other reporting requirements, such as the need to file a Form 8-K. Similarly, the staff challenges registrants' conclusions that errors are immaterial (e.g., whether the method of correcting the error is appropriate; whether restatement language is presented; and whether an Item 4.02 Form 8-K, indicating nonreliance on previously issued financial statements, was required).

Accordingly, a registrant should first decide whether an individual error is material by considering (1) the affected line item subtotals and totals in the financial statements and (2) the financial statements as a whole. Then, if the registrant concludes that an individual error has not caused the financial statements as a whole to be materially misstated, it should consider other errors, including offsetting errors, in determining whether the errors taken as a whole are materially misleading. In reaching this conclusion, the registrant should consider individual line items, subtotals and totals in the financial statements, and the financial statements as a whole. The SEC staff has cautioned registrants to avoid bright-line rules or litmus tests and "not to succumb" to rules of thumb or percentage thresholds when determining materiality because no one factor can be viewed as determinative.[2]

SAB Topic 1.M specifies quantitative and qualitative factors a registrant should consider when assessing the materiality of known errors to its financial statements. However, in observing that registrants' materiality assessments are often presented in a "checklist" fashion in which only the factors in

[1] FASB Concepts Statement 2, which has been superseded by FASB Concepts Statement 8, defined materiality as the "magnitude of an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement."

[2] The SEC commented on this topic at the 2011 AICPA Conference. See Deloitte's December 14, 2011, *Heads Up* for additional information.

SAB Topic 1.M are considered, the SEC staff has indicated that registrants should (1) describe all factors that are relevant to their materiality assessment (i.e., not just those factors noted in SAB Topic 1.M) and (2) explain how each of those factors was considered. That is, a registrant should provide a detailed, thoughtful analysis that takes into account the registrant's specific circumstances and is relevant to its investors and financial statement users.[3] In addition, the SEC staff has stressed that quantitative considerations in registrants' materiality assessments continue to be overemphasized while qualitative factors are often insufficiently evaluated.[4]

The SEC staff has also indicated that registrants should consider company-specific trends, performance metrics that may influence investment decisions, and the effects of unrelated circumstances on factors that are important to reasonable investors (such as the magnification of an error in the income statement simply because it occurs in a period in which net income is "abnormally small" relative to historical and expected trends).

In considering company-specific trends and performance metrics, a registrant should address in its materiality assessments what metrics it deemed important enough to include in press releases and earnings calls as well as what analysts cover in their reports. The SEC staff often considers analysts' reports and investor calls as it assesses the registrant's assertion of what is important to investors.

When considering whether net income is abnormally small, management should determine whether a decline in operating performance is an abnormal event or whether it represents a new normal. Management should also determine whether "unusual" or infrequent events or transactions, such as an asset sale or impairment that would affect trends, are reflected in the results. In those instances, it sometimes may be appropriate to evaluate the relative significance of the identified error by using adjusted or "normalized" metrics, which may cause an otherwise quantitatively significant error to be less significant. Documentation of such considerations should be included in management's analysis.

The SEC staff has also observed that certain registrants have argued that a quantitatively large error in the GAAP financial statements is immaterial when it has a quantitatively small impact on non-GAAP metrics. While the staff has indicated that it may be appropriate for a registrant to look at metrics other than those that are GAAP-based in determining whether the financial statements taken as a whole are materially misstated, the SEC staff will most likely focus on the GAAP metrics until a registrant can demonstrate why other metrics are more important to its investors. In addition, the SEC staff has acknowledged that while it is possible for quantitatively small errors to be material and for quantitatively large errors to be immaterial,[5] a quantitatively material GAAP error does not become immaterial simply because of the presentation of non-GAAP measures.[6] Further, there may be circumstances in which an error that is otherwise immaterial to the GAAP financial statements — when taken as a whole and depending on the focus that management, investors, and financial statement users have historically placed on non-GAAP information — is material in the context of non-GAAP information.[7]

In addition to inquiring about a registrant's materiality analysis under SAB Topics 1.M and 1.N, the SEC staff often asks questions about the errors themselves. Registrants should consider the impact that misstatements (and immaterial restatements) may have on their previous conclusions about ICFR and DC&P. As a result of such misstatements, the SEC staff may question whether a material weakness existed at the time of the initial assessment. For additional considerations, see the Disclosure Controls and Procedures and Internal Control Over Financial Reporting sections.

After reaching a materiality conclusion, registrants should also consider whether they are required to file Form 8-K. Under Item 4.02(a) of Form 8-K, a registrant must file Form 8-K when it has concluded that previously issued financial statements, covering either an annual or interim period, should no longer be relied on because of an error.

3 In an October 2010 joint webcast with the CAQ, the SEC staff provided its views about registrants' materiality assessments.

4 The SEC staff discussed qualitative and quantitative factors at the 2012 AICPA Conference. For more information, see Deloitte's December 11, 2012, *Heads Up*.

5 At the 2007 and 2008 AICPA conferences, the SEC staff addressed these topics. For more information, see Deloitte's December 20, 2007, and December 18, 2008, *Heads Up* newsletters.

6 At the 2010 AICPA Conference, the staff expressed its views on this topic. See Deloitte's December 16, 2010, *Heads Up* on the conference.

7 In its October 2010 joint webcast with the CAQ, the SEC staff also discussed non-GAAP financial measures in the context of materiality.

Noncontrolling Interests

Examples of SEC Comments

- We note the reconciliation of net income (loss) to net loss attributable to [your stockholders] on your consolidated statements of income (loss). Please tell us the basis for the attributing amounts to the parent and the non-controlling interests and tell us how amounts are calculated as it relates to your non-controlling interests, such as net (income) loss attributable to non-controlling interests on the consolidated statements of income (loss).
- We note that your non-controlling interests of the [consolidated entities include] both redeemable non-controlling interests reported outside of the permanent capital section (when investors have the right to redeem their interest) and equity attributable to non-controlling interests of [the consolidated entities] reported inside the permanent capital section (when investors do not have the right to redeem their interests). In the interest of transparency, please revise throughout your filing to label your redeemable non-controlling interests as redeemable non-controlling interests of [the consolidated entities].

SEC staff comments related to noncontrolling interests (NCIs) continue to focus on the allocation of net income (loss) to the NCI and the parent. Consequently, the staff frequently asks registrants to provide it with detailed information about how the registrant determined the allocation, particularly when the allocation is disproportionate to the NCI holder's investment.

The SEC staff also continues to comment on registrants' accounting for redeemable NCIs since SEC rules still prohibit registrants from including redeemable equity in any caption titled "total equity." ASC 480-10-S99-3A(2) indicates that equity instruments are required to be classified outside of permanent equity if they are redeemable for cash or other assets in one of the following ways:

- "[A]t a fixed or determinable price on a fixed or determinable date."
- "[A]t the option of the holder."
- "[U]pon the occurrence of an event that is not solely within the control of the issuer."

Thus, the SEC staff has indicated that "registrants with redeemable noncontrolling interests, redeemable preferred stock or other redeemable equity classified outside permanent equity should not include these items in any total or subtotal caption titled 'total equity.'" Further, changing "the caption in the statement of changes in shareholders' equity [from] 'total equity' to 'total' does not make the inclusion of redeemable equity acceptable."[1]

For additional information about classification of redeemable securities, see the Debt section.

[1] Quoted text is from the highlights of the June 2009 CAQ SEC Regulations Committee joint meeting with the SEC staff.

Pensions and Other Postretirement Benefits

The SEC staff continues to comment on disclosures related to how registrants account for pension and other postretirement benefit plans and how key assumptions and investment strategies affect their financial statements. Further, registrants may be asked how they concluded that assumptions used for their pension and other postretirement benefit accounting are reasonable relative to (1) current market trends and (2) assumptions used by other registrants with similar characteristics.

Critical Accounting Estimates

Examples of SEC Comments

- In future filings, please provide a more robust discussion of your critical accounting policies and estimates to focus on the assumptions and uncertainties that underlie your critical accounting estimates rather than duplicating the accounting policy disclosures in the financial statement footnotes. Please quantify, where material, and provide an analysis of the impact of critical accounting estimates on your financial position and results of operations for the periods presented. In addition, please include a qualitative and quantitative analysis of the sensitivity of reported results to changes in your assumptions, judgments, and estimates, including the likelihood of obtaining materially different results if different assumptions are applied. For example, if reasonably likely changes in the discount rate or long-term rate of return used in accounting for your pension plans would have a material effect on your financial condition or results of operations, the impact that could result given the range of reasonable outcomes should be disclosed and quantified. Please refer to SEC Release No. 34-48960. In your response, please show us what your disclosure would have looked like if these changes were made in your most recently filed Form 10-K.
- Please tell us how you determined the discount rates used in the measurement of plan obligations at the most recent balance sheet date and why you believe the discount rates are reasonable based on the expected dates and amounts of cash outflows associated with retiree pension benefits.

Because of factors such as the low-interest-rate environment, optionality in U.S. GAAP accounting methods, and significant assumptions used in benefit obligation valuation, the SEC staff has continued to ask registrants about assumptions related to their pension and other postretirement benefit plans. For example, the staff has requested more quantitative and qualitative information about the nature of registrants' assumptions. In particular, the staff has focused on the discount rate and the expected return on plan assets. Further, the staff has asked registrants how their disclosures in the critical accounting estimates section of MD&A align with their accounting policy disclosures in the notes to the financial statements.

In addition, the SEC staff has indicated that it may be appropriate for a registrant to disclose the following:

- Whether a corridor[1] is used to amortize the actuarial gains and losses; and, if so, how the corridor is determined and the period for amortization of the actuarial gains and losses in excess of the corridor.
- A sensitivity analysis estimating the impact of a change in expected returns on income. This estimate should be based on a reasonable range of likely outcomes.
- Regarding the extent to which historical performance was used to develop the expected rate of return assumption, if use of the arithmetic mean to calculate the historical returns yields results that are materially different from the results yielded when the geometric mean is used to perform this calculation, it may be appropriate for the registrant to disclose both calculations.
- The reasons why the expected return has changed or is expected to change in the future.

[1] ASC 715-30-35-24 provides guidance on net periodic pension benefit cost and defines the corridor as "10 percent of the greater of the projected benefit obligation or the market-related value of plan assets." Similarly, ASC 715-60-35-29 provides guidance on net periodic postretirement benefit cost and defines the corridor as "10 percent of the greater of the accumulated postretirement benefit obligation or the market-related value of plan assets."

- The effect of plan asset contributions during the period on profit or loss, when this effect is significant. The SEC staff has indicated that additional plan asset contributions reduce net pension costs even if actual asset returns are negative because the amount included in profit or loss is determined through the use of expected and not actual returns. Consequently, such information can provide an understanding of unusual or nonrecurring items or other significant fluctuations so that investors can ascertain the likelihood that past performance is indicative of future performance.

Liquidity and Capital Resources

Example of an SEC Comment

We note . . . that you had changes in both your discount rate and mortality assumptions during 2014 that have significantly affected your benefit obligations and related funding status. Particularly, your unfunded obligations have increased by approximately $[X] since 2013. We further note from your risk factor . . . that you "could" experience increases in your pension expense due to such changes as decreases in discount rates. In this regard, please revise your Liquidity section of MD&A to identify and discuss any known trends, demands, commitments, events, or uncertainties that will result in or that are reasonably likely to result in your liquidity increasing or decreasing in any material way. Your revised disclosure should clearly explain the significant increase in both your benefit obligations at December 31, 2014 and your unfunded status and the related impacts on your financial statements and liquidity. Please refer to Item 303(a)(1) of Regulation S-K.

Registrants should sufficiently disclose how changes to their plan assets and obligations may affect their liquidity and capital resources. The SEC staff has encouraged registrants to explain the trends and uncertainties related to pension or other postretirement benefit obligations (e.g., a registrant's funding requirements may be affected by changes in the measurement of its plan obligations and assets). A registrant also may want to disclose in both qualitative and quantitative terms what its plan contributions have been in the past and the expected changes to those contributions.

Registrants may take steps to "de-risk" their pension plans by acquiring bonds for their plan asset portfolios whose expected maturities match the expected timing of the plans' obligations. The SEC staff has reminded registrants that they are required to disclose their plan investment strategy. MD&A should inform investors about any changes to that investment strategy, the reasons for those changes, and how a change in strategy affects the underlying plan assumptions and the registrant's ability to fund the plans. For example, a decision to invest more in fixed-income securities could be expected to lower the overall rate of return on plan assets.

When a pension plan is funded with a noncash transaction (e.g., the registrant's own stock), it may be appropriate to disclose how management funded the pension plan, with a reference to the associated cash flow statement line items.

When commenting on other postretirement benefit plans, which are usually funded as the related benefit payments become due, the SEC staff has noted that the footnote disclosures should include the plan's expected future benefit payments for each of the next five years and in the aggregate for the five years thereafter. This information may provide insight into a registrant's expected liquidity requirements, which could then warrant discussion in the liquidity section of MD&A or in the contractual obligations table.

Fair Value of Plan Assets

The disclosures required by ASC 715 for fair value measurements for retirement plan assets are similar to the disclosures about fair value measurements required by ASC 820. These disclosures include employers' investment strategies, major categories of plan assets, concentrations of risk within plan assets, and valuation techniques used to measure the fair value of plan assets. The SEC staff may ask registrants about their compliance with such disclosure requirements. For more information, see the Fair Value section. A registrant also should disclose whether the fair value or calculated value[2] of plan assets is used to determine the expected return on plan assets and, if the calculated value is used, how this value is determined.

Immediate Recognition of Gains and Losses

The SEC staff has noted instances in which registrants have changed their method of accounting for the amortization of actuarial gains and losses in net periodic pension or other postretirement benefit cost. For example, some registrants have decided to move to an approach under which they immediately recognize all actuarial gains and losses or, alternatively, all actuarial gains and losses outside the corridor, as a component of net periodic pension cost. In accordance with ASC 250, such registrants have retrospectively applied this change in accounting principles to their financial statements.

Once an entity adopts a policy of immediately recognizing gains and losses, changing to a less preferable method (i.e., a subsequent change to a method that results in slower amortization) would be difficult to support. When entities adopt a policy of immediately recognizing actuarial gains and losses as a component of net periodic pension cost, they often present non-GAAP financial measures that "remove the actual gain or loss from the performance measure and include an expected long-term rate of return."[3] The SEC staff will generally comment when (1) the disclosures are not clear and the pension-related adjustment (e.g., actuarial gains or losses) is not labeled; (2) an adjustment is labeled as a "noncash" pension expense, because the pension liability will ultimately be settled in cash; and (3) context about adjustments related to actuarial gains and losses is not provided.

Mortality Assumption

Example of an SEC Comment

We understand that the Society of Actuaries developed an update[d] set of mortality assumptions presented in its RP-2014 Mortality Tables Report issued in October 2014. We also understand that the RP-2014 mortality tables represent the most current and complete benchmarks of U.S. private pension plan mortality experience. Please tell us what consideration you gave to changing the mortality table used to calculate the present value of pension and postretirement plan liabilities. If you did not adopt the new mortality assumptions, please tell us the mortality table used to calculate the present value of pension and postretirement plan liabilities and why you believe the mortality rate assumptions [reflect] the best estimate of expected mortality rates for your participant population. If you adopted the RP-2014 mortality tables, please tell us the impact on pension and postretirement plan liabilities.

The SEC believes that the RP-2014 mortality tables released by the Society of Actuaries (SOA) in October 2014 should not be disregarded in the development of the best estimate[4] of mortality since entities have historically used the data issued by the SOA. Further, since a change in the mortality assumption may have a significant effect on the entity's result of operations, registrants should consider the requirement in ASC 715-20-50-1(r) to disclose an "explanation of any significant change in the benefit obligation or plan assets not otherwise apparent in the other disclosures required by [ASC 715-20]." In addition to footnote disclosures, registrants should consider the need to highlight in MD&A the effects of a change in the mortality assumption.[5]

[2] ASC 715-30-20 defines the market-related value of plan assets as follows: "A balance used to calculate the expected return on plan assets. The market-related value of plan assets is either fair value **or a calculated value** that recognizes changes in fair value in a systematic and rational manner over not more than five years. Different ways of calculating market-related value may be used for different classes of assets" (emphasis added).

[3] For more information, see the highlights of the June 2012 CAQ SEC Regulations Committee joint meeting with the SEC staff.

[4] Under ASC 715-20 and ASC 715-60, each assumption should represent the "best estimate" for that assumption as of the current measurement date.

[5] For more information, see Deloitte's December 15, 2014, *Heads Up* on the 2014 AICPA Conference.

Disclosures Related to Non-U.S. Plans

ASC 715-20-50-4 states that a "U.S. reporting entity may combine disclosures about pension plans or other postretirement benefit plans outside the United States with those for U.S. plans unless the benefit obligations of the plans outside the United States are significant relative to the total benefit obligation and those plans use significantly different assumptions." The SEC staff may ask registrants to explain the basis for combining pension and other postretirement benefit plan disclosures related to U.S. and non-U.S. plans. When there are significant differences in trends and assumptions between the U.S. and non-U.S. plans and the benefit obligation of the foreign plan is significant, the SEC staff has required registrants to provide disaggregated footnote disclosure for the U.S. and non-U.S. plans.

Other Deloitte Resources

- Financial Reporting Alert 15-3, "Employers' Accounting for Defined Benefit Plans — Alternatives for Applying Discount Rates to Measure Benefit Cost."
- August 14, 2015, *Heads Up*, "FASB Issues ASU on Employee Benefit Plan Accounting."
- Financial Reporting Alert 14-4, "Financial Reporting Considerations Related to Pension and Other Postretirement Benefits."
- Financial Reporting Alert 11-2, "Pension Accounting Considerations Related to Changes in Amortization Policy for Gains and Losses in the Market-Related Value of Plan Assets."

Revenue Recognition

Revenue Recognition Disclosures

Examples of SEC Comments

- We see that your revenue recognition policy cites the four general criteria from SAB Topic 13. Please tell us how you apply the criteria from your disclosure in determining the appropriate timing of revenue recognition. For instance, describe what you consider to be pervasive evidence of an arrangement, tell us when title and risk of loss transfer to your customers, and describe the factors you consider in concluding that the price is fixed and determinable and that collection is reasonably assured.
- Please tell us and revise to clarify how your revenue recognition policy addresses each type of revenue discussed . . . . In this regard, [you describe] data analytics, subscriptions and data-driven intervention platform services but your revenue recognition policy [in your financial statements] describes data analytics and data-driven intervention platforms and multiple element arrangements. Clarify how each of the revenue components . . . is accounted for [in your financial statements], the nature of the services being subscribed for and which product and service offerings are subject to software accounting under ASC 985-605.

In addition to requesting general policy information, the SEC staff often asks that registrants clearly state whether and, if so, how a revenue recognition policy complies with SAB Topic 13, particularly the four criteria that generally must be met for revenue to be recognized. The staff may also ask how a criterion has been applied in the context of a particular transaction or group of transactions. For example, the SEC staff may inquire about whether collectibility is “reasonably assured” and whether the sales price the registrant charges resellers for products is “fixed or determinable.”

When reviewing the disclosures in a registrant’s revenue policy footnote, the SEC staff often checks for completeness and consistency with the revenue streams described in the business section, in MD&A, and on the registrant’s Web site. Registrants should consider expanding or clarifying their revenue recognition disclosures to include:

- The type, nature, and terms of significant revenue-generating transactions.
- The specific revenue recognition policy (including the manner in which revenue is recognized) for each type of revenue-generating transaction, including policies related to discounts, promotions, sales returns, post-shipment obligations, customer acceptance, warranties, credits, rebates, and price protection.
- The specific events or actions that trigger revenue recognition (i.e., avoid “boilerplate language”).
- Relevant information about significant uncertainties related to revenue recognition (e.g., rights of return or variable consideration).
- A detailed breakdown of revenue by product/service line or business segment when the disclosure of revenue in the filing is less granular than the discussion of the registrant’s results of operations in other publicly available information in or outside the filing.

The SEC staff may request more specific disclosures on the basis of the complexity or subjectivity of registrants’ revenue recognition policies.[1]

[1] The SEC staff discussed its expectations related to the completeness and consistency of revenue policy footnotes at the 2013 AICPA Conference.

Sales Returns

Examples of SEC Comments

- Please tell us whether your wholesale customers have the right to return goods and, if so, confirm to us that you record an estimate for anticipated returns when sales are recorded. Also confirm to us that you will revise your revenue recognition disclosure in future filings to clarify your wholesale customers' return rights and your policy for estimating returns on wholesale sales; and provide us with your draft disclosure in your response letter.
- We note your statement that the sales return reserve represents the gross profit effect of sales returns. Please explain to us in more detail how you determine and record your sales return reserve. It is unclear to us if you are reducing sales for the gross profit of expected returns or if you are reducing sales and cost of sales to reflect estimated returns. Please refer to ASC 605-15-45-1.

The SEC staff continues to comment on registrants' failure to separately present or disclose information about their sales returns, particularly when other information in a registrant's filing or in other public communications suggests that sales returns may be material. In addition, the SEC staff will comment if it appears that a registrant has accounted for sales returns as a reduction in revenue on the basis of the gross profit of the related transactions instead of as a reduction in both sales and cost of sales as required by ASC 605-15. Comments on these topics are particularly prevalent in the retail industry.

Multiple-Element Arrangements

Examples of SEC Comments

- We note that you have multiple-element arrangements. . . . In future filings please disclose the following as required by FASB ASC 605-25-50-1:
    - o Disclose the significant deliverables within the arrangement including your maintenance and service agreements or tell us why the maintenance and service agreements are not part of the arrangements;
    - o Disclose the general timing of delivery or performance of services for the deliverables in the arrangement;
    - o Discuss the significant factors, inputs, assumptions, and methods used to determine selling price for the significant deliverables; and
    - o Disclose whether the significant deliverables in the arrangement qualify as separate units of accounting, and the reasons that they do not qualify as separate units of accounting, if applicable.

  Please provide us with your proposed disclosure.
- Your disclosure . . . indicates that some of the revenue from non-refundable upfront fees is recognized over the estimated customer life . . . . If any of the non-refundable upfront fees are recognized over the estimated customer life, please tell us whether the non-refundable upfront fees have standalone values and are considered separate units of account and tell us your basis for recognizing the revenue over the estimated customer life. If you do not have non-refundable upfront fees that are recognized over the estimated customer life, please remove the reference from your disclosure in future filings.

The SEC staff often asks registrants about the nature of, and accounting for, their multiple-element arrangements and whether they evaluated these arrangements under ASC 605-25. The staff typically asks for additional information, and sometimes requests more disclosure, about multiple-element arrangements, including:

- A description of the registrant's rights and obligations under the arrangement.
- The registrant's method for determining whether certain deliverables in an arrangement qualify as separate units of accounting and the factors the registrant considered in making this assessment.
- The registrant's accounting policy for allocating and recognizing revenue for each deliverable.
- The registrant's support for its conclusion that a delivered item has stand-alone value.
- An analysis of how the transaction price was allocated to each deliverable, including how the selling price used for each unit of accounting was determined (i.e., VSOE, TPE, or estimated selling price).
- The period over which each unit of accounting is recognized.

The SEC staff has also focused on registrants' accounting for up-front fees. It has asked registrants to explain whether such fees are related to specific performance obligations and how they determined the period over which the up-front fees are recognized.

Principal-Versus-Agent Considerations

Example of an SEC Comment

We note your disclosure . . . that you act as a billing and collection agent for many nominees. We specifically note that you collect the fees and remit to nominees any difference between the fees that the nominees are entitled to collect and the amount that the nominees have agreed to pay you for your services. Please tell us how you recognize revenues from these transactions and how you considered including disclosures in your revenue recognition accounting policies explaining whether you record such revenues gross as a principal or net as an agent. Please refer to ASC 605-45.

The SEC staff often inquires about principal-versus-agent considerations. ASC 605-45 discusses factors that an entity should consider in determining whether it acts as a principal (and records revenue at the gross amount billed to a customer) or as an agent (and records revenue at the net amount retained). The staff has asked registrants to explain how they determined gross or net reporting to be appropriate for certain revenue transactions under ASC 605-45. In addition, the SEC staff may request detailed information about the rights and obligations of the parties involved in a registrant's revenue transactions. The staff may ask registrants to provide expanded disclosures that describe the nature of these transactions and the factors they considered when determining whether revenue from such transactions should be recorded on a gross or a net basis.

The focus of these disclosures is to provide information that would enable an investor to understand whether title is transferred and who is the primary obligor. The SEC staff has stated that the analysis it applies to identify the primary obligor focuses on (1) identifying the product or service that is desired by the customer and (2) determining whether the registrant is responsible for providing that product or service.

Revenue Recognition for Long-Term Construction-Type and Production-Type Contracts

Examples of SEC Comments

- For the long-term [Product X] manufacturing contracts you enter into, please tell us the following:
  - The nature and terms of these contracts;
  - The amount of revenue recognized for each period presented related to these contracts; and
  - Expand your disclosure to include the method of measuring the extent of progress toward completion for your percentage of completion contracts in accordance with ASC 605-35-50-2.
- It appears $[X] of operating income . . . resulted from a change in estimates underlying your percentage-of-completion accounting on long-term contracts. [P]lease provide a discussion of the underlying reasons for the significant changes in estimates, including quantified information where available and useful for an investor's understanding of contract performance, the impact on operations, and the potential impact on future operations.

ASC 605-35 provides guidance on how and when to recognize revenue and costs for certain long-term construction-type and production-type contracts. The SEC staff may ask registrants to clarify their treatment of these contracts under ASC 605-35. For instance, the staff may inquire about:

- How the registrant developed its estimate of total contract costs and how those costs are directly related to contract performance.
- How the registrant treated precontract and early-stage contract costs, which should normally be expensed.
- The nature, status, amounts, and types of change orders and claims that occurred during the periods presented and how the registrant accounted for those change orders and claims.
- Policy disclosures, including which contract accounting method was used (i.e., percentage-of-completion or completed-contract) and which method was used to measure progress toward completion (e.g., cost-to-cost, units of work).
- The historical accuracy of the registrant's past estimates and the likelihood of changes in its estimates in the future.
- The amount of contract losses recorded during each period presented.
- Disclosures (under ASC 250-10-50-4) related to the effect of any changes in estimates in the financial statements (e.g., the estimate of percentage complete or amount of profit recognized on claims).
- For transactions for which revenue is recognized under the completed-contract method, the specific criteria used to determine when a contract is substantially completed.

In addition, registrants that use the percentage-of-completion method should be aware that the SEC staff has asked some registrants to enhance their disclosures in MD&A about the effect of changes in contract estimates. For example, the SEC staff may ask registrants to add disclosures in MD&A about gross aggregate favorable and gross aggregate unfavorable changes in contract estimates for each period presented.

Other Deloitte Resources

- February 2015, *Revenue From Contracts With Customers — A Roadmap to Applying the Guidance in ASU 2014-09*.
- December 2011, *Software Revenue Recognition — A Roadmap to Applying ASC 985-605*.
- July 2010, *Multiple-Element Arrangements — A Roadmap to Applying the Revenue Recognition Guidance in ASU 2009-13*.

SAB Topic 11.M (SAB 74) — Disclosures About the Impact of Recently Issued Accounting Pronouncements

Example of an SEC Comment

Please revise to include a discussion of the potential effects that recently issued accounting standards will have on your financial statements when adopted in a future period. Refer to SAB Topic 11.M. For example, please revise to disclose the potential effect of ASU No. 2014-09, Revenue from Contracts with Customers.

SAB Topic 11.M (SAB 74) indicates that a registrant should disclose the effects of recently issued ASUs and SABs that are not yet effective "unless the impact on [the registrant's] financial position and results of operations is not expected to be material" (footnote omitted). These disclosures are meant to help financial statement users assess the effect that new standards will have once adopted. Disclosure is not required when a registrant will adopt a new accounting standard that will not affect the reported results (i.e., when only enhanced disclosures would be required by the new accounting standard).

According to SAB Topic 11.M, a registrant should consider including the following disclosures in MD&A and the footnotes to the financial statements:

- A brief description of the new standard, the date that adoption is required and the date that the registrant plans to adopt, if earlier.
- A discussion of the methods of adoption allowed by the standard and the method expected to be utilized by the registrant, if determined.
- A discussion of the impact that adoption of the standard is expected to have on the financial statements of the registrant, unless not known or reasonably estimable. In that case, a statement to that effect may be made.
- Disclosure of the potential impact of other significant matters that the registrant believes might result from the adoption of the standard (such as technical violations of debt covenant agreements, planned or intended changes in business practices . . .).

The SEC staff does not expect the disclosures to include a "laundry list" of new standards that registrants state will have no material effect on their financial statements; only those ASUs that are expected to have a material impact should be described in the financial statements. Further, the staff expects disclosures about the potential effects of a new standard to be increasingly clear and precise as the standard's effective date approaches.

Accordingly, the SEC staff has commented on the following items related to SAB Topic 11.M disclosures:

- Failure to provide the required disclosures.
- Inadequate discussion of the accounting changes and how they will be adopted (i.e., whether retrospectively or prospectively and what periods will be affected).
- Disclosures about prospective accounting standards that are exactly the same in both the notes to the financial statements and MD&A. For example, registrants may consider the effect of adoption on their operations, financial condition, or liquidity in future periods and provide related disclosures in their MD&A. Disclosures in the financial statements should focus on whether the historical financial information will change (e.g., as a result of the retrospective application of the standard).

Segment Reporting

Segment reporting remains a perennial topic of SEC staff comments. Like those issued in previous years, recent SEC staff comments have specifically addressed (1) the identification and aggregation of operating segments, (2) changes in reportable segments, (3) product and service revenue by segment, (4) operating segments and goodwill impairment, and (5) information about geographic areas.

Identification and Aggregation of Operating Segments

In asking registrants about the identification and aggregation of their operating segments, the SEC staff's comments have focused on (1) the identification of the chief operating decision maker (CODM), (2) how registrants identify operating segments and support their process for identifying them, (3) the quantitative and qualitative factors used to support the aggregation of operating segments, and (4) how registrants have considered whether their previous conclusions about the identification and aggregation of operating segments remain appropriate (i.e., how they have continued to assess such conclusions in light of changes in their management or operations).

Example of an SEC Comment

We note that your [CODM] is provided an income statement overview by business unit and that your CODM holds team meetings with your functional leaders and segment managers for [Segment A] and [Segment B]. In order to assist us with our evaluation of how you considered the guidance in FASB ASC 280, please address the following comments:

- Please provide to us the names of your business units and a summary of how these business units are structured. Discuss who manages the business units and describe their role with the company.
- Please describe to us the nature of interactions between the CODM and the business unit managers.
- Clarify for us the role of the segment managers and describe how the segment managers interact with the business unit managers and the CODM.
- Describe to us how the business unit manager's responsibilities differ from the segment manager's responsibilities.
- Clarify the roles and responsibilities of the functional leaders within the company and if they are different from the business unit managers and segment managers.
- Provide to us more information about your budgeting process. Within your discussion, describe who is involved with each level of review and approval during the budgeting process. Also discuss who is responsible for assessing actual performance versus budgeted performance. Clarify who is responsible for discussing any excesses or shortfalls and who is involved in these discussions and to what level of detail.
- Please explain to us if there are situations where the [Segment A] or [Segment B] managers are responsible for any elements of the business units. Within your response discuss if each business unit is aligned solely under one segment manager or if certain business units report to both segment managers.

ASC 280 prescribes the "management approach" for the presentation of segments in a public entity's financial statements. The objective of the management approach is to allow financial statement users to (1) see through the eyes of management the entity's performance, (2) assess the entity's prospects for future cash flows, and (3) make more informed judgments about the entity as a whole. It is presumed that investors would prefer disaggregated information. Consequently, operating segments should not be aggregated unless providing more detailed information would not enhance an investor's understanding of the entity.

Determining an entity's operating segments is the first step in the assessment of what segment information needs to be reported in the entity's financial statements. An operating segment is a component of the business (1) that engages in business activities from which it may earn revenues and incur expenses, (2) whose operating results are regularly reviewed by the public entity's CODM, and (3) that has discrete financial information available. When challenging a registrant's conclusion about its operating segments, the SEC staff has historically placed a great deal of weight on the information regularly provided to, and reviewed by, the CODM (i.e., the CODM package). The SEC staff would frequently request copies of the CODM package to determine whether the information in the CODM package supports how operating segments are identified and aggregated.

However, technology advancements in registrants' financial reporting systems allow the CODM to easily access additional information that may not be reflected in the CODM package. These advancements have led the SEC staff to revisit its views on the relative importance of the CODM package to the segment identification analysis. At the September 2014 AICPA Banking Conference and December 2014 AICPA Conference, the SEC staff noted that while it may have previously emphasized the importance of using the information in a registrant's CODM package to identify operating segments, the staff's views on how it should weight information in a registrant's CODM package have evolved. The staff indicated that instead of viewing the CODM package as the determinative factor in the identification of operating segments, it would now treat the CODM package as only one of many factors to be considered. Similarly, the staff noted that it would not view the CODM package as a safe harbor for registrants. In other words, the staff would not be supportive of an assertion that information in the CODM package automatically nullifies other information (i.e., information that might suggest different operating segments). Other factors that may be considered in the identification of operating segments include (1) a registrant's organizational chart, (2) a registrant's overall management structure, (3) the basis on which budgets and forecasts are prepared, and (4) the basis on which executive compensation is determined. A registrant should expect that the staff will review other publicly available information for consistency with the registrant's segment disclosures; such information may include the forepart of Form 10-K (i.e., the business section and MD&A), the registrant's Web site, analysts' reports, and press releases.

As used in ASC 280, the term "chief operating decision maker" identifies a function, not an individual in the company who has the specific title. The CODM determines the allocation of resources and assesses the performance of the operating segments. While the CODM is usually an individual, sometimes the function is performed by a group.

Accordingly, at the September 2014 AICPA Banking Conference and December 2014 AICPA Conference, the SEC staff further noted that it has placed a renewed emphasis on the determination of a registrant's CODM. The staff remarked that although most registrants identify their CEO as the CODM, questions from the staff sometimes engender a change in the registrant's conclusion about its CODM's identity, which in turn affects the registrant's determination of operating segments. In light of this, the staff encouraged registrants to reassess their determination of the CODM and, when doing so, to focus on understanding management's structure (e.g., through organizational charts or other information).

Under ASC 280-10-50-11, entities may aggregate operating segments into reportable segments if the operating segments exhibit (1) similar economic characteristics (e.g., similar historical and expected future performance, such as through similar long-term average gross margins) and (2) other similar characteristics, including:

a. The nature of the products and services
b. The nature of the production processes
c. The type or class of customer for their products and services

d. The methods used to distribute their products or provide their services

e. If applicable, the nature of the regulatory environment, for example, banking, insurance, or public utilities.

ASC 280-10 does not define the term "similar" or provide much guidance on the aggregation criteria, and the determination of whether two or more operating segments are similar depends on the individual facts and circumstances and is subject to a high degree of judgment. As a result, the SEC staff may ask a registrant to provide an analysis on how it determined that its aggregation of operating segments complies with both the quantitative and qualitative requirements in ASC 280-10. In the assessment of whether operating segments may be aggregated, determining the basis for economic similarity is particularly difficult for registrants that have complex models and organization and reporting structures. Accordingly, the SEC staff may ask registrants that have aggregated segments how they satisfied the quantitative requirements of ASC 280-10 and may further comment when the economic measures of a registrant's aggregated operating segments have not converged over time despite the registrant's previous assertion that it expected such measures to become more similar. In addition, the SEC staff has emphasized that registrants should also focus on the qualitative factors in ASC 280 (e.g., similar products and customers) when assessing whether operating segments are similar for aggregation purposes. Further, at the 2014 AICPA Conference, the SEC staff noted that registrants should consider whether aggregation is consistent with the objective and basic principles of ASC 280.

Changes in Reportable Segments

Example of an SEC Comment

In your Form 8-K filed July 9, 2014, you indicate your board of directors approved your new organizational design at its meeting on June 19, 2014. Please explain why you waited until the first quarter of fiscal 2015 to reevaluate the impact of the Organizational Redesign restructuring program on the determination of your operating segments and reporting units. Please explain why the reclassification of [Brand X] from [Operating Segment A] to [Operating Segment B] was not reflected in your financial statements as of June 30, 2014. Please refer to ASC 280-10-50-34.

Registrants should continually monitor any changes in facts and circumstances that may affect the identification or aggregation of operating segments. Examples of changes that may prompt the SEC staff to seek additional information about registrants' reportable segments include changes in internal reporting after an acquisition and changes in the CODM.

If a registrant changes the structure of its business in a manner that causes the composition of its reportable segments to change, it is required, in accordance with ASC 280-10-50-34 and 50-35, to restate segment information from prior periods for consistency with current reportable segments unless doing so would be impracticable. If a registrant changes the structure of its business after year-end or quarter-end, the new segment structure should not be presented in financial statements until operating results managed on the basis of that structure are reported (typically in a periodic filing such as a Form 10-K or 10-Q). Paragraph 13310.1 of the FRM indicates that "[i]f annual financial statements are required in a registration or proxy statement that includes subsequent periods managed on the basis of the new organization structure, the annual audited financial statements should include a revised segment footnote that reflects the new reportable segments." A registrant can include the revised financial statements (1) in the registration or proxy statement or (2) in a Form 8-K, which can be incorporated by reference. See the SEC Reporting section for more information.

Product and Service Revenue by Segment

Example of an SEC Comment

We note . . . that you offer a number of different products and in your earnings release you also discuss and quantify sales for different products. Please explain to us your consideration of the guidance in FASB ASC 280-10-50-40 with respect to revenues for each product.

Registrants should remember to identify the "[t]ypes of products and services from which each reportable segment derives its revenues" and to report the total "revenues from external customers for each product and service or each group of similar products and services" in accordance with ASC 280-10-50-21 and ASC 280-10-50-40, respectively. The SEC staff has objected to overly broad views of what constitutes "similar" products and services.

Operating Segments and Goodwill Impairment

Registrants should be aware that incorrect identification of operating segments can affect goodwill impairment testing. Goodwill is tested at the reporting-unit level in accordance with ASC 350-20, and reporting units are identified as either operating segments or one level below. If a registrant has not correctly identified its operating segments, it could incorrectly identify its reporting unit and, as a result, improperly test goodwill for impairment. See the Impairments of Goodwill and Other Long-Lived Assets section for additional information.

Information About Geographic Areas

The SEC staff has frequently asked registrants to include disclosures about geographic information in future filings in accordance with ASC 280-10-50-41 unless it is impracticable to do so.

Other Deloitte Resources

- December 15, 2014, *Heads Up*, "Highlights of the 2014 AICPA Conference on Current SEC and PCAOB Developments."
- Financial Reporting Alert 14-3, "Segment Reporting."
- December 16, 2013, *Heads Up*, "Highlights of the 2013 AICPA Conference on Current SEC and PCAOB Developments."

Share-Based Payments

Disclosures

> **Example of an SEC Comment**
>
> Please review the disclosure requirements for stock-based compensation found at ASC 718-10-50 and provide the following disclosures in future annual filings:
>
> - [Please] revise future filings to include the total intrinsic value of options exercised during the year pursuant to ASC 718-10-50-2d2;
> - Please disclose the weighted-average remaining contractual term of options currently exercisable pursuant to ASC 718-10-50-2e; and
> - Please revise future filings to include the method used to estimate the fair value of all of your options, as well as, the significant assumptions used to determine fair value pursuant to ASC 718-10-50-2b & f.

Registrants should ensure that their disclosures address the following objectives outlined in ASC 718-10-50-1:

- The "nature and terms" of share-based payment arrangements.
- The "effect of [the related] compensation cost . . . on the income statement."
- The "method [for determining] the fair value of the equity instruments granted."
- The "cash flow effects [of] share-based payment arrangements."

Accordingly, the SEC staff's comments on share-based payment disclosures have focused on items such as:

- The nature of, and reason for, a modification in the share-based payment award's terms and how the registrant accounted for that modification.
- The terms and conditions of awards, including vesting conditions and whether award holders are entitled to dividends or dividend equivalents.
- The number of awards that are expected to vest, and the assumptions that were used to determine that number.
- The registrant's valuation method, including significant assumptions used (e.g., volatility, expected term, dividend yield).
- The "weighted-average grant-date fair value" of equity instruments granted during the year.
- The "total intrinsic value of options exercised."

In its comments about disclosures, the SEC staff frequently refers to ASC 718-10-50-2, which describes the "minimum information needed to achieve the objectives in [ASC 718-10-50-1]."

In addition, the SEC staff often asks registrants about share-based payment information they are required to include in a proxy statement (e.g., those disclosures required by Regulation S-K, Item 402). See the Executive Compensation and Other Proxy Disclosures section for more information about SEC staff comments on registrants' proxy statements.

Share-Based Payment Awards Issued by Privately Held Companies

> **Example of an SEC Comment**
>
> Please tell us the estimated IPO price range. To the extent there is a significant difference between the estimated grant-date fair value of your common stock during the past twelve months and the estimated IPO price, please discuss for us each significant factor contributing to the difference.

Calculating share-based compensation for privately held companies can be complex and may require registrants to use significant judgment in determining the fair value of the equity instrument because there is typically no active market for the common stock of such companies. The SEC staff continues to comment on registrants' accounting and valuation assumptions for equity securities issued as compensation in periods before an IPO (commonly referred to as "cheap stock" considerations). The AICPA's accounting and valuation guide *Valuation of Privately-Held Company Equity Securities Issued as Compensation* (known as the "Cheap Stock Guide") contains guidance on these accounting considerations.

A registrant preparing for an IPO should also refer to paragraph 7520.1 of the FRM, which outlines considerations for registrants when the "estimated fair value of the stock is substantially below the IPO price." In such situations, registrants should be able to reconcile the change in the estimated fair value of the underlying equity between the award grant date and the IPO by taking into account, among other things, intervening events and changes in assumptions that support the change in fair value.

Whereas the SEC staff had historically asked registrants to expand the disclosures in their critical accounting estimates to provide additional information about the valuation methods and assumptions used for share-based compensation in an IPO, it updated its FRM in 2014 to indicate that registrants should significantly reduce such disclosures. Specifically, Section 9520 of the FRM was revised to clarify what disclosures are expected in an IPO registration statement and thereby encourage registrants to provide less information about cheap stock. However, paragraph 9520.2 of the FRM notes that the staff may continue to "issue comments asking companies to explain the reasons for valuations that appear unusual (e.g., unusually steep increases in the fair value of the underlying shares leading up to the IPO)." Such requests are meant to ensure that a registrant's analysis and assessment support its accounting for share-based compensation and do not necessarily indicate that the registrant's disclosures need to be enhanced.

At the Practising Law Institute's "SEC Speaks in 2014" Conference, the SEC staff provided insights into how registrants would be expected to apply the guidance in paragraph 9520.1 of the FRM (and thereby reduce their share-based compensation disclosures):

- The staff does not expect much detail about the valuation method registrants used to determine the fair value of their pre-IPO shares. A registrant need **only** state that it used the income approach, the market approach, or a combination of both.

  Further, while registrants are expected to discuss the nature of the material assumptions they used, they would **not** be required to quantify such assumptions. For example, if a registrant used an income approach involving a discounted cash flow method, it would only need to provide a **statement** indicating that "a discounted cash flow method is used and [such method] involves cash flow projections that are discounted at an appropriate rate"; no additional details would be needed.

- Registrants would have to include a **statement** indicating that the estimates in their share-based compensation valuations are "highly complex and subjective." They would not need to provide additional details about the estimates.

- Registrants would also need to include a **statement** disclosing that such "valuations and estimates will no longer be necessary once the company goes public [because] once it goes public, it will rely on the market price to determine the market value of [its] common stock."

For a discussion of SEC staff comments related to IPOs, see the Initial Public Offerings section.

Significant Assumptions — The Simplified Method

Examples of SEC Comments

- We . . . note your disclosure does not explain the reasons why you use the simplified method to determine the expected term for your stock options. Please revise your disclosure to include the reasons why the simplified method was used.
- We note your disclosure that you use the simplified method to estimate the expected term of your stock options. Considering the extent of exercise activity since your initial public offering, please explain to us why you continue to believe that it is appropriate to use the simplified method rather than using historical information.

As noted above, the SEC staff's comments have focused on significant assumptions used in a registrant's valuation of share-based payment awards, such as volatility, expected term, and dividend yield. For example, there were a number of comments related to the use of the "simplified method" to calculate the expected term of employee share options. Under ASC 718, the expected term of an option is a key factor for measuring the option's fair-value-based amount and the related compensation cost. In SAB Topic 14, Question 6 of Section D.2 discusses the simplified method[1] of estimating the expected term of "plain-vanilla" share options and permits a registrant to use the simplified method under certain circumstances if the registrant "concludes that its historical share option exercise experience does not provide a reasonable basis upon which to estimate expected term." The SEC staff's comments have focused on a registrant's use of the simplified method, and in certain instances, registrants were asked to explain why they believe that their historical share option experience does not provide a reasonable basis for estimating the expected term.

In accordance with the staff's guidance in Question 6, a registrant that uses the simplified method should disclose in the notes to its financial statements (1) that the simplified method was used, (2) the reason the method was used, (3) the types of share option grants for which the simplified method was used if it was not used for all share option grants, and (4) the period(s) for which the simplified method was used if it was not used in all periods presented.

Other Deloitte Resources

- June 12, 2015, *Heads Up*, "FASB Issues Proposed ASU to Simplify the Accounting for Share-Based Payments."
- April 2015, *A Roadmap to Accounting for Share-Based Payment Awards*.
- April 28, 2014, *Heads Up*, "MD&A Disclosures About 'Cheap Stock' in IPO Transactions."

1 Question 6 states that under the simplified method, the "expected term = ((vesting term + original contractual term) / 2)."

SEC Disclosure Topics

Management's Discussion and Analysis

Regulation S-K, Item 303, provides guidance on the information a registrant should consider providing in its discussion of financial condition and results of operations in MD&A. The SEC staff continues to indicate that MD&A is the leading source of SEC staff comments, many of which are about the results of operations section. While the SEC staff's comments have addressed various topics of MD&A,[1] they have continued to focus on greater transparency in registrants' disclosures about (1) material trends and uncertainties that affect results of operations, (2) liquidity and capital resources, (3) estimates in critical accounting policies, (4) disclosure of contractual obligations, and (5) early-warning disclosures.

The staff continues to stress that registrants should focus on providing disclosures that are material and relevant to their operations. In addition, the SEC staff continues to recommend that registrants consider including an executive overview section in MD&A that contains a balanced discussion of the key drivers, challenges, and risks that affect results of operations and liquidity.[2]

Results of Operations

The SEC staff frequently comments on how a registrant can improve its discussion and analysis of known trends, demands, commitments, events, and uncertainties and their impact on the results of operations. Such discussion and analysis is crucial to a financial statement user's understanding of the quality of, and potential variability in, a company's earnings and cash flows as well as the extent to which reported results indicate future performance. A determination of the appropriate disclosure generally should include (1) consideration of financial, operational, and other information; (2) identification of known trends and uncertainties; and (3) an assessment of whether these trends and uncertainties will have, or are reasonably likely to have, a material impact on the company's financial condition and operating performance.

Example of an SEC Comment

Please revise this section in future filings to include, if material, substantive disclosure on prospective developments and strategies that may affect your company. Your current disclosure . . . contains a list of factors that broadly affect your segments, but there is no disclosure addressing management's views about the trends and uncertainties that you reasonably expect will have a material impact on your operations. We note that . . . management expressed expectations for a number of items including oil prices, global macroeconomic conditions, raw materials, currency fluctuations and end market demand for each of your segments. In the future, to the extent material, please enhance your discussion of any particular trends, events or uncertainties that you expect may have a material impact on your operations. Please see Section III.B.3 of SEC Release 33-8350 and Item 303(a)(3)(ii) of Regulation S-K.

Under Item 303(a)(3), registrants are required to disclose in MD&A material known trends or uncertainties that may affect future performance (whether favorable or unfavorable). Registrants are commonly asked to (1) quantify components of overall changes in financial statement line items and (2) enhance their analysis of the underlying factors that cause such changes or the reasons for the components affecting the overall change — including an analysis of changes at the segment level because such an analysis is often meaningful in MD&A. The SEC staff has suggested that in addition to discussing how volume and product mix affect their results of operations, registrants should consider explaining other potential influences, such as pricing changes, acquisitions, new contracts, inflation, and foreign exchange rates.

For example, at the Practising Law Institute's "SEC Speaks in 2015" Conference, the SEC staff stressed the importance for a registrant to disclose in MD&A the effects of the decline in the price of crude oil, gas, and other commodities (e.g., iron, copper) if the decline materially affects, or is expected to affect, the registrant's operations. In addition, the staff noted that the mining and oil and gas industries may be particularly affected by such a price decline. Further, registrants with foreign operations in regions

1 See paragraphs 9110.1 and 9110.2 of the FRM for the SEC staff's interpretive views about the objectives of a registrant's MD&A.

2 See the SEC's interpretive release for additional information.

experiencing economic struggles (e.g., Greece, Puerto Rico) or that are otherwise exposed to material business or financial risks resulting from recent economic events should discuss in their MD&A any material trends, risks, and uncertainties related to their operations.[3]

The SEC staff has also encouraged registrants to:

- Use appropriate metrics to help them "tell their story" — including those that may be common to their industry (e.g., same-store sales, average subscribers). However, the SEC staff distinguishes such metrics from non-GAAP measures that are adjusted GAAP measures. See the Non-GAAP Financial Measures and Key Metrics section for additional information.

- Present changes in a tabular format (e.g., a table that summarizes disaggregated cost of sales components by reportable segment).

Further, the SEC staff has asked registrants to separately discuss the impact of online sales on their results of operations.

Liquidity and Capital Resources

Example of an SEC Comment

You state that you believe you will have sufficient capital to fund your operations for the next twelve months. Please discuss the company's capital needs over that period, what the capital will be used for, and what sources of capital and liquidity management believes it has access to. Please refer to Item 303(a)(1) of Regulation S-K and Item 303(a)(2)(i) of Regulation S-K.

The SEC staff frequently requests more meaningful analysis in a registrant's MD&A of material cash requirements, historical sources and uses of cash, and material trends and uncertainties so that investors can understand the registrant's ability to generate cash and meet cash requirements. In addition, rather than repeating items that are reported in the statement of cash flows, registrants should (1) concentrate on disclosing the primary drivers of cash flows and the reasons for material changes in specific items underlying the major captions reported in their financial statements and (2) disclose significant developments in liquidity or capital resources that occur after the balance sheet date.

The SEC staff has noted that it is important for registrants to "accurately and comprehensively explain [their] liquidity story" and has advised registrants to consider including discussions of key liquidity indicators, such as leverage ratios and other metrics that management uses to track liquidity.[4] In addition, the SEC staff has indicated that MD&A disclosures should take into account how the following factors, among others, affect a registrant's liquidity:

- Any changes in leverage strategies.
- Any strains on liquidity caused by changes in availability of previously reliable funding.
- Sources and uses of funds.
- Intraperiod debt levels.
- Restrictions on cash flows between the registrant (i.e., the parent) and its subsidiaries.[5]
- The impact of liquidity on debt covenants and ratios.

Registrants should also consider whether they need to provide enhanced disclosures about:

- Significant debt instruments, guarantees, and covenants.[6]
- Effects on liquidity of material cash balances that are held.[7]

[3] For additional information, see Deloitte's Financial Reporting Alert 15-2, "Financial Reporting Implications Related to Regions Experiencing Economic Struggles."

[4] At the 2011 AICPA Conference, the SEC staff highlighted the need for registrants to include appropriate narratives regarding liquidity and capital resources. See Deloitte's December 14, 2011, *Heads Up* for additional information.

[5] See the Debt section for more information.

[6] See footnote 5.

[7] See the Income Taxes section for more information.

Critical Accounting Estimates

> **Example of an SEC Comment**
>
> Please note that the accounting policy notes in the financial statements should generally describe the method you use to apply an accounting principle; whereas the discussion in Management's Discussion and Analysis of Financial Condition and Results of Operations should present your analysis of the uncertainties involved in applying a principle at a given time or the variability that is reasonably likely to result from its application over time. In future filings please include an analysis, to the extent material, of factors such as how you arrived at critical estimates, how accurate the estimate/assumption has been in the past, how much the estimate/assumption has changed in the past, and whether the estimate/assumption is reasonably likely to change in the future. In addition, your disclosure should address sensitivity of the estimate/assumption to change based on other outcomes that are reasonably likely to occur and would have a material effect. Please refer to the Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations, Release No[.] 34-48960.

The critical accounting policies section of MD&A is intended to highlight only those financial statement items that require significant management estimates and judgment. When reviewing the section, the SEC staff has frequently focused on the estimates that management used in valuations (e.g., estimates used in the valuation of pension assets, impairment of long-lived assets, income taxes including DTAs and uncertain tax positions, and fair value determinations). Registrants should not simply copy their accounting policy disclosures from the footnotes to the financial statements. Instead, the SEC staff expects discussion and analysis of material uncertainties associated with assumptions underlying each critical accounting estimate.

To provide comprehensive and meaningful disclosures, management should consider disclosing the following items in the critical accounting policies section of MD&A:

- The method(s) used to determine critical accounting estimates.
- The accuracy of past estimates or assumptions.
- The extent to which the estimates or assumptions have changed.
- The drivers that affect variability.
- Which estimates or assumptions are reasonably likely to change in the future.

In addition, registrants should include an analysis of the sensitivity of estimates to change on the basis of outcomes that are reasonably likely to occur and that would have a material effect. The sensitivity analysis should be quantitative if it is reasonable for registrants to obtain such information.

For more information, see the Pensions and Other Postretirement Benefits and Impairments of Goodwill and Other Long-Lived Assets sections.

Tabular Disclosure of Contractual Obligations

Examples of SEC Comments

- With respect to your purchase obligations, we note the discussion of the types of purchase obligations [is] not included in the table in the paragraph following the table. Please tell us how you considered the definition of purchase obligations in Item 303(a)(5)(ii)(D) of Regulation S-K.
- We note . . . that you have long-term raw material and power supply contracts. Please tell us why you do not report these long-term contracts in your contractual obligations table under Item 303(a)(5) of Regulations S-K. In addition, tell us why amounts due under your revolving credit agreement are also excluded from the table. Please provide revised tabular disclosure of your contractual obligations to be included in future filings which includes these obligations or tell us how your current presentation complies with Item 303(a)(5) of Regulation S-K.

The SEC staff's comments on the contractual obligations table and the associated footnotes and disclosures continue to focus on a registrant's omission of (1) material obligations, such as interest payments on debt, pension obligations, and uncertain tax position liabilities, and (2) disclosures about the terms of obligations, such as those related to purchase obligations.

Some registrants have questioned how obligations subject to uncertainties about timing or amount should be presented in the table of contractual obligations. The SEC staff has noted that registrants should consider their circumstances and use judgment in determining whether to include such information in the table or the footnotes to the table.[8] The staff has also indicated that the footnotes should be used to clarify amounts in the table and to (1) explain the nature of the obligations, including whether they were included in, or excluded from, the table (and the reasons for inclusion or exclusion); (2) describe whether the obligations are subject to uncertainty; and (3) describe the uncertainty.[9]

Early-Warning Disclosures

Item 303 requires disclosure of "any known trends or uncertainties that . . . the registrant reasonably expects will have a material favorable or unfavorable impact on net sales or revenues or income from continuing operations." Early-warning disclosures may give investors insight into (1) when charges may be incurred in the future; (2) whether a charge is related to contingencies, restructuring activities, impairment of goodwill or other long-lived assets, or the settlement of uncertain tax positions; (3) when revenue growth or profit margins may not be sustainable because of underlying economic conditions; or (4) when the registrant will be unable to comply with debt covenants. Accordingly, such disclosures may alert investors to the underlying conditions and risks that the company faces before a material charge or decline in performance is reported.

8 See the highlights of the September 2012 CAQ SEC Regulation Committee joint meeting with the SEC staff for discussion of a registrant's use of judgment related to disclosures in the table of contractual obligations.

9 To the extent that the obligations cannot be quantified, the SEC staff expects registrants to disclose information that investors and users need to understand the nature and extent of the registrant's obligations. As indicated in paragraph 9240.7 of the FRM, registrants may include footnotes "to describe provisions that create, increase or accelerate obligations, or other pertinent data to the extent necessary for an understanding of the timing and amount of the registrant's specified contractual obligations."

SEC Reporting

SEC authoritative literature includes a number of requirements in Regulation S-X that govern the form and content of a registrant's financial statements and other information that must be included in filings with the SEC. The SEC staff often comments on these requirements, and they have been the subject of discussion at a variety of forums, including the annual AICPA Conference, various industry conferences, and joint meetings of the SEC staff and the CAQ SEC Regulations Committee. However, there may be situations in which registrants seek relief from complying with certain SEC reporting rules and regulations. With this in mind, the SEC staff has acknowledged that relief may be warranted in some cases and that registrants may seek to obtain a waiver from the CF-OCA. The SEC staff has provided best practices for registrants to consider when seeking reporting relief.

Further, on September 25, 2015, the SEC announced that it is seeking public comment on the effectiveness of financial disclosure requirements in Regulation S-X, including those related to the form and content of financial disclosures about (1) acquired businesses and the accompanying pro forma financial information, (2) equity method investees, and (3) guarantors and issuers of guaranteed securities.[1] SEC Chairman Mary Jo White indicated that the request for comment, which is part of the SEC's disclosure effectiveness initiative, "is an important step in [the SEC's] review of the disclosure requirements" and "will help [the SEC] evaluate potential changes to Regulation S-X that would benefit both investors and companies."

Private-Company Accounting Alternatives

As noted above and discussed further below, there are instances in which a registrant must provide the financial statements of other entities in its registration statements or periodic filings. Among the entities that meet the definition of a public business entity (PBE) under ASU 2013-12 are those that are "required by the [SEC] to file or furnish financial statements, or [do] file or furnish financial statements (including voluntary filers), with the SEC (including other entities whose financial statements or financial information are required to be or are included in a filing)." PBEs are not permitted to adopt private-company accounting alternatives. Accordingly, the effects of any previously elected private-company accounting alternatives would have to be eliminated from the historical financial statements of an entity whose financial statements are included in the SEC filing of a registrant.

Significant Business Acquisitions (Rule 3-05)

Examples of SEC Comments

- Please tell us how you determined that it was not necessary to provide audited financial statements of [Company A] in accordance with Rule 3-05 of Regulation S-X. Please provide us with your [significance] calculations pursuant to Rule 3-05(b)(2) and Rule 1-02(w) of Regulation S-X.
- The company filed a Form 8-K . . . indicating that it intends to file by amendment the historical financial statements of [Company A], and pro formas reflecting the acquisition, not later than 71 calendar days after the date the Form 8-K was required to be filed. Your registration statement may not be declared effective before the financial statements meeting the requirements of Rule 3-05 of Regulation S-X are provided, if the transaction exceeds the 50% significance level. Please provide us with a reasonably detailed presentation of your significance level computations.

[1] For more information about the SEC's request for comment, see Deloitte's October 6, 2015, *Heads Up*.

When a registrant consummates, or it is probable that it will consummate, a significant business acquisition, the SEC staff may require the registrant to file certain financial statements for the acquired or to be acquired business (acquiree) in accordance with Regulation S-X, Rule 3-05, in a Form 8-K, registration statement, or proxy statement. The following factors govern whether, and for what period, financial statements for the acquiree are required:

- Whether the acquired or to be acquired assets and liabilities meet the definition of a business for SEC reporting purposes. The definition of a business for SEC reporting purposes under Regulation S-X is not the same as the definition under ASC 805 for U.S. GAAP purposes.
- The significance of the acquired or to be acquired business. The significance is calculated on the basis of three tests: the investment (purchase price) test, the asset test, and the income test.
- Whether consummation of the business acquisition is probable or has occurred.

The SEC staff comments on the application of Rule 3-05 in connection with significant business acquisitions when registrants:

- Incorrectly determine that the acquired or to be acquired assets and liabilities do not meet the definition of a business for SEC reporting purposes.
- Do not perform the significance calculations correctly. Some of the most common mistakes are misapplications of the income test, such as excluding unusual or one-time gains or losses from the test.
- Do not realize that Rule 3-05 also applies, in a registration statement or certain proxy statements, to probable acquisitions whose significance is greater than 50 percent.
- Do not consider, in a registration statement or proxy statement, the cumulative significance of previously consummated individually insignificant acquisitions.

The staff may also question the financial statements provided by a registrant under Rule 3-05 when the registrant has acquired only selected parts of an entity. In such situations, it may be appropriate, on the basis of the facts and circumstances, for the registrant to include (1) full financial statements of the entity, (2) carve-out financial statements of the assets and operations acquired, or (3) abbreviated financial statements (i.e., Statement of Assets Acquired and Liabilities Assumed; Statement of Revenue and Direct Expenses). For additional information about how to determine what financial statements are appropriate when the registrant has acquired selected parts of an entity, see Section 2065 of the FRM.

Investments in Equity Method Investees (Rules 4-08(g) and 3-09)

Example of an SEC Comment

Please tell us why you have not presented the summarized financial data under Rule 4-08(g) of Regulation S-X for your equity method investments for the years presented. Additionally, please provide us with your significance test with respect to income before continuing operations before income taxes to determine whether the financial statements of [Company A] are required under Rule 3-09 of Regulation S-X. Please refer to Rule 1-02(w)(3) of Regulation S-X.

When a registrant has a significant equity method investment, Regulation S-X, Rules 4-08(g) and 3-09, may require the registrant to provide summarized financial information of the investee in the footnotes to the financial statements, separate financial statements of the investee, or both. To determine whether summarized information is required under Rule 4-08(g), a registrant must perform all three significance tests: the investment test, the asset test, and the income test.

Under Rule 3-09, significance is calculated for equity method investees on the basis of only two tests performed annually: the investment test and the income test. If an investee is significant, its separate financial statements must be filed in the registrant's Form 10-K or in a related amendment. Thus, a registrant's compliance with Rule 3-09 is particularly important because its failure to file the financial statements of a significant investee may cause it to become a delinquent filer and lose Form S-3 eligibility.

Common errors that registrants make when performing the significance tests under Rules 4-08(g) and 3-09 include:

- Failure to document the tests each year. This is most common when an equity method investee has been clearly insignificant in the past. In certain situations, such as a near-break-even year for the registrant or a large income or loss at the investee level, the current year's significance may change, making the equity method investee significant for the first time and thus requiring audited financial statements for the current year and unaudited financial statements for prior years.
- Failure to update the tests each year. Registrants should update and reassess the significance tests for all years presented in a Form 10-K after they report a retrospective change, such as a change in accounting principle or classification of a component as a discontinued operation. See paragraph 2410.8 of the FRM.

For additional SEC staff interpretations of Rules 4-08(g) and 3-09, see Section 2400 of the FRM.

Restrictions on Dividends (Rules 4-08(e), 5-04, and 12-04)

Registrants must consider the requirements of Regulation S-X, Rules 4-08(e), 5-04, and 12-04, when the transfer of assets (cash or other funds) to the parent company/registrant from its subsidiary (or subsidiaries) or equity method investee (1) is materially restricted, (2) is limited, or (3) requires a third party's approval.

For additional discussion, see the Debt section.

Guarantors of Registered Securities (Rule 3-10)

Regulation S-X, Rule 3-10, requires a registrant to provide separate financial statements for each subsidiary issuer or guarantor of debt securities registered or being registered unless certain criteria are met. The information required under Rule 3-10 must be presented in registration and proxy statements as well as Forms 10-K and 10-Q. Therefore, a registrant should consider the requirements under Rule 3-10 if (1) the registrant registers debt and the debt is guaranteed by one or more of its subsidiaries or (2) one of the registrant's subsidiaries registers debt and the debt is guaranteed by the parent company or one or more of its other subsidiaries.

Rule 3-10 contains certain exceptions under which a registrant may provide more limited financial information in lieu of full financial statements. If the registrant meets the exception criteria, it may be eligible to provide, in a footnote to the parent company's financial statements, either of the following types of modified financial information in lieu of separate financial statements:

- Condensed consolidating financial information.
- Narrative disclosures about each subsidiary issuer or guarantor.

While each of the exceptions under Rule 3-10 has additional provisions that must be met for a registrant to qualify for the relief, all of them require (1) the subsidiary issuer and guarantors to be "100 percent owned" by the registrant and (2) the guarantee to be "full and unconditional." The SEC staff sometimes comments on whether the registrant specifically meets these and other criteria necessary for the presentation of modified financial information.

For additional SEC staff interpretations of Rule 3-10, see Section 2500 of the FRM.

Definition of 100 Percent Owned

> **Example of an SEC Comment**
>
> It is not clear that you have provided all of the disclosures required by Rule 3-10(i)(8) to (11) of Regulation S-X. For example, pursuant to Rule 1-02(aa) of Regulation S-X, wholly-owned is not equal to 100% owned.

Registrants must disclose that a subsidiary is 100 percent owned to meet one of the conditions for relief under Rule 3-10. The SEC staff has reminded registrants that under Regulation S-X, "100 percent owned" does not mean the same thing as "wholly owned" and that the terms are therefore not interchangeable. The staff has indicated that wholly owned under Regulation S-X, Rule 1-02, means that the parent owns substantially all of the outstanding voting stock of the subsidiary whereas 100 percent owned is defined as ownership of all outstanding shares of the subsidiary. For further clarification of the definition of 100 percent owned, see Rule 3-10(h)(1).[1]

Full and Unconditional Guarantees and Release Provisions

> **Example of an SEC Comment**
>
> Your disclosure indicates that the subsidiary guarantees are full and unconditional. We note that the related indenture agreements contain certain release provisions. For example, . . . there are provisions under which the guarantees shall automatically terminate or the subsidiary guarantor shall be released and discharged from all obligations. Please tell us what consideration you gave to disclosing such release provisions to the full and unconditional guarantees in order to more accurately describe the qualifications to the subsidiary guarantors.

A guarantee must be full and unconditional to allow the registrant to provide limited financial information in lieu of full financial statements under Rule 3-10. Paragraph 2510.4 of the FRM clarifies that an "arrangement that permits a guarantor to opt out of its obligation prior to or during the term of the debt is not a full and unconditional guarantee." However, a subsidiary whose guarantee is released automatically by one of the customary release provisions referred to in paragraph 2510.5 of the FRM may rely on the relief provided by Rule 3-10. Accordingly, registrants should disclose any qualifications of subsidiary guarantees and should not characterize a subsidiary guarantee as full and unconditional without disclosing the circumstances under which it can be released.

The FRM's guidance on customary release provisions applies only to subsidiary guarantees, not to parent guarantees. The SEC staff has clarified that to qualify for Rule 3-10 relief, a registrant must meet certain conditions specified in the rule, one of which is the filing of the parent company's financial statements for the periods indicated. Therefore, if the parent could be released from its guarantee, there would be no basis for relief under Rule 3-10. However, the staff has allowed limited exceptions to parent release provisions, such as situations in which the parent's guarantee is released when the debt is repaid. Registrants are encouraged to contact the staff regarding any parent release provisions in their debt indentures.

[1] Registrants may wish to consult legal counsel when interpreting Rule 3-10(h)(1).

Condensed Consolidating Financial Information

Examples of SEC Comments

- [T]ell us your consideration of the need to include a separate column for the condensed consolidating financial information of the subsidiary issuer(s). Refer to Rule 3-10 (b)–(f) of Regulation S-X.
- Please tell us the consideration you gave to presenting the material components of investing and financing activities in your condensed consolidating statements of cash flows. Refer to Rule 3-10(i)(1) and Rule 10-01(a)(4) of Regulation S-X.

If a registrant presents condensed consolidating financial information, it should use a columnar format and include certain or all of the following as applicable: (1) the parent, (2) subsidiary issuer(s) of the security, (3) subsidiary guarantor(s), (4) nonguarantor subsidiaries, and (5) consolidating adjustments. Registrants should also provide sufficient detail about the assets, liabilities, operations, and cash flows for each of the parent, issuer, subsidiary guarantors, and nonguarantor subsidiaries, as appropriate.

The SEC staff often discusses form and content considerations related to the preparation of condensed consolidating financial information under Rule 3-10 and has highlighted that under this rule:

- The information should be presented at the same level of detail (i.e., the major financial statement captions) as interim financial statements prepared in accordance with Regulation S-X, Article 10.
- The information should be presented in accordance with U.S. GAAP[2] (e.g., intercompany receivables should be shown as an asset and not as a negative liability).
- The classifications in the condensed consolidated statement of cash flows should also comply with U.S. GAAP (i.e., gross versus net reporting, investing versus financing classification).
- A total for comprehensive income should be presented in either a single continuous statement or two separate but consecutive statements.[3]

The SEC staff may also comment when a registrant:

- Incorrectly assumes that certain exceptions in Rule 3-10 are met and therefore concludes that it does not have to provide separate financial statements, condensed consolidating financial information, or narrative disclosures.
- Incorrectly prepares the required condensed consolidating financial information by not presenting subsidiaries under the equity method of accounting, or not presenting information in sufficient detail to allow investors to determine the assets, results of operations, and cash flows of each of the consolidating groups.

The SEC staff has also commented when the parent (or guarantor) has recorded positive operating cash flows in a particular period in the absence of any revenue-generating activities during that time frame. Positive cash flow from operations often results when the parent (or guarantor) classifies dividends received from its subsidiaries as a "return on its investment." In accordance with ASC 230-10-45-16(b) and ASC 230-10-45-12(b), the parent (or guarantor) should consider its particular facts and circumstances when determining whether the cash flows resulting from a dividend distribution represent a "return on" or a "return of" the related investment in the underlying subsidiary. The SEC staff may ask registrants to disclose (1) how they have accounted for such dividends and (2) the amount of dividends received from subsidiaries included in cash flows from operations. For more information about the SEC staff's comments regarding cash flow statement classification, see the Financial Statement Classification, Including Other Comprehensive Income section.

[2] One exception is that investments in subsidiaries should be presented under the equity method of accounting. See Rule 3-10(i)(5).

[3] The SEC staff has clarified that a registrant should present total comprehensive income in a manner consistent with the interim requirements for the registrant's primary financial statements. See paragraphs 2515.2 and 2810.1 of the FRM for additional information.

Recently Acquired Subsidiary Issuers or Subsidiary Guarantors (Rule 3-10(g))

Under Rule 3-10(g), which applies to recently acquired subsidiary issuers or subsidiary guarantors, a registrant must provide separate financial statements of a significant subsidiary issuer or guarantor if the subsidiary's historical results have not been included in the parent's audited financial statements for at least nine months of the most recent fiscal year. The SEC staff has noted that the significance test under Rule 3-10(g) is different from the tests under Rule 3-05 for businesses acquired or to be acquired (see Significant Business Acquisitions (Rule 3-05) above). To determine significance under Rule 3-10(g), a registrant should compare the subsidiary's net book value or purchase price (whichever is greater) with the principal amount of the securities being registered. If the test result equals or exceeds 20 percent, the registrant must file separate financial statements of the acquired subsidiary that are (1) audited in accordance with the standards of the PCAOB for the most recent fiscal year and (2) unaudited for the appropriate interim period preceding the acquisition.

In computing significance under Rule 3-10(g), a registrant must aggregate the acquisitions of a group of related subsidiary issuers or guarantors before their acquisition. A registrant is also required to include financial statements in registration statements but not in periodic reports filed under the Exchange Act (e.g., Forms 10-K and 10-Q).

Pro Forma Financial Information (Article 11)

Examples of SEC Comments

- [P]lease explain the adjustments for the acceleration of certain profits interests awards from [Company A] as a result of the offering. Tell us why these adjustments are considered factually supportable, directly attributable to the transaction, and expected to have a continuing impact on the statement of operations. Refer to Rule 11-02(b)(6) of Regulation S-X.
- We note the terms and form of future earn-out payments . . . have not been finalized. . . . As a range of terms are under consideration, you should provide additional pro forma presentations which give effect to the range of possible results, consistent with the guidance in Rule 11-02(b)(8) of Regulation S-X. This information should fully address the anticipated impact upon future results of operations, earnings per share, and ownership percentages.

Pro forma information is required under Regulation S-X, Article 11, when (1) it is material to an understanding of a significant consummated or probable transaction, such as a business combination; (2) a transaction is subject to a shareholder vote; or (3) other conditions outlined in Article 11 are met. Pro forma financial information under Article 11 may be required in a registration statement, proxy statement, or Form 8-K, but it is not required in a Form 10-K or 10-Q. Although Article 11 pro forma financial statements are not required in a registrant's Form 10-K or 10-Q, a registrant must separately evaluate the need for supplemental pro forma disclosures under ASC 805 (related to business combinations) in its financial statements included in a Form 10-K or 10-Q. See the Business Combinations section for more information about supplemental pro forma disclosures that are required under U.S. GAAP.

Registrants should generally present Article 11 pro forma financial statements in columnar form with separate columns for historical financial information, pro forma adjustments, and pro forma results. In limited circumstances, registrants may present narrative disclosures in lieu of pro forma financial statements. Further, Article 11 requires pro forma balance sheet adjustments to reflect events that are (1) factually supportable and (2) directly attributable to the transaction. In addition, pro forma income statement adjustments must have a "continuing impact" on the registrant's operations (i.e., they are not "one time").[4] The SEC staff continues to comment on certain form and content matters, such as when a registrant fails to clearly explain each financial statement adjustment or does not clearly demonstrate how the above requirements are met.

[4] The SEC staff has expanded on its view of what would constitute continuing impact. See the highlights of the June 2012 and March 2013 CAQ SEC Regulations Committee joint meetings with the SEC staff for additional information.

When calculating pro forma adjustments, registrants should assume that the transaction occurred (1) as of the date of the most recent balance sheet for the pro forma balance sheet and (2) at the beginning of the fiscal year presented for the pro forma income statement. In the past, the SEC staff has clarified that this guidance applies only to calculating the amount of the pro forma adjustment and should not be used to determine whether an adjustment is appropriate. For example, in the preparation of a pro forma income statement, it would be inappropriate for a registrant to make a pro forma adjustment for a charge in the historical financial statements on the basis of an assertion that if the transaction had been consummated at the beginning of the year, the charge would not have been incurred.

For companies doing an IPO, the SEC staff has clarified that it would be rare for costs "that a company expects to incur as a public company" to be pro forma adjustments "since such costs are not directly attributable to the transactions for which pro forma information is presented."[5] However, the staff has noted that depending on the facts and circumstances, a registrant may disclose the types and ranges of such costs in the notes to the pro forma financial information. For additional reporting considerations related to IPOs, see the Initial Public Offerings section.

Further, transactions may be structured in a manner such that significantly different results may occur. In these instances, registrants should comply with the requirement under Regulation S-X, Rule 11-02(b)(8), to disclose additional pro forma information that gives effect to the range of possible outcomes resulting from the transaction.

Section 3300 of the FRM summarizes issues that are often associated with pro forma financial information.

[5] Quoted text is from the highlights of the March 2012 CAQ SEC Regulations Committee joint meeting with the SEC staff.

Disclosures About Risk

The SEC staff continues to expect registrants to provide investors with tailored, comprehensive, and transparent risk disclosures.

Risk Factors

Example of an SEC Comment

Some of your risk factors appear to combine separate risk factors under one heading. Please review each risk factor heading to ensure it clearly conveys a separate, detailed risk to investors regarding your company, industry or security.

In recent years, the SEC staff has emphasized that registrants should present tailored risk factors in their filings and avoid using boilerplate language. In an April 11, 2014, speech[1] highlighting the SEC staff's "disclosure effectiveness" initiative, a staff member indicated that "risk factors could be written better — less generic and more tailored — and they should explain how the risks would affect the company if they came to pass."

Accordingly, the SEC staff routinely asks registrants to replace boilerplate risk disclosures with a discussion of the risks that specifically affect the registrant and their possible impact on the registrant's business. Instead of combining separate risk factors under a single heading and providing a general discussion, registrants are asked to review each risk factor heading to ensure that it clearly conveys and adequately describes a separate, detailed risk to investors. In addition, the SEC staff requests more specific discussion and enhanced explanations of how the risks could materially affect the registrant's business. This discussion may be supplemented with quantitative information to provide additional context about the risks. In addition, the staff often asks registrants whether they have (1) discussed all relevant risk factors and (2) provided sufficient MD&A discussion when a risk constitutes a material trend or uncertainty.

Cybersecurity

Example of an SEC Comment

We note that you may have been subject to [distributed denial of service] attacks in the past. Please clarify whether you have knowledge of the occurrence of any such attacks in the past. If attacks have occurred, and were material either individually or in the aggregate, revise to discuss the related costs and consequences. For additional guidance, consider our CF Disclosure Guidance: Topic No. 2 on Cybersecurity.

The SEC staff has noted the increasingly frequent occurrence of cyberincidents, which may cause registrants to incur significant remediation and other costs for (1) direct damages (both real and reputational), (2) the impact on their customers, and (3) increased protection from future cybersecurity attacks. It is important for registrants to consider the nature of any cyberincidents that occur and to provide the appropriate level of disclosure about such incidents in their filings.

Currently, there are no SEC rules that explicitly require registrants to disclose cybersecurity-related matters in their filings. Therefore, some registrants' cybersecurity disclosures have been viewed as generic and uninformative. However CFDG Topic 2 provides SEC staff views on potential disclosures related to material cybersecurity matters. CFDG Topic 2 indicates that under existing SEC requirements, registrants may need to provide disclosures in various sections of an SEC filing, including risk factors, legal proceedings, MD&A, and the financial statements. For example, cybersecurity risks and cyberincidents may constitute material known trends and uncertainties that registrants should consider disclosing in MD&A in accordance with Regulation S-K, Item 303(a)(3)(ii).

[1] Keith Higgins, director, Division of Corporation Finance, "Disclosure Effectiveness: Remarks Before the American Bar Association Business Law Section Spring Meeting," April 11, 2014.

In cybersecurity disclosures, registrants should avoid using boilerplate language and instead should include information such as (1) the aspects of the business that are subject to cybersecurity risks, (2) updates for new information, and (3) cost estimates, if possible and material. Registrants should not state that there is a risk of a cybersecurity breach after the occurrence of an actual cyberattack; rather, such registrants should disclose that they have experienced security breaches or cyberattacks.

Accordingly, the SEC staff may monitor information outside a registrant's filings and ask why certain cyberincidents are not disclosed. Further, a registrant may be asked to confirm that it has disclosed the occurrence of material cyberincidents in its filings.

Other Deloitte Resources

- October 16, 2014, *Heads Up*, "SEC Staff Suggests Ingredients for Effective Disclosures."
- August 26, 2014, *Heads Up*, "The Road to Effective Disclosures."
- April 8, 2014, *Heads Up*, "Highlights of the SEC's Cybersecurity Roundtable."
- March 20, 2014, *Heads Up*, "Highlights of the 'SEC Speaks in 2014' Conference."

Non-GAAP Financial Measures and Key Metrics

Example of an SEC Comment

We note your presentation of the line item "net revenue" here and in the financial statement table within MD&A, which you describe on page 22 of MD&A as revenue minus transportation costs. As you appear to generally be the primary obligor for generally recognizing gross revenues under ASC Topic 605-45-45 and you report gross revenue in your audited financial statements, presenting "net revenue" appears to be a non-GAAP measure under Item 10(e) of Regulation S-K for which a tabular presentation reconciling net revenue to the most directly comparable GAAP measure would be necessary. As such, please revise the tables in Selected Financial Data and MD&A to disclose that the line item net revenue represents a non-GAAP measure. In a footnote to the tables, please describe how this measure is calculated and further, how it is used by management and how it should be used by an investor. Please revise in future filings.

SEC Rule 33-8176 defines a non-GAAP financial measure as a "numerical measure of a registrant's historical or future financial performance, financial position or cash flows" that includes amounts that are not part of the most directly comparable GAAP measure or excludes amounts that are part of the most directly comparable GAAP measure. Common non-GAAP financial measures include EBITDA or adjusted EBITDA, adjusted revenues, free cash flows, core earnings, funds from operations, and measures presented on a constant-currency basis.

Regulation S-K, Item 10(e)(1)(i), states that for financial measures used in documents that are filed with the SEC, the following information should accompany a registrant's disclosure of non-GAAP financial measures:

(A) A presentation, with equal or greater prominence, of the most directly comparable financial measure or measures calculated and presented in accordance with [GAAP];

(B) A reconciliation (by schedule or other clearly understandable method), which shall be quantitative for historical non-GAAP measures presented, and quantitative, to the extent available without unreasonable efforts, for forward-looking information, of the differences between the non-GAAP financial measure disclosed or released with the most directly comparable financial measure or measures calculated and presented in accordance with GAAP . . . ;

(C) A statement disclosing the reasons why the registrant's management believes that presentation of the non-GAAP financial measure provides useful information to investors regarding the registrant's financial condition and results of operations; and

(D) To the extent material, a statement disclosing the additional purposes, if any, for which the registrant's management uses the non-GAAP financial measure that are not disclosed pursuant to [subparagraph (C) above].

At the 2013 AICPA Conference, the SEC staff noted that it continues to focus on disclosures of non-GAAP measures and particularly on whether registrants have (1) clearly labeled and described non-GAAP measures and adjustments (e.g., titles should not be confusingly similar to those of GAAP financial measures), (2) used appropriate conventional accounting terminology, and (3) provided context for their presentation.

Further, the SEC staff has indicated that a registrant should not present non-GAAP measures if they are misleading — regardless of whether the registrant intends to use them in or outside a filing. In addition, the staff has indicated that the following items should not be excluded from non-GAAP financial measures:

- Expenses that are necessary to run the business, such as traditional recurring cash operating expenses.
- The largest expenses that are necessary to generate the registrant's revenues.

The staff has also indicated that registrants should not eliminate recurring cash charges from a profit measure in a misleading way. When the staff believes that a registrant's presentation of a non-GAAP measure is misleading, it may take action in addition to issuing a comment, which could include bringing an enforcement action against the registrant.

In addition, the staff often comments when adjustments to non-GAAP measures are labeled as nonrecurring, infrequent, or unusual. Regulation S-K, Item 10(e), prohibits registrants from adjusting a non-GAAP financial performance measure "to eliminate or smooth items identified as non-recurring, infrequent or unusual, when the nature of the charge or gain is such that it is reasonably likely to recur within two years or there was a similar charge or gain within the prior two years." Question 102.03 of the C&DIs related to non-GAAP financial measures clarifies that guidance by indicating that a charge or gain may be included as an adjustment as long as it is not inappropriately labeled or described as nonrecurring, infrequent, or unusual.

Liquidity Versus Performance Measures

Example of an SEC Comment

We note that you reconcile your non-GAAP measure, Adjusted EBITDA, to net income attributable to [Company A]. Because you adjust this measure for changes in deferred revenue and course expenses, effectively reflecting cash disbursements and receipts as opposed to earned revenues and incurred expenses, it appears to be a measure of liquidity as opposed to performance. Therefore, we believe the most directly comparable GAAP measure is cash provided by operating activities rather than net income. Please advise or revise accordingly.

The SEC staff has continued to comment when a non-GAAP financial measure is not reconciled to the appropriate GAAP measure as determined on the basis of whether the purpose of the non-GAAP measure is to assess the registrant's performance or its liquidity. For example, the staff has indicated that the most directly comparable GAAP measure for reconciling EBITDA and adjusted EBITDA is typically net income (loss) for a performance measure and cash flows from operating activities for a liquidity measure.

Relevance and Consistency of Non-GAAP Measures

Examples of SEC Comments

- We note your disclosure of the non-GAAP measures free cash flow, EBIT, and ongoing EPS. Furthermore, your disclosure states that "the presentation of non-GAAP financial measures is intended to supplement investor's understanding of our operating performance." It appears your disclosures are overly general and therefore, not consistent with the objective of Item 10(e)(1)(i) of Regulation S-K. Please revise to include disclosure concerning the reasons why the management believes that presentation of the non-GAAP financial measure provides useful information to investors in accordance with Instruction 2 to Item 2.02 of Form 8-K and Item 10(e)(1)(i) of Regulation S-K.
- While three of the factors disclosed in the press release and the Form 10-Q are the same, there are two factors disclosed in the press release that were not included in the Form 10-Q and one factor in the Form 10-Q that was not included in the press release. Please help us understand why there appears to be an inconsistency between the press release and the Form 10-Q.

The SEC staff has continued to comment on the extent of a registrant's disclosures and whether the disclosures demonstrate the purpose of the measures (i.e., how management uses them and their usefulness to investors).

Further, the SEC staff focuses on consistency in communications with investors. It may ask a registrant about inconsistencies between (1) the non-GAAP measures identified in information disclosed outside the registrant's SEC filings, such as on its Web site and in its press releases, earnings calls, and analyst presentations, and (2) the non-GAAP measures in the registrant's SEC filings. The SEC staff has noted that it does not require registrants to use non-GAAP measures in their filings. However, the staff may comment if a registrant discusses non-GAAP financial measures in other communications to investors but such discussion is omitted from, or contradicts, the information in the registrant's filings. In addition, if a non-GAAP measure is the focal point in all of a registrant's outside communications but is not included in filed documents, the SEC staff may ask why.[1]

Undue Prominence of a Non-GAAP Financial Measure

Example of an SEC Comment

We note that you present full non-GAAP income statements for the three months ended December 31, 2014 and 2013. We believe that the presentation of a full non-GAAP income statement attaches undue prominence to the non-GAAP information, results in the creation of many additional non-GAAP measures, and may give the impression that the non-GAAP income statement represents a comprehensive basis of accounting. Please confirm to us that you will revise your presentation to provide relevant information to investors without providing full non-GAAP income statements in future filings. For additional guidance, please refer to [Question 102.10 of the C&DIs related to non-GAAP financial measures].

The SEC staff will comment when a registrant presents its non-GAAP financial measures more prominently than its GAAP measures in terms of the order of presentation or the degree of emphasis. A registrant may receive a comment if its discussion of non-GAAP financial measures is significantly longer than its discussion of the corresponding GAAP financial measures, or if it uses a full non-GAAP income statement format that is generally not appropriate under Question 102.10 of the C&DIs related to non-GAAP financial measures. In recent comments, the SEC staff has indicated that as a substitute for presenting a full non-GAAP income statement, registrants may consider presenting only individual non-GAAP measures (e.g., line items) as long as each measure is used in a manner consistent with Regulation S-K, Item 10(e)(1)(i).

Key Metrics

Example of an SEC Comment

We note your discussion . . . of the number of your customers and your annual dollar-based net expansion rate. Please tell us what consideration you have given to discussing these metrics, as well as other measures you use to evaluate your business, in a separately titled section and discussing any trends in such metrics and related material impacts on your business. For example, it appears that the growth rates of property manager customers and law firm customers are slowing. See Item 303(a) of Regulation S-K, and for additional guidance, refer to Section III.B of SEC Release No. 33-8350.

A registrant may include in its SEC filings unique financial or operating metrics (e.g., same-store sales, average rental rates, number of online users, room night stays, catalogs mailed) to illustrate the size and growth of its business. In public remarks, the SEC staff has stated that (1) metrics may differ from non-GAAP measures and (2) it is generally not referring to non-GAAP measures when discussing metrics.

At the "SEC Speaks in 2015" Conference, the SEC staff discussed metrics used in registrants' IPO registration statements and periodic filings. The staff indicated that because not all investors may be familiar with a registrant's metrics, such metrics should be discussed informatively. Accordingly, a registrant should (1) clearly define the metrics used and how they are calculated, (2) describe any important assumptions and limitations of the metrics (e.g., whether the metric is a "hard" amount or

[1] The SEC staff discussed this topic at the 2010 AICPA Conference. See Deloitte's December 16, 2010, *Heads Up* for additional information.

an estimate), (3) present a metric within a balanced discussion, and (4) clearly describe how a metric is related to current or future results of operations. A registrant should also consider disclosing how management uses specific metrics and why they are important to investors. In addition, the staff indicated that because metrics evolve over time, it expects registrants to disclose what the changes are and the reasons for using a new metric.

A registrant must use judgment in determining whether to include metrics in its filings. The staff noted at the "SEC Speaks in 2015" Conference that registrants should ask themselves the following questions in making this determination:

- Is the metric integral to the story?
- Does the metric help investors understand changes quickly and effectively?
- Is the metric discussed outside of periodic filings (e.g., in earnings calls or supplemental packages)?

Disclosure Controls and Procedures

In discussions of disclosure controls and procedures (DC&P)[1] registrants must use language that conforms to the requirements in Rule 13a-15(e) or Rule 15d-15(e) of the Exchange Act.[2] The SEC staff often comments when registrants do not use the proper definition of DC&P or omit certain language in reaching conclusions about the effectiveness of their DC&P. In these situations, the staff frequently requires registrants to confirm that their DC&P are effective in the current year and to revise their disclosures in future filings.

Inappropriate Conclusion About DC&P

Example of an SEC Comment

We note your statement that your disclosure controls and procedures are not effective for a company your size. Please revise to remove the qualifier "for a company our size." Refer to Item 307 of Regulation S-K, which requires a clear and unqualified statement as to whether your disclosure controls and procedures are effective or ineffective.

The SEC staff has noted that management must clearly state, without using any qualifying or alternative language, its conclusion about whether DC&P are "effective" or "ineffective" as of the end of the respective quarter. Examples of unacceptable language include phrases such as "adequate," "effective except for," "effective except as disclosed below," or "reasonably effective."

The SEC staff has also commented when registrants refer to the level of assurance of the design of their DC&P. Although registrants are not required to discuss such assurance, the staff has asked registrants that choose to do so to also state clearly whether the DC&P are, in fact, effective at the "reasonable assurance" level.

In addition, when registrants have concluded that their DC&P are ineffective, the staff has asked them to discuss how they intend to remedy the deficiencies identified.

Incomplete, Inconsistent, or Inaccurate Information in Disclosure About DC&P

Examples of SEC Comments

- We note your Chief Executive Officer and Chief Financial Officer concluded that your disclosure controls and procedures as of June 30, 2014 were effective; however, you did not include the definition of disclosure controls and procedures or refer to such definition as stated in the Exchange Act Rules. Please confirm to us, if true, that your officers concluded your disclosure controls and procedures are effective as of June 30, 2014, to ensure that the information required to be disclosed by the company in reports that it files under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Commission´s rules and forms and also to ensure that information required to be disclosed in the reports that you file or submit under the Exchange Act is accumulated and communicated to management, as appropriate, to allow timely decisions regarding required disclosure. Further, in future filings, revise your disclosures to include the full definition of disclosure controls and procedures or clearly indicate that the evaluation was made with respect to disclosure controls and procedures as defined in Rule 13a-15(e) and 15d-15(e) of the Exchange Act. We refer you to Item 307 of Regulation S-K.
- The disclosure . . . that management concluded that your [DC&P] were effective [as of] December 31, 2013 is not consistent with your risk factor [regarding which] you disclose that management concluded that your DC&P were not effective due to the existence of certain material weaknesses.

[1] Under Part I, Item 4, of Form 10-Q and Part II, Item 9A, of Form 10-K.

[2] As required by Regulation S-K, Item 307.

Registrants are not required to define DC&P in their conclusion (they may refer to the definition in the Exchange Act Rules instead). However, if they choose to define the term, they must use the entire definition in Rule 13a-15(e) or Rule 15d-15(e). The SEC staff has commented when registrants (1) define DC&P but do not use the entire definition or (2) neither fully define DC&P nor refer to the definition in the Exchange Act. In addition, the staff has commented when a registrant's DC&P disclosure (1) is inconsistent with other disclosures in the filing or previous filings or (2) does not contain all of the required information.

Conclusion That DC&P Were Effective If a Restatement Is Required, a Material Weakness Exists, or Reports Were Not Filed in a Timely Manner

Examples of SEC Comments

- We note your disclosure of a material weakness related to the failure to maintain qualified accounting personnel. Your disclosure describes certain remediation efforts and states that you expect remediation to continue. Given [that ICFR is] an integral part of [DC&P], please tell us how you came to the conclusion that your material weakness related to ICFR did not impact your conclusion on the effectiveness of your DC&P or amend to revise your conclusion on the effectiveness of your DC&P.
- [P]lease consider whether management's failure to perform or complete its report on internal control over financial reporting impacts its conclusions regarding the effectiveness of your disclosure controls and procedures as of June 30, 2014 and revise your disclosure as appropriate.

Paragraph 4310.9 of the FRM states, "Because of the substantial overlap between ICFR and [DC&P], if management concludes that ICFR is ineffective, it must also consider the impact of the material weakness on its conclusions related to [DC&P]." If a registrant concludes that its DC&P are effective when a material weakness exists, the SEC staff often asks for information on the factors the registrant considered in reaching such a conclusion. In addition, when a registrant is required to file amended periodic reports containing restated financial statements, the SEC staff generally asks the registrant to reconsider its conclusions about the effectiveness of its DC&P.

The SEC staff has also asked about management's conclusion that DC&P were effective when a registrant did not file periodic reports in a timely manner. A registrant should design DC&P to ensure that information disclosed in its reports filed or submitted under the Exchange Act is recorded, processed, summarized, and reported within the periods specified in the SEC's rules. If the registrant does not report such information within these periods, the staff may request the registrant to supply additional information to support management's conclusion.

A Change in the Conclusion That DC&P Were Effective If No Changes to ICFR Were Disclosed

Example of an SEC Comment

You concluded your disclosure controls and procedures were effective as of September 30, 2014. In forming this conclusion, please tell us how you considered the following: (a) the three material weaknesses you had as of December 31, 2013, (b) your internal control over financial reporting was not effective as of December 31, 2013, (c) your disclosure controls and procedures were not effective as of December 31, 2013, March 31, 2014 and June 30, 2014 and (d) you disclosed in each of your Forms 10-Q filed during 2014 that no material changes in your internal control over reporting had occurred. Please also tell us the factors you considered to support management's conclusion that your disclosure controls and procedures were effective as of September 30, 2014. Please revise your disclosures regarding changes in your internal control over financial reporting and corrections of material weaknesses, as appropriate. Otherwise, please amend your Form 10-Q for the period ended September 30, 2014 to disclose, if true, your disclosure controls and procedures were not effective as of September 30, 2014.

If a registrant concludes that its DC&P were effective after a period in which the DC&P had been deemed ineffective, the SEC staff may ask the registrant to explain the basis for its conclusion. The SEC staff is especially likely to do so if the registrant has disclosed in the same period that there have been no changes to its ICFR.

Internal Control Over Financial Reporting

In addition to disclosing material changes in ICFR on a quarterly basis,[1] a registrant must annually provide management's report on ICFR and, if applicable, the attestation report of the registrant's registered public accounting firm.[2] These reports are not required in registration statements or Form 11-K.[3] Further, newly public companies generally do not need to provide management's report on ICFR in the first Form 10-K that they file after their initial public registration statement is declared effective.[4] In addition, the JOBS Act amended Section 404(b) of the Sarbanes-Oxley Act by exempting emerging growth companies (EGCs) from the requirement to obtain an attestation report on ICFR for as long as such entities retain their EGC status. See the Emerging Growth Companies section for considerations related to EGCs.

Entities should be mindful of the SEC's interpretive release regarding management's assessment of ICFR, particularly the guidance on the evaluation of control deficiencies. The OCA has stated that internal control reporting is a focus in its reviews and enforcement actions, and this focus is evidenced by past SEC cases. For example, in one case, the SEC's Division of Enforcement brought an enforcement action against the CEO and former CFO of a computer equipment company alleging internal control violations, including (1) the failure to disclose to their company's auditors significant deficiencies in internal control and (2) falsely representing in their signed certifications under Section 302 of the Sarbanes-Oxley Act that they disclosed all such deficiencies to the auditors. In another case, an enforcement action was brought against a corporation for Foreign Corrupt Practices Act (FCPA) violations, including internal control violations of the Exchange Act, with the chief of the Division of Enforcement's FCPA Unit noting that the FCPA violations were the result of a "lax internal control environment."

Evaluation of Severity of Control Deficiencies

Examples of SEC Comments

- Please describe in detail your evaluation of the severity of the key control deficiency. Refer to the guidance for evaluation of control deficiencies beginning on p. 34 of SEC Release No. 33-8810 "Commission Guidance Regarding Management's Report on Internal Control Over Financial Reporting Under Section 13(a) or 15(d) of the Securities Exchange Act of 1934." Include in your analysis a description of the maximum potential amount or total of transactions exposed to the deficiency and how that determination was made.
- Please address the following in relation to [the error you identified]:
  - Provide further information to help us understand how you considered the identification and correction of the error in your evaluation of [ICFR] as of December 31, 2013 and whether control deficiencies existed due to the error. To the extent that you determined there were control deficiencies due to the error, describe the deficiencies and how you evaluated the severity of each identified.
  - In addition, describe the evaluation performed on whether there was a reasonable possibility that your controls would have failed to prevent or detect a material misstatement associated with other related aspects of the consolidation process.
  - Last, tell us if the identification and correction resulted in changes to your internal controls and if so, describe those changes and the timing.

The SEC staff has continued to issue comments to registrants that have identified numerous control deficiencies without reporting a material weakness to understand how the registrants evaluated the severity of the deficiencies in the aggregate. The SEC staff has reiterated that the existence of a material weakness does not depend on the actual magnitude of an error (or whether an error existed) but instead depends on whether there was a reasonable possibility that a material misstatement could have occurred without being detected or prevented by the registrant's ICFR. In the interpretive release discussed above, the SEC stated that management needs to consider "whether each deficiency, individually or in

[1] Under Part I, Item 4, of Form 10-Q and Part II, Item 9A, of Form 10-K.

[2] The requirement for an attestation report applies only to large accelerated and accelerated filers because nonaccelerated filers are exempt from this requirement under Section 404(b) of the Sarbanes-Oxley Act.

[3] Form 11-K is used to file the annual reports for employee stock purchase, savings, and similar plans.

[4] However, paragraph 4310.6 of the FRM states, "A company that historically reported under the Exchange Act as a voluntary filer or because of registered debt, and therefore filed annual reports up to and through the date of its [equity] IPO, in which it was required to comply with . . . Item 308(a) of Regulation S-K, is therefore required to provide management's report on ICFR in its first annual report following the IPO."

combination, is a material weakness as of the end of the fiscal year . . . even though such deficiencies may be individually less severe than a material weakness"; in addition, the SEC noted an increased likelihood of misstatement when there are "[m]ultiple control deficiencies that affect the same financial statement amount or disclosure." At the 2013 AICPA Conference, Brian Croteau, deputy chief accountant in the OCA, stated that he remains convinced that "at least some of the PCAOB's inspection findings related to the audits of internal control over financial reporting are likely indicators of similar problems with management's evaluations of ICFR, and thus potentially [are] also indicative of risk for unidentified material weaknesses." He also questioned whether all material weaknesses are being properly identified and noted that only in rare instances does management identify a material weakness in the absence of a material misstatement. He attributed this to the following possibilities: (1) "the deficiencies are not being identified in the first instance" or (2) "the severity of deficiencies is not being evaluated appropriately."

Mr. Croteau reiterated these points at the 2014 AICPA Conference, where he stated that he "continue[s] to question whether material weaknesses are being properly identified, evaluated, and disclosed." He also stated that the "efforts throughout the SEC pertaining to the ICFR requirements are ongoing, coordinated, and increasingly integrated into [the SEC's] routine consultation, disclosure review and enforcement efforts," thus indicating that ICFR will remain a focus of the SEC staff.

Evaluation of Control Deficiencies Related to Immaterial Misstatements

Example of an SEC Comment

We note that you concluded that the errors related to deferred tax assets were immaterial to the previously reported amounts contained in your periodic reports. Please tell us the following concerning these errors:

- Explain to us in greater detail the nature of the errors and how they were determined and remediated;
- Tell us if there was any impact on the evaluation of your disclosure controls and procedures and your conclusion on Internal Control over Financial Reporting; and
- Provide us with your SAB 99 materiality analysis beginning with the initial time period in which the errors were detected, addressing how you concluded that these errors were immaterial to the previously reported amounts contained in your periodic reports.

At the September 2014 AICPA Banking Conference, the SEC staff indicated that it will continue to question how registrants have considered and evaluated the severity of deficiencies in ICFR related to immaterial misstatements that were corrected by immaterial restatements.[5] The staff reminded registrants that the severity of a deficiency does not depend on whether a misstatement actually has occurred; rather, it depends on whether there is a reasonable possibility that the deficiency could have resulted in a misstatement. The evaluation of the severity warrants consideration of risk factors including, but not limited to, the potential future consequences of the deficiency.[6] Accordingly, it is possible that an immaterial restatement represents a material weakness in ICFR even though the actual magnitude of an error was not material. The SEC's interpretive release states:

> Management evaluates the severity of a deficiency in ICFR by considering whether there is a reasonable possibility that the company's ICFR will fail to prevent or detect a misstatement of a financial statement amount or disclosure; and the magnitude of the potential misstatement resulting from the deficiency or deficiencies. The severity of a deficiency in ICFR does not depend on whether a misstatement actually has occurred but rather on whether there is a reasonable possibility that the company's ICFR will fail to prevent or detect a misstatement on a timely basis.

[5] An immaterial restatement is a restatement of previously issued financial statements for the correction of a misstatement that is either of the following:

- Not material to the prior period being changed but would be material to the current period if corrected in the current period.
- Not material to any periods being presented.

[6] At the December 2014 AICPA Conference, the SEC staff indicated that "[c]onsidering the nature of the deficiency is an important next step in determining the magnitude of the potential misstatement." This evaluation should include consideration of both the nature and current number of transactions affected by the deficiency and the expected amount or volume of transactions that may be affected in the future.

Evaluation of Deficiencies Identified in the Other COSO Components

Examples of SEC Comments

- Tell us how you considered the various errors identified at your corporate location and across multiple geographic regions, some of which were the result of control deficiencies, including significant deficiencies, in different components of the COSO Framework, in evaluating the effectiveness of the control environment component of COSO, especially as it relates to the factor regarding competence (i.e., knowledge, skills, training, and experience of the relevant employees).
- For the significant deficiencies you identified in the risk assessment, monitoring, and information and communication components, tell us why the severity of each is limited to the specific, individual process-level errors you describe in your response and how you determined that the reasonably possible potential error for each is limited to the various errors identified. For example, how was it determined that the significant deficiency in the risk assessment component related to "not having the appropriate resources" is limited to only being manifested through an immaterial error in a specific type of revenue transaction?
- Tell us how you concluded that the significant deficiency resulting in the embedded derivative error is appropriately classified within the information and communication component, as opposed to the failure to identify the relevant clauses in the contracts resulting from, for example, a lack of appropriate employee technical skill (control environment), an improper risk assessment of the types of activities that could lead to embedded derivatives, or the ineffective monitoring of the regional accounting team by the corporate accounting team.

The SEC staff has questioned whether deficiencies in control activities may be related to deficiencies in one or more of the following components of ICFR:

- Control environment.
- Information and communication.
- Risk assessment.
- Monitoring.

Specifically, the SEC staff may ask a registrant to provide a detailed analysis on how it concluded that the controls related to each of the other four COSO components were effective. This point was illustrated at the 2014 AICPA Conference by Kevin Stout, senior associate chief accountant in the OCA, who cited an example in which a growing company had "not employed sufficient resources in the finance department to keep up." Mr. Stout stated that such a situation "raises questions about what other amounts or disclosures could be impacted by the lack of resources and how the Control Environment and Risk Assessment components of COSO had been evaluated." Mr. Stout explained that if management does not understand the nature of all deficiencies, it "is more likely to overlook the possibility that there is a deficiency in another COSO component that may already represent, or could otherwise be developing into, a material weakness."

Disclosure of Material Changes in ICFR

> **Example of an SEC Comment**
>
> [Y]our disclosure indicates that there were no significant changes in your internal control over financial reporting during the last quarterly period covered by this report. This seems to contradict your statement that the signing of the acquisition agreement with [Company A] and the change in management, both of which occurred in November 2013, represent steps to cure deficiencies in your internal control over financial reporting. Please clarify.

The SEC staff has commented when a registrant has not explicitly and clearly asserted whether there has been a change in ICFR in the last fiscal quarter that had or could have a material effect on its ICFR, as required by Regulation S-K, Item 308(c). Registrants should state clearly whether there were changes in ICFR for the quarter and, if so, should disclose the nature of the changes. The staff has stressed that registrants should avoid "boilerplate" disclosure that there have been no material changes affecting ICFR in a period, particularly when there have been identifiable events such as layoffs, changes in outsourcing arrangements, or changes in accounting policies.

Consequently, the staff expects to see increased disclosures regarding changes in ICFR, specifically those related to remediation of material weaknesses. For example, the SEC staff has reminded registrants that it is important for management to monitor and consider disclosing a change in ICFR in the quarter in which management remediates a material weakness.[7]

In reviewing registrants' filings, the SEC staff looks for indicators of potential ICFR deficiencies. Common indicators include disclosures about changes in ICFR and corrections of errors (discussed below). If indicators are observed, the staff routinely asks registrants about management's consideration of such indicators in relation to its conclusions about the effectiveness of ICFR (i.e., whether a deficiency in internal control represents a material weakness that should have been identified and disclosed). For the quarter in which any material changes in ICFR occur, registrants should provide disclosures about such material changes, including (1) the identification of any material weaknesses and (2) changes made to remediate material weaknesses.

Disclosures About the Impact and Remediation of Material Weaknesses

> **Example of an SEC Comment**
>
> We note your disclosure that your independent registered public accounting firm identified material weaknesses in the internal controls over financial reporting during the 2014 and 2013 audits. Please revise to address the following:
>
> - Please provide information surrounding each of the material weaknesses identified. Quantify the effects of each one on your financial statements.
> - Please provide an expanded discussion of the specific steps you have taken and put into place to resolve each material weakness. Identify which material weaknesses have been resolved and which have not been resolved.
> - Please revise MD&A to provide a discussion of the material weaknesses that includes the information requested in the first two bullets points of this comment and that includes a discussion of how the material weaknesses affected your financial condition, results of operations and cash flows.

[7] The SEC staff discussed remediation of material weaknesses and related disclosure considerations at the 2010 AICPA Conference. For additional information, see Deloitte's December 16, 2010, *Heads Up*.

The SEC staff has indicated that management's disclosures about material weaknesses are expected to go beyond merely identifying the existence of one or more material weaknesses or providing a limited description. Rather, such disclosures should contain enough information to allow investors to understand the cause of a material weakness and determine the pervasiveness of its effect on ICFR.

Similarly, the staff has called for more transparent disclosures about the pervasiveness of a material weakness's impact on the registrant's financial reporting and its ICFR. The staff has stressed that registrants need to avoid narrowly focusing their disclosures on a particular financial statement line item affected by a material weakness and should consider other financial statement line items that may also be affected.[8]

Registrants that have identified a material weakness have been asked to discuss (1) management's plans to remediate the weakness, (2) the estimated timing of management's remediation efforts, and (3) the related material costs.

In addition, in certain instances, the SEC staff has observed that questions about the validity and completeness of management's disclosures regarding material weaknesses have arisen as a result of management's discussion of its remediation plans. Sometimes the remediation plans are broader than the material weakness identified, potentially indicating that the actual material weakness is more pervasive than the material weakness disclosed or that there may be another material weakness that was not identified and disclosed. In providing disclosures about remediation plans, registrants should therefore consider the root cause of a material weakness and whether it highlights a more pervasive material weakness in their ICFR or deficiencies in other controls.

Further, the SEC staff has recently commented when registrants identified one or more material weaknesses in ICFR but either refrained from concluding on the effectiveness of ICFR or concluded that their ICFR is effective. In such instances, the staff has reminded registrants that Regulation S-K, Item 308(a)(3), prohibits a conclusion that ICFR is effective when one or more material weaknesses exist and has asked registrants to amend their filings to state that their ICFR is not effective as a result of the material weaknesses that were identified.

Conclusion That ICFR Remains Effective After a Restatement

Example of an SEC Comment

Please tell us what consideration was given to management's assessment at December 31, 2013 and at dates before then during 2011, 2012 and 2013 of the effectiveness of disclosure controls and procedures and internal control over financial reporting in light of the restatement discussed in [your notes]. Explain why you believe both disclosure controls and procedures and internal controls over financial reporting were effective at those dates in light of the errors and why no modifications to the disclosures contained in management's report, including any material changes made to ICFR, were required.

Because a restatement is typically indicative of a material weakness in ICFR, the SEC staff may challenge registrants when they conclude that their ICFR and DC&P are effective after restating their financial statements. In addition, since most elements of ICFR are subsumed in the definition of DC&P and it is therefore typically difficult for a registrant to conclude that its DC&P are effective when its ICFR is ineffective, the SEC staff may ask registrants after a restatement has occurred to explain why they concluded that their DC&P are effective. At the 2013 AICPA Conference, Mr. Croteau discussed a registrant's responsibility to maintain effective DC&P and directed registrants' management to (1) review an SEC enforcement order that addresses a registrant's failure to maintain effective controls and (2) consider whether its own DC&P and ICFR processes and procedures could be improved in light of the issues raised in that order. He also indicated that the adequacy of such controls and management's evaluations and conclusions about them are likely to be a focus of future Enforcement Division investigations.

8 This issue was discussed at the Forums on Auditing in the Small Business Environment hosted by the PCAOB in December 2012.

Registrants should consider paragraphs 4310.16 and 4310.17 of the FRM regarding the restatement of financial statements:

> There is no requirement for a company to reevaluate the effectiveness of its internal controls and/or reissue a revised management's report on ICFR when a company restates its financial statements to correct errors . . . . However, a company may need to consider whether or not its original disclosures in management's report continue to be appropriate in light of these errors, and should modify or supplement its original disclosure to include any other material information that is necessary for such disclosures not to be misleading in light of the restatement. . . . If a company's management concludes that its original assessment of ICFR was incorrect, it should consider whether or not to revise its original report on ICFR.

Disclosure of the Framework Used to Evaluate ICFR

Example of an SEC Comment

Please revise future filings to clarify which version, 1992 or 2013, of the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission in *Internal Control — Integrated Framework* you utilized when performing your assessment of internal control over financial reporting.

The COSO framework is one of the most widely applied frameworks used by registrants in evaluating the effectiveness of their ICFR. On May 14, 2013, COSO released an updated version of its *Internal Control — Integrated Framework* to reflect the significant changes in business and operational environments that have occurred since the original framework was introduced in 1992. Although the components of internal control under the framework remain unchanged, the update introduced 17 new principles that explicitly articulate and describe the components of internal control.[9] At the 2013 AICPA Conference, the SEC staff stated that registrants must disclose the internal control framework they applied in assessing the effectiveness of their ICFR in accordance with paragraph 4310.7 of the FRM. Because the COSO framework was updated in 2013 and provides for a transition period before the original framework is superseded, registrants should disclose whether they applied the 2013 framework or the original framework.

The SEC staff often comments when registrants do not disclose the framework used to evaluate the effectiveness of ICFR. The staff has cited specific examples in which management did not identify the framework used, as well as instances in which management inappropriately referred to SEC guidance or COSO's small-company guidance as the framework used for the evaluation. As a result, when a registrant has not disclosed the framework it used, it may be asked to advise the SEC staff of the framework it used in the current year and to revise its disclosures in current and future filings.

The SEC staff has also noted that "the longer issuers continue to use the 1992 framework, the more likely they are to receive questions from the staff about whether the issuer's use of the 1992 framework satisfies the SEC's requirement to use a suitable, recognized framework."[10]

[9] For additional information, see Deloitte's June 10, 2013, *Heads Up* on the revised COSO framework.

[10] For additional information, see the highlights of the September 2013 CAQ SEC Regulations Committee joint meeting with the SEC staff.

Incomplete or Missing ICFR Evaluation

Examples of SEC Comments

- [Y]ou did not include your conclusion regarding the effectiveness of your internal control over financial reporting. Please confirm to us that you intended to state . . . that your internal control over financial report is not effective, if correct, and confirm that you will include your conclusions for your assessments of the effectiveness of your disclosure controls and procedures and internal control over financial reporting in all future Forms 10-K.
- We note that management's report does not provide all the required information. Specifically, it does not define management's responsibility for establishing and maintaining adequate internal control over financial reporting, nor does it identify the framework used by management to evaluate the effectiveness of internal control over financial reporting at December 31, 2013.

Regulation S-K, Item 308(a)(3), requires registrants to assess and conclude on the effectiveness of their ICFR as of the end of their most recent fiscal year. In several instances, the SEC staff has issued comments to registrants that omitted a conclusion or provided one that did not contain all of the required information. The staff has also issued comments to registrants that failed to indicate a date for their ICFR evaluation or included in their filing a date other than the end of their most recent fiscal year. Registrants should ensure that the appropriate date of their ICFR evaluation is prominently displayed in any filing with the SEC.

Other Deloitte Resources

- December 15, 2014, *Heads Up*, "Highlights of the 2014 AICPA Conference on Current SEC and PCAOB Developments."
- September 5, 2014, *Heads Up*, "Challenges and Leading Practices Related to Implementing COSO's *Internal Control — Integrated Framework*."
- December 16, 2013, *Heads Up*, "Highlights of the 2013 AICPA Conference on Current SEC and PCAOB Developments."

Executive Compensation and Other Proxy Disclosures

Proxy disclosure, particularly executive compensation, remains a topic of focus in SEC staff comments to registrants, including those issued to smaller reporting companies. Many of the staff's comments are related to (1) disclosures about how performance is assessed, including the use of performance targets and benchmarking; (2) disclosures in CD&A, including compensation table disclosures; and (3) disclosures about related-party transactions.

Further, the SEC continues to expand executive compensation and other proxy disclosure requirements through its rulemaking under the Dodd-Frank Act. See Other Deloitte Resources below for additional considerations.

Determining Compensation — Assessment of Performance

Performance Targets

> **Example of an SEC Comment**
>
> We note disclosure that the maximum bonus opportunities were set between [X]% and [Y]% of base salary for each of your named executive officers. In future filings, please clearly disclose the threshold, target and maximum bonus opportunities as a percentage of salary for each of your named executive officers. Please also disclose all previously established performance goals (such as company operating income), the actual level of achievement, and how you calculated the performance based bonus award for each named executive officer. [P]lease provide us supplementally with draft disclosure showing how you will present this information in future filings. Refer to Items 402(b)(1)(v) and (2)(v) of Regulation S-K.

The SEC staff frequently asks registrants that use performance targets to disclose them and provide information about their use.[1] Under Regulation S-K, Item 402(b), a registrant is required to discuss any compensation awarded to named executive officers (NEOs) in its CD&A. The discussion should include (1) the objectives of the compensation program, (2) what the compensation program is designed to reward, (3) the elements of the compensation, (4) the registrant's reasons for paying each element, (5) how each element is calculated (including any formula used), and (6) how the program fits into the registrant's objectives. The SEC staff frequently comments on how certain performance factors affect compensation arrangements for NEOs as well as how nonequity incentive compensation granted to NEOs is calculated. Item 402(b) also requires discussion of whether and, if so, how the results of shareholder advisory votes on executive compensation may affect the registrant's decisions and policies related to executive compensation.

To help financial statement users understand the registrant's compensation policies and decisions, the SEC staff has asked registrants to:

- Quantify and disclose the performance target and explain the purpose of performance factors.
- Disclose actual performance results and detail the specific elements of individual performance and contributions that affected the compensation received.
- Discuss the correlation between achievement of performance targets and the compensation ultimately awarded.
- Indicate whether the compensation committee or others had discretion or additional qualitative input when determining the final amount of compensation awarded, and the factors that affected the determination.

[1] Registrants may exclude performance targets (and other confidential information) if disclosing such material would result in competitive harm. However, registrants must satisfy "confidential-treatment" criteria and demonstrate to the SEC staff, upon request, that they have done so. Even when omission of targets or other factors or criteria is appropriate, a registrant should disclose how difficult it will be for the executive, or how likely it will be for the registrant, to achieve the undisclosed target levels or other criteria.

Benchmarking

> **Example of an SEC Comment**
>
> In future filings, please disclose the component companies used for benchmarking the compensation of your named executive officers. See Item 402(b)(2)(xiv) of Regulation S-K. We also note that target total annual compensation was within the [X] percentile. In future filings, please revise to disclose where actual total annual compensation fell for your named executive officers in relation to the benchmarked parameters.

A registrant may use benchmarks for total compensation or a material element of compensation (e.g., the registrant compares its executive compensation to that of a peer group in the same industry or uses compensation surveys to determine compensation levels). When it does, the registrant must identify (1) the benchmark for each NEO and (2) the components of compensation used and the entities that constitute the benchmark group.[2]

If benchmarks are used, the SEC staff may request that registrants disclose:

- All elements of compensation that are subject to benchmarking.
- The impact of the benchmarking on compensation decisions.
- Additional details about how they used the comparison information, including whether they had discretion regarding when and how to use it as well as the nature and extent of such discretion.
- Where payments fell with respect to the benchmark for each NEO.
- The degree to which their compensation committees consider entities in the benchmark group to be comparable to the registrants themselves.

The staff has also asked for explanations when actual compensation fell outside the targeted range.

Disclosures in CD&A

> **Examples of SEC Comments**
>
> - You disclose that the amounts of the 2014 cash incentives are included in the Bonus column. If the bonus was granted under a plan providing for compensation intended to serve as incentive for performance to occur over a specified period of time, then the bonus should be disclosed under the "Non-Equity Incentive Compensation Plan" column. Amounts earned under the plan as adjusted for the exercise of negative discretion would still be reportable in the Non-Equity Incentive Plan Compensation column. Please explain to us why the payments under the 2014 Annual Incentive Plan awards are being disclosed in the "Bonus" column, and to the extent necessary revise your future filing accordingly. For guidance, please refer to Question 119.02 of Regulation S-K Compliance and Disclosure Interpretations.
> - We note disclosure that Mr. [A] has received fees related to his services on the company's board . . . for a total aggregate of $[X]. Please tell us where these fees have been disclosed in the summary compensation table, and in future filing, identify them through the use of footnote disclosure to the extent applicable. Please see instruction 3 to Item 402(c) of Regulation S-K.

The SEC staff continues to focus on CD&A disclosures, particularly those in the summary compensation table, because they give investors important information about a registrant's compensation policies and decisions. Frequently, the staff asks about inconsistencies between the amounts disclosed in the financial statements and the amounts disclosed in the summary compensation table.

[2] See Regulation S-K, Item 402(b)(2)(xiv), for additional information.

Regulation S-K, Item 402(c), requires that for each NEO, registrants include tabular disclosures specifying (1) the NEO's name and principal position, (2) the fiscal year covered, (3) the base salary earned, (4) the bonus earned, (5) the stock/option awards, (6) nonequity incentive plan compensation, (7) the change in pension value and nonqualified deferred compensation earnings, (8) all other compensation, and (9) the total amount of compensation. Both the cash portion and the noncash portion of salary and bonus must be disclosed.

Accordingly, the SEC staff often comments when registrants disclose amounts in incorrect columns of, or exclude types of compensation from, the table. For example, the staff often asks why bonuses paid to NEOs (on the basis of achieved performance targets) are disclosed in the bonus column instead of in the nonequity incentive plan compensation column.

In addition, for stock awards included in CD&A, the SEC staff often asks for the aggregate grant-date fair value of the awards as computed in accordance with ASC 718 and for disclosure of all assumptions used in the valuation of share-based compensation, which the registrant can provide by including a reference to its footnotes to the financial statements or to the critical accounting policies section of its MD&A. Regulation S-K, Item 402(k)(2)(iii), also requires disclosure of the aggregate grant-date fair value and aggregate number of stock awards as of the fiscal year-end for each director.

Related-Party Transactions

Regulation S-K, Item 404(a), requires disclosure of transactions that the registrant participated in, or will participate in, with related parties in which the "amount involved exceeds $120,000, and [the related party] had or will have a direct or indirect material interest." ASC 850 does not establish a quantitative threshold but requires disclosure in the financial statements when the information "would make a difference in decision making." In addition, Regulation S-X, Rule 4-08(k), requires registrants to (1) disclose related-party transactions that affect the financial statements and (2) separately present the amounts of such related-party transactions on the face of the balance sheet, income statement, or statement of cash flows when those amounts are material. Types of related-party transactions that the SEC staff often comments about include sales and loans involving related parties.

As part of identifying related-party transactions, registrants should consider consulting with legal counsel and reviewing the instructions to Item 404(a) to better understand the definition of a "related person" and the types of transactions they need to disclose.

Policies and Procedures

> **Example of an SEC Comment**
>
> Please tell us your Committees' policies and procedures for the review, approval, or ratification of covered transactions. Please see Item 404(b) of Regulation S-K.

The SEC staff may request that the registrant provide a complete discussion of the policies and procedures related to the review, approval, or ratification of transactions with related persons, as required by Regulation S-K, Item 404(b). Registrants often disclose the existence, or a general summary, of such policies and procedures but exclude material features such as the types of transactions covered by the policies and procedures, the standards to be applied to the transactions, and the persons or group of persons responsible for applying the policies and procedures.

Transactions Involving Indebtedness

Example of an SEC Comment

Please provide the disclosure required by Item 404(a)(5) of Regulation S-K. In addition, please update the balance of the related party debt as of the most recent financial statements.

The SEC staff also often asks registrants to improve their disclosures about related-party transactions involving indebtedness. Item 404(a) indicates that registrants should disclose the major terms of related-party indebtedness (e.g., the amounts involved, the largest principal amount outstanding during the period and as of the latest practicable date, the principal and interest payments during the period, the interest rate, and the interest-payable amount).

Other Deloitte Resources

- September 10, 2015, *Heads Up*, "SEC Issues Final Rule on Pay Ratio Disclosure."
- August 5, 2015, *Heads Up*, "SEC Proposes Rule on 'Clawback' Policies."
- May 29, 2015, *Heads Up*, "SEC Proposed Rule on Pay Versus Performance."

Emerging Growth Companies

An emerging growth company (EGC) is a new type of issuer created by the JOBS Act to encourage public offerings by small and developing companies. The regulatory and reporting requirements for EGCs are less stringent than they are for other types of issuers and include the following:

- Only two years of audited financial statements are required in an IPO for common equity.
- The periods required for selected financial data in both registration statements and periodic filings do not extend to periods before the first year presented in the EGC's equity IPO registration statement.
- EGCs may elect to defer the adoption of new accounting standards until they become effective for private companies (i.e., nonissuers).
- EGCs are exempt from the requirement to obtain an attestation report on ICFR from their auditor.

In addition, an EGC may submit registration statements to the SEC for confidential reviews. Under the JOBS Act, an EGC would be required to make publicly available (at least 21 days before its "road show") any documents that were submitted to the SEC staff for confidential review. Accordingly, the SEC staff's comment letters to the EGC (and the EGC's responses) must be filed on EDGAR.

The staff in the SEC's Division of Corporation Finance has issued FAQs on numerous aspects of the JOBS Act, many of which are related to qualifying for EGC status and the filing requirements for EGCs. In addition, the SEC staff has incorporated EGC-related guidance in section 10000 of the FRM.

In its comment letters to EGCs, the SEC staff primarily has asked companies to disclose (1) that they qualify for EGC status, (2) how and when they may lose their EGC status, (3) the elections they made under Title I of the JOBS Act, and (4) their qualification for an exemption from Section 404(b) of the Sarbanes-Oxley Act.

EGC Status and Elections

Example of an SEC Comment

It appears that you qualify as an "emerging growth company," as defined in the Jumpstart Our Business Startups Act. If true, in an appropriate section of the filing please disclose that you are an emerging growth company and revise your registration statement to:

- Describe how and when a company may lose emerging growth company status;
- Briefly describe the various exemptions that are available to you, such as [an exemption] from Section 404(b) of the Sarbanes-Oxley Act of 2002 . . . ; and
- State your election under Section 107(b) of the JOBS Act:
    - If you have elected to opt out of the extended transition period for complying with new or revised accounting standards pursuant to Section 107(b), include a statement that the election is irrevocable; or
    - If you have elected to use the extended transition period for complying with new or revised accounting standards under Section 102(b)(2), provide a risk factor explaining that this election allows you to delay the adoption of new or revised accounting standards that have different effective dates for public and private companies until those standards apply to private companies. Please state in your risk factor that, as a result of this election, your financial statements may not be comparable to companies that comply with public company effective dates. Include a similar statement in your critical accounting policy disclosures.

Filing Status

Because a key objective of the JOBS Act is to promote smaller companies' access to capital markets, some of the JOBS Act's accommodations for EGCs resemble reporting requirements for smaller reporting companies (e.g., annual financial statement requirements in an IPO registration statement under Regulation S-X, Article 8). However, the rules are not the same, and the SEC staff has asked EGC filers to clarify descriptions of their filing status. Further, a company can maintain EGC status for up to a maximum of five years after an equity IPO as long as certain conditions apply;[1] and the SEC staff has asked EGC filers to disclose information about their filing status, including how and when the company may lose EGC status.

Extended Transition Period to Adopt New or Revised Accounting Standards

EGCs are allowed to adopt new or revised accounting standards on the basis of effective dates applicable to private companies (i.e., nonissuers) for ASUs issued after April 5, 2012 (i.e., the date of the enactment of the JOBS Act). Consequently, the SEC staff has asked EGC filers to indicate the basis on which they are adopting accounting standards. Further, the SEC staff has asked EGCs that elect to adopt accounting standards on the basis of adoption and transition dates that apply to private companies to disclose as a risk factor that their financial statements may not be comparable with those of registrants that elect (or are required) to adopt accounting standards on the basis of adoption and transition dates that apply to public companies. The SEC staff has also asked registrants to include similar disclosures in their critical accounting policy section of MD&A.

Section 404(b) Exemption

The JOBS Act amends Section 404(b) of the Sarbanes-Oxley Act by exempting EGCs from the requirement to obtain an attestation report on the company's ICFR from its registered public accounting firm. The staff has required registrants to disclose that they are exempt from obtaining an audit of their ICFR (for as long as they maintain EGC status).[2]

Other Considerations

Reduced Financial Reporting Requirements

Examples of SEC Comments

- You state here that you have not made a final decision to take advantage of certain of the exemptions available to you as an emerging growth company. Please tell us when you intend [to] make that decision and whether your current executive compensation disclosures reflect the reduced disclosure obligations applicable to a smaller reporting company.
- Briefly describe . . . exemptions [from the requirements related to obtaining shareholder approval of executive compensation under] Section 14A(a) and (b) of the Securities Exchange Act of 1934.

An EGC is required to present only two years of audited financial statements in its equity IPO registration statement. In addition, the periods for which an EGC presents select financial data in its registration statements and periodic filings may be limited to the earliest year presented in its equity IPO registration statement. Further, certain JOBS Act provisions related to scaled disclosures may interact with certain SEC rules (e.g., other entities' financial statements may be required under Regulation S-X, Rules 3-05 and 3-09); accordingly, the SEC staff has issued comments on reduced disclosure requirements. For example, under the JOBS Act, EGCs can comply with the SEC's proxy requirements regarding executive compensation by providing the same reduced disclosures that are required of smaller reporting companies.[3] Consequently, the staff has asked whether EGCs' executive compensation disclosures reflect reduced disclosure requirements. EGCs should therefore consider the SEC staff's FAQs on the JOBS Act to assess whether reduced reporting requirements apply in these situations. For additional information on Rules 3-05 and 3-09, see the SEC Reporting section.

1 For example, the EGC's total gross revenues do not exceed $1 billion during the five-year period; the EGC's market capitalization does not exceed $700 million (i.e., the EGC does not meet the definition of a large accelerated filer); and the EGC does not issue more than $1 billion in nonconvertible debt in a three-year period (which is not limited to calendar or fiscal years and is a rolling three-year period from the date of the EGC's last debt issuance).

2 EGCs are also exempt from any future PCAOB rules that may require (1) auditor rotation or (2) expansion of the auditor's report to include an auditor's discussion and analysis of the company under audit.

3 EGCs are also exempt from certain proxy provisions of the Dodd-Frank Act.

Requests for Written Communications

Example of an SEC Comment

We note that you are an "emerging growth company," as defined in the Jumpstart Our Business Startups Act. Please supplementally provide us with the following:

- [C]opies of all written communications, as defined in Rule 405 under the Securities Act, that you, or anyone authorized to do so on your behalf, present to potential investors in reliance on Section 5(d) of the Securities Act, whether or not they retain copies of the communications; and
- [A]ny research reports about you that are published or distributed in reliance upon Section 2(a)(3) of the Securities Act of 1933 added by Section 105(a) of the Jumpstart Our Business Startups Act by any broker or dealer that is participating or will participate in your offering.

The JOBS Act significantly changed the rules governing communication between EGCs and certain potential investors. Under the JOBS Act, an EGC, or any person authorized to act on behalf of an EGC, may engage in oral or written communications with potential investors that are qualified institutional buyers or institutional accredited investors to "test the waters" before the EGC files its registration statement. Consequently, the SEC staff has requested copies of such communications.

Other Deloitte Resources

April 15, 2014, *Heads Up*, "Two Years After the JOBS Act."

Other SEC Reporting Matters

Certifications

Example of an SEC Comment

We note that the beginning of the certifications filed . . . are missing the first line of text relating to the individual certifying the filing as required by Item 601(b)(31) of Regulation S-K (i.e., the declaration that the party is certifying). We also note that you have omitted the introductory language in paragraph 4 referring to internal control over financial reporting. Accordingly, please file an amendment to your Form 10-K that includes the entire filing together with the certifications of each of your current CEO and CFO in the form currently set forth in Item 601(b)(31) of Regulation S- K.

Registrants must provide quarterly and annual certifications in the form specified by Regulation S-K, Item 601(b)(31). When these certifications contain errors, registrants are often asked to file an amendment to an entire periodic filing in addition to submitting a corrected certification. Interpretation 246.14 of the C&DIs of Regulation S-K states:

> The following errors in a certification required by Item 601(b)(31) are examples of errors that will require the company to file a corrected certification that is accompanied by the entire periodic report: (1) the company identifies the wrong periodic report in paragraph 1 of the certification; (2) the certification omits a conformed signature above the signature line at the end of the certification; (3) the certification fails to include a date; and (4) the individuals who sign the certification are neither the company's principal executive officer nor the principal financial officer, or persons performing equivalent functions.

The SEC staff often comments when registrants' certifications, including punctuation marks and parenthetical phrases, do not appear exactly as specified in Item 601(b)(31). The staff routinely notes that including the title, rather than the name, of the certifying officer in the first sentence of the certification constitutes an inappropriate modification. In addition, the staff regularly comments on certifications that are dated incorrectly.

Registrants must include certifications when they are filing amendments to periodic reports. See Question 161.01 of the C&DIs of Exchange Act Rules for guidance on what paragraphs can be excluded from certifications filed with amendments to periodic reports.

Use of Experts and Consents

> **Example of an SEC Comment**
>
> We note that the prospectus includes market and industry data derived from publications, surveys, and reports, including from [Entities A, B, C, D, E, F, and G]. If any of these publications, surveys, or reports were commissioned by you for use in connection with the registration statement, please file consents of such third parties pursuant to Rule 436 of the Securities Act as exhibits to your registration statement or tell us why you believe you are not required to do so.

In their registration statements under the Securities Act and periodic reports under the Exchange Act (e.g., Forms 10-K and 10-Q), registrants sometimes refer to an "independent valuation firm" or other third party. The SEC staff has asked such registrants whether management or the board relied on a third-party expert and will sometimes infer reliance on a third-party expert even when the registrants do not refer to one. Examples of third-party experts that registrants commonly consider or rely on include the following:

- Valuation firms, about:
  - The valuation of a registrant's common and preferred stock in an IPO.
  - The fair value determination of goodwill and assets acquired and liabilities assumed in a business combination.
  - The determination of goodwill impairment.
  - The determination of an environmental liability.
- An independent actuary, about the estimation of workers' compensation liability.
- Petroleum engineers, about the evaluation of oil and gas reserves.
- Pricing services or brokers that provide information used to determine the fair values of financial assets or liabilities. See the Fair Value section for additional considerations.
- Counsel providing legal opinions.
- Tax specialists providing tax opinions.

The SEC staff has stated that in registration statements or periodic reports, registrants generally are not required to refer to an independent valuation firm or other expert. If a registrant does not refer to the expert in its filing, the registrant is not required to name the expert or obtain the expert's consent; however, certain SEC requirements may compel the registrant to include or summarize an expert's report or opinion in its filing and could trigger a consent requirement. Registrants that refer to experts in their filings should consider the implications related to periodic reports and registration statements.

Periodic Reports (Exchange Act)

Consents are not required for Form 10-K or 10-Q. However, the guidance below on registration statements should be applied if the registrant (1) refers to an independent valuation firm or other expert in a periodic report and attributes statements in the report to the expert and (2) incorporates that periodic report by reference into a registration statement.

Registration Statements (Securities Act)

Historically, if a registrant has referred to third-party experts in a registration statement, the SEC staff has asked the registrant to provide the experts' consents, including those from the registrant's independent registered public accounting firm. However, C&DIs issued by the staff appear to indicate that the key to assessing whether a consent will be required is determining the degree to which management takes responsibility for statements related to work performed by a third-party expert that are included in or incorporated into the registration statement. The SEC staff typically evaluates the totality of the disclosure provided when determining whether management is taking responsibility for the conclusion.[1]

Scope

The SEC staff has also commented on the use of "limiting" language in consents provided by third-party experts. The staff has emphasized that an expert's consent should not contain any language that limits the use of the consent to the registrant or suggests that there is a limit on potential investor reliance.

Material Contracts

Example of an SEC Comment

You state that you rely on the uninterrupted operation of your data centers. Yet it appears that you do not plan to file as exhibits any agreements with the third parties that host your network operating centers. To the extent you have entered into agreements with respect to your network operating centers, please revise the Business section to discuss the material terms of your material agreements. In addition, explain to us how you determined that the agreements need not be filed as exhibits pursuant to Item 601(b)(10) of Regulation S-K. Alternatively, file the agreements as exhibits to the registration statement.

Regulation S-K, Item 601, requires registrants to file certain material contracts as exhibits if, during the reporting period, such contracts (1) become effective or (2) are executed, amended, or modified. For example, Item 601(b)(10) requires a registrant to file:

- Every material contract that is "not made in the ordinary course of business."
- Any material contract "made in the ordinary course of business":
  - With certain parties, such as directors, officers, promoters, voting trustees, certain security holders, or underwriters, other than contracts involving only the purchase or sale of current assets at a price that equals a determinable market price.
  - On which the registrant's business substantially depends.
  - For the acquisition or disposition of any property, plant, or equipment for consideration exceeding 15 percent of the registrant's total consolidated fixed assets.
  - For a lease under which part of the property is held by the registrant.
- Generally, any management contract or compensatory plan, contract, or arrangement in which a director or NEO of the registrant participates (such contracts are considered material) and any other material management contract or any other compensatory plan, contract, or arrangement in which any other executive officer of the registrant participates.[2]
- Any other material compensatory plan, contract, or arrangement "adopted without the approval of security holders pursuant to which equity may be awarded" in which any employee of the registrant (i.e., regardless of whether the employee is an executive officer) participates.

1 Registrants may look to Question 233.02 of the C&DIs of the Securities Act Rules that were issued by the SEC staff in November 2008 but should be aware that other consent-related C&DIs of the Securities Act Rules may apply to their specific circumstances and that they should therefore review such C&DIs periodically.

2 For examples of management contracts or compensatory plans, contracts, or arrangements that are exempt from this filing requirement, see Item 601(b)(10)(iii)(C).

Accordingly, the SEC staff issues comments when registrants omit certain material agreements. Recent comment letters have instructed registrants to do either of the following:

- File the material agreements in their entirety, including schedules and related exhibits, as exhibits to Form 10-K or 10-Q or separately on Form 8-K in accordance with Item 601.
- Explain why they have not filed the agreements.

For SEC staff views on when registrants may be required to file agreements as exhibits under Item 601, see Sections 146, 206, and 246 of the C&DIs of Regulation S-K.

Backlog Disclosures

Examples of SEC Comments

- Please tell us how and when the "order process" that you mention was changed and how that will affect age outs. Also, please (1) clarify this issue in future filings where you mention the order process change, [and] (2) tell us about any other changes to the method that you used to determine the dollar amount of reported backlog during the last three fiscal years, the extent to which the change affected backlog, and where you describe those changes in your filings.
- To the extent material, please disclose the amount of backlog related to uncompleted contracts for which you have recorded a provision for estimated losses. Please also disclose the amount of backlog not reasonably expected to be filled within the current fiscal year, and seasonal or other material aspects of backlog. Refer to Item 101(c)(1)(viii) of Regulation S-K.

Regulation S-K, Item 101(c)(1)(viii), requires disclosure of the "dollar amount of backlog orders believed to be firm, as of a recent date and as of a comparable date in the preceding fiscal year, together with an indication of the portion thereof not reasonably expected to be filled within the current fiscal year, and seasonal or other material aspects of the backlog." Because companies may compute backlog information differently, the SEC staff has requested expanded disclosures about it, including (1) the methods used (or changes in methods used) to determine backlog and (2) changes in backlog resulting from new contracts, canceled contracts, and contracts recognized in revenue. In addition, the SEC staff has reminded registrants to disclose in accordance with Item 101(c)(1)(viii) the backlog not reasonably expected to be filled within the current fiscal year.

Disclosures Regarding State Sponsors of Terrorism

Examples of SEC Comments

- You state . . . that [Company X] accounted for 10% of your sales in 2014. [Company X's] wholly-owned subsidiaries . . . both provide contact information on their respective websites for their respective [businesses] in each of [Sudan and] Syria. [Sudan and] Syria are designated by the Department of State as state sponsors of terrorism, and are subject to U.S. economic sanctions and export controls. Please describe to us the nature and extent of your past, current, and anticipated contacts with . . . Sudan and Syria, if any, whether through subsidiaries, affiliates, distributors, partners, customers, joint ventures or other direct or indirect arrangements. You should describe any services, products, information, or technology you have provided to [Sudan or] Syria, directly or indirectly, and any agreements, commercial arrangements, or other contacts you have had with the governments of those countries or entities they control.
- Please discuss the materiality of any contacts with . . . Sudan and Syria you describe in response to the comment above, and whether those contacts constitute a material investment risk for your security holders. You should address materiality in quantitative terms, including the approximate dollar amounts of any associated revenues, assets, and liabilities for the last three fiscal years and the subsequent interim period. Also, address materiality in terms of qualitative factors that a reasonable investor would deem important in making an investment decision, including the potential impact of corporate activities upon a company's reputation and share value. Various state and municipal governments, universities, and other investors have proposed or adopted divestment or similar initiatives regarding investment in companies that do business with U.S.-designated state sponsors of terrorism. You should address the potential impact of the investor sentiment evidenced by such actions directed toward companies that have operations associated with [Sudan and] Syria.

The U.S. Department of State has designated three countries as state sponsors of terrorism — Iran, Sudan, and Syria. These countries are subject to U.S. economic sanctions and export controls. Generally, registrants that do business in these countries are required to disclose material operations conducted in them (whether through subsidiaries, affiliates, distributors, partners, customers, joint ventures, or other direct or indirect arrangements) and any agreements, commercial arrangements, or other contacts with the countries' respective governments or with entities controlled by such governments.[3] The SEC staff regularly comments on this subject and believes that such disclosures are important to investors in making investment decisions. The staff has asked registrants to disclose the nature and extent of these contacts (past, present, and probable) — as well as to provide a detailed analysis of the materiality of contacts with these countries — on the basis of both quantitative and qualitative factors. In addition to providing quantitative disclosures of revenues, assets, and liabilities associated with these countries, registrants are encouraged to disclose any related qualitative factors that may have a significant impact on their activities.[4]

[3] In 2007, the SEC issued a concept release that requested input on certain matters related to sponsors of state terrorism. The concept release indicates that the "federal securities laws do not impose a specific disclosure requirement that addresses business activities in or with a country based upon its designation as a State Sponsor of Terrorism." However, as with other requirements to disclose material information, the "federal securities laws do require disclosure of business activities in or with a State Sponsor of Terrorism if this constitutes material information that is necessary to make a company's statements, in the light of the circumstances under which they are made, not misleading." [Footnote omitted]

[4] Further, the Iran Threat Reduction and Syria Human Rights Act of 2012 requires registrants to include certain disclosures about sanctionable activities with those countries in all quarterly and annual reports. There is no materiality threshold for such reporting; therefore, a registrant may be required to disclose immaterial transactions meeting the criteria specified in the Act. For implementation guidance, see Questions 147.01 through 147.07 of the C&DIs of Exchange Act Sections.

Interactive Data — eXtensible Business Reporting Language (XBRL)

SEC Staff's Review and Observations

Examples of SEC Comments

- The staff notes that you have not submitted electronically and posted on your corporate Web site every Interactive Data File required to be submitted and posted during the preceding 12 months. Please file this information pursuant to Rule 405 of Regulation S-T.
- The XBRL Document and Entity Identification Information rendered as part of your filing appears to contain a number of data element errors, including but not limited to, your classification as a non-accelerated filer. Please revise to comply with the requirements of Section 405 of Regulation S-T and the EDGAR Filer Manual.

The SEC staff continues to monitor registrants' interactive data file (i.e., XBRL) submissions for completeness and compliance with the provisions of Regulation S-T, Rule 405. The staff often asks whether the registrant has (1) submitted its interactive data files as an exhibit to Form 10-K and Form 10-Q in accordance with Regulation S-K, Item 601(b)(101); (2) checked the appropriate box on the cover page of its Form 10-K or 10-Q to indicate that all required interactive data files have been submitted; and (3) posted its interactive data files on its Web site. When a registrant has omitted a required interactive data file exhibit, the staff may ask why and request an amended filing that includes the missing information.

The SEC staff also considers the quality of interactive data filings and has commented broadly on the problems encountered in that regard. For example, the staff has indicated that it continues to see basic errors in interactive data submissions and has directed registrants to its observations on the SEC's Web site for additional details. Specifically, the staff has reminded registrants to (1) use negative values properly, (2) ensure the completeness of tagging, and (3) use custom tags only when appropriate.

In its July 2014 report *Staff Observations of Custom Tag Rates*, the SEC staff noted that although it has seen a steady decline in custom tag use by larger filers, it has not observed a similar decline in usage by smaller filers.[5] Further analysis revealed that this trend may be partially attributable to smaller filers' use of certain third-party providers. The staff expressed its intention to continue monitoring registrants' use of custom tags and indicated that it may issue further guidance or take additional action in the future.

Requirement to Include Calculation Relationships

Sections 6.14 and 6.15 of the EDGAR Filer Manual provide guidance on complying with the requirement to include calculation relationships in an interactive data file. In addition, the SEC staff's "Dear CFO" letter,[6] which was posted to the SEC's Web site in July 2014 and has been sent to a number of public companies, reminds registrants that the XBRL rules require them to "include calculation relationships for certain contributing line item elements for [the] financial statements and related footnotes." The letter advises registrants to "take the necessary steps to ensure that [they] are including all required calculation relationships" in their XBRL files.

Interactive Data Requirements in Other Filings

Example of an SEC Comment

Please provide the XBRL interactive data file that is required to be submitted pursuant to Item 601(b)(101)(i) of Regulation S-K. For guidance, please refer to Regulation S-K Compliance and Disclosure Interpretations Question 146.17, available at: http://www.sec.gov/divisions/corpfin/guidance/regs-kinterp.htm.

[5] The staff used the term "smaller filers" to refer to U.S. GAAP filers that are not large accelerated filers.

[6] *Sample Letter Sent to Public Companies Regarding XBRL Requirement to Include Calculation Relationships.*

Under Regulation S-T and Regulation S-K, Item 601(b)(101)(i), registrants must submit an interactive data file as an exhibit to a registration statement if the statement contains (1) financial statements and (2) a price or price range. For purposes of Item 601(b)(101)(i), the disclosure of the "offering price" of a shelf offering, an at-the-market offering, an exchange offer, or a secondary offering in a filed registration statement is construed as a price or price range.

In addition, Item 601(b)(101)(i) highlights that an interactive data file would be required for a Form 8-K filing "when the Form 8-K contains audited annual financial statements that are a revised version of financial statements that previously were filed with the [SEC] that have been revised pursuant to applicable accounting standards to reflect the effects of certain subsequent events, including a discontinued operation, a change in reportable segments or a change in accounting principle."

Further, registrants should monitor new rules issued by the SEC as a result of the Dodd-Frank Act or other legislation to see whether they require XBRL tagging of specified information that otherwise would be outside the scope of the SEC's interactive data requirements. For example, under the SEC's recently proposed rule on pay-versus-performance disclosures, which would implement Section 953(a) of the Dodd-Frank Act, registrants would be required to provide such disclosures "in tagged data format using [XBRL]."[7]

Other Deloitte Resources

- July 8, 2014, *Deloitte Accounting Journal*, "SEC Staff Issues Communications to XBRL Filers."
- December 16, 2013, *Heads Up*, "Highlights of the 2013 AICPA Conference on Current SEC and PCAOB Developments."
- September 19, 2013, *Heads Up*, "XBRL — Past, Present, and Future."

Audit Report Requirements

Example of an SEC Comment

Please amend your filing to include an audit opinion which encompasses all of the financial statements included in your filing. In this regard, we note that your audit opinion refers to " . . . the related consolidated statements of operations, comprehensive loss, changes in stockholders' equity and cash flows for the year then ended." However, you have included more than one year of financial statements. We note the same terminology was used in the concluding paragraph of the audit opinion. Additionally, please ensure that your independent auditor properly references the city and state where the audit report was issued. Please refer to Rule 2-02 (a) of Regulation S-X. We remind you to also include currently dated certifications that refer to the amended form.

The SEC staff continues to comment when a registrant does not comply with Regulation S-X, Rule 2-02(a), and Regulation S-T, Rule 302. For example, the staff has commented when:

- A signature did not conform to Regulation S-X and S-T requirements.
- A public accounting firm's city and state were omitted from the audit report.
- A registrant included a report from its auditor that does not appropriately identify all financial statements covered by the audit report.

[7] For additional information about the SEC's proposed rule, see Deloitte's May 29, 2015, *Heads Up*.

The SEC staff will generally ask the registrant to amend its filing or provide a revised audit report if the report is not in compliance with the technical requirements of Regulation S-X, Rule 2-02(a), or Regulation S-T, Rule 302, including the requirements related to typed "signatures" in electronic submissions.

In addition, the CAQ issued Alert 2012-16 to remind auditors that "it **would not** be appropriate for the auditor's report for issuers or other entities that require compliance with PCAOB requirements to reference only the ***auditing*** **standards** of the PCAOB" since this qualifying language may imply that the auditor did not adhere to other standards of the PCAOB (e.g., its independence standards). The alert also encouraged registrants and auditors to review paragraph 4110.5 of the FRM for additional information regarding certain PCAOB requirements in various SEC filings.

Selected Quarterly Financial Data

Example of an SEC Comment

We note in your disclosure that you describe the effects of certain significant items on an aggregate basis for each respective year. Please revise to clearly disclose how such unusual or infrequently occurring items are material to the results of each quarter. Please refer to Item 302 (a)(3) of Regulation S-K.

The SEC staff has issued comments on the sufficiency of disclosures about selected quarterly financial information under Regulation S-K, Item 302(a). For example, the staff has asked registrants to revise such disclosures when the disclosures fail to mention the effects of items recognized during quarters within the two most recent fiscal years, such as (1) the disposal of a segment of a business or (2) extraordinary, unusual, or infrequently occurring items.

A registrant is generally not required to provide selected quarterly financial data in its initial registration statement on Form S-1 because the requirement does not apply until a company has registered securities in accordance with Section 12(b) or Section 12(g) of the Exchange Act. However, at the March 2015 CAQ SEC Regulations Committee joint meeting with the SEC staff, the staff clarified that registrants that file a follow-on registration statement[8] before filing their first Form 10-K would generally be required to provide selected quarterly financial data because their securities are typically registered under Section 12(b) or Section 12(g) at the time the follow-on registration statement is filed.

[8] That is, a registration statement filed after the IPO.


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Disclosure Topics in Initial Public Offerings

Initial Public Offerings

An IPO is most commonly thought of as the initial sale of equity or debt securities to the public by a private company that registers its securities on Form S-1. However, there are other situations in which a company can register debt or equity securities with the SEC for the first time, such as by exchanging debt securities previously issued in a private transaction for registered debt securities (typically on a Form S-4), registering currently outstanding equity securities, or distributing shares in a spin-off transaction by a public company (typically on a Form 10). All such transactions are referred to as IPOs in this discussion. However, as a result of the JOBS Act, which was signed into law on April 5, 2012, certain companies that meet the requirements for emerging growth company (EGC) status are eligible to raise capital and register as new issuers by complying with less stringent regulatory and reporting requirements than those required for a typical IPO. See the Emerging Growth Companies section for additional information on such requirements.

Because an IPO typically represents a company's first filing with the SEC, the SEC staff almost always reviews the related registration statement. The staff's review is typically comprehensive, covering reporting, accounting, and legal issues. In addition, the SEC staff's comments often focus on the following reporting topics (most of which are further discussed in the SEC Reporting section):

- Significant business acquisitions (Regulation S-X, Rule 3-05).
- Investments in equity method investees (Regulation S-X, Rule 3-09).
- Guarantors of registered securities (Regulation S-X, Rule 3-10).
- Issuers of securities that collateralize registered securities (Regulation S-X, Rule 3-16).
- Pro forma financial statements (Regulation S-X, Article 11).

It is also common for SEC staff comments on IPO registration statements to address accounting and disclosure topics such as (1) complex equity instruments; (2) share-based compensation, including equity securities issued as compensation in periods before an IPO (commonly referred to as "cheap stock" considerations); and (3) revenue recognition. For more information, see the Debt, Financial Instruments, Share-Based Payments, and Revenue Recognition sections. The SEC staff also comments on certain issues that are more specific to IPO registration statements. Such issues are discussed in this section.

Registrant Financial Statements

A company undergoing an IPO is required to present its financial statements, footnotes, and schedules for certain annual and interim periods in its registration statement. Regulation S-X, Rules 3-01 through 3-04, describe the general financial statement requirements for the registrant and its predecessors. Registrants must determine which financial statements to include in their initial registration statement on the basis of their individual facts and circumstances and must continue to update the financial statements throughout the registration process to provide current financial information. The SEC staff often comments when registrants do not include the required financial statements in the registration statement.

Age of Financial Statements

Example of an SEC Comment

Please amend your filing to provide financial statements for [Company A] and its predecessor that comply with Rule 3-12 of Regulation S-X at the date the registration statement becomes effective.

A registrant's financial statements must meet the "age of financial statements" requirements as of every filing date as well as when the registration statement is declared effective. The age of financial statements generally refers to the specific annual and interim periods for which financial statements are required in a filing. Regulation S-X, Rule 3-12, provides guidance on such periods and on when the financial statements become stale (i.e., should be updated).

Recently Organized Registrant

> **Example of an SEC Comment**
>
> Please provide audited financial statements of the registrant (i.e. the current subsidiary that will become [Company X]) and [the existing entity] as required by Rule 3-01(a) of Regulation S-X, or tell us why you believe such financial statements are not required.

Sometimes the legal entity registering securities in an IPO is a newly formed company that will succeed to the operations of an existing business before the effective date of the initial registration statement. In such cases, the entity may need to include the balance sheet of the recently organized registrant in addition to the financial statements of the existing business. See Section 1160 of the FRM for additional guidance on newly formed entities. In addition, Regulation S-X, Rule 3-01, provides guidance on a registrant's balance sheet requirements.

Predecessor Financial Statements

> **Example of an SEC Comment**
>
> Please tell us what factors you considered, and why you concluded, [Company A] represents your predecessor. In your response, please tell us how you are actually succeeding to substantially all of the business of [Company A], and what impact control of [Company A] has upon your ability to succeed to the business. We may have further comment.

Section 1170 of the FRM addresses the requirements for predecessor financial information. It states that the designation "predecessor" is required when "a registrant succeeds to substantially all of the business (or a separately identifiable line of business) of another entity (or group of entities) and the registrant's own operations before the succession appear insignificant relative to the operations assumed or acquired." Because a predecessor's historical financial information is considered important to an investing decision, when a predecessor is identified, the registration statement must also present the predecessor's financial information and reflect such information as if it were the registrant's. That is, financial statements for both the registrant and its predecessor should be presented as of and for all periods required by Regulation S-X.

Trends related to predecessor financial statements in put-together transactions were considered at the March 2015 CAQ SEC Regulations Committee joint meeting with the SEC staff. The meeting highlights published by the CAQ state:

> The Committee and staff also discussed how registrants should evaluate who the predecessor is in put-together transactions where multiple entities that are roughly the same size are acquired by a [new entity ("Newco")] in a business combination in which Newco is the accounting acquirer. In this situation, the staff noted that it may not be readily apparent which entity or entities should be treated as the predecessor. The [s]taff also noted that the fact patterns it has seen have been unique, and in certain circumstances registrants have concluded that there is more than one predecessor.

In summary, the reasoning behind an entity's conclusion on what should be included in its predecessor financial statements — and on whether the entity has a single predecessor or multiple predecessors — remains a focus of the SEC staff.

Carve-Out Financial Statements

Example of an SEC Comment

You disclose that the combined financial statements may not include all of the actual expenses that would have been incurred had [the new entity] been a [stand-alone] company during the periods presented and that actual costs would have been different. Please disclose your estimate as to what the expenses would have been on a stand-alone basis for [the new entity], that is, the cost that would have been incurred if [the new entity] had operated as an unaffiliated entity for all years reported when such basis produces materially different results. Please refer to Question 2 of SAB Topic 1.B.1.

"Carve-out financial statements" is a generic term used to describe separate financial statements that are derived from the financial statements of a larger parent company. A carve-out occurs when a parent company segregates a portion of its operations and prepares a distinct set of financial statements for the segregated portion in preparation for a sale, spin-off,[1] or IPO of the "carve-out entity." Examples of a carve-out entity may include (1) all or part of a subsidiary of a parent company or (2) a line of business that was previously part of a larger parent company.

Often, the parent may not have historically accounted for the carve-out entity separately, and the registrant (i.e., the carve-out entity) may have relied on the parent for certain functions. SAB Topic 1.B indicates that the registrant's historical income statements should present all of the costs of doing business, including expenses incurred by the parent on behalf of the registrant. Examples of such costs include salary, rent, depreciation, advertising, accounting and legal services, and other SG&A. Registrants must use a reasonable method to allocate the common expenses from the parent to the registrant if specific identification is not practicable. The method for such allocation must also be disclosed in the notes to the financial statements, with an explanation of why management believes such method is reasonable. To the extent that the registrant and the parent have shared functions (e.g., treasury or cash management), these shared functions need to be evaluated so that the appropriate amount of expense to be allocated to the carve-out entity can be determined.

When financial statements of a carve-out entity are used in an IPO, it is critical that the carve-out financial statements identify the appropriate assets and operations of the registrant. A registrant's determination of the composition of the carve-out financial statements depends on its specific facts and circumstances and may require significant judgment because the process of identifying appropriate assets and operations of the registrant in an IPO transaction is complicated. At the 2014 AICPA Conference, the SEC staff acknowledged that determining what financial statements to include in a registration statement can be complex and that registrants need to use judgment when doing so, particularly because (1) there may not be SEC guidance directly on point and (2) accounting guidance (e.g., the guidance in ASC 505-60 on determining the accounting spinnor and spinnee) may not be wholly determinative of the SEC's reporting requirements. Further, at the March 2015 CAQ SEC Regulations Committee joint meeting with the SEC staff, the staff discussed financial reporting differences that can arise depending on the legal form of the transaction.

Accordingly, registrants should consider the context of their Description of Business section and MD&A and whether that information, along with the financial statements, provides a full picture for investors. At the 2014 AICPA Conference, the SEC staff encouraged registrants to submit a prefiling letter to resolve any complex issues ahead of time and thereby potentially avoid having to address them during the staff's review of their IPO filing.

In addition, the SEC staff discussed at the 2014 AICPA Conference the recent prevalence of IPO transactions that contemplate the formation of a master limited partnership. Examples include situations in which assets that function as internal services have been contributed by the sponsor but operations

[1] ASC 505-60-20 defines a spin-off as the "transfer of assets that constitute a business by an entity (the spinnor) into a new legal spun-off entity (the spinnee), followed by a distribution of the shares of the spinnee to its shareholders, without the surrender by the shareholders of any stock of the spinnor."

have not had historical revenue streams. Registrants need to carefully analyze the facts and circumstances to determine what historical financial statements to include. Again, the staff encouraged registrants to submit a prefiling letter to help resolve these unique and complex issues.

Spin-off transactions can be highly complex and involve numerous legal and accounting decisions that registrants must consider, including the accounting for the transaction (i.e., spin-off or reverse spin-off) in accordance with ASC 505-60. Registrants should also consider other aspects of carve-out financial statement reporting, including (1) the allocation of items such as pension and postretirement benefit plans, income taxes, impairment of goodwill and other intangible assets, and debt and contingencies and (2) treatment of intercompany transactions. In addition, carve-out entities in an IPO will need to consider their ongoing compliance with Rules 3-05 and 3-09 for acquisitions and equity method investments, respectively, whose level of significance may differ from that of the parent's acquisitions and equity method investments. Further, the SEC staff may ask about segment reporting and EPS in these complex transactions.

For additional considerations related to carve-out transactions, see Deloitte's publication *A Roadmap to Accounting and Financial Reporting for Carve-Out Transactions*.

Public-Entity Disclosures and Transition Provisions

A nonpublic entity's previously issued financial statements may not be sufficient for an IPO. Nonpublic entities may need to revise their financial statements to include the public entity disclosures required under U.S. GAAP and Regulation S-X.[2] In addition, such entities will need to obtain an auditor's report on their financial statements that (1) is issued by a PCAOB-registered accounting firm and (2) refers to the PCAOB's standards.[3]

U.S. GAAP

Certain provisions of U.S. GAAP differ for public and nonpublic entities. A registrant's financial statements in an IPO must adhere to accounting principles and disclosures required for public entities for all periods presented.[4] The term "public entity" generally refers to an entity that files its financial statements with the SEC. However, there are different definitions of public entity under U.S. GAAP. Examples of accounting principles and disclosures that apply to public entities but not nonpublic entities include EPS (under ASC 260-10-15-2 and 15-3); segment reporting (under ASC 280-10-15-3 and ASC 280-10-20); temporary equity classification of redeemable securities (under ASC 480-10-S99-3A); and pensions and other postretirement benefits, such as defined benefit plans (under ASC 715-20-20).

In addition, the effective date of a new accounting pronouncement may be sooner for public entities than for nonpublic entities. Since registrants must apply public-entity guidance for all periods presented in the IPO financial statements, a nonpublic entity may be required to retrospectively change its date of adoption of a new standard to that required for a public entity.[5]

Further, a company that is preparing to go public — or that may consider going public in the future — should be cautious about electing the alternatives developed by the PCC. Once a company is considered a PBE, it would no longer be permitted to apply PCC accounting alternatives. Consequently, any previously elected PCC alternatives would need to be eliminated from the company's historical financial statements before such statements can be included in its IPO registration statement. See the SEC Reporting section for additional information about PBEs.

[2] EGCs are allowed to adopt new or revised financial accounting standards on the basis of effective dates applicable to private companies (i.e., nonissuers) "if such standards apply to companies that are not issuers." See the Emerging Growth Companies section for additional information.

[3] See paragraph 4110.5 of the FRM for additional information.

[4] See footnote 2.

[5] See footnote 2.

SEC Rules and Regulations

Examples of SEC Comments

- Please revise future filings to disclose the amount of income (loss) before income tax expense attributable to domestic or foreign operations. Refer to Rule 4-08(h) of Regulation S-X.
- Please revise to provide separate disclosure in your consolidated statements of operations of the license fee expense paid to [Company A], a company affiliated with one of your principal shareholders, during all periods presented. Refer to the guidance outlined in Rule 4-08(k) of Regulation S-X.

In an IPO, the registrant's financial statements should comply with the applicable requirements of Regulation S-X, and SEC staff views in SABs, for each period presented in the financial statements. Because such requirements and views are new to the registrant, its disclosures may not be fully compliant; as a result, the SEC staff frequently requests additional disclosures. Regulation S-X prescribes the types, form, and content of the financial information that registrants must file. Many of these requirements expand on the disclosures directly required by U.S. GAAP. SABs provide staff views on 14 broad topics, including business combinations, revenue recognition, and share-based payment arrangements. Requirements addressed by Regulation S-X and SABs that often affect nonpublic-entity financial statements during the IPO process include:

- Balance sheet and income statement presentation requirements (Regulation S-X, Rules 5-02 and 5-03) and age of financial statement requirements (Regulation S-X, Rule 3-12).
- Summarized financial information of subsidiaries not consolidated and 50 percent or less owned persons (Regulation S-X, Rule 4-08(g)).
- Income tax expense (Regulation S-X, Rule 4-08(h)).
- Related-party disclosures (Regulation S-X, Rule 4-08(k)).
- Audited financial statement schedules (Regulation S-X, Articles 5 and 12).
- Preferred stock and other securities (e.g., common stock) subject to mandatory redemption requirements or whose redemption is outside the issuer's control (Regulation S-X, Rule 5-02.27; ASR 268; ASC 480-10-S99-3A).

For additional reporting considerations related to these topics, see the Financial Statement Classification, Including Other Comprehensive Income; Income Taxes; and SEC Reporting sections.

Distributions to Owners

Example of an SEC Comment

We note that you plan to distribute all of the proceeds from the offering of common units and a portion of the proceeds from your new credit facility to [Entity A] upon closing of the offering. Please explain to us what consideration you gave to providing a pro forma balance sheet alongside your latest historical balance sheet reflecting the distribution. Additionally, please tell us what consideration you gave to providing pro forma per unit data for the latest year and interim period within your historical financial statements to the extent that the distribution exceeds the current year's earnings. . . . We refer you to SAB Topic [1.B.3].

It is common for registrants to plan dividends or distributions to owners as of, or immediately before, the closing of an IPO. The SEC staff often comments on the need for pro forma information related to such distributions.

SAB Topic 1.B.3 and paragraph 3420.1 of the FRM express the SEC staff's view that a significant planned distribution that is not reflected in the latest historical balance sheet should be presented in a pro forma balance sheet regardless of whether it has been declared or will be paid from the proceeds of the offering. The pro forma balance sheet should be presented alongside the most recent historical balance sheet in the filing and should reflect the distribution (but not give effect to the offering proceeds).

In addition, SAB Topic 1.B.3 indicates that if a distribution will be paid to owners from the proceeds of the offering rather than from the earnings in the current year, the registrant should present pro forma EPS data for the latest year and interim period in addition to historical EPS. Paragraph 3420.2 of the FRM provides additional interpretive guidance on the calculation of such pro forma per share data.

Changes in Capitalization

Entities often have other capitalization changes that occur before, or concurrently with, the effective date or closing of an IPO. Some changes, such as a stock split, are reflected retrospectively in all periods presented in the financial statements. Other changes, which may include (but are not limited to) the redemption or automatic conversion of preferred stock into common stock or the conversion of debt to equity, are only recorded prospectively and may not be reflected in the financial statements presented in an IPO filing. Registrants should present such changes in capitalization as part of the pro forma information. The SEC staff often focuses on the presentation of such pro forma information.

Pro Forma Information

Examples of SEC Comments

- Please revise to include a pro forma balance sheet presented alongside the historical balance sheet giving effect to the conversion of your A, B and C preferred shares. Also if the conversion will result in a material reduction of earnings per share, please include pro forma EPS for the latest year and interim period giving effect to the conversion.
- We note your use of net proceeds from this offering includes the repayment of outstanding balances under your credit facility. Please revise your pro forma net loss per share information to address the effect of the proceeds intended to be used for debt repayment. In this regard, you should disclose the effects of the interest expense adjustment and the number of shares issued in this offering whose proceeds will be used to repay the credit facility. Please ensure that the footnotes to your pro forma disclosures clearly support the calculations of both the numerator and denominator used in computing pro forma net loss per share. We refer you to SAB Topic 3.A by analogy and Rule 11-01(a)(8) and Rule 11-02(b)(7) of Regulation S-X.

The SEC staff asks registrants to present pro forma information when changes in capitalization will occur after the date of the latest balance sheet. Paragraph 3430.2 of the FRM indicates that when such changes will result in a material reduction in permanent equity or are the result of a redemption of a material amount of securities in conjunction with the offering, a filing should include a pro forma balance sheet (presented alongside the historical balance sheet) that takes into account the change in capitalization but not the effects of the offering proceeds.

In addition, paragraph 3430.3 of the FRM indicates that when a conversion of outstanding securities occurs after the latest balance sheet date and will result in a material reduction in EPS exclusive of the effects of the offering, registrants should present pro forma EPS (but should exclude the effects of the offering). Such pro forma EPS should be presented for the latest fiscal year and interim period.

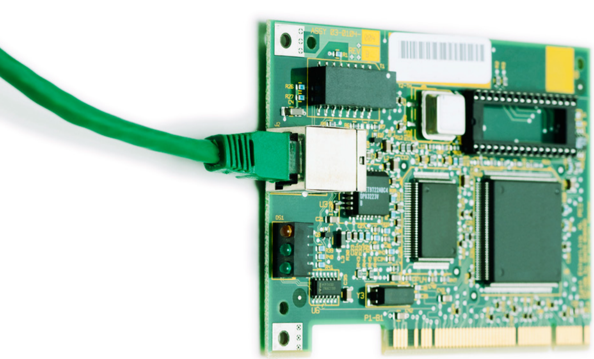
Further, SEC staff comments have noted that to the extent that proceeds of an offering are used for the repayment of outstanding borrowings, registrants should include the impact of such repayments in their pro forma EPS amounts by (1) increasing the denominator by the number of shares necessary to repay the outstanding borrowings and (2) adjusting interest expense in the numerator.

Draft Audit Reports

Example of an SEC Comment

We note that your reverse stock split will be effective immediately prior to completion of the offering. This reverse split should be retrospectively reflected in the financial statements, selected financial data and elsewhere throughout the filing. If the transaction prevents the auditor from expressing an opinion on the financial statements at the time of filing, we will not object to the filing of a "draft report" in the form that it will be expressed at effectiveness. In this case, the draft report should be accompanied by a signed preface of the auditor stating that it expects to be in a position to issue the report in the form presented at effectiveness. No registration statement can be declared effective until the preface is removed and the accountant's report [is] finalized.

In accordance with Regulation S-X, Rule 2-02, and interpretive guidance (e.g., Section 4710 of the FRM), the auditor's report should be dated and signed by the auditor and should not contain restrictive language (e.g., "draft"). The SEC staff will generally not commence its review of a registrant's filing if the registrant has filed a registration statement that does not meet these requirements. However, if a transaction (e.g., a stock split) is expected to occur immediately before the registration statement is declared effective, the registrant may wish to give effect to the transaction before it occurs. When such an anticipated transaction has been included in the historical financial statements, the SEC staff has accepted the filing of a "draft report" in the form in which the report will be expressed at the time the registration statement becomes effective to prevent the auditor from expressing an opinion regarding the financial statements at the time of filing (because the filing took place before the transaction occurred and before the registration statement was declared effective). Such a report would include a preface indicating that the report will not be final until the transaction is completed. The SEC staff will remind registrants to remove the preface from a registration statement that was filed before being declared effective because no registration statement can be declared effective until the preface is removed and the accountant's report is finalized.



Dilution Disclosure

Examples of SEC Comments

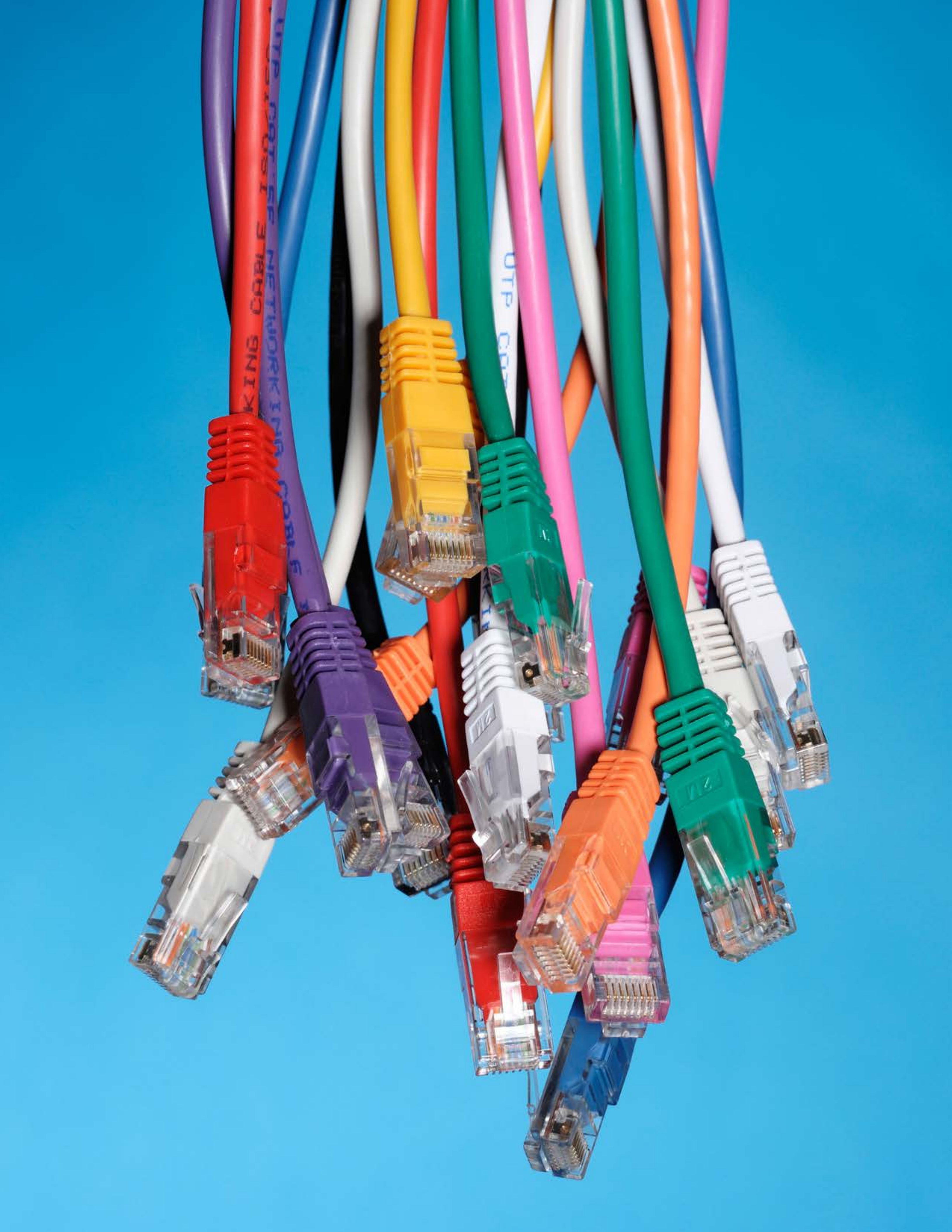
- Please tell us why you are including noncontrolling interest in your calculation of historical net tangible book value for purposes of assessing dilution to shareholders that invest at the time of your IPO.
- We note that you removed the measure of net tangible book value from your disclosure in addition to removing your measure of net tangible liabilities. Please revise your disclosures to present the net tangible book value measures required by Item 506 of Regulation S-K, or tell us why you believe these disclosures are no longer applicable.

Under Regulation S-K, Item 506, certain disclosures (including net tangible book value per share before and after a distribution) are required when "common equity securities are being registered and there is substantial disparity between the public offering price and the effective cash cost to officers, directors, promoters and affiliated persons of common equity acquired by them."

Section 8300 of the FRM acknowledges that there is no authoritative definition of "tangible book value" but notes that the metric "is used generally as a conservative measure of net worth, approximating liquidation value." The interpretive guidance (1) indicates what tangible assets should exclude and (2) cites examples of when the SEC staff has allowed dual calculation of tangible book value. Accordingly, the staff may question a registrant's calculation of dilution and its related disclosures, particularly if net tangible book value reported in the dilution section of the registration statement appears to be inconsistent with the historical financial statements.

Other Deloitte Resources

- December 15, 2014, *Heads Up*, "Highlights of the 2014 AICPA Conference on Current SEC and PCAOB Developments."
- December 24, 2013, *Deloitte Accounting Journal*, "FASB Defines a Public Business Entity."



Foreign Private Issuers

Foreign Private Issuers Using IFRSs

The SEC staff's comments to FPIs have addressed a number of financial accounting and disclosure topics. Many of the comments are generally consistent with those issued to domestic filers and raise topics that are discussed in other sections of this publication (albeit staff comments to FPIs on financial statement topics refer to IFRSs). In addition, FPIs have received staff comments about (1) the presentation of financial statements (i.e., under IAS 1); (2) accounting for expenditures related to the exploration for, and evaluation of, mineral resources (i.e., under IFRS 6); (3) their consolidation analysis and disclosures (e.g., under IFRS 10); and (4) references to the use of IFRSs as issued by the IASB.

Presentation of Financial Statements

Examples of SEC Comments

- Please confirm that you have disclosed all material expenditures by nature as required under paragraph 104 of IAS 1 or revise your disclosure to quantify these expenditures.
- We note . . . that you view the loss of settlement as [being] unrelated to your operations because the settlement was based on an allegation of infringement and no finding of infringement was ever made by a court of proper jurisdiction. We would expect that it is normal operational activity for companies to defend their patents used in operations against claims of infringement, whether litigated or settled. Since the patents involved are used by your operations, we continue to believe that the associated settlement costs are representative of activities that would normally be regarded as operating. Refer to BC 56 of IAS 1.

The SEC staff's comments have often focused on missing disclosures about the nature of expenses when FPIs used a functional presentation of expenses in the statement of profit or loss and OCI. The staff has also commented on the exclusion of certain expenses from amounts presented as results of operating activities (i.e., operating income). In addition, the staff has asked FPIs to present additional line items in the statement of profit or loss and OCI when such presentation is relevant to an understanding of the issuer's financial performance.

Under IAS 1, an entity can present expenses either by nature or by function. According to paragraph 104 of IAS 1, an entity that presents expenses by function must provide additional disclosures about the "nature of expenses, including depreciation and amortisation expense and employee benefits expense." As explained in paragraph 105 of IAS 1, this is "because information on the nature of expenses is useful in predicting future cash flows." The use of the term "including" in IAS 1 implies that additional disclosures about the nature of expenses may not be limited to depreciation, amortization, and employee benefit expenses. Rather entities should disclose other expenses by nature if such information may be useful in predicting future cash flows. An entity that uses a functional format should ensure that all additional disclosures are included in the footnotes and should consider including them in a single footnote for greater transparency. Paragraph IG6 of IAS 1 illustrates income statements that are presented by nature and by function.

Paragraphs 82 and 82A of IAS 1 each list line items that an entity should include, at a minimum, in its statement of profit or loss and OCI. Disclosure of the results of operating activities as a separate line item in the statement of profit or loss and OCI is not required; however, an entity that decides to present the results of operating activities or a similar line item should refer to paragraph BC56 of IAS 1, which notes, in part, that "it would be misleading and would impair the comparability of financial statements if items of an operating nature were excluded from the results of operating activities, even if that had been industry practice."

Further, paragraph 85 of IAS 1 requires an entity to present additional line items, headings, and subtotals on the face of the statement of comprehensive income "when such presentation is relevant to an understanding of the entity's financial performance." When including such line items and subtotals, an entity should consider providing transparent disclosures that clearly convey the relevance of the items to financial statement users. In such cases, an entity may amend the description of the line items and reorder them to explain the particular element of financial performance.

Exploration for, and Evaluation of, Mineral Resources

Examples of SEC Comments

- We note . . . that you rely on IFRS 6 guidance in capitalizing exploration expenditures. We also note . . . that capitalized exploration costs are classified as mine development assets and you are relying on the guidance in IAS 16. To help us better understand your accounting policy for capitalizing exploration expenditures, please address the following items:
  - Tell us why you consider it appropriate to classify the capitalized exploration costs as mine development assets under IFRS 6 paragraphs 10 and 25.
  - Tell us how you reclassify the capitalized exploration costs when the technical feasibility and commercial viability of extracting a mineral resource are demonstrable under the guidance in IFRS 6 paragraph 17 if the related capitalized exploration costs have been recorded as mine development assets.
  - Tell us the amount of exploration costs capitalized by mine at [Mine A and Mine B].
- We note your disclosure that you capitalize exploration and evaluation costs as intangible assets and reclassify these costs to mining properties when intended production levels are achieved. Please provide us a detailed discussion of how your accounting policy complies with IFRS 6, particularly paragraph 17. Additionally, please tell us how you define intended production levels being achieved.

The SEC staff has often requested more information about an FPI's accounting policy related to the types of expenditures that the issuer recognizes as exploration and evaluation assets, including whether such policy complies with IFRS 6.

IFRS 6 requires an entity to develop an accounting policy that specifies the types of expenditures it recognizes as exploration and evaluation assets and to apply that policy consistently — particularly because IFRS 6 does not require entities to capitalize exploration and evaluation expenditures. In addition, when specified conditions are met, IFRS 6 permits entities to continue applying the accounting policies they used to account for exploration and evaluation expenditures before adopting IFRS 6.

Under IFRS 6, an entity's assessment of which expenditures would qualify as exploration and evaluation assets is determined on the basis of how closely the expenditures are associated with finding specific mineral resources. IFRS 6 provides a nonexhaustive list of expenditures that an entity might consider including in the initial measurement of its exploration and evaluation assets. Such expenditures include those related to:

- Acquisition of rights to explore minerals.
- Topographical, geological, geochemical, and geophysical studies.
- Exploratory drilling.
- Trenching.
- Sampling.
- Activities related to evaluating the technical feasibility and commercial viability of extracting a mineral resource.

However, in accordance with IFRS 6, entities should not recognize expenditures related to the development of mineral resources as exploration and evaluation assets; instead, entities are required to apply the *Conceptual Framework for Financial Reporting* and IAS 38 to determine an appropriate accounting policy for such amounts. Further, although the term "development" is not defined, paragraph 5(b) of IFRS 6 indicates that the development phase begins "after the technical feasibility and commercial viability of extracting a mineral resource are demonstrable."

References to the Use of IFRSs as Issued by the IASB

Example of an SEC Comment

Please amend your filing to include an audit opinion that refers to and opines on International Financial Reporting Standards as issued by the International Accounting Standards Board or include a reconciliation to US GAAP. Refer to Item 17(c) of Form 20-F.

The SEC staff has requested that FPIs amend their Form 20-F when they have not asserted, and the audit report has not stated, that the financial statements were prepared in accordance with "IFRSs as issued by the IASB."

As stated in paragraph 6310.2 of the FRM and similarly indicated in Item 17 of Form 20-F, the issuer's "accounting policy footnote must state compliance with [IFRSs] as issued by the IASB and the auditor's report must opine on compliance with [IFRSs] as issued by the IASB." An issuer that does not prepare its financial statements in accordance with IFRSs as issued by the IASB is required to reconcile its financial statements to U.S. GAAP. The SEC staff has reiterated that FPIs need to provide a statement of compliance with "IFRSs as issued by the IASB" to be eligible to omit the U.S. GAAP reconciliation.

Consolidations

Examples of SEC Comments

- We note that upon adoption of IFRS 10, you deconsolidated five companies because you determined you are not exposed to variable returns although you have power over the relevant activities. [F]or [Entity A] and [Entity B], your ownership percentage is 100.00% and 92.64%, respectively. Tell us and revise your future filings to disclose the significant judgments and assumptions made in your determination that you are not exposed to variable returns for these entities even though you have substantially all voting rights.
- We note that your adoption of IFRS 11 resulted in accounting for several entities under the equity method instead of the proportional consolidation method you used prior to the adoption of IFRS 11. Please tell us in sufficient detail how you determined these joint arrangements qualified as joint ventures as opposed to joint operations. Ensure your analysis discusses the structure and form of the arrangements and the involved parties' rights and obligations arising from the arrangements.

FPIs have received SEC staff comments about their IFRS 10 conclusions, including whether they have (1) power over the relevant activities of an investee, (2) exposure or rights to the variable returns of an investee, and (3) the ability to affect an investee's variable returns through their power over the investee.

In addition, FPIs have been asked to provide disclosures required by IFRS 12 related to (1) their interests in other entities and (2) the significant judgments and assumptions they made in determining that they have control, joint control, or significant influence over another entity.

Further, the SEC staff has inquired about how a registrant determined whether joint arrangements qualified as joint ventures rather than joint operations.

Industry-Specific Topics

Consumer and Industrial Products

Retail and Distribution

The SEC staff's comments to registrants in the retail and distribution industry have focused on the convergence of digital technology with the traditional "brick-and-mortar" and direct channels. Retailers citing an omnichannel customer experience have received comments on MD&A related to the impact of multiple distribution channels on trends in results of operations and in liquidity and capital resources. Other frequent comments include (1) questions about the accounting for and disclosure of certain revenue recognition items and (2) requests for additional disclosures related to sales returns and allowances.

In addition, given that registrants in the industry typically have multiple distribution channels (e.g., stores, catalogs, the Internet), geographic locations, and store concepts and brands, the SEC staff frequently asks such registrants about the identification and aggregation of their operating segments, particularly when they disclose only one reportable segment. Further, many retailers have received comments related to the disclosure of revenue by products and services in accordance with ASC 280-10-50-40. See the Segment Reporting section for additional information.

MD&A

Examples of SEC Comments

- [P]lease expand your discussion of how the trend towards mobile and multi-channel shopping will affect both your liquidity and capital resources expenditures moving forward.
- Since it appears that your online business has a significant impact on your results, please provide a quantified discussion of your online business as part of providing investors with a view of the company through the eyes of management. . . . In making this disclosure, please disclose the revenues and profitability of your online channel for each period presented and provide a comprehensive discussion and analysis of the performance and known trends related to your online operations.
- While we recognize that situations such as placing an online order while standing in a store make it difficult to present pure store and online sales amounts, we assume that if management separately tracks the sales from stores and online you are using a reasonable allocation methodology to make those figures meaningful to you, and we believe that your investors would benefit from you sharing this information along with your allocation methodology.
- We note your eCommerce sales are included within your same store sales calculation. Tell us your basis for inclusion of online sales in your same store sales calculation and explain to us what consideration you gave to also disclosing same store sales excluding eCommerce sales. In explaining your basis, please tell us and disclose whether the prices, margins or types of products ordered online differ materially from products available at your brick and mortar stores.

The SEC staff frequently asks registrants to improve their MD&A (e.g., by including operational and statistical measures) to help investors see registrants' performance through the eyes of management. Many retailers consider same-store sales a key operating metric; accordingly, same-store sales are often discussed in MD&A to help explain fluctuations in results of operations. Because there can be variability in the way same-store sales are calculated, the SEC staff often asks registrants to enhance their disclosures about such metrics and elaborate on any factors that could affect year-to-year comparability.

Further, in a manner consistent with SEC staff remarks at the 2013 AICPA Conference, the SEC staff continues to ask registrants with significant online sales to separately discuss (1) the impact of such sales on the results of operations, including changes in overall gross margin, and (2) any trends affecting online sales. Incrementally, retailers have received comments requesting expanded disclosure of the impact that online sales have on year-to-year sales metrics, such as same-store sales. See the Management's Discussion and Analysis and Non-GAAP Financial Measures and Key Metrics sections for additional information.

Revenue Recognition — Accounting and Disclosure

Examples of SEC Comments

- We note that delivery sales are recognized at the time of shipment rather than upon delivery to and acceptance by the customer. Please explain why this policy is appropriate referencing authoritative literature.
- Please tell us how you account for your customer loyalty program and your consideration of disclosing your accounting policy specifically as it relates to the program.
- Please tell us how you determined that it was appropriate to classify income from unredeemed gift cards as a reduction of selling, general and administrative expenses as opposed to within net sales or other operating income. Further, tell us and, if material, disclose the amount of breakage income recognized during the periods presented.

The SEC staff may ask registrants to clarify the key terms and related accounting and disclosure for certain revenue recognition items common among retailers, including matters related to direct sales, customer loyalty programs, and gift card breakage. For example, since there is diversity in practice regarding the classification of gift card breakage (i.e., classification as a reduction of SG&A versus within net sales or other operating income), the SEC staff frequently asks registrants to explain the rationale for their classification.

Sales Returns and Allowances

Example of an SEC Comment

Please tell us your consideration of disclosing your accounting policy for sales returns and allowances and your consideration of including the activity in Schedule II as prescribed by Rule 12-09 of Regulation S-X in accordance with Rule 5-04 of Regulation S-X.

The SEC staff has focused on sales returns and allowances for retailers. Given that retailers' online sales are increasing significantly, trends in sales returns may become more important since the rate of sales returns is frequently greater in retailers' direct channels (e.g., online sales) than in their brick-and-mortar channels. Accordingly, registrants whose sales returns have a material impact on their financial statements should consider providing expanded disclosures about their accounting policy in the notes to the financial statements as well as additional quantitative and qualitative information about sales returns in MD&A. Further, some registrants may provide a rollforward of sales returns and allowances in Schedule II under Regulation S-X, Rule 12-09, or similar disclosure in the notes to the financial statements.

Travel, Hospitality, and Leisure

The SEC staff's comments to registrants in the THL industry have focused on (1) revenue recognition accounting and disclosures, (2) impairment of long-lived assets, and (3) VIEs.

Revenue Recognition

Examples of SEC Comments

- We note from your revenue recognition critical accounting policy that at the majority of your private clubs, members are expected to pay an initiation fee or deposit upon acceptance as a member to the club for which revenue related to the initiation fee is recognized over the expected life of an active membership. . . . In this regard, please tell us and revise your critical accounting policies to disclose the expected lives or range of expected lives of active memberships for purposes of recognizing revenue associated with initiation fees and deposits for each of the periods presented in your financial statements. Your revised discussion should address attrition rates and how they are used in determining the expected lives of active memberships.
- We refer to the September 2013 modifications to your [Entity A] agreement that have changed the way you record [travel program miles] sold. We note your disclosure that you allocate the consideration received from selling miles to all deliverables based on their relative standalone sales price and you disclose your method for determining your best estimate of selling prices. Please clarify for us, and revise to disclose the timing when revenue is recognized for each deliverable and the classification of the revenue in the statements of operations.
- Given your acquisition of [Entity A] during 2013 and a portion of [A's] revenues being derived from membership fees, please revise your revenue recognition policy to disclose how you recognize membership fees, the period over which such revenue is recognized and how you account for any deferred revenue and the classification of such on your balance sheet.

The SEC staff often asks THL registrants to clarify and support their revenue recognition policies by disclosing in MD&A or footnotes information such as:

- Any estimates used in the determination of deferred or recognized revenue. For example, the SEC staff may ask for additional disclosure about (1) estimation processes used to determine timing of recognition (e.g., how breakage estimates for loyalty programs were determined) or (2) estimates associated with determining selling prices for contracts with multiple-elements. The SEC staff may also ask THL registrants to disclose amounts recorded in revenue that are based on such estimates.
- The specific inputs and assumptions used to calculate estimates for revenues recognized over time. The SEC staff may ask THL registrants to clarify in their critical accounting policies (1) the significant inputs and assumptions used to determine estimates and (2) the values of the inputs and assumptions used to determine the estimates for the periods reported (e.g., customer attrition rates used to determine average membership life).

In addition, THL registrants have received SEC staff comments asking them to (1) disclose the percentage of revenue derived from key customers mentioned in the registrants' respective SEC filings and (2) provide the staff with quantitative and qualitative information related to any contracts or agreements with countries designated by the U.S. government as state sponsors of terrorism (see the Disclosures Regarding State Sponsors of Terrorism section for more information).

Long-Lived Assets

> **Example of an SEC Comment**
>
> Please consider expanding the Critical Accounting Policies section of MD&A to include a table summarizing your owned vessels that details by vessel, the date of acquisition, purchase price and carrying value at the balance sheet date. Also, please identify within this table any vessels whose estimated market values are less than their carrying values. In this regard, for those vessels whose estimated market value is below their carrying value, please add disclosure below the table of the aggregate market value and aggregate book value of such vessels. This additional disclosure will provide investors with an indication of the estimated magnitude of the potential aggregate impairment charge related to these vessels, if you decided to sell all of such vessels. Also, the disclosure accompanying the table should discuss the related accounting treatment of your vessels, and describe the circumstances under which you would be required to record an impairment loss for those vessels with a carrying value in excess of their estimated fair market values.

The SEC staff has encouraged shipping company registrants to provide tabular disclosures in the critical accounting policies section of MD&A that include information about assets at the individual-vessel level, especially if asset values are depressed. Further, the SEC staff has asked such registrants to disclose, on a comparative basis, the aggregate amount by which their vessels' carrying value exceeds the vessels' aggregate basic charter-free market value (or valuation for covenant compliance purposes). This disclosure is intended to highlight the potential for impairment, the trend in vessel values, and how that trend could affect future results of operations.

In addition, the SEC staff may ask shipping company registrants to discuss more thoroughly (1) the factors and conditions that would lead them to recognize an impairment loss and (2) the sources or events that are driving the change in fair value for recorded impairment charges at the individual-vessel level.

The SEC staff may also ask for more robust disclosures about the sensitivity of assumptions used in the impairment test, particularly those used in the selection of historical average charter rates. Accordingly, registrants are encouraged to consider disclosing the margins by which estimated future undiscounted cash flows would exceed each vessel's carrying value if management were to use various historical trailing averages (e.g., those based on one-year, three-year, and five-year periods).

VIEs

> **Example of an SEC Comment**
>
> Please tell us more specifically how you determined that it was appropriate to not consolidate the variable interest [entity] which you manage, but do not consolidate. Please refer to the specific guidance starting at ASC 810-10-25-20 and compare and contrast to your [c]onsolidated VIEs.

THL registrants may enter into arrangements that result in their holding variable interests (e.g., interests related to real estate investments, property management ventures, or investments in utilities that supply energy to property developments). Since holders of variable interests are required to perform a consolidation analysis, the SEC staff often inquires, or requests additional disclosures, about (1) the specific terms of such arrangements, (2) the initial determination and evaluation of the primary beneficiary under ASC 810-10, and (3) changes in circumstances (e.g., development plans) that could affect the primary beneficiary analysis. In addition, the SEC staff has asked THL registrants to clarify why a consolidated VIE's assets (or liabilities) are not separately presented on the face of the primary beneficiary's statement of financial position if the consolidated VIE's assets can only be used to settle obligations of the consolidated VIE (or the consolidated VIE's liabilities do not provide creditors with recourse to the general credit of its primary beneficiary).

For more information, see the Consolidation section.

Energy and Resources

Oil and Gas

The SEC staff's comments to registrants in the oil and gas industry continue to focus on (1) distributable cash flow and maintenance capital expenditures for master limited partnerships (MLPs); (2) oil and gas reserves; (3) disclosures about drilling activities, wells and acreage data, and delivery commitments; (4) income statement classification; and (5) declines in oil and gas prices.

Distributable Cash Flow and Maintenance Capital Expenditures for MLPs

Example of an SEC Comment

Please tell us and disclose whether you incurred any capital expenditures that had an element of both maintenance capital expenditures and expansion capital expenditures. If so, please revise your disclosure to quantify the portion allocated to expansion capital expenditures for each of the periods presented. In your response, please show us what your disclosure would have looked like had such disclosures been provided in your current Form 10-K.

The partnership agreements of MLPs typically define distributable cash flow and often call for a distinction between capital expenditures related to maintenance and those related to growth. In turn, MLPs frequently disclose distributable cash flow and capital expenditure amounts. Consequently, because distributable cash flow is not determined on the basis of SEC rules or U.S. GAAP, SEC staff comments to registrants in the oil and gas industry may focus on:

- Providing (1) greater clarity about how distributable cash flow is calculated and (2) disclosure of any changes in the calculation of distributable cash flows from prior periods.
- How maintenance capital expenditures are defined, and how they affect distributable cash flow.
- Describing the relationship between the calculated amount of distributable cash flow and actual distributions.
- Understanding the liquidity ramifications of cash distribution requirements, including the risk that the registrant will be unable to maintain the same level of distributions in the future.
- Compliance with the requirements of Regulation S-K, Item 10(e), related to non-GAAP financial measures.

Oil and Gas Reserves

PUD Reserves

Examples of SEC Comments

- You state that "at June 30, 2014, none of our proved undeveloped reserves, which are all at [Location A], have remained undeveloped for five years from the date of initial recognition and disclosure as proved undeveloped reserves." Please disclose the extent to which these proved undeveloped reserves are not expected to be converted from undeveloped to developed status within five years since your initial disclosure of these reserves. If any of your proved undeveloped reserves will take more than five years to develop since initial disclosure, you should disclose the specific circumstances to comply with Item 1203(d) of Regulation S-K.
- We note that your inventory of proved undeveloped drilling locations included four wells that had been recognized as proved reserves for five years or longer. Please quantify the reserves related to these wells, describe the specific circumstances that justified the continued recordation of these reserves, and outline your progress in drilling these four wells. Refer to Rule 4-10(a)(31) of Regulation S-X.

Under Regulation S-X, Rule 4-10(a)(22), a registrant should be reasonably certain when estimating proved reserves that the reserves can be recovered in future years under existing economic conditions. In accordance with Rule 4-10(a)(31)(ii), "[u]ndrilled locations can be classified as having undeveloped reserves only if a development plan has been adopted indicating that they are scheduled to be drilled within five years, unless the specific circumstances, justify a longer time."

At the 2014 AICPA Conference, the SEC staff referred registrants to Rule 4-10(a) and Question131.04 of the C&DIs of the oil and gas rules for the definition of proved undeveloped (PUD) oil and gas reserves and staff views on the interaction of that definition with a registrant's development plan. The staff noted that a mere intent to develop reserves does not constitute adoption of a development plan, which would require a final investment decision. Further, a registrant's scheduled drilling activity should reconcile to its investment plans that have been approved by management.

The SEC staff may ask registrants to justify recorded PUD reserves that will remain undeveloped for more than five years because a registrant's decision not to develop PUD reserves for such a long period may indicate uncertainty regarding development and ultimate recoverability. In accordance with Regulation S-K, Item 1203(d), a registrant may be asked to explain why the reserves have not been or will not be developed, why it believes that the reserves are still appropriate, and how it plans to develop the reserves within five years given the registrant's historical conversion rate. The SEC staff may also ask registrants to support engineering assumptions, such as terminal decline rates, used in proved reserve estimates, as well as assumptions used in future cash flow analyses (e.g., estimated future well costs).

In addition, at the 2014 AICPA Conference, the SEC staff reminded registrants in the oil and gas industry to consider the recent declines in oil and gas prices and the related potential impact on exploration, development, and production levels. See Declines in Oil and Gas Prices below for more information.

Separate Disclosure of NGL Reserves

Example of an SEC Comment

We note your disclosure of "wet" natural gas reserves including NGLs in the presentation of your proved and probable reserves as of June 30, 2013. If your reserves as of June 30, 2013 represent a combination of two separate sales products, please revise your disclosure to provide separate disclosure by product type. In this regard, the staff considers natural gas liquids to be a separate product type under Item 1202(a)(4) of Regulation S-K. Therefore, NGL reserves, if material, should be presented as separate quantities for disclosure under Item 1202(a)(2) of Regulation S-K. Please revise your disclosure or tell us why a revision is not necessary.

Although NGLs are not separately identified as a product type in Regulation S-K, Item 1202(a), they are discussed in ASC 932-235-50-4. Accordingly, the SEC staff may ask registrants to disclose NGLs separately if they aggregate significant NGLs with other product types in their disclosures of proved reserves.

Significant Changes in Reserves and Standardized Measures

Examples of SEC Comments

- Please revise your disclosure to include an explanation of significant changes in reserve quantities as discussed in FASB ASC 932-235-50-10.
- Despite the decrease in [PUDs] from [X thousand barrels of oil equivalent (MBoe)] at December 31, 2013 to [X] MBoe at December 31, 2014, we note that future development costs used to calculate the standardized measure of discounted future net cash flows increased from approximately $[X] to approximately $[X]. Please tell us whether you expect the PUDs recorded as of December 31, 2014 to require greater expenditure for development to proved developed status than PUDs converted in prior periods.

The SEC staff has commented on registrants' disclosures about (1) changes in proved reserves and standardized measures and (2) their compliance with ASC 932-235-50. Accordingly, the SEC staff may ask registrants to:

- Describe the technical factors (e.g., the activities, findings, and circumstances) that led to significant changes in proved reserves.
- Address negatively revised estimates attributable to performance separately from negatively revised estimates attributable to price reductions.
- Explain significant changes in extensions and discoveries.
- Disclose prices used in the calculation of standardized measures.
- Discuss how certain tax attributes were used to determine the future income tax expenses.

Further, the SEC staff may (1) ask registrants whether abandoned assets have been included in the standardized measure and, if so, to provide information about them and (2) refer registrants to a sample letter expressing views of the SEC's Division of Corporation Finance on the required disclosures.

Reserve Reports

Example of an SEC Comment

The discussion of methods employed in the estimation of reserves provided in the Appendix to the reserves report lists four methods customarily employed in the estimation of reserves. While this appears to be a comprehensive list of the methods available to the evaluator, Item 1202(a)(8)(iv) of Regulation S-K requires that the disclosure should address the methods and procedures used in connection with the preparation of the estimates specific to the report. Please obtain and file an amended report to revise the discussion, if necessary, to list only those methods and/or combinations of methods actually used to estimate the reserves contained in the report.

Under Regulation S-K, Item 1202(a)(8), a registrant must file a third-party report as an exhibit to its periodic report or registration statement when it "represents that a third party prepared, or conducted a reserves audit of, the registrant's reserves estimates, or any estimated valuation thereof, or conducted a process review." Accordingly, certain disclosures are required under Item 1202(a)(8). The SEC staff issues comments when these required disclosures are omitted. Often, the staff's comments are related to the requirement in Item 1202(a)(8)(iv) to disclose the "assumptions, data, methods, and procedures used, including the percentage of the registrant's total reserves reviewed in connection with the preparation of the report, and a statement that such assumptions, data, methods, and procedures are appropriate for the purpose served by the report."

Drilling Activities, Wells, Acreage, and Delivery Commitments

Examples of SEC Comments

- [P]lease revise your disclosure to provide additional information regarding the minimum remaining terms of leases and concessions. As currently presented, your disclosure only provides information on acreage expirations for the three fiscal years following the periods covered by your Form 10-K. Refer to Item 1208(b) of Regulation S-K.
- Please expand the disclosure of your production to present the total annual quantities, by final product sold, for each of the periods presented to comply with the requirements in Item 1204(a) of Regulation S-K.

The SEC staff has continued to focus on registrants' disclosures about production information, drilling activities, wells and acreage data, and delivery commitments under Regulation S-K, Items 1204 through 1208. Additional disclosures that may be requested include (but are not limited to) the following:

- Production by geographic area and for each country and field that contains 15 percent or more of the registrant's total proved reserves.
- Drilling activities for each of the last three years by geographic area.
- Steps to be taken to meet significant delivery commitments.
- The number of wells that the registrant operates, including the total gross and net productive wells, expressed separately for oil and gas by geographic area.
- Information related to undeveloped acreage regarding minimum remaining terms of leases and concessions for material acreage concentrations, including significant undeveloped acreage that will be expiring over the next three years.

Income Statement Classification

Example of an SEC Comment

We note your disclosure . . . indicating that in certain instances you take title to the natural gas, NGLs or crude oil that you gather, store, or transport for your customers. We further note the disclosure in your revenue recognition footnote . . . that you recognize revenues for services and products. Please tell us how much revenue you have recognized, for each financial period presented, related to the sales of tangible product for which you have taken title and the amount of revenue related to services. Also tell us how you determined you were not required to separately disclose net sales of tangible products and revenues from services to comply with Rule 5-03(b)(1) of Regulation S-X and to separately disclose the related costs and expenses to comply with Rule 5-03(b)(2).

Under Regulation S-X, Rule 5-03, if product or service revenue is greater than 10 percent of total revenue, disclosure of such component is required as a separate line item on the face of the income statement, and costs and expenses related to the product or service revenue should be presented in the same manner. Revenue streams vary by sector within the oil and gas industry. For example, in the midstream sector, revenue streams could include transportation and storage of crude or refined petroleum products, processing of natural gas, and marketing fees generated from the sale of such products. In connection with these services, midstream companies may purchase, take title to, or otherwise have risk of ownership for the related products they are transporting, storing, or processing. If revenues from these product sales exceed 10 percent of total revenues, registrants are required to disclose such revenues and costs and expenses separately in the income statement. For more information, see the Financial Statement Classification, Including Other Comprehensive Income section.

Declines in Oil and Gas Prices

Example of an SEC Comment

You indicate that a continued low price environment could cause a "significant revision" in the carrying value of oil and gas properties in future periods. Section III.B.3. of SEC Release No. 33-8350 provides guidance regarding quantitative disclosure of reasonably likely effects of material trends and uncertainties. Please revise to provide more extensive discussion, including, where reasonably practicable, quantification of the impact of current commodity prices on the carrying value of your oil and gas properties. Your revised disclosure should also quantify the impact of potential scenarios deemed reasonably likely to occur on your estimated reserve volumes.

At the 2014 AICPA Conference, the SEC staff reminded registrants in the oil and gas industry to consider the recent declines in oil and gas prices and that such changes may:

- Represent a known trend or uncertainty that should be discussed in MD&A.
- Represent a risk that should be discussed in risk factor disclosures.
- Affect the determination of estimated proved reserves.

The SEC staff has noted that one of the most important elements necessary to gaining an understanding of a company's performance, and the extent to which reported financial information is indicative of future results, is the discussion and analysis of known trends and uncertainties. Section III.B.3 of SEC Release No. 33-8350 calls for the quantification of material effects of known material trends and uncertainties and states that "material forward-looking information regarding known material trends and uncertainties is required to be disclosed as part of the required discussion of those matters and the analysis of their effects." Given the nature of the oil and gas industry, significant changes to commodity prices could affect the overall operations of the company. In particular, a significant decline in commodity prices could have a material impact on the carrying value of an exploration and production company's oil and gas properties and may be an early-warning sign of impairment. Accordingly, registrants in the oil and gas industry should quantify, to the extent possible, the impact of commodity prices on their (1) future development and capital programs and (2) oil and gas properties, including reserves. For more information, see Deloitte's January 2015 *Oil & Gas Spotlight*. Registrants should also consider their risk factor disclosures, including quantitative disclosures about the potential impact of the recent changes in commodity prices on their reserves, and whether those disclosures adequately address the risks arising from the uncertainty associated with the price changes. See PUD Reserves above.

Other Deloitte Resources

December 15, 2014, *Heads Up*, "Highlights of the 2014 AICPA Conference on Current SEC and PCAOB Developments."

Power and Utilities

The focus of recent SEC staff comments to registrants in the P&U industry is largely consistent with that of staff comments issued in past years. Specifically, the staff has concentrated on (1) dividend restrictions; (2) accounting for the impact of rate making; (3) regulatory disallowance of property, plant, and equipment; and (4) identification of possible phase-in plans.

The SEC staff has also issued comments related to whether registrants in the P&U industry have complied with requirements under ASC 450 to disclose their range of loss in connection with litigation and other contingencies. Further, the staff has asked such registrants to explain the considerations they gave to separately disclosing the revenues and costs of revenues related to nonregulated businesses in light of Regulation S-X, Rule 5-03(b)(1) and (2). For additional considerations related to these topics, refer to the Contingencies and Financial Statement Classification, Including Other Comprehensive Income sections.

Dividend Restrictions

Example of an SEC Comment

Reference is made to your disclosure . . . of [Company A's] maximum ratio of consolidated financial indebtedness to consolidated total capitalization imposed by a credit agreement. Please tell us whether this covenant, other financial covenants and/or restrictions imposed by regulatory commissions restrict the ability of your subsidiaries or investments accounted for by the equity method to transfer funds to you in the form of loans, advances or cash dividends. If so, please tell us: (i) the amount of restricted net assets of consolidated subsidiaries and your equity in the undistributed earnings of investments accounted for by the equity method as of September 30, 2014 and how you computed the amount; (ii) your consideration of providing the disclosures required by Rule 4-08(e)(3)(i) and (ii) of Regulation S-X; and (iii) your consideration of providing the condensed financial information prescribed by Rule 12-04 of Regulation S-X in accordance with Rule 5-04 of Regulation S-X.

Given the nature of regulation in the P&U industry, there may be constraints on a P&U registrant's financial flexibility and its relationships with affiliated parties, including the parent company. For example, a utility subsidiary may be subject to requirements imposed by federal and state regulators that establish a minimum equity capitalization ratio or set limits on the payment of dividends. In addition, the capital-intensive demands of the P&U industry require significant financing agreements at the subsidiary level that may restrict (1) a subsidiary's transfer of assets in the form of advances, loans, or dividends to the parent company or another affiliated party or (2) other types of transactions between a subsidiary and its affiliates. The inability of a subsidiary to transfer assets to the parent company could, in turn, restrict the parent company's ability to pay dividends to its own shareholders.

Consequently, several P&U registrants have received comments from the SEC staff about their compliance with Regulation S-X, Rules 4-08(e) and 5-04. Those comments have included inquiries about whether consideration was given to regulatory or other limitations (e.g., debt agreements) that could restrict the transfer of assets from a subsidiary to the parent company through dividends, loans, advances, or returns of capital. As a result of the staff's comments, several P&U registrants have been required, or have agreed, to prospectively (1) expand their notes to the financial statements about potential dividend restrictions in accordance with Rule 4-08(e) and (2) include a Schedule I in their annual Form 10-K filing in accordance with Rule 5-04. Registrants should be aware that the calculations for determining the note disclosures required under Rule 4-08(e) should be performed independently of the calculations for determining the required Schedule I disclosures, and that compliance with one set of disclosure requirements does not satisfy the requirements of the other.

For additional considerations about dividend restrictions, see the Debt section.

Accounting for the Impact of Rate Making

Example of an SEC Comment

We noted a significant increase in your regulatory asset related to [Matter X] during the fiscal year ended December 31, 2014 . . . . We also note your disclosure . . . that the [state legislation] leaves the decision on cost recovery determinations related to [Matter Y] to the normal ratemaking processes before utility regulatory commissions and your disclosure . . . that you believe recovery is probable. We further note your disclosure in multiple instances . . . that an order from the regulatory authorities disallowing recovery of costs related to [Matter Z] could have an adverse impact on your financial statements. As it appears you do not have a regulatory order supporting the deferral of these costs, please tell us why you believe the amounts you have deferred as regulatory assets are probable of recovery under U.S. GAAP and provide us with your detailed analysis supporting this conclusion including both positive and negative evidence you considered. Refer to ASC 980-340-25-1.

The SEC staff's comments have focused on (1) ensuring that P&U registrants are thoughtful in determining the initial and continuing probability of cost recovery inclusive of the expected recovery period, (2) providing supplemental explanations or separate detailed analysis and evidence that support the P&U registrant's recognition of regulatory assets, and (3) whether a particular regulatory asset of the P&U registrant is earning a rate of return. Further, the SEC staff continues to issue comments on (1) how the P&U registrant's current regulated rates are designed to recover its specific costs of providing service, (2) the nature of the P&U registrant's material regulatory assets and liabilities, and (3) the P&U registrant's accounting policies for revenues subject to refund.

Regulatory Disallowance of Property, Plant, and Equipment

Example of an SEC Comment

We note from your Form 8-K filed on March 9, 2015 that [Utility Commission A] voted to disallow recovery of costs related to [Capital Project A] and that you expect to record a charge of approximately $[X] during the first quarter of 2015. Considering the recovery disallowance recommendations of [Intervenor A] and [Intervenor B] during 2014 along with the February 2015 [administrative law judge] recovery disallowance proposal, please tell us in more detail why no charges were recorded during fiscal 2014 related to the [Capital Project A] prudence investigation.

SEC staff comments to public utility registrants continue to focus on the guidance in ASC 980-360-35 on subsequent measurement and recognition of property, plant, and equipment related to regulated operations. Under that guidance, an entity should record a disallowance related to a recently completed plant if it determines that a disallowed amount is probable and reasonably estimable; the entity must use judgment to make that determination. In light of recent regulatory orders by state public utility commissions that limit a public utility entity's cost recovery, registrants have been asked to explain their considerations related to the timing of recording a disallowance, particularly when a disallowance was not recorded until a rate order was received.

Identification of Possible Phase-In Plans

> **Example of an SEC Comment**
>
> Please explain to us in detail why the method of recognition of allowable costs in rates associated with bare steel and cast iron replacement activities of [Subsidiary A] and [Subsidiary B], the capital infrastructure program of [Subsidiary A,] and [the replacement of] bare steel and cast iron pipelines and other infrastructure by [Subsidiary C] are not considered phase-in plans as defined in ASC 980-340-20.

To lessen the impact of a rate increase as part of a current rate proceeding, a regulator may decide to defer costs associated with a major new plant addition. A deferral of any costs associated with a major, newly completed plant could be a phase-in plan. In accordance with ASC 980-340-25-2, cost deferrals are not permitted for phase-in plans. To qualify as a phase-in plan, a method for recognizing allowable costs must meet the three criteria outlined in ASC 980-340-20.

If a major, newly completed plant is being included in rates for the first time and the regulator provides for a deferral of any costs associated with the new plant for inclusion in future rates rather than as part of the cost of service in the current proceeding, those costs may not qualify as regulatory assets under U.S. GAAP regardless of whether the incurred costs are probable of recovery in future rates unless an exception applies.

Mining

Examples of SEC Comments

- We note you have combined your proven and probable reserve categories which is contrary to the explicit guidance of Industry Guide 7, which provides that reserves may be combined as "proven and probable" only if proven and probable reserves cannot be readily segregated. Your filing does not state that your proven and probable reserves cannot be differentiated or segregated with an explanation. Please modify your filing and segregate your proven reserves from your probable reserves in the appropriate reserve tables or provide a statement that this is not possible with the appropriate explanation.
- We note you refer to [Properties A and B] as development stage properties . . . . The terms development and production have very specific meanings within Industry Guide 7 (see www.sec.gov/about/forms/industryguides.pdf). These words/terms reference the development stage when preparing reserves for production, and the production stage when companies are engaged in commercial-scale, profit-oriented extraction of minerals. Since you do not disclose any reserves for these properties, as defined by Guide 7, please remove the terms develop, development or production throughout your document, and replace this terminology, as needed, with the terms such as explore or exploration.
- We note your disclosure of proven and probable reserves for [Mine A]. Please forward to our engineer, as supplemental information and not as part of your filing, your technical report or the information that establishes the legal, technical and economic feasibility of the materials designated as reserves, as required by paragraph (c) of Industry Guide 7. This information should include:
    - Acreage breakdown by owned, leased or other.
    - Maps showing property, mine permit and reserve boundaries; including recent and historic production areas.
    - Drill-hole maps showing drill intercepts.
    - Justifications for the drill hole spacing used at various classification levels.
    - General cross-sections that indicate the relationship between seams, geology, and topography.
    - A detailed description of your procedures for estimating reserves.
    - The specific criteria used to estimate reserves.
    - An indication of how many years are left in your longest-term mining plan for each reserve area.
    - Site specific economic justification for the criteria you used to estimate reserves.
    - Mining plans or feasibility studies, including production schedules, cost estimates and cash flow projections.
    - Third party reviews of your reserves that were developed within the last three years.
    - Any other information needed to establish legal, technical and economic feasibility.

The SEC staff often comments when a registrant has not separately disclosed proven and probable reserves in accordance with paragraph (a) of SEC Industry Guide 7. Under paragraph (b) of Guide 7, such reserves may be combined if "the difference in degree of assurance between the two classes of reserves cannot be readily defined."

Registrants should also ensure that they are appropriately using the terms "exploration stage," "development stage," and "production stage." These terms are explicitly defined in Section (a) of Guide 7.

Further, paragraph (c) of Guide 7 outlines the supplemental information that registrants should disclose "[i]f an estimate of proven (measured) or probable (indicated) reserves is set forth in the [technical] report." Such information includes (1) "maps drawn to scale showing any mine workings and the outlines of the reserve blocks involved together with the pertinent sample-assay thereon," (2) "all pertinent drill data and related maps," and (3) "the calculations whereby the basic sample-assay or drill data were translated into the estimates made [of] the grade and tonnage of reserves in each block and in the complete reserve estimate." Accordingly, the SEC staff may ask for supplemental information for proven and probable reserves. For example, the staff may ask registrants to furnish the technical report or the information that establishes the legal, technical, and economic feasibility of the materials designated as reserves.

Financial Services

Banking and Securities

The SEC staff's comments to registrants in the banking industry have moderated over the past couple of years; however, they continue to focus on (1) the estimation of allowances for loan losses, (2) disclosures about credit quality, (3) acquired loans, and (4) loan modifications and TDRs.

Further, registrants in the securities industry have received SEC staff comments requesting enhanced disclosures about (1) market risk and VaR, (2) asset management and administration fees, (3) order flow revenues and disclosures about license agreements, and (4) the impact of regulatory reporting errors on ICFR.

Allowance for Loan Losses — Collateral Appraisals

Example of an SEC Comment

Please revise your future filings to disclose whether your policy for obtaining appraisals for properties outside of [Country A] is consistent with your policies disclosed here for properties inside [Country A]. If not, disclose the similar policies for obtaining appraisals for properties outside of [Country A]. Additionally, please revise future filings to disclose whether your collateral valuations for construction or development projects that are in process contemplate collateral values "as is" or "as complete/developed."

To understand how registrants determine their allowance for loan losses, the SEC staff often requests disclosures about (1) their appraisal policies, including differences in those policies for various jurisdictions; (2) how frequently they obtain updated appraisals for impaired collateral-dependent loans; and (3) the types of adjustments made to appraised values, if any.

Disclosures About Credit Quality Under ASC 310-10

Example of an SEC Comment

[Please revise future filings to:]

1. [D]isclose the allowance for loan losses rollforward by portfolio segment. Refer to ASC 310-10-50-11B.c for guidance and provide us your planned disclosure in your response.
2. [D]isclose both the balance of your allowance for loan losses and your recorded investment in financing receivables by impairment method (e.g. collectively evaluated, individually evaluated) for each loan portfolio segment. Refer to ASC 310-10-50-11B(g) and (h), ASC 310-10-50-11C, and the example disclosure in ASC 310-10-55-7 for guidance and provide us your planned disclosure in your response.
3. [I]nclude all of the disclosure requirements of ASC 310-10-50-14A through [50-20] related to impaired loans and provide us your planned disclosure in your response.
4. [I]nclude all of the disclosure requirements of ASC 310-10-50-28 through [50-30] related to credit quality information and provide us your planned disclosure in your response.
5. [I]nclude the disclosure requirements of ASC 310-10-50-7(b) and [ASC] 310-10-50-7A regarding past due loans. Refer to ASC 310-10-55-9 for guidance and provide us your planned disclosure in your response.

The SEC staff continues to focus on the disclosures prescribed by ASC 310-10, particularly the granularity of those disclosures. ASC 310-10 requires entities to enhance and disaggregate their disclosures about the credit quality of their financing receivables and their allowance for credit losses.

Specifically, as indicated in ASU 2010-20, ASC 310-10 requires disclosure of the following information about credit exposure and reserving methodology on the basis of disaggregated portfolio segments and classes of financing receivables:

1. Credit quality indicators of financing receivables at the end of the reporting period by class of financing receivables
2. The aging of past due financing receivables at the end of the reporting period by class of financing receivables
3. The nature and extent of troubled debt restructurings that occurred during the period by class of financing receivables and their effect on the allowance for credit losses
4. The nature and extent of financing receivables modified as troubled debt restructurings within the previous 12 months that defaulted during the reporting period by class of financing receivables and their effect on the allowance for credit losses
5. Significant purchases and sales of financing receivables during the reporting period disaggregated by portfolio segment.

Acquired Loans

Example of an SEC Comment

[R]evise your future filings [as follows]:

- [P]lease enhance the relevant sections of your MD&A disclosures to disaggregate your allowance for credit losses and related asset quality disclosures[,] differentiating between your acquired loan portfolio for all periods presented and your originated loan portfolio. . . .
- [D]isclose how changes in the credit quality of your originated loan portfolio are reflected in the amount of your provision for loan loss[es] recorded during the period and the amount of the allowance for loan losses at period end . . . . Your analysis should quantify each loan portfolio component of your allowance for loan losses (ASC 310-10, ASC 450-20) and explain how incremental credit quality changes are reflected.

The SEC staff has requested disclosures that clearly distinguish between the registrant's originated loans and its acquired loans (both PCI and non-PCI) to enable financial statement users to understand the key characteristics of each portfolio and the related impact on the determination of the allowance for credit losses.

Loan Modifications and TDRs

Example of an SEC Comment

Please revise your disclosure in future filings to provide [information about your forbearance program as follows]:

- Clarify whether you have any limits on the number of times a borrower may request a modification of the terms of [its] loan. If not, please discuss how you consider multiple modifications in determining whether a loan has been renegotiated or refinanced.
- [S]eparately disclose the balance of loans that have received multiple modifications [and the balance of loans] that have received only one modification.
- [R]evise future filings to discuss how you consider the level of loans needing more than one modification as well as the level of re-defaults of refinanced or renegotiated loans when determining the appropriate level of allowance for loan losses. If you believe this disclosure is no longer meaningful, please tell us why.

The SEC staff continues to request enhanced disclosures about loan restructurings. The staff has also inquired about whether such restructurings should be accounted for as TDRs and therefore should be included in the registrant's risk element disclosures required by SEC Industry Guide 3.

The SEC staff has suggested that registrants consider disclosing:

- How modifications affect the timing of the recording of the allowance for loan losses.
- A description of the key features of the registrant's loan modification programs, including whether the programs are government- or company-sponsored and whether they are short- or long-term.
- How frequently loans are modified and remodified.
- More granular and quantitative information about the levels of loan modifications and remodifications.
- Quantification of the types of concessions made (e.g., rate reductions, payment extensions, forgiveness of principal, forbearance) and discussion of success with the different types of concessions.
- The accounting policy for restructured loans, including how and when a restructured loan is determined to be nonaccrual or accrual (i.e., noninterest accruing or interest accruing); the factors the registrant considered in determining whether the loan should accrue interest; the anticipated period and number of borrower payments for a restructured loan to return to accrual status; and whether any loan loss allowance has been recorded or any portion of the loan has been charged off.
- Confirmation of whether loan restructurings should be classified as TDRs under ASC 310-40 and, if so, separate disclosure of the loans in the nonperforming assets table under SEC Industry Guide 3, Item III(C)(1).
- TDRs by loan type, classified separately as accrual or nonaccrual.

In addition, if there are material changes in TDRs, the SEC staff may ask about such changes and request additional disclosures, including a rollforward detailing loan sales, payments, charge-offs, and loans that have been removed from TDR status.

Further, when a material amount of a registrant's loan modifications is not accounted for as TDRs, the SEC staff often requests disclosures that explain:

- Triggers and factors the registrant considered to identify loans to modify and to support its conclusion that modifications are not TDRs.
- Key features of the modification programs, including a description of the significant terms modified and the typical length of each modified term.
- Success rates of the modification programs.
- The amount of the loans modified in each period presented.
- Whether the modified loans are included in the registrant's impairment analysis of the general reserve (ASC 450-20) or individual reserve (ASC 310-10) and, if included in the general reserve analysis, whether a materially different amount would have resulted if the loans had been included in the individual reserve analysis.

In evaluating whether a loan modification represents a TDR, a registrant must use judgment to determine whether (1) the debtor (i.e., the borrower) is experiencing financial difficulty and (2) the lender has granted a concession to the borrower.

ASC 310-40 outlines considerations for determining whether a borrower is experiencing financial difficulties (e.g., debtor default, debtor bankruptcy, and concerns about the borrower's ability to continue as a going concern). Further, it clarifies that a borrower not currently in default could be experiencing financial difficulties if default is probable in the foreseeable future.

Disclosures About Market Risk and VaR

Example of an SEC Comment

We note that you made significant changes to your regulatory VaR and stressed-VaR models in 2013. We also observe . . . that certain significant variances in VaR measures from June 30, 2013 to September 30, 2013 were the result of changes made to your VaR models (i.e. you replaced relative or percentage changes in interest rate risk factors with absolute changes). Finally, we note that you have omitted comparative information for 2012 because of the changes made to your VaR models. Please explain to us and revise your future filings to address the following:

- Disclose comparative information for prior periods under the current model or additionally provide current and comparative information under the previous model until all reported periods are presented under the current model. Refer to Item 305(a)(1)(iii)(4)(ii) of Regulation S-K which requires the disclosure of both the old and new methods for the purposes of comparability.
- Explain to us your basis for making the changes to your VaR models (i.e. explain how this change has made your model more precise). Include in your explanation a description of any other changes made to your model and indicate which changes were the result of regulatory guidance.

The SEC continues to ask registrants in the banking and securities industries to provide enhanced quantitative and qualitative disclosures about market risk and VaR. In addition, the SEC staff may ask registrants to:

- Quantify the amount of the investment positions excluded from the VaR measure.
- Explain whether the VaR measure includes the market risk associated with securities sold but not yet purchased.
- Include comparative disclosures for the prior year, along with a discussion describing the reasons for material quantitative changes in market risk.
- Explain the reason for the length of the historical observation period used to calculate VaR-based measures.
- Identify whether VaR-based measures are based on regulatory or internal risk management parameters and include a description of the parameters used.
- Revise future filings to present information under a stressed-VaR scenario or to explain why this information would not be meaningful.

Asset Management and Administration Fees

Example of an SEC Comment

We note that a significant amount of your asset management and administration fees are generated from [your] money market funds, equity and bond funds, and [Mutual Fund A] (i.e. mutual fund service fees). In an effort to enhance your disclosure and provide greater transparency to investors, please revise your future filings to address the following:

- Provide a separate roll-forward of your assets under management and administration (AUM&A) for each asset class (as noted above). Your roll-forward should include, but not be limited to, gross in-flows and gross out-flows, market appreciation (depreciation), and the effects of foreign currency translations for each period provided.
- Disclose the average AUM&A for each asset class for each period provided. In addition, consider expanding your client metrics . . . to provide your average client assets.
- Provide an analysis (preferably in tabular format) comparing your weighted average fee rate charged (e.g. by basis points) for the aforementioned asset classes.
- Provide a discussion here, and elsewhere within your MD&A as necessary, of any significant trends experienced in AUM&A (e.g. new client assets or redemptions, significant changes between asset classes attributable to specific or general economic factors, etc.).

The SEC staff has asked registrants in the banking and securities industries to enhance their disclosure about asset management and administration fees to provide greater transparency to investors. Specifically, the staff has asked registrants to include (1) a separate rollforward of AUM for each asset class, and (2) the rollforwards that reflect gross inflows, gross outflows, and market appreciation (depreciation) separately from effects of foreign currency translations for each period. In addition, the SEC staff may ask registrants to present the net return on AUM for each period presented to give investors a better understanding of AUM performance.

Order Flow Revenues and Disclosures About License Agreements

Examples of SEC Comments

- It appears that order flow revenues have been a significant component of your "Other Revenue" line item in each of last three fiscal years. However, your disclosure does not indicate the amount of order flow payments or the amount of the change, year over year. We note that payments made to brokers by market venues were subject to a significant amount of public, press, regulatory and congressional scrutiny. Also, we note that on your website you provide customers with disclosure about the revenue per share you receive from various market venues. In order for investors to better understand the impact of order flow payments and any changes to the arrangements, please revise your disclosure in future filings to disclose the amounts of revenue generated from order flow in each period. Please discuss the major components of order flow revenues. Please also discuss the reasons for any material changes in order flow revenues, such as whether an increase was a result of a higher trade volume or a change in the fee structure paid by the market venues.
- We note from your disclosure . . . that licensing agreements in place with [Entities A, B, and C] expire in 2017, 2015 and 2015, respectively. Please tell us and, in future filings, consider discussing the impact that the expiration of these licenses could have on your business, to the extent that they are material individually or in the aggregate. In addition, in future filings, consider disclosing the expiration date of your license agreement with [Entity D] and include it in the discussion suggested above to the extent that [the license agreement] will expire in the near term.

Although other revenues and expenses may not typically be thought of as items that require additional disclosure, the SEC staff has asked registrants in the securities industry to identify significant components of other revenue and expense items that may be of interest, or may be material, to users.

Impact of Regulatory Reporting Errors on ICFR

Example of an SEC Comment

We note your disclosure that you applied an incorrect adjustment . . . , resulting in an overstatement of your historical regulatory capital ratios included in prior SEC filings and other regulatory reports. Additionally, . . . you filed an 8-K disclosing that a third party was engaged to perform certain procedures . . . , and that this review resulted in adjustments to your regulatory capital ratios . . . . Lastly, . . . a spokesperson for the company noted that you made an error in calculating the volume data you sent to FINRA regarding the equity volume transacted on your alternative trading system. In light of these errors noted in your SEC and other regulatory reporting, please provide us with the following additional information:

- Tell us whether the identification of the regulatory capital ratio error and subsequent adjustments are indicative of the existence of one or more material weaknesses in [ICFR], and, if so, whether any such material weaknesses also would have existed as of December 31, 2013;
- To the extent you identified significant deficiencies in your original assessment of ICFR as of December 31, 2013, tell us the nature of each, including the impacted component(s) of the [COSO] Internal Control Integrated Framework, and how you evaluated their severity individually and in the aggregate, including in aggregation with any deficiencies identified upon discovery of the above regulatory capital ratio errors, if applicable; and
- Upon discovery of the error related to alternative trading system volume in your regulatory reporting to FINRA, tell us the extent to which there may be common root causes to the errors in your regulatory capital ratio reporting that are relevant to the evaluation of the nature and severity of any deficiencies in ICFR (especially the control environment, risk assessment, or monitoring components of COSO).

Registrants should be aware that regulatory disclosures are a critical part of the financial statements and that the SEC staff asks issuers to determine how deficiencies in regulatory reporting affect ICFR.

Other Considerations

The SEC staff has asked registrants to explain, and disclose in future filings, (1) whether they have evaluated the impact of a decline in the market and (2) how their brokerage revenues and investment holdings would be affected.

For more information, see the Management’s Discussion and Analysis section.

Insurance

In many of its comments to registrants in the insurance industry, the SEC staff has continued to focus on (1) reserves and loss adjustment expense; (2) disclosures related to the current interest rate environment; and (3) various other considerations, including those related to statutory disclosures, disclosures about dividend restrictions, captive subsidiaries, and investments and financial instruments.

In addition to the insurance-related matters (discussed below), the SEC staff's comments to registrants in the insurance industry have focused on goodwill and income taxes. See the Impairments of Goodwill and Other Long-Lived Assets and Income Taxes sections for more information.

Reserves and Loss Adjustment Expense

Example of an SEC Comment

Please tell us the variations in loss and loss adjustment expenses for the appropriate periods that relate to prior year loss reserve development and provide proposed revised disclosure to be included in future periodic reports that discusses the amount and underlying causes of prior year loss development.

The SEC staff has asked registrants to discuss in the critical accounting policy section of their MD&A the drivers of change to their loss reserve, including assumptions that have changed and assumptions that are reasonably likely to change. In addition, the SEC staff continues to ask registrants to (1) explain the key methods and assumptions they used in deriving their loss adjustment expense and related reserves and (2) provide current disclosures that comply with the requirements of SEC Industry Guide 6.

Interest Rate Environment

Example of an SEC Comment

You state that the current low interest rate environment has meant that you have invested or reinvested cash flows at substantially lower yields than your existing portfolio yield, while your ability to reduce credited rates has been limited by contractual minimums. Please provide us proposed disclosure to be included, in MD&A, in future periodic reports that discloses the expected effects of this known trend or uncertainty on your future financial position, results of operations and cash flows. To the extent that information about cash flows you expect to have to reinvest at lower rates due to potential maturities or calls of your investments, or [information about] cash flows that you are committed to pay due to products with guaranteed features[,] is necessary to understand these effects, please include information such as the amount of maturing or callable investments and their weighted average yields and the amount of products with guaranteed features and their rates in your proposed disclosure.

Depending on the interest rate environment, the SEC staff may comment on effective interest rates and ask registrants to expand their disclosures about the expected effects of the interest rate environment and the impact of those effects on future financial information (e.g., financial position, results of operations, and cash flows).

Other Considerations

Statutory Disclosures and Disclosures About Dividend Restrictions

SEC staff comments to registrants in the insurance industry continue to focus on compliance with existing disclosure requirements about statutory capital, surplus, and dividend restrictions under ASC 944-505-50 and Regulation S-X, Rule 4-08(e). When registrants have used in their annual audited financial statements labels such as "Unaudited," "Approximate," or "Preliminary" to describe their statutory capital and surplus, the staff will remind them that these disclosures are required to be audited. Further, the staff has asked registrants to enhance disclosures on minimum capital and surplus requirements for both domestic and foreign subsidiaries.

The SEC staff has also asked registrants in the insurance industry about their compliance with Regulation S-X, Rules 4-08(e) and 7-05(c),[1] when there appear to be restrictions on the payment of dividends. In addition, registrants in the industry have been asked to provide additional information about the considerations underlying their determination of why they did not need to disclose information required under Rules 4-08(e) and 7-05(c). Further, the staff has reminded registrants that in applying Rule 4-08(e), they must consider foreign insurance operations and nonregulated subsidiaries in addition to U.S. domestic subsidiaries. See the Debt section for additional information.

Captive Subsidiaries

Many insurance entities have captive subsidiaries, which insure specific risks for the parent entity and its affiliates. These captive subsidiaries allow entities to manage their own risks and provide many advantages, including capital management benefits. The SEC staff has continued to request expanded disclosures about transactions between registrants in the insurance industry and their captive subsidiaries, such as the nature, purpose, and number of those transactions. Further, it has requested enhanced disclosures about the impact of captive subsidiaries on registrants' financial statements and about the risks and uncertainties associated with those subsidiaries.

Investments and Financial Instruments

Given the significance of investment portfolios to most registrants in the insurance industry, the SEC staff may ask such registrants about their investments and financial instruments and whether related disclosures portray their financial position accurately. Accordingly, the staff may concentrate on conclusions reached by management about the credit quality of investments and may ask registrants to summarize the procedures they performed (and other support they obtained) to make such determinations.

The SEC staff may also question registrants' disclosures about key drivers that affected their net derivative results. When there has been significant volatility in results for multiple periods, registrants may be asked to enhance their disclosures about the drivers of net derivative gains and losses.

[1] Rule 7-05(c) requires registrants in the insurance industry to file Schedule II if the rule's conditions are met. These conditions are identical to those under Regulation S-X, Rule 5-04, that govern whether a commercial company must file Schedule I. See the Debt section for information about Rule 5-04.

Investment Management

The SEC staff's recent comments to investment advisers and business development companies in the investment management industry have continued to focus on topics such as (1) fair value measurement, (2) risk oversight, (3) consolidation, and (4) commitments and contingencies. The staff has also commented on quantitative and qualitative disclosures about market risk. For more information about risk factors, see the Disclosures About Risk section.

In addition, the SEC's Office of Compliance Inspections and Examinations (OCIE) highlighted the examination priorities of the SEC's 2015 National Exam Program for investment advisers and investment companies, which include issues such as conflicts of interest and fund marketing and performance. This year, the OCIE's examination priorities are organized into three themes: (1) protecting retail investors and investors saving for retirement, (2) assessing market-wide risks, and (3) using data analytics to identify signals of potential illegal activity. For more information about these priorities, see the OCIE's 2015 National Exam Program.

Fair Value Measurement

Example of an SEC Comment

We note that you use valuations provided by third party pricing services as the basis for your fair value measurements for several different types of financial instruments. Please revise your future filings to disclose the procedures you perform to validate the valuations received from such third party pricing services.

The SEC staff continues to focus on fair value measurement and related disclosures in comments to investment advisers in the investment management industry. In particular, the SEC staff will frequently ask investment advisers to disclose additional qualitative information about their processes for determining fair value. Specifically, it will ask a registrant for additional information about (and, potentially, additional disclosures related to) Level 3 inputs, adjustments to quoted market prices, and investments for which the investment adviser's net asset value per share does not represent fair value. Further, the SEC staff has asked investment advisers to disclose additional information about the procedures they use to validate values obtained from external sources (e.g., broker quotes[2]). In addition, the SEC staff has often asked investment advisers to expand quantitative disclosures, such as a weighted average or range of inputs in the tabular disclosure of Level 3 unobservable inputs. For more information, see the Fair Value section.

Risk Oversight

Example of an SEC Comment

Please expand your risk management discussion to describe in more detail the various tools you use to monitor risk. You should address:

- Whether you have identified triggering events that require reports/communications to the committee;
- Whether you have a Chief Risk Officer and this person's role in the risk management process; and
- Potential challenges your organization faces in managing risk.

An Exchange Act registrant is required to disclose its board's risk management policies and procedures under Regulation S-K, Item 407(h). The SEC staff may ask an investment adviser in the investment management industry to elaborate on its board's risk management oversight of investment vehicles and to disclose additional information about the risk management responsibilities of board committees (e.g., the audit and compliance committees).

[2] For SEC staff remarks about the use of third-party pricing services to measure fair value, see Deloitte's December 14, 2011, *Heads Up*.

Consolidation

Example of an SEC Comment

We note your consolidation policy related to variable interest entities ("VIEs"). Please revise your future filings to address the following:

- Expand your disclosure to discuss how you assess your rights in determining if you have the power to direct the activities of the VIE that most significantly impact the [VIE's] economic performance.
- In your discussion of VIEs evaluated for consolidation that are not money market funds or investment companies you state that "when determining whether the Company stands to absorb the majority of a VIE's expected losses or receive a majority of [the] VIE's expected returns, if the Company determines it has control over the activities that most significantly impact the economic performance of the VIE and it will absorb a majority of the VIE's expected variability, [the Company] will consolidate the [VIE."] Explain how your disclosure here is consistent with the guidance in ASC 810-10-25-38.
- In your discussion of [VIEs] that will be consolidated when you have both the power to direct the activities of the VIE that most significantly impact the VIE's economic performance and the obligation to absorb losses or right to receive benefits that could potentially be significant to the VIE, clarify how the calculation of variability, based on an analysis of projected probability-weighted cash flows based on the design of a particular VIE, complies with the guidance in ASC 810-10-25-38A(b) in determining whether losses and benefits could potentially be significant to the VIE.
- Expand the examples of entities assessed for consolidation under the different frameworks described in your policy discussion . . . to increase transparency as to the basis for entities consolidated (e.g. [collateralized debt obligations], pooled investment vehicles, etc.).

Because VIEs are common in the investment management industry, the SEC staff continues to comment on management's conclusions regarding the consolidation or deconsolidation of VIEs and asks investment advisers to clarify why certain vehicles have been consolidated and others have not. The SEC staff frequently questions (1) the consolidation model applied to specific investments, (2) the qualitative and quantitative assessments used to determine the primary beneficiary, and (3) the related disclosures. For more information, see the Consolidation section.

Commitments and Contingencies

Example of an SEC Comment

In future financial statements, please include a line item for "Commitments and Contingencies," along with a reference directing the reader to the related footnote in the Company's Notes to Financial Statements . . . . See Regulation S-X Rule 6-04.15.

Business development companies have received SEC staff comments related to their financial statements. Recently, the SEC staff has focused on the requirements of Regulation S-X, Rule 6-04.15, and has asked business development companies to include a line item on the balance sheet for commitments and contingencies along with a reference to the related footnote.

Real Estate

The SEC staff's comments to registrants in the real estate industry have focused on topics such as (1) whether, for U.S. GAAP purposes, real estate acquisitions represent business combinations or asset acquisitions and whether, for SEC reporting purposes, a registrant has acquired a business or real estate operations; (2) leasing activities; (3) capitalization of real estate development, construction, and leasing costs; (4) non-GAAP financial measures; (5) liquidity considerations associated with distributions; and (6) consolidation.

In addition, in industries other than real estate, the SEC staff has observed a higher frequency of REIT transactions (e.g., conversions, spin-offs, and carve-outs) involving nontraditional real estate assets such as cell towers, data centers, and billboards. REITs holding nontraditional real estate assets have received staff comments suggesting that they should strive to comply with the spirit of the disclosure requirements prescribed for REITs that hold traditional real estate assets (e.g., requirements related to Schedule III,[3] portfolio occupancy, effective rents, material tenant concentrations, category and physical location of the assets, significant lease types, and lease expiration dates). REITs holding traditional real estate assets that provided insufficient disclosures have also received comments from the staff.

Real Estate Acquisitions

Examples of SEC Comments

- Please provide us with the results of the significance tests for your 2013 and 2014 acquisitions in accordance with Rule 3-14 of Regulation S-X. For each property acquisition where Rule 3-14 financial statements are required, please tell us where you have filed these financial statements.
- Please tell us and disclose your policy for determining whether the acquisition of real estate is a business or asset purchase and the result of that determination on how [you] record the cost of the transaction.

Regulation S-X, Rule 3-05, requires a registrant to provide full financial statements (and pro forma financial information) for significant acquired or to be acquired businesses. However, Regulation S-X, Rule 3-14, permits a registrant to file only abbreviated income statements (and pro forma financial information) for significant acquired or to be acquired real estate operations that meet certain requirements. Because the requirements of Rules 3-05 and 3-14 are different, it is important for a registrant to determine whether it acquired a real estate operation (see the SEC Reporting section for additional information about Rule 3-05). As a result, from an SEC reporting standpoint, the SEC staff may ask a registrant to provide an analysis supporting its conclusion that its acquisitions are real estate operations under Rule 3-14.

In addition, from an accounting standpoint, the SEC staff has asked registrants with material acquisitions to elaborate on their process and policies for determining whether the acquired assets, including acquired real estate that is subject to a lease, qualify as a business or an asset acquisition under U.S. GAAP. This determination is important because the accounting for an asset acquisition differs from the accounting for a business combination. In acquisitions accounted for as business combinations, all transaction costs must be expensed as incurred. In asset acquisitions, however, transaction costs are capitalized as part of the purchase price. The SEC staff has asked registrants to enhance their disclosures to discuss the accounting policies they apply to property acquisitions, including policies for allocating value to identified intangible assets and for recognizing acquisition-related costs.

[3] Under Regulation S-X, Rule 5-04, certain real estate companies are required to file a Schedule III that presents supplemental information about real estate investments and accumulated depreciation on a property-by-property basis in the manner prescribed by Regulation S-X, Rule 12-28.

Leasing Activities

Triple Net Leases

Examples of SEC Comments

- It appears that [Entity X] is a significant lessee of properties under a long-term triple-net lease. Please tell us how you determined it was not necessary to provide audited financial statements of [Entity X].
- We note that you have presented within . . . [Forms 8-K] summary financial information for [Entity X], [Entity Y] and [Entity Z], along with disclosure as to where audited financial statements could be located on the internet for these companies. Please tell us how you have complied with the applicable rules to provide financial statements of significant asset concentrations as these financial statements have not been filed pursuant to the Exchange Act.

In a triple net lease, a lessee is typically required to pay costs that are normally associated with ownership, such as property taxes, insurance, utilities, and maintenance costs. In accordance with Section 2340 of the FRM, a registrant that leases, under triple net leases, one or more properties to a single lessee may need to provide full audited financial statements of the lessee (or guarantor) for the periods required by Regulation S-X, Rules 3-01 and 3-02, if a determination was made that the properties represent a "significant" portion of the registrant's assets (i.e., more than 20 percent of the registrant's assets as of its most recent balance sheet date). Section 2340 further states that if the lessee is a public company subject to the periodic reporting obligations of the Exchange Act, a registrant that would otherwise be required to provide such full audited financial statements may instead include in its filing a statement that refers investors to a publicly available Web site containing financial statements the lessee filed with the SEC. Accordingly, when a registrant enters into a triple net lease and its filing does not include or refer to a lessee's financial statements, the SEC staff may request information related to the significance test performed to determine whether there is significant asset concentration. Similarly, the SEC staff will inquire about significant asset concentration when a registrant acquires a property that is subject to a triple net lease.

Disclosures About Rental Performance

Examples of SEC Comments

- In future Exchange Act periodic reports, please provide more detailed leasing statistics, including the amount of space available at the start of the period, the amount of lease expirations, the amount of new leases, the amount of renewals and the amount of vacant space at the end of the period. Additionally, please provide more detailed disclosure regarding tenant improvement costs and leasing commission costs for new leases.
- In future Exchange Act periodic reports, please include a discussion that compares new leases and renewed leases on previously leased properties to prior rents received. Such amounts should be adjusted for any tenant concessions provided, such as free rent.

Over the past few years, as rental rates in many markets have fluctuated, the SEC staff has commented about registrants' disclosures in MD&A of lease rollover trends, including changes in rental rates on lease renewals and new leases in the reporting period. For space expected to be re-leased over the next 12 months, the staff has commented on the difference between existing rents and current market rents to better understand registrants' current and future performance trends.

The SEC staff has also requested information about activity related to new and expiring leases and lease renewals during the reporting period, including:

- Square feet leased.
- Average rents.
- Per-square-foot costs associated with leasing (e.g., leasing commissions, tenant allowances, and tenant improvements).

See the Leases section for additional staff comments on leasing transactions.

Capitalization of Real Estate Development, Construction, and Leasing Costs

Examples of SEC Comments

- [C]onsider including in future filings a breakdown of your capital expenditures by type (new development, redevelopment/renovation, tenant improvements/allowances, CAM, etc.) and by period presented.
- In future filings, please expand your disclosure to clearly describe your capitalization policy as it relates to construction/development costs including interest, salaries and G&A, real estate taxes and any other significant amounts that are capitalized during the pre-acquisition phase and the construction phase including a discussion of when the capitalization period ends.

The SEC staff frequently asks registrants to enhance their disclosures about the capitalization of real estate development, construction, and leasing costs (including their accounting for these costs). For example, the SEC staff has asked registrants to clarify their accounting policy for capitalizing or deferring costs in accordance with ASC 835-20, ASC 840-20-25-16, and ASC 970-10. It has also requested quantitative disclosures of certain expenses that are being capitalized, such as soft costs (e.g., interest and payroll).

In addition, the SEC staff has asked registrants to expand their disclosures about capital expenditures (either on the face of the statement of cash flows or in MD&A) to separately disclose expenditures related to acquisitions, new development, redevelopment, and improvements to existing properties.

Non-GAAP Financial Measures

Examples of SEC Comments

- In future Exchange Act periodic reports, in order to illustrate for investors your internal earnings growth, please disclose period to period same store net operating income. Additionally, please disclose how you determine the properties that fall within the “same store” pool, including also a discussion of any properties that were excluded from the pool that were owned in all periods compared, and how you determined which revenues and expenses to include in determining NOI. For example, please explain if you include items such as tenant improvement and leasing commissions, ground rent, lease termination fees and marketing costs.
- In arriving at Funds from operations, you start with Net income available to common stockholders. As a result, it appears Funds from operations is actually Funds from operations attributable to just common stockholders instead of all equity stockholders. In future periodic filings please re-title “Funds from operations” to the more appropriate “Funds from operations attributable to common stockholders.”

The SEC staff has continued to comment on inconsistencies between (1) the key performance measures identified in press releases, earnings calls, and analyst presentations and (2) the non-GAAP financial measures disclosed in registrants’ SEC filings. Although the SEC filings of most REITs include FFO as defined by the National Association of Real Estate Investment Trusts (NAREIT), REIT communications to shareholders and analysts may use other performance measures, such as modified FFO, adjusted FFO, core FFO, EBITDA, NOI, or core earnings.[4] When these key performance measures are provided in other communications to investors, the SEC staff may ask registrants why such non-GAAP financial measures were not disclosed in their periodic reports (e.g., Forms 10-K and 10-Q).

In addition, the staff has recently issued comments on FFO disclosures that are inconsistent with NAREIT's definition of FFO. Many of these comments have specifically asked the registrant to confirm whether its FFO calculation is in accordance with NAREIT's definition of FFO and have focused on whether FFO is reported gross or net of noncontrolling interest adjustments. In situations in which the FFO calculation appears to consider noncontrolling interest adjustments and is simply labeled "FFO," the staff has asked registrants to update the labeling of the total to reflect "FFO attributable to common stockholders" or "FFO attributable to the company."

The SEC staff has also focused on non-GAAP performance metrics used in MD&A. The staff has requested clarification of how registrants define NOI to determine whether any additional property operating costs should be included. The SEC staff will often question whether the MD&A disclosure of period-to-period changes clarifies the impacts of same-property and non-same-property results, particularly when the discussion does not address the drivers of changes in the operating results (e.g., occupancy, rental rates) besides changes in the number of properties. To improve transparency, disclosures of "same-property NOI" should (1) be accompanied by a clear explanation of how the same-property pool is defined and determined and (2) highlight any changes in the pool from the prior reporting period, including the number of properties that were added to and removed from such metrics in any given year.

Over the past couple of years, the SEC staff has also requested additional information and disclosure about backlog from (1) real estate companies involved in engineering and construction and (2) home builders.

See the Backlog Disclosures, Management's Discussion and Analysis, and Non-GAAP Financial Measures and Key Metrics sections for additional information.

Liquidity and Capital Resources — Distributions

Example of an SEC Comment

In future Exchange Act periodic reports, please provide separate disclosure showing cash coverage and earnings coverage of distributions for the last fiscal year . . . . Highlight the relationship between total distributions paid, and cash flow from operations showing the source of any shortfall. In addition, show the relationship of the total distributions paid and earnings, net income or FFO. To the extent there is a shortfall in either cash flow from operations coverage or FFO . . . coverage, please specify the percentage coverage in a risk factor related to dividend coverage.

The SEC staff frequently requests disclosures that investors can use to evaluate the registrant's ability to maintain or increase its historical distribution yield. When GAAP cash flow from operations is insufficient to cover the total distributions paid during a particular period, the SEC staff may inquire about the cash resources used to cover the shortfall, such as borrowings or offering proceeds. Registrants should adequately disclose the risks associated with paying distributions in excess of GAAP cash flow from operations. In addition, the SEC staff may request disclosures that compare earnings (or FFO) with paid distributions, including amounts reinvested through a distribution reinvestment plan. The staff sometimes asks registrants to disclose these items on a cumulative basis so that financial statement users can better understand the relationship between earnings (or FFO) and distributions.

See the Management's Discussion and Analysis section for further discussion about liquidity and capital resources.

[4] See Questions 102.01 through 102.03 of the C&DIs on non-GAAP financial measures for additional information about FFO and NAREIT.

Consolidation

Example of an SEC Comment

Please clarify how you determined that you do not have a controlling interest in either of [your] joint ventures. Your disclosure . . . suggests that you are the managing member in each of the joint ventures and as such there would be a presumption of control by analogy to ASC 970-810-25-3.

The SEC staff continues to focus on registrants' involvements with VIEs and joint ventures and has inquired about consolidation assessments.

The SEC staff also routinely asks for additional information and disclosures about non-VIE joint ventures, particularly when (1) a registrant uses the equity method of accounting and either has a majority ownership interest or is the general partner or managing member or (2) the qualitative disclosures about such arrangements are not robust. Disclosures about these arrangements should include a discussion of the ownership structure as well as the governance provisions that led the registrant to conclude that it does not have a controlling financial interest in the joint venture. In addition, the SEC staff routinely asks for clearer qualitative disclosures when there are amendments to management agreements or changes in ownership structure or percentages that do not result in a change to a registrant's consolidation conclusion.

See the Consolidation section for further discussion about VIEs.

Health Sciences

Life Sciences

The SEC staff's comments to registrants in the life sciences industry have focused on topics such as (1) revenue recognition, (2) disclosures related to risk factors, (3) MD&A disclosures, (4) business combinations, and (5) commitments and contingencies.

Revenue Recognition

Collaborative Arrangements

Examples of SEC Comments

- In order to help us understand more fully how your collaborative arrangements impact your financial statements for each period presented, please provide us, in table format, the amounts . . . by year and by line item included in your statements of operations attributable to transactions arising from collaborative arrangements between you and the other participants and third-parties. Please provide separate tables for each of your "significant" collaborative arrangements and for all of your collaborative arrangements in the aggregate (i.e. the "significant" arrangements and all other arrangements). Present separately amounts with other participants and third-parties that are netted in a financial statement line item.
- You indicate that collaborative activities may include research and development, marketing and selling (including promotional activities and physician detailing), manufacturing, and distribution. Tell us your accounting policies regarding separation and allocation for your collaborative arrangements.
- Although you disclose your accounting policies for income you generate as a result of collaboration agreements under "revenue recognition" . . . , tell us your accounting recognition for other aspects of these arrangements and where these policies are disclosed.

Collaborative arrangements are common among biotech and pharmaceutical companies. ASC 808-10 provides guidance on the income statement presentation, classification, and disclosures related to collaborative arrangements but "does not address recognition or measurement matters related to collaborative arrangements, for example, determining the appropriate units of accounting, the appropriate recognition requirements for a given unit of accounting, or when the recognition criteria are met." As a result, the SEC staff often asks registrants in the industry about the nature of, and accounting for, their collaborative arrangements and has continued to probe them to better understand the basis for such accounting under U.S. GAAP.

Inquiries to registrants have focused on the registrant's conclusion about whether certain transactions with the collaboration partner represent true vendor-customer activities. Collaborative arrangements within the scope of ASC 808 are based on the premise that each party to the agreement assumes a proportionate share of risks and, therefore, a vendor-customer relationship does not exist. Even if the registrant concludes that it is a party to a collaborative agreement, however, there may be circumstances in which certain elements of the agreement represent activities that are similar to those in a vendor-customer relationship. Accordingly, the SEC staff seeks to understand the registrant's accounting policies regarding separation (i.e., unit of accounting) and allocation (i.e., when multiple units exist) for collaborative arrangements.

In addition, since collaborative arrangements often include up-front payments, royalty or profit-share payments, and expense reimbursements, the SEC staff has requested supplemental explanation of the registrant's determination and disclosure of (1) the separation, allocation, recognition, and classification principles that were used to account for payments between collaboration partners and (2) the factors that led the registrant to conclude that it is the principal (or agent) in transactions with third parties.

The SEC staff also has requested enhanced disclosures about registrants' collaborative agreements, including the overall effect of collaborative arrangements on the financial statements. Staff requests for such disclosures have focused on clearly describing the material terms of a collaborative arrangement, such as (1) each party's rights and obligations under the arrangement, (2) potential payments, (3) the existence of royalty provisions, and (4) duration and termination provisions. Further, the SEC staff has asked that registrants prepare a tabular summary to provide the staff with a composite disclosure of the financial statement impact of all collaborative arrangements. For all periods presented, the staff may request a separate table for each significant collaborative arrangement and a table for all collaborative arrangements in the aggregate; in addition, the staff may request separate presentation in such tables of amounts attributable to transactions with other participants and third parties that are presented net in a financial statement line item.

Further, the staff may ask registrants to file a material collaborative arrangement as an exhibit to their filing in accordance with Regulation S-K, Item 601(b)(10). For more discussion, see the Material Contracts section.

Milestones

Example of an SEC Comment

Your disclosure . . . lists the awarding of a license as an example of an appropriate milestone for revenue recognition. Please provide us with a detailed explanation of your basis for previously recognizing this revenue, including the specific milestones previously reached that made recognition of the revenue on the affected contracts appropriate. Also, please clarify your ongoing revenue recognition policy in terms of when it is appropriate to recognize revenue prior to obtain[ing] a license.

The SEC staff has continued to comment on disclosures related to the milestone method of revenue recognition under ASC 605-28. When such disclosures apply, the staff will review the registrant's filings to determine whether they contain the following disclosures outlined in ASC 605-28-50-2:

a. A description of the overall arrangement

b. A description of each milestone and related contingent consideration

c. A determination of whether each milestone is considered substantive

d. The factors that the entity considered in determining whether the milestone or milestones are substantive

e. The amount of consideration recognized during the period for the milestone or milestones.

Registrants in the industry will often make adjustments for milestones when determining non-GAAP income. For a discussion of adjustments made by registrants when determining their non-GAAP measures, see the Non-GAAP Financial Measures and Key Metrics section.

Multiple-Element Arrangements

Example of an SEC Comment

You disclose that you recognize revenue from the licensing of product rights and the performance of research or selling activities over the periods earned. Please tell us the amounts of each of these streams of [revenue] you recognized in each of the last three years and address the following:

- Tell us your consideration for disclosing each revenue stream separately under Item 5-03.1 of Regulation S-X;
- Tell us your consideration for disclosing the terms of any material arrangements under which these revenues are earned; and
- To the extent these streams are material, provide us proposed revised policy disclosure to be provided in future periodic reports that clarifies how you recognize these revenues "over the periods earned."

The SEC staff often asks registrants in the life sciences industry to expand or clarify their disclosures about multiple-element arrangements, particularly those involving licenses of product rights and other deliverables. Registrants could improve their required disclosures about the nature and terms of such arrangements by (1) separating the description of the obligations and rights from the discussion of how they were accounted for, (2) ensuring that the description is complete (i.e., that all material terms are disclosed for each revenue stream), and (3) precisely describing the rights conveyed by the license.

In addition, the staff has reminded registrants that they should explicitly identify each deliverable in the arrangement and explain why it represents (or does not represent) a separate unit of accounting. The staff has also suggested that registrants could improve their disclosures about the relative selling price method of allocating arrangement consideration by (1) quantifying the total arrangement consideration to be allocated, (2) identifying the amount of consideration allocated to each unit of accounting, and (3) explaining how the estimated selling price for each unit was determined (including the significant assumptions used). For more information about multiple-element arrangements and other revenue-related considerations, see the Revenue Recognition section.

Risk Factors

Example of an SEC Comment

You disclose your plan to initially conduct further clinical trials in Europe and that you intend to put off any clinical trials in the United State until 2015. Accordingly, please also discuss here any risks to your product development and domestic commercialization strategy from conducting trials outside of the United States. For example, you should address the possibility that the FDA may not accept the results of such trials and how such lack of acceptance could impact the regulatory approval process.

The SEC staff recently issued several comments on risk factors related to product development. More specifically, when registrants have used boilerplate language for risk factor disclosures, the staff has commented that risk factor disclosures should focus on providing additional detail specifically related to the registrant and the risks associated with the registrant's product development. In addition, the staff has asked registrants to explain how they would be affected by such risks if those risks came to pass.

MD&A Disclosures

R&D Expenses

> **Example of an SEC Comment**
>
> Please revise your disclosure to disclose the costs incurred during each period presented and to date for each of your research and development projects. If you do not maintain any research and development costs by project, disclose that fact and explain why you do not maintain and evaluate research and development costs by project and provide other quantitative or qualitative disclosure that indicates the amount of your resources being used on each of your projects.

The SEC staff has asked registrants in the life sciences industry to expand their disclosures about internal R&D expenses and estimated future expenses beyond those required under ASC 730-10. In addition to disclosing the types of activities and elements included in R&D expenses and the amount of R&D expenses incurred during each reporting period, registrants may be asked to revise their MD&A (and Business section) to include information about each major R&D project. If registrants do not maintain information about R&D costs by project or program, they may be asked to explain why.

Registrants must carefully consider whether their R&D projects are significant enough to warrant disclosure and whether the timing of the costs associated with the projects can be reasonably estimated. Registrants involved in late-stage clinical trials should consider expanding their disclosures about such projects to reflect the uncertainty of ultimate regulatory approval and commercial success.

The SEC staff may also ask a registrant to include, in its contractual obligations table in MD&A, commitments to make payments for R&D contractual relationships. See the Management's Discussion and Analysis section for more information about the contractual obligations table.

Revenue Adjustments

> **Examples of SEC Comments**
>
> - We believe that your disclosure related to estimates of items that reduce revenues such as product returns, chargebacks, rebates and other sales deductions could be improved. . . . [P]lease provide us a revised table to be included in future periodic reports that presents the following:
>   - Current provision related to sales made in current period,
>   - Current provision related to sales made in prior periods,
>   - Actual returns or credits in current period related to sales made in current period, and
>   - Actual returns or credits in current period related to sales made in prior periods[.]
> - [P]lease provide us disclosure to be provided in future periodic reports that discusses the amount of and reason for fluctuations for each type of reduction of revenue (i.e. product returns, chargebacks, rebates and other sales deductions) including the effect that changes in your estimates of these items had on your sales and operations.

The SEC staff has asked registrants to expand their MD&A disclosure related to the reductions in revenue incurred as a result of product returns, chargebacks, rebates, and other revenue adjustments. Enhancement requests have focused on (1) describing in tabular format the period-over-period fluctuations that occurred and (2) disclosures describing the reasons for changes, such as changes in pricing strategies or changes in contracts. Further, the SEC staff has asked registrants to clarify the period to which their recorded provisions or processed credits apply.

Patents

Examples of SEC Comments

- We note your disclosure regarding your patent portfolio which you have provided in bullet point format . . . . Please revise your disclosure regarding your patents and patent applications to provide the following information:
    - Please specify which of your patents and [patent] applications are owned and which are licensed. For the patents and patent applications which are licensed, please specify from whom they are licensed;
    - Please disclose in which jurisdictions your patents have been granted and which jurisdictions your patent applications are currently pending. In this regard we note that you provide this information in some of your bullet points but not in others; and
    - Please provide the expected expiration dates if your pending patent applications are approved. Please provide this information separately from the expiration dates of your approved patents where applicable.
- Please tell us, and disclose in future filings, when the patents . . . expire. In this regard, please tell us which patents, if any, expired and will expire in the near future that are resulting in or are likely to result in material competition from generic products; include in your response the portion of your revenue and income derived from those patents.

The SEC staff has regularly commented on life sciences registrants' disclosure of patents, particularly on patent exclusivity of their products in U.S. and foreign jurisdictions and the impact of such exclusivity on revenues and overall operations. Patent expiration and challenges can affect not only a registrant's current-period earnings but also its future operations and liquidity, particularly if the patents are for core products. Registrants should consider Regulation S-K, Items 101 and 503(c), respectively, for guidance on (1) disclosing patent information in the Business section of their periodic filings and (2) discussing patent expiration and challenges as possible risk factors in their annual reports. In addition, the SEC staff has requested information on the subject matter, type of patent coverage (e.g., method of use, composition of matter), and jurisdiction of a registrant's patents.

Liquidity

Examples of SEC Comments

- We note your disclosure that a significant amount of your earnings occur outside the U.S., and that non-U.S. subsidiaries hold funds that are indefinitely reinvested there and that are available for use by your non-U.S. operations. However, it appears from your disclosure . . . that you intend to borrow these funds from your non-U.S. subsidiaries.
- You disclose that during fiscal 2014, 2013 and 2012, you provided for U.S. and non-U.S. income and withholding taxes in the amount of $[X], $[X] and $[X], respectively, on earnings that were or are intended to be repatriated. You further indicate that, in general, the remaining earnings of your subsidiaries are considered to be permanently reinvested and that you have approximately $[X] of undistributed earnings that are considered to be permanently reinvested. Please quantify the amounts repatriated for each period presented and tell us the facts and circumstances for repatriating your subsidiaries earnings.

Life sciences companies typically have manufacturing and distribution sites, as well as holding company subsidiaries, domiciled in countries with favorable tax rates. If a life sciences registrant discloses that it will reinvest undistributed earnings of its foreign subsidiaries indefinitely, the SEC staff is likely to examine the registrant's liquidity disclosure to determine whether its cash holdings are sufficient to meet its long- and short-term liquidity needs. Therefore, the disclosures in the liquidity section of MD&A about how the registrant plans to meet its funding obligations should be clear and robust. See the Income Taxes section for additional information.

Business Combinations

> **Example of an SEC Comment**
>
> You state that you acquired no significant processes in your . . . acquisition of all of the outstanding shares of [Company A]. Please provide your analysis supporting this conclusion and that this was not an acquisition of a business. Refer to ASC 805-10-55-4 through [55-9].

In recent years, the life sciences industry has seen an increase in M&A activity. While many entities in the industry have sought ways to expand their pipeline of products in development or acquire additional commercial products, others have explored how to generate additional returns on assets that are no longer a strategic focus.

Accounting for a transaction as a business combination differs significantly from accounting for a transaction as an asset acquisition. For example, whereas an entity would capitalize acquired IPR&D and recognize the fair value of contingent consideration and goodwill in a business combination, it would expense acquired IPR&D and not recognize contingent consideration and goodwill in an asset acquisition. Consequently, when acquisitions occur, it is important to determine whether what is being acquired meets the definition of a business under ASC 805. Accordingly, the SEC staff often issues comments related to whether the acquired set meets the definition of a business and further inquires about the basis for the registrant's conclusion.

In addition, in business combinations involving the acquisition of intangible assets, acquirers must determine the useful life of each intangible asset acquired. Because the intangible assets acquired are typically the patent rights to a product or potential product, most life sciences companies begin their analysis by considering the patent life of the underlying product. However, useful life could be affected by other factors, such as the risk of competition from branded or generic products before the company's patent expires or a high barrier to market entry even after the company's patent expires. Therefore, the SEC staff has asked registrants to provide additional analysis that explains the basis for their conclusions about the useful lives of acquired intangible assets.

For additional accounting and reporting considerations related to acquisitions, see the Business Combinations section.

Commitments and Contingencies

Example of an SEC Comment

Please summarize for us your potential milestone and royalty payments related to your collaborations and explain why these potential payments are excluded from the Contractual Obligations and Commitments table. Refer to Item 303(a)(5) of Regulation S-X.

Pharmaceutical and medical device companies often enter into licensing arrangements that include up-front payments and royalty or profit-share payments contingent on the occurrence of certain future events linked to the success of the asset in development. The SEC staff often comments on life sciences registrants' disclosures about these commitments and contingencies associated with payments due to licensors of intellectual property. Registrants can improve such disclosures by disclosing the nature, timing, and amount of contingent milestone and royalty payments, including the factors that trigger payment. For additional accounting and disclosure considerations related to contingencies, see the Contingencies section.

Other Deloitte Resources

March 2015, *Life Sciences: Accounting and Financial Reporting Update — Including Interpretive Guidance*.

Health Plans

The SEC staff's recent comments to health plan registrants have focused mainly on (1) accounting for risk adjustment, reinsurance, and risk corridor programs (the "three Rs") and (2) statutory disclosures. Like other registrants, health plan registrants have also continued to receive comments related to MD&A, contingencies, goodwill impairment, and revenue recognition. For more information on these topics, see the Management's Discussion and Analysis, Contingencies, Impairments of Goodwill and Other Long-Lived Assets, and Revenue Recognition sections.

In addition, because health plan registrants are primarily engaged in offering health care insurance products, SEC staff comments to registrants in the insurance industry may also apply to health plans. For more information, see the Insurance section.

Accounting for the Three Rs

Example of an SEC Comment

Please provide us with your accounting policy for the risk corridor, reinsurance and risk adjustment ("three Rs") that you reference . . . . Please also tell us the amounts you have recorded for each item as well as for the reinsurance fee assessment.

The Patient Protection and Affordable Care Act (PPACA) provided for the establishment of three premium stabilization programs. Commonly referred to as the three Rs, these programs became effective on January 1, 2014, and consist of the following:

- *Risk adjustment program* — This program is designed to enable health insurers to price and offer policies to individuals and small groups without regard to the health status of individual policyholders or group members. It is the only permanent program among the three Rs.
- *Reinsurance program* — Designed as a temporary measure for the 2014–2016 calendar years, the reinsurance program aims to mitigate the effects of a potential increase in the number of large claims filed by policyholders in the individual health care insurance market.

- *Risk corridor program* — Like the reinsurance program, the risk corridor program was designed to be a temporary measure for the 2014–2016 calendar years. Its purpose is to help protect health care insurers from variability in the individual and small group markets by limiting gains and losses. The program applies only to qualified health plans established under the PPACA in the individual and small-group markets.

Similar risk adjustment provisions may also exist in registrants' insurance plan contracts that are not subject to the PPACA.

The SEC staff has asked health plan registrants about their accounting policies and recorded amounts related to the three Rs as well as the method they used to determine such amounts.

Statutory Disclosures

Example of an SEC Comment

Please provide us disclosure to be included in future periodic reports of the restricted net assets for your subsidiaries as of the balance sheet date or otherwise provide disclosure that complies with the objective in Rule 4-08(e)(3)(ii) of Regulation S-X such as disclosing the amount available from these subsidiaries. In this regard, you indicate that dividends received from your regulated subsidiaries are a source of liquidity.

Regulation S-X, Rule 4-08(e)(3), requires footnote disclosure in the consolidated financial statements about the nature and amount of significant third-party restrictions on the ability of subsidiaries to transfer funds to the registrant if restricted net assets of consolidated subsidiaries and equity method investees exceed 25 percent of consolidated net assets. The SEC staff has commented when disclosures required under ASC 944-505 (e.g., disclosures about statutory requirements related to minimum capital standards and certain restricted accounts or assets that may limit payment of dividends) and Rule 4-08(e) are incomplete or missing. In addition, the SEC staff has reminded health plan registrants that disclosures under ASC 944-505 should not be labeled as unaudited. For more information, see the Debt and Insurance sections.

Technology and Telecommunications

Technology

Over the past year, the technology industry has seen a continued high volume of initial public offering (IPO) filings in both domestic and foreign markets. As the amount of capital available to the technology industry rises, business models in various sectors of the industry keep evolving, leading to a need for more robust and transparent disclosures about (1) how companies in those sectors earn revenue and (2) the related critical accounting policies and estimates. Accordingly, when the SEC staff reviews IPO and annual financial report filings, it continues to focus largely on matters related to revenue recognition, including (1) accounting policies and disclosures regarding multiple-element arrangements, (2) gross versus net reporting, and (3) accounting for nonrefundable up-front fees. In addition, the staff has focused on registrants' use of key metrics in MD&A. See the Revenue Recognition section for more information about SEC staff comments on revenue-related topics.

In addition, SEC staff comments to registrants in the technology industry, like those received by registrants in other industries, have concentrated on disclosures about contingencies, income taxes, segment determination, and share-based compensation. See the Contingencies, Income Taxes, Segment Reporting, and Share-Based Payments sections for additional information about such comments.

Revenue Recognition — Multiple-Element Arrangements

Accounting Policies and Disclosures Regarding Multiple-Element Arrangements

Examples of SEC Comments

- Please explain to us how you apply FASB ASC 605-25-30, which requires arrangement consideration to be allocated based on the relative selling price to all deliverables in your multiple element arrangements. Please identify each unit of accounting and discuss how you determine the selling price for each deliverable under FASB ASC 605-25-30-2. Please also include clarifying disclosure in future filings.
- We note your disclosure that implementation services that are delivered prior to the customer being able to use the platform do not have stand-alone value and are recognized over the longer of the life of the subscription or the expected life of the customer relationship. Please explain your basis for concluding that these services do not have [stand-alone] value and tell us how you considered ASC 605-25-25-5(a). In this regard, we note that you disclose that these services can be provided by the Company, third-party service providers or distributors.
- Disclose how you are allocating the arrangement fee to each element or deliverable identified in an arrangement. Further, describe how you account for [one or more arrangements] with a customer that [contain] software-related and non-software related elements, if any. We refer you to ASC 985-605-15-4A.

Under ASC 605-25, consideration in multiple-element arrangements must be allocated to the deliverables on the basis of their relative selling price. To determine the selling price of each deliverable, entities apply a hierarchy that requires them to use vendor-specific objective evidence (VSOE) if available, third-party evidence (TPE) if VSOE is not available, or their best estimate of the selling price if neither VSOE nor TPE is available. The SEC staff focuses on how technology registrants allocate consideration to elements in such arrangements and may request additional information about the factors, inputs, and assumptions used to determine the selling price of each element.

Given the prevalence of multiple-element arrangements in the industry, when the SEC staff reviews the filings of technology registrants, it may comment on the manner in which revenue is measured and recognized in such arrangements as well as on the related disclosures. Historically, registrants have been asked to clarify the descriptions of the elements or deliverables in an arrangement, how they determined that deliverables have stand-alone value, and the timing of each element's delivery or performance.

For multiple-element arrangements that include tangible products containing software, the staff may ask registrants to clarify the accounting guidance they applied and how they determined whether a tangible product's software components and nonsoftware components function together to deliver its essential functionality (and are therefore outside the scope of the guidance in ASC 985-605). Accordingly, registrants should (1) carefully consider all facts when determining the appropriate accounting guidance to apply to arrangements that involve tangible products containing software and (2) clearly and adequately disclose the guidance they applied to such arrangements.

Disclosures About VSOE

> **Example of an SEC Comment**
>
> You indicate that you have established VSOE for consulting days, training and software support, except for software support bundled with time-based licenses, based on separate stand-alone sales of these elements. Please describe in greater detail the methodology for establishing VSOE for these arrangements, including the volume and range of [stand-alone] sales used to establish VSOE. We refer you to ASC 985-605-25.

Establishing VSOE of fair value can significantly affect how revenue is recognized under ASC 985-605. To recognize revenue for a delivered element (e.g., a software license) in a software arrangement, a vendor must first establish VSOE for any undelivered elements (e.g., postcontract customer support (PCS) or professional services). If the vendor cannot establish VSOE of fair value for undelivered elements, it generally must defer all revenue in the arrangement until VSOE is established, the undelivered elements are delivered, or the last remaining deliverable is PCS.

The SEC staff periodically asks registrants that have multiple-element arrangements within the scope of ASC 985-605 — many of which are undergoing IPOs — to expand their disclosures about how they determined VSOE. The additional information may include:

- The percentage of customers that renew at contractually stated rates for PCS and how the rates are substantive when contractually stated renewal rates are used to establish VSOE.
- An explanation of how the registrant determined VSOE if it does not use stated renewal rates or a bell-curve analysis of stand-alone sales to establish VSOE.
- A description of the process used to evaluate the various factors that affect VSOE.
- A quantitative description of the volume and range of stand-alone sales used to establish VSOE and how the registrant accounts for contracts whose sales volume falls outside that range.
- A description of how VSOE is determined when different levels of renewable rates exist.
- An explanation of why the registrant believes that it cannot determine VSOE for its undelivered elements if it accounts for software arrangement elements ratably because they are not separated.
- An explanation of why the registrant could not determine VSOE in prior years and, in cases in which VSOE is first established or is reestablished, what changes arose in the current year.

Revenue Recognition — Gross Versus Net Reporting

Under ASC 605-45, an entity should report revenue on a gross basis when it is acting as the principal of the transaction and on a net basis when acting as an agent to the transaction; applying this guidance often requires careful consideration and judgment. Although ASC 605-45 refers to eight indicators of gross reporting, the SEC staff has placed a higher emphasis on (1) which party is the primary obligor to the transaction and (2) which party has general inventory risk.

Determining the principal in an online transaction is challenging for technology companies, particularly those engaging in transactions related to software as a service (SaaS), online gaming, or online advertising, since there is no tangible product (and, in some instances, transactions are executed almost instantaneously). Because these types of arrangements have become more prevalent, they are topics of increased SEC staff focus.

At the 2014 AICPA Conference, the SEC staff discussed challenges related to determining whether an entity is a principal or an agent under ASC 605-45 when the guidance is applied to emerging business models, such as digital advertising. The staff observed that this analysis should generally begin with the identification of a "deliverable" in the transaction and the party ultimately responsible for its fulfillment. In this regard, the staff may scrutinize the deliverable identified by a registrant and consider all available information (e.g., MD&A, Web sites, marketing materials, contractual arrangements) in evaluating the reasonableness of this determination. Further, the staff noted that the deliverable that is ultimately identified for ASC 605-45 application purposes should be consistent with the deliverable that is subsequently evaluated for revenue recognition purposes.

In its discussion of principal-versus-agent considerations at the 2014 AICPA Conference, the SEC staff also indicated that it is likely to focus on a registrant's assessment of the primary obligor and general inventory risk indicators under ASC 605-45. If the identity of the primary obligor is unclear, the staff may focus its analysis on other factors, such as general inventory risk and latitude in establishing pricing. The staff also noted that latitude in establishing pricing should be evaluated in the context of any "economic constraints" in accordance with ASC 605-45.

SaaS and Online Gaming

Example of an SEC Comment

We note . . . that you believe the second type of arrangement is not within the scope of ASC 605-45. Please clarify whether the partner's customer will enter into any agreement or licensing rights with you to have the right to access your software. Indicate whether the partner's customer will seek remedy from your partner or you. That is, tell us whom the partner's customer will consider responsible for the acceptability and fulfillment of the services. Describe how any marketing materials or other representations made in executing these arrangements describe your role. Your response should address how you considered that you are hosting and providing the services that the customers want.

SaaS and online gaming companies often use operator or reseller partners to target new markets. Questions arise about which party is the primary obligor (i.e., the party responsible for providing the product or service desired by the customer). The SEC staff has challenged the conclusions of various SaaS and online gaming companies (and their resellers) about the appropriateness of gross or net reporting for their transactions and has asked such registrants to provide additional analysis with an emphasis on the factors outlined in ASC 605-45-45. The staff may also request additional disclosures about the nature of these transactions and the role of each of the parties.

Online Advertising

> **Example of an SEC Comment**
>
> We note that you recognize advertising revenue from customers that are advertising networks on a net basis, while advertising revenues earned directly from advertisers are recognized on a gross basis. Also we note your agreements with [Company X] and [Company Y] executed in September and October 2013, respectively. With the agreements you have apparently transferred the primary responsibility to fill substantially all website advertising inventory to [X] and mobile advertising inventory to [Y]. Further both [X] and [Y] will pay for all advertising requests regardless of their ability to fill the inventory. In light of the arrangements, please explain how you have considered whether your website and mobile advertising revenue should be recognized on a gross or net basis under ASC 605-45-45.

Like other forms of advertising, online advertising often involves at least three parties:

- An owner/operator of the online content (a "publisher") that provides the online space or search engine results in which advertising content may be placed.
- A party (an "advertiser") that desires to place the advertising content.
- A third-party service provider (e.g., an "advertising agency").

In addition, there are many companies that offer various technologies and solutions to help advertisers and publishers in what is commonly referred to as the "ad tech" industry. These include "ad networks" or "demand-side platforms," "ad exchanges," and "supply-side platforms."

A registrant that has entered into an online advertising arrangement needs to evaluate the terms of the arrangement and the responsibilities of each of the parties to the agreement to determine whether it should report revenues on a gross or net basis. As a result, the SEC staff may review the contractual terms and marketing materials related to the transaction to determine the nature of the deliverable and the party ultimately responsible for fulfillment. For example, it may be challenging for an advertising agency to conclude that it is the primary obligor (and therefore the principal) if it cannot demonstrate that it is responsible for displaying the advertising content but instead appears to be acting as an agent by matching advertisers with publishers. On the other hand — to understand whether, for example, a demand-side platform is the principal — the SEC staff often seeks to understand contractual terms (among other factors) to determine whether there are sufficient economic and fulfillment risks analogous to inventory risk. Accordingly, the SEC staff may review the contractual agreements with advertisers to understand whether the demand-side platform provided a firm commitment to deliver a certain amount of advertising space at fixed pricing by means of contractual insertion orders (a common contractual form used in the online advertising industry).

Because of the complexity and judgments associated with determining whether to record revenues on a gross or net basis, technology registrants should (1) thoroughly document the basis for their conclusions and (2) consider whether additional disclosures would be appropriate for investors.

Revenue Recognition — Accounting for Nonrefundable Up-Front Fees

Example of an SEC Comment

We note that your [Segment X] business recognizes nonrefundable setup fees as services are performed. Please tell us whether the setup fees have standalone value. Refer to ASC 605-25-25-5(a). If they do not have standalone value, please tell us how you determined that recognition of revenue as services are performed is appropriate. Refer to footnote 39 of SAB Topic [13.A.3(f)].

SAB Topic 13.A.3(f) provides guidance on the accounting for nonrefundable up-front fees. In the technology industry, up-front fees often exist in hosting or SaaS arrangements. These fees, which are typically charged together with a subscription fee for the hosting or SaaS services, cover items such as training, connection services, data migration, and other implementation services. Entities entering into such arrangements are generally required to determine whether the activities associated with the up-front fees and those related to the ongoing hosting or SaaS services are separate units of accounting in a multiple-element arrangement under ASC 605-25. To make this determination, entities must assess whether the activities associated with the up-front fees have stand-alone value and can therefore be regarded as a separate unit of accounting. In assessing stand-alone value, entities need to consider whether such activities are sold separately by any vendor or whether the customer can resell any products or services received.

When the activities associated with an up-front fee and the hosting or SaaS services are treated as a single unit of accounting under ASC 605-25, registrants apply the guidance in SAB Topic 13.A.3(f) to determine an appropriate accounting policy for recognizing revenue related to the up-front fee. Under that guidance, "[u]nless the up-front fee is in exchange for products delivered or services performed that represent the culmination of a separate earnings process," revenue is typically deferred and recognized over the period in which the up-front fee is earned, which may extend beyond the initial contract term.

Footnote 39 of SAB Topic 13.A.3(f) states that the "revenue recognition period should extend beyond the initial contractual period if the relationship with the customer is expected to extend beyond the initial term and the customer continues to benefit from the payment of the up-front fee." The SEC staff has asked registrants about their accounting policies for recognizing revenue in these circumstances. Specifically, it has focused on the period during which registrants recognize revenue for up-front fees, particularly when revenue is recognized either immediately or over the initial contract period despite indications that the relationship with the customer may extend beyond that period.

Disclosures About Key Metrics in MD&A

Examples of SEC Comments

- We note . . . that you expect to significantly increase your subscription base and the annual value per subscription, which you state will ultimately drive billings growth. Considering your transition to cloud based and flexible licenses in fiscal 2014, tell us how you considered providing quantification of your subscription base and annual value per subscription as key metrics in analyzing revenues. We refer you to . . . Section III.B.1 of SEC Release 33-8350.
- We note you provide information regarding the cumulative number of customers that have made at least one purchase since inception of your business and that you believe this metric helps you understand the activity rate of your subscribers. Please explain further why you believe this information is meaningful to your investors and how this metric relates to your results of operations. For example, based on your description, it appears the cumulative number of customers is a metric that is always going to increase and does not factor in currently active or inactive customers. Similar concerns apply to your metric regarding the cumulative number of repeat customers. Please advise.

Technology registrants often use metrics to convey information to their investors. Because there are various types of registrants in the industry (i.e., offering a broad range of products and services), there is diversity in metrics discussed in registrants' earnings calls, registration statements, and periodic filings. Examples of metrics common to registrants in the technology industry include (1) number of "likes," (2) revenue per user, (3) daily or monthly active users, and (4) weighted average duration of contracts. The SEC staff has questioned registrants when certain metrics are not explained in MD&A, changes are not appropriately quantified, and it is unclear whether metrics represent key performance indicators. Accordingly, the staff may ask registrants to provide a detailed quantitative and qualitative discussion and analysis of the impact of changes in their key metrics disclosed in MD&A, in a manner consistent with Sections III.B.1 and III.B.2 in SEC Release No. 33-8350 and Regulation S-K, Item 303(a)(3)(iii). In addition, registrants that have not already done so are asked to provide disclosures in MD&A to discuss why the metrics were chosen, how they are used, and any inherent limitations in the metrics selected.

Because of the vast volume of the metrics used, the SEC staff has been concerned that (1) metrics may not be presented with appropriate context and (2) the link between registrants' key metrics and their income and future profitably may not be clear. Registrants should review their metrics to ensure that the metrics portray a balanced discussion and remain relevant. If that is not the case, registrants should consider removing metrics (or replacing them with new ones).

Other Deloitte Resources

December 15, 2014, *Heads Up*, "Highlights of the 2014 AICPA Conference on Current SEC and PCAOB Developments."

Telecommunications

The SEC staff's comments to registrants in the telecommunications industry have focused on topics such as revenue recognition and long-lived asset impairment.

Revenue Recognition

Examples of SEC Comments

- While your disclosure addresses the basic revenue recognition criteria related to product sales, it is not clear when delivery typically occurs and when the related revenues are typically recognized. . . . Please tell us what consideration was given to disclosing the general timing of delivery or performance of service and the general timing of revenue recognition for product sales. Please refer to ASC 605-25-50-2.
- Tell us and explain why [Product A shipments] were not recognized as revenues. It is unclear from the Critical Accounting and Estimates section of the MD&A what revenue recognition criteria were not met. In addition, tell us in detail the nature of your sell-through to end users and how you are accounting for such sales.

The SEC staff often asks registrants in the telecommunications industry to expand or clarify their disclosures about revenue recognition. For example, the SEC staff may ask registrants for details about their compliance with the four criteria for revenue recognition contained in SAB Topic 13. The staff has indicated that registrants must carefully monitor these criteria when selling products to resellers and distributors and, in particular, should evaluate whether the substance of an arrangement is such that the price is not fixed or determinable until the product is sold to the end customer. When revenue is deferred because a criterion was not satisfied, registrants should specify which criterion was not met and disclose how and when the transaction will be recognized.

As the telecommunications industry continues to evolve, registrants in the industry must consider the revenue recognition implications of new business practices and ensure transparent disclosure. Wireless operators, for example, are increasingly offering subscribers more flexible handset-purchase options, such as installment plans and exchange rights. Such offerings can have significant revenue recognition implications. New offerings also may trigger a requirement for registrants in the industry to provide financial statement disclosures not previously considered significant. These could include disclosures about financing receivables for which registrants may not have historical information to appropriately predict an allowance for credit losses, credit quality indicators, and potential guarantee liabilities that arise from the various handset-purchase options. New business practices are likely to draw SEC staff scrutiny if the registrants' relevant revenue recognition policies and considerations are not clearly disclosed.

In addition, in light of the prevalence of multiple-element arrangements in the telecommunications industry and the complexities associated with accounting for them, the SEC staff frequently issues comments related to such arrangements. Further, registrants in the industry have received staff comments requesting an analysis that supports the registrant's conclusion about whether it is a principal or an agent in certain transactions.

For information on multiple-element arrangements and other revenue-related considerations, see the Revenue Recognition section.

Long-Lived Asset Impairment

Example of an SEC Comment

We note that you conducted a long-lived asset impairment analysis in the fourth quarter of [201X] and [201Y] and in each case concluded that your long-lived assets were not impaired. In this regard, please disclose events or changes in circumstances that occurred during those periods that indicated that the carrying value of your assets or assets groupings may not be recoverable. Disclose the extent to which the fair value of your assets or asset groups exceeded their carrying value. Disclose if any of your assets are at risk of impairment.

The SEC staff continues to question registrants in the telecommunications industry about the recoverability of their long-lived assets, including physical network assets and spectrum licenses. For example, the staff inquires about the reasonableness of the useful-life estimates used by registrants to determine whether their long-lived assets are potentially impaired. Such assets may be subject to a greater risk of impairment as a result of the rapid rate of technological innovation. In addition, the staff has asked registrants to disclose the carrying value of significant types of assets and the methods used to estimate the assets' useful lives.

For additional information, see the Impairments of Goodwill and Other Long-Lived Assets section.

Appendixes

Appendix A: Topic "Graveyard"

This appendix is a "graveyard" of comment letter topics discussed in our publication's eighth edition that no longer represent recent trends. Although such topics are not discussed in the current edition, we realize that they remain relevant to a registrant that may receive SEC staff comments regarding them and to any preparer who is interested in understanding topics on which the SEC staff has historically focused. Accordingly, this appendix links topic headings from last year's SEC comment letter book that do not appear elsewhere in the current edition. For information about a previously discussed topic, click one of the topic heading links below (also available on our US GAAP Plus Web site at http://www.iasplus.com/en-us/tag-types/united-states) and you will be directed to the corresponding section or subsection of the eighth edition. Linked titles of past comment letter book editions are also provided below.

Links to Prior-Year Topic Headings Not Included in This Year's Sections

Financial Statement Accounting and Disclosure Topics

Consolidation — VIEs in Foreign Jurisdictions

Financial Statement Classification, Including Other Comprehensive Income — Current Versus Noncurrent [Balance Sheet] Classification

Leases — Nonperformance Provisions

Other-Than-Temporary Impairment of Investments in Securities

Share-Based Payments — Financial Statement Presentation

SEC Disclosure Topics

Management's Discussion and Analysis — Off-Balance-Sheet Arrangements

SEC Reporting:

- Issuers of Securities That Collateralize Registered Securities ([Regulation S-X,] Rule 3-16).
- SEC Reporting Considerations for Material Changes That Require Retrospective Application.

Disclosures About Risk — Issuers Based in China

Internal Control Over Financial Reporting — Domestic Companies With a Majority of Operations Outside the United States

Foreign Private Issuers

Foreign Private Issuers Using IFRSs — Going-Concern Language in PCAOB Audit Reports

Industry-Specific Topics

Consumer and Industrial Products

Transportation, Travel, Hospitality, and Leisure — Capital Expenditures

Financial Services

Insurance:

- Reinsurance Receivables.
- Deferred Acquisition Costs.

Investment Management — Revenue Recognition

Real Estate — Impairments

Health Sciences

Life Sciences — Branded Pharmaceutical Drug Annual Fee

Health Plans — Provision For Adverse Deviation

Past Editions of Deloitte's SEC Comment Letter Publication

SEC Comment Letters on Domestic Registrants — A Closer Look (First Edition)

SEC Comment Letters on Domestic Registrants —A Closer Look (Second Edition)

SEC Comment Letters on Domestic Registrants — A Closer Look (Third Edition)

SEC Comment Letters — Including Industry Insights: A Snapshot of Current Themes (Fourth Edition)

SEC Comment Letters — Including Industry Insights: Improving Transparency (Fifth Edition)

SEC Comment Letters — Including Industry Insights: Highlighting Risks (Sixth Edition)

SEC Comment Letters — Including Industry Insights: Constructing Clear Disclosures (Seventh Edition)

SEC Comment Letters — Including Industry Insights: A Recap of Recent Trends (Eighth Edition)

Appendix B: SEC Staff Review Process

The SEC's Division of Corporation Finance (the "Division") selectively reviews filings made under the Securities Act and the Exchange Act. In January 2009, the SEC staff issued an overview that explains its filing review and comment letter process.[1] The overview aims to increase transparency in the review process and expresses the staff's willingness to discuss issues with registrants. For example, the overview indicates that the "[staff] views the comment process as a dialogue with a company about its disclosure" and that a "company should not hesitate to request that the staff reconsider a comment it has issued or reconsider a staff member's view of the company's response to a comment at any point in the filing review process."

The overview is divided into two main sections:

- *The filing review process* — This section explains that the Division comprises 11 offices staffed by experts in specialized industries, accounting, and disclosures. The section includes background on the different types of review (required and selective) and covers the comment process, indicating that "[m]uch of the [staff's] review [process] involves evaluating the disclosure from a potential investor's perspective and asking questions that an investor might ask when reading the document." The section also addresses how to respond to staff comments and close a filing review.
- *The reconsideration process* — This section emphasizes that "staff members, at all levels, are available to discuss disclosure and financial statement presentation matters with a company and its legal, accounting, and other advisors." In addressing a registrant's potential request for the SEC staff to reconsider a staff member's comment or view on a registrant's response, the staff emphasizes that registrants do not have to "follow a formal protocol." However, the staff explains where registrants should start and the steps involved in the normal course of the reconsideration process. The staff also specifies contact information for each office for both accounting and financial disclosure matters and legal and textual disclosure matters.

Registrants may involve the SEC's Office of the Chief Accountant (OCA) during any stage of the review process. Unlike the Division's role, which is to address matters related to the age, form, and content of registrants' financial statements that are required to be filed, the OCA's role is to address questions concerning a registrant's application of GAAP. Guidance on consulting with the OCA is available on the SEC's Web site.

A registrant that receives an SEC comment letter should generally respond within the time frame indicated in the letter. See Appendix C for more information about responding to SEC comment letters. The registrant should continue to respond to any requests for more information until it receives a letter from the Division stating that the Division has no further comments. A registrant that does not receive a completion letter within a reasonable amount of time after submitting a response letter should call its SEC staff reviewer (named in the letter) to ask about the status of the review. If the review is complete, the registrant should request a completion letter.

To increase the transparency of the Division's review process, comment letters and company responses to those letters are made public, via the SEC's Web site, at least 20 business days after the Division has completed its review of a periodic or current report or declared a registration statement effective. See Appendix D for tips on searching the SEC's comment letter database.

[1] An overview of the legal, regulatory, and capital markets offices is also available on the SEC's Web site.

Appendix C: Best Practices for Managing Unresolved SEC Comment Letters

The best practices below are intended to help registrants resolve any staff comment letters in a timely manner. Unresolved comments may affect a registrant's ability to issue financial statements and an auditor's ability to issue the current-year audit report. In addition, when responding to staff comment letters, registrants should be mindful of their responses because all responses to staff comment letters are made publicly available and become part of a registrant's "total mix of information" and disclosure records (i.e., investors may read such responses similarly to how they interpret a registrant's other filings and publicly available information).[1] A registrant should therefore do the following:

- Review the comment letter immediately and respond to the SEC staff reviewer (named in the letter) within the time indicated in the comment letter (usually 10 business days). If possible, the registrant should not request an extension, since this may delay resolution of the comment letter. However, in certain circumstances, the registrant should consider requesting an extension to provide a more thorough and complete response that addresses all of the staff's comments.
- If the registrant does not fully understand any specific comment, it should contact its SEC staff reviewer quickly for clarification so that it can provide an appropriate response.
- Consider the impact the comment letter may have on its ability to issue the financial statements.
- Consult with its SEC legal counsel about the impact the comment letter may have on the certifications contained in its Form 10-K.
- Consult with its auditors to discuss the impact the comment letter may have on their ability to issue the current-year audit report.
- Include in the response a discussion of supporting authoritative accounting literature and references to the specific paragraph(s) from the standard(s).
- Because some comments may request disclosure in future filings, the registrant should consider including such disclosure in the response letter to potentially eliminate additional requests from its SEC staff reviewer.
- If an immaterial disclosure is requested, the registrant should consider explaining why the disclosure is immaterial instead of including the immaterial disclosure in future filings.
- Maintain contact with its SEC staff reviewer and make the reviewer aware of the registrant's required timing (on the basis of its current-year filing deadlines).
- If the registrant has not received a follow-up letter or been contacted within two weeks of filing the initial response letter, the registrant should contact its SEC staff reviewer to determine the status of the comments. The registrant should promptly address any follow-up questions.
- If the registrant is uncertain about whether its review has been completed without further comments, it should ask the SEC staff reviewer about the status of the review. If the review is complete, the registrant should ask the reviewer for a completion letter.

Oral Comments

In certain circumstances, the SEC staff may provide oral comments to a registrant instead of a written comment letter. The registrant should ask the SEC staff reviewer how he or she would like to receive the registrant's response to the oral comments. If the reviewer requests a response via EDGAR, a registrant should respond with a written letter. If the reviewer requests an oral response or identifies no preference, a registrant should still, although it is not required to do so, consider responding to the staff's comments with a letter to formally document the registrant's understanding of the staff's comments and the discussions held as well as the registrant's response.

[1] The SEC staff discussed this topic at the 2012 AICPA Conference. Refer to Deloitte's December 11, 2012, *Heads Up* for more information.

Disclosure Requirements

Under the Securities Offering Reform, large accelerated filers, accelerated filers, and well-known seasoned issuers must disclose in their Forms 10-K the substance of any material unresolved SEC staff comments that were issued 180 or more days before the end of the current fiscal year.

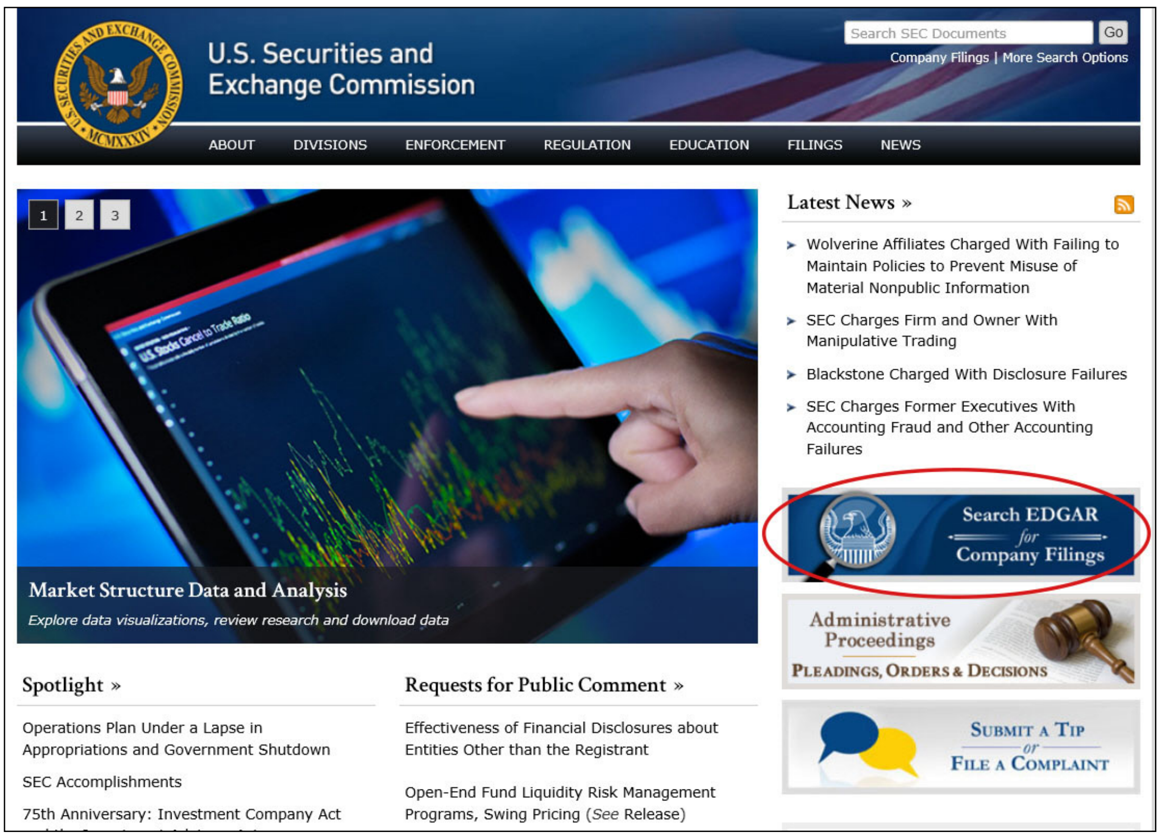
Appendix D: Tips for Searching the SEC's Database for Comment Letters

The SEC adds comment letters (and responses from registrants) to its EDGAR database no earlier than 20 days after its review of a filing is complete. Registrants can refer to such comments as part of their financial statement review process and to improve their own accounting and overall disclosure.

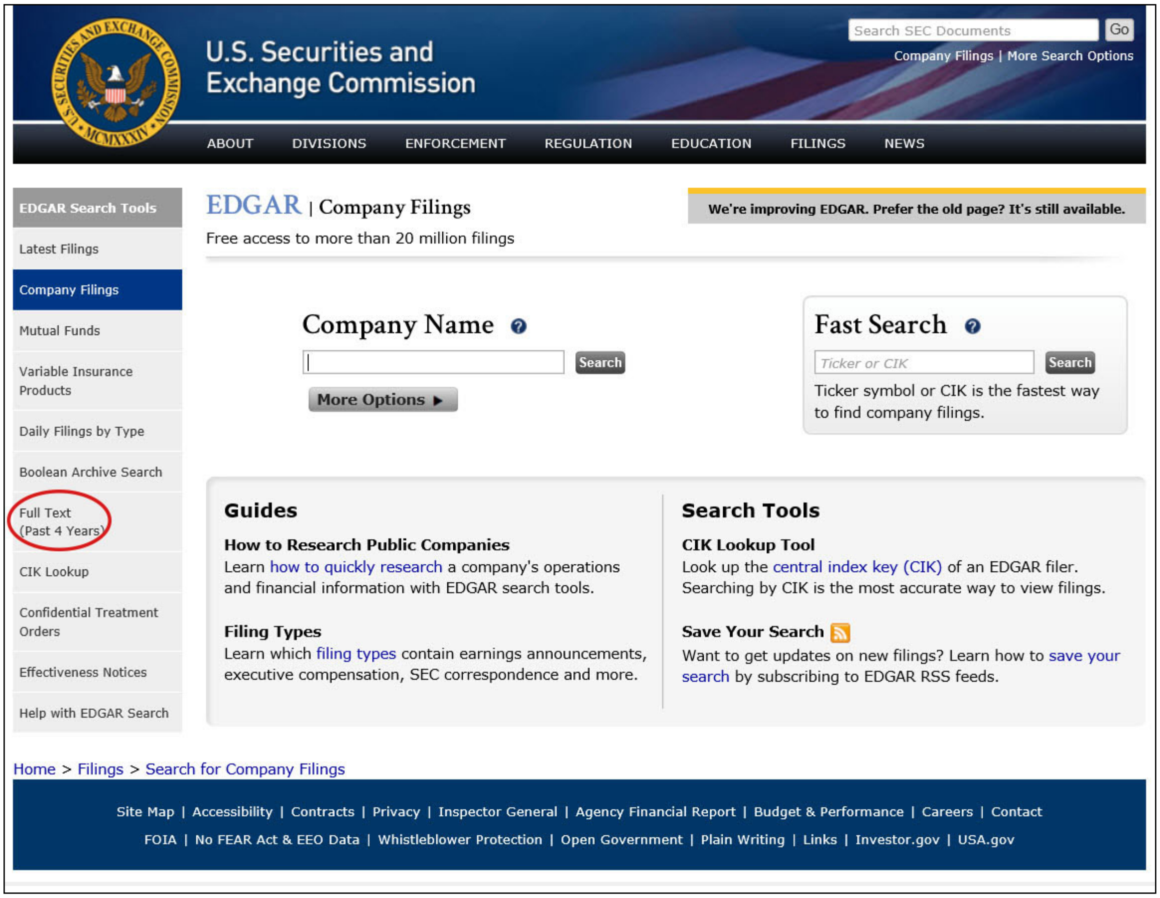
Although the SEC has updated the EDGAR search engine to simplify searches of corporate filings, users may still wish to use the "full-text" search feature to find the text of specific comment letters posted within the last four years and to generally narrow their search results. The process of performing a full-text search is discussed below.

Full-Text Searching

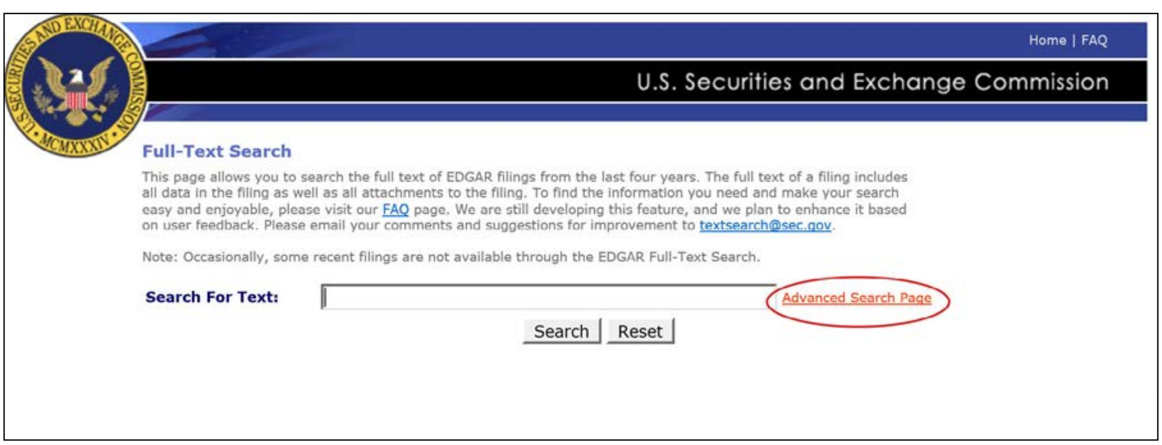
To perform a full-text search, first go to the SEC's home page (www.sec.gov) and click the "Search EDGAR for Company Filings" image:



Then, click the “Full Text” link in the left sidebar on the “EDGAR | Company Filings” page:



On the “Full-Text Search” page, select “Advanced Search Page”:



This brings up the following form:

In the form, limit the search results to SEC comment letters by using the drop-down menu next to **"In Form Type"** and choosing "UPLOAD" (or select "CORRESP" to include registrant responses as well).

Then, enter search terms in the **"Search for Text"** field. The documents found will contain at least one of the words entered as well as variations of the key word(s). To search for specific phrases, enclose the phrase in quotation marks (e.g., "management's discussion and analysis"). Results will include documents that contain the quoted phrase as well as conceptually related phrases, such as "managerial discussion & analysis."

Enhancing Search Results

Searches can be further refined by using Boolean operators such as AND, OR, and NOT (capitalization of these terms is required). For an operator to work effectively, a key word or phrase generally must be included before and after it (e.g., goodwill AND impairment). Searches in which operators are used will produce results as follows:

- *AND* — Documents will contain **all** terms connected (but not necessarily in the same sentence or paragraph) by the AND operator. The terms can appear in any order in the document.
- *OR* — Documents will contain **any** terms connected by the OR operator.
- *NOT* — Documents will contain one term but **not** another term.

Using wildcards or the "nearness" feature can also enhance search results:

- *Wildcards* — While certain variations of key words are automatically included in search results, using an asterisk (*) can ensure that all variations are included. For example, the wildcard "impair*" can be used to find documents that contain the words impair, impaired, impairing, impairment, or impairs.

- *Nearness* — Key words or phrases within a certain distance of each other can be searched by stipulating a range. The range is determined by using the term "NEARn," with "n" representing the maximum number of words in the range (e.g., "impairment NEAR5 test" would find documents with impairment and test within five words of each other).

Advanced search features can frequently be combined. For example, quotations used to find a specified phrase can be combined with Boolean operators (e.g., goodwill AND "impairment test").

Note that numbers are ignored in searches. Thus, a search for "Final Rule 108" will only locate documents that contain the terms "Final" and "Rule." Searches can, however, be sorted by other criteria, such as dates, as discussed below.

Sorting by Dates and Other Specific Criteria

On the full-text search form, selections can also be made to limit results to a specified:

- Company name.
- Central index key (CIK).[1]
- Standard industrial classification (SIC) code.[2]
- Date range.

Note that clicking the SIC code in the list of search results will display a list of additional companies that have the same SIC code:

Example


10/09/2015 S-3 for PACIFIC MERCANTILE BANCORP
COMPANY NAME(s) - [PACIFIC MERCANTILE BANCORP (CIK - 1109546 /SIC - 6021)]
As filed with the Securities and Exchange Commission on October 9, 2015 Registration No. 333- UNITED STATES SECURITIES AND EXCHANGE COMMISSION Washington, D.C. 20549 FORM S-3 REGISTRATION

Controlling and Displaying Search Results

The **Results Per Page** drop-down list can be used to limit the number of search results that display. To open a comment letter, click on the underlined title of the form to the right of the date. The comment letters will include any attachments or exhibits.

Example of the Benefits of Using Full-Text Search Features

Assume that a user is interested in SEC comments issued over the past two years that are related to results of operations in the hotel industry. By searching for the words "results" and "operations" with "All Forms" selected and no dates specified, the user would obtain over 8,000 results, many of which are not relevant.

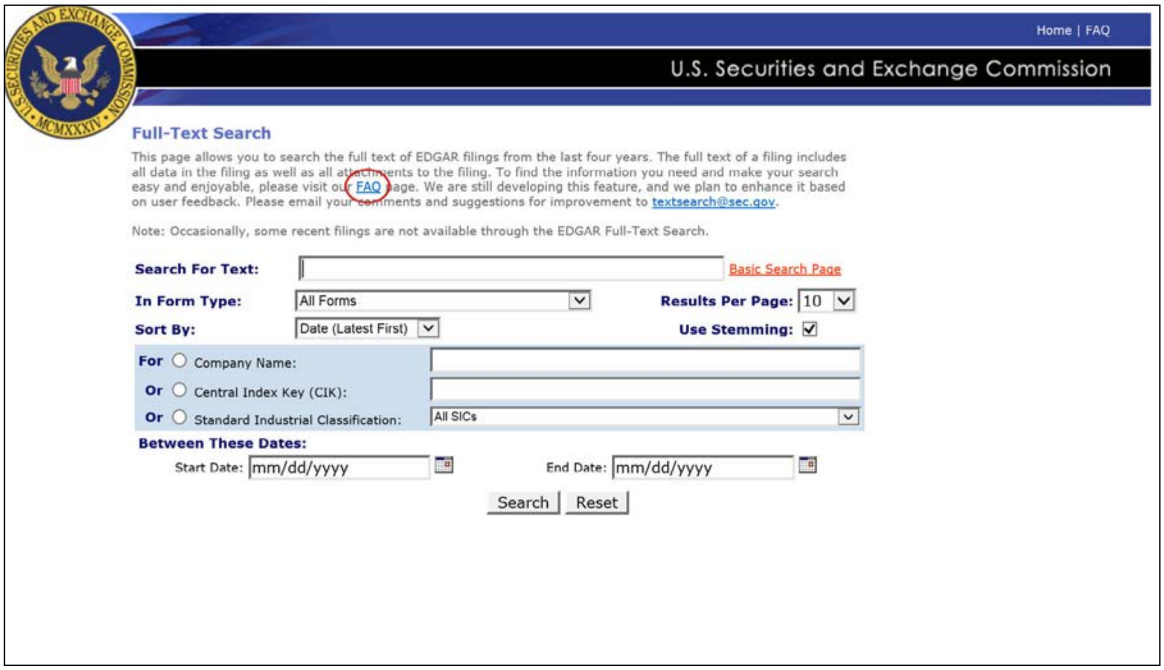
However, if the user narrowed his or her search by (1) selecting the form type UPLOAD, (2) entering the search term "results of operations" in quotation marks, (3) entering the industry code for the hotel/motel industry (SIC 7011), and (4) providing a date range spanning the last two years, the number of results will be more relevant and manageable.

[1] According to the SEC's Web site, a "CIK is the unique number that the SEC's computer system assigns to individuals and corporations [that] file disclosure documents with the SEC. All new electronic and paper filers, foreign and domestic, receive a CIK number."

[2] A SIC code is an industry designation. Note that some of the SIC code descriptions are similar, so narrowing results by SIC code may not include certain issuers that are in a similar industry yet have a different assigned SIC code.

Additional Information

For more information about full-text searching, click the FAQ link on in the search form:



Appendix E: Glossary of Standards and Other Literature

The standards and literature below were cited or linked to in this publication.

AICPA Accounting and Valuation Guide

Valuation of Privately-Held-Company Equity Securities Issued as Compensation ["Cheap Stock Guide"]

FASB ASC References

For titles of *FASB Accounting Standards Codification* references, see Deloitte's "Titles of Topics and Subtopics in the *FASB Accounting Standards Codification*."

FASB — Other Literature

See the FASB's Web site for titles of:

- Accounting Standards Updates.
- Pre-Codification literature (Statements, Staff Positions, EITF Issues, and Topics).
- Concepts Statements.

International Standards

See Deloitte Touche Tohmatsu's IAS Plus Web site for the titles of citations to:

- International Financial Reporting Standards (IFRSs).
- International Accounting Standards (IASs).
- Other pronouncements.

PCAOB Auditing Standards

See the Standards page on the PCAOB's Web site for titles of its auditing standards.

SEC ASR

Accounting Series Release No. 268, "Presentation in Financial Statements of 'Redeemable Preferred Stocks'" (Rule 5-02.28 of SEC Regulation S-X)

SEC C&DI Topics

Exchange Act Rules

Exchange Act Sections

Non-GAAP Financial Measures

Oil and Gas Rules

Regulation S-K

Securities Act Rules

SEC Concept Release

33-8860, *Mechanisms to Access Disclosures Relating to Business Activities in or With Countries Designated as State Sponsors of Terrorism*

SEC Division of Corporation Finance Disclosure Guidance

Topic 2, "Cybersecurity"

SEC Division of Corporation Finance EDGAR Filer Manual

Volume II, *EDGAR Filing*

- Section 6.14, "Syntax of Calculation Linkbases."
- Section 6.15, "Content of Calculation Linkbases."

SEC Division of Corporation Finance FRM

Topic 1, "Registrant's Financial Statements"

Topic 2, "Other Financial Statements Required"

Topic 3, "Pro Forma Financial Information"

Topic 4, "Independent Accountants' Involvement"

Topic 6, "Foreign Private Issuers & Foreign Businesses"

Topic 7, "Related Party Matters"

Topic 8, "Non-GAAP Measures of Financial Performance, Liquidity, and Net Worth"

Topic 9, "Management's Discussion and Analysis of Financial Position and Results of Operations (MD&A)"

Topic 10, "Emerging Growth Companies"

Topic 13, "Effects of Subsequent Events on Financial Statements Required in Filings"

SEC Final Rule

33-8176, *Conditions for Use of Non-GAAP Financial Measures*

SEC Industry Guides

Guide 3, "Statistical Disclosure by Bank Holding Companies"

Guide 6, "Disclosures Concerning Unpaid Claims and Claim Adjustment Expenses of Property-Casualty Insurance Underwriters"

Guide 7, "Description of Property by Issuers Engaged or to Be Engaged in Significant Mining Operations"

SEC Interpretive Release

33-8350 (34-48960), *Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations*

33-8810, *Commission Guidance Regarding Management's Report on Internal Control Over Financial Reporting Under Section 13(a) or 15(d) of the Securities Exchange Act of 1934*

SEC Regulation S-K

Item 10, "General"

Item 101, "Description of Business"

Item 103, "Legal Proceedings"

Item 302, "Supplementary Financial Information"

Item 303, "Management's Discussion and Analysis of Financial Condition and Results of Operations"

Item 305, "Quantitative and Qualitative Disclosures About Market Risk"

Item 307, “Disclosure Controls and Procedures”

Item 308, “Internal Control Over Financial Reporting”

Item 402, “Executive Compensation”

Item 404, “Transactions With Related Persons, Promoters and Certain Control Persons”

Item 407, “Corporate Governance”

Item 503, “Prospectus Summary, Risk Factors, and Ratio of Earnings to Fixed Charges”

Item 506, “Dilution”

Item 601, “Exhibits”

Item 1202, “Disclosure of Reserves”

Item 1203, “Proved Undeveloped Reserves”

Item 1204, “Oil and Gas Production, Production Prices and Production Costs”

Item 1205, “Drilling and Other Exploratory and Development Activities”

Item 1206, “Present Activities”

Item 1207, “Delivery Commitments”

Item 1208, “Oil and Gas Properties, Wells, Operations, and Acreage”

SEC Regulation S-T

Rule 302, “Signatures”

Rule 405, “Interactive Data File Submissions and Postings”

SEC Regulation S-X

Rule 1-02, “Definitions of Terms Used in Regulation S-X”

Rule 2-02, “Accountants’ Reports and Attestation Reports”

Rule 3-01, “Consolidated Balance Sheets”

Rule 3-02, “Consolidated Statements of Income and Changes in Financial Position”

Rule 3-03, “Instructions to Income Statement Requirements”

Rule 3-04, “Changes in Stockholders’ Equity and Noncontrolling Interests”

Rule 3-05, “Financial Statements of Businesses Acquired or to Be Acquired”

Rule 3-09, “Separate Financial Statements of Subsidiaries Not Consolidated and 50 Percent or Less Owned Persons”

Rule 3-10, “Financial Statements of Guarantors and Issuers of Guaranteed Securities Registered or Being Registered”

Rule 3-12, “Age of Financial Statements at Effective Date of Registration Statement or at Mailing Date of Proxy Statement”

Rule 3-14, “Special Instructions for Real Estate Operations to Be Acquired”

Rule 3-16, “Financial Statements of Affiliates Whose Securities Collateralize an Issue Registered or Being Registered”

Rule 4-08, “General Notes to Financial Statements”

Rule 4-10, “Financial Accounting and Reporting for Oil and Gas Producing Activities Pursuant to the Federal Securities Laws and the Energy Policy and Conservation Act of 1975”

Article 5, “Commercial and Industrial Companies”

Rule 5-02, “Balance Sheets”

Rule 5-03, “Income Statements”

Rule 5-04, “What Schedules Are to Be Filed”

Rule 6-04, “Balance Sheets”

Rule 7-05, “What Schedules Are to Be Filed”

Article 8, “Financial Statements of Smaller Reporting Companies”

Article 10, “Interim Financial Statements”

Article 11, “Pro Forma Financial Information”

Rule 11-01, “Presentation Requirements”

Rule 11-02, “Preparation Requirements”

Article 12, “Form and Content of Schedules”

Rule 12-04, “Condensed Financial Information of Registrant”

Rule 12-09, “Valuation and Qualifying Accounts”

Rule 12-28, “Real Estate and Accumulated Depreciation”

SEC SAB Topics

SAB Topic 1.B, “Allocation of Expenses and Related Disclosure in Financial Statements of Subsidiaries, Divisions or Lesser Business Components of Another Entity”

SAB Topic 1.M, “Materiality” (SAB 99)

SAB Topic 1.N, “Considering the Effects of Prior Year Misstatements When Quantifying Misstatements in Current Year Financial Statements” (SAB 108)

SAB Topic 3.A, “Convertible Securities”

SAB Topic 5.P, “Restructuring Charges”

SAB Topic 5.Y, “Accounting and Disclosures Relating to Loss Contingencies”

SAB Topic 6.K, “Accounting Series Release 302 — Separate Financial Statements Required by Regulation S-X”

SAB Topic 11.B, “Depreciation and Depletion Excluded From Cost of Sales”

SAB Topic 11.M, “Disclosure of the Impact That Recently Issued Accounting Standards Will Have on the Financial Statements of the Registrant When Adopted in a Future Period” (SAB 74)

SAB Topic 13, “Revenue Recognition” (SAB 101 and SAB 104)

SAB Topic 13.A, “Selected Revenue Recognition Issues”

SAB Topic 14, “Share-Based Payment”

Securities Act of 1933 Rules

Rule 405, "Definitions of Terms"

Rule 436, "Consents Required in Special Cases"

Securities Exchange Act of 1934 Rules

Rule 13a-15, "Issuer's Disclosure Controls and Procedures Related to Preparation of Required Reports"

Rule 15d-15, "Controls and Procedures"

Appendix F: Abbreviations

Abbreviation	Description
AICPA	American Institute of Certified Public Accountants
AICPA Banking Conference	AICPA National Conference on Banks and Savings Institutions
AICPA Conference	AICPA Conference on Current SEC and PCAOB Developments
ASC	FASB Accounting Standards Codification
ASR	SEC Accounting Series Release
ASU	FASB Accounting Standards Update
AUM	assets under management
AUM&A	assets under management and administration
BC	Basis for Conclusions
BCF	beneficial conversion feature
CAM	common area maintenance
CAQ	Center for Audit Quality
C&DI	SEC Compliance and Disclosure Interpretation
CD&A	Compensation Discussion and Analysis
CEO	chief executive officer
CF-OCA	SEC's Division of Corporation Finance, Office of the Chief Accountant
CFDG	Corporation Finance Disclosure Guidance
CFO	chief financial officer
CIK	central index key
CODM	chief operating decision maker
COSO	Committee of Sponsoring Organizations of the Treadway Commission
DC&P	disclosure controls and procedures
DTA	deferred tax asset
DTL	deferred tax liability
EBIT	earnings before interest and taxes

Abbreviation	Description
EBITDA	earnings before interest, taxes, depreciation, and amortization
EDGAR	SEC's Electronic Data Gathering, Analysis, and Retrieval system
EGC	emerging growth company
EPS	earnings per share
FASB	Financial Accounting Standards Board
FAQs	frequently asked questions
FDA	Food and Drug Administration
FFO	funds from operations
FINRA	Financial Industry Regulatory Authority
FPI	foreign private issuer
FRM	SEC Financial Reporting Manual
G&A	general and administrative expense
GAAP	generally accepted accounting principles
IAS	International Accounting Standard
IASB	International Accounting Standards Board
ICFR	internal control over financial reporting
IFRS	International Financial Reporting Standard
IPO	initial public offering
IPR&D	in-process research and development
LLC	limited liability company
M&A	mergers and acquisitions
MBoe	thousand barrels of oil equivalent
MD&A	Management's Discussion and Analysis
MLP	master limited partnership
NAREIT	National Association of Real Estate Investment Trusts
NCI	noncontrolling interest

Abbreviation	Description
NEO	named executive officer
NGL	natural gas liquid
NOI	net operating income
OCA	SEC's Office of the Chief Accountant
OCI	other comprehensive income
OCIE	SEC's Office of Compliance Inspections and Examinations
P&U	power and utilities
PBE	public business entity
PCAOB	Public Company Accounting Oversight Board
PCC	Private Company Council
PCI	purchased credit-impaired
PCS	postcontract customer support
PUD	proved undeveloped
R&D	research and development
REIT	real estate investment trust
SaaS	software as a service
SAB	SEC Staff Accounting Bulletin
SEC	Securities and Exchange Commission
SG&A	selling, general, and administrative expense
SIC	standard industrial classification
SOA	Society of Actuaries
TDR	troubled debt restructuring
THL	travel, hospitality, and leisure
TPE	third-party evidence
VaR	value at risk
VIE	variable interest entity
VSOE	vendor-specific objective evidence
XBRL	eXtensible Business Reporting Language

The following is a list of short references for the Acts mentioned in this publication:

Abbreviation	Act
Dodd-Frank Act	Dodd-Frank Wall Street Reform and Consumer Protection Act
Exchange Act	Securities Exchange Act of 1934
FCPA	Foreign Corrupt Practices Act
JOBS Act	Jumpstart Our Business Startups Act
PPACA	Patient Protection and Affordable Care Act
Sarbanes-Oxley Act	Sarbanes-Oxley Act of 2002
Securities Act	Securities Act of 1933

GOODWIN PROCTER ALERT

AUGUST 19, 2015

SEC Adopts Final CEO Pay Ratio Disclosure Rule

by Daniel P. Adams, John O. Newell, Ettore A. Santucci, Marian A. Tse

Speed Read

The SEC has adopted a final rule requiring public companies to disclose the ratio of its CEO compensation to the median compensation of its employees, as mandated by the Dodd-Frank Act. Disclosure of the pay ratio will be required in registration statements, proxy and information statements, and annual reports that require executive compensation disclosure. Subject to certain transition provisions, the final rule will first apply to compensation paid for a company's first full fiscal year that begins on or after January 1, 2017 and, therefore, will not require new disclosure in SEC filings by calendar year-end companies until 2018.

On August 5, 2015, the Securities and Exchange Commission adopted the final CEO pay ratio disclosure rule by a 3-2 vote. The final rule amends Item 402 of Regulation S-K, as required by Section 953(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. The rules require public companies to disclose:

- the median annual total compensation for all employees of the company other than the CEO (subject to limited exceptions for foreign employees) for the last completed fiscal year;
- the annual total compensation of the CEO (or equivalent position) for the last completed fiscal year; and
- the ratio of the two amounts.

The pay ratio disclosure may be expressed as a ratio with the median employee compensation equal to one (for example, "x to 1" or "x:1"), or may be expressed narratively (for example, "The CEO's annual total compensation is x times that of the median total annual compensation of employees").

As discussed in greater detail in a separate section below, the CEO pay ratio disclosure rule will first apply to compensation paid for a company's first full fiscal year that begins on or after January 1, 2017 and will therefore not require new disclosure in a company's SEC filings until 2018. Although the final rule is likely to face legal challenges in court and there are already bills in both the House of Representatives and the Senate that would repeal the section of the Dodd-Frank Act under which the SEC adopted the final rule, companies should begin to evaluate whether they have information and reporting systems that would produce the required data and how compliance would impact internal and external reporting and disclosure.

Companies Covered by the Final Rule

The CEO pay ratio disclosure rule applies to all companies that are required to provide Summary Compensation Table disclosure under Item 402(c) of Regulation S-K. The final rule therefore does not apply to smaller reporting companies, emerging growth companies, U.S.-Canadian multijurisdictional disclosure system filers, foreign private issuers or registered investment companies.

Identifying the Median Employee

Employee Population. In determining the employees from which the median employee is identified, a company may use its full employee population or a statistical sampling and/or other reasonable methods. A company's full employee population for purposes of identifying the median employee for a particular year includes all individuals other than the CEO who were employed by the company or any of its consolidated subsidiaries as of a date selected by the company that is within the last three months of its fiscal year. All full-time, part-time, seasonal and temporary workers who were employed on the date selected are included. Workers who provide services to the company as independent contractors or "leased" workers are excluded if they were employed by and their compensation was determined by an unaffiliated third party. In addition, companies may exclude persons who became employees as the result of a business combination or acquisition occurring during the year and, under limited exemptions described below, non-U.S. employees.

Employee Compensation. The final rule provides companies with significant flexibility in determining the compensation measure to be used to identify the median employee. Companies may use annual total compensation, calculated in the same way as total compensation is for the named executive officers in the Summary Compensation Table, or any other compensation measure that is consistently applied to all employees included in the calculation. For example, a company may use information from its tax or payroll records to identify the median employee. Companies also may use a measure that is defined differently across jurisdictions, such as "taxable wages," and may include different annual periods as long as the company applies the measure consistently within each jurisdiction. As described in more detail below, companies may also make cost-of-living adjustments to the compensation of employees in jurisdictions other than the jurisdiction in which the CEO resides.

Frequency of Determination. Companies must identify the median employee at least once every three years; provided that if there has been a change in employee population or compensation arrangements during a company's prior fiscal year that the company reasonably believes would result in a significant change to its pay ratio disclosure, the company must re-identify the median employee for that fiscal year.

Substitution of Median Employee. In cases where a company would otherwise not be required to re-identify the median employee for a particular year but it is no longer appropriate to use the median employee for the prior year because of a change in the employee's circumstances that the company reasonably believes would result in a significant change in its pay ratio disclosure, the final rule permits a company to use another employee whose compensation was substantially similar to the original median employee based on the compensation measure that the company used to select the original median employee. This could become necessary if the original median employee is no longer employed by the company in year two or year three, or if the employee's compensation significantly changes in year two or year three (for example, as a result of a promotion that significantly increases his or her compensation).

Disclosure Requirements. The final rule includes a number of disclosure requirements relating to the identification of the median employee. In particular, a company must disclose:

- the date selected by the company to determine the full employee population, and if such date was changed from the prior year, disclosure of the change and a brief explanation of the reason for the change;
- the compensation measure used to identify the median employee if the company uses a compensation measure other than annual total compensation;
- if true, that the company is using the same median employee as it did in the prior year and a brief description of the basis for its reasonable belief that there have been no changes in employee population or compensation arrangements during its prior fiscal year that it reasonably believes would significantly affect its pay ratio disclosure;
- the approximate number of employees that have been omitted because they became employees as the result of a business combination or acquisition during the year, if any, and the identity of the acquired business that is excluded; and
- if cost-of-living adjustments are made, the additional disclosures described in that section.

Companies also must briefly describe the methodology and any material assumptions, adjustments or estimates they use to identify the median employee. In addition, if a company changes its methodology or its material assumptions, adjustments or estimates from those used in its pay ratio disclosure for the prior fiscal year, and the effects of any such change are significant, the company must briefly describe the change and the reason for the change. The final rule also separately requires companies to clearly identify any estimates used. As an example, the adopting release stated that when a company uses statistical sampling, it must describe the size of both the sample and the estimated full employee population, any material assumptions used in determining the sample size and the sampling methods used.

Determination of Annual Total Compensation

Median Employee. The annual total compensation of the median employee that is required to be disclosed and used to determine the CEO pay ratio is to be calculated in the same way total compensation is calculated for the named executive officers in the Summary Compensation Table pursuant to Item 402(c)(2)(x) of Regulation S-K, except as noted below. Companies are required to recalculate the annual total compensation of the median employee each year, even in situations where they were not required to re-identify the median employee for the particular year.

Salary. For non-salaried employees, references to "salary" refer instead to "wages plus overtime."

Annualizing Adjustments. Companies may annualize total compensation for all permanent employees that were employed for less than the full year, such as newly hired employees or those on unpaid leave. Companies may not annualize total compensation for temporary or seasonal positions, and may not make a full-time equivalent adjustment for any employee.

Personal Benefits. Companies may include (1) personal benefits that are less than $10,000 in the aggregate and (2) non-discriminatory benefit plan compensation in calculating annual total compensation of their median employee if they include the same items in the annual total compensation of their CEOs used for purposes of calculating the CEO pay ratio. If a company does so, it must explain the difference between the CEO's annual total compensation used for the pay ratio disclosure and the total compensation shown in the Summary Compensation Table if the difference is material.

Reasonable Estimates. Companies are permitted to use reasonable estimates to calculate annual total compensation or any element of annual total compensation for the median employee. As interpreted by the SEC in the adopting release, this means that companies must have a reasonable basis to conclude that their estimates approximate the actual amounts of compensation, or a particular element of compensation, calculated in accordance with Item 402(c)(2)(x) of Regulation S-K. The SEC did state that companies may use reasonable estimates in determining an amount that reasonably approximates the aggregate change in the actuarial present value of the median employee's defined pension benefit. In this situation, the SEC recognized that companies may not have access to the information needed to calculate the precise amount.

Companies must clearly identify any estimates they use in calculating the annual total compensation or any element of annual total compensation for the median employee. Companies must also briefly describe any material assumptions, adjustments, or estimates they use to determine total compensation. If a company changes its assumptions, adjustments or estimates from the prior fiscal year and the effects of the change are significant, the company must describe the change and the reason for the change. These disclosure requirements are the same as the disclosure requirements relating to assumptions, adjustments and estimates used to identify the median employee.

Cost-of-Living Adjustments. As described in more detail below, the final rule permits companies to make cost-of-living adjustments to the compensation of employees in jurisdictions other than the jurisdiction where the CEO resides if they use such an adjustment to identify the median employee.

Multiple CEOs During a Single Year. The final rule permits a company that has more than one non-concurrent CEO serving during a single fiscal year to calculate the annual total compensation for its CEO in either of two manners:

- the company may calculate and combine the compensation provided to each person who served as CEO during the year for the period during which he or she served as CEO; or
- the company may calculate and annualize compensation for the individual who was serving as CEO on the date the company selected for identification of the median employee.

The final rule requires the company disclose which option it chose and how it calculated the CEO's annual total compensation.

Cost-of-Living Adjustments

The final rule permits companies to make cost-of-living adjustments to the compensation of employees in jurisdictions other than the jurisdiction where the CEO resides. From the discussion in the adopting release, these references to "jurisdiction" appear to be limited to different countries rather than different U.S. states or local jurisdictions. If a company uses such an adjustment to identify the median employee, and the median employee is in a jurisdiction other than the jurisdiction where the CEO resides, the company must use the same adjustment to calculate the median employee's annual total compensation and disclose the median employee's jurisdiction. The company must also briefly describe the cost-of-living adjustment it used (1) to identify the median employee and (2) to calculate the median employee's annual total compensation, including the measure used as the basis for the cost-of-living adjustment. If the company makes a cost-of-living adjustment, it must also present the median employee annual total compensation and pay ratio determined *without* the cost-of-living adjustment. To calculate these amounts, the company will need to identify the median employee without using any cost-of-living adjustment. Companies must disclose if they change from using a cost-of-living adjustment to not using that adjustment (or vice versa).

Non-U.S. Employees

The CEO pay ratio rule provides two exemptions for employees located outside the United States.

Data Privacy Exemption. The final rule allows companies to exclude non-U.S. employees from the company's employee population if they are employed in a foreign jurisdiction in which the laws or regulations governing data privacy are such that, despite reasonable efforts to obtain or process the necessary information, the company is unable to do so without violating those laws or regulations. If a company excludes any non-U.S. employees under this exemption in a particular jurisdiction, it must exclude all non-U.S. employees in that jurisdiction. The data privacy exclusion is subject to the following additional requirements:

- A company's "reasonable efforts" to obtain the necessary information must include, at a minimum, using or seeking an exemption or other relief under the applicable data privacy laws or regulations.
- If a company excludes any employees under this exemption, it must identify the excluded jurisdiction(s) and identify the specific data privacy laws or regulations that prohibit the collection of information and explain how complying with the CEO pay ratio disclosure rule would violate those laws or regulations (including the efforts the company made to seek an exemption from the laws or regulations). Companies must also indicate the approximate number of employees excluded from each jurisdiction based on this exemption.
- A company that relies on this exemption must obtain a legal opinion from counsel that opines on the company's inability to obtain or process the required information without violating the jurisdiction's data privacy laws or regulations, including the company's inability to obtain an exemption or other relief. Companies must file this legal opinion as an exhibit to the filing that includes CEO pay ratio disclosure.

The data privacy exclusion is not subject to the 5% limitation of the *de minimis* exemption described below, but employees excluded under the data privacy exemption count against the 5% limitation of the *de minimis* exemption.

De Minimis Exemption. The adopted rule also provides a "*de minimis*" exemption for non-U.S. employees. To the extent available, this exemption permits companies to exclude up to 5% of their total employees. If a company's non-U.S. employees account for 5% or less of its total employees, the company may choose to exclude all (but not less than all) of its non-U.S. employees under this exemption. If a company's non-U.S. employees exceed 5% of its total employees, a company may exclude up to 5% of its total employees who are non-U.S. employees, subject to the following restrictions:

- If a company excludes any non-U.S. employees in a jurisdiction, it must exclude all employees in that jurisdiction. If more than 5% of the company's employees are in a single non-U.S. jurisdiction, companies may not exclude any employees in that jurisdiction under the *de minimis* exemption.
- Companies may not use the *de minimis* exemption if the number of employees excluded under the data privacy exemption equals or exceeds 5% of the company's total employees. Non-U.S. employees excluded under the data privacy law exemption count against the 5% total that may be excluded under the *de minimis* exemption.
- If employees excluded under the data privacy exemption are less than 5% of the company's total employees, the company may use the *de minimis* exemption to exclude up to the number of non-U.S. employees that would, combined with employees excluded under the data privacy exemption, not exceed 5% of the company's total employees.

If a company uses the *de minimis* exemption, it must disclose the jurisdiction or jurisdictions from which it is excluding employees, the approximate number of employees excluded from each jurisdiction under the *de minimis* exemption, the total number of its U.S. and non-U.S. employees calculated without regard to the data privacy and/or *de minimis* exemptions, and the total number of its U.S. and non-U.S. employees used for its *de minimis* calculation.

Additional Disclosure Permitted

The final rule permits (but does not require) companies to present additional information, including additional ratios, such as additional pay ratios for U.S. employees or non-U.S. employees. Additional information and ratios must be clearly identified and must not be misleading or presented with greater prominence than the required ratio.

Personally Identifiable Employee Information

The final rule provides that companies are not required to, and should not, disclose any personally identifiable information about the median employee other than his or her compensation. The final rule permits companies to generally identify an employee's position to put the employee's compensation in context, but does not require companies to provide this information and provides that companies should not do so if providing that information could identify any specific individual.

CEO Compensation Not Available and New Form 8-K Disclosure

If a company's CEO's salary or bonus is not calculable through the latest practicable date for a filing that otherwise would require disclosure of the CEO pay ratio, the company must disclose that the pay ratio cannot be calculated until the CEO salary or bonus, as applicable, has been determined and the date on which it expects to determine the CEO's actual total compensation. The company must then include the CEO pay ratio disclosure required by the final rule in the current report under Item 5.02(f) of Form 8-K that discloses the CEO's salary or bonus.

Compliance Date, Affected Filings and Transition Periods

For companies that are subject to the CEO pay ratio disclosure rule, the final rule will first apply to compensation paid for their first fiscal year beginning on or after January 1, 2017. As a result, the final rule will not require CEO pay ratio disclosure until 2018 for calendar year-end companies.

Filings Affected. Companies are required to include CEO pay ratio disclosures in any registration statement, proxy or information statement and annual report that requires executive compensation disclosure pursuant to Item 402 of Regulation S-K.

Disclosure Timing. Generally, CEO pay ratio disclosure is subject to the same filing timetable as other compensation disclosure required by Item 402. This means that the final rule does not require a company to file CEO pay ratio disclosure for the last completed fiscal year until it files its annual report on Form 10-K or, if later, when the company files its definitive proxy or information statement relating to its next annual meeting of shareholders or written consent in lieu of such a meeting. As is the case with other Item 402 compensation disclosure, a company may incorporate the CEO pay ratio disclosure into its annual report on Form 10-K from its definitive proxy statement. If the company does not file its definitive proxy statement within 120 days after the end of its prior fiscal year, the company must file the CEO pay ratio disclosure and other disclosure that would have been incorporated by reference from its definitive proxy statement in an amendment to its annual report on Form 10-K. Unlike other disclosures required by Item 402, if the CEO pay ratio disclosure for the mostly recently completed fiscal year would be required in a registration statement or a proxy or information statement that is filed before such disclosure is included, or required to be included, in a company's Form 10-K, the company would not be required to include the updated CEO pay ratio disclosure in that filing. The adopting release suggests that, in that instance, the most recent CEO pay ratio disclosure that previously had been included in a Form 10-K (i.e., the prior year's CEO pay ratio disclosure) would be required to be included in the filing.

Filed, not Furnished. CEO pay ratio disclosure will be treated as "filed" rather than "furnished" for purposes of the federal securities laws, and will be subject to the CEO/CFO certifications required by Rule 13a-14 under the Securities Exchange Act of 1934 and Section 906 of the Sarbanes-Oxley Act.

Transitional Relief for New Reporting Companies. For a new reporting company that is not an emerging growth company or a smaller reporting company, the final rule will first apply to compensation paid for the first fiscal year following the year on which it first becomes subject to reporting requirements under Section 13(a) or Section 15(d) of the Securities Exchange Act, but not for any fiscal year that begins before January 1, 2017. For example, a company that completes its initial public offering in 2016 would first be required to provide CEO pay ratio disclosure with respect to 2017 compensation in its Form 10-K or definitive proxy statement filed in 2018. Similarly a company that completes its initial public offering in 2018 would first be required to provide CEO pay ratio disclosure with respect to 2019 compensation in its Form 10-K or definitive proxy statement filed in 2020.

Transitional Relief for Emerging Growth and Smaller Reporting Companies. For a company that qualifies as an emerging growth company or smaller reporting company, the final rule will first apply to compensation paid for the first fiscal year commencing on or after the date on which the company ceases to be an emerging growth company or smaller reporting company, as applicable, but not for any fiscal year that begins before January 1, 2017. For example, a company that ceases to be an emerging growth company during 2017 would first be required to provide CEO pay ratio disclosure with respect to 2018 compensation in its Form 10-K or definitive proxy statement filed in 2019.

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GOODWIN PROCTER

GOODWIN PROCTER ALERT

FEBRUARY 26, 2015

SEC Proposes Hedging Policy Disclosure Rule

by Daniel P. Adams, John O. Newell, Marian A. Tse

Speed Read

The SEC has proposed a rule that would require new hedging policy disclosure by companies that are subject to SEC proxy rules. The proposed rule would in most cases expand the hedging policy disclosure currently provided by companies. The proposed rule would also extend this requirement to companies that are not currently required to provide hedging disclosure, such as smaller reporting companies and emerging growth companies. The proposed rule is subject to public comment through April 20, 2015 and therefore is very unlikely to affect disclosure in proxy statements for 2015 annual meetings by companies with calendar year-end fiscal years.

On February 9, 2015, the Securities and Exchange Commission proposed a rule that would require companies to disclose their policies with respect to hedging of equity securities of the company, as well as its parent and subsidiaries of the company or its parent, by the company's employees, officers and directors. The proposed rule, which expands current SEC disclosure requirements for hedging policies, is one of four compensation-related disclosure mandates under the Dodd-Frank Wall Street Reform and Consumer Protection Act.

To date, the SEC has proposed rules covering CEO pay ratio disclosure and hedging policy disclosure. The SEC has not yet proposed rules covering clawbacks of incentive compensation under stock exchange rules or pay for performance disclosure. The goal of the proposed rule is to provide investors with additional information about the governance practices of companies in which they invest.

The proposed rule is subject to public comment through April 20, 2015. Even if the SEC were to adopt a final rule promptly after the comment period closes, the final rule is therefore very unlikely to affect disclosure by companies with calendar year-end fiscal years in proxy statements for 2015 annual meetings. The full text of the proposed rule is available on the SEC web site.

In the proposing release, the SEC solicits public comment on a significant number of questions, so it is possible that the final rule may be somewhat different from the proposed rule. A joint statement released on February 9 by Commissioners Gallagher and Piwowar, who voted for the proposed rule, identified five areas about which they "remain quite concerned" and for which they "hope to receive robust public comment." These include:

- lack of an exemption for emerging growth companies and/or smaller reporting companies;
- lack of an exemption for certain investment companies (specifically, listed, closed-end funds);
- lack of an exemption for hedging by employees that cannot affect a company's share price;
- application of the proposed rule to the equity securities of a company's subsidiaries, parents, and brother-sister companies; and
- whether the proposed rule reflects the best prioritization of SEC staff and resources.

Proposed Hedging Disclosure

Companies and SEC Filings Covered. The proposed rule would require hedging policy disclosure in proxy and information statements for the election of directors by companies subject to the federal proxy rules, including smaller reporting companies, emerging growth companies, and registered closed-end investment companies with shares listed and registered on a national securities exchange. The proposed rule would not require companies to adopt anti-hedging policies. However, as discussed below, many companies have already done so, and, depending on the scope of the final rule, other companies may choose to do so.

Persons Covered. The proposed disclosure of hedging policies would apply to hedging activities by any employees (including officers) and directors of the company and any of their designees. A company that permits hedging transactions by some, but not all, of the categories of persons covered by the proposed rule would be required to disclose the categories of persons who are permitted to engage in hedging transactions and those who are not.

Hedging Activities Covered. The proposed rule would require a company to disclose whether it permits its employees, officers or directors (1) to purchase financial instruments (including prepaid variable forward contracts, equity swaps, collars, and exchange funds) or (2) otherwise to engage in transactions that are designed to or have the effect of hedging or offsetting any decrease in the market value of equity securities that (A) have been granted to the employee, officer or director by the company as part of the compensation of the employee, officer or director or (B) are held, directly or indirectly, by the employee, officer or director.

The proposed rule would require a company to disclose the categories of hedging transactions that it permits and those that it prohibits. The proposed rule would permit a company to disclose that it prohibits or permits particular categories and permits or prohibits, respectively, all other hedging transactions, if true. If a company does not permit any hedging transactions, or permits all hedging transactions, it would be required to disclose that fact and would not be required to describe specific categories of hedging transactions. A company that permits hedging transactions would be required to disclose sufficient detail to explain the scope of the permitted hedging transactions.

The proposed rule would apply to hedging policies with respect to equity securities that are registered under Section 12 of the Securities Exchange Act of 1934 and that have been issued by the company, any parent of the company, any subsidiary of the company, or any subsidiary of any parent of the company.

The disclosure required by the proposed rule would not be deemed to be incorporated by reference into any filing under the Securities Act of 1933, the Securities Exchange Act of 1934 or the Investment Company Act of 1940 except to the extent that the company specifically incorporates the disclosure by reference.

Current Hedging Disclosure Requirements and Practice

There are current disclosure requirements relating to hedging policies, and many companies have adopted hedging policies, often in response to the policies of proxy advisory firms. However, the new rule as currently proposed would extend disclosure of hedging policies to companies that are not currently subject to these disclosure requirements, and would expand disclosure requirements significantly beyond the disclosure that most companies currently provide.

Under current SEC rules, the principal disclosure requirement relating to hedging policies in proxy statements is the requirement to disclose in Compensation Discussion and Analysis the material information necessary to understand a company’s compensation policies and decisions regarding its named executive officers. In addition, in recent years, proxy advisory firms have implemented policies that encourage companies to adopt and disclose anti-hedging policies. As a result, many companies have already adopted and disclose the existence of anti-hedging policies. A study published in September 2014 by Meridian Compensation Partners LLC indicated that 91% of the 250 large publicly traded companies that comprise the Meridian 250 disclosed the existence of an anti-hedging policy, up from 82% in 2013.

Because the principal current disclosure requirement is part of CD&A, it does not apply to smaller reporting companies, emerging growth companies, registered investment companies or foreign private issuers. In addition, the current CD&A disclosure requirement does not cover hedging policies that apply to directors, executive officers who are not named executive officers, or other employees. Although anti-hedging policies adopted by companies often apply to a broader group of people than the company’s named executive officers, they generally do not apply to all employees. Additionally, these policies may not cover registered securities, if any, issued by a subsidiary or the company’s parent or another subsidiary of the parent, and may not apply to as broad a range of hedging transactions as those covered by the proposed rule.

As a result, when the final rule is adopted, most companies with existing anti-hedging policies will need to review their policies and disclosure in light of the new rule. In addition, many companies that have not adopted anti-hedging policies may need to consider doing so.

Actions to Take

The SEC has solicited public comment on a large number of questions that could affect which employees and securities are subject to disclosure under the new rule. The SEC has also solicited comment on whether the final rule should apply to classes of companies such as emerging growth companies and smaller reporting companies. As a result, we expect that many companies will wait for the SEC to adopt the final rule before amending existing anti-hedging policies or considering whether to adopt anti-hedging policies in response to these new disclosure requirements.

Ultimately, when the SEC adopts the final rule, we expect that companies may have additional policy decisions to consider. For example, if the proposed rule is adopted in its current form, companies would need to consider whether anti-hedging policies should apply to all employees. Companies would also need to consider the types of hedging transactions that will be subject to a company policy. Companies that wish to comment on the proposed rule should consider submitting comments on the proposed rule to the SEC on or before April 20, 2015.

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GOODWIN PROCTER ALERT

JULY 16, 2015

SEC Proposes Mandatory Incentive Compensation Clawback Rules

by Daniel P. Adams, John O. Newell, Ettore A. Santucci, Marian A. Tse

Speed Read

The SEC has proposed long-awaited rules on incentive compensation clawbacks under the Dodd-Frank Act. The proposed rules would require national securities exchanges to adopt new listing standards requiring listed companies to adopt and enforce clawback policies. The proposed rules would also require listed companies to make a variety of disclosures concerning their clawback policies and any clawbacks required by these policies. The proposed rules are sweeping in their scope, in terms of the number of listed companies covered, the number of executives covered, the types of incentive compensation covered and the number of fiscal years covered. If the SEC adopts these rules as proposed, the potential impact on executive compensation could be significant.

On July 1, 2015, the Securities and Exchange Commission proposed rules, consisting of new Rule 10D-1 and related rule and form amendments, that would require clawbacks of incentive compensation received by executive officers of listed companies in the event of subsequent accounting restatements. The SEC proposed these rules to implement Section 10D of the Securities Exchange Act of 1934, which was added by Section 954 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010.

The proposed rules would require national securities exchanges, including the NYSE and Nasdaq, to adopt rules that would prohibit the initial or continued listing of any security of a company that does not adopt and comply with a written policy providing that, in the event the company is required to prepare an accounting restatement as a result of material non-compliance with any financial reporting requirement under the securities laws, the company will recover (*i.e.,* “claw back”) the amount of excess incentive-based compensation received by the company’s executive officers during the three fiscal years preceding the date on which the company is required to prepare the restatement. The proposed rules would also require each listed company to publicly file its written clawback policy and, if there is a restatement that is subject to the policy, to disclose specified information regarding the restatement and the company’s application of its policy in connection with the restatement.

As described in more detail below, the new clawback policies that would be required could raise several difficult issues if the SEC adopts the proposed rules in their current form. For example:

- *Stock Price and TSR-Based Incentive Compensation*. The proposed rules would require listed company clawback policies mandated by the proposed rules to apply to compensation that had been earned based on the company’s stock price or total shareholder return (TSR). In this situation, the listing standards required by the proposed rules would require that the amount of compensation to be clawed back be based on “a reasonable estimate of the effect of the accounting restatement on the stock price or total shareholder return upon which the incentive-based compensation was received.” Companies would likely encounter significant difficulties and uncertainties when they attempt to determine the precise impact of the misstated financial information on the company’s stock price, and would likely need to hire a third party to assist with this determination. Requiring a company to make and publicly disclose these estimates could also harm the company’s ability to defend potential litigation relating to a restatement.
- *No Tax Offset*. The new clawback policies would require companies to compute clawback amounts without regard to any taxes paid. As a result, if an executive ultimately is not able to obtain a full refund or credit for the taxes paid on compensation that is clawed back, the proposed rules would not provide for a reduction in the amount required to recovered from the executive and the executive could potentially be worse off than if the executive had never received the compensation in the first place.

- *Determination of When Restatement is Required*. The proposed rules would require companies to claw back excess incentive-based compensation received by the company's executive officers during the three fiscal years preceding the date on which the company is required to prepare the restatement. The definition of the date on which the company is required to prepare the restatement includes the date on which the relevant decision maker at the company "concludes, *or reasonably should have concluded*, that the company's previously issued financial statements contain a material error" (emphasis added). As a result, in order for a company to comply with its clawback policy, it would need to determine whether it reasonably should have reached this conclusion earlier than it actually did. Because the date of this conclusion determines the fiscal years that are subject to the company's clawback policy, this would introduce uncertainty into the determination of which compensation needed to be clawed back and potentially expose companies to delisting in the event they are second-guessed as to when they reasonably should have determined that a material error existed in prior financial statements. In addition, because the proposed rules would require companies to disclose the date on which the company was required to prepare the restatement and Form 8-K already requires companies to disclose the date on which they actually reach the conclusion that prior financial statements contain a material error, a company's determination that it reasonably should have concluded that a material error existed earlier than it actually did would be completely transparent to the public. Public disclosure of the difference between these dates could further compound the potential adverse consequences of a restatement to a company.

Which Companies Would be Affected?

The clawback policies that would be required by the listing standards under the proposed rules would apply to all companies with a class of listed securities, subject to very limited exceptions. The proposed rules would not permit exceptions for smaller reporting companies, emerging growth companies or foreign private issuers, among others.

Which Executives Would be Covered?

The new clawback policies would be required to apply to any individual who served as an "executive officer" of the company at any time during the performance period for incentive-based compensation that is subject to the clawback policy. The proposed rules define "executive officer" in the same manner that the rules under Section 16 of the Securities Exchange Act define "officer."

What Compensation Would be Subject to Mandatory Clawback?

Clawback policies under the proposed rules would require companies to claw back "incentive-based compensation," as defined by the proposed rules, that was received:

- during the three completed fiscal years immediately preceding the date that the company is required to prepare a restatement of its previously issued financial statements to correct a material error;
- while the company had a class of securities listed on a securities exchange; and
- by an individual who served as an executive officer at any time during the performance period for such incentive-based compensation.

The amount of incentive-based compensation that companies would be required to claw back would be the amount that exceeds the amount that otherwise would have been received if the incentive-based compensation had been determined based on the accounting restatement, computed without regard to any taxes paid.

"Incentive-Based Compensation." The proposed rules define "incentive-based compensation" as any compensation that is granted, earned or vested based wholly or in part upon the attainment of a financial reporting measure. Financial reporting measures would be defined as:

- measures that are determined and presented in accordance with the accounting principles used in preparing the company's financial statements;
- any measures that are derived wholly or in part from those measures (*e.g.*, EBITDA, FFO, return on assets or invested capital, financial ratios, liquidity, return and earnings measures, and sales per square foot or same store sales, among others); and
- stock price and TSR.

Financial reporting measures would not be limited to measures presented within the company's financial statements or SEC filings.

Because the definition of incentive-based compensation includes compensation earned "in part" upon achieving a financial reporting measure, these clawback policies would also apply to compensation that is not tied to these measures in a strictly formulaic manner. This would include discretionary bonuses paid from a bonus pool, where the size of the pool is determined based wholly or in part on the attainment of a financial reporting measure, or awards based on the attainment of a financial reporting measure that are subject to discretionary increase or decrease. Incentive-based compensation would also include compensation that was earned based on the company's performance with respect to a financial reporting measure (for example, stock price and TSR) relative to a peer group.

The proposed rules would not apply to the following types of compensation:

- salary;
- bonuses or equity awards paid solely on a discretionary basis, other than those paid from a bonus pool the size of which was determined wholly or in part by satisfying a financial reporting measure;
- bonuses or equity awards paid solely on satisfaction of subjective standards, completion of a specified employment period or the achievement of goals that do not constitute financial reporting measures, such as opening a specified number of stores, obtaining regulatory approvals of a product, consummating a merger or divestiture or completing a restructuring plan or financing transaction.

When Compensation is "Received." Pursuant to the proposed rules, incentive-based compensation would be deemed received in the company's fiscal period during which the financial reporting measure specified in the incentive-based compensation award is attained, even if the payment or grant of the incentive-based compensation occurs after the end of that period. For instance, an equity award that is earned based on the company's TSR for the three-year period ending December 31, 2018 would be deemed received in 2018 even though the shares are not issued until early 2019, and even if the shares are subject to additional time-based vesting. As a result, the shares would be subject to these clawback provisions if the company was required to prepare a restatement in 2019, 2020 or 2021.

When a Company is "Required to Prepare a Restatement." Under the proposed rules, the date on which a company is required to prepare an accounting restatement would be the earlier of:

- the date the company's board of directors, a committee of the board of directors, or officer(s) of the company authorized to take that action if board action is not required, concludes, or reasonably should have concluded, that the company's previously issued financial statements contain a material error; or
- the date a court, regulator or other legally authorized body directs the company to restate previously issued financial statements to correct a material error.

The proposed rules include a note that the first date above is generally expected to coincide with the date of the triggering event under Item 4.02(a) of Form 8-K, which requires the company to file a Form 8-K if relevant company decision makers conclude that previously issued financial statements should no longer be relied upon because of an error. However, the Form 8-K triggering event and the proposed rule's definition of the date on which a company would be required to prepare an accounting restatement differ in one potentially significant way. The Form 8-K reporting requirement is only triggered when the relevant decision makers actually reach the required conclusion. In contrast, the clawback requirement would be triggered when the relevant decision makers *reasonably should have* reached the required conclusion.

This subjective standard would introduce an element of potential uncertainty into the determination of the compensation that is required to be clawed back, and potentially require companies to disclose in their SEC filings that they reasonably should have concluded that a material error existed in their financial statements earlier than they actually reached this conclusion. Accounting standards can be very complex and/or may rely upon inherently subjective judgments. In situations where accounting standards are subsequently determined to have been misapplied, it may be difficult to determine exactly when the relevant decision maker reasonably should have concluded that a material error existed in previously issued financial statements. Uncertainty or potential second-guessing of when this conclusion reasonably should have been made could expose a company to significant risks because the consequences of failing to implement the clawback policy and make the required disclosures at the required date include delisting of the company's securities. Further, publicly disclosing that the company should have reasonably concluded that a material error existed earlier than it actually reached this conclusion could further compound the potential adverse consequences of a restatement to a company.

Excess Incentive-Based Compensation. The listing standards would require companies to claw back excess incentive-based compensation. The amount of the excess incentive-based compensation is the amount of the applicable incentive-based compensation that exceeds the amount that otherwise would have been received had it been determined based on the accounting restatement (*i.e.*, using the restated results). As noted above, companies must determine and recover the amount of excess incentive-based compensation without regard to any taxes paid.

For incentive-based compensation based on a company's stock price or TSR, where the amount of excess incentive-based compensation is not subject to mathematical recalculation directly from the information in an accounting restatement, the proposed rules would require that:

- the amount be based on a reasonable estimate of the effect of the accounting restatement on the stock price or TSR upon which the incentive-based compensation was received; and
- the company maintain documentation of the determination of that reasonable estimate and provide that documentation to the securities exchange on which it is listed.

The SEC also provided additional guidance in the proposing release describing how it intended the proposed rules to operate with respect to the determination of the amount of excess incentive-based compensation. In particular, the SEC noted the following:

- if a company originally used negative discretion to reduce formulaic incentive-based compensation, the excess incentive-based compensation would equal the formulaic amount determined using the restated results less the amount originally received (*i.e.*, recovery would be deemed to have already been received to the extent of any prior exercise of negative discretion);
- if a company originally used positive discretion to increase formulaic incentive-based compensation, the excess incentive-based compensation would equal the formulaic amount determined using the restated results less the formulaic amount originally determined (*i.e.*, the executive would be permitted to retain the full amount of the discretionary increase in compensation) provided that the company would have been permitted to make such a discretionary increase based on the restated results;
- for awards received from bonus pools, where the size of the pool is determined based wholly or in part on the attainment of a financial reporting measure, no recovery is required unless the aggregate amount of awards received exceeds the size of the pool based on the restated results and the excess amount of any executive's award will be a pro rata portion of the aggregate deficiency (*i.e.*, no discretion to pursue differential recovery among executives is permitted); and
- for exercised options or SARs where the underlying shares have been sold, the recoverable amount would be the sale proceeds received with respect to the excess number of shares reduced to reflect the applicable exercise price paid.

Neither the proposed rules nor the proposing release address the potential for offsetting increases where restated results would have decreased the amount of incentive-based compensation received in one year, but increased the amount received in another year (for example, in a situation where the aggregate amount of revenues or expenses recognized over a multi-year period does not change, but the specific periods in which the revenues or expenses are recognized does change).

Indemnification Prohibited. The proposed rules would prohibit companies from indemnifying executive officers against the loss of any excess incentive-based compensation.

Are Companies Required to Recover Excess Incentive-Based Compensation Under All Circumstances?

The stock exchange listing standards mandated by the proposed rules would require a company to recover excess incentive-based compensation in accordance with its clawback policy unless the company's compensation committee determines recovery is impractical because either (i) the direct expense paid to a third party to assist in enforcing the policy would exceed the amount to be recovered or (ii) the recovery would violate home country law adopted prior to July 14, 2015.

Before concluding that recovery is impracticable based on the expense of enforcement, a company must first make a reasonable attempt to recover the excess incentive-based compensation, document that attempt and provide that documentation to the securities exchange on which the company's securities are listed. Before concluding that recovery is impracticable based on home country law, a company must first obtain an opinion of home country counsel, not unacceptable to the securities exchange on which the company's securities are listed, that recovery would result in a violation of applicable home country law and provide that opinion to the securities exchange. Neither the proposed rules nor the proposing release specify whether "home country law" is intended to refer to the laws of the country in which the company is domiciled or has its headquarters or whether it refers to the laws of any foreign jurisdiction that applied to an executive officer (for example, an executive officer located in a foreign office of a domestic company).

A company that does not comply with its clawback policy will be subject to delisting by the securities exchange on which it is listed. The proposing release suggested that the securities exchanges would have some discretion when determining whether and when to commence delisting proceedings. Because the proposed rules would not require that the clawback be completed within a specific period of time, the securities exchange would be required to determine whether the steps a company was taking constituted compliance by the company with its clawback policy. In the proposing release, the SEC indicated that a securities exchange, in making this assessment, would need to determine, among other things, whether the company was making a good faith effort to pursue recovery promptly. Because a company's failure to comply with its own policy could result in delisting, companies should be careful to craft their clawback policies in a manner that will minimize the potential for delisting due to noncompliance with requirements that are not strictly mandated by applicable SEC rules or securities exchange listing standards.

If a securities exchange delists a company for failing to comply with the clawback policy required by the securities exchange, the company will not be permitted to list its securities on any securities exchange thereafter until it has complied with its clawback policy.

How Quickly Must Companies Recover Excess Incentive-Based Compensation?

Although the proposed rules do not specify a minimum period of time within which clawback policies must require a company to recover excess incentive-based compensation, the SEC stated in the proposing release that a company should recover excess incentive-based compensation reasonably promptly, since undue delay would constitute non-compliance with its clawback policy. However, as noted below, the proposed rules would generally require a company to disclose any shortfalls in recovery that existed as of the end of the prior fiscal year in the company's proxy statement.

What New Disclosures Would be Required by the Proposed Rules?

Filing of Clawback Policy. The proposed rules would require each company that had a class of securities listed on a securities exchange at any time during its last completed fiscal year to file its required clawback policy as an exhibit to its annual report on Form 10-K.

Proxy Statement Clawback Disclosure After a Restatement. The proposed rules would require each company that had a class of securities listed on a securities exchange at any time during its last completed fiscal year to provide additional disclosure if at any time during the last completed fiscal year either (1) the company completed a restatement that required recovery of excess incentive-based compensation pursuant to the company's clawback policy or (2) there was an outstanding balance of excess incentive-based compensation from a prior restatement. In these cases, the company would be required to disclose the following information in its proxy or information statement that included executive compensation disclosure under Item 402 of Regulation S-K and in its annual report on Form 10-K, either directly or through incorporation by reference to its proxy statement:

- *Clawback Amounts.* For each restatement, the company would be required to disclose:
  - the date on which the company was required to prepare an accounting restatement;
  - the aggregate dollar amount of excess incentive-based compensation attributable to the accounting restatement;
  - the estimates that were used in determining the excess incentive-based compensation attributable to the accounting restatement if the financial reporting measure related to a stock price or TSR metric; and

- the aggregate dollar amount of excess incentive-based compensation that the company had not recovered at the end of the last completed fiscal year.

If the company has not yet determined the amount of excess incentive-based compensation, the company must disclose that fact and explain the reasons.

- *Recoveries Not Pursued.* If during the last completed fiscal year the company decided not to pursue recovery of excess incentive-based compensation from any individual subject to its clawback policy, the company would be required to disclose, for each individual, the name and amount forgone and a brief description of the reason the company decided not to pursue recovery.
- *Unpaid Recoveries.* If, as of the end of the last completed fiscal year, any excess incentive-based compensation owed by an individual had been outstanding for 180 days or longer since the date on which the company determined the amount owed, the company would be required to disclose name of the individual and the outstanding dollar amount of excess incentive-based compensation due.

The proposed rules also provide that any amounts recovered from an executive pursuant to a company's required clawback policy would reduce the executive's compensation reported in the Summary Compensation Table for the fiscal year in which the recovered amount was initially reported as compensation, and would be identified by a footnote.

Under the proposed rules, the securities exchange listing standards would require each listed company to file all disclosures with respect to its clawback policy "in accordance with the requirements of the federal securities laws." A company that failed to comply with SEC disclosure requirements about its clawback policy would therefore be subject to delisting.

This new disclosure would not be incorporated by reference into registration statements except to the extent that the company specifically does so. Companies would also be required to file this new disclosure in XBRL format, block-text tagged, as an exhibit to each filing containing this new disclosure.

Other Proposed Amendments. The proposed rules would also amend Schedule 14A, Form N-CSR, Form 20-F and Form 40-F to include corresponding changes to the disclosure requirements in these forms for registered investment companies, registered management investment companies, foreign private issuers and filers under the multijurisdictional disclosure system.

When Will Companies be Required to Comply with the New Rules?

The proposed rules, other than those related to the new disclosure requirements, would not apply directly to companies, but would require national securities exchanges to adopt rules prohibiting the initial or continued listing of any security of a company that does not comply with the requirements of the listing standards required by the proposed rules. The proposed rules containing new SEC disclosure requirements would not become effective until the securities exchange listing standards requiring companies to adopt clawback policies become effective. As a result, a company will not be required to take any action until the SEC has adopted final rules and the securities exchange on which the company's securities are listed has adopted new listing standards and those listing standards have become effective. The proposed rules provide a detailed schedule for implementation of the new listing standards and disclosure requirements. The key dates are shown in the table below.

Event	Date
National securities exchanges must file proposed rules/amendments	Not more than 90 days after publication of final SEC rules
National securities exchanges rules/amendments must be effective	Not more than one year after publication of final SEC rules
Listed companies must adopt a clawback policy	Not more than 60 days after the effective date of the securities exchange rules/amendments
Incentive-based compensation subject to clawback policy	Compensation "received" on or after the effective date of the final rules adopted by the SEC
Companies must comply with new disclosure requirements	SEC filings required on or after the effective date of the securities exchange rules/amendments

Practical Considerations

In recent years, companies have increasingly redesigned their incentive compensation programs to pay compensation based on performance metrics that would be subject to the clawback policies mandated by the proposed rules. In particular, performance-based awards that use TSR, on a relative and/or absolute basis, have become commonplace. The final requirements and effective date of the proposed rules remain uncertain, but if the SEC adopts final rules that are consistent with the proposed rules, the impact of these rules on executive compensation policies could be wide-ranging and long-lasting. For example, these rules could create real tension between what many companies have seen as proper alignment/good governance policies, on the one hand, and effective incentives and fairness to executives on the other hand, as they relate to the risk/reward balances reflected in compensation policies and programs.

Companies may choose to defer any action until the mandated new securities exchange listing standards are finalized. However, companies – particularly those that rely on multi-year incentive programs that may pay compensation in future years after the SEC final rules and securities exchange listing standards become effective – may wish to begin considering how the stock exchange listing standards mandated by the proposed rules could affect their existing compensation structures and how they would comply with these listing standards and rules if the SEC adopts the proposed rules in their current form.

Associate Courtney Leffingwell contributed to the production of this alert.

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November 24, 2015

Via E-mail: rule-comment@sec.gov

Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090
Attn: Secretary

Re: Effectiveness of Financial Disclosures About Entities Other Than the Registrant – File No. S7-20-15

Dear Ladies and Gentlemen:

We appreciate the opportunity to submit this letter in response to the request by the Securities and Exchange Commission (the "Commission") for comment on the effectiveness of financial disclosure requirements in Regulation S-X for certain entities other than the registrant. In particular, we are writing to suggest certain amendments to Rule 3-14 of Regulation S-X ("Rule 3-14").

While we believe that Rule 3-14 serves an important purpose and supports the Commission's goal of ensuring that investors have the information needed to make informed decisions, unnecessary inconsistencies between Rule 3-05 of Regulation S-X ("Rule 3-05") and Rule 3-14 can result in inefficiencies and uncertainties and place undue burdens on registrants, without providing investors with meaningful information. We respectfully request the Commission consider the following suggestions to harmonize certain requirements of Rule 3-14 with those of Rule 3-05.

1. **Rule 3-14 should be amended to align it with Rule 3-05(b)(4)(i), so that Rule 3-14 contains an exception for acquisitions that are less than or equal to 50% significant.**

Rule 3-05(b)(4)(i) provides that if an acquisition or probable acquisition of a business is less than or equal to 50% significant, financial statements of such business need not be included in the acquiror's registration statement or proxy statement unless the registration statement is declared effective, or the proxy statement is mailed, 75 days or more after the acquisition is consummated, and the financial statements have not previously been filed by the acquiror.[1] Rule 3-14 does not provide a similar exception, and Section 2310.2 of the Division of Corporation Finance's *Financial Reporting Manual* specifically states that the exception in 3-05(b)(4)(i) does not apply to Rule 3-14 financial statements.

[1] See also Section 2040.1 of the Division of Corporation Finance's *Financial Reporting Manual*.

The inconsistency between Rule 3-14 and 3-05(b)(4)(i) does not have a compelling rationale. In *Streamlining Disclosure Requirements Relating to Significant Business Acquisitions*, Release No. 33-7355 (Oct. 10, 1996), the Commission amended Rule 3-05 to add Rule 3-05(b)(4)(i). In adopting such amendment, the Commission noted that appropriate policy strives “to remove obstacles to proceeding with registered offerings despite pending or recent acquisitions, but recognizes that an acquisition could be so large relative to an issuer that investors would need financial statements of the acquired business for a reasoned evaluation of any primary capital raising transaction by the issuer.”[2] It appears that the same reasoning for adding Rule 3-05(b)(4)(i) is also applicable to Rule 3-14. In Release No. 33-7355, the Commission specifically decided against applying the amendment to add Rule 3-05(b)(4)(i) to Rule 3-14, noting that “[b]ecause Rule 3-14 is intended to address unique features of [the real estate] industry, such as the ‘‘blind pool’’ type of offering frequently used in the industry, the Commission has decided to consider revision of Rule 3-14 in the context of its evaluation of a more comprehensive disclosure scheme.”[3] As noted in Release No. 33-7355, such an amendment would “provide issuers greater flexibility and efficiency in accessing the public securities markets.”[4]

Whether it is part of a more comprehensive disclosure scheme or a more focused amendment, we respectfully ask that the Commission amend Rule 3-14 to align it with Rule 3-05(b)(4)(i), so that financial statements for property acquisitions that are less than or equal to 50% significant are not required to be included in the acquiror’s registration statement or proxy statement unless such registration statement is declared effective, or a proxy statement is mailed, 75 days or more after the acquisition is consummated.

2. **Rule 3-14 should be amended to align it with Rule 3-05(b)(4)(iii), so that it is clear that financial statements of an acquired property are not required to be separately presented once the financial results of such property are reflected in the audited consolidated financial statements of the acquiror for a full fiscal year.**

Rule 3-05(b)(4)(iii) provides that separate financial statements of an acquired business are not required to be separately presented once the operating results of the acquired business have been reflected in the audited consolidated financial statements of the acquiror for a complete fiscal year unless such financial statements have not been previously filed or unless the acquired business is of major significance. Rule 3-14 is silent on this point and there is a divergence in practice in connection with how long acquirors continue to separately present Rule 3-14 financial statements. Consistent with Rule 3-05, some acquirors stop separately presenting Rule 3-14 financial statements after such financial statements have been reflected in the audited consolidated financial statements of the acquiror for a full fiscal year. Other acquirors continue

[2] *Streamlining Disclosure Requirements Relating to Significant Business Acquisitions*, Release No. 33-7355 (Oct. 10, 1996) [61 Fed. Reg. 54509, 54510].
[3] *Id* at 54512.
[4] *Id* at 54513.

to separately present Rule 3-14 financial statements for all significant property acquisitions made during the period covered by the acquiror's financial statements.

Similar to the inconsistency with Rule 3-05(b)(4)(i), the inconsistency between Rule 3-14 and 3-05(b)(4)(iii) does not have a compelling rationale. Once the financial results of an acquisition, whether of a business or property, that have previously been presented on a standalone basis are reflected in an acquiror's financial statements, there is no reason that the financial statements of the acquisition should also be presented separately. When amending Regulation S-X to establish uniform instructions governing the periods to be covered by financial statements, the Commission noted that the instructions had been designed by the Commission with "the intention of providing users with easy access to sufficient data for an informed decision while refraining from requiring data in excess of the amount necessary to satisfy most users or data for which the costs of preparation cannot be justified by the benefits."[5] The Commission's concern of providing users with sufficient information for an informed decision without requiring information in excess of the amount necessary is reflected in Rule 3-05(b)(4)(i) but not in Rule 3-14.

We respectfully ask that the Commission amend Rule 3-14 to align it with Rule 3-05(b)(4)(iii), so that it is clear that separate financial statements of acquired property need not be separately presented once the financial results of such property have been reflected in the audited consolidated financial statements of the acquiror for a complete fiscal year.

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We would be happy to discuss any questions with respect to this letter, and any such questions may be directed to David H. Roberts at (617) 570-1039.

Sincerely,

Goodwin Procter LLP

GOODWIN PROCTER LLP

[5] Release No. 33-6234 (Sept. 2, 1980) [45 Fed. Reg. 63682, 63684].

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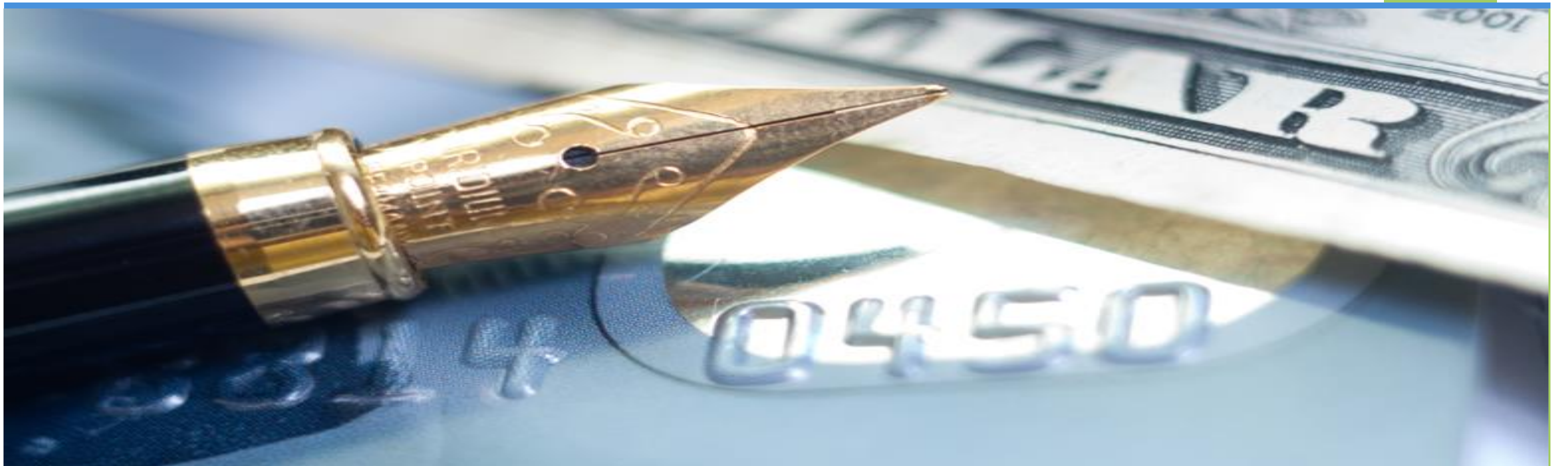

Corporate & Securities/Capital Markets | GT Alert

November 2015

SEC Adopts Regulation Crowdfunding to Facilitate Early Capital Raises

On Oct. 30, 2015, the Securities and Exchange Commission (SEC) adopted Regulation Crowdfunding by a 3-1 vote. The rules were adopted despite concerns expressed in comment letters to the SEC that capital raising through crowdfunding could lead to fraudulent activities, and thereby place unsophisticated investors at risk. Regulation Crowdfunding governs offers and sales of securities under Section 4(a)(6) of the Securities Act of 1933, as amended (Securities Act), which came into effect as part of the JOBS Act in 2012. Securities sold under the new rules are exempt from the registration requirements of Section 12(g) of the Securities Exchange Act of 1934, as amended (Exchange Act). Regulation Crowdfunding will become effective May 16, 2016, except for certain provisions relating to funding portals, as discussed below. Under the new rules, an issuer may raise up to a maximum of $1 million in any rolling 12-month period from investors, including non-accredited investors. All offerings relying on Regulation Crowdfunding must utilize a SEC-registered broker-dealer or funding portal.

“Crowdfunding” has evolved in recent years as a method of raising capital through general solicitation, typically over the internet, for a variety of projects. The JOBS Act created an exemption under the U.S. federal securities laws to enable this funding alternative to be utilized for the offer and sale of securities, subject to certain investment size, and manner of offering limits. The provisions in the JOBS Act were designed to provide startup companies and small businesses with access to capital through relatively low dollar offerings of securities, featuring a less costly means of capital raising by relying on the “crowd.” In recent years, the concept has been confused with capital raises under Rule 506(c) under the Securities Act of 1933, as amended (Securities Act), and Regulation A+, adopted by the SEC last summer. However, as discussed below, crowdfunding under the newly-adopted rules draws important distinctions from other available exemptions. Offerings made in reliance on Section 4(a)(6) will not be integrated with other exempt offerings that occur prior to, concurrently with, or subsequent to the offering, provided that all conditions for each exemption relied upon are satisfied.

Issuer Eligibility: For purposes of determining aggregate amounts offered and sold, including under prior offerings, the term "issuer" is defined broadly to include "all entities controlled by or under common control with the issuer and any predecessors of the issuer. Among other issuer requirements, in order to rely upon Regulation Crowdfunding, the issuer must not be:

- a non-U.S. company;
- an existing SEC reporting company under the Exchange Act;
- a company (or affiliates) that is disqualified as a "bad actor" under Rule 503 under Regulation Crowdfunding;
- an investment company (subject to certain limitations);
- a development stage company with no specific business plan or that has indicated its business plan is to engage in a merger or acquisition with an unidentified company; or
- a company that has sold securities in reliance on Regulation Crowdfunding and has not filed the requisite reports with the SEC and provided the required annual reports to investors during the two years immediately preceding the filing of the required offering statement.

Disclosure Requirements. In conducting an equity crowdfunding offering, companies must file certain information with the SEC and make certain disclosures available to investors and the broker-dealer, or to the funding portal facilitating the offering, in the interest of providing transparency. Initial disclosure about the offering must be filed with the SEC on new Form C, which the intermediary (i.e., the broker-dealer or funding portal through which the offering is being conducted) would then post on its website or provide a link for potential investors. The required disclosures are akin to those included in a Form 1-A qualification statement under Regulation A+. Issuers can opt to include a Q&A-style format to provide certain disclosures. Amendments to the Form C must be filed for any updates to the information, or for material changes that would affect an investment decision. Progress reports on Form C-U are required to be filed with the SEC within five days after completion of certain milestones, such as: investor commitments for at least 50% of the offering; commitments for 100% of the offering; acceptance of oversubscriptions; and closing of the offering.

Form C disclosures are not insubstantial and include information about officers, directors, and owners of 20% or more of the company, certain related party transactions, the price to the public of the securities being offered or the method for determining the price, the target offering amount, offer mechanics, whether the company will accept investments greater than the target amount, any deadline by which the company must reach the target amount, a description of the company's business, the intended use of proceeds from the offering, indebtedness, a description of other exempt offerings over the past three years, risk factors, transfer restrictions, a discussion of the financial condition of the company, and financial statements of the company. Information must also be provided about the intermediary, including compensation arrangements, and any other financial interests the intermediary may have in the offering or in the issuer. The discussion of offering mechanics must include a statement that the investor can cancel a subscription up to 48 hours prior to the identified deadline and that, if not cancelled, the investor's funds will be released to the issuer at closing.

The scope of the financial information that must be provided depends upon the amount of securities being offered and sold during a 12-month period, as set out below:

- <u>for offerings up to $100,000</u>: total income, taxable income, and total tax, or equivalent line items, as reported on the issuer's federal tax return for the most recently completed year, and certified by the principal executive officer. The issuer's financial statements must also be provided and certified by the same officer. Alternatively, if financial statements have either been reviewed or audited by an independent public accountant, this information must be provided instead;
- <u>for offerings over $100,000 and up to $500,000</u>: financial statements reviewed by an independent public accountant, unless audited financial statements are available;
- <u>for offerings over $500,000 and up to $1 million</u>: financial statements audited by an independent public accountant; however, first-time issuers may provide financial statements that have been reviewed by an independent public accountant if audited statements are not available.

Financial statements must be prepared in accordance with U.S. GAAP and, where required, audited in accordance with AICPA or PCAOB standard. Audited financial statements must include a signed audit report from the independent public accountant.

Ongoing Reporting. Companies that conduct an offering under the new rules are required to file an annual report with the SEC on Form C-AR within 120 days after the issuer's fiscal year-end. The report must include the information required in the Form C, as well as financial statements certified by the principal executive officer.

The ongoing reporting requirements can be terminated upon the first to occur of:

> the issuer becoming subject to the reporting requirements of the Exchange Act;
> after filing at least one annual report, the issuer has fewer than 300 record holders;
> after filing at least three annual reports, the issuer's assets do not exceed $10 million;
> all of the issuer's securities issued under Section 4(a)(6) have been repurchased or redeemed; or
> the issuer dissolves or is liquidated under state law.

Holders of securities sold in reliance on Section 4(a)(6) are excluded from the determination of the number of the issuer's "holders of record," for purposes of determining whether the issuer is required to register the class of securities under Section 12(g) of the Exchange Act. However, the issuer is required to maintain a method for tracking its shareholders, which may require engaging a transfer agent or similar third-party service provider.

Offering Communications: Rule 204 under Regulation Crowdfunding permits issuers to release a notice to the public similar to the tombstone-type information allowed for conventional public offerings under Securities Act Rule 134. The information is limited to: the name, address, phone number and website of the issuer, together with an email address for the issuer's representative; the name of the related intermediary for the offering, including a link to the intermediary's offering page; the amount, nature and price of offered securities; the closing date; and a brief description of the issuer's business. All other communications with investors must occur through the intermediary's platform. The issuer may, however, continue to release information about its business in the ordinary course, without mentioning the offering; such releases will not have the benefit of an express safe harbor.

Investor Requirements: Investors themselves are subject to significant limitations on the amount they may invest in crowdfunding offerings over a rolling 12-month period. For investors with annual income or net worth less than $100,000, the maximum investment in all offerings relying upon Regulation Crowdfunding is the greater of (x) $2,000, or (y) 5% of the lesser of the investor's annual income or net worth. If annual income and net worth each equal or exceed $100,000, then the investment limit is 10% of such annual income or net worth, whichever is less.

Unlike securities acquired in a Regulation A+ offering, securities purchased through crowdfunding are subject to a one-year restriction on resale or transfer, except to the issuer, an accredited investor, a family member, or in connection with estate transfers, or in connection with an offering registered under the Securities Act.

Platform Requirements: Section 4A under the Securities Act was adopted as part of the JOBS Act and sets out the statutory requirements for intermediaries participating in a crowdfunding offering under Section 4(a)(6). All issuers conducting offerings under Section 4(a)(6) and Regulation Crowdfunding are required to use a SEC-registered intermediary, either a broker-dealer or funding portal. The intermediary essentially functions as a gatekeeper to protect investors from fraudulent transactions. Only one such intermediary may be used for a particular offering. The offering must be conducted on and through the intermediary's platform. A "platform" is "a program or application accessible via the Internet or other similar electronic communication medium through which a registered broker or a registered funding portal acts as an intermediary in a transaction involving the offer or sale of securities in reliance on Section 4(a)(6) of the Securities Act." Funding portals must register with the SEC on new Form Funding Portal and must also become a member of FINRA. The proposed FINRA framework is not covered in this Alert. The new Form will become effective Jan. 29, 2016. Registration will become effective on the later of 30 days after the filing of Form Funding Portal with the SEC, or the date upon which the portal is approved for membership in FINRA.

Under the new rules, intermediaries must, among other things:

- provide investors that open accounts with educational materials in plain English by electronic link that explain the process for investing on the platform, the types of securities offered, investment limits, company information, resale/transfer restrictions, right to cancel a commitment, and post-transaction relationships with the issuer and the intermediary;
- adopt measures to reduce the risk of fraud, including having a reasonable basis for believing the company complies with the new rules and has established means to keep accurate records of securities holders. The intermediary must conduct background and securities regulatory enforcement checks on each issuer, as well as the issuer's officers, directors, and beneficial owners of at least 20% of the issuer's securities;
- make the company disclosure available on the platform throughout the offering period, and for at least 21 days prior to the sale of any security in the offering;
- provide communication channels on the platform to facilitate discussions among investors and issuers about offerings made available on the intermediary's site, without participation by the intermediary itself; and
- disclose to investors the intermediary's compensation relating to the offering, as well as that of any promoter.

Intermediaries must require investors to open an account on the platform before accepting any investment; however, the intermediary cannot require a potential investor to open an account in order to receive information about the offering or an issuer. The intermediary must have a reasonable belief that the investor meets and complies with the investment limitations under the rules. The issuer may rely upon the intermediary's calculation of the investment limits relative to an investor, provided that the issuer does not otherwise have knowledge that the limits would be exceeded as a result of participating in the offering. Upon receipt of a commitment from an investor, the intermediary must provide an electronic notice to the investor confirming the dollar amount of the commitment, price of the securities, name of the issuer, and deadline for cancellation of the commitment. Prior to acceptance of the investor's commitment, the intermediary must obtain confirmation from the investor that the investor understands the restrictions on cancellation of a commitment and the ability to secure a return of the investment, the restrictions on resale and transfer of the securities, and the potential for complete loss of the investment and the ability to withstand such loss. Once the investment has been accepted, the intermediary must provide electronic confirmations to each of the investors at or before completing the sale.

Intermediaries are prohibited under the rules from engaging in certain activities. Companies may not be permitted access to the platform if the intermediary has a reasonable belief that there is a potential for fraud, among other concerns. Intermediaries are prohibited from having a financial interest in a company offering on its platform, unless that interest was received as compensation for its services, subject to certain limitations. In addition, no person may be compensated by the intermediary for providing personally identifiable information of any investor or potential investor.

Crowdfunding portals are subject to additional restrictions on their activities, as distinguished from broker-dealers. Funding portals cannot offer investment advice, make investment recommendations, solicit purchases, sales, or offers to buy securities, compensate promoters or other persons for soliciting investors or based upon the sale of securities, or hold, possess or handle investor funds or securities.

State Securities Law Preemption: Section 305 of the JOBS Act amended Securities Act Section 18(b)(4) to preempt the ability of state securities commissions to regulate certain aspects of crowdfunding conducted in reliance upon Section 4(a)(6). Although preemption of state registration requirements will reduce the costs of these offerings for issuers, certain states and commentators have expressed concern that such preemption will remove a layer of protection for investors in preventing fraud. In the adopting release, the SEC noted that certain restrictions included in the statute and the final rules are intended to offset this concern, such as through public disclosure requirements, investment limits, the use of an intermediary, and the disqualification provisions. In addition, the antifraud provisions of the federal and state securities laws will apply to these offerings.

* * * * * * * * * *

Regulation Crowdfunding will not become effective until May 16, 2016. This time lag will enable funding portals to begin the registration process with the SEC, once the applicable forms become available at the end of January 2016. It will also allow funding portals the necessary time to apply for FINRA membership. Early stage companies will now be able to consider the viability of raising capital through the "crowd," as compared to Regulation A+, or more traditional forms of private placements, such as Regulation D. However, given all the "chatter" that has surrounded crowdfunding since the enactment of the JOBS Act, we anticipate that early stage companies will welcome these new rules and seek to be part of the expanding crowd. Notwithstanding this enthusiasm, participants in crowdfunding must carefully prepare to meet the extensive requirements and safeguards imposed under the JOBS Act and Regulation Crowdfunding, as well as the associated costs.

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SEC Update

March 15, 2016

Print

See note below about Hogan Lovells

SEC staff issues no-action letter facilitating Rule 144 sales of REIT shares received in exchange for operating partnership units

On March 14, the staff of the SEC's Division of Corporation Finance issued a no-action letter that will enable holders of shares of a publicly traded real estate investment trust (REIT) received in exchange for privately placed units of the REIT's operating partnership to sell the shares under Rule 144 without having to start a new holding period for them. The staff issued the letter in response to a no-action request jointly submitted by Bank of America, N.A. and Merrill Lynch, Pierce, Fenner & Smith Incorporated and three law firms, including Hogan Lovells. The letter is captioned *Bank of America, N.A., Merrill Lynch, Pierce, Fenner & Smith Incorporated* and is available **here**.

The parties submitting the no-action request did not identify specific parties or specific transactions to which the SEC staff directed its no-action relief. The staff's no-action letter accordingly represents an interpretive position on which any holder of REIT shares received in a covered exchange transaction should be able to rely. By facilitating Rule 144 resales, the no-action relief could reduce the number of registration statements REITs have to file related to these exchange transactions, alleviate the hardships that would be encountered by unit holders in the event a registration statement is not available, and provide lenders greater comfort in accepting units as collateral for loans.

Background

Entity and transaction structure. The staff's no-action relief encompasses exchange transactions involving securities of entities in an umbrella partnership real estate investment trust (UPREIT) structure as summarized in the no-action request.

REIT and operating partnership. In an UPREIT structure, all of the REIT's real estate assets are acquired and owned directly or indirectly by its umbrella partnership, which is organized as a limited partnership or limited liability company and is typically referred to as an "operating partnership." The REIT's only material assets are its holdings of interests (units) in the operating partnership, through which the REIT operates its business. The REIT either serves as the general partner of the operating partnership or controls the general partner.

Operating partnership units. Units also are held by other investors that

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acquire the securities in non-public offerings, typically in exchange for real estate assets they contributed to the operating partnership, either at the time of the REIT's initial public offering or in subsequent transactions. These investors pay the full purchase price for their units when they acquire them. There is no public market for the units, which are subject to significant transfer restrictions under the agreement governing the formation of the operating partnership.

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One unit is the economic equivalent of one share of common stock of the REIT, or of another specified number of shares of REIT common stock fixed to ensure economic parity between the REIT shares and the units. The units are substantially identical economically to the REIT shares, in that they represent the same right to the same proportionate interest in the same underlying pool of assets.

Exchange transaction. The REIT shares are registered under Section 12 of the Exchange Act and are publicly traded on a national securities exchange. After an initial one-year holding period, unit holders may request that the operating partnership redeem their units for cash. The REIT, at its option, may assume the operating partnership's redemption obligation and acquire the units for REIT shares based on the fixed ratio. Unit holders are not required to pay any additional consideration for the REIT shares at redemption, and the cash value of each unit at redemption directly corresponds to the REIT common stock's market value at that time.

Rule 144. Rule 144 provides a "safe harbor" from registration under the Securities Act for sales by holders of "restricted securities," which are securities acquired from the issuer or an affiliate of the issuer in a transaction not involving a public offering. Under Rule 144(d)'s "holding period" requirement, the securities must be held for at least six months after they have been fully paid for (or for at least one year if the securities are issued by a company that has been public for fewer than 90 days). In some situations, a holder of restricted securities may "tack" (or add on) the holding period of other parties or related securities to the holding period of newly acquired securities.

Before it issued the no-action letter, the SEC staff had not formally addressed the application of the holding period requirement to REIT shares received in exchange for operating partnership units, although it informally had indicated that a new holding period was required for the shares. Under this position, a unit holder's Rule 144(d) holding period for the REIT shares began upon its acquisition of the shares rather than upon its acquisition of the units it exchanged for the shares.

The staff's informal view had the unfortunate effect of subjecting holders of units who privately exchanged their units for REIT shares to a waiting period under Rule 144 of at least six months after receipt of the shares before they could sell the shares publicly. This would be a hardship for the holders, because, although taxes on the exchange would be triggered when the exchange occurred, the holders could not sell their shares under Rule 144 to help pay for the taxes until at least six months had elapsed. Many REITs have addressed the hardship by filing a registration statement under the Securities Act covering either the exchange of the units for REIT shares or the resale of the REIT shares received upon exchange. These filings require considerable time and expense to complete.

No-action request

The parties requesting no-action relief asked the SEC staff to concur with their view that a seller of REIT shares received upon an exchange of operating partnership units should be allowed under Rule 144 to tack the holding period of the units to the holding period of the REIT shares and therefore be able to sell the REIT shares immediately upon receipt if the units had been held for the requisite period. The staff traditionally has taken the position that the holding period requirement is satisfied only if the seller has been at full economic risk with respect to the securities for the entire period required by Rule 144. Where an exchange of securities occurs, the economic risk of the new securities typically is different from that of the exchanged securities, thereby requiring the start of a new holding period.

The requestors argued in their submission that in the case of a REIT structured as an UPREIT, the economic risk of the operating partnership units is identical to that of the REIT shares (apart from tax considerations). Under the UPREIT structure, the operating partnership units and the REIT common stock acquired upon redemption represent the same proportionate right to the assets of the operating partnership, so that the exchange does not result in any change to the economic risk of the investment in the underlying assets. The unit holder has the same economic risk as a holder of REIT common stock during the entire period it holds the units and the unit holder retains the same economic risk and the same proportionate share of the underlying real estate assets after the exchange. Accordingly, from the date the unit holder pays the full purchase price for the units to the date it exchanges the units for REIT common stock, the economic value of a unit is the same as the market price of, and therefore the economic value of, a corresponding share of REIT common stock. Because the economic risk is the same after the exchange, the requestors said the holding periods of the two securities should be combined under the rule.

The staff agreed with the requestors that the holding periods of operating partnership units and REIT shares could be tacked under Rule 144. Because most UPREITs are structured to require holders of units to hold their units for at least one year, the staff's position will permit most unit holders to sell immediately under Rule 144 any REIT shares they receive in exchange for the units. Sales by affiliates of the REIT will be subject to the volume limitation and other requirements of Rule 144. For tax purposes, a new holding period will commence upon that exchange, so a sale within one year after the exchange would result in short-term capital gain to the extent the shares have appreciated in value since the exchange.

The staff's position is consistent with two orders the SEC issued in 1995 and 1998 under Section 12(h) of the Exchange Act that exempted two REITs having an UPREIT structure from the application of Section 16 of that Act to their ownership of, and transactions in, units of their operating partnerships. The orders, the first of which was obtained upon a request prepared by our firm, were based on the same principle on which the request for the new no-action letter was based, which is that the economic risk is the same (apart from taxes) for both the operating partnership units and the REIT shares received in exchange for them, so that no purchase or sale effectively occurs under Section 16 upon the exchange.

Americas

Includes U.S., Canada, and Brazil

Proxy Voting Guidelines Updates

2016 Benchmark Policy Recommendations

Effective for Meetings on or after Feb. 1, 2016

Published Nov. 20, 2015

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UNITED STATES

BOARD OF DIRECTORS- VOTING ON DIRECTOR NOMINEES IN UNCONTESTED ELECTIONS

Unilateral Bylaw/Charter Amendments

Current General Recommendation: Generally vote against or withhold from directors individually, committee members, or the entire board (except new nominees, who should be considered case-by-case) if the board amends the company's bylaws or charter without shareholder approval in a manner that materially diminishes shareholders' rights or that could adversely impact shareholders, considering the following factors, as applicable:

- The board's rationale for adopting the bylaw/charter amendment without shareholder ratification;
- Disclosure by the company of any significant engagement with shareholders regarding the amendment;
- The level of impairment of shareholders' rights caused by the board's unilateral amendment to the bylaws/charter;
- The board's track record with regard to unilateral board action on bylaw/charter amendments or other entrenchment provisions;
- The company's ownership structure;
- The company's existing governance provisions;
- Whether the amendment was made prior to or in connection with the company's initial public offering;
- The timing of the board's amendment to the bylaws/charter in connection with a significant business development;
- Other factors, as deemed appropriate, that may be relevant to determine the impact of the amendment on shareholders.

Key Changes:

- Separate the methodology for evaluating adoptions of bylaw or charter provisions made prior to or in connection with a company's initial public offering from the methodology for evaluating unilateral board amendments to the bylaws or charter made following completion of a company's initial public offering, and
- Explicitly state that ISS will consider both such actions in determining vote recommendations for director nominees until such time as the actions are reversed or submitted to a binding vote of public shareholders.

New General Recommendation:

1.17. Generally vote against or withhold from directors individually, committee members, or the entire board (except new nominees, who should be considered case-by-case) if the board amends the company's bylaws or charter without shareholder approval in a manner that materially diminishes shareholders' rights or that could adversely impact shareholders, considering the following factors:

- The board's rationale for adopting the bylaw/charter amendment without shareholder ratification;
- Disclosure by the company of any significant engagement with shareholders regarding the amendment;
- The level of impairment of shareholders' rights caused by the board's unilateral amendment to the bylaws/charter;
- The board's track record with regard to unilateral board action on bylaw/charter amendments or other entrenchment provisions;
- The company's ownership structure;
- The company's existing governance provisions;
- The timing of the board's amendment to the bylaws/charter in connection with a significant business development; and,
- Other factors, as deemed appropriate, that may be relevant to determine the impact of the amendment on shareholders.

Unless the adverse amendment is reversed or submitted to a binding shareholder vote, in subsequent years vote case-by-case on director nominees. Generally vote against (except new nominees, who should be considered case-by-case) if the directors:

- Classified the board;
- Adopted supermajority vote requirements to amend the bylaws or charter; or
- Eliminated shareholders' ability to amend bylaws.

1.18. For newly public companies, generally vote against or withhold from directors individually, committee members, or the entire board (except new nominees, who should be considered case-by-case) if, prior to or in connection with the company's public offering, the company or its board adopts bylaw or charter provisions adverse to shareholders' rights, considering the following factors:

- The level of impairment of shareholders' rights caused by the provision;
- The company's or the board's rationale for adopting the provision;
- The provision's impact on the ability to change the governance structure in the future (e.g., limitations on shareholder right to amend the bylaws or charter, or supermajority vote requirements to amend the bylaws or charter);
- The ability of shareholders to hold directors accountable through annual director elections, or whether the company has a classified board structure; and,
- A public commitment to put the provision to a shareholder vote within three years of the date of the initial public offering.

Unless the adverse provision is reversed or submitted to a vote of public shareholders, vote case-by-case on director nominees in subsequent years.

Rationale for Update:

This update clarifies ISS policy and aligns ISS' approach to evaluating unilateral bylaw and charter amendments by pre-IPO companies and post-IPO company board members with feedback received from institutional investors. This update also establishes separate methodologies to evaluate adoptions of bylaw or charter provisions made prior to or in connection with a company's initial public offering and unilateral board amendments made to the bylaws or charter following completion of a company's initial public offering. This bifurcation reflects the differing expectations that investors may have for the governance structures of a newly-public company versus a company that has been public for some period of time.

At companies that are already public, investors have seen a marked increase in moves by boards to circumvent votes by unilaterally amending their companies' governing documents—usually the bylaws—to reduce shareholders' rights. While ISS tracked 10 such cases in 2013 (the historic norm in terms of volume), unilateral adoptions jumped to 64 in 2014, and there have been 62 thus far in 2015.

A majority of investor respondents to the ISS 2015–2016 policy survey favor adverse vote recommendations for director nominees when a board unilaterally adopts bylaw or charter amendments that "materially diminish" shareholders' rights until such time as the rights are restored. Both investor and non-investor respondents identify "classifying the board" and "establishing supermajority vote requirements for bylaw/charter amendments" as the unilateral actions for which continuing adverse vote recommendations would be most appropriate.

A significant percentage of recent IPOs have included provisions that limit board accountability to post-IPO investors and make it difficult for shareholders to amend the company's governing documents or take other corporate actions. While some pre-IPO boards argue that these governance structures will benefit investors over the long run, few of them provide opportunities for post-IPO shareholders to ratify these provisions. Notably, the lion's share of recent IPO firms have limited directors' accountability to shareholders by staggering board terms (via classified boards) and adopting supermajority vote provisions to amend the firms' governing documents. A law firm analysis of governance practices at more than 400 “emerging growth companies” that completed their IPOs in the period from Jan. 1, 2013, through Dec. 31, 2014, for example, found that 69 percent of these firms went public with classified boards and nearly three-quarters had supermajority vote requirements in place.[1] A separate law firm analysis of large IPOs at 46 non-controlled companies for the Sept. 1, 2001, to Oct. 31, 2013, period, found that 70 percent of the boards had staggered terms and 70 percent of the firms required supermajority votes to amend their bylaws.[2]

Overboarded Directors

Current General Recommendation: Vote against or withhold from individual directors who:

- Sit on more than six public company boards; or
- Are CEOs of public companies who sit on the boards of more than two public companies besides their own—withhold only at their outside boards[3].

Key Changes:

- In 2016, ISS will note in its analysis if a director is serving on more than five (5) public company boards.
- Starting in February of 2017, ISS will recommend against directors who sit on more than five (5) public company boards.

New General Recommendation: Vote against or withhold from individual directors who:

- Sit on more than six public company boards; for meetings on or after Feb. 1, 2017[4], sit on more than five public company boards; or
- Are CEOs of public companies who sit on the boards of more than two public companies besides their own—withhold only at their outside boards[3].

Rationale for Update:

More than a decade ago, in response to rising investor concerns about over-boarding and academic research questioning the performance of “busy” directors, ISS set limits of six directorships for most board members and three total board memberships (service on the home company board and two outside directorships) for sitting CEOs.

Since these limits were adopted, the average time commitment for board service has exploded. According to the National Association of Corporate Directors’ (NACD) 2014-2015 Public Company Governance Survey, respondent directors of public companies now spend an average of 242 hours a year (or more than 30 eight-hour work days annually) on board service. This typical time commitment jumps up to 278 hours (or nearly five more eight-hour work days) when you add in the survey respondents’ estimates of additional time spent in informal meetings/conversations with management. In contrast, the average annual director time commitment reported by NACD’s survey respondents in 2005 was 190 hours (or fewer than 24 eight-hour work days).

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[1] Morrison & Foerster, Getting the Measure of EGC Corporate Governance Practices: A survey and related resources, 2015.
[2] Davis Polk &Wardwell, Corporate Governance Practices in U.S. Initial Public Offerings (Excluding Controlled Companies, Jan, 2014.
[3] Although all of a CEO’s subsidiary boards will be counted as separate boards, ISS will not recommend a withhold vote from the CEO of a parent company board or any of the controlled (>50 percent ownership) subsidiaries of that parent, but may do so at subsidiaries that are less than 50 percent controlled and boards outside the parent/subsidiary relationships.
[4] This policy change includes a 1-year transition period to allow time for affected directors to address necessary changes if they wish.

Recent academic research generally shows a negative association between board "busyness" and firm performance and director attendance at board meetings[5]. Notably, the authors of most of these studies define a "busy" director's workload as three or more boards.

Many boards have responded to concerns about overboarding by placing limits on the number of public company directorships that that their members may hold. Some boards appear to address time commitment concerns via their nominating panels. Spurred by these policies and common sense, most board members limit their board seats to four or fewer directorships.

ISS has periodically updated its overboarding policy since it was implemented in 2004, to incorporate the evolving market realities. The new policy aligns with feedback and research received from institutional investors as well as the issuer community (via our 2015-2016 policy survey and roundtable discussions) regarding the ability of a director to devote sufficient time to each board commitment. Based on that feedback as well as draft policy comments, ISS will continue evaluating the optimal level of directorships for individuals who are CEOs of public companies.

Proxy Contests/Proxy Access — Voting for Director Nominees in Contested Elections

Current General Recommendation: Vote case-by-case on the election of directors in contested elections, considering the following factors:

- Long-term financial performance of the target company relative to its industry;
- Management's track record;
- Background to the proxy contest;
- Nominee qualifications and any compensatory arrangements;
- Strategic plan of dissident slate and quality of critique against management;
- Likelihood that the proposed goals and objectives can be achieved (both slates);
- Stock ownership positions.

When the addition of shareholder nominees to the management card ("proxy access nominees") results in a number of nominees on the management card which exceeds the number of seats available for election, vote case-by-case considering the same factors listed above.

Key Changes:

- Clarifying a policy analysis framework to evaluate candidates nominated pursuant to proxy access as well as nominees in a proxy contest.
- While several factors may be similar in each evaluation, there may be factors that are unique to analyzing proxy access nominations.

New General Recommendation: Vote case-by-case on the election of directors in contested elections, considering the following factors:

[5] Cashman, George D. and Gillan, Stuart and Jun, Chulhee, Going Overboard? On Busy Directors and Firm Value (March 1, 2012). Available at SSRN: http://ssrn.com/abstract=2044798 or http://dx.doi.org/10.2139/ssrn.2044798; Falato, Antonio and Kadyrzhanova, Dalida and Lel, Ugur, Distracted Directors: Does Board Busyness Hurt Shareholder Value? (December 10, 2013). Available at SSRN: http://ssrn.com/abstract=2272478 or http://dx.doi.org/10.2139/ssrn.2272478; Jiraporn, Pornsit and Davidson, Wallace N. and Ning, Yixi and DaDalt, Peter J., Too Busy to Show Up? An Analysis of Directors' Absences (January 21, 2008). Available at SSRN: http://ssrn.com/abstract=1254642 or http://dx.doi.org/10.2139/ssrn.1254642

- Long-term financial performance of the target company relative to its industry;
- Management's track record;
- Background to the contested election;
- Nominee qualifications and any compensatory arrangements;
- Strategic plan of dissident slate and quality of critique against management;
- Likelihood that the proposed goals and objectives can be achieved (both slates); and
- Stock ownership positions.

In the case of candidates nominated pursuant to proxy access, vote case-by-case considering any applicable factors listed above or additional factors which may be relevant, including those that are specific to the company, to the nominee(s) and/or to the nature of the election (such as whether or not there are more candidates than board seats).

Rationale for Update:

This policy revision provides an analytical framework for evaluating candidates nominated pursuant to proxy access. ISS has a policy for evaluating director nominees in contested elections, which currently applies to proxy contests as well as proxy access nominations. However, the circumstances and motivations of a proxy contest and a proxy access nomination may differ significantly. Therefore, it is necessary to create adequate analytical latitude for evaluating candidates nominated through proxy access.

Proxy access rights have grown into a high-visibility corporate governance issue for US-listed companies. In 2014, ISS evaluated 18 shareholder proposals seeking proxy access rights. That number rose to more than 90 in 2015. Further, while five of the proposals received majority support in 2014, 52 have received majority support so far in 2015. Moreover, following the 2015 US proxy season, numerous companies have unilaterally adopted proxy access rights, even in the absence of majority-supported shareholder proposals.

While it is unlikely that many (or perhaps any) proxy access nominees will materialize in 2016, ISS believes it is prudent to update its framework for evaluating candidates nominated via proxy access right. In some cases, the nominating shareholder's views on the current leadership or company strategy may be opposed to the existing board's views. Alternatively, a shareholder nominator may generally agree with the company's strategy or have no specific critiques of incumbent directors, but may propose an alternative candidate to address a specific concern, such as board diversity or boardroom skills gaps.

COMPENSATION

Advisory Votes on Executive Compensation— Problematic Pay Practices

Insufficient Executive Compensation Disclosure by Externally Managed Issuers

Current General Recommendation: None.

Currently, insufficient disclosure regarding compensation arrangements for executives at an externally-managed issuer (EMI) is not considered a problematic pay practice under ISS policy. Absent any other significant concerns identified, ISS has generally not issued adverse say-on-pay recommendations on this basis. ISS does raise concerns, however, regarding the lack of transparency resulting when an EMI provides a say-on-pay proposal without information that enables investors to make an informed voting decision on the proposal.

Key Changes: Update the Problematic Pay Practice policy, add "Insufficient Executive Compensation Disclosure by Externally Managed Issuers (EMIs)" to the list of practices that may result in an adverse recommendation on the advisory vote on executive compensation. This refers to an EMI's failure to provide sufficient disclosure to enable shareholders to make a reasonable assessment of compensation arrangements for the EMI's named executive officers.

New General Recommendation: For externally-managed issuers (EMIs), generally vote against the say-on-pay proposal when insufficient compensation disclosure precludes a reasonable assessment of pay programs and practices applicable to the EMI's executives.

Rationale for Update:

Lack of Disclosure Precludes a Reasonable Assessment of Executive Compensation Arrangements

Like most U.S. public companies, EMIs are subject to periodic, advisory say-on-pay vote requirements. However, an EMI typically does not directly compensate its executives. Instead, executives are compensated by the external manager, which is reimbursed by the EMI through a management fee.

EMIs typically do not disclose any details about their compensation arrangements or payments made to executives by external managers. Many EMIs do not provide even basic disclosure regarding executive compensation arrangements and payments between the external manager and the EMI's executives. When “executive compensation information” is disclosed, it is usually limited to the aggregate management fee paid by the EMI to its manager. Without adequate information, shareholders are unable to conduct a reasonable assessment of executive compensation arrangements in order to identify potentially problematic aspects of those arrangements and to make an informed decision when voting on the EMI's say-on-pay proposal.

Some EMIs provide disclosure about the value and nature of NEOs' compensation arrangements in sufficient detail to enable shareholders to reasonably assess the arrangements and cast an informed vote on the EMI's say-on-pay proposal. Some EMIs, for example, disclose the aggregate portion of such fees that is allocable to executive compensation expenses. A small number of EMIs disclose detailed information on behalf of their external managers. This enhanced transparency demonstrates that such information can be made available within the constraints of company agreements with external managers.

As such, ISS will consider insufficient disclosure regarding compensation arrangements between executives and the external manager to be a problematic practice that warrants an AGAINST recommendation on the say-on-pay proposal.

2015-2016 Policy Survey

Based on 2015-2016 ISS Policy Survey results, 71% of investor respondents indicated that, in the event an EMI does not provide disclosure on the compensation paid to management by the eternal manager, ISS should recommend an AGAINST vote on the say-on-pay proposal, given that the level of disclosure does not meet shareholders' informational needs. Even a sizable minority (24%) of non-investor respondents (companies and advisors) responded that an AGAINST recommendation would be warranted.

U.S. Compensation Roundtables

At the 2015 ISS U.S. Compensation Roundtable held on Sept. 22, 2015, nearly all participants expressed their support for a policy update in which ISS would recommend AGAINST the say-on-pay proposals for EMIs that do not provide sufficient executive compensation disclosure. No participant expressed a preference for continuation of ISS' current approach of supporting the say-on-pay proposals in such cases. At the 2014 ISS U.S. Compensation Roundtable held on Sept. 16, 2014, participants similarly indicated that they considered an EMI's lack of compensation disclosure to inhibit shareholders' ability to fully assess the merits of the company's pay program and practices.

Hold Equity Past Retirement or for a Significant Period of Time

Current General Recommendation: Vote case-by-case on shareholder proposals asking companies to adopt policies requiring senior executive officers to retain all or a significant portion of the shares acquired through compensation plans, either:

- while employed and/or for two years following the termination of their employment ; or
- for a substantial period following the lapse of all other vesting requirements for the award ("lock-up period"), with ratable release of a portion of the shares annually during the lock-up period.

The following factors will be taken into account:

- Whether the company has any holding period, retention ratio, or officer ownership requirements in place. These should consist of:
  - Rigorous stock ownership guidelines;
  - A holding period requirement coupled with a significant long-term ownership requirement; or
  - A meaningful retention ratio;
- Actual officer stock ownership and the degree to which it meets or exceeds the proponent's suggested holding period/retention ratio or the company's own stock ownership or retention requirements;
- Post-termination holding requirement policies or any policies aimed at mitigating risk taking by senior executives;
- Problematic pay practices, current and past, which may promote a short-term versus a long-term focus.

A rigorous stock ownership guideline should be at least 10x base salary for the CEO, with the multiple declining for other executives. A meaningful retention ratio should constitute at least 50 percent of the stock received from equity awards (on a net proceeds basis) held on a long-term basis, such as the executive's tenure with the company or even a few years past the executive's termination with the company.

Vote case-by-case on shareholder proposals asking companies to adopt policies requiring Named Executive Officers to retain 75% of the shares acquired through compensation plans while employed and/or for two years following the termination of their employment, and to report to shareholders regarding this policy. The following factors will be taken into account:

- Whether the company has any holding period, retention ratio, or officer ownership requirements in place. These should consist of:
  - Rigorous stock ownership guidelines, or
  - A holding period requirement coupled with a significant long-term ownership requirement, or
  - A meaningful retention ratio,
- Actual officer stock ownership and the degree to which it meets or exceeds the proponent's suggested holding period/retention ratio or the company's own stock ownership or retention requirements.
- Problematic pay practices, current and past, which may promote a short-term versus a long-term focus.

A rigorous stock ownership guideline should be at least 10x base salary for the CEO, with the multiple declining for other executives. A meaningful retention ratio should constitute at least 50 percent of the stock received from equity awards (on a net proceeds basis) held on a long-term basis, such as the executive's tenure with the company or even a few years past the executive's termination with the company.

Generally vote against shareholder proposals that mandate a minimum amount of stock that directors must own in order to qualify as a director or to remain on the board. While ISS favors stock ownership on the part of directors, the company should determine the appropriate ownership requirement.

Key Changes:

- Broaden policy to encompass executive equity retention proposals more generally, eliminating the need for a separate policy covering proposals seeking retention of 75% of net shares.
- Clarify that the proposed retention ratio and the required duration of retention are some of the several factors that will be considered in ISS' case-by-case analysis.

New General Recommendation: Vote case-by-case on shareholder proposals asking companies to adopt policies requiring senior executive officers to retain a portion of net shares acquired through compensation plans. The following factors will be taken into account:

- The percentage/ratio of net shares required to be retained;
- The time period required to retain the shares;
- Whether the company has equity retention, holding period, and/or stock ownership requirements in place and the robustness of such requirements;
- Whether the company has any other policies aimed at mitigating risk taking by executives;
- Executives' actual stock ownership and the degree to which it meets or exceeds the proponent's suggested holding period/retention ratio or the company's existing requirements; and
- Problematic pay practices, current and past, which may demonstrate a short-term versus long-term focus.

Rationale for Update:

This policy update clarifies the factors considered in ISS' case-by-case analysis. It also broadens the policy to encompass equity retention proposals more generally, thereby eliminating the need for a separate policy tied to a specified retention ratio.

Specifically, the revised policy clarifies that the proponent's suggested retention percentage/ratio and the required retention duration are two of the several factors to be assessed under ISS' case-by-case approach. This change eliminates the need for separate policies tied to specified retention ratios (i.e. a separate policy for proposals requesting 75% net share retention), since the retention ratio is a factor to be considered for every proposal. In more clearly identifying the factors and eliminating repetitive language, the new policy is more streamlined and easier to understand.

ENVIRONMENTAL AND SOCIAL ISSUES

Animal Welfare

Current General Recommendation: Generally vote for proposals seeking a report on a company's animal welfare standards, unless:

- The company has already published a set of animal welfare standards and monitors compliance;
- The company's standards are comparable to industry peers; and
- There are no recent, significant fines or litigation related to the company's treatment of animals.

Key Changes:

- Add "or animal welfare-related risks" to introductory sentence;
- Add "controversies" to last bullet point; and
- Add "and/or its suppliers'" to the last bullet point.

New General Recommendation: Generally vote for proposals seeking a report on a company's animal welfare standards, or animal welfare-related risks, unless:

- The company has already published a set of animal welfare standards and monitors compliance;
- The company's standards are comparable to industry peers; and
- There are no recent significant fines, litigation, or controversies related to the company's and/or its suppliers' treatment of animals.

Rationale for Update:

In 2014, some proponents began submitting shareholder proposals requesting reports on the risks associated with the use of certain methods of animal housing (e.g. gestation crates and battery cages) and other animal welfare practices deemed inhumane in a company's supply chain. The updated policy clarifies that proposals requesting a report on animal welfare-related risks, including the aforementioned resolutions on supply chain risks, are analyzed under this policy. The inclusion of controversies, along with fines and litigation, provides for consistent language across the Environmental and Social Issues policies, and ensures consistent evaluation and incorporation of relevant information.

Pharmaceutical Pricing, Access to Medicines, and Prescription Drug Reimportation

Current General Recommendation: Vote case-by-case on proposals requesting that a company report on its product pricing or access to medicine policies, considering:

- The nature of the company's business and the potential for reputational and market risk exposure;
- Existing disclosure of relevant policies;
- Deviation from established industry norms;
- Relevant company initiatives to provide research and/or products to disadvantaged consumers;
- Whether the proposal focuses on specific products or geographic regions; and
- The potential burden and scope of the requested report.

Key Changes:

- Add "regulatory" to the risk exposure bullet point; and
  Add a bullet point for "recent signficiant controveries, litigation, or fines at the company."

New General Recommendation: Vote case-by-case on proposals requesting that a company report on its product pricing or access to medicine policies, considering:

- The potential for reputational, market, and regulatory risk exposure;
- Existing disclosure of relevant policies;
- Deviation from established industry norms;
- Relevant company initiatives to provide research and/or products to disadvantaged consumers;
- Whether the proposal focuses on specific products or geographic regions;
- The potential burden and scope of the requested report;
- Recent significant controversies, litigation, or fines at the company.

Rationale for Update:

This update codifies ISS' current practice. When evaluating resolutions that request a report on a company's policies related to product pricing and access to medicine, ISS considers the potential for regulatory risks and the company's exposure to controversies, litigation, or fines.

The addition of the controversies bullet point reflects the increased criticism regarding the pricing of pharmaceutical products, in particular specialty drugs. This criticism has not only resulted in media coverage, but also Senate and U.S. Department of Justice investigations at some companies. Additionally, a growing number of states have either passed or have presented legislation aiming to cap pricing for certain products or to require drug manufacturers to provide increased disclosure on the cost of drug research and production, resulting in additional regulatory risks for the pharmaceutical industry.

Climate Change/Greenhouse Gas (GHG) Emissions

Current General Recommendation: Generally vote for resolutions requesting that a company disclose information on the impact of climate change on its operations and investments, considering:

- Whether the company already provides current, publicly-available information on the impacts that climate change may have on the company as well as associated company policies and procedures to address related risks and/or opportunities;
- The company's level of disclosure is at least comparable to that of industry peers; and
- There are no significant controversies, fines, penalties, or litigation associated with the company's environmental performance.

Key Changes:

Add "such as financial, physical, or regulatory risks" to the introductory sentence.

New General Recommendation: Generally vote for resolutions requesting that a company disclose information on the risks related to climate change on its operations and investments, such as financial, physical, or regulatory risks, considering:

- Whether the company already provides current, publicly-available information on the impact that climate change may have on the company as well as associated company policies and procedures to address related risks and/or opportunities;
- The company's level of disclosure is at least comparable to that of industry peers; and
- There are no significant controversies, fines, penalties, or litigation associated with the company's environmental performance.

Rationale for Update:

During the 2015 proxy season, proponents filed new shareholder proposals addressing companies' capital expenditure strategies as they relate to investments in fossil fuel and stranded carbon asset risk (investment in high-cost, high-carbon assets could be stranded, as global demand for fossil fuels slows in the coming years and/or potential climate change regulations make them unburnable). These resolutions asked companies to either report on the consistency of their capital expenditure strategies with policymakers' goals to limit greenhouse gas emissions, or a company's strategy to address the risk of stranded assets presented by global climate change and associated demand reductions for oil and gas.

The revisions to the current policy clarify the types of risks related to climate change that can impact a company's operations and investments. It also clarifies that the capital expenditure strategy and stranded carbon asset resolutions are evaluated pursuant to this policy.

CANADA

BOARD OF DIRECTORS- VOTING ON DIRECTOR NOMINEES IN UNCONTESTED ELECTIONS

Overboarded Directors –TSX

Current General Recommendation: Generally vote withhold for individual director nominees if:

- Irrespective of whether the company has adopted a majority voting policy, the director is overboarded[6] AND the individual director has attended less than 75 percent of his/her respective board and committee meetings held within the past year without a valid reason for these absences.

Cautionary language will be included in ISS reports where directors are overboarded regardless of attendance.

Key Changes:
- Change the definition of "overboarded" from more than 2 outside public company boards to more than 1 in the case of CEOs, and from more than 6 total public company boards to more than 4 in the case of non-CEOs.
- Commencing as of February 2017 meeting dates, the new policy definition will be implemented under the ISS Canada TSX Overboarded Directors policy.

New General Recommendation: Generally vote withhold for individual director nominees if:
- Irrespective of whether the company has adopted a majority voting policy, the director is overboarded[6,7] AND the individual director has attended less than 75 percent of his/her respective board and committee meetings held within the past year without a valid reason for these absences.

Cautionary language will be included in ISS reports where directors are overboarded regardless of attendance.

Rationale for Update:

Directors need sufficient time and energy in order to be effective representatives of shareholders' interests. Directors' responsibilities are increasingly complex as board and key committee memberships demand greater time commitments.

In a 2014 study, 120 board chairs, directors and CEOs across Canada were surveyed regarding their annual time commitment per board on which they served. The survey found that the average annual time commitment per board for a Canadian director was 304 hours. This number was higher for directors of companies with assets of more than CA$5 billion (388 hours) and also higher for those with assets between CA$1 billion and CA$5 billion (335 hours). There

[6] "Overboarded" is defined as: a CEO of a public company who sits on more than 2 outside public company boards in addition to the company of which he/she is CEO (withholds would only apply on outside boards these directors sit on), OR the director is not a CEO of a public company and sits on more than 6 public company boards in total.

[7] Starting February 1, 2017, "overboarded" will be defined as: a CEO of a public company who sits on more than 1 outside public company board in addition to the company of which he/she is CEO (withholds would only apply on outside boards these directors sit on), OR the director is not a CEO of a public company and sits on more than 4 public company boards in total.

was also a correlation between the role of a director and average annual time commitment. As expected, being a board chair is the most time consuming role; however, being a committee chair can be almost as time consuming.

While it appears that no comparable studies were conducted for previous years in Canada, according to a 2014-2015 US survey conducted by the National Association of Corporate Directors (NACD), directors of US public companies spent an annual average of 278 hours on board-related matters.

Based on the results of the 2015-16 ISS Global Policy Survey, a plurality of investor responses indicated that four total board seats is an appropriate limit for directors who are not active CEOs, and that a total of two board seats (a CEO's "home board" plus one outside board) is an appropriate limit for directors who are active CEOs.

ISS also obtained feedback in one-on-one discussions with institutional investors, the results of which indicate that a majority of those canvassed support maximum limits of four and two total board seats for non-CEO directors and CEO directors, respectively. These limits are reasonable in light of the "double-trigger" approach of jointly evaluating both number of board seats and attendance under Canadian policy.

Externally-Managed Issuers (EMIs) –TSX and TSXV

Current General Recommendation: None.

Key Changes:

Provide a framework for reviewing board accountability at EMIs, in cases where disclosure is limited or insufficient with respect to the management services agreement and how senior management is compensated.

New General Recommendation: Vote case-by-case on say-on-pay resolutions where provided, or on individual directors, committee members, or the entire board as appropriate, when an issuer is externally-managed and has provided minimal or no disclosure about their management services agreements and how senior management is compensated. Factors taken into consideration may include but are not limited to:

- The size and scope of the management services agreement;
- Executive compensation in comparison to issuer peers and/or similarly structured issuers;
- Overall performance;
- Related party transactions;
- Board and committee independence;
- Conflicts of interest and process for managing conflicts effectively;
- Disclosure and independence of the decision-making process involved in the selection of the management services provider;
- Risk mitigating factors included within the management services agreement such as fee recoupment mechanisms;
- Historical compensation concerns;
- Executives' responsibilities; and
- Other factors that may reasonably be deemed appropriate to assess an externally-managed issuer's governance framework.

Rationale for Update:

Externally-managed issuers (EMIs) typically pay fees to outside firms in exchange for management services. In most cases, some or all of the EMI's executives are directly employed and compensated by the external management firm.

EMIs typically do not disclose details of the management agreement in their proxy statements and only provide disclosure on the aggregate amount of fees paid to the manager, with minimal or incomplete compensation information.

Say-on-pay resolutions are voluntarily adopted in Canada, and none of the currently identified Canadian EMIs had a say-on-pay resolution on ballot this past year. Additionally, all non-controlled TSX-listed issuers are required to adopt majority voting director resignation policies which could result in a director being required to resign from a board if he or she receives more 'withhold' than 'for' votes at the shareholders' meeting. Some investor respondents to ISS' 2015-16 ISS Global Policy Survey indicated that in cases where an externally managed company does not have a say-on-pay proposal (i.e., 'withhold' votes may be recommended for individual directors), factors other than disclosure should be considered, such as performance, compensation and expenses paid in relation to peers, board and committee independence, conflicts of interest, and pay-related issues. Policy outreach sessions conducted with Canadian institutional investors resulted in identical feedback.

COMPENSATION

Equity Compensation Plans–TSX

Current General Recommendation: Vote case-by-case on equity-based compensation plans. Vote against the plan if any of the following factors applies:

- **Cost of Equity Plans:** The total cost of the company's equity plans is unreasonable;
- **Dilution and Burn Rate:** Dilution and burn rate are unreasonable, where the cost of the plan cannot be calculated due to lack of relevant historical data.
- **Plan Amendment Provisions:** The provisions do not meet ISS guidelines regarding those amendments that should require shareholder approval..
- **Non-Employee Director Participation:** Participation of directors is discretionary or unreasonable.
- **Pay for performance:** There is a disconnect between CEO pay and the company's performance.
- **Repricing Stock Options:** The plan expressly permits the repricing of stock options without shareholder approval and the company has repriced options within the past three years.
- **Problematic Pay Practices:** The plan is a vehicle for problematic pay practices.

Key Changes:

Similar to the model introduced in the United States for the 2015 proxy season, ISS is adopting a "scorecard" model (Equity Plan Scorecard – "EPSC") for Canadian TSX equity plans that considers a range of positive and negative factors to evaluate equity incentive plan proposals. In concert with ISS' longstanding Canadian policies for TSX equity plans (relating to non-employee director participation, amendment provisions, and repricing without shareholder approval), the total EPSC score will determine whether ISS recommends for or against the proposal.

EPSC factors will fall under three categories ("EPSC pillars"): Plan Cost, Plan Features, and Grant Practices.

As part of the new approach, the updated policy will:

- Utilize two index groups to determine certain thresholds and factor weightings: [8]
    - S&P/TSX Composite Index; and
    - Non-Composite TSX-listed Issuers.
- Utilize individual scorecards for both index groups, as well as Special Cases versions of these scorecards where certain historic data are unavailable;
- Measure plan cost (Shareholder Value Transfer or SVT) through both of the following:
    - The company's total new and previously reserved equity plan shares plus outstanding grants and awards ("A+B+C shares"); and
    - Only the new request plus previously reserved but ungranted shares ("A+B shares");
- Incorporate a wide range of new factors for consideration, both positive and negative, in determining how to recommend for a given equity plan.

New General Recommendation: Vote case-by-case on equity-based compensation plans using an "equity plan scorecard" (EPSC) approach. Under this approach, certain features and practices related to the plan[9] are assessed in combination, with positively-assessed factors potentially counterbalancing negatively-assessed factors and vice-versa. Factors are grouped into three pillars:

- **Plan Cost**: The total estimated cost of the company’s equity plans relative to industry/market cap peers, measured by the company's estimated Shareholder Value Transfer (SVT) in relation to peers and considering both:
    - SVT based on new shares requested plus shares remaining for future grants, plus outstanding unvested/unexercised grants; and
    - SVT based only on new shares requested plus shares remaining for future grants.

- **Plan Features:**
    - Absence of problematic change-in-control (CIC) provisions, including:
        - Single-trigger acceleration of award vesting in connection with a CIC; and
        - Settlement of performance-based equity at target or above in the event of a CIC-related acceleration of vesting regardless of performance.
    - No financial assistance to plan participants for the exercise or settlement of awards;
    - Public disclosure of the full text of the plan document; and
    - Reasonable share dilution from equity plans relative to market best practices.

- **Grant Practices:**
    - Reasonable three-year average burn rate relative to market best practices;
    - Meaningful time vesting requirements for the CEO's most recent equity grants (three-year lookback);
    - The issuance of performance-based equity to the CEO;
    - A clawback provision applicable to equity awards; and
    - Post-exercise or post-settlement share-holding requirements (S&P/TSX Composite Index only).

Generally vote against the plan proposal if the combination of above factors, as determined by an overall score, indicates that the plan is not in shareholders' interests. In addition, vote against the plan if any of the following unacceptable factors have been identified:

- Discretionary or insufficiently limited non-employee director participation;

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[8] Additional Special Cases versions of both models will also be developed for companies that have recently IPO'd or emerged from bankruptcy and where the burn-rate factor would therefore not apply.
[9] In cases where certain historic grant data are unavailable (e.g. following an IPO or emergence from bankruptcy), Special Cases models will be applied which omit factors requiring these data.

- An amendment provision which fails to adequately restrict the company's ability to amend the plan without shareholder approval;
- A history of repricing stock options without shareholder approval (three-year look-back);
- The plan is a vehicle for problematic pay practices or a significant pay-for-performance disconnect under certain circumstances; or
- Any other plan features that are determined to have a significant negative impact on shareholder interests.

Rationale for Update:

As issues around cost transparency and best practices in equity-based compensation have evolved in recent years, ISS has determined to update its Canadian Equity Plans policy in order to provide for a more nuanced consideration of equity plan proposals.

Currently, the Canadian policy for equity plans comprises a series of pass/fail tests relating to plan cost and to three key concerns of Canadian investors:

- Non-employee director participation;
- Plan amendment provisions; and
- Repricing without shareholder approval.

While the three policy cornerstones above will continue to be overriding negative factors under the new policy, the pass/fail test for plan cost will be replaced with a scorecard approach designed to provide a robust overview of an equity plan's strengths and weaknesses.

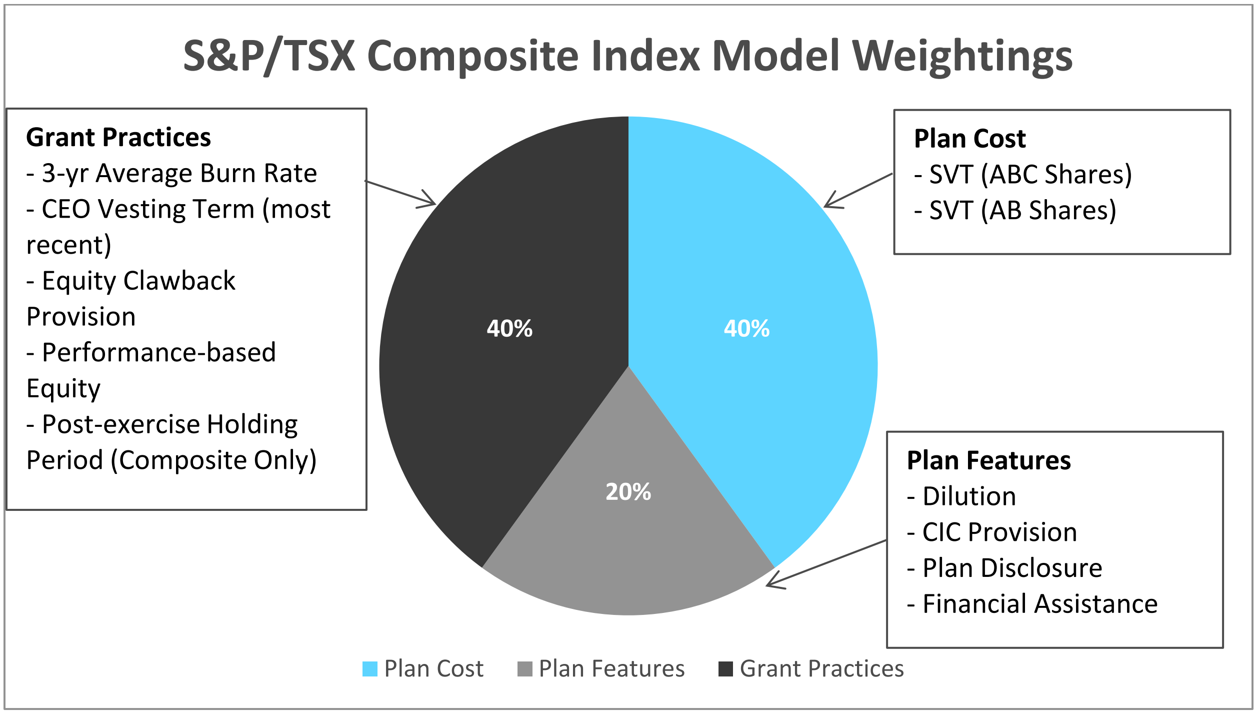
Feedback obtained through ongoing consultation with institutional investors since the 2013-2014 ISS policy cycle indicates strong support for the new approach, which incorporates the following key goals:

1. Consider a range of factors, both positive and negative, in determining vote recommendations;
2. Select factors based on institutional investors' concerns and preferences and on best practices within the Canadian market established through regulation, disclosure requirements, and best practice principles;
3. Establish factor thresholds and weightings which are cognizant of the Canadian governance landscape (separate scorecards for the S&P/TSX Composite Index and the broader TSX);
4. Ensure that key concerns addressed by policy continue to hold paramount importance (institution of overriding negative factors).

The EPSC policy for equity plan proposals significantly iterates ISS' current Canadian policy by providing a full-spectrum overview of plan cost, plan features, and historic grant practices. This allows shareholders greater insight into rising governance concerns, such as the implementation of risk-mitigating mechanisms, the strength of vesting provisions, and the use of performance-based equity, while also providing added assessments of longstanding concerns relating to equity plans such as burn rate and dilution.

By assessing these factors in combination, the EPSC is designed to facilitate a more holistic approach to vote recommendations. For example, a plan where cost is nominally higher than a company's allowable cap may receive a favourable recommendation if sufficient positive factors are present. Conversely, a plan where cost is nominally lower than the allowable cap may ultimately receive a negative recommendation if a preponderance of scorecard factors demonstrates adverse qualities. Plans will, however, continue to be subject to the scrutiny of overriding negative factors reflecting ISS' current policies regarding problematic non-employee director participation, insufficient plan amendment provisions, repricing without shareholder approval, and other egregious practices. Plans permitting these unacceptable practices will continue to receive an "against" recommendation.

A scorecard approach will enable the evaluation of equity plan proposals in consideration of a range of best practices. Weightings for the three scorecard pillars applicable to S&P/TSX Composite Index constituents and non-Composite TSX-listed issuers are shown below, along with the factors within each pillar. More information about the policy and weightings will be included in ISS' EPSC FAQ to be published in December.



BRAZIL

BOARD OF DIRECTORS - DIRECTOR ELECTIONS

Election of board and fiscal council nominees presented by minority ordinary and preferred holders under separate election items

Current General Recommendation: Vote against the election of directors nominated by non-controlling shareholders presented as a separate voting item if the nominee names are not disclosed in a timely manner prior to the meeting.

The policy is silent regarding the election of fiscal council members (statutory auditors) nominated by non-controlling shareholders, presented as separate voting items, as allowed by the Brazilian Corporate Law.

Key Changes:

› Recommend an abstain vote in the absence of timely disclosure regarding the names of the minority shareholders' director nominees (both ordinary minority nominee and/or preferred minority nominee, as applicable), when presented under a separate election; and

› Add the provision of an abstain vote recommendation in the absence of timely disclosure regarding the names of minority shareholders' fiscal council nominees and alternates (both ordinary and preferred minority nominees, as applicable), when presented under a separate election.

New General Recommendation: Vote abstain on the election of directors and fiscal council members nominated by non-controlling shareholders presented as a separate voting item if the nominee names are not disclosed in a timely manner prior to the meeting.

Rationale for Update:

The current recommendation to vote against the election of directors nominated by non-controlling shareholders presented as a separate voting item if the nominee names are not disclosed in a timely manner prior to the meeting is part of the Brazilian policy carved out from the Americas Regional policy mid-2013, effective as of Feb. 1, 2014, but was not fully implemented by the Latin America Research team due to the evolving processes in the voting operations chain regarding minority elections presented under separate items in the Brazilian market.

Minority nominees are generally considered independent and, as they can legally be presented up to the time of the meeting, a vote against would disenfranchise minority shareholders who could benefit from greater independent representation. Nonetheless, a vote for minority nominees in the absence of the disclosure of such names is inconsistent with ISS transparency principles and the overall policy framework for the Latin America region.

As such, an abstain vote is the most effective (and neutral) way to address minority shareholder election items when adequate disclosure is not provided in a timely manner. The policy update maintains the current practice of recommending a for vote if the names of the minority nominees are disclosed, and, in the absence of timely disclosure, to recommend an abstain vote for all minority election items, including directors and fiscal council nominees (ordinary and preferred shareholder meeting).

Combined Chairman/CEO

Current General Recommendation: None specific to the combination of Chair/CEO.

Key Changes:
Introduce policies for voting on directors at companies listed under the differentiated corporate governance segments in Brazil that maintain a combined Chair/CEO structure

New General Recommendation: Vote against the bundled election of directors of companies listed under the differentiated corporate governance segments of the Sao Paulo Stock Exchange (BM&FBovespa)--Novo Mercado, Nivel 2, and Nivel 1-- if the company maintains or proposes a combined chairman/CEO structure, after three (3) years from the date the company's shares began trading on the respective differentiated corporate governance segment.

Vote against the election of the company's chairman, if the nominee is also the company's CEO, when it is presented as a separate election at companies listed under the differentiated corporate governance segments of the Sao Paulo Stock Exchange (BM&FBovespa)–Novo Mercado, Nivel 2, and Nivel 1-- after three (3) years from the date the company's shares began trading on the respective differentiated corporate governance segment.

Rationale for Update:

The policy update is consistent with the current regulatory requirements of the Brazilian differentiated corporate governance listing segments (Novo Mercado, Nivel 2, and Nivel 1) adopted by the BM&FBovespa in 2010, which established the following:

No Accumulation of Positions. The offices of chairman of the board of directors and the chief executive officer or major executive officer of the Company shall not be accumulated in a single person, except in case of vacancy, in which event the circumstance will be disclosed to the market and action will be taken within the subsequent one hundred and eighty (180) days to fill in the positions.

However, accumulation of positions of chairman of the board of director and chief executive officer or major executive officer of the Company will be permitted on an exceptional and transitional basis for a maximum period of three (3) years starting from the date the Company shares begin to trade on the Novo Mercado, the Nivel 2 and Nivel 1.

Conflicts of Interest (Policy change applies to Americas Regional policy as well)

Current General Recommendation: Under extraordinary circumstances, vote against individual directors, members of a committee, or the entire board, due to:

- Material failures of governance, stewardship, risk oversight, or fiduciary responsibilities at the company;
- Failure to replace management as appropriate; or
- Egregious actions related to a director's service on other boards that raise substantial doubt about his or her ability to effectively oversee management and serve the best interests of shareholders at any company.

Key Changes:
Include the provision to recommend against an individual nominee, committee members, or the entire board in light of a conflict of interest that raises significant risk, which has not yet materialized (forward looking), in the absence of mitigating measures.

New General Recommendation: Under extraordinary circumstances, vote against individual directors, member(s) of a committee, or the entire board, due to:

- Material failures of governance, stewardship, risk oversight, or fiduciary responsibilities at the company;
- Failure to replace management as appropriate; or
- Egregious actions related to a director's service on other boards that raise substantial doubt about his or her ability to effectively oversee management and serve the best interests of shareholders at any company.

Vote against individual directors, members of a committee, or the entire board due to a conflict of interest that raises significant potential risk, in the absence of mitigating measures and/or procedures.

Rationale for Update:

The current policy framework refers to conflicts of interest that raise concern in specific transactions. The update addresses a conflict of interest that raises potential significant risk in terms of future possible actions or transactions that could be adverse to shareholders' interests, when the company does not disclose policies and procedures that would mitigate such risk.

COMPENSATION

Management Compensation

Current General Recommendation: Generally vote for management compensation proposals that are presented in a timely manner and include all disclosure elements required by the Brazilian Securities Regulator (CVM).

Vote against management compensation proposals when:

- The company fails to present a detailed remuneration proposal or the proposal lacks clarity; or
- The company does not disclose the total remuneration of its highest-paid executive; or
- The figure provided by the company for the total compensation of its highest-paid administrator is not inclusive of all elements of the executive's pay.

Key Changes:
Include a provision that a significant increase in the proposed remuneration cap on a year-over-year basis will trigger further scrutiny of the company's remuneration proposal, providing a framework for a more qualitative remuneration analysis.

New General Recommendation: Generally vote for management compensation proposals that are presented in a timely manner and include all disclosure elements required by the Brazilian Securities Regulator (CVM).

Vote against management compensation proposals when:

- The company fails to present a detailed remuneration proposal or the proposal lacks clarity; or
- The company does not disclose the total remuneration of its highest-paid executive; or
- The figure provided by the company for the total compensation of its highest-paid administrator is not inclusive of all elements of the executive's pay.

Vote case-by-case on global remuneration cap (or company's total remuneration estimate, as applicable) proposals that represent a significant increase of the amount approved at the previous AGM (year-over-year increase). When further scrutinizing year-over-year significant remuneration increases, jointly consider some or all of the following factors, as relevant:

- Whether there is a clearly stated and compelling rationale for the proposed increase;
- Whether the remuneration increase is aligned with the company's long-term performance and/or operational performance targets disclosed by the company;
- Whether the company has had positive TSR for the most recent one- and/or three-year periods;
- Whether the relation between fixed and variable executive pay adequately aligns compensation with the company's future performance.

Rationale for Update:

In Brazil, shareholders are asked to approve the aggregate remuneration of directors and executive officers annually through a binding resolution presented at a shareholder meeting. Regulatory changes implemented late 2009, effective as of January 2010 (Instructions 480 and 481), provided the framework of full disclosure of the proposed remuneration, including detailed information of executive remuneration (not individualized), which has now been in place for several years. While current policy has based recommendations solely on companies' compliance with the disclosure requirements, this update provides for a more qualitative analysis when a significant year-over-year increase signals that further scrutiny of remuneration practices is warranted.

Compensation Plans

Current General Recommendation: ISS will generally support reasonable equity pay plans that encourage long-term commitment and ownership by its recipients without posing significant risks to shareholder value.

Practically all of the plans presented since the implementation of the 2009 CVM guidelines have included reasonable dilution limits and adequate vesting conditions. Performance criteria, meanwhile, are rarely disclosed. ISS' assessments of these plans have generally hinged on the presence of discounted exercise prices (which are common in Brazil), particularly in the absence of specific performance criteria.

Vote against a stock option plan, or an amendment to the plan, if:

- The plan lacks a minimum vesting cycle of three years; and/or
- The plan permits options to be issued with an exercise price at a discount to the current market price, in the absence of explicitly stated, challenging performance hurdles related to the company's historical financial performance or the industry benchmarks; and/or
- The maximum dilution exceeds ISS guidelines of 5 percent of issued capital for a mature company and 10 percent for a growth company. However, ISS will support plans at mature companies with dilution levels up to 10 percent if the plan includes other positive features such as challenging performance criteria and meaningful vesting periods, as these features partially offset dilution concerns by reducing the likelihood that options will become exercisable unless there is a clear improvement in shareholder value; and/or
- Directors eligible to receive options under the scheme are involved in the administration of the plan.

Key Changes:
Reference restricted share plans to clarify that ISS will recommend against such plans based on the proposal of full-value shares (which essentially represent a 100-percent discount to market price) in the absence of publicly disclosed performance targets and hurdles.

New General Recommendation: ISS will generally support reasonable equity pay plans that encourage long-term commitment and ownership by its recipients without posing significant risks to shareholder value.

Practically all of the plans presented since the implementation of the 2009 CVM guidelines have included reasonable dilution limits and adequate vesting conditions. Performance criteria, meanwhile, are rarely disclosed. ISS' assessments of these plans have generally hinged on the presence of discounted exercise prices (which are common in Brazil), particularly in the absence of specific performance criteria.

Vote against a stock option plan and/or restricted share plan, or an amendment to the plan, if:

- The plan lacks a minimum vesting cycle of three years; and/or
- The plan permits options to be issued with an exercise price at a discount to the current market price, or permits restricted shares to be awarded (essentially shares with a 100 percent discount to market price), in the absence of explicitly stated, challenging performance hurdles related to the company's historical financial performance or the industry benchmarks; and/or
- The maximum dilution exceeds ISS guidelines of 5 percent of issued capital for a mature company and 10 percent for a growth company. However, ISS will support plans at mature companies with dilution levels up to 10 percent if the plan includes other positive features such as challenging performance criteria and meaningful vesting periods, as these features partially offset dilution concerns by reducing the likelihood that options will become exercisable unless there is a clear improvement in shareholder value; and/or
- Directors eligible to receive options under the scheme are involved in the administration of the plan.

Rationale for Update:

Currently, ISS Brazil policy does not address restricted share plans, only stock option plans, although the latter have been seen more frequently in the last couple of years. As such, this policy update includes specific reference to restricted share plans under the current policy framework already adopted for stock options plans.

The Global Leader In Corporate Governance

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U.S. Executive Compensation Policies

Frequently Asked Questions

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New/updated questions highlighted in yellow

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U.S. EXECUTIVE PAY OVERVIEW

1. Which named executive officers' total compensation data are shown in the Executive Pay Overview section?

The executive compensation section will generally reflect the same number of named executive officer's total compensation as disclosed in a company's proxy statement. However, if more than five named executive officers' total compensation has been disclosed, only five will be represented in the section: the CEO and the four highest paid executives. Current executives will take precedence over terminated executives (except that a terminated CEO whose total pay is within the top five will be included, since s/he was an executive officer within the past fiscal year).

2. There was a CEO transition in the last fiscal year. Which CEO's pay is shown in the report and used for the quantitative screen?

The quantitative pay-for-performance screen will generally use the CEO in office on the last day of the fiscal year; however, the longer tenured CEO may be displayed in some cases where the transition occurs very late in the year. Both CEOs' compensation may be evaluated in the qualitative review.

3. How is Total Compensation calculated?

Total Compensation = Base Salary + Bonus + Non-equity Incentive Plan Compensation + Stock Awards*+ Option Awards** (based on full grant date values, as calculated by ISS) + Change in Pension Value and Nonqualified Deferred Compensation Earnings + All Other Compensation. The calculation will generally match the Summary Compensation Table with the exception of the stock option value and/or stock awards, described further below.

*Stock Awards - Grant date value, generally as reported in the Grants of Plan-Based Awards Table for stock awards, but ISS may calculate values as deemed appropriate based on assessment of the grant. Note that performance shares (equity incentive plan awards) are generally calculated at target value (target # of shares X stock price on grant date).

**Option Awards - Grant date value of options using ISS' Black-Scholes option pricing model.

4. What inputs are used in ISS' Black-Scholes methodology?

Variable	Item	Source	Comments
C	Option Value	Calculated	
S	Stock Price	Proxy	
E	Exercise Price	Proxy	
σ	Volatility	XpressFeed	Historical three-year stock price volatility measured on a daily basis from the date of grant. If a company has not been publicly traded for at least three years, ISS measures volatility from the IPO date through grant date.

Q	Dividend Yield	XpressFeed	Average dividend yield over five years. If a company has not been publicly traded for at least five years, ISS averages dividend yield from the IPO date and the grant date of option. Dividend yield is based on each dividend divided by the closing stock price on the last business day before the dividend date. The calculation excludes the payouts of special dividends.
R	Risk Free Rate	Dept of Treasury website	U.S. Government Bond Yield on the date of grant corresponding to the term of the option. For example, if the option has a 10-year term, the risk free rate is the 10-year U.S. Government Bond Yield on the date of grant.
T	Term/Expected Life	Proxy	Full term of the option.
E	Base of Natural Logarithm	N/A	N/A
Ln	Natural Logarithm	N/A	N/A
N(x)	Cumulative Normal Distribution Function	N/A	N/A

5. How is the present value of all accumulated pensions calculated in the CEO Tally Sheet table?

This figure represents the aggregate amounts disclosed as the present value of the benefits for all pension plans (including qualified and non-qualified), as disclosed in the Pension Benefits table of the proxy statement.

6. How is the value of Non-Qualified Deferred Compensation calculated in the CEO Tally Sheet table?

This figure represents the sum of all deferred compensation values, as disclosed in the Non-Qualified Deferred Compensation table.

7. How are Potential Termination Payments calculated in the CEO Tally Sheet table?

The values for an involuntary termination without cause and a change in control related termination are provided as disclosed under the relevant termination scenario in the Change in Control Table and/or narrative of the proxy statement.

Financial Data: Total Shareholder Return and Revenue

8. Where does ISS obtain a company's 1-year fiscal total shareholder return, 3-year fiscal total shareholder return, and revenue?

ISS obtains all financial data in the Compensation Profile from Standard & Poor's Compustat and Research Insight. Here is a link to their data dictionary.

9. How does Compustat calculate a company's TSRs and financial/operational measures?

For information on how Compustat calculates TSR and financial/operational measures, such as revenue and net income, see the data dictionary.

10. Why does CEO pay as percent of revenue or net income show as "N/A"?

This will show as "N/A" when the company's revenue or net income is not greater than zero.

MANAGEMENT SAY ON PAY (MSOP) AND ISS' EXECUTIVE PAY EVALUATION

11. What is ISS' Executive Pay Evaluation policy?

The Executive Pay Evaluation policy consists of three primary areas: Pay for Performance, Problematic Pay Practices, and Compensation Committee Communication and Responsiveness. Recommendations issued under the Executive Pay Evaluation policy may apply to any or all of the following ballot items, depending on the pay issue (as detailed in the policy): Election of Directors (primarily compensation committee members), Advisory Votes on Compensation (management say on pay -- MSOP), and/or Equity Plan proposals in certain circumstances.

12. When may ISS' compensation-related recommendations affect director election vote recommendations?

In general, if a company has an MSOP resolution on the ballot, the compensation-related recommendations will be applied to that proposal; however, if egregious practices are identified, or if there are recurring problematic issues or responisveness concerns, ISS may also recommend withhold/against votes with respect to compensation committee members or, if appropriate, the full board. In addition, if there is no advisory pay vote on the ballot, any adverse recommendations related to executive compensation may apply to compensation committee members.

13. A company has not included a say on pay proposal on ballot without a valid exemption or has not presented the proposal in adherence with the company's previously adopted frequency. What action is warranted under ISS policy?

In the absence of clearly disclosed and compelling rationale, failure to adhere to the adopted say on pay frequency or failure to include the say on pay proposal on the ballot without a valid exemption may result in against or withhold recommendations against incumbent Compensation Committee members/chair or, in exceptional circumstances, the full board. While the SEC rule requires inclusion of say on pay proposals at least once every three calendar years, if the company's annual meeting date changes due to, for example, a change in fiscal year, or if the proposal is not presented at a meeting where shareholders may reasonably expect to see it for any other reason, companies should provide an explanation about the timing of the next say on pay resolution.

14. If one or more directors received a negative recommendation in the prior year due to ISS' concerns over compensation practices, will it have a bearing on the following year's recommendation?

The prior year recommendation is not a specific consideration in the following year's analysis, although the underlying concern may be. If one or more directors received less than 50 percent of shareholders' support (regardless whether it is a compensation issue), ISS may recommend that shareholders withhold from the entire board with the exception of new nominees if the company fails to take adequate action to respond to or remediate the issues raised in the previous report. If one or more directors received a high level of dissent (30 percent to 49.5 percent), the company should discuss any action or consideration taken to address the concern. A high level of dissent indicates an overall dissatisfaction and the board/committee should be responsive to shareholders' concerns. A lack of discussion or consideration, coupled with existing concerns may have a bearing on the following year's recommendation.

15. What impact might an identified pay for performance misalignment have on equity plan proposals?

If ISS identifies a significant pay-for-performance misalignment that results in an adverse recommendation on the say-on-pay proposal or compensation committee members, ISS may also recommend a vote against an equity plan proposal on the same ballot. Considerations in recommending against the equity plan include, but are not limited to:

- Severity of pay for performance misalignment;
- Whether problematic equity grant practices are driving the misalignment; and
- Whether equity plan awards have been heavily concentrated to the CEO and/or the other NEOs (as opposed to the plan being considered broad-based).

In determining whether the equity plan is broad-based, ISS examines the three-year average concentration ratio for equity awards made to the CEO and other NEOs. If the average concentration ratio exceeds 30% for the CEO (or 60% for all NEOs, including the CEO), this would indicate that the plan is not broad-based. Also see ISS' Equity Plan Scorecard FAQ.

Pay for Performance Evaluation

Please also see ISS' "Evaluating Pay for Performance Alignment" white paper for a detailed explanation of the quantitative methodology used in the first phase of this analysis, and a discussion of the qualitative factors considered.

16. How does ISS' quantitative pay for performance screen work?

The first step in ISS' evaluation of pay for performance has historically been a quantitative assessment of how well a company's CEO pay has been aligned with its shareholder returns. The current screen (which, as of 2015, applies to all S&P 500 and Russell 3000E Index companies, as well as selected additional companies that are widely held) identifies companies that demonstrate a significant level of misalignment between the CEO's pay and company TSR, either on an absolute basis or relative to a group of peers similar in size and industry (see below for more information about ISS peer groups). Three independent measures assess alignment over multiple time horizons. If any or a combination of these measures indicates a pay for performance misalignment, ISS performs an in-depth qualitative review of the company's pay programs and practices to ascertain likely causal factors, or mitigating factors, and a relevant vote recommendation. Note that all companies' pay programs and practices are evaluated.

17. What are the three quantitative screens?

The quantitative screens work as follows:

- Relative Degree of Alignment. This relative measure compares the percentile ranks of a company's CEO pay and TSR performance, relative to an industry-and-size derived comparison group, annualized for the prior three fiscal year periods. Specifically, CEO pay is averaged for the three-year period; annualized TSR is the geometric mean of the three fiscal year TSRs in the period.
- Multiple of Median. This relative measure expresses the prior year's CEO pay as a multiple of the median pay of its comparison group for the same period.
- Pay-TSR Alignment. This absolute measure compares the trends of the CEO's annual pay and the value of an investment in the company over the prior five-year period.

18. How does the initial quantitative pay for performance analysis affect the ultimate compensation-related vote recommendation?

The quantitative pay for performance analysis serves as an initial screen to identify cases that suggest there has been a significant misalignment of CEO pay and performance. An elevated concern from the quantitative screen results in a more in-depth initial qualitative review of the company's pay programs and practices to identify the probable causes of the misalignment and/or mitigating factors. We note that any company can receive an in-depth qualitative review, and all companies' pay programs and practices are evaluated.

However, a company with a Low quantitative concern level may still receive an in-depth qualitative review if deemed appropriate (for example, if the prior say-on-pay proposal received substantial shareholder opposition). While the quantitative screen indicates potential pay for performance outliers, the result of ISS' in-depth qualitative review is what ultimately determines the vote recommendation.

19. What are the factors that ISS considers in conducting the qualitative review of the pay for performance analysis?

Here are some of the key factors that ISS generally considers in conducting the qualitative review of the pay for performance analysis:

- The ratio of performance- to time-based equity awards;
- The overall ratio of performance-based compensation;

- The completeness of disclosure and rigor of performance goals;
- The company's peer group benchmarking practices;
- Actual results of financial/operational metrics, such as growth in revenue, profit, cash flow, etc., both absolute and relative to peers;
- Special circumstances related to, for example, a new CEO in the prior FY or anomalous equity grant practices (e.g., bi-annual awards);
- Realizable pay compared to granted pay; and
- Any other factors deemed relevant.

20. If a company received a "low" concern in the quantitative pay for performance model, will ISS still evaluate the company's incentive programs?

Yes, ISS reviews all companies' Compensation Discussion and Analysis and highlights noteworthy issues to investors regardless of the quantitative concern level. This qualitative evaluation, as well as any in-depth qualitative evaluation subsequent to the quantitative screens, is the most important part of the analysis. Problematic incentive designs such as multi-year guaranteed payments, discretionary pay components, inappropriate perquisites (including tax gross-ups) or lack of rigorous goals are generally addressed in the qualitative analysis and may result in a negative recommendation despite a "low" quantitative concern.

21. How does ISS use realizable pay in its analysis?

ISS' standard research report will generally show three-year realizable pay compared to the three-year granted pay for S&P 1500 companies. See the next question for ISS' definition of realizable pay and how it will be calculated.

Realizable pay may be discussed in the qualitative review. For S&P 1500 companies, we may utilize the realizable pay chart to see if realizable pay is higher or lower than granted pay (see related questions below) and further explore the underlying reasons. For example, is realizable pay lower than granted pay due to the lack of goal achievement in performance based awards, or simply due to a decline in stock price? Is realizable pay higher than granted pay due to above target payouts in performance based equity awards (and, if so, are the underlying goals sufficiently rigorous), or is the difference due to increasing stock price?

For all companies, ISS' consideration of realized and/or realizable pay is to assist in determining whether the company demonstrates a strong commitment to a pay for performance philosophy. The fact that realizable pay is lower, or higher, than granted pay will not necessarily obviate other strong indications that a company's compensation programs are not sufficiently tied to performance goals designed to enhance shareholder value over time. However, in the absence of such indications, realizable pay that demonstrates a pay for performance commitment will be a positive consideration.

22. How is Realizable Pay computed?

ISS' goal is to calculate an estimated amount of "realizable pay" for the CEOs of S&P 1500 companies. It includes the cash and benefit values actually paid, and the value of any amounts "realized" (i.e., exercised or earned due to satisfaction of performance goals) from incentive grants made during a specified measurement period*, based on their value as of the end of the measurement period. Equity grants made during the measurement period that remain on-going as of the end of the period (i.e., not yet earned or forfeited) will be revalued using the company's stock price at the end of the period. For periods that include multiple CEOs, the departed CEO's pay (excluding any grants forfeited) will be valued as of his/her termination date.

In short, realizable pay includes all non-incentive compensation amounts delivered during the measurement period, plus the value of equity or long-term cash incentive awards made during the period and either earned or, if the award remains on-going, revalued at target level as of the end of the measurement period. The total realizable value for these grants and payments will thus be the sum of the following:

- Base salary reported for all years in the measurement period;
- Bonus reported for all years;
- Short-term (typically annual) awards reported as Non-equity Incentive Plan Compensation for all years;
- For all prospective long-term cash awards made during the measurement period, the earned value of the award (if earned during the same measurement period) or its target value in the case of on-going award cycles;
- For all share-based awards made during the measurement period, the value (based on stock price as of the end of the measurement period) of awards made during the period (less any shares/units forfeited due to failure to meet performance criteria); or, if awards remain on-going, the target level of such awards;
- For stock options granted during the measurement period, the net value realized with respect to such granted options which were also exercised during the period; for options granted but not exercised during the measurement period, ISS will re-calculate the option value, using the Black-Scholes option pricing model, as of the end of the measurement period;
- Change in Pension Value and Nonqualified Deferred Compensation Earnings reported for all years; and
- All Other Compensation reported for all years.

*Generally three fiscal years, based on the company's fiscal year. For realizable pay calculated as part of ISS' 2016 analyses, this will generally consist of fiscal years 2013 through 2015.

Note that ISS' realizable pay amount will be based on a consistent approach, using information from company proxy disclosures. Since current SEC disclosure rules are designed to enumerate "grant-date" pay rather than realizable pay, these estimates will be based on ISS' best efforts to determine necessary inputs to the calculation. In cases where, for example, it is not sufficiently clear whether an applicable award has been earned or forfeited during a measurement period, ISS will use the target award level granted.

23. How does ISS calculate the "Granted Pay" that is compared to a CEO's "Realizable Pay"?

The CEO's "Granted Pay" presented in the "3-Year Granted vs. Realizable CEO pay" chart in ISS' reports is calculated as the sum of the following for the 3-year measurement period:

- Base salary reported for all years in the measurement period;
- Bonus reported for all years;

- Target short-term (typically annual) awards reported as Non-equity Incentive Plan Awards in the Grants of Plan-Based Awards table, for all years; if a target award is not determinable, none will be included;
- Target long-term cash awards made during the measurement period (as reported in the Grants of Plan-Based Awards table, or elsewhere in the CD&A);
- The grant-date value of all share-based awards made during the measurement period;
- For stock options granted during the measurement period, grant-date value is calculated by ISS using the Black-Scholes option pricing model, per ISS' standard stock option valuation methodology.
- Change in Pension Value and Nonqualified Deferred Compensation Earnings reported for all years; and
- All Other Compensation reported for all years.

24. Why doesn't ISS use the intrinsic value (exercise price minus current market price) of stock options when calculating realizable pay?

Top executives' stock options typically expire after seven to 10 years, meaning that even if an option is underwater in the first few years after its grant, there is a substantial likelihood it will ultimately deliver some value to the holder prior to expiration. Shareholders recognize that, in considering "realizable" pay as a pay for performance factor, it is important to include the economic value of underwater options (which will also reflect the impact of a lower stock price, if applicable).

25. A company would like to disclose ongoing and/or completed performance-based equity awards for awards made in the past three years. What type of disclosure format would ISS suggest?

Disclosure of ongoing or completed performance-based equity awards in a consistent manner would facilitate ISS' calculation of realizable pay (which is based on a best efforts extraction of necessary information from proxy statements). If a company has awarded performance-based equity awards in the past three years, disclosure of the awards in the following table would be helpful:

Grant Date	Threshold Payout (#)	Target Payout	Maximum Payout	Performance Period*	Target/Actual Earned Date	Actual Payout
3/1/2009	100,000	150,000	200,000	1 year	6/1/2010	180,000
3/1/2010	150,000	200,000	250,000	3 years	6/1/2012	Not determined yet

*Performance period does not include time-vesting requirement.

26. With respect to pay for performance alignment and realizable pay calculations, how will ISS treat CEOs who have not been in the position for three years?

The quantitative methodology will analyze total CEO pay for each year in the analysis without regard to whether all years are the same or different CEOs. If that analysis indicates significant pay for performance misalignment, the ensuing qualitative analysis may take into account any relevant factors related to a change in CEO during the period. However, given an apparent disconnect between performance and CEO pay, shareholders would expect the new CEO's pay package to be substantially performance-based.

For years when a company has more than one CEO, only one CEO's pay will be included to calculate granted pay (generally the CEO who was in the position at or near the end of the fiscal year) for purposes of the pay-for-performance quantitative screen. CEO base salary will be annualized.

With respect to realizable pay, ISS will include both pay packages and calculate the realizable amount, as of the end of the measurement period, of the Summary Compensation Table pay reported for the CEO in office on the last day of each fiscal year in the measurement period. Pay for a terminated CEO (including the value of unforfeited awards as if they were paid out on the last day of service or the end of the fiscal year, based on information in disclosures) will also be included in realizable pay.

27. How is three-year total shareholder return (TSR) calculated? How are "peaks and valleys" accounted for in the five-year analysis?

The Relative Degree of Alignment (RDA) measure uses annualized three-year TSR – i.e., the annualized rate of the three 12-month periods in the three-year measurement period (calculated as the geometric mean of the three TSRs). TSR reflects stock price appreciation plus the impact of reinvestment of dividends (and the compounding effect of dividends paid on reinvested dividends) for the period.

Under the absolute assessment, indexed TSR represents the value of a hypothetical $100 investment in the company, assuming reinvestment of dividends. The investment starts on the day five years prior to the month-end closest to the company's most recent fiscal year end, and is measured on the subsequent five anniversaries of that date. The Pay-TSR Alignment (PTA) measure (as outlined in the ISS "Evaluating Pay for Performance Alignment" white paper) is designed to account for the possibility of "bumps" in the overall trend.

28. What TSR time period will ISS use for the subject company and the peers in the Pay for Performance analysis? What about the compensation period?

TSRs for the subject company and all its peers are measured from the last day of the month closest to the subject company's fiscal year end. For example, if the subject company's fiscal year end is September 30, then the one-year and three-year TSRs for the subject company and its peers will be based on September 30. Compensation figures for all companies are as of the most recent available date.

29. For companies with meetings early in the year, whose latest year peer CEO pay has not yet been released, what pay data does ISS use?

ISS uses the latest compensation data available for the peer companies, some of which may be from the previous year. This circumstance is considered in any related qualitative review, as deemed relevant.

30. Do you include the subject company in the derivation of the peer group median? When you say 14 companies minimum for peers, does the 14 include the subject company?

No, neither the CEO pay nor the TSR of the subject company is included in the median calculation. The subject company is also not included in the minimum number of peer companies, which will generally be 14 (also see **Determining Peer Companies**, below).

31. If a company has not been publicly traded for at least three or five years, does the relevant quantitative pay for performance evaluation still apply? Does this affect whether a company would be used as a peer?

If the company has not been publicly traded for five fiscal years, the relative assessments, specifically the relative annualized three-year TSR pay and performance rank and the multiple of pay against the peer median, will still apply. If the company has been publicly traded for less than three years, the relative assessment will be based on as many complete years of annualized TSR and CEO pay data as is available. The company's limited life as a publicly traded company will also be considered as part of any qualitative evaluation.

Generally, only companies with three full years of data will be peer companies. In limited circumstances, a company with less than three years of data may be used when the quantitative evaluation focuses on only one year.

32. How does ISS take the year-over-year change in pension benefits value into account in assessing CEO pay?

ISS includes changes in pension value in our pay assessments because companies that do not offer supplemental defined benefit pensions (SERPs) to their top executives often provide for post-retirement compensation through larger grants of equity-based awards and thus could be disadvantaged in company-to-company pay comparisons if SERP-related compensation is omitted from the annual figures. Because ISS' quantitative analysis has a long-term orientation, pay anomalies caused by issues such as a single large increase in year-over-year pension accumulations (e.g., due to interest rate changes) should not have a significant impact on the results. However, such anomalies are considered in the qualitative evaluation.

33. What actions can the company take to address concerns when ISS has issued an adverse recommendation on the basis of a pay for performance disconnect?

The pay for performance evaluation is a case-by-case analysis, and actions intended to address concerns should be tailored according to the underlying issues identified in the pay for performance disconnect. Prospective commitments to increase the proportion of performance-based pay in the future will not adequately address concerns; adjustment to recent awards to strengthen their performance linkage may be considered, however. As an example, if the primary source of a pay increase is due to time-vested equity awards, a remedy could be for the company to make a substantial portion (i.e. at least 50 percent) of such equity awards to named executive officers performance-based.

Any pay for performance action(s) should be disclosed in a public filing, such as a Form 8-K or DEFA 14A. Based on the additional disclosure, ISS may change its vote recommendation if the company's actions sufficiently remedy the pay for performance disconnect. However, ISS' recommendation will depend on the company providing compelling and sufficient evidence of action to strengthen the performance-linkage to its executives' compensation and comprehensive additional disclosure.

34. When will ISS consider equity awards to be performance-based?

The company should disclose the details of the performance metric(s) (e.g., return on equity) and the associated goals (e.g., 15 percent) associated with the performance awards at the time they are made. From this disclosure, shareholders will know the minimum level of performance required for any equity grants to be earned. In this context, strongly performance-based equity awards do not include standard time-based stock options or performance-accelerated grants. Instead, performance-based equity awards are performance-contingent grants, where the individual will not receive the equity grant if the performance goal is unmet. Premium-priced options must have a meaningful premium in order to be considered strongly performance-based. If option vesting is contingent on the stock reaching a specified price, the price condition should be maintained for at least 30 consecutive trading days before vesting in order for the grant to be considered strongly performance-based.

In order for shareholders to assess the rigor of performance-based bonus and equity programs, the company needs to disclose the performance measures and goals. To ensure complete and transparent disclosure, the company should disclose the following:

1. the measures(s) used (and rationale for the selections);
2. the goal(s) that were set for each metric and the target (and, if relevant, threshold and maximum) payout level(s) set for each NEO;
3. the reason that each goal was determined to be appropriate for incentive pay purposes (including the expected difficulty of attaining each goal);
4. the actual results achieved with respect to each goal; and
5. the resulting award (or award portion) paid (or payable) to the NEO with respect to each goal.

35. Will ISS take into account the timing of equity grants (such as for grants made subsequent to the applicable performance year) when conducting its pay for performance evaluation?

Grant timing issue can be problematic for investors evaluating the relationship between performance and pay. The value of equity grants generally represents a significant proportion of top executives' pay; if the grants are made subsequent to the "performance year," disclosures in the Grants of Plan-Based Awards Table may distort the pay for performance link.

Some investors believe that equity awards can incentivize and retain executives for past and future performance; therefore, adjustments for such timing issues may not be relevant. In addition, ISS' pay for performance analysis has a long-term orientation, where these types of timing issues are less relevant than in an evaluation of one year's pay. Nevertheless, ISS may consider the timing of equity awards made early in a fiscal year in its qualitative assessment if complete disclosure and discussion is made in the proxy statement.

In order to ensure that pay for performance alignment is perceived, the company should discuss the specific pre-established performance measures and goals that resulted in equity awards made early in the next fiscal year. A general reference to last year's performance is not considered sufficient and meaningful to shareholders. If the company makes equity grants early in each year, based on the prior year's specific performance achievement, shareholders should not be required to search for the information in Form 4s and compute the adjusted total compensation for the top executives in order to make a year-over-year comparison. Instead, companies should provide information about grants made in relation to the most recently completed fiscal year in the proxy statement for the shareholder meeting that follows that fiscal year (aligned with other compensation reported for that year). Many companies provide an alternate summary compensation table that takes into account the recent equity awards made in the current fiscal year. The number of options or stock awards with the relevant exercise price or grant price should be disclosed in the proxy statement. The term of the options should be provided as well. In order for ISS to compute the adjusted total compensation and include it for purposes of our narrative discussion and analysis, companies need to make transparent and complete disclosure in the proxy statement; ISS will not search for the companies' Form 4 filings to make such adjustments but will rely on the specific grant disclosures found in the proxy statement.

36. A company grants time-vesting equity awards that were contingent on meeting specific performance criteria. Does ISS consider such awards to be performance-conditioned?

ISS will generally consider such awards to be performance-conditioned if the performance measures and goals were pre-established and are disclosed in the proxy statement.

37. How does ISS capture transition period compensation?

Disclosure of transition period compensation varies across companies; therefore, ISS does not apply a standardized methodology in all cases. When transition periods represent an extension of a recently completed fiscal year (until the start of a new fiscal year period), ISS will generally include transition period pay as part of the most recently completed fiscal year pay. Cash pay components such as base salary and bonus will be annualized and equity pay components will be added, subject to a company-specific case by case review.

38. Which companies are subject to ISS quantitative pay-for-performance screens?

At a minimum, all companies in the S&P500 and Russell 3000E indexes.

39. How does ISS evaluate pay-for-performance alignment at companies for which pay data is not analyzed in the quantitative screens?

For companies outside the Russell 3000E Index (which includes all companies in the Russell 3000 and Russell Microcap indexes), ISS reviews the CD&A, including the Summary Compensation Table and other compensation tables, to assess the level of NEOs' pay relative to internal standards developed to identify potential egregious pay levels and problematic compensation practices (similar to the Problematic Pay Practices component of the Executive Pay Evaluation Policy). If that evaluation does not identify any significant concerns, the ISS research report indicates that (and notes any items that shareholders may nevertheless wish to consider). If significant concerns are identified, the ISS analysis addresses them to determine whether or not the situation warrants an adverse recommendation.

Determining Peer Companies

40. How does ISS select constituents for the peer groups used in its pay for performance analysis?

ISS' methodology for selecting peers maintains a focus on identifying companies that are reasonably similar to the subject company in terms of industry profile, size, and market capitalization, taking into account a company's self-selected peers to guide industry selections. This peer group is used with respect to two of the three quantitative pay-for-performance screens that may trigger and in-depth review and analysis of a company's pay program in connection with say on pay evaluations.

ISS' selected peer group generally contains a minimum of 14 (and always at least 12) and maximum of 24 companies, based on the following factors:

1) The GICS industry classification of the target company
2) The GICS industry classifications of the company's disclosed CEO pay benchmarking peers
3) Size constraints for both revenue (or assets for certain financial companies) and market value.

Subject to the size constraints, and while choosing companies that push the subject company's size closer to the median of the peer group, peers are selected from a potential peer universe in the following order:

1. from the subject's own 8-digit GICS group
2. from the subject's peers' 8-digit GICS groups
3. from the subject's 6-digit GICS group
4. from the subject's peers' 6-digit GICS groups
5. from the subject's 4-digit GICS group

When choosing peers, priority is given to potential peers within the subject's "first-degree" peer group (the companies that are either in the subject's own peer group, or that have chosen the subject as a peer), and companies with numerous connections (by choosing as peer or being chosen as a peer) to these first-degree peers. All other considerations being equal, peers closer in size are preferred.

41. Will a company's self-selected peers always appear in the ISS peer group, if they meet ISS' size constraints?

Not necessarily. While the methodology does place a priority on the company's own peer selections, there are a number of reasons why a company selected peer may not appear in the final ISS list, even if it meets the relevant size (revenue or assets and market capitalization) parameters. As noted above, the methodology also places priority on other factors as it builds the peer group:

- The company's own 8-digit GICS category
- Maintaining the subject company size at or near the median of its peer group
- Maintaining the approximate distribution of GICS industry codes as reflected in the company's self-selected peer group

At times, including a company's self-selected peer may push the subject company away from the median, or lead to an overrepresentation of that industry within the final peer group. In these cases the company's self-selected peer may not be included. In addition, if a company's self-selected peer is the only peer company in its 6- and 8-digit GICS category, that industry grouping will not be utilized in the peer selection process (since the company may have selected that peer solely due to geographic proximity, for example).

42. What are ISS' size parameters for qualifying a potential peer?

ISS applies two size constraints to qualify potential peers:

1. Revenue (or assets for certain financial companies or market capitalization for certain oil & gas companies, as described in the following question below)
   In general, peers should fall in the range of 0.4 to 2.5 times the company's revenue (or assets). These ranges are expanded when the subject company's revenue is larger than $5 billion or smaller than $200 million in revenue (assets). Companies smaller than $100 million in revenue (assets) are treated as if they have $100 million in revenue (assets).

2. Market capitalization (in millions)

   Companies are classified into market capitalization buckets as follows:

Bucket	Low end	High end
Micro	0	200
Small	200	1,000
Mid	1,000	10,000
Large	10,000	No cap

   While ISS may choose peers that fall outside a subject company's market cap bucket if necessary to reach a minimum peer group size, none may have a market cap of less than 0.25 times the low end or more than 4 times the high end of the subject's market capitalization bucket.

43. Which industry groups will not use revenue for size comparisons? What happens when a company has potential peers in industry groups measured by different size metrics?

ISS will use balance sheet assets (rather than revenue) to measure the size of companies in the following 8-digit GICS groups:

- 40101010 Commercial Banks
- 40101015 Regional Banks
- 40102010 Thrifts + mortgage
- 40202010 Consumer Finance
- 40201020 Other diversified

Additionally, ISS will use market cap rather than revenue to qualify peers for companies within these GICS groups:

- 10102010 Integrated Oil & Gas

- 10102020 Oil & Gas Exploration & Production
- 10102030 Oil & Gas Refining & Marketing
- 10102040 Oil & Gas Storage & Transportation
- 10102050 Coal & Consumable Fuels

Both subject and potential peer must be in the asset- or market cap-based GICS groups listed above in order to be compared on the basis of assets or market cap, as applicable. In cases where a subject company is in one of the asset- or market cap-based GICS groups and a potential peer is not, revenues will be used for size comparisons. This principle applies to the size comparisons made to qualify a peer for potential inclusion as a peer, to the size rankings made to maintain the subject company near the median size of the peer group, and to the size prioritization of peers.

In addition, as deemed appropriate by ISS, additional 8-digit GICS categories may be determined to utilize assets and/or market cap to identify peers.

44. When will a company's peer group have more than 14 members?

In general, the closer the industry match, the larger the subject size of the peer group: for direct matches to the company's own 8-digit GICS with respect to all potential peers, as many as 24 peers may be chosen. For matches that include the company's peers' 8-digit GICS, as many as 18 peers may be chosen, falling to a maximum of 14 peers when peers are selected solely from the company's 4-digit GICS. In all cases, however, additional peers may be selected in order to bring the target company's size closer to the median of the peers or to enhance the consistency of the pay-for-performance screens using these peer groups.

45. If the standard methodology fails to yield the minimum number of acceptable peers, what peer group will be used?

In cases where the standard methodology does not provide a sufficient number of peers, ISS will supplement those peer groups according to the principles above, generally by relaxing size parameters while maintaining the subject company at or near the median size. In selected cases, ISS may also relax industry group constraints.

In exceptional cases, the ISS peer group may contain a minimum of 12 constituents.

46. How does ISS treat foreign-domiciled or privately-held company peers?

ISS uses all company peers to identify relevant GICS industry groups, if industry data is readily available. Foreign-domiciled companies that file Def14A, 10-Qs, and 10-Ks may be included as ISS selected peers. Privately-held or other foreign-domiciled companies that do not make such filings are not included as ISS selected peers, although their GICS classifications may be utilized to select alternative peers whose data is publicly available.

47. If a company used multiple peer benchmarking groups, which group will ISS use as an input to the process? What does ISS do if a company does not employ a peer group for benchmarking?

ISS uses the company peer group that is used for CEO pay benchmarking purposes. If there is no peer group employed, the peer methodology will draw peers from the company's own 8-, 6- and 4-digit GICS groups, subject to ISS' size constraints.

48. Does ISS apply additional judgment in the process of building peer groups?

ISS generally does not adjust peer groups that are generated from the standard methodology and have the requisite minimum number of constituents. In exceptional circumstances, where a peer group appears to have inappropriate constituents at the time of our analysis, limited adjustments may be made, following the basic principles of the methodology: peers should come from similar industries and be of similar size, and company peers will be prioritized where possible.

49. When will ISS reconstruct peer groups?

Company peer groups are reconstructed during December and early January, effective for meetings as of the following February 1. A subsequent peer group construction will occur in July and August, after the Russell 3000 index is updated in July, to be in place for research in process as of September 15 (generally affecting companies that have filed DEF14As after mid-August).

50. What opportunities will companies have to communicate changes made to their benchmarking peer groups following their more recent proxy disclosures?

In December, ISS provides companies a "peer update" opportunity to communicate changes made to their benchmarking peer groups following their most recent proxy diclosures. For companies with later fiscal year-end dates (approximately September 15 through the following January), ISS provides a similar peer update opportunity after proxy season, prior to reconstruction of its peer groups per above. During the update process, companies should inform ISS of updates to the peer groups they used to benchmark executive compensation that will be reported in their upcoming proxy statements (not to benchmark the upcoming year's pay).

Companies that do not participate in the ISS peer update process will continue to have their most recently disclosed compensation peers used in the ISS peer group construction process.

51. What companies can be used as peer companies? Will ISS use companies that an issuer considers as peers (specified in the proxy) to develop the ISS comparator group?

If a company discloses the names of public companies that it uses as its peers, ISS will collect the data on them even if they are not in the index of companies that are screened through ISS' quantitative pay-for-performance model (the Russell 3000E index). If these companies fit ISS' criteria for peers, then they may be used as ISS peers as of the next update of ISS peer groups.

52. What are GICS codes? Who can I contact if I disagree with the GICS classification?

The Global Industry Classification Standard (GICS) was developed by Standard & Poor's and MSCI in response to the financial community's need for a reliable, complete (global) standard industry classification system. GICS codes correspond to various business or industrial activities, such as Oil & Gas Drilling or Wireless Telecommunication Services. GICS is based upon a classification of economic sectors, which is further subdivided into a hierarchy of industry groups, industries and sub-industries. The GICS methodology is widely accepted as the industry analysis framework for investment research, portfolio management, and asset allocation.

ISS does not classify companies into the GICS codes. Please contact Standard & Poor's at 1-800-523-4534 if you believe that a company has been misclassified.

53. Are the same peer companies that are used for the pay-for-performance analysis also used to calculate a company's Shareholder Value Transfer Benchmark related to an equity plan proposal?

No, the list of companies shown in the executive compensation section is not the same peer group used in calculating a company's SVT Benchmark. The peer group used for benchmarking executive pay is based on a combination of industry and size (revenue/assets and market cap); the peer group used for creating the SVT Benchmark for stock compensation plan proposals is based on 4-digit GICS industry groups, with adjustments for market cap size.

54. How are peer medians calculated for the Components of Pay table?

The median is separately calculated for each component of pay and for the total annual compensation. For this reason, the median *total compensation* (TC) of the peer CEOs will not equal the sum of all the peer median pay components, because the values are calculated separately for each pay component; the median TC reflects the median of TC of the peer group constituents.

Problematic Pay Practices/Commitments on Problematic Pay Practices

55. What is ISS' Problematic Pay Practices evaluation?

Pay elements that are not directly based on performance are generally evaluated on a CASE-BY-CASE basis considering the context of a company's overall pay program and demonstrated pay for performance philosophy. Based on input from client surveys and roundtables, ISS has identified certain practices that are contrary to a performance-based pay philosophy, which are highlighted in the list below. ISS evaluates these practices on a case-by-case basis, considering the facts and circumstances disclosed, in determining whether any extraordinary perks or benefits are a poor use of company assets which could also have other detrimental effects (e.g., creating or contributing to an “imperial CEO” culture).

- Egregious employment contracts:
  - Contracts containing multi-year guarantees for salary increases, non-performance based bonuses, or equity compensation.
- New CEO with overly generous new-hire package:

  - Excessive "make whole" provisions without sufficient rationale;
  - Problematic termination-related equity vesting provisions;
  - Any of the problematic pay practices listed in this policy.
- Abnormally large bonus payouts without justifiable performance linkage or proper disclosure:
  - Includes performance metrics that are changed, canceled, or replaced during the performance period without adequate explanation of the action and the link to performance
- Egregious pension/SERP (supplemental executive retirement plan) payouts:
  - Inclusion of additional years of service not worked that result in significant benefits provided in new arrangements
  - Inclusion of performance-based equity or other long-term awards in the pension calculation
- Excessive Perquisites:
  - Perquisites for former and/or retired executives, such as lifetime benefits, car allowances, personal use of corporate aircraft, or other inappropriate arrangements
  - Extraordinary relocation benefits (including any home loss buyouts)
  - Excessive amounts of perquisites compensation
- Excessive severance and/or change in control provisions:
  - Change in control cash payments exceeding 3 times base salary plus target/average/most recent bonus;
  - New or materially amended arrangements that provide for change-in-control payments without loss of job or substantial diminution of job duties (single-triggered or modified single-triggered, where an executive may voluntarily leave for any reason and still receive the change-in-control severance package);
  - New or materially amended employment or severance agreements that provide for an excise tax gross-up. Modified gross-ups would be treated in the same manner as full gross-ups;
  - Excessive payments upon an executive's termination in connection with performance failure;
  - Liberal change in control definition in individual contracts or equity plans which could result in payments to executives without an actual change in control occurring
- Tax Reimbursements: Excessive reimbursement of income taxes on executive perquisites or other payments (e.g., related to personal use of corporate aircraft, executive life insurance, bonus, restricted stock vesting, secular trusts, etc; see also excise tax gross-ups above)
- Dividends or dividend equivalents paid on unvested performance shares or units.
- Internal pay disparity: Excessive differential between CEO total pay and that of next highest-paid named executive officer (NEO)
- Repricing or replacing of underwater stock options/stock appreciation rights without prior shareholder approval (including cash buyouts, option exchanges, and certain voluntary surrender of underwater options where shares surrendered may subsequently be re-granted).
- Other pay practices that may be deemed problematic in a given circumstance but are not covered in the above categories.

56. Which problematic practices are most likely to result in an adverse recommendation?

The list below highlights the problematic practices that carry significant weight and will likely result in adverse vote recommendations:

- Repricing or replacing of underwater stock options/SARs without prior shareholder approval (including cash buyouts and voluntary surrender of underwater options);
- Excessive perquisites or tax gross-ups, potentially including any gross-up related to a secular trust or restricted stock vesting, and home loss buyouts;
- New or extended executive agreements that provide for:
  - CIC payments exceeding 3 times base salary and average/target/most recent bonus;
  - CIC severance payments without involuntary job loss or substantial diminution of duties ("single" or "modified single" triggers);
  - CIC payments with excise tax gross-ups (including "modified" gross-ups).

57. How does ISS view hedging or significant pledging of company stock by an executive or director?

Hedging is a strategy to offset or reduce the risk of price fluctuations for an asset or equity. Stock-based compensation or open market purchases of company stock should serve to align executives' or directors' interests with shareholders. Therefore, hedging of company stock through covered call, collar or other derivative transactions sever the ultimate alignment with shareholders' interests. Any amount of hedging by a company insider will be considered a problematic practice warranting a negative vote recommendation against appropriate board members.

Significant levels of pledging of company stock – regardless of whether the shares were obtained through compensation programs or whether the pledged shares exclude the number of shares required to be held under a company's stock ownership guidelines – also may raise risks for the company's stock price or for violation of insider trading restrictions. Please see the FAQ on Policies & Procedures – Board Accountability for more insight on ISS policy in this regard.

58. Does the presence of single trigger vesting acceleration in an equity plan result in an automatic against recommendation for the plan, the say on pay vote, the entire compensation committee, or the full board?

With regard to equity-based compensation, ISS policy encourages “double trigger” vesting of awards after a CIC (considered best practice), although recommendations are determined case-by-case, considering all aspects of company programs.

In the absence of double-triggered vesting, the current preferred practice is for the board to have flexibility to determine the best outcome for shareholders (e.g., to arrange for outstanding grants to be assumed, converted, or substituted), rather than the plan providing for *automatic* accelerated vesting upon a CIC.

Equity plans or arrangements that include a liberal CIC definition (such as a very low buyout threshold or a CIC occurring upon shareholder approval of a transaction, rather than its consummation), coupled with a provision for automatic full vesting upon a CIC, are likely to receive a negative recommendation. Also see the Equity Compensation Plans FAQ.

59. What level of compensation disclosure by externally-managed issuers (EMIs) would be sufficient to enable a reasonable assessment of pay programs to

make an informed say-on-pay vote and avoid an adverse say-on-pay recommendation?

Although EMIs are required to present a say-on-pay vote, most EMIs provide little, if any, disclosure regarding the compensation arrangements between their executive officers and the external manager. Based on ISS' review of EMI compensation disclosure, most EMIs provide only the aggregate management and incentive fees paid to the manager. Without more information, shareholders are unable to make a reasonable assessment of pay programs and practices applicable to the EMI's executives, and therefore are unable to cast an informed say-on-pay vote. In assessing whether an EMI has provided sufficient compensation disclosure to allow for an informed say-on-pay vote, ISS will look for all of the following disclosures:

- The portion of the EMI's management fee that is allocated to NEO compensation paid by the external manager (aggregated values for all NEOs is acceptable);
- Of this compensation, the breakdown of fixed vs. variable/incentive pay; and
- The metrics utilized to measure performance to determine NEOs' variable/incentive pay.

While the above does not represent a complete picture of executive compensation, it represents the minimum disclosure necessary to enable shareholders to reasonably evaluate pay arrangements between the EMI's executives and the external manager. Absent this disclosure, ISS will generally recommend against the EMI's say-on-pay proposal.

60. After incentive awards were earned below target, a company granted special retention awards to executives. How would ISS view such awards?

Investors do not expect boards to reward executives when performance goals are not achieved, whether by "moving the goalposts" (i.e., lowering goals) or granting other awards to compensate for the absent incentive payouts. They recognize, however, that retention of key talent may be critical to performance improvements and future shareholder value. Companies that grant special retention awards of cash or equity to executives when regular incentive plan goals are not met should provide clear and compelling rationale in their proxy disclosure. Awards should be conservative and reflect the fact that performance is lagging (i.e., should generally be significantly less than unearned target award levels). Optimally, "extra" awards designed to encourage retention should not be a regular occurrence and should also include performance conditions that will ensure strong alignment of pay and performance going forward and avoid "pay for failure" scenarios if the executive is not retained.

61. How will ISS evaluate problematic pay practices relating to agreements or decisions in the current fiscal year as opposed to those from the most recently completed fiscal year?

For problematic provisions (excise tax gross-ups, single-trigger severance, etc.) contained in a new/materially amended executive agreement, ISS will generally issue an adverse recommendation when such provisions are disclosed by the company, even if the problematic agreement was entered into or amended after the most recent fiscal year end. For example, if a company with a calendar fiscal year discloses a new problematic agreement entered into in February following the FYend, ISS will generally recommend against the current say-on-pay proposal.

However, in certain cases ISS may wait to further evaluate the problematic issue in the following year, when our analysis could be informed by additional information that would be disclosed in the following year's proxy statement. For example, ISS may wait until the following year in the case of a potentially problematic equity grant to a new CEO hired in February after the FYend, in order to evaluate the grant in the context of the new CEO's total pay as disclosed in the following year's proxy statement.

62. While guaranteed multi-year awards are problematic, is providing a guaranteed target pay opportunity for what ISS considers a performance-based vehicle acceptable?

While guaranteeing any executive pay elements (outside of salary and standard benefits) is not considered best practice, if the payout of such an award ultimately depends on the attainment of rigorous performance goals (i.e., no payout would occur if performance is below a specified standard), this would generally mitigate concerns about the guaranteed award opportunity.

63. How will ISS view existing/legacy problematic provisions in executive agreements?

While maintaining problematic provisions in legacy arrangements (i.e. agreements not entered into or amended in the most recently completed fiscal year) is not considered a best practice, such legacy arrangements generally will not on their own result in an adverse vote recommendation. However, legacy problematic provisions will be considered as part of the holistic analysis, and they should be removed whenever the agreement is amended or extended (see related questions below).

64. Are material amendments other than extensions of existing contracts a trigger for analysis with respect to problematic existing contract provisions?

Shareholders are concerned with the perpetuation of problematic practices; thus, new or recently amended agreements will face the highest scrutiny and weight in ISS' analysis. Any material amendments to such agreements will be considered an opportunity for the board to fix problematic issues.

65. Would a legacy employment agreement that is automatically extended (e.g., has an evergreen feature) but is not otherwise amended warrant an adverse vote recommendation if it contains a problematic pay practice?

Automatically renewing/extending agreements (including agreements that do not specify any term) are not considered a best practice, and existence of a problematic practice in such a contract is a concern. However, if an "evergreen" employment agreement is not materially amended in manner contrary to shareholder interests, it will be evaluated on a holistic basis, considering a company’s other compensation practices along with features in the existing agreement.

66. What if a problematic pay practice is contained under a separate plan or agreement that runs indefinitely, but an executive has a separate employment agreement that is extended or modified?

The policy relevant for "new or extended executive agreements" applies to any and all agreements or plans under which the executive whose contract is being modified is covered. In other words, ISS may view the modification to an employment agreement as also being a modification or extension of the executive's separate severance and/or CIC arrangement. Alternatively, the modification to the employment agreement should include a removal of the executive's entitlement to the problematic pay practice under the separate agreement.

67. If a company put a problematic pay practice provision in new or modified agreements in the last fiscal year, what action can they take to prevent an adverse recommendation from ISS?

The company can remove that provision from the new agreements and disclose this action in the proxy statement.

Frequency of Advisory Vote on Executive Compensation

68. In the event that a company's board decides not to adopt the say on pay vote frequency supported by a plurality of the votes cast, what are the implications in terms of ISS' voting recommendations at subsequent meetings?

If the board adopts a longer frequency for say-on-pay votes than approved by a plurality of shareholder votes, ISS will make a case-by-case recommendation, considering the following:

› The board's rationale for choosing a frequency that is different from the frequency which received a plurality;
› The company's ownership structure;
› ISS' analysis of the company's executive compensation and whether there are compensation concerns or a history of problematic compensation practices; and
› The previous year's support level on the company's say-on-pay proposal.

Advisory Vote on Golden Parachutes (SOGP)

69. If a truncated performance period is used when accelerating awards in a CIC, how would ISS determine whether the performance goals would not have been achieved had no CIC transaction occurred?

Best practice is pro rata vesting for actual achievement levels during a partial performance period. If it is impossible to measure performance under pre-determined performance criteria the board should justify paying an award as if target or highest performance goals were met.

70. How does ISS determine whether specified golden parachute payouts are "excessive"?

In evaluating disclosed payouts related to a change in control with respect to the SOGP proposal, ISS may consider a variety of factors, including the value of the payout on an absolute basis (e.g., relative to an executive's annual compensation) or one or total payouts relative to the transaction's equity value. There are no bright line thresholds for these considerations, since they are made in conjunction with other factors in ISS' review.

71. How will ISS consider existing problematic change-in-control severance features in its SOGP evaluation?

ISS considers both new and existing problematic features and practices. Recent amendments that incorporate problematic features will tend to carry more weight on the overall analysis. However, the presence of multiple legacy problematic features will also be closely scrutinized.

The questions and answers in this FAQ are intended to provide general guidance regarding the way in which ISS' Global Research Department will analyze certain issues in the context of preparing proxy analyses and determining vote recommendations for U.S. companies. However, these responses should not be construed as a guarantee as to how ISS' Global Research Department will apply its benchmark policy in any particular situation.

The Global Leader In Corporate Governance

www.issgovernance.com

American Assets Trust, Inc.
11455 El Camino Real, Suite 200
San Diego, CA 92130

Via EDGAR and Fed-Ex

July 13, 2015

Securities and Exchange Commission
Division of Corporation Finance
100 F Street, N.E.
Washington, D.C. 20549

Attention: Jennifer Monick, Staff Accountant
Mark Rakip, Staff Accountant

Re: American Assets Trust, Inc.
Form 10-K
Filed February 20, 2015
File No 1-35030

Dear Ms. Monick and Mr. Rakip:

The purpose of this letter is to respond to the comments of the Division of Corporation Finance of the Securities and Exchange Commission (the "Commission"), received by email on July 6, 2015 (the "Comment Letter"), with respect to the American Assets Trust, Inc. (the "Company") Form 10-K filed February 20, 2015 (the "2014 Form 10-K"). For ease of review, we have set forth below each of the numbered comments of the Comment Letter and the Company's responses thereto. All page numbers and captions in the responses below refer to the 2014 Form 10-K, except as otherwise noted below.

General

1. **Please tell us how you determined it is appropriate to provide combined periodic reports for parent and subsidiary registrants given that you owned approximately 70.9% of your operating partnership at March 31, 2015.**

   Response: The Company advises the Staff that it has assessed the appropriateness of combining periodic reports for parent (American Assets Trust, Inc. ("REIT")) and subsidiary (American Assets Trust, L.P. ("OP")) registrants for purposes of reporting under the Securities Exchange Act of 1934. We have concluded that the REIT owns substantially all of the OP, there are nominal differences between the financial statements of the REIT and OP and the non-financial disclosures of the REIT and the OP are substantially similar as described below and in our Explanatory Notes in our 2014 Form 10-K and March 31, 2015 Form 10-Q.

Furthermore, the REIT is the sole general partner of the OP and, in addition to owning the general partner interest, owned an approximate 70.9% limited partner interest in the OP at March 31, 2015. The REIT and the OP are structured to achieve economic parity between a common share of beneficial interest of the REIT and a common unit of limited partnership interest of the OP. Whenever the REIT issues common shares, the OP issues an equal number of common units to the REIT at the same price for which the common shares were sold. All of the REIT's operating activities are conducted through the OP and the OP's subsidiaries and the OP reimburses the REIT for any operating expenses (e.g., taxes and any expenses associated with the REIT's equity capital raising activities). As such, the REIT is in effect a holding company; the only assets of which are its equity interests in the OP. As the sole general partner of the OP, the REIT is exclusively vested with managerial control and authority over the business and affairs of the OP. Accordingly, the REIT's financial statements include the OP and the OP's subsidiaries. Because the REIT conducts no business operations other than through the OP and the OP's subsidiaries, the REIT's financial statements are substantially the same as the financial statements of the OP (with the most notable difference being the fact that the OP also has outside minority unitholders).

Since the overwhelming majority of the information included in the REIT's and OP's periodic reports is the same due to the organizational structure described above, we concluded that filing combined periodic reports, where possible, would significantly reduce internal costs and expenses associated with the preparation of largely duplicative reports and eliminate the risk of inadvertent or unintentional errors that could result from the process of generating two reports. Given that the users of the OP financial statements need both entities' financial statements to understand the performance of their investment given its convertible nature, we also believe the use of one report minimizes redundancy and disclosure overload. Moreover, we believe that combining the disclosure - where appropriate - helps convey the manner in which the operations and activities of the REIT and the OP are interrelated for the purposes of the REIT shareholders and OP unit holders. For this reason, we believe that a combined presentation is beneficial to an investors' understanding of the business and financial condition of and relationship between the two entities.

Additionally, the 2014 Form 10-K filing was the first presentation of combined periodic reports of the REIT and OP. The Company voluntarily began filing combined periodic reports effective as of December 31, 2014, and for all years presented, in anticipation of the OP potentially becoming a required filer. As of the date of our response, the OP is not a required filer and it does not appear probable that it will be a required filer in 2015.

American Assets Trust, L.P.

Consolidated Statements of Comprehensive Income, page F-10

2. **Please tell us why your operating partnership has adjusted for net income attributable to unitholders in the Operating Partnership in amounts equal to those applicable to American Assets Trust, Inc. In your response, please also address why you have not included the adjustment for net income attributable to unitholders in the Operating Partnership in your operating partnership’s consolidated statements of comprehensive income for the interim period ended March 31, 2015.**

Response: In preparing the American Assets Trust, L.P. financial statements for the first time, we started with the American Assets Trust, Inc. financial statements because as noted above the assets, liabilities, revenues and expenses are identical and the earnings per share/units of the REIT and the OP are designed to have parity on a per share/unit basis. Due to the fact that the financial statement accounts and numbers are identical, the REIT financial statements only required changes in titles, labels and minor reformatting. During the activity of changing titles, labels and reformatting, we inadvertently did not delete the row titled "Net income attributable to unitholders in the Operating Partnership" and also neglected to update the weighted average shares of common stock outstanding - basic. This was a clerical oversight. Following the receipt of the Staff's comment, we have determined that none of the other financial information within the Form 10-K and specifically the American Assets Trust, L.P. financial statements are impacted by the clerical error. As you noted in your comment**,** this ministerial error was not repeated in the Company's Form 10-Q for the three months ending March 31, 2015 and 2014, respectively.

In order to correct this ministerial error, we intend to file an Amendment No. 1 to our Form 10-K/A on or about the date that we file our Form 10-Q for the period ended June 30, 2015. As American Assets Trust, L.P. is currently a voluntary filer. We believe the numbers as shown in the line item "incorrectly titled" Net Income Attributable to American Assets Trust, L.P. (as these amounts are actually the Net Income Attributable to American Assets Trust, Inc.) are not meaningful to the users of the Form10-K as the users of these financial statements are the owners of the REIT common stock and Operating Partnership units. Currently there are no direct users of the Operating Partnership's financial statements. However, the potential users of the Operating Partnership financial statements are the holders of the operating partnership units. As the operating partnership units have the exact same economics as the REIT common stock holders, all key financial information that is needed by the unit holders is accurately reported in both the REIT and Operating Partnership financial statements, including net income and net income attributable to each class of ownership as depicted on the statement of equity, and earnings per share/unit. However we believe an Amendment to the Form 10-K should be filed so that the presentation is comparable to what is in the quarterly reports and to have the corrected information on file prior to American Assets Trust, L.P. becoming a required registrant, which may or may not happen in future periods.

In our Amended Form 10-K, we intend to present an Explanatory Paragraph as follows:

> This Amendment No.1 to Form 10-K is being filed for the purpose of correcting a ministerial error in the American Assets Trust, L.P. Consolidated Statements of Comprehensive Income on page F-10 of the annual report on Form 10-K for the year ending December 31, 2014 filed on February 20, 2015 (the "Original Report"). Specifically, this Amendment removes the line item "Net Income attributable to unitholders in the Operating Partnership" from the American Assets Trust, L.P. Statement of Comprehensive Income and updates the weighted average units outstanding, basic. These amounts were inadvertently copied from the American Assets Trust, Inc. statement of comprehensive income without appropriate modification in formatting and labeling. As a result of these changes, the calculation of earnings per unit - basic - from continuing operations is updated.

For ease of reference, this Amendment sets forth the entire Original Report as previously filed, amended only to give effect to the correction discussed above. In addition, pursuant to Rule 12b-15 under the Securities Exchange Act of 1934, as amended, this Amendment includes new certifications of our principal executive officer and principal financial officer on Exhibits 31 and 32, each as of the date of filing this Amendment.

This Amendment does not affect any other section of the Original Report and continues to speak as of the date of the Original Report.

A summary of the corrections are as follows (which will also be included in the filing of the Amendment):

American Assets Trust, L.P.
Consolidated Statements of Comprehensive Income
(In Thousands, Except Units and Per Unit Data)

	Year Ended December 31,		
As originally reported:	**2014**	**2013**	**2012**
NET INCOME	$ 31,145	$ 22,594	$ 51,601
Net income attributable to restricted shares	(374)	(536)	(529)
Net income attributable to unitholders in the Operating Partnership	(9,015)	(6,838)	(16,134)
NET INCOME ATTRIBUTABLE TO AMERICAN ASSETS TRUST, L.P.	$ 21,756	$ 15,220	$ 34,938
EARNINGS PER UNIT - BASIC			
Continuing operations	$ 0.52	$ 0.38	$ 0.24
Discontinued operations	—	—	0.66
Earnings per unit, basic	$ 0.52	$ 0.38	$ 0.90
Weighted average units outstanding, basic	42,041,126	39,539,457	38,736,113
EARNINGS PER UNIT - DILUTED			
Continuing operations	$ 0.51	$ 0.38	$ 0.24
Discontinued operations	—	—	0.66
Earnings per unit, diluted	$ 0.51	$ 0.38	$ 0.90
Weighted average units outstanding, diluted	59,947,474	57,515,810	57,053,909

	Year Ended December 31,		
As corrected:	**2014**	**2013**	**2012**
NET INCOME	$ 31,145	$ 22,594	$ 51,601
Net income attributable to restricted shares	(374)	(536)	(529)
NET INCOME ATTRIBUTABLE TO AMERICAN ASSETS TRUST, L.P.	$ 30,771	$ 22,058	$ 51,072
EARNINGS PER UNIT - BASIC			
Continuing operations	$ 0.51	$ 0.38	$ 0.24
Discontinued operations	—	—	0.66
Earnings per unit, basic	$ 0.51	$ 0.38	$ 0.90
Weighted average units outstanding, basic	59,947,474	57,515,810	57,053,909
EARNINGS PER UNIT - DILUTED			
Continuing operations	$ 0.51	$ 0.38	$ 0.24
Discontinued operations	—	—	0.66
Earnings per unit, basic	$ 0.51	$ 0.38	$ 0.90
Weighted average units outstanding, diluted	59,947,474	57,515,810	57,053,909

American Assets Trust, Inc.
11455 El Camino Real, Suite 200
San Diego, CA 92130

Via EDGAR and Fed-Ex

July 30, 2015

Securities and Exchange Commission
Division of Corporation Finance
100 F Street, N.E.
Washington, D.C. 20549

Attention: Jennifer Monick, Staff Accountant
Mark Rakip, Staff Accountant

Re: American Assets Trust, Inc.
Form 10-K
Filed February 20, 2015
File No 1-35030

Dear Ms. Monick and Mr. Rakip:

The purpose of this letter is to respond to the comments of the Division of Corporation Finance of the Securities and Exchange Commission (the "Commission"), received by email on July 23, 2015, with respect to the American Assets Trust, Inc. (the "Company") Form 10-K filed February 20, 2015 (the "2014 Form 10-K"). For ease of review, we have set forth below each of the numbered comments of the Comment Letter and the Company's responses thereto. All page numbers and captions in the responses below refer to the 2014 Form 10-K, except as otherwise noted below.

General

1. We note your response to prior comment one. It does not appear that you qualify for combined periodic reporting given you do not appear to own substantially all of the ownership of the American Assets Trust, L.P. Please separately file the required periodic reports for the REIT and OP or advise.

Response: The Company respectfully advises the Staff that it will formally be requesting a waiver from the Staff of the Office of Chief Accountant of the Division of Corporation Finance to permit American Assets Trust, Inc. (the "REIT") and American Assets Trust, L.P. (the "OP") to be able to make combined filings of periodic reports beginning with the 2014 Form 10-K for the REIT's and the OP's fiscal year ended December 31, 2014 and for all subsequent periods.

American Capital Agency Corp.
Two Bethesda Metro Center,
14th Floor
Bethesda, MD 20814
(301) 968-9300
(301) 968-9301 Fax

April 15, 2015

VIA EDGAR AND EMAIL

Ms. Jaime G. John
Ms. Kristi Marrone
Securities and Exchange Commission
Division of Corporation Finance
100 F Street, N.E.
Washington, D.C. 20549

RE: American Capital Agency Corp. Form 10-K for the year ended December 31, 2014 (File. No. 001-34057)

Dear Mses. John and Marrone:

American Capital Agency Corp. (the "Company") is in receipt of your comment letter dated March 17, 2015 (the "Comment Letter"), which sets forth the comments of the staff (the "Staff") of the Division of Corporate Finance (the "Division") of the Securities and Exchange Commission (the "Commission") regarding the above-mentioned filing. The numbered paragraphs below respond to each of the Staff's comments in the Comment Letter, by setting forth the Staff's comment followed by the Company's response thereto.

Note 7. Fair Value Measurements, page 99

1. We note your disclosure on page 84 that you estimate the fair value of your "non-centrally cleared" interest rate swaps using inputs from counterparty and third-party pricing models to estimate the net present value of the future cash flows. We further note that these assets and liabilities are classified within Level 2 of the fair value hierarchy. Please provide us with additional details to support your Level 2 classification.

As noted in Note 7 (page 99) of the filing, we classify assets and liabilities within Level 2 of the fair value hierarchy when the fair value of such instruments is derived from inputs based on quoted prices for similar assets and liabilities in active markets; quoted prices for identical or similar instruments in markets that are not active; and model-derived valuations whose inputs are observable or whose significant value drivers are observable.

We determine the fair value of our non-centrally cleared interest rate swaps based on valuations obtained from third-party pricing services and the swap counterparty (collectively "third-party valuations"). The third-party valuations are model-driven using observable inputs consisting of LIBOR and the forward yield curve. We also consider the creditworthiness of both us and our counterparties and the impact of netting and credit enhancement provisions contained in each derivative agreement, such as collateral postings. All of our non-centrally cleared interest rate swaps are subject to bilateral collateral arrangements. Consequently, no credit valuation adjustment was made in determining the fair value of such instruments.

In response to the Staff's comment, in future filings we will clarify our disclosure pertaining to the classification of non-centrally cleared interest rate swaps within Level 2 of the fair value hierarchy as described above.

In submitting this letter, the Company acknowledges:

- the Company is responsible for the adequacy and accuracy of the disclosure in the filing;

- Staff comments or changes to disclosure in response to Staff comments do not foreclose the Commission from taking any action with respect to the filing; and

- the Company may not assert Staff comments as a defense in any proceeding initiated by the Commission or any person under the federal securities laws of the United States.

We hope that this letter addresses the Staff's questions and comments. If we can be of assistance in facilitating the Staff's review of our responses to the Comment Letter, please contact Cydonii Fairfax at (301) 841-1384 or me at (301) 841-1405. Thank you in advance for your prompt attention to this matter.

Sincerely,

/s/ Samuel A. Flax

Samuel A. Flax
Executive Vice President and Secretary

30601 Agoura Road, Suite 200
Agoura Hills, CA 91301
(805)413-5300
www.americanhomes4rent.com

Via EDGAR May 19, 2015

Jaime G. John
Accounting Branch Chief
Division of Corporation Finance
Securities and Exchange Commission
Washington, D.C. 20549

Re: American Homes 4 Rent
Form 10-K for the fiscal year ended December 31, 2014
Filed March 2, 2015
File No. 1-36013

Dear Ms. John:

American Homes 4 Rent (the "Company") submits this letter to respond to the comments of the staff (the "Staff") of the Division of Corporation Finance of the U.S. Securities and Exchange Commission (the "Commission") contained in your letter dated May 6, 2015, regarding the Company's Form 10-K for the year ended December 31, 2014. The Staff's comments are repeated below in bold italics preceding each response.

Management's Discussion and Analysis of Financial Condition and Results of Operations

Non-GAAP Measures, page 67

1. We note that NOI presented on page 68 excludes operating expenses for vacant single-family properties and therefore appears to be NOI for your leased properties only. Please advise and revise the label in future filings to clearly indicate that this measure relates to NOI for leased properties.

The Company advises the Staff that NOI excludes "vacant property operating expenses," which consists of operating expenses associated with properties that have been renovated, but not initially leased, and includes "leased property operating expenses," which consists of operating expenses associated with properties that have been initially leased, whether or not they are currently leased. Therefore, the Company's measure of NOI represents NOI from properties that have been initially leased, whether or not they are currently leased. Descriptions of "leased property operating expenses" and "vacant property operating expenses" have previously been disclosed on pages 54 and 55 of the Company's Form 10-K for the year ended December 31, 2014. In response to the Staff's comment, the Company has revised the description and label of this measure to read "Initially Leased Property Core NOI" in the Company's Form 10-Q for the quarter ended March 31, 2015, to indicate that NOI is from initially leased properties only. The Company will include the revised label in its future Exchange Act periodic reports.

2. We note that your reconciliation of FFO and Core FFO begins with Net loss attributable to common shareholders and includes an adjustment to include non-controlling interest in the Operating Partnership. It appears that your FFO and Core FFO measures represent FFO and Core FFO attributable to common shareholders and operating partnership unitholders. Please advise and revise your presentation in future filing to clearly label each measure.

The Company advises the Staff that FFO and Core FFO represent FFO and Core FFO attributable to common shareholders and operating partnership unitholders, which has been described in footnote (1) to the table appearing on page 69 of the Company's Form 10-K for the year ended December 31, 2014. In response to the Staff's comment, the Company has revised the label of each measure in the Company's Form 10-Q for the quarter ended March 31, 2015, to add "and units" after FFO and Core FFO to indicate that each is attributable to common shareholders and operating partnership unitholders. The Company will include the revised labels in its future Exchange Act periodic reports.

In connection with our responses to the Staff's comments, we hereby acknowledge that:

May 8, 2015

Correspondence Filing Via Edgar

United States Securities and Exchange Commission
Division of Corporation Finance
Office of Real Estate and Business Services
100 F Street, NE
Washington, D.C. 20549-3561
Attn: Jennifer Monick

Re: Apartment Investment and Management Company
Form 10-K for the Fiscal Year Ended December 31, 2014
Filed February 27, 2015
File No. 001-13232

AIMCO Properties, L.P.
Form 10-K for the Fiscal Year Ended December 31, 2014
Filed April 24, 2015
File No. 0-24497

Ladies & Gentlemen:

This letter responds to the comments of the staff of the Securities and Exchange Commission (the "Staff") addressed to Ernest M. Freedman on behalf of Apartment Investment and Management Company ("Aimco") and AIMCO Properties, L.P., a Delaware limited partnership (collectively, the "Companies"), in a letter dated April 27, 2015. The Companies' response to the Staff's comment is set forth below.

* * * * *

Form 10-K

Balance Sheet and Liquidity, page 22

Comment: We note your use of pro forma and actual leverage ratios. It does not appear your presentation of these leverage ratios complies with Item 10(e) of Regulation S-K. Please revise future periodic filings to disclose that these leverage ratios are non-GAAP, disclose how management deems the measures useful, and provide a reconciliation of any non-GAAP measures used in these leverage ratios. Your reconciliation should reconcile any non-GAAP measures to the most directly comparable financial measure or measures calculated and presented in accordance with GAAP. Further, your reconciliation of your pro forma measures should include an explanation of any assumptions made. Please provide us with an example of your proposed disclosure.

Response: In response to the Staff's comment, the Companies will revise future periodic filings to disclose that their leverage ratios are non-GAAP, to explain how management deems these measures useful, and will provide a reconciliation of the non-GAAP measures used in these ratios to the most directly comparable financial measure or measures calculated and presented in accordance with GAAP. To the extent the Companies present any pro forma leverage ratios, the accompanying disclosures will include an explanation of any assumptions made in the pro forma calculation. As requested by the Staff, an example of the Companies' proposed disclosure is provided below.

Balance Sheet and Liquidity

Our leverage strategy seeks to increase financial returns while using leverage with appropriate caution. We target the ratio of Adjusted Debt plus Preferred Equity to Adjusted EBITDA to be below 7.0x and we target the ratio of Adjusted EBITDA Coverage of Adjusted Interest and Preferred Dividends to be greater than 2.5x. We also focus on the ratios of Adjusted Debt to Adjusted EBITDA and Adjusted EBITDA Coverage of Adjusted Interest.

We believe the ratios of ratios of Adjusted Debt to Adjusted EBITDA and Adjusted Debt plus Preferred Equity to Adjusted EBITDA are important measures as they are commonly used by investors and analysts to assess the relative financial risk associated with balance sheets of companies within the same industry, and they are additionally used by rating agencies to assess the potential for companies defaulting on their debt obligations.

The ratios of Adjusted EBITDA Coverage of Adjusted Interest and Adjusted EBITDA Coverage of Adjusted Interest and Preferred Dividends provide a measure of a company's ability to pay its current interest and preferred dividend requirements. We believe these are meaningful to investors, analysts and rating agencies in assessing financial risk associated with a company's debt levels and provide an indication of the health of the company's earnings in relation to interest and preferred dividend requirements. Additionally, these measures allow for comparison of our debt and earnings levels to those of other companies within our industry.

Adjusted Debt, Adjusted EBITDA and Adjusted Interest, as used in these ratios, are non-GAAP financial measures, which are further discussed and reconciled under the Non-GAAP Leverage Measures heading. Preferred Equity represents Aimco's preferred stock and the Aimco Operating Partnership's preferred OP Units.

Our leverage ratios for the trailing twelve month and annualized three month periods ended December 31, 2014 and 2013, are presented below:

	Pro-forma Trailing Twelve Months Ended December 31,	Actual Trailing Twelve Months Ended December 31,	
	2014 (1)	2014	2013
Adjusted Debt to Adjusted EBITDA	6.5x	7.1x	7.1x
Adjusted Debt plus Preferred Equity to Adjusted EBITDA	7.0x	7.6x	7.3x
Adjusted EBITDA Coverage of Adjusted Interest	2.9x	2.7x	2.6x
Adjusted EBITDA Coverage of Adjusted Interest and Preferred Dividends	2.7x	2.5x	2.5x

(1) During January 2015, Aimco completed a common stock offering resulting in net proceeds of approximately $367 million. The pro-forma ratios presented for the trailing twelve months ended December 31, 2014, have been adjusted to reflect the following: a) Repayment of $112.3 million of outstanding borrowings under our Credit Agreement at December 31, 2014; b) Repayment of $102.2 million of property debt that will be repaid in 2015 to further supplement Aimco's unencumbered pool; c) Repayment of $27.0 million of Aimco's CRA Preferred Stock; and d) Investment of the remaining proceeds from the common offering. The effect of the repayment of debt, redemption of preferred stock and investment of the remaining proceeds from the common offering resulted in a pro forma reduction of Interest and Preferred Dividends of $11.2 million and $0.4 million for the trailing twelve months ended December 31, 2014. The pro forma interest and preferred dividend adjustments are based on the contractual amounts for the debt repaid or preferred securities redeemed, and investment of the remaining proceeds assumed an annual return of one percent. Refer to Note 16 to the consolidated financial statements in Item 8 for additional information regarding this stock offering.

We expect future leverage reduction from both earnings growth, the lease up of redevelopment communities and from regularly scheduled property debt amortization repaid from retained earnings. We also expect to increase our financial flexibility by expanding our pool of unencumbered apartment communities. As of December 31, 2014, this pool included 15 consolidated apartment communities, which we expect to hold beyond 2015, with an estimated fair value of more than $1 billion.

Non-GAAP Financial Measures

Note: Our 10-K, as filed, includes our Funds From Operations ("FFO") and Adjusted Funds From Operations ("AFFO") discussion, along with the related non-GAAP disclosures and reconciliations, within Management's Discussion and Analysis ("MD&A"). Based on the expanded non-GAAP disclosure in response to the Staff's comment, we plan to add a Non-GAAP Financial Measures section within the MD&A in future filings, which would include our existing FFO and AFFO disclosures, along with the proposed expanded non-GAAP disclosures below. For the purpose of this Comment Letter response, we have not repeated the FFO and AFFO disclosure.

Non-GAAP Leverage Measures

Adjusted Debt represents our share of the debt obligations recognized in our consolidated financial statements, as well as our share of the debt obligations of our unconsolidated partnerships, reduced by our share of the cash and restricted cash of our consolidated and unconsolidated partnerships, and our investment in the subordinate tranches of a securitization that holds certain of our property debt (essentially, our investment in our own non-recourse property loans). We believe Adjusted Debt is useful to investors as it is a measure of our net exposure to debt obligations, assuming the application of cash and restricted cash balances as well as reducing our leverage by our investment in our own property debt. Adjusted Debt, as used in our leverage ratios discussed under the Balance Sheet and Liquidity heading, is calculated as set forth in the table below.

Preferred Equity, as used in our leverage ratios, represents the redemption amounts for Aimco's preferred stock and the Aimco Operating Partnership's preferred OP Units. Preferred Equity, although perpetual in nature, is another component of our overall leverage.

Adjusted EBITDA is a non-GAAP performance measure. We believe Adjusted EBITDA provides investors relevant and useful information because it allows investors to view income from our operations on an unleveraged basis, before the effects of taxes, depreciation and amortization, gains or losses on sales of and impairment losses related to real estate, and various other items described below that are not necessarily representative of our ability to service our debt obligations or preferred equity requirements.

Adjusted EBITDA represents Aimco's share of the consolidated amount of our net income adjusted to exclude the effect of the following items for the reasons set forth below:

- interest, to allow investors to compare a measure of our earnings before the effects of our capital structure and indebtedness with that of other companies in the real estate industry;
- income taxes, to allow investors to measure our performance independent of income taxes, which may vary significantly from other companies within our industry due to leverage and tax planning strategies, among other drivers;
- depreciation and amortization, gains or losses on dispositions and impairment losses related to real estate, for similar reasons to those set forth in our discussion of FFO and AFFO in the preceding section;
- provisions for (or recoveries of) losses on notes receivable, gains on dispositions of non-depreciable assets and non-cash stock-based compensation, as these are items that periodically affect our operations but that are not necessarily representative of our ability to service our debt obligations;
- the interest income earned on our investment in the subordinate tranches of a securitization that holds certain of our property debt, as we subtract this income from our interest expense in our calculation of Adjusted EBITDA coverage of Adjusted Interest; and
- EBITDA amounts related to our legacy asset management business, as the debt obligations and associated interest expense for the legacy asset management business are excluded from our leverage ratios and the associated interest payments are not funded from our operations.

While Adjusted EBITDA is a relevant measure of performance, it does not represent net income as defined by GAAP, and should not be considered as an alternative to net income in evaluating our performance. Further, our computation of Adjusted EBITDA may not be comparable to similar measures reported by other companies.

Adjusted Interest, as calculated in our leverage ratios, is a non-GAAP measure that we believe is meaningful for investors and analysts as it presents our current recurring interest requirements associated with leverage. Our calculation of Adjusted Interest is set forth in the table below. We exclude from our calculation of Adjusted Interest

- the amortization of deferred financing costs, as these amounts have already been expended in previous periods and are not representative of our current or prospective debt service requirements; and
- debt prepayment penalties and other items that from time to time, affect our operating results, but are not representative of our scheduled interest obligations.

Our calculation of Adjusted Interest is also reduced by income we receive on our investment in the subordinate tranches of a securitization that holds certain of our property debt, as this income is being generated indirectly from our payments of principal and interest associated with the property debt held by the trust and such amounts will ultimately repay our investment in the trust.

Preferred Dividends represents the preferred dividends paid on Aimco's preferred stock and the preferred distributions paid on the Aimco Operating Partnership's preferred OP Units. We add Preferred Dividends to Adjusted Interest for a more complete picture of the interest and dividend requirements of our leverage, inclusive of perpetual preferred equity.

For the years ended December 31, 2014 and 2013, reconciliations of the most closely related GAAP measures to our calculations of Adjusted Debt, Preferred Equity, Adjusted EBITDA, Adjusted Interest and Preferred Dividends, as used in our leverage ratios, are as follows (in thousands):

	Year Ended December 31,	
	2014	**2013**
Total indebtedness	$ 4,135,139	$ 4,388,185
Adjustments:		
Debt related to assets classified as held for sale	27,296	—
Proportionate share adjustments related to debt obligations of consolidated and unconsolidated partnerships	(117,827)	(142,136)
Cash and restricted cash	(120,416)	(182,788)
Proportionate share adjustments related to cash and restricted cash held by consolidated and unconsolidated partnerships	2,103	15,317
Securitization trust assets	(61,043)	(58,408)
Bond repayment on December 31, 2014, effective on January 1, 2015	(34,000)	—
Adjusted Debt, as used in leverage calculations	$ 3,831,252	$ 4,020,170
Preferred stock	186,126	68,114
Preferred OP Units	87,937	79,953
Preferred Equity	274,063	148,067
Adjusted Debt plus Preferred Equity	$ 4,105,315	$ 4,168,237

	Year Ended December 31, 2014	Year Ended December 31, 2013
Net income attributable to Aimco Common Stockholders	$ 300,220	$ 203,673
Adjustments:		
Noncontrolling interests in Aimco Operating Partnership's share of net income	23,349	18,876
Preferred Dividends	7,947	2,804
Interest expense, net of noncontrolling interest	216,880	241,025
Depreciation and amortization, net of noncontrolling interest	275,175	295,584
Income tax benefit	(20,026)	(3,101)
Gains on disposition and other, net of income taxes and noncontrolling partners' interests	(265,358)	(184,382)
Provision for (recovery of) impairment losses related to depreciable assets, net of noncontrolling partners' interests	2,197	(855)
Recovery of (provision for) losses on notes receivable	(237)	(1,827)
Gains on disposition of other	(501)	(11)
Non-cash stock-based compensation	5,781	5,645
Interest income received on securitization investment	(5,697)	(5,322)
Net income of legacy asset management business, excluding interest expense	(2,556)	(3,977)
Adjusted EBITDA, as calculated in leverage ratios	$ 537,174	$ 568,132

	Year Ended December 31, 2014	Year Ended December 31, 2013
Interest expense, continuing operations	$ 220,971	$ 237,048
Interest expense, discontinued operations	—	13,346
Adjustments:		
Proportionate share adjustments related to interest of consolidated and unconsolidated partnerships	(6,064)	(10,189)
Amortization of deferred loan costs, debt prepayment penalties and other	(12,905)	(13,706)
Interest income received on securitization investment	(5,697)	(5,322)
Adjusted Interest, as calculated in leverage ratios	$ 196,305	$ 221,177
Preferred stock dividends	7,947	2,804
Preferred OP Unit distributions	6,497	6,423
Preferred dividends and distributions	14,444	9,227
Adjusted Interest and Preferred Dividends, as calculated in leverage ratios	$ 210,749	$ 230,404

August 24, 2015

VIA EDGAR AND FEDEX

Jaime G. John
United States Securities and Exchange Commission
Division of Corporation Finance
100 F Street, N.E.
Washington, D.C. 20549-0404

Re: Apollo Commercial Real Estate Finance, Inc.
Form 10-K for the Year-Ended December 31, 2014
Filed February 26, 2015
File No. 1-34452

Dear Ms. John:

On behalf of Apollo Commercial Real Estate Finance, Inc., a Maryland corporation (the "**Company**"), set forth below are the responses of the Company to the comments of the staff of the Division of Corporation Finance (the "**Staff**") of the Securities and Exchange Commission (the "**Commission**") by letter dated August 12, 2015 (the "**Comment Letter**") with respect to the Company's Form 10-K for the year ended December 31, 2014 (the "**Form 10-K**").

The Company's responses to the comments of the Staff contained in the Comment Letter are set out below in the order in which the comments were set out in the Comment Letter and are numbered accordingly. Defined terms used herein but not otherwise defined have the meanings given to them in the Form 10-K.

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

Investments, page 34

1. **We note your weighted average underwritten IRR for first mortgages and CMBS significantly exceeds your weighted average yield. Please tell us why these amounts differ.**

Company Response:

In response to the Staff's comment, the Company advises the Staff that the weighted average underwritten IRR for first mortgages and CMBS differs from the weighted average yield because the weighted average underwritten IRR takes into account borrowings assumed by the Company to finance its investments and, as is set out in footnote 3 to the table referenced in this comment, assumes that the cost of borrowings remains constant over the remaining term. The Company intends to modify the disclosure in future filings to also note that the weighted average underwritten IRR takes leverage into account.

Notes to Consolidated Financial Statements

Note 3 – Fair Value Disclosure, page 69

2. **Regarding your estimated fair value of the CMBS portfolio and your disclosure that adjustments to broker quotes are made as deemed necessary by management. Please tell us the nature of any adjustments made to broker quotes. Further, please tell us what consideration you gave to disclosing the nature of material adjustments made to broker quotes.**

Company Response:

In response to the Staff's comment, the Company advises the Staff that there were no events or instances that resulted in the Company making material adjustments to the broker quotes to value CMBS in its consolidated financial statements for the periods presented. The estimated fair value of the Company's CMBS portfolio is determined by reference to market prices provided by certain dealers who make a market in these financial instruments. However, broker quotes are only indicative of fair value and may not necessarily represent what the Company would receive in an actual trade for the applicable instrument. The Company generally seeks multiple broker quotes for a CMBS and uses the average value of the prices received to determine fair value. The Company then evaluates such pricing information taking into account factors such as recent trades, weighted average life, duration, coupon, prepayment experience, fixed/adjustable rate, coupon index and similar credits, among other factors. If the Company determines (based on such a comparison and management's market knowledge and expertise) that a security is priced significantly differently than similar securities, it may contact brokers for additional information regarding such brokers' valuation of the security. The Company may further adjust the value from the broker quotes based on its analysis of the above market-based factors.

* * * * *

In regards to the Form 10-K, the Company acknowledges that:

- the Company is responsible for the adequacy and accuracy of the disclosure in the filing;
- Staff comments or changes to disclosure in response to Staff comments do not foreclose the Commission from taking any action with respect to the filing; and
- the Company may not assert Staff comments as a defense in any proceeding initiated by the Commission or any person under the federal securities laws of the United States.

Should the Staff have additional questions or comments regarding any of the foregoing, please do not hesitate to contact the undersigned at (212) 822-0726 or Jay L. Bernstein or Andrew S. Epstein of Clifford Chance US LLP, counsel to the Company at (212) 878-8527 or (212) 878-8332.

March 4, 2015

VIA EDGAR

U.S. Securities and Exchange Commission
Division of Corporation Finance
100 F Street, N.E.
Washington, D.C. 20549
Attention: Jaime G. John, Branch Chief

Re: Ares Commercial Real Estate Corporation
Form 10-K for the Fiscal Year Ended December 31, 2013
Filed March 17, 2014
File No. 1-35517

Dear Ms. John:

This letter sets forth the responses to the comment of the Staff of the Division of Corporation Finance (the "Staff") contained in your letter dated February 18, 2015 relating to the above-referenced filing (the "10-K").

Set forth below is the comment of the Staff contained in the Staff's letter and immediately below the comment is the response with respect thereto and the location in the relevant filing of the requested disclosure.

Item 8. Financial Statements and Supplementary Data

Consolidated Statements of Operations, page F-4

1. *We note in your response to prior comment 1 of our letter dated January 27, 2015 that you elected to use the proceeds from the convertible notes to repay outstanding amounts under your secured funding agreements. Therefore, please revise your presentation of net interest margin in future filings to reflect the interest associated with this convertible debt.*

   Response: In response to the Staff's comment, the Company will revise its presentation of net interest margin in future filings to include the interest expense associated with the convertible notes in "Interest Expense" within the consolidated statements of operations.

The Company understands that:

(a) the Company is responsible for the adequacy and accuracy of the disclosure in the filings;

(b) Staff comments or changes to disclosure in response to Staff comments in the filings reviewed by the Staff do not foreclose the SEC from taking any action with respect to the filings; and

(c) the Company may not assert Staff comments as a defense in any proceeding initiated by the SEC or any person under the federal securities laws of the United States.

Please do not hesitate to call me at (202) 721-6111 if you have any additional questions or require any additional information.

Very truly yours,

/s/Tae-Sik Yoon
Tae-Sik Yoon
Chief Financial Officer

Enclosures

cc: Todd Schuster, Ares Commercial Real Estate Corporation
Michael Weiner, Ares Commercial Real Estate Corporation
Anton Feingold, Ares Commercial Real Estate Corporation
Monica J. Shilling, Proskauer Rose LLP

Boston Properties, Inc.
800 Boylston Street, Suite 1900
Boston, MA 02199-8103

May 8, 2015

VIA EDGAR

Ms. Jaime G. John
Branch Chief
Division of Corporation Finance
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-7010

Re: **Boston Properties, Inc.**
Form 10-K for the fiscal year ended December 31, 2014
Filed March 2, 2015
File No. 001-13087

Boston Properties Limited Partnership
Form 10-K for the fiscal year ended December 31, 2014
Filed March 2, 2015
File No. 000-50209

Dear Ms. John:

This letter is submitted in response to the comments of the staff of the Division of Corporation Finance (the "Staff") of the Securities and Exchange Commission (the "Commission") with respect to the Forms 10-K for the year ended December 31, 2014 of Boston Properties, Inc. (the "Company") and Boston Properties Limited Partnership (the "Operating Partnership"), as set forth in your letter (the "Comment Letter") dated May 1, 2015 to Michael E. LaBelle, Chief Financial Officer of the Company.

For reference purposes, the text of the Comment Letter has been reproduced herein with responses below each numbered comment.

General

Comment No. 1

1. *Please revise all future filing of Boston Properties, Inc. as well as Boston Properties Limited Partnership in response to these comments, as applicable.*

Response to Comment No. 1

The Company will revise all of its future filings and those of the Operating Partnership in response to the Staff's comments in the Comment Letter.

Item 7 – Management's Discussion and Analysis of Financial Condition and Results of Operations

Capitalization, page 99

Comment No. 2

2. *We note your disclosure of total adjusted debt on Page 100. Please provide a tabular reconciliation to your total consolidated debt recognized in accordance with GAAP in future filings.*

Response to Comment No. 2

In future periodic filings, including the Forms 10-Q for the quarterly period ended March 31, 2015, each of the Company and the Operating Partnership will provide a tabular reconciliation of total consolidated debt in accordance with GAAP to total adjusted debt in the relevant portion of the section entitled "Debt Summary." An example of the disclosure as it would have appeared on page 101 of the Company's Form 10-K and page 98 of the Operating Partnership's Form 10-K is set forth below:

	December 31,	
	2014	2013
	(dollars in thousands)	
Debt Summary:		
Balance		
Fixed rate mortgage notes payable	$ 4,309,484	$ 4,449,734
Variable rate mortgage notes payable	—	—
Unsecured senior notes, net of discount	5,287,704	5,835,854
Unsecured exchangeable senior notes, net of discount and adjustment for the equity component allocation	—	744,880
Unsecured Line of Credit	—	—
Mezzanine notes payable	309,796	311,040
Total consolidated debt	9,906,984	11,341,508
Add:		
Our share of unconsolidated joint venture debt	351,500	329,188
Deduct:		
Partners' share of consolidated mortgage notes payable	(1,057,879)	(759,239)
Partners' share of consolidated mezzanine notes payable	(123,918)	(124,416)
Total adjusted debt	$ 9,076,687	$10,787,041

Funds from Operations, page 105

Comment No. 3

3. *Please revise the labels on your reconciliation in future filings to clarify that you are presenting $899 million of "Funds from Operations (FFO) attributable to common shareholders and Operating Partnership unitholders" and $808 million of "FFO attributable to Boston Properties, Inc. common shareholders", reconciled from $433 million of "Net income attributable to Boston Properties, Inc. common shareholders."*

Response to Comment No. 3

In future periodic filings, the Company will revise the labels on its Funds from Operations (FFO) reconciliation in the form requested by the Staff. However, as discussed with the Staff on May 5, 2015, the Company intends to clarify that it is presenting $899 million of "Funds from Operations (FFO) attributable to Operating Partnership common unitholders (including Boston Properties, Inc.)." Because the number of outstanding shares of common stock of the Company at all times equals the number of common units of the Operating Partnership that are owned by the Company, we believe this language (which is slightly different from that proposed by the Staff) is more accurate and will lessen the chance that a reader will believe that "double-counting" has occurred.

As requested in the Comment Letter, the Company hereby acknowledges the following:

(1) the Company is responsible for the adequacy and accuracy of the disclosure in the filing;

(2) Staff comments or changes to disclosure in response to staff comments do not foreclose the Commission from taking any action with respect to the filing; and

(3) the Company may not assert staff comments as a defense in any proceeding initiated by the Commission or any person under the federal securities laws of the United States.

If you have any questions concerning these responses, please contact me at (617) 236-3352.

Sincerely,

/s/ Michael E. LaBelle

Michael E. LaBelle
Senior Vice President, Chief Financial Officer of Boston Properties, Inc.

cc: Eric G. Kevorkian
Senior Vice President, Senior Corporate Counsel
Lori Silverstein
Vice President, Controller
Daniel Adams, Esq.
Goodwin Procter LLP

BRIXMOR®
420 Lexington Avenue : New York, NY 10170 : 800.468.7526

April 16, 2015

Division of Corporation Finance
United States Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549

Attn: Ms. Jennifer Monick, Staff Accountant

Re: Brixmor Property Group Inc.
Form 10-K for the Fiscal Year Ended December 31, 2014
Filed February 19, 2015
File No. 1-36160

Brixmor Operating Partnership LP
Form 10-K for the Fiscal Year Ended December 31, 2014
Filed February 19, 2015
File No. 333-201464-01

Dear Ms. Monick:

This letter sets forth the response of Brixmor Property Group Inc. and Brixmor Operating Partnership LP (collectively, the "Company") to the comment letter from the Staff of the Division of Corporation Finance of the Securities and Exchange Commission (the "Commission"), received by email on April 13, 2015, relating to the Company's Form 10-K for the year ended December 31, 2014, filed with the Commission on February 19, 2015. For your convenience, we have set forth each of the Staff's original comments immediately preceding our response.

<u>Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations, Page 35</u>

1. On pages F-19 and F-20, you disclose that you capitalize personnel costs to real estate under redevelopment and deferred leasing costs. Please tell us the amount of personnel costs you have capitalized. To the extent material, in future periodic filings, please separately quantify and disclose personnel costs capitalized to real estate under redevelopment and deferred leasing costs for all periods presented and discuss fluctuations in capitalized personnel costs for all periods presented within your MD&A. To the extent you do not believe these amounts are material, please tell us how you made that determination.

Response

In response to the Staff's comment, in our future periodic filings we will, to the extent material, separately quantify and disclose personnel costs capitalized to real estate under redevelopment and deferred leasing costs for all periods presented and discuss significant fluctuations in capitalized personnel costs for all periods presented within our MD&A. For the years ended December 31, 2014 and 2013, the Company capitalized personnel costs of $5.8 million and $5.2 million, respectively, to real estate under redevelopment and $15.1 million and $13.3 million, respectively, to deferred leasing costs.

Notes to Consolidated Financial Statements, page F-16
16. Commitments and Contingencies, page F-34
Insurance captive, page F-34

2. In future periodic filings, please disclose a roll forward of your insurance reserves for each year presented. The roll forward should include the amount of incurred claims, any changes in the provision for prior year events, and the amount of payments made. Please provide an example of your proposed disclosure. To the extent you do not believe this disclosure is material, please tell us how you made that determination.

Response

In response to the Staff's comment, in our future annual reports we will disclose a roll forward of the Company's insurance reserves for each year presented as follows:

	201X	201X
Balance at the Beginning of the year	$ XXX	$ XXX
Incurred related to:		
Current year	X	X
Prior years	X	X
Total incurred	X	X
Paid related to:		
Current year	X	X
Prior years	X	X
Total paid	X	X
Changes in the provision for prior year events	X	X
Balance at the end of the year	$ XXX	$ XXX

June 3, 2015

Mr. Tom Kluck
Branch Chief
Securities and Exchange Commission
100 F Street, N. E., Mail Stop 3010
Washington, D.C. 20549

RE: Camden Property Trust
Form 10-K
Filed February 20, 2015
File No. 001-12110

Dear Mr. Kluck:

The following is the response of Camden Property Trust to the comments contained in the Staff's comment letter dated May 26, 2015 concerning the above-referenced report.

FORM 10-K

General

1. Please advise us whether you consider net operating income and same property net operating income to be key performance indicators. We may have further comment.

We do not consider net operating income and same property net operating income to be key performance indicators. They are two of many individual operating metrics used by the real estate industry to assess company performance. Accordingly, Camden provides these measurements to securities analysts and investors.

Unlike Funds From Operations as defined by the National Association of Real Estate Investment Trusts ("NAREIT"), there is no standard industry definition regarding the method of calculation of either net operating income or same property net operating income. As a result, neither net operating income nor same property net operating income is consistently defined or calculated by peer companies or investors. Net operating income, for example, does not take into account all aspects of the Company's performance as net operating income does not include the impact of certain revenues and expenses such as equity in income of joint ventures, interest expense, income taxes, and general and administrative expenses.

Risk Factors, page 3

2. We note that your Geographic Diversification table on page 26 indicates that 18.4% of your real estate assets were concentrated in Washington, D.C. Metro and 9.5% of your real estate assets were concentrated in Houston, Texas. To the extent that you consider this geographic concentration to represent a material risk, please include a risk factor specifically addressing this risk in future Exchange Act periodic reports.

We refer you to the first risk factor on page 3 of our Form 10-K under the heading **"Risks Associated with Capital Markets, Credit Markets, and Real Estate -** ***Volatility in capital and credit markets, or other unfavorable changes in economic conditions, either nationally or regionally in one or more of the markets in which we operate, could adversely impact us."***

In this risk factor, we discuss key economic risks for (a) local conditions in the first bullet point, (b) declines in market rental rates in the third bullet point, and, (c) regional economic downturns affecting geographic markets in the sixth bullet point.

Item 2. Properties, page 8

3. We note your disclosure to the effect that your operating properties have an average age of 12 years, "calculated on the basis of investment dollars." In future Exchange Act periodic reports, please clarify how this number is calculated.

The average age of our operating properties is based upon the average of the product of the gross capitalized cost of each property multiplied by the property's physical age divided by gross capitalized costs. We will clarify this calculation in future Exchange Act periodic reports.

Management's Discussion and Analysis of Financial Condition and Results of Operations

Completed Construction in Lease-Up, page 24

4. In future Exchange Act periodic reports, with respect to any disclosure on costs incurred with respect to completed construction in lease-up, please clarify whether costs incurred include leasing costs.

With respect to our disclosure on costs incurred for completed construction in lease-up, we do not include leasing costs. Leasing costs are expensed as incurred. We will clarify leasing costs are expensed as incurred in future Exchange Act periodic reports.

Proxy Statement

General

5. We were unable to locate the disclosures required by Item 407(d)(4) of Regulation S-K. Please revise your future Exchange Act periodic reports or proxy statements, as applicable, to include such disclosures or advise.

The establishment of a separately-designated audit committee, comprised solely of independent trust managers, is disclosed on page 4 of our recently-filed proxy statement and a further description of the Company’s Audit Committee, including the identity of each committee member, is disclosed on page 7 of our proxy. In future filings, we will clarify the Audit Committee has been established in accordance with Section 3(a)(58)(A) of the Exchange Act.

We acknowledge:

- the Company is responsible for the adequacy and accuracy of the disclosure in the filing;
- staff comments or changes to disclosure in response to staff comments do not foreclose the Commission from taking any action with respect to the filing; and,
- the Company may not assert staff comments as a defense in any proceeding initiated by the Commission or any person under the federal securities laws of the United States.

If you have any questions, please do not hesitate to contact the undersigned at (713) 354-2500.

Very truly yours,

/s/ Michael P. Gallagher
Michael P. Gallagher
Senior Vice President - Chief Accounting Officer

CBL & ASSOCIATES PROPERTIES, INC.
CBL Center
2030 Hamilton Place Blvd., Suite 500
Chattanooga, Tennessee 37421

June 1, 2015

Mr. Daniel L. Gordon
Senior Assistant Chief Accountant
U.S. Securities and Exchange Commission
Division of Corporation Finance
100 F Street, NE
Washington, DC 20549-3561

RE: CBL & Associates Properties, Inc. (herein "CBL")
Form 10-K for the Fiscal Year Ended December 31, 2014
Filed March 2, 2015
SEC File No. 001-12494

CBL & Associates Limited Partnership (herein the "Operating Partnership")
Form 10-K for the Fiscal Year Ended December 31, 2014
Filed March 2, 2015
SEC File No. 333-182515-01

Dear Mr. Gordon:

In reference to your comment letter of May 15, 2015 and with respect to your review of our Form 10-K for the fiscal year ended December 31, 2014, filed March 2, 2015, this letter sets forth CBL's and the Operating Partnership's (collectively, the "Company") responses to each comment, numbered to correspond to the Staff's letter.

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

Same-center Net Operating Income, page 55

1. **It appears that the NOI measures on page 56 are inclusive of NOI attributable to non-controlling interests in the OP. Please revise labels of these non-GAAP measures in future filings to indicate that they include both the company's share and the non-controlling interests' share of property NOI and same-center NOI.**

We acknowledge the Staff's comment. The following is an example of the revised disclosure we intend to include in future filings related to same-center net operating income to clarify our presentation, using the disclosure from our Form 10-K for the Fiscal Year Ended December 31, 2014 as an example, with the revisions highlighted in red below:

Same-center Net Operating Income

NOI is a supplemental measure of the operating performance of our shopping centers and other Properties. We define NOI as property operating revenues (rental revenues, tenant reimbursements and other income) less property operating expenses (property operating, real estate taxes and maintenance and repairs).

~~Similar to FFO,~~ W~~w~~e compute NOI based on our Operating Partnership's pro rata share of both consolidated and unconsolidated Properties. We believe that presenting NOI and same-center NOI (described below) based on our Operating Partnership's pro rata share of both consolidated and unconsolidated Properties is useful since we conduct substantially all of our business through our Operating Partnership and, therefore, it reflects the performance of the Properties in absolute terms regardless of the ratio of ownership interests of our common shareholders and the noncontrolling interest in the Operating Partnership. Our definition of NOI may be different than that used by other companies and, accordingly, our calculation of NOI may not be comparable to that of other companies.

Since NOI includes only those revenues and expenses related to the operations of our shopping center Properties, we believe that same-center NOI provides a measure that reflects trends in occupancy rates, rental rates and operating costs and the impact of those trends on our results of operations. Our calculation of same-center NOI excludes lease termination income, straight-line rent adjustments, and amortization of above and below market lease intangibles in order to enhance the comparability of results from one period to another, as these items can be impacted by one-time events that may distort same-center NOI trends and may result in same-center NOI that is not indicative of the ongoing operations of our shopping center and other Properties. Same-center NOI is for real estate properties and does not include the results of operations of our subsidiary that provides janitorial, security and maintenance services.

We include a Property in our same-center pool when we have owned all or a portion of the Property since January 1 of the preceding calendar year and it has been in operation for both the entire preceding calendar year ended December 31, 2013 and the current year ended December 31, 2014. New Properties are excluded from same-center NOI, until they meet this criteria. The only Properties excluded from the same-center pool that would otherwise meet this criteria are Non-core Properties, Properties under major redevelopment, Properties being considered for repositioning, Properties where we intend to renegotiate the terms of the debt secured by the related Property and Properties included in discontinued operations. Madison Square and Madison Plaza were classified as Non-core Properties as of December 31, 2014. Lender Properties consisted of Gulf Coast Town Center, Triangle Town Center and Triangle Town Place as of December 31, 2014. Properties under major redevelopment as of December 31, 2014 included the Annex at Monroeville, CoolSprings Galleria and Northgate Mall. Properties where we are considering alternatives to reposition the Property included Chesterfield Mall and Wausau Center at December 31, 2014.

Due to the exclusions noted above, same-center NOI should only be used as a supplemental measure of our performance and not as an alternative to GAAP operating income (loss) or net income (loss). A reconciliation of our same-center NOI to net income attributable to the Company for the years ended December 31, 2014 and 2013 is as follows (in thousands):

	Year Ended December 31,	
	2014	**2013**
Net income ~~attributable to the Company~~	$ **253,033**	$ 110,370
Adjustments: [(1)]		
Depreciation and amortization	**326,237**	319,260
Interest expense	**272,669**	266,843
Abandoned projects expense	**136**	334
Gain on sales of real estate assets	**(6,329)**	(2,002)
(Gain) loss on extinguishment of debt	**(87,893)**	9,108
Gain on investment	**—**	(2,400)
Loss on impairment	**18,539**	75,283
Income tax provision	**4,499**	1,305
Lease termination fees	**(3,808)**	(4,217)
Straight-line rent and above and below market rent	**(3,359)**	(1,502)
Net income attributable to noncontrolling interests in ~~earnings of Operating Partnership~~ other consolidated subsidiaries	**(3,777)**	(18,041)
Gain on discontinued operations	**(276)**	(1,144)
General and administrative expenses	**50,271**	48,867
Management fees and non-property level revenues	**(36,386)**	(23,552)
~~Company's~~ Operating Partnership's share of property NOI	**783,556**	778,512
Non-comparable NOI	**(63,968)**	(75,492)
Total same-center NOI	$ **719,588**	$ 703,020

(1) Adjustments are based on our Operating Partnership's pro rata ownership share, including our share of unconsolidated affiliates and excluding noncontrolling interests' share of consolidated Properties.

Same-center NOI increased $16.6 million for the year ended December 31, 2014 compared to 2013. Our NOI growth of 2.4% for 2014 was driven primarily by increases of $13.4 million in minimum rent and $4.1 million in tenant reimbursements. The increases in rental rates were a result of our positive leasing spreads of 12.6% for our Stabilized Mall portfolio as we continued to upgrade our tenant mix. Additionally, maintenance and repair expenses, as compared to the prior-year period, were relatively flat for 2014 as a $1.0 million increase in snow removal expenditures was offset by a similar decline in maintenance and supplies expense due to operating efficiencies.

Funds from Operations, page 81

2. **We note your reconciliation of FFO and FFO, as adjusted on page 82. In future filings, please revise the labels of these non-GAAP measures to indicate that the measure represents Funds from operations of the Operating Partnership common unitholders and Funds from operations of the Operating Partnership common unitholders, as adjusted.**

We will modify our presentation of our FFO reconciliations in future filings as follows, using the disclosure from our Form 10-K for the Fiscal Year Ended December 31, 2014 as an example, with the changes shown in red below:

Funds From Operations

FFO is a widely used measure of the operating performance of real estate companies that supplements net income (loss) determined in accordance with GAAP. The National Association of Real Estate Investment Trusts ("NAREIT") defines FFO as net income (loss) (computed in accordance with GAAP) excluding gains or losses on sales of depreciable operating properties and impairment losses of depreciable properties, plus depreciation and amortization, and after adjustments for unconsolidated partnerships and joint ventures and noncontrolling interests. Adjustments for unconsolidated partnerships and joint ventures and noncontrolling interests are calculated on the same basis. We define FFO ~~allocable to common shareholders~~ as defined above by NAREIT less dividends on preferred stock of the Company or distributions on preferred units of the Operating Partnership, as applicable. Our method of calculating FFO ~~allocable to common shareholders~~ may be different from methods used by other REITs and, accordingly, may not be comparable to such other REITs.

We believe that FFO provides an additional indicator of the operating performance of our Properties without giving effect to real estate depreciation and amortization, which assumes the value of real estate assets declines predictably over time. Since values of well-maintained real estate assets have historically risen with market conditions, we believe that FFO enhances investors' understanding of our operating performance. The use of FFO as an indicator of financial performance is influenced not only by the operations of our Properties and interest rates, but also by our capital structure.

We present both FFO allocable to ~~of our~~ Operating Partnership common unitholders and FFO allocable to common shareholders, as we believe that both are useful performance measures. We believe FFO allocable to ~~of our~~ Operating Partnership common unitholders is a useful performance measure since we conduct substantially all of our business through our Operating Partnership and, therefore, it reflects the performance of the Properties in absolute terms regardless of the ratio of ownership interests of our common shareholders and the noncontrolling interest in our Operating Partnership. We believe FFO allocable to common shareholders is a useful performance measure because it is the performance measure that is most directly comparable to net income (loss) attributable to common shareholders.

In our reconciliation of net income (loss) attributable to common shareholders to FFO allocable to Operating Partnership common unitholders ~~shareholders~~ that is presented below, we make an adjustment to add back noncontrolling interest in income (loss) of our Operating Partnership in order to arrive at FFO of the ~~our~~ Operating Partnership common unitholders. We then apply a percentage to FFO of the ~~our~~ Operating Partnership common unitholders to arrive at FFO allocable to common shareholders. The percentage is computed by taking the weighted-average number of common shares outstanding for the period and dividing it by the sum of the weighted-average number of common shares and the weighted-average number of Operating Partnership units held by noncontrolling interests during the period.

FFO does not represent cash flows from operations as defined by GAAP, is not necessarily indicative of cash available to fund all cash flow needs and should not be considered as an alternative to net income (loss) for purposes of evaluating our operating performance or to cash flow as a measure of liquidity.

FFO, as adjusted, for the year ended December 31, 2014 excludes an $83.2 million gain on extinguishment of debt, net of non-cash default interest expense, primarily related to the conveyance of Chapel Hill Mall and Columbia Place and the foreclosure of Citadel Mall. It also excludes a partial litigation settlement of $7.8 million, net of related expenses. FFO, as adjusted, for the year ended December 31, 2013, excludes a $9.1 million loss on extinguishment of debt, a $2.4 million gain on investment and an $8.2 million partial litigation settlement. In 2012, we recorded a gain on investment of $45.1 million related to the acquisition of the remaining 40% noncontrolling interest in Imperial Valley Mall in December 2012. Considering the significance and nature of these items, we believe that it is important to identify the impact of these changes on our FFO measures for a reader to have a complete understanding of our results of operations. Therefore, we have also presented FFO excluding these items.

FFO of the Operating Partnership increased 24.7% to $545.5 million for the year ended December 31, 2014 compared to $437.5 million for the prior year. Excluding the litigation settlements, the gain on investments, non cash default interest expense and gain (loss) on extinguishment of debt, FFO of the Operating Partnership increased 4.3% for the year ending December 31, 2014 to $454.6 million compared to $435.9 million in 2013.

The reconciliation of ~~FFO to~~ net income attributable to common shareholders to FFO allocable to Operating Partnership common unitholders is as follows (in thousands):

	Year Ended December 31,		
	2014	**2013**	**2012**
Net income attributable to common shareholders	**$ 174,258**	$ 40,312	$ 84,089
Noncontrolling interest in income of Operating Partnership	**30,106**	7,125	19,267
Depreciation and amortization expense of:			
Consolidated properties	**291,273**	278,911	255,460
Unconsolidated affiliates	**41,806**	39,592	43,956
Discontinued operations	**—**	6,638	13,174
Non-real estate assets	**(2,311)**	(2,077)	(1,841)
Noncontrolling interests' share of depreciation and amortization	**(6,842)**	(5,881)	(5,071)
Loss on impairment, net of tax benefit	**18,434**	73,485	50,343
Gain on depreciable property	**(937)**	(7)	(652)
Gain on discontinued operations, net of taxes	**(273)**	(647)	(566)
FFO~~unds from operations of the~~ allocable to Operating Partnership common unitholders	**545,514**	437,451	458,159
Litigation settlement, net of related expenses	**(7,763)**	(8,240)	—
Gain on investments	**—**	(2,400)	(45,072)
Non cash default interest expense	**4,695**	—	—
(Gain) loss on extinguishment of debt	**(87,893)**	9,108	(265)
FFO~~unds from operations of the~~ allocable to Operating Partnership common unitholders, as adjusted	**$ 454,553**	$ 435,919	$ 412,822

The reconciliations of FFO allocable to ~~of the~~ Operating Partnership common unitholders to FFO allocable to common shareholders, including and excluding the litigation settlements, gain on investments, non cash default interest and the gain (loss) on extinguishment of debt are as follows (in thousands):

	Year Ended December 31,		
	2014	**2013**	**2012**
FFO~~unds from operations of the~~ allocable to Operating Partnership common unitholders	**$ 545,514**	$ 437,451	$ 458,159
Percentage allocable to common shareholders (1)	**85.27%**	84.97%	81.36%
FFO~~unds from operations~~ allocable to common shareholders	**$ 465,160**	$ 371,702	$ 372,758
FFO~~unds from operations of the~~ allocable to Operating Partnership common unitholders, as adjusted	**$ 454,553**	$ 435,919	412,822
Percentage allocable to common shareholders (1)	**85.27%**	84.97%	81.36%
FFO~~unds from operations~~ allocable to common shareholders, as adjusted	**$ 387,597**	$ 370,400	$ 335,872

(1) Represents the weighted-average number of common shares outstanding for the period divided by the sum of the weighted-average number of common shares and the weighted-average number of Operating Partnership units held by noncontrolling interests during the period.

[LETTERHEAD OF CHESAPEAKE LODGING TRUST]

July 7, 2015

VIA EDGAR

Mr. Daniel Gordon
Ms. Kristi Marrone
United States Securities and Exchange Commission
Division of Corporation Finance
100 F Street, N.E.
Washington, D.C. 20549

Re: Chesapeake Lodging Trust
Form 10-K for the fiscal year ended December 31, 2014
Filed on February 19, 2015
File No. 001-34572

Ladies and Gentlemen:

This letter is submitted in response to the comments of the staff of the Division of Corporation Finance (the "*Staff*") of the Securities and Exchange Commission (the "*Commission*") contained in the Commission's letter dated May 26, 2015 (the "*Letter*") with respect to the Annual Report on Form 10-K for the fiscal year ended December 31, 2014 (the "*Form 10-K*") of Chesapeake Lodging Trust (the "*Trust*"), which was filed with the Commission on February 19, 2015.

For convenience of reference, each Staff comment is reprinted below in italics, numbered as it was in the Letter, and is followed by the Trust's corresponding response.

<u>Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations</u>

<u>Results of Operations, page 28</u>

1. *In future filings, please include a discussion of the significant individual components of revenue and hotel operating expenses. For example, we note that almost half of hotel operating expenses consist of "indirect" expense. Please clarify the types of indirect expenses included and provide an analysis of significant changes from the prior year, as well as any known trends.*

   RESPONSE: The Trust acknowledges the comment and will provide additional responsive disclosure in future filings.

Hotel Operating Results, page 30

2. *Please remove the term "pro forma" from your narrative disclosure of hotel operating metrics since their presentation is not in accordance with Article 11.*

RESPONSE: As discussed with the Staff, the Trust uses the term "pro forma" to describe its comparisons of the Trust's key metrics of hotel operating performance (occupancy, ADR, RevPAR, Adjusted Hotel EBITDA and Adjusted Hotel EBITDA Margin) as if the Trust had owned each of its hotels owned at the end of the applicable reporting period for the entirety of each comparative period. The Trust's disclosures clearly indicate the meaning of the term as used in this context and do not create any implication that the term is intended to connote Article 11 compliance. Please see the Trust's response to comment 3, below, for further information as to why the Trust believes presentation of these "pro forma" operating metrics is valuable for its investors.

Non-GAAP Financial Measures, page 31

3. *We note that you present Hotel EBITDA and Adjusted Hotel EBITDA including results of operations for certain hotels prior to acquisition and that the measure is reconciled to revenues. To the extent that you present these measures in future filings, please exclude hotel operations prior to acquisition. Item 10(e) of Regulation S-K requires reconciliation of all non-GAAP measures to the most comparable measure calculated in accordance with GAAP. The inclusion of pre-acquisition operating data makes it impossible to reconcile these non-GAAP measures to your historical financial statements and is therefore impermissible. Also see Question 103.02 of the Compliance and Disclosure Interpretations that states that these types of measures should be reconciled to net income.*

RESPONSE: Based on feedback it has received, the Trust continues to believe that presenting Hotel EBITDA and Adjusted Hotel EBITDA on a "pro forma" basis, in a manner that includes the operating results of hotels prior to their acquisition by the Trust, and therefore permits easy comparison of these operating metrics irrespective of the owner of the hotels across comparative periods, provides useful information for its investors and securities analysts. The Trust notes, however, that its acquired hotels generally have a different cost basis (i.e., depreciation expense) and capital structure (i.e., interest expense) under prior ownership for the periods prior to the Trust's acquisitions of the hotels, and as a result does not believe that it would be informative to investors and securities analysts to provide a reconciliation of Hotel EBITDA of the acquired hotels to the prior owners' net income. Accordingly, the Trust proposes to provide a reconciliation of pro forma Hotel EBITDA and Adjusted Hotel EBITDA, including the impact of pre-acquisition operating results from its acquired hotels, to the Trust's reported net income as shown on Exhibit A.

Notes to Consolidated Financial Statements

Note 2. Summary of Significant Accounting Policies, page F-9

4. *Please include a description of your capitalization policy as it relates to renovation and repositioning costs, clearly describing your treatment of interest, salaries, real estate taxes, general and administrative and any other significant amounts that are capitalized during the construction phase. Your disclosure should include a discussion of the periods of capitalization, including when the capitalization period ends.*

RESPONSE: The Trust acknowledges the comment but notes that its past practice generally has been to conduct renovation and repositioning efforts by taking only a portion of the affected hotel out of service at any point in time (i.e., the hotel continues to operate and generate cash flow). In addition, much of the renovation and repositioning activity in which the Trust has been engaged at its hotels has focused on replacement of soft and hard goods and has occurred over short periods of time. As a result, the Trust has not capitalized interest, salaries, real estate taxes or other general and administrative costs related to these efforts.

* * *

EXHIBIT A

CURRENT PRESENTATION:

	Three Months Ended March 31, 2015 Pro Forma
Total revenue	$ 119,870
Less: Total hotel operating expenses	90,145
Hotel EBITDA	29,725
Add: Non-cash amortization	(81)
Adjusted Hotel EBITDA	$ 29,644
Adjusted Hotel EBITDA Margin	24.7%

PROPOSED PRESENTATION:

		Three Months Ended March 31, 2015
Net income		$ 1,552
Add:	Interest expense	7,179
	Depreciation and amortization	14,927
	Air rights contract amortization	130
	Hotel acquisition costs	369
	Corporate general and administrative	4,577
Less:	Income tax benefit	(3,348)
	Interest income	—
Hotel EBITDA		25,386
Less:	Non-cash amortization(1)	(81)
Adjusted Hotel EBITDA		25,305
Add:	Prior owner Hotel EBITDA(2)	4,339
Pro forma Adjusted Hotel EBITDA(2)		$ 29,644
Total revenue		$ 109,290
Add:	Prior owner total revenue(2)	10,580
Pro forma total revenue(2)		$ 119,870
Pro forma Adjusted Hotel EBITDA Margin(2)		24.7%

(1) Includes non-cash amortization of ground lease asset, deferred franchise costs, deferred key money, and unfavorable contract liability.
(2) Includes results of operations for certain hotels prior to our acquisition.

[LETTERHEAD OF CHESAPEAKE LODGING TRUST]

July 17, 2015

VIA EDGAR

Mr. Daniel Gordon
Ms. Kristi Marrone
United States Securities and Exchange Commission
Division of Corporation Finance
100 F Street, N.E.
Washington, D.C. 20549

Re: Chesapeake Lodging Trust
Form 10-K for the fiscal year ended December 31, 2014
Filed on February 19, 2015
File No. 001-34572

Ladies and Gentlemen:

This letter is submitted in response to the comments of the staff of the Division of Corporation Finance (the "*Staff*") of the Securities and Exchange Commission (the "*Commission*") contained in the Commission's letter dated July 14, 2015 (the "*Letter*") with respect to the Annual Report on Form 10-K for the fiscal year ended December 31, 2014 (the "*Form 10-K*") of Chesapeake Lodging Trust (the "*Trust*"), which was filed with the Commission on February 19, 2015.

For convenience of reference, each Staff comment is reprinted below in italics, numbered as it was in the Letter, and is followed by the Trust's corresponding response.

<u>Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations</u>

<u>Non-GAAP Financial Measures, page 31</u>

1. *In future filings revise your disclosure to clearly explain what is included in the adjustments for corporate general and administrative and non-cash amortization and why each of these adjustments is appropriate.*

   RESPONSE: The Trust acknowledges the comment and will include appropriately responsive disclosure in future filings.

* * *

Chimera Investment Corporation
1211 Avenue of the Americas
New York, NY 10036

April 27, 2015

Ms. Jaime G. John
Division of Corporation Finance
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

Re: Chimera Investment Corporation
Form 10-K
Filed March 2, 2015
File No. 00133796

Dear Ms. John:

On behalf of Chimera Investment Corporation ("we", "our" or the "Company"), set forth below is our response to the comments of the staff of the Division of Corporation Finance of the Securities and Exchange Commission, received by letter dated April 13, 2015 in which you provided comments to the reports referenced above.

For your convenience, we have reproduced your comment followed by our corresponding response.

<u>Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations, page 51</u>

<u>Liquidity and Capital Resources, page 74</u>

1. *We note that your disclosure on page 76 provides the weighted average haircut on your repurchase agreements collateralized by your Agency RMBS separately from your non-Agency RMBS. Please disclose the weighted average haircut on your repurchase agreements collateralized by both your Agency and non-Agency RMBS as of the end of each period presented and discuss any known trends or material changes from the prior year.*

Response:

We will disclose the weighted average haircut on our repurchase agreements collateralized by both our Agency and Non-Agency RMBS as of the end of each period presented and discuss any known trends or material changes from the prior year in our subsequent filings with the SEC.

The combined weighted average haircut on our repurchase agreements collateralized by both Agency and Non-Agency RMBS was 4.8% and 8.0% as of December 31, 2013 and December 31, 2014, respectively. The increase was due to the addition of Non-Agency repurchase agreements during the period ending December 31, 2014 which generally required higher collateral requirements. The combined weighted average haircut remained unchanged from the period ending September 30, 2014.

SEC Comment:

Note 3. Residential Mortgage-Backed Securities, page F-17

2. *We note that you define Alt-A mortgage securities on page F-23 as non-Agency RMBS where (i) the underlying collateral has weighted average FICO scores between 680 and 720 or (ii) for instances where FICO scores are greater than 720, RMBS have 30% or less of the underlying collateral composed of full documentation loans. This appears to be a more narrow definition than the one used prior to September 30, 2014. Please explain to us the reasons why management changed the internal definition used to classify Alt-A loans, and disclose in future filings.*

Response:

As part of our financial statement review, we evaluate ways to improve our disclosures, including making our disclosures more comparable with others in the industry. As part of this effort, we reviewed public information of our peers and, as a result of this review, we updated our definition of Alt-A residential mortgage loans. We believe the updated definition is consistent with others in the financial industry. We will disclose this in our first quarter filing with the SEC.

****

In connection with responding to your comments, we acknowledge that:

- the Company is responsible for the adequacy and accuracy of the disclosures in its filing
- SEC Staff comments or changes to disclosures in response to SEC Staff comments do not foreclose the Commission from taking action with respect to such filings; and
- the Company may not assert SEC Staff comments as a defense in any proceeding initiated by the commission or any person under the federal securities laws of the United States.

Please feel free to contact me at 212-696-0100 with any comments or questions you may have with respect to our responses.

Very truly yours,

/s/ Rob Colligan

Rob Colligan
Chief Financial Officer

cc: R. Nicholas Singh, Esq.
Fixed Income Discount Advisory Company

Colony Capital, Inc.

May 19, 2015

Ms. Jennifer Monick
Mr. Isaac Esquivel
Division of Corporation Finance
United States Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549

Dear Ms. Monick and Mr. Esquivel:

This letter is submitted in response to comments from the staff of the Division of Corporation Finance (the "Staff") of the Securities and Exchange Commission (the "Commission") in a letter dated May 5, 2015 (the "Comment Letter") with respect to Colony Capital, Inc.'s (the "Company") Form 10-K for the fiscal year ended December 31, 2014, which was filed with the Commission on February 27, 2015 (the "Form 10-K"), as amended on March 31, 2015, and Form 8-K filed on February 20, 2015 (the "Form 8-K").

For your convenience, the Staff's numbered comments set forth in the Comment Letter have been reproduced in bold herein with responses immediately following each comment. Unless otherwise indicated, page references in the reproductions of the Staff's comments refer to the Form 10-K or the Form 8-K, as applicable.

Form 10-K for the year ended December 31, 2014
Notes to Consolidated Financial Statements
6. Investments in Unconsolidated Joint Ventures, page F-22

1. We note you have a 75% ownership interest in Portfolio 8 Investors, LLC and we further note your disclosure that the minority member has control over the day-to-day operations. Given the ownership interest in the entity, please elaborate and explain to us in detail the facts and circumstances specific about this entity that would cause you to conclude that equity method treatment is more appropriate than consolidation. Please cite applicable guidance in your response.

Portfolio 8 Investors, LLC ("Portfolio 8") is a joint venture established to invest in a portfolio of multifamily properties. The Company owns an 83% interest in a separate consolidated entity ("Preferred Member"), which holds a preferred equity interest in Portfolio 8, representing 75% of the total equity of Portfolio 8. The remaining 25% of equity in Portfolio 8 is held by a third party sponsor ("Common Member"). In addition to a 12% preferred return, the Company's preferred equity is entitled to a 30% profit participation after each member has attained a 12% internal rate of return. Although the Company's preferred equity interest represents more than 50% of the total equity of Portfolio 8, the Company determined that the Common Member controls the venture and that the Company does not currently have the ability to exercise substantive participating or liquidation rights that would overcome the presumption of control by the Common Member. Accordingly, the Company accounts for its investment using the equity method under ASC 323.

Variable Interest Assessment

To evaluate Portfolio 8 for consolidation, the Company first considered the applicability of the variable interest model. While the Company has a variable interest in Portfolio 8 through its preferred equity investment, the Company determined that Portfolio 8 did not meet any of the following characteristics of a variable interest entity under ASC 810-10-15-14:

- *Insufficient equity investment at risk* — At inception, Portfolio 8 was capitalized with $55 million of equity and $171 million of third party non-recourse debt financing, with equity investment at risk representing approximately 24% of the venture's total assets. The Company's preferred equity in Portfolio 8 was deemed to be "at risk" because it participates significantly in both profits and losses, albeit not on a pari passu basis with the Common Member. The Preferred Member participates significantly in profits of Portfolio 8 through its 12% preferred return and 30% of residual return. Based upon these equity-like returns, we determined that the Preferred Member participates significantly in profits of Portfolio 8. The Preferred Member also participates significantly in losses as there is no recourse to the Common

Member, thus the preferred equity investment is subject to total loss. The third party debt obtained by Portfolio 8 was based on customary market terms and without significant guaranties from its equity owners or any of their related parties. In light of the venture's ability to obtain customary third-party debt and its debt-to-total capital ratio, which is consistent with other entities that hold similar assets, the Company concluded that Portfolio 8 has sufficient equity at risk to finance its activities without additional subordinated financial support.

- *Holders of equity investment at risk lack the characteristics of a controlling financial interest* — Portfolio 8 is controlled by a Board of Directors (the "Board") which has delegated day-to-day management of the venture to the Administering Member, which is initially the Common Member. The Common Member cannot be removed as Administering Member without unanimous consent of the Board (composed of two members appointed by the Company and a single member appointed by the Common Member). As the Administering Member, the Common Member is responsible for all aspects of the day-to-day operations, leasing and management of the underlying investment properties, and identifying future investment opportunities, which are deemed to be the activities that most significantly impact the economic performance of the venture. While the members' participation in profits and losses are not on a pari passu basis (due to the preferred return and sharing of residual returns that are not proportionate to the members' economic interests), there are no contractual or other arrangements which protect the members, as a group, from absorbing losses or cap their returns. Since the equity holders, as a group, have the ability to elect the Board, thereby appoint the Administering Member, and have the obligation to absorb expected losses and the right to receive expected residual returns, the equity holders, as a group, have the characteristics of a controlling financial interest.

- *Entity is established with non-substantive voting interests* — The manner in which profits and losses are shared between the members (as noted above) are not proportionate to the members' voting rights (which are split 66.7%/33.3% between the Company and the Common Member, respectively, based upon the members' Board representation and 50%/50% where unanimous consent is required). However, the Company concluded that Portfolio 8 is not established with non-substantive voting interests as substantially all of the activities of Portfolio 8 are not conducted on behalf of, or involve, a member with disproportionately few voting rights relative to its economic interest. In making this qualitative assessment, the Company considered the following:
    - Both the Company and the Common Member invest in real estate; accordingly, the operations of Portfolio 8 are substantially similar in nature to the activities of both members.
    - While the members have rights to buy or sell their equity interest under certain circumstances, these rights are not equivalent to an option with a fixed price or "in the money" put or call feature.
    - While there are transfer restrictions on each member's equity interest, de facto agents identified by ASC 810-10-25-43(d) are not considered in applying the anti-abuse clause, and there are no other arrangements which would create a de facto agency relationship between the members.

Since none of the characteristics of ASC 810-10-15-14 were present, Portfolio 8 was evaluated for consolidation under the voting model.

Voting Interest Assessment
After considering the voting interest model, the Company concluded that Portfolio 8 is a limited liability company which has governing provisions that are the functional equivalent of a limited partnership. Although Portfolio 8 is governed by a Board, the Board has effectively delegated its powers and ceded control over day-to-day operation and management of the investment properties, which represent the core activities of Portfolio 8, to the Common Member as the Administering Member. The role of the Administering Member is akin to that of a general partner in a limited partnership or a managing member in a limited liability company, which is typical in real estate joint ventures. In this regard, the Preferred Member is analogous to a limited partner.

Under the voting interest model for limited partnerships, ASC 810-20-25-3 provides a presumption that the general partner controls the limited partnership, regardless of the extent of its ownership interest. This presumption of control by the general partner can be overcome if the limited partners have either substantive liquidation rights, or substantive kick-out rights without cause, or substantive participating rights that could be exercised by a simple majority vote of limited partners (or by a single limited partner).

The Company does not currently have substantive kick-out or liquidation rights since removal of the Common Member as the Administering Member without cause and liquidation of the venture require unanimous consent of the Board (including the Common Member). Although the Company has the rights to control certain decisions made by the Board, such decisions, which include liquidation of the entity, protection against dilution in economic rights and ownership interests, and new asset acquisition, are protective in nature. Similarly, while the Board is required to approve the venture's annual business plan, the plan is subject to automatic approval as long as it provides for sufficient cash flow to pay debt service and fund the preferred return. Accordingly, the budget approval right does not allow the Company to participate in decision-making in the ordinary course of business. As the rights retained by the Board are non-substantive, the presumption of control by the Administering Member is not overcome.

Based upon the foregoing analysis, the Company concluded that controlling financial interest over Portfolio 8 resides with the Common Member. The Company's preferred equity investment allows it to exert significant influence but not control over Portfolio 8. Accordingly, the Company accounts for its investment in Portfolio 8 under the equity method.

There have been no reconsideration events or changes in the contractual rights of the members since the inception of the investment that affected the assessment described above. We will continue to evaluate any changes in the rights or duties of the members which are conditioned upon future contingent events (including the Common Member's fulfillment of its obligations as Administering Member) to assess if there may be a change to the presumption of control by the Common Member at that time.

Schedule IV, page F-54

2. We note your footnote (3) to your table. Please tell us if you have aggregated loans whose carrying values are individually greater than 3% of the total carrying value. Specifically, address the line item Hotel -various, USA with two loans that have a combined carrying value of $328 million. Please refer to Rule 12-29 of Regulation S-X.

At December 31, 2014, the Company had four loans whose carrying values individually exceeded 3% (or approximately $63.9 million) of total carrying value of loans, all of which are listed individually in Schedule IV.

The two mezzanine loans included in Schedule IV on an aggregate basis were originated as part of a single refinancing of a portfolio of 152 hotels located throughout the United States and represent two subordinate tranches of the debt stack comprising a first mortgage loan owned by third parties with a principal balance of $775 million and two partial mezzanine positions owned by the Company with a combined carrying value of $328 million. The mezzanine loans include a first mezzanine loan with a carrying value of $25 million and a second mezzanine loan with a carrying value of $303 million. Since the carrying value of the first mezzanine loan is less than the 3% threshold, it would have been aggregated with other unrelated loans. However, since the loans share the same collateral pool that is cross-collateralized for the entire debt stack and management views and manages the loans as a single investment, the Company determined that it was more appropriate to combine the two related mezzanine positions for presentation in Schedule IV.

3. Please tell us how you complied with Rule 12-29 of Regulation S-X, or tell us how you determined it was not necessary to disclose the aggregate cost for Federal income tax purposes.

The Company acknowledges the Staff's comment and notes that the aggregate cost basis for Federal income tax purposes as of December 31, 2014 for the mortgage, subordinated and mezzanine loans included in Schedule IV was approximately $2.12 billion, which is not materially different from the GAAP carrying value of $2.13 billion. In future filings, the Company will include this additional information.

Form 8-K Filed on February 20, 2015
Exhibit 99.1 Press Release dated February 19, 2015

4. We note that you present fair value as a non-GAAP financial measure in your press release. Please explain to us how this presentation complies with Regulation G; specifically, please tell us how you determined it was not necessary to provide a reconciliation of this measure to your net book value. If after further consideration you determine to revise your disclosure of the non-GAAP presentation, please provide us with your revised presentation to be included in future filings.

Until recently, the majority of the Company's investment portfolio had been composed of financial instruments (including loans receivable and equity investments in unconsolidated entities) for which we disclose fair value on a quarterly basis in accordance with ASC 825. Certain mortgage REITs that we once viewed as our peers had elected the fair value option for similar financial instruments, and the fair value metrics in our press release were furnished to provide our investors a basis for comparison, as if we had made a similar election.

However, given our increased focus on equity investments and recent combination with Colony Capital, LLC, we view fair value to no longer be relevant to our investors since equity REITs and asset managers that we now view as our peers do not report this metric. Accordingly, beginning in the first quarter of 2015, we have eliminated our disclosure of fair value in our press release. Nonetheless, we acknowledge the Staff's comment and have provided below a reconciliation of the fair value metrics disclosed in our press release, which are primarily derived from our GAAP financial statements.

(In thousands)	Book Value		Fair Value		Excess of Fair Value Over Book Value
Loans receivable, net	$ 2,131,134	(1)	$ 2,163,500	(2)	$ 32,366
Real estate assets, net	1,643,997	(1)	1,650,276	(3)	6,279
Investments in unconsolidated joint ventures	1,646,977	(1)	1,963,965	(2)	316,988
CMBS debt	537,268	(1)	536,927	(2)	341
Convertible senior notes	604,498	(1)	617,763	(2)	(13,265)
Noncontrolling interests	518,313	(1)	527,158	(4)	(8,845)
Total excess of fair value over book value attributable to stockholders					$ 333,864

(In thousands, except per share data)	December 31, 2014	
Total stockholders' equity	$ 2,417,480	(1)
Excess of fair value over book value attributable to stockholders as calculated above	333,864	
Less: Preferred stock liquidation preference	(338,250)	(1)
Fair value of common equity	2,413,094	
Shares of common stock outstanding	109,634	(1)
Fair value per common share	$ 22.01	

____

(1) Derived from the Company's audited consolidated balance sheet as of December 31, 2014

(2) Derived from Note 11 of the Company's audited consolidated financial statements for the year ended December 31, 2014

(3) Estimated based upon discounted cash flows and/or recent transaction prices

(4) Calculated based upon noncontrolling interests' share of each investment entity's estimated fair value of equity under hypothetical liquidation at fair value.

Given that we no longer provide fair value metrics other than as required by GAAP, we do not expect to include such reconciliation in our future filings.

* * * * *

The Company acknowledges that:

- The Company is responsible for the adequacy and accuracy of the disclosure in the filings;
- Staff comments or changes to disclosure in response to staff comments do not foreclose the Commission from taking any action with respect to the filings; and
- The Company may not assert staff comments as a defense in any proceeding initiated by the Commission or any person under the federal securities laws of the United States.

If you have any questions concerning this letter or if you would like any additional information, please do not hesitate to call me at (310) 552-7230.

Sincerely,

/s/ Darren J. Tangen

Darren J. Tangen

Chief Financial Officer and Treasurer

cc: Ronald M. Sanders

Colony Capital, Inc.

David W. Bonser

James E. Showen

Hogan Lovells US LLP

July 8, 2015

Via EDGAR

Securities and Exchange Commission
Division of Corporation Finance
100 F Street, N.E.
Washington, D.C. 20549
Attn: Ms. Jennifer Monick, Staff Accountant

Re: Columbia Property Trust, Inc.
Form 10-K for the fiscal year ended December 31, 2014
Filed February 12, 2015
File No. 1-36113

Form 10-Q for the quarterly period ended March 31, 2015
Filed April 30, 2015
File No. 1-36113

Dear Ms. Monick:

On behalf of Columbia Property Trust, Inc. (the "Company"), we are responding to the comments from the Securities and Exchange Commission Staff (the "Staff") contained in its letter dated June 23, 2015 regarding our Annual Report filed on Form 10-K for the fiscal year ended December 31, 2014 and our Quarterly Report filed on Form 10-Q for the quarterly period ended March 31, 2015 (together, the "Filings"). For your convenience, this letter sets forth in italics each of the Staff's comments before each response.

Form 10-K for the fiscal year ended December 31, 2014

General

1. *We note you jointly filed a Form S-3ASR with Columbia Property Trust Operating Partnership, L.P. ("Columbia LP") on September 15, 2014, and, on March 10, 2015, you jointly filed a 424B with Columbia LP relating to senior notes. We further note the disclosure in Note 15 of your financial statements. Please tell us how you considered (i) whether Columbia LP is an Exchange Act reporting company, (ii) whether it was required to be an Exchange Act reporting company at the time the Form S-3ASR was filed and (iii) whether it has satisfied its reporting obligations.*

Response: In accordance with Rule 3-10(c) of Regulation S-X, the Company is permitted to include, and does include, in its periodic reports condensed consolidating financial information in

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T 800 899 8411
T 404 465 2200
F 404 465 2201

lieu of separate financial statements of Columbia LP (the subsidiary issuer) because all of the following criteria are met:

(1) Columbia LP (the subsidiary issuer) is 100% owned by the Company (the parent guarantor);

(2) the guarantee is full and unconditional; and

(3) no other subsidiary of the Company (the parent guarantor) guarantees the senior notes.

In addition, in accordance with Rule 12h-5(a) of the Exchange Act, Columbia LP, as the issuer of a guaranteed security that is permitted to omit financial statements by Rule 3-10(c) of Regulation S-X, is exempt from the requirements of Section 13(a) or 15(d) of the Exchange Act.

Therefore, we respectfully advise the Staff that:

(I) Columbia LP is exempt from the reporting requirements of Sections 13(a) and 15(d) of the Exchange Act;

(II) Columbia LP was exempt from the reporting requirements of Sections 13(a) and 15(d) of the Exchange Act at the time of the filing of the Form S-3ASR because (i) all of the conditions described above were met for the Company to include condensed consolidating financial information in lieu of separate financial statements of Columbia LP, and (ii) such information was included in the Company's periodic reports at such time, thereby exempting Columbia LP under Rule 12h-5(a) of the Exchange Act; and

(III) based on (i) and (ii) above, we believe Columbia LP has satisfied any reporting obligations.

Item 2. Properties

Property Statistics, page 14

2. *In future Exchange Act periodic reports, please revise to provide disclosure, here or in MD&A, regarding the relationship of rental rates on leases that expired in the reporting period and the rental rates on renewals or new leases on the same space. In addition, please disclose the relationship between rents on leases scheduled to expire in the current period and current market rents for the expiring space.*

   Response: In future periodic Exchange Act reports, beginning with our Form 10-Q for the period ended June 30, 2015, the Company will provide disclosure within the MD&A Overview to discuss the relationship between the rental rates on leases that expired in the reporting period and the rental rates on renewals or new leases on the same space. Further, to the extent material, the Company will also provide commentary regarding the relationship between rental rates on leases scheduled to expire over the near term and the Company's view on current market rents for those spaces within the MD&A Overview.

3. *Please also supplement your disclosure in future Exchange Act periodic reports to discuss leasing costs, including tenant improvement costs and leasing commissions, for both renewals and new leases*

on a per square foot basis.

Response: In future periodic Exchange Act reports beginning with our Form 10-Q for the period ended June 30, 2015, the Company will provide disclosure within the MD&A Overview of the Company’s tenant improvement costs and leasing commissions for both renewals and new leases on a per square foot basis.

Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations, page 22

4. *Please tell us the amount, if any, of internal costs you capitalize to deferred leasing costs and real estate assets for all periods presented. If material, please confirm for us that you will disclose this information within future periodic filings and discuss any significant fluctuations in such capitalized internal costs within your MD&A.*

Response: We have capitalized the following internal costs to deferred leasing costs and real estate assets for the periods presented in the Filings (in thousands):

	For the Years Ended December 31,			For the Three Months Ended March 31,	
	2014	**2013**	**2012**	**2015**	**2014**
Deferred leasing costs	$ 47	$ —	$ —	$ 18	$ 6
Real estate assets	$ 271	$ 187	$ —	$ 81	$ 68

We do not believe these amounts are material, and therefore, do not intend to disclose them. However, in the event these items become material in future periods, the Company confirms that it will disclose the amount of internal costs capitalized to deferred leasing costs and real estate assets and discuss any significant fluctuations in such amounts within MD&A.

Overview, page 22

5. *In future Exchange Act periodic reports, please revise to provide net operating income as well as same store net operating income or advise.*

Response: In future periodic Exchange Act reports beginning with our Form 10-Q for the period ended June 30, 2015, the Company will disclose net operating income and same store net operating income within MD&A. The Company monitors performance metrics that are considered most useful to investors, analysts and other financial statement users. In the future, to the extent the Company deems it appropriate to use different performance metrics or to revise the manner in which such metrics, including net operating income and same store net operating income, are calculated to improve their utility, such revisions will be made consistently in the Company’s Exchange Act periodic reports and in its supplemental financial reports.

Results of Operations

Comparison of the Year Ended December 31, 2014 to 2013

Continuing Operations, page 25

6. *In future Exchange Act periodic reports, please revise here or elsewhere in MD&A to address period to period changes in net income for the comparable pool and also include disclosure addressing the relative impact of same store occupancy changes and average rent changes on the results.*

   Response: In future periodic Exchange Act reports beginning with our Form 10-Q for the period ended June 30, 2015, the Company will discuss within MD&A the period to period changes impacting net income for the comparable pool of properties, including addressing the relative impact of same store occupancy and average rental rate changes on the Company's operating results.

Notes to Consolidated Financial Statements

2. Summary of Significant Accounting Policies

Intangible Assets and Liabilities Arising from In-Place Leases Where Columbia Property Trust is the Lessor

7. *With respect to your below-market lease intangibles, please tell us how you considered any fixed rate renewal options in your estimate of the remaining term of the underlying leases and your basis for your determination. Your response should address, but not necessarily be limited to, whether or not you use a threshold in your evaluation. To the extent you use thresholds, please tell us how you concluded that these thresholds are appropriate and tell us the potential impact to your financial statements if you were to conclude that all below market fixed rate renewal options would be exercised.*

   Response: We amortize below-market in-place lease intangibles over the remaining non-cancelable term of the respective lease, including fixed rate below-market renewal options for which exercise of the renewal option appears to be reasonably assured.

   In estimating the fair value of below-market lease intangibles, we assume that tenants with a fixed rate renewal option would be reasonably assured to exercise the option if the present value of the option rent is at least 10% less than the present value of the corresponding market rent. We utilize a third-party expert to assist us in this determination. For example, if the present value of the market rent over the option term is $100 per square foot and the present value of the contractual option rent over the option term is $90 per square foot, we assume the renewal will be exercised. We have utilized this assumption, which we believe to be reasonable, because we believe that such a discount would be compelling and that tenants would elect to renew their leases under such favorable terms relative to market.

   At a discount of less than 10%, we believe the tenant's consideration of qualitative factors may outweigh the discount in deciding whether to renew a below-market lease. Such qualitative factors may include the tenant's long-term projected space needs, employee and customer preference related to location, image and functionality of the building and office space, and convenience and proximity to transportation, amenities and housing.

As of March 31, 2015, less than $3.0 million of our net intangible below-market lease liability balance of $78.1 million relates to fixed-rate renewal options at our in-place leases. If we had determined that all fixed rate below-market renewal options at our in-place leases would be exercised, there would not have been a material change to the intangible below-market lease liability balance or to the related amortization for any of the periods presented in the Filings.

In future Exchange Act periodic reports, the Company will include the following additional disclosure related to the accounting policies used to measure and amortize below market tenant lease intangibles, including the effect of below market renewal options:

Identifiable intangible assets and liabilities are calculated for above-market and below-market tenant and ground leases where we are either the lessor or the lessee. The difference between the contractual rental rates and our estimate of market rental rates is measured over a period equal to the remaining non-cancelable term of the leases, including significantly below market renewal options for which exercise of the renewal option appears to be reasonably assured.

The remaining term of leases with renewal options at terms significantly below market reflect the assumed exercise of such below market renewal options and assume the amortization period would coincide with the extended lease term.

Schedule III, page S-1

8. *Please tell us how you complied with Rule 12-28 of Regulation S-X, or tell us how you determined it was not necessary to disclose the aggregate cost for Federal income tax purposes of your real estate assets.*

   Response: The Company acknowledges that disclosure of the aggregate cost of its real estate assets for Federal income tax purposes is required by Rule 12-28 of Regulation S-X. The Company will include such disclosure in a footnote to Schedule III beginning in our Form 10-K for the year ended December 31, 2015. As of December 31, 2014, the aggregate gross cost of the Company’s real estate assets for Federal income tax purposes is $5.807 billion.

Form 10-Q for the quarterly period ended March 31, 2015

Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations

Results of Operations, page 30

9. *We note you have multiple factors that impact your results of operations for several line items. In future periodic filings, please confirm that you will separately quantify the impact from each factor.*

Response: In future periodic Exchange Act reports beginning with our Form 10-Q for the period ended June 30, 2015, the Company will quantify the impact of the individual factors impacting the line items discussed in Results of Operations when multiple factors are present.

The Company acknowledges that it is responsible for the adequacy and accuracy of the disclosure in the Filings, and that Staff comments or changes to disclosure in response to Staff comments do not foreclose the Securities and Exchange Commission from taking any action with respect to the Filings. The Company further acknowledges that it may not assert Staff comments as a defense in any proceeding initiated by the Securities and Exchange Commission or by any person under the federal securities laws of the United States.

If we can be of any assistance in explaining these responses, please let us know. Please contact me with any questions or comments at (404) 465-2200.

Very truly yours,

/s/ James A. Fleming
James A. Fleming

cc: Isaac Esquivel, Securities and Exchange Commission
Jerard Gibson, Securities and Exchange Commission
Jennifer Gowetski, Securities and Exchange Commission
Alan Prince, King & Spalding LLP
Mark Scalese, Deloitte & Touche LLP

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Ms. Jaime G. John
Accounting Branch Chief
Division of Corporation Finance
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

July 31, 2015

Re: Corporate Office Properties Trust
Form 10-K for the fiscal year ended December 31, 2014
Filed February 18, 2015
File No. 1-14023

Corporate Office Properties, L.P.
Form 10-K for the fiscal year ended December 31, 2014
Filed February 18, 2015
File No. 333-189188

Dear Ms. John:

Corporate Office Properties Trust ("COPT") and Corporate Office Properties, L.P. ("COPLP") are writing in response to the letter dated July 21, 2015 received from the Staff of the Securities and Exchange Commission (the "Commission") regarding COPT's and COPLP's Annual Reports on Form 10-K for the year ended December 31, 2014 (the "2014 Form 10-K" or the "filing"). Our responses to the Staff's comments appearing in the letter are set forth below. For reference, the Staff's comments, set forth in bold font, precede the Company's responses.

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

Funds from Operations, page 50

1. **Given that you indicate that Basic FFO represents FFO available to common share and common unit holders, in future periodic filings revise Basic and Diluted FFO in your reconciliation on page 52 to clearly label this measure.**

Response: We will clearly label those measures in future filings.

Item 8. Financial Statements and Supplementary Data

Note 17 — Operating Leases, page F-47

2. **We note your disclosure on page 34 that the majority of your leases with the United States Government consist of a series of one-year renewal options or provide for early termination rights. Please tell us how these leases are reflected in your table on page F-47 of gross minimum future rentals on noncancelable leases and tell us the percentage of each amount in the table that includes such leases.**

Response: Our disclosure of gross minimum future rentals in the table on page F-47 includes rents from our leases with the United States Government when we conclude that the exercise of these renewal options is reasonably assured. Rents from these leases comprise the following percentages of each amount in the table:

2015	18%
2016	19%
2017	20%
2018	18%
2019	19%
Thereafter	27%

In connection with our response to the Staff's comments, COPT and COPLP acknowledge that:

- COPT and COPLP are responsible for the adequacy and accuracy of the disclosure in the filing;

Corrections Corporation of America
10 Burton Hills Blvd.
Nashville, TN 37215

July 10, 2015

VIA EDGAR

Mr. Jaime G. John
Branch Chief
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-7010

Re: Corrections Corporation of America
Form 10-K for Fiscal Year Ended December 31, 2014
Filed February 25, 2015
Form 8-K filed on May 7, 2015
File No. 1-16109

Dear Mr. John:

This letter is in response to your comment letter dated July 6, 2015, with respect to the documents referenced above filed by Corrections Corporation of America (the "Company").

Given the Staff's comments and the Company's proposed responses, we respectfully request that the Company be permitted to make any necessary changes in future filings beginning with the Company's Form 10-K for the fiscal year ended December 31, 2015, as indicated in your comment letter. In any event, we would appreciate the opportunity to discuss our proposed responses with you to determine if they appropriately address the Staff's concerns. We have prepared these responses with the assistance of our counsel and the proposed responses have been read by our independent registered public accounting firm. In accordance with your instructions, we have keyed our responses to the specific numbered comments contained in your letter dated July 6, 2015.

In accordance with your letter dated July 6, 2015, the Company acknowledges that the Company is responsible for the adequacy and accuracy of the disclosure in any Company filing and that Staff comments or changes to disclosures in response to Staff comments do not foreclose the Securities and Exchange Commission (the "Commission") from taking any action with respect to the filing. The Company also acknowledges that it may not assert Staff comments as a defense in any proceeding initiated by the Commission or any person under the federal securities laws of the United States.

Form 10-K for the Fiscal Year Ended December 31, 2014

General

1. In future Exchange Act reports, please include a schedule of facility contract expirations for each of the next ten years, stating the number of facility contracts expiring, the total number of beds covered by such contracts, the annual revenue represented by such contracts, and the percentage of total annual revenue represented by such contracts. Refer to Item 15(f) of Form S-11 as a guide.

Response to Question 1:

We typically enter into facility contracts with governmental entities for terms of up to five years, with additional renewal periods at the option of the contracting governmental agency. Most of our facility contracts also contain clauses that allow the government agency to terminate the contract at any time without cause and our contracts are generally subject to annual or bi-annual legislative appropriations of funds. As a result, there is not significant incremental risk to our contracts which have expired or are scheduled to expire within twelve months from the reporting date to those contracts that have remaining renewal options.

We have exchanged correspondence with the Commission on matters similar to the question raised herein on a letter dated March 25, 2010 from us with follow up correspondence submitted on April 9, 2010 regarding disclosures made in our Form 10-K for the year ended December 31, 2009. In that correspondence we agreed to include a statement in future periodic filings that we believe we will renew all contracts that have expired or are scheduled to expire within the next twelve months that would have a material effect on our financial statements if not renewed, other than those contracts with customers that are specifically disclosed to be terminated or for which management believes that it is reasonably likely that a renewal will not be obtained and for which the non-renewal would have a material effect on our financial statements.

For each reporting period we assess the facts and circumstances related to our contracts to determine which contracts, if any, we believe are reasonably likely to expire upon termination or which contracts the customer is reasonably likely to elect to terminate prior to expiration and would have a material impact to revenue or income from continuing operations. We also determine which contracts are necessary to disclose as a risk of termination and make such disclosure in our Management’s Discussion and Analysis of Financial Condition and Results of Operations in our quarterly periodic filings along with the statement that we believe we will renew all other contracts. We have included such disclosure for each quarterly period since our correspondence with the Commission on April 9, 2010.

We have reviewed the information in Item 15(f) of Form S-11 as well as examples of similar tabular disclosures from other public REITs. Given that many of our contracts are short-duration, three to five years in most cases, and, unlike other REITs, are subject to fluctuations in revenue based on fluctuations in inmate populations, we believe that such a disclosure may misleadingly suggest that a larger portion of our contracts are likely to terminate in the near term than has historically been the case. We believe our renewal rate on existing contracts remains high as a result of a variety of reasons including, but not limited to, the constrained supply of available beds within the U.S. correctional system, our ownership of the majority of the beds we operate, and the quality of our operations. Similarly, a table of contract expirations may mistakenly suggest that revenue from a contract is secure through contract expiration when, in fact, the government customer has the right to terminate prior to its expiration. Based on the foregoing, we respectfully request that the Commission reconsider the need for a tabular schedule presenting the revenues of all contracts scheduled to expire over the next ten years.

Item 1A. Risk Factors

We are subject to terminations, non-renewals, or competitive re-bids of our government contracts, page 27

2. We note your disclosure on page 27 that twenty-three of your facility contracts are scheduled to expire by December 31, 2015. In future Exchange Act reports please revise your risk factor disclosure regarding such expiring contracts to quantify the revenue and the percentage of total revenues represented by the facility contracts as of the most recent fiscal year.

Response to Question 2:

We advise the Staff that in future Annual Reports on Form 10-K we will disclose in the risk factor the revenue and the percentage of total revenues represented by the facility contracts that are scheduled to expire within the next twelve months. The aggregate revenue earned during the year ended December 31, 2014 for the twenty-three contracts with scheduled maturity dates, notwithstanding contractual renewal options, on or before December 31, 2015 was $526.1 million, or 32% of total revenue.

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

Critical Accounting Policies

Self-Funded Insurance Reserves, page 53

3. Please provide to us a roll forward of your insurance reserves. The roll forward should include the amount of incurred claims, any changes in the provision for prior year events, and the amount of payments made.

Response to Question 3:

Self-funded insurance reserves include accrued liabilities for employee health, workers' compensation, and automobile insurance claims. We have consistently accrued the estimated liability for employee health insurance claims based on our history of claims experience and the estimated time lag between the incident date and the date we pay the claims. We have accrued the estimated liability for workers' compensation claims based on a third-party actuarial valuation of the outstanding liabilities, discounted to the net present value of the outstanding liabilities, using a combination of actuarial methods to project ultimate losses, and our automobile insurance claims based on estimated development factors on claims incurred. Please see the roll forward of our self-funded insurance reserves. *(in millions):*

Balance as of December 31, 2013	$ 33.8
Claims provision	81.2
Payments	(83.0)
Balance as of December 31, 2014	$ 32.0

Investing activities, page 76

4. We note from your disclosure on page F-10 that you capitalize construction costs directly associated with the development of a correctional facility. In future filings please disclose the total amount of soft costs capitalized, such as payroll and other G&A costs, for the respective years. Also provide a narrative discussion for fluctuations from year to year, if material.

Response to Question 4:

The only soft cost that has historically been capitalized by us during the development of a correctional facility is capitalized interest which we disclose in both the statement of cash flows and the Management's Discussion and Analysis of Financial Condition and Results of Operations in our periodic filings. In the future, if we undertake the development of real estate and capitalize internal soft costs in accordance with Accounting Standards Codification ("ASC") 970-10-15, "Real Estate – General" we will disclose the material components of the amounts capitalized.

Item 8. Financial Statements and Supplementary Data

Notes to Consolidated Financial Statements

Note 18. Condensed Consolidating Financial Statements of CCA and Subsidiaries, page F-40

5. Please tell us the consideration you gave to presenting the material components of investing and financing activities in your condensed consolidating statements of cash flows. Refer to Rule 3-10(i)(1) and Rule 10-01(a)(4) of Regulation S-X.

Response to Question 5:

According to Rule 3-10 of Regulation S-X, we are required to provide condensed consolidating financial information with a separate column for the parent company, subsidiary issuer(s), combined subsidiary guarantor(s), combined subsidiary non-guarantors (if not minor) and each subsidiary issuer or subsidiary guarantor that is not 100% owned, whose guarantee is not full and unconditional, or whose guarantee is not joint and several with the guarantees of other subsidiaries. Further, Rule 10-01(a)(4) of Regulation S-X provides guidance specific to the cash flow presentation. It states that that the statement of cash flows may be abbreviated starting with a single figure of net cash flows from operating activities and showing cash changes from investing and financing activities individually only when they exceed 10% of the average of net cash flows from operating activities for the most recent three years. Notwithstanding this test, §210.4-02 applies and de minimis amounts therefore need not be shown separately.

Our basis for the abbreviated disclosure in the condensed consolidating statement of cash flows was primarily that substantially all cash flow activity occurs within either the parent or the guarantor subsidiaries. In our view, the primary benefit of this statement to the users of the financial statements would be the disclosure of any material cash flows occurring within non-guarantor subsidiaries. Given that the activity reported in the Consolidating Adjustments and Other column reflect only intercompany eliminations and thus there is no cash flow activity occurring in non-guarantor subsidiaries, we did not feel that an expanded disclosure would add meaningful value to the overall disclosure since the expanded data is already provided in the consolidated statements of cash flows.

Schedule III – Real Estate Assets and Accumulated Depreciation, page F-48

6. Please tell us the consideration you gave to instruction 6 to Rule 12-28 of Regulation S-X which requires disclosure of the aggregate cost for Federal income tax purposes of your real estate assets.

Response to Question 6:

The Company has omitted the disclosure in prior filings because the aggregate cost of real estate assets for federal income tax purposes has not differed materially from the gross value reported in schedule III. Given the Staff's comment, however, we confirm that we will include the disclosure in future filings. The aggregate cost of real estate assets for federal income tax proposes was approximately $3.1 billion at December 31, 2014, the same as the gross cost of the real estate.

Form 8-K filed on May 7, 2015

Exhibit 99.1 Press Release dated May 6, 2015

7. We note that you present net operating income in your earnings releases as a non-GAAP measure. Please revise future earnings releases to include all of the disclosures required by Item 10(e)(1)(i) of Regulation S-K for this measure. In your response, provide an example of your proposed disclosure.

Response to Question 7:

Net operating income is a measure that we believe supplements our discussion and analysis of our results of operations and is a measure that is used by management to assess operating performance. We confirm that to the extent we continue to use net operating income in future press releases we will include all of the disclosures required by Item 10(e)(1)(i) of Regulation S-K for this measure. An example of our disclosure and the related reconciliation to the most comparable GAAP measure is included as requested.

Adjusted Net Income, net operating income (NOI), EBITDA, Funds From Operations (FFO), Normalized FFO and Adjusted Funds From Operations (AFFO), and their corresponding per share metrics are non-GAAP financial measures. CCA believes that these measures are important operating measures that supplement discussion and analysis of the Company's *results of operations and are used to review and assess operating performance of the Company and its correctional facilities and their management teams. CCA believes that it is useful to provide investors, lenders and security analysts' disclosures of its results of operations on the same basis that is used by management. FFO and AFFO, in particular, are widely accepted non-GAAP supplemental measures of REIT performance, each grounded in the standards for FFO established by the National Association of Real Estate Investment Trusts (NAREIT).*

NAREIT defines FFO as net income computed in accordance with generally accepted accounting principles, excluding gains (or losses) from sales of property and extraordinary items, plus depreciation and amortization of real estate and impairment if depreciable real estate. EBITDA, NOI, FFO, and AFFO are useful as supplemental measures of performance of the Company's correctional facilities because they add back non-cash expenses such as depreciation and amortization, or with respect to EBITDA, the impact of the Company's tax provisions and financing strategies.

(Amounts in thousands)	For the Three Months Ended March 31,	
	2015	2014
Net income	$ 57,277	$ 51,738
Income tax expense	1,385	1,367
Other income	(26)	(387)
Interest expense, net	10,190	10,348
General and administrative	26,872	25,392
Depreciation and amortization	28,685	28,384
Asset impairments	955	—
Net operating income	$ 125,338	$ 116,842

If you have any questions concerning our responses to your questions and comments, please do not hesitate to contact me at (615) 263-3008, or by facsimile at (615) 263-3010 or our outside counsel, William J. Cernius of Latham & Watkins at (714) 755-8172 or by facsimile at (714) 755-8290.

Sincerely,

David M. Garfinkle
Executive Vice President and
Chief Financial Officer

Corrections Corporation of America
10 Burton Hills Blvd.
Nashville, TN 37215

July 31, 2015

VIA EDGAR

Mr. Jaime G. John
Branch Chief
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-7010

Re: Corrections Corporation of America
Form 10-K for Fiscal Year Ended December 31, 2014
Filed February 25, 2015
Form 8-K filed on May 7, 2015
File No. 1-16109

Dear Mr. John:

On Wednesday, July 22, 2015, the SEC provided comments with respect to Corrections Corporation of America's (the "Company") response dated July 10, 2015 to the comments issued by the Staff in its letter dated July 6, 2015 in relation to the Company's Form 10-K for the year ended December 31, 2014. For your ease of reference, we have included your original comments in italics below and have provided a response after the comment.

We have prepared this response with the assistance of our counsel and the proposed response has been read by our independent registered public accounting firm. The Company acknowledges that the Company is responsible for the adequacy and accuracy of the disclosure in any Company filing and that Staff comments or changes to disclosures in response to Staff comments do not foreclose the Securities and Exchange Commission (the "Commission") from taking any action with respect to the filing. The Company also acknowledges that it may not assert Staff comments as a defense in any proceeding initiated by the Commission or any person under the federal securities laws of the United States.

Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations

Critical Accounting Policies

Self-Funded Insurance Reserves, page 53

We note your response to prior comment 1. Please tell us the consideration you gave to disclosing the amount of claims provisions and payments. Additionally, confirm to us that you did not adjust your claims provision for re-estimates due to prior year loss development.

Response:

As we noted in our response dated July 10, 2015, our self-funded insurance reserves include accrued liabilities for employee health, workers’ compensation, and automobile insurance claims. We have consistently accrued the estimated liability for employee health insurance claims based on our history of claims experience and the estimated time lag between the incident date and the date we pay the claims. We review the time lag related to our employee health claims on a monthly basis and have found it to be consistent and short-term in nature, with a range between 45 and 50 days. Due to the short-term nature of the time lag, we do not believe re-estimates due to prior year loss development, if any, would have a material impact on our reserve for employee health claims. Further, as of December 31, 2014, our employee health claims reserve accrual was $8.6 million, which represented approximately 3% of total current liabilities and less than 1% of total liabilities.

Additionally, as noted in our response on July 10, 2015, we have accrued the estimated liability for workers’ compensation claims based on a third-party actuarial valuation of the outstanding liabilities, discounted to the net present value of the outstanding liabilities, using a combination of actuarial methods to project ultimate losses, and our automobile insurance claims based on estimated development factors on claims incurred. Generally, our payments and incurred expense under our workers’ compensation and automobile insurance claim provisions are consistent from period to period. For the years ended 2014 and 2013, management reviewed the impact of the prior year loss development re-estimates on projected workers’ compensation ultimate losses as provided by our third-party actuary. We noted a change of approximately $34,000 in the workers’ compensation liability from 2013 to 2014 related to these re-estimates. Given the immaterial amounts of re-estimates for prior year loss development, we presented the amounts in the claims provision in our roll forward provided in our July 10, 2015 response. Further, as of December 31, 2014, our workers’ compensation reserve accrual was $22.5 million, which represented approximately 7% of total current liabilities and 1% of total liabilities. As of December 31, 2014, our automobile insurance claim accrual was $0.9 million, which represented less than 1% of total current liabilities and less than 1% of total liabilities.

In response to the Staff’s comment and based on the information provided, we believe our current disclosure of our accounting policies related to our self-insurance reserves provides a balanced presentation of such estimates. Further, based on our analyses, we do not believe re-estimates due to prior year loss development, if any, were material to our self-insurance reserves and, thus, would not necessitate separate disclosure. Further, when we have experienced material fluctuations in the total provision for self-insured insurance reserves we have disclosed the impact in our Results of Operations section of Management's Discussion and Analysis. In future filings, if we identify material changes in the re-estimates of prior year loss development or material changes in the development of self-insured losses we will consider the need to emphasize the factors that led to such a change within the Critical Accounting Policy as well as our Results of Operations.

If you have any questions concerning our responses to your questions and comments, please do not hesitate to contact me at (615) 263-3008, or by facsimile at (615) 263-3010 or our outside counsel, William J. Cernius of Latham & Watkins at (714) 755-8172 or by facsimile at (714) 755-8290.

Sincerely,

David M. Garfinkle
Executive Vice President and
Chief Financial Officer

CUBESMART

July 8, 2015

Via EDGAR

Jamie G. John
Branch Chief
Division of Corporation Finance
Securities and Exchange Commission
100 F St. Street, NE
Washington, D.C. 20549

Re: CubeSmart
Form 10-K for the Year Ended December 31, 2014
Filed February 27, 2015
File No. 001-32324

CubeSmart, L.P.
Form 10-K for the Year Ended December 31, 2014
Filed February 27, 2015
File No. 000-54462

Dear Mr. John:

This letter is submitted on behalf of CubeSmart and CubeSmart, L.P. (collectively, the "***Company***") in response to the comments regarding the above-referenced filings (the "***Filings***") that you provided on behalf of the staff of the Division of Corporate Finance (the "***Staff***") of the Securities and Exchange Commission (the "***Commission***") to Timothy M. Martin, the Company's Chief Financial Officer, in your letter dated June 23, 2015 (the "***Comment Letter***"). The responses are set out in the order in which the comments were set out in the Comment Letter and are numbered accordingly. For reference purposes, the text of the comments contained in the Comment Letter have been reproduced herein (in italics), with the Company's response below such comment.

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

Revenues, page 50

1. *We note your disclosure that your same-store portfolio provided an $18.7 million increase in rental income during 2014 as compared to 2013, due to increases in net rental rates and average occupancy. In future Exchange Act reports, please expand upon your narrative description of same-store performance to explain whether the increases in*

net rental rates were a result of increased rates on new tenants or existing tenants, reduced promotional discounts, or otherwise.

Response: In response to the Staff's comment, in future reports filed by us pursuant to the Securities Exchange Act of 1934, as amended, ("***Exchange Act reports***") in which we discuss same-store performance, we will include an explanation of whether changes in net rental rates are the result of changes in rates on new tenants or existing tenants, changes to promotional discounts, or otherwise.

Non-GAAP Financial Measures

FFO, as adjusted, page 55

2. *We note that your presentation of FFO appears to represent "FFO attributable to common shareholders and Operating Partnership unitholders". Please advise and revise your label accordingly in future filings.*

Response: We confirm that the presentation of funds from operations ("***FFO***") in the Filings does represent FFO attributable to common shareholders and Operating Partnership unitholders. In our future Exchange Act reports where FFO is presented, we will label the presentation of FFO accordingly.

Item 11. Executive Compensation

Definitive Proxy Statement filed on April 17, 2015

Compensation Discussion and Analysis, page 23

3. *We note your disclosure on pages 23 through 24 regarding the 2014 peer group your Compensation Committee used "for benchmarking purposes." In future Exchange Act reports, please provide more detail about how you benchmark compensation against the compensation of your peer group. Please refer to Item 402(b)(2)(xiv) of Regulation S-K.*

Response: In response to the Staff's comment, in future Exchange Act reports where we disclose information regarding the peer group our Compensation Committee uses for benchmarking purposes, we will provide additional detail regarding how our Compensation Committee benchmarks the compensation of our management against the compensation of similarly situated management in the peer group.

Annual Incentive Compensation, page 26

4. *We note your disclosure on page 26 that the Annual Incentive Compensation is measured in part by your funds from operations growth, same-store net operating income growth, and the achievement of "strategic goals consisting of external growth." In future Exchange Act reports, please identify the strategic goals for external growth. Please also*

disclose your target levels with respect to these metrics, or provide us with your analysis for concluding that the disclosure of such targets is not required because it would result in competitive harm and that such disclosure may be omitted pursuant to Instruction 4 to Item 402(b) of Regulation S-K. To the extent you omit disclosure of targets because it will result in competitive harm, please include a discussion in future Exchange Act reports of how difficult it will be for the executive or how likely it will be for the company to achieve the undisclosed target level or other factor or criteria. Please see Instruction 4 to Item 402(b) and Regulation S-K Compliance & Disclosure Interpretation 118.04..

Response: In response to the Staff's comment, in future Exchange Act reports where we include a discussion of annual incentive compensation (or other, similar compensation based upon the achievement of specific performance metrics), we will identify the goals or performance metrics and disclose target levels with respect to such metrics. However, to the extent we believe that the disclosure of the target levels of such goals or performance metrics will cause us competitive harm, we will not disclose such target levels, but rather will provide an analysis of why we concluded that disclosure of such target levels will cause us competitive harm, allowing us to forgo such disclosure of the target levels. Further, to the extent we do not disclose the target levels of relevant goals and performance metrics, we will include a discussion of how difficult it will be for the executive, or how likely it will be for the Company, to achieve the undisclosed target levels of such goals and performance metrics.

In responding to the Staff's comments, the Company acknowledges that:

- the Company is responsible for the adequacy and accuracy of the disclosure in the Filings;
- the Staff's comments or changes to disclosure in response to the Staff's comments do not foreclose the Commission from taking any action with respect to the Filings; and
- the Company may not assert the Staff's comments as a defense in any proceeding initiated by the Commission or any person under the federal securities laws of the United States.

Sincerely,

/s/ Timothy M. Martin

Timothy M. Martin
Chief Financial Officer

July 8, 2015

Via EDGAR

Jamie G. John
Branch Chief
Division of Corporation Finance
Securities and Exchange Commission
100 F St. Street, NE
Washington, D.C. 20549

Re: CubeSmart
Form 10-K for the Year Ended December 31, 2014
Filed February 27, 2015
File No. 001-32324

CubeSmart, L.P.
Form 10-K for the Year Ended December 31, 2014
Filed February 27, 2015
File No. 000-54462

Dear Mr. John:

This letter is submitted on behalf of CubeSmart and CubeSmart, L.P. (collectively, the "***Company***") in response to the comments regarding the above-referenced filings (the "***Filings***") that you provided on behalf of the staff of the Division of Corporate Finance (the "***Staff***") of the Securities and Exchange Commission (the "***Commission***") to Timothy M. Martin, the Company's Chief Financial Officer, in your letter dated June 23, 2015 (the "***Comment Letter***"). The responses are set out in the order in which the comments were set out in the Comment Letter and are numbered accordingly. For reference purposes, the text of the comments contained in the Comment Letter have been reproduced herein (in italics), with the Company's response below such comment.

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

Revenues, page 50

1. *We note your disclosure that your same-store portfolio provided an $18.7 million increase in rental income during 2014 as compared to 2013, due to increases in net rental rates and average occupancy. In future Exchange Act reports, please expand upon your narrative description of same-store performance to explain whether the increases in*

net rental rates were a result of increased rates on new tenants or existing tenants, reduced promotional discounts, or otherwise.

Response: In response to the Staff's comment, in future reports filed by us pursuant to the Securities Exchange Act of 1934, as amended, ("***Exchange Act reports***") in which we discuss same-store performance, we will include an explanation of whether changes in net rental rates are the result of changes in rates on new tenants or existing tenants, changes to promotional discounts, or otherwise.

Non-GAAP Financial Measures

FFO, as adjusted, page 55

2. *We note that your presentation of FFO appears to represent "FFO attributable to common shareholders and Operating Partnership unitholders". Please advise and revise your label accordingly in future filings.*

Response: We confirm that the presentation of funds from operations ("***FFO***") in the Filings does represent FFO attributable to common shareholders and Operating Partnership unitholders. In our future Exchange Act reports where FFO is presented, we will label the presentation of FFO accordingly.

Item 11. Executive Compensation

Definitive Proxy Statement filed on April 17, 2015

Compensation Discussion and Analysis, page 23

3. *We note your disclosure on pages 23 through 24 regarding the 2014 peer group your Compensation Committee used "for benchmarking purposes." In future Exchange Act reports, please provide more detail about how you benchmark compensation against the compensation of your peer group. Please refer to Item 402(b)(2)(xiv) of Regulation S-K.*

Response: In response to the Staff's comment, in future Exchange Act reports where we disclose information regarding the peer group our Compensation Committee uses for benchmarking purposes, we will provide additional detail regarding how our Compensation Committee benchmarks the compensation of our management against the compensation of similarly situated management in the peer group.

Annual Incentive Compensation, page 26

4. *We note your disclosure on page 26 that the Annual Incentive Compensation is measured in part by your funds from operations growth, same-store net operating income growth, and the achievement of "strategic goals consisting of external growth." In future Exchange Act reports, please identify the strategic goals for external growth. Please also*

disclose your target levels with respect to these metrics, or provide us with your analysis for concluding that the disclosure of such targets is not required because it would result in competitive harm and that such disclosure may be omitted pursuant to Instruction 4 to Item 402(b) of Regulation S-K. To the extent you omit disclosure of targets because it will result in competitive harm, please include a discussion in future Exchange Act reports of how difficult it will be for the executive or how likely it will be for the company to achieve the undisclosed target level or other factor or criteria. Please see Instruction 4 to Item 402(b) and Regulation S-K Compliance & Disclosure Interpretation 118.04..

Response: In response to the Staff's comment, in future Exchange Act reports where we include a discussion of annual incentive compensation (or other, similar compensation based upon the achievement of specific performance metrics), we will identify the goals or performance metrics and disclose target levels with respect to such metrics. However, to the extent we believe that the disclosure of the target levels of such goals or performance metrics will cause us competitive harm, we will not disclose such target levels, but rather will provide an analysis of why we concluded that disclosure of such target levels will cause us competitive harm, allowing us to forgo such disclosure of the target levels. Further, to the extent we do not disclose the target levels of relevant goals and performance metrics, we will include a discussion of how difficult it will be for the executive, or how likely it will be for the Company, to achieve the undisclosed target levels of such goals and performance metrics.

In responding to the Staff's comments, the Company acknowledges that:

- the Company is responsible for the adequacy and accuracy of the disclosure in the Filings;
- the Staff's comments or changes to disclosure in response to the Staff's comments do not foreclose the Commission from taking any action with respect to the Filings; and
- the Company may not assert the Staff's comments as a defense in any proceeding initiated by the Commission or any person under the federal securities laws of the United States.

Sincerely,

/s/ Timothy M. Martin

Timothy M. Martin
Chief Financial Officer

July 15, 2015

VIA EDGAR
Mr. Jaime G. John, Branch Chief
United States Securities and Exchange Commission
Division of Corporation Finance
100 F Street, N.E.
Washington, D.C. 20549

RE: CYS Investments, Inc.
Form 10-K for fiscal year ended December 31, 2014
Filed on February 17, 2015
File No. 1-33740

Dear Mr. John:

This letter is submitted in response to the comment of the Staff of the Division of Corporation Finance (the "**Staff**") of the Securities and Exchange Commission (the "**Commission**") contained in your letter dated July 6, 2015 with respect to the Form 10-K for the fiscal year ended December 31, 2014 of CYS Investments, Inc. (the "**Company**"), which was filed with the Commission on February 14, 2015 (the "**Form 10-K**").

For convenience of reference, the Staff comment contained in your July 6, 2015 comment letter is reprinted below in italics, and followed by the corresponding response of the Company.

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

Quantitative and Qualitative Disclosures about Short-Term Borrowings, page 46

In future annual filings, please quantify the average quarterly balance for all periods presented, the period end balance for each of those quarters and the maximum balance at any month-end. Additionally, explain significant variances among these amounts. Provide an example of your proposed revisions within your response.

RESPONSE: In the Company's future annual filings with the Commission, it will include the average quarterly balance for all periods presented, the period end balance for each of those quarters and the maximum balance at any month-end. Additionally, the Company will endeavor to explain significant variances among these amounts. An example of such disclosure that the Company anticipates in its future Exchange Act annual reports is as follows:

"The following table discloses quantitative data about our short-term repo borrowings during the years ended December 31, 2014 and 2013:

(Dollars in millions)

Quarter ended	December 31, 2014	September 30, 2014	June 30, 2014	March 31, 2014
Outstanding at period end	$ 11,290	$ 10,403	$ 9,874	$ 10,014
Weighted average rate at period end	0.35%	0.20%	0.30%	0.31%
Average outstanding during period	$ 10,854	$ 10,189	$ 9,981	$ 10,868
Weighted average rate during period	0.34%	0.30%	0.30%	0.35%
Largest month end balance during period	$ 11,290	$ 10,403	$ 10,095	$ 11,771

Quarter ended	December 31, 2013	September 30, 2013	June 30, 2013	March 31, 2013
Outstanding at period end	$ 11,207	$ 11,735	$ 13,809	$ 13,760
Weighted average rate at period end	0.41%	0.39%	0.39%	0.41%
Average outstanding during period	$ 11,384	$ 12,181	$ 13,871	$ 14,108
Weighted average rate during period	0.41%	0.39%	0.41%	0.43%
Largest month end balance during period	$ 11,735	$ 13,809	$ 14,050	$ 14,544

From quarter to quarter, fluctuations occur in our short-term repo borrowings that are fairly tightly correlated with the expansion and contraction of our investment portfolio. Though it varies by quarter, we currently require repo borrowing funding for approximately 85-90 percent of our investment portfolio."

* * * *

The Company acknowledges that:

- the Company is responsible for the adequacy and accuracy of the disclosure in the filing;
- Staff comments or changes to disclosure in response to Staff comments do not foreclose the Commission from taking any action with respect to the filing; and
- the Company may not assert Staff comments as a defense in any proceeding initiated by the Commission or any person under the federal securities laws of the United States.

If you have any questions or comments regarding the foregoing, or have additional questions or comments, please do not hesitate to contact me at (617) 639-0403.

Very truly yours,

/s/ Frances R. Spark
Frances R. Spark, Chief Financial Officer

FRS/tar
c: Kevin E. Grant, Chief Executive Officer
Thomas A. Rosenbloom, General Counsel
S. Gregory Cope, Esquire, Hunton & Williams LLP
Gregory L. Comeau, Deloitte & Touche LLP

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LATHAM&WATKINS LLP

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May 22, 2015

VIA EDGAR

United States Securities and Exchange Commission
Division of Corporation Finance
100 F Street, N.E.,
Washington, D.C. 20549
Attention: Daniel Gordon

Re: Digital Realty Trust, Inc.
Form 10-K for the fiscal year ended December 31, 2014
Filed March 2, 2015
File No. 1-32336

Digital Realty Trust, L.P.
Form 10-K for the fiscal year ended December 31, 2014
Filed March 2, 2015
File No. 0-54023

Dear Mr. Gordon:

This letter sets forth the response of Digital Realty Trust, Inc. and Digital Realty Trust, L.P. (collectively, the "***Subject Companies***") to the comments received on May 19, 2015 from the staff (the "***Staff***") of the Division of Corporation Finance of the United States Securities and Exchange Commission (the "***Commission***") regarding the Form 10-K (the "***2014 Form 10-K***") filed by the Subject Companies on March 2, 2015.

For ease of review, we have set forth below the numbered comment of the Staff in its letter dated May 19, 2015 and the Subject Companies' response thereto.

4. Investments in Unconsolidated Joint Ventures

Griffin Capital Essential Asset REIT, Inc. Joint Venture, page 127

1. We note you contributed a property valued at $185.5 million in September 2014 to a joint venture with Griffin Capital Essential Asset REIT, Inc., and net of proceeds received, recognized a gain of $93.5 million. Please provide to us the basis of your conclusion to deconsolidate the property and record a gain on the sale of the 80% interest in the joint venture, and cite the appropriate accounting literature in your response. Also in your response, outline all decisions determined by the company to be major that require approval of the GCEAR member as well as those decisions that do not require such approval.

Response: Pursuant to our agreement with Griffin Capital Essential Asset REIT, Inc. ("***GCEAR***"), the Subject Companies contributed a wholly owned property to the joint venture in exchange for cash and a retained 20% interest in the joint venture (the "***Venture***"). We considered the consolidation guidance in ASC 810 to determine our subsequent accounting for our interest in the Venture. We note that the Venture did not meet the criteria to be considered a variable interest entity as the entity has sufficient equity to finance its activities, the equity interest holders are the only parties with the ability to direct the activities of the entity, and there are no non-substantive voting rights. Thus we concluded that our accounting for our interest in the Venture should follow the voting interest model. We note that the unanimous member consent requirements of the Venture agreement give GCEAR the right and ability to approve all significant decisions related to the Venture. As a result, we concluded that even though we are the managing member of the Venture, GCEAR had substantial participating rights that precluded our ability to control the Venture, and thus we concluded that the equity method of accounting for our retained interest in the Venture was appropriate.

A summary of the decisions that require approval of GCEAR are noted below:

1. Adopt or amend any Annual Plan or cause the joint venture to materially deviate from the Annual Plan.
2. Acquire any real property, or interest therein, either directly or indirectly.
3. Acquire any other material asset for the use, operation, maintenance, repair, construction, financing, refinancing, pledge, encumbrance, ownership, leasing, redevelopment, renovation, improvement, or disposition of the property.
4. Cause the property or any portion thereof to be sold.
5. Market the property or any portion thereof.
6. Obtain, prepay or amend any financing other than the incurrence of trade payables.
7. Issue a joint venture interest.
8. Issue or sell any debt securities of the joint venture.
9. Make any distribution other than amounts authorized by the agreement.
10. File or initiate the filing of a bankruptcy, reorganization or insolvency petition.
11. Enter into, modify or terminate any Lease in excess of 8,000 square feet.
12. Initiate, negotiate, or settle any litigation in excess of $100,000.
13. Enter into, amend, modify, or terminate any agreement with a member notwithstanding GCEAR's rights enumerated elsewhere in the agreement.
14. Make any decision regarding tax matters.
15. Change or replace KPMG as accountant.
16. Make or settle any claims or make any adjustments under the contribution agreement.
17. Approve, determine or take any other action expressly reserved to the Subject Companies and GCEAR under the agreement.

In determining whether a gain should be recognized in connection with the contribution of the property and the amount of such gain, the Subject Companies considered the guidance in ASC 970-323-30-3 which indicates that in situations where an investor receives a cash distribution upon the contribution of properties to a venture and is not otherwise committed to reinvest that cash in the venture, the substance of the transaction is a partial sale of an interest in the properties contributed. As the Subject Companies are not required to make further capital contributions to the Venture, the Subject Companies concluded that this transaction met the requirements for partial sale accounting and looked to the guidance in ASC 360-20-40-46 through 360-20-40-49 to determine the amount of any gain to recognize. Further, the Subject Companies are not obligated to support the operations of the Venture to an extent greater than its proportional interest, and the agreement governing the Venture provides GCEAR with a priority on cash distributions. Thus, the Subject Companies concluded that the amount of gain to be recognized would be limited to the amount by which the net proceeds the Subject Companies received were in excess of the costs of the contributed property, in accordance with ASC 360-20-46-49. The gain of $93.5 million recorded by the Subject Companies was calculated as the difference between the net proceeds received of $167.5 million less the carrying value of the property sold to the Venture of $74.0 million, including deferred rent receivables and other required costs related to the property.

****

Please do not hesitate to contact me by telephone at (213) 891-8371 or by fax at (213) 891-8763 with any questions or comments regarding this correspondence.

Very truly yours,

/s/ Julian T.H. Kleindorfer

Julian T.H. Kleindorfer
of LATHAM & WATKINS LLP

cc: A. William Stein, Digital Realty Trust, Inc. and Digital Realty Trust, L.P.
Joshua A. Mills, Digital Realty Trust, Inc. and Digital Realty Trust, L.P.

May 22, 2015

VIA EDGAR

United States Securities and Exchange Commission
Division of Corporation Finance
100 F Street, N.E.,
Washington, D.C. 20549
Attention: Daniel Gordon

Re: Digital Realty Trust, Inc.
Form 10-K for the fiscal year ended December 31, 2014
Filed March 2, 2015
File No. 1-32336

Digital Realty Trust, L.P.
Form 10-K for the fiscal year ended December 31, 2014
Filed March 2, 2015
File No. 0-54023

Dear Mr. Gordon:

In connection with the letter dated May 22, 2015 pursuant to which Digital Realty Trust, Inc. and Digital Realty Trust, L.P. (collectively, the "***Subject Companies***") responded to the comments of the staff of the Division of the Corporate Finance of the Securities and Exchange Commission (the "***Commission***"), received by electronic mail on May 19, 2015, the Company hereby acknowledges that, (a) the Company is responsible for the adequacy and accuracy of the disclosure in the filings it makes with the Commission, (b) staff comments or changes to disclosures in response to staff comments do not foreclose the Commission from taking any action with respect to the filings, and (c) the Company may not assert staff comments as a defense in any proceeding initiated by the Commission or any person under the federal securities laws of the United States.

Very truly yours,

DIGITAL REALTY TRUST, INC.
DIGITAL REALTY TRUST, L.P.

By: /s/ Joshua A. Mills
Name: Joshua A. Mills
Title: Senior Vice President, General Counsel and Secretary

600 East 96th Street
Suite 100
Indianapolis, IN 46240
317.808.6000
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June 8, 2015

VIA EDGAR

Ms. Jennifer Monick
Staff Accountant
Division of Corporation Finance
Securities and Exchange Commission
100 F Street, N.E.
Washington D.C. 20549

Re: Duke Realty Corporation
Duke Realty Limited Partnership (collectively referred to as the "Company")
Form 10-K for the Fiscal Year Ended December 31, 2014
Filed February 20, 2015
File Numbers 1-9044 and 0-20625

Dear Ms. Monick:

The Company is providing this letter to you in response to the comments of the staff of the Division of Corporate Finance (the "Staff") of the Securities and Exchange Commission (the "Commission"), as set forth in your letter, dated May 27, 2015 (the "Comment Letter") related to the Company's 2014 Annual Report on Form 10-K (the "2014 Form 10-K"). The numbered paragraph below corresponds to the numbered paragraph in the Comment Letter. To facilitate your review, the Company has reproduced below the original text of the Staff's comment, and has included its response immediately following such comment.

Please note that the Company is filing this response letter via EDGAR submission.

FORM 10-K FOR THE YEAR ENDED DECEMBER 31, 2014

General

1. Please provide us with your Rule 3-09 significance test calculations for 2014. Additionally, please tell us how you determined the unconsolidated joint venture that sold an office tower in Atlanta, Georgia during 2014 was not significant under Rule 3-09.

Response:

We have included our Rule 3-09 significance test calculations as requested. As shown in these calculations, none of our individual unconsolidated joint ventures, including the unconsolidated joint venture that sold an office tower in Atlanta, Georgia during 2014 (3630 Peachtree Road Holdings Limited Partnership or "3630 Peachtree"), were determined to be significant under Rule 3-09.

The 2014 Rule 3-09 significance tests were computed as follows (in thousands):

Investment Test	**Texas Dugan LLC**	**Duke/Hulfish LLC**	**Duke HHC Realty Development LLC**	**Linden Development LLC**	**All Other - Investments Individually Less than $20 million**	**Total as Presented in 2014 Form 10-K**
Investment in Unconsolidated Entity (Numerator for Investment Test)	$ 102,869	$ 45,894	$ 40,040	$ 32,104	$ 72,743	$ 293,650
Total Assets per 2014 Form 10-K - Duke Realty Corporation ("DRE") and Duke Realty Limited Partnership ("DRLP") - (Denominator for Investment Test)	$7,754,839	$ 7,754,839	$ 7,754,839	$ 7,754,839		
Significant Subsidiary Calculation	**1.3%**	**0.6%**	**0.5%**	**0.4%**		
Significant Pursuant to S-X 3-09 for Investment Test?	**No**	**No**	**No**	**No**		

Income Test

	3630 Peachtree		Dugan Millennia LLC		Duke/Hulfish LLC		Texas Dugan LLC		All Other - Registrant Share of Equity in Earnings Individually Less than $5 million	Total as Presented in 2014 Form 10-K
Equity in Earnings - 2014	$ 58,612		$ 15,656		$ 6,759		$ 6,475		$ 6,815	$ 94,317
Less Basis Differences and Registrant Share of Investee -Level Earnings from Discontinued Operations	(58,458)	**(1)**	(15,462)	**(1)**	(19)		—		(500)	
Numerator for Significance Test	**$ 154**	**A**	**$ 194**	**A**	**$ 6,740**	**A**	**$ 6,475**	**A**	**$ 6,315**	
Income from Continuing Operations Before Taxes per 2014 Form 10-K (DRE and DRLP)	$ 225,125		$ 225,125		$ 225,125		$225,125			
Less Equity in Earnings Amounts Excluded from Numerator of Test	(58,458)		(15,462)		(19)		—			
Less DRE Noncontrolling Interest Attributable to Continuing Operations	(2,607)		(2,607)		(2,607)		(2,607)			
DRE Income from Continuing Operations Attributable to Common Shareholders (Denominator for Income Test)	**$ 164,060**	**B**	**$ 207,056**	**B**	**$ 222,499**	**B**	**$222,518**	**B**		
Add Back DRE Noncontrolling Interest Attributable to Continuing Operations	2,607		2,607		2,607		2,607			
Less DRLP Noncontrolling Interest Attributable to Continuing Operations	(240)		(240)		(240)		(240)			
DRLP Income from Continuing Operations Attributable to Common Shareholders (Denominator for Income Test)	**$ 166,427**	**C**	**$ 209,423**	**C**	**$ 224,866**	**C**	**$224,885**	**C**		
DRE - Significant Subsidiary Calculation (A/B)	**0.1%**		**0.1%**		**3.0%**		**2.9%**			
DRLP - Significant Subsidiary Calculation (A/C)	**0.1%**		**0.1%**		**3.0%**		**2.9%**			
Significant Pursuant to S-X 3-09 for Income Test?	**No**		**No**		**No**		**No**			

(1) The sole purpose of these joint ventures was to own and operate real estate assets. During 2014, both of these joint ventures sold all of their real estate assets, repaid their third party debt and distributed the resultant cash proceeds to us and their other owners. The gain on sale of those real estate assets, and all of the pre-sale operations from those real estate assets, met the criteria to be classified within discontinued operations at the investee level. Such items meeting the criteria to be classified as discontinued operations at the investee level were excluded from the income significance test based on the guidance in Section 2410.3 of the Commission's Financial Reporting Manual, which indicates that the numerator in the income test is calculated based on the registrant's share of pre-tax income from continuing operations reflected in the separate financial statements of the investee prepared in accordance with U.S. GAAP for the period in which the registrant recognizes income or loss from the investee under the equity method, adjusted for any basis differences.

Equity in earnings related to basis differences excluded from both the numerator and denominator of the income significance tests pertain primarily to impairment charges on the investment in the 3630 Peachtree joint venture recognized at the registrant level (and not in the investee's separate financial statements) during 2009, which caused a basis difference. Additionally, the equity in earnings impact at the registrant level of any other basis differences written off as a direct result of the sale of the underlying joint venture assets, which were not reflected in the separate financial statements of the investee, are excluded from both the numerator and the denominator of the income significance test.

Because the sales of the assets underlying these joint ventures represented the effective liquidation of our ownership interests in these joint ventures, we believe the results of these sales would also be appropriately excluded from the numerator of the income test, pursuant to the guidance in section 2410.8 of the Commission's Financial Reporting manual, had the sales been included in income from continuing operations at the investee level.

August 10, 2015

VIA EDGAR

Ms. Jennifer Monick
Senior Staff Accountant
Division of Corporate Finance
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

RE: DuPont Fabros Technology, Inc.
Form 10-K for the Year Ended December 31, 2014
Filed February 25, 2015
File No. 001-33748

DuPont Fabros Technology, L.P.
Form 10-K for the Year Ended December 31, 2014
Filed February 25, 2015
File No. 333-165465-17

Dear Ms. Monick:

Reference is made to your letter, dated July 29, 2015, regarding comments made by the Staff (the "Staff") of the U.S. Securities and Exchange Commission (the "Commission") with respect to the above referenced Annual Report on Form 10-K for the year ended December 31, 2014. This letter repeats the comment in the Staff's letter in bolded typeface followed by a response prepared by management of DuPont Fabros Technology, Inc. and DuPont Fabros Technology, L.P. together with our legal representatives. We have also sent to your attention courtesy copies of this letter.

General

1. **Please tell us how you determined it is appropriate to provide combined periodic reports for parent and subsidiary registrants given that you owned approximately 81.1% of your operating partnership at December 31, 2014.**

COMPANY RESPONSE: Management has determined it is appropriate to provide combined periodic reports for DuPont Fabros Technology, Inc. (the "Company") and DuPont Fabros Technology, L.P. (the "Operating Partnership"). The Company began presenting combined periodic reports in 2010. In evaluating that presentation, management believed (and continues to believe) combining the periodic reports of the Company and the Operating Partnership into a single report provides several benefits, including:

- enhancing investors' understanding of the Company and the Operating Partnership by enabling investors to view the business as a whole in the same manner as management views and operates the business (discussions with investors support that this benefit has resulted from the combined presentation);

- eliminating duplicative disclosure and provides a more streamlined and readable presentation since a substantial portion of the disclosure in the periodic reports applies to both the Company and the Operating Partnership; and

- creating time and cost efficiencies through the preparation of one combined report instead of two separate reports.

We have considered the SEC staff guidance in Section 1370 of the Division of Corporate Finance Financial Reporting Manual ("FRM"). Although "substantially all" is not defined, we believe there is not a material difference in the financial statement presentation between 81.1% ownership and a higher percentage, particularly in this case where the Company is the sole general partner of the Operating Partnership and, as such, has exclusive control of the day-to-day management of the Operating Partnership. Since the Company owned approximately 81.1% of the Operating Partnership as of December 31, 2014, we considered the nature of 18.9% of the Operating Partnership not owned by the Company. The units of limited partnership interest ("OP units") in the Operating Partnership held by limited partners have the economic equivalent of, and are convertible on a one for one basis for, shares of common stock of the Company. Therefore, we believe the overall substance of the relationship between the entities and their owners is economically equivalent to the Company owning 100% of the equity interests in the Operating Partnership. We believe the holders of OP units have equal or greater interest in the performance of the Company as they do in the Operating Partnerships and it would be less effective and potentially confusing to investors to present the information in two separate filings.

Management believes it is important for investors to understand that there are no differences between the Company and the Operating Partnership in the context of how the Company and the Operating Partnership operate as a consolidated company and believes the preparation of combined periodic reports best enhances this understanding. The only difference between the assets of the Company and those of the Operating Partnership is a cash balance of about $4 million. There is no difference from a financial, business or operational perspective between ownership levels of 81.1% and 99% in the Company's UPREIT structure.

In preparing combined periodic reports for the Company and the Operating Partnership, management complies with the staff position set forth in Section 1370 of the FRM. The combined periodic reports of the Company and the Operating Partnership include separate audit reports, separate reviewed interim financial statements (where applicable), separate reports on disclosure controls and procedures and internal controls over financial reporting, separate complete financial statements, separate footnotes for areas that differ and separate CEO/CFO certifications. Given the Company's compliance with these requirements and the other considerations cited above, management believes it is appropriate to provide combined periodic reports for the Company and the Operating Partnership

2. **We note your triple-net lease with Microsoft represents 20.5% of your annualized base rent and 21.6% of your consolidated revenues for the year ended December 31, 2014. Please tell us if Microsoft leases in excess of 20% of your assets as of December 31, 2014. To the extent that Microsoft leases in excess of 20% of your assets, please tell us how you determined it was unnecessary to include a statement referring investors to a publicly-available website with the lessee's SEC filed financial statements.**

COMPANY RESPONSE: As of December 31, 2014, Microsoft leased less than 20% of our total assets. Therefore, we were not required to include a statement referring investors to a publicly-available website with the lessee’s SEC filed financial statements. Management will continue to monitor the percentage of our total assets leased by our most significant customers.

Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations

Reconciliation of Same Store Operating Income to Same Store Net Operating Income and Cash Net Operating Income, page 41

3. **It appears from your disclosure in footnote (1) on page 41 that you have reconciled NOI and Cash NOI to the operating income attributable only to the properties included in the analysis. In future filings, please include a reconciliation of these non-GAAP measures to operating income as a whole as presented in your consolidated statements of operations. Refer to Item 10(e)(1)(i)(B) of Regulation S-K.**

COMPANY RESPONSE: Beginning with the 10-Q for the quarter ending September 30, 2015 we will include a reconciliation of same store NOI and same store Cash NOI to operating income as a whole as presented on our consolidated statements of operations.

The Company acknowledges that:

- the company is responsible for the adequacy and accuracy of the disclosure in the filing;
- staff comments or changes to disclosure in response to staff comments do not foreclose the Commission from taking any action with respect to the filing; and
- the company may not assert staff comments as a defense in any proceeding initiated by the Commission or any person under the federal securities laws of the United States.

Please contact me at (202) 478-2333 in connection with questions or comments concerning the above response. Thank you for your attention to this matter.

Very truly yours,

/s/ Jeffrey H. Foster

Jeffrey H. Foster
Executive Vice President and Chief Financial Officer

July 6, 2015

Mr. Tom Kluck

Legal Branch Chief

U.S. Securities and Exchange Commission

Division of Corporation Finance

100 F Street, NE

Washington, DC 20549

Re: EastGroup Properties, Inc.

Form 10-K for the year ended December 31, 2014

Filed February 17, 2015

File No. 001-07094

Dear Mr. Kluck:

In connection with your review of the EastGroup Properties, Inc. (the "Company") Form 10-K for the year ended December 31, 2014 (the "2014 Form 10-K"), we respectfully submit the following responses to the comments included in your letter dated July 1, 2015. Each of the Staff's comments are restated in bold with our responses to the comments following immediately thereafter.

Properties, page 10

1. **Please tell us what consideration you have given to disclosing in greater detail your tenant-type concentration.**

Response: We consider tenant-type concentration when preparing our disclosures. We disclose the fact that we are geographically concentrated in the Sunbelt region of the United States and we discuss the risks associated with our geographic concentration in "Item 1A. Risk Factors-Risks Associated with Our Properties-We face risks due to lack of geographic and real estate sector diversity" on page 7 of the 2014 Form 10-K. We also disclose in that risk factor that as of December 31, 2014, we owned operating properties totaling 6.2 million square feet in Houston, which represents 18.6% of the Company's total Real estate properties on a square foot basis. We supplementally note that as of December 31, 2014 no single tenant in Houston accounted for more than 5% of that market on a square foot basis and that the Company estimates that tenants that are directly involved in the oil and gas industry represent approximately 24% of the Houston market on a square foot basis and approximately 5% of the Company’s aggregate annualized base rent. Accordingly, we have not historically included any information regarding tenant-type concentration under Item 2-Properties. In preparing disclosure in our future Exchange Act periodic reports we will continue to evaluate our portfolio with respect to tenant-type concentration and will include appropriate disclosure, if a material concentration is identified.

Management's Discussion and Analysis of Financial Condition and Results of Operations, page 15

2. **We note your disclosure on page 17 comparing the same property average rental rates in 2013 to 2014. In future Exchange Act periodic reports, please disclose whether average rental rate is based on effective rent that includes free rent periods.**

Response: We calculate average rental rates in accordance with GAAP. In light of the Staff's comment we will disclose in future Exchange Act periodic reports that our average rental rates are calculated in accordance with GAAP and are based on effective rent that includes free rent periods.

Exhibits

3. **We note that you incorporate by reference your Articles of Incorporation from your proxy statement for your annual meeting held on June 5, 1997. It appears that the document has been on file with the Commission for more than five years. See Item 10(d) or Regulation S-K. In future Exchange Act filings, please file the Articles of Incorporation as an exhibit or advise.**

Response: We note that Item 10(d)(2) provides an exception to the five-year rule for "[d]ocuments that the registrant specifically identifies by physical location by SEC file number reference, provided such materials have not been disposed of by the Commission pursuant to its Records Control Schedule." We further note that the 1997 proxy statement was filed by the Company via EDGAR on April 24, 1997 under file number 1-07094 and that the retention period under the Records Control Schedule for proxy materials is 30 years. Accordingly in future Exchange Act filings we will specifically reference the SEC file number when incorporating by reference any document on file with the Commission for more than five years.

***

In connection with our responses, the Company acknowledges the following:

- The Company is responsible for the adequacy and accuracy of the disclosure in its filings;
- Staff comments or changes to disclosure in response to Staff comments do not foreclose the Commission from taking any action with respect to the filings; and
- The Company may not assert Staff comments as a defense in any proceeding initiated by the Commission or any person under the federal securities laws of the United States.

If you need additional information, please contact me at (601) 354-3555.

Sincerely,

/s/ N. Keith McKey

N. Keith McKey

Executive Vice President, Chief Financial Officer,

Treasurer and Secretary

cc: Michael Donlon

999 S. Shady Grove Road, Ste. 600
Memphis, TN 38120
901.259.2500 phone
www.EdRtrust.com

July 24, 2015

Via EDGAR

Kevin Woody
Branch Chief
United States Securities and Exchange Commission
Division of Corporate Finance
450 Fifth Street, N.W.
Washington, D.C. 20549

RE: Education Realty Trust, Inc.
Form 10-K
Filed February 27, 2015
File No. 001-32417

Dear Mr. Woody:

The following sets forth the responses of Education Realty Trust, Inc. (the "***Company***") to the comments issued by the staff (the "***Staff***") of the Securities and Exchange Commission (the "***Commission***") with respect to the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2014 (the "***2014 Form 10-K***") in the Staff's letter (the "***Comment Letter***") dated July 21, 2015. For your convenience, we have restated the Staff's comment in italics with the Company's response immediately following the comment.

Form 10-K for the fiscal year ended December 31, 2014

Item 7. Management's discussion and analysis of financial condition and results of operations, page 34

Non-GAAP measures, page 56

Funds from operations (FFO), page 56

Comment: *We note that your calculation of FFO includes an adjustment for gain on insurance settlement. Please tell us whether management determined that this adjustment is in compliance with NAREIT's definition of FFO. Please tell us management's consideration for presenting an FFO, as an adjusted amount.*

Response: Management of the Company determined that the calculation of FFO disclosed in the 2014 Form 10-K has been prepared in compliance with the NAREIT definition of FFO and is consistent with the standards established by the Board of Governors of NAREIT in its March 1995 White Paper (as amended). As disclosed on page 56 of the 2014 Form 10-K, the Company makes certain adjustments in its calculation of FFO, including a deduction for "gain on insurance settlement." The Company believes this gain on insurance settlement is synonymous with a gain on sale of a depreciable real estate asset, and therefore, has determined that the inclusion of such adjustment is consistent with the NAREIT definition of FFO.

One of the Company's income-producing communities was partially destroyed by a fire and sustained significant property damage. Costs to rebuild the community were covered under an existing insurance policy, and during the fiscal year ended December 31, 2014, the insurance claim related to the rebuild was settled with the insurance carrier. The insurance settlement exceeded the net book value of this asset, resulting in a gain on insurance proceeds of $8.1 million. Management of the Company believes that this gain is similar in nature and has the same characteristics as an adjustment for gains/losses from the sale of depreciable property, which are required to be excluded from FFO under NAREIT's definition.

For the reasons discussed above, management of the Company believes that the presentation of FFO and its reconciliation to net income is both consistent with NAREIT's definition of FFO and provides users of the Company's financial statements the ability to assess the Company's operating performance relative to its performance in prior reporting periods and relative to the operating performance of other REITs.

****

In responding to the Staff's comments, the Company acknowledges that:

- the Company is responsible for the adequacy and accuracy of the disclosure in the filing;
- the Staff's comments or changes to disclosure in response to the Staff's comments do not foreclose the Commission from taking any action with respect to the filing; and
- The Company may not assert the Staff's comments as a defense in any proceeding initiated by the Commission or any person under the federal securities laws of the United States.

If you have any questions concerning our responses to your questions and comments, please do not hesitate to contact the undersigned at (901) 259-2507.

Sincerely,

/s/Edwin B. Brewer, Jr.
Edwin B. Brewer, Jr.
Executive Vice President and Chief Financial Officer

Empire State Realty Trust, Inc.
Empire State Realty OP, L.P.
One Grand Central Place
60 East 42nd Street
New York, New York 10165

August 21, 2015

VIA EDGAR

Ms. Jaime G. John
Branch Chief
Securities and Exchange Commission
100 F Street, N.E.
Washington D.C. 20549

RE: Empire State Realty Trust, Inc.
Form 10-K for the fiscal year ended December 31, 2014
Filed February 27, 2015
File No. 1-36105

Empire State Realty OP, L.P.
Form 10-K for the fiscal year ended December 31, 2014
Filed February 27, 2015
File No. 1-36106

Dear Ms. John:

We are writing in response to your letter dated July 31, 2015, setting forth the comments of the Staff of the Division of Corporation Finance (the "Staff") on the above mentioned filings for Empire State Realty Trust, Inc. and Empire State Realty OP, L.P. (together, the "Company"). We have considered the Staff's comments and our responses are set forth below. To facilitate the Staff's review, we have keyed our responses to the headings and numbered comments used in the Staff's comment letter, which we have reproduced in bold print.

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

Results of Operations, page 53

1. **We note that you have provided a discussion of "combined" financial data for the predecessor period ended October 6, 2013 and the successor period ended December 31, 2013. Please note that your primary discussion should be of the actual results for each period (i.e. predecessor and successor separately). It is inappropriate to merely combine information for predecessor and successor periods. You can supplement your**

discussion of the actual historical results of operations with a discussion of pro forma financial information (e.g. predecessor period plus successor period plus pro forma adjustments).

The pro forma financial information should be presented in a format consistent with Article 11 of Regulation S-X and any discussion of such pro forma information should supplement and not be given greater prominence than actual results. Please tell us how you to intend to revise the disclosure in future filings.

Response: In response to the Staff's comment, the Company respectfully notes that in preparing the presentation of operating results in its Form 10-K, the Company considered that presenting historical 2013 results on a combined basis would facilitate the most comprehensive and meaningful discussion of results of operations and that, conversely, the presentation of pro forma financial information, as required by Article 11 of Regulation S-X, would not provide meaningful information or be useful to investors, and would potentially be confusing.

Per the Staff's comment, however, the Company respectfully advises the Staff that in future filings that require disclosure of our results for periods that include both the predecessor and successor periods, we will not base our results of operations discussion for such periods on combined financial information, but rather, we will present separate results for each of the respective predecessor and successor periods. Any pro forma financial information that we may include in future filings will comply with Article 11 of Regulation S-X.

Funds from Operations ("FFO"), page 66

2. We note that your FFO calculation includes an adjustment for preferred unit distributions. Based upon your reconciliation, it appears that the $214.8 million FFO for the year ended December 31, 2014 represents FFO attributable to common shareowners and non-controlling interests. Please revise your presentation in future filings to clearly label the FFO measure. Also make adjustments to earnings releases filed on Form 8-K, as appropriate.

Response: The Company hereby confirms that, in future filings after the date of this response letter, including future earnings releases filed on Form 8-K, Empire State Realty Trust, Inc. will use the label "Funds from Operations attributable to common stockholders and non-controlling interests" and Empire State Realty OP, L.P. will use the label "Funds from Operations attributable to common unitholders."

Item 8. Financial Statements and Supplementary Data

Note 10 – Commitments and Contingencies

Litigation, page F-28

3. We note your disclosure on F-31 regarding the risk of a material adverse effect related to the "Second Class Actions" and the defense and indemnity rights held by certain other defendants. Please expand your disclosure to comply with the requirements of ASC 450-20-50 including disclosure of an estimate of the reasonably possible range of loss or a statement that such an estimate cannot be made.

Response: In response to the Staff's comment, the Company respectfully notes that members of our internal legal and financial teams quarterly evaluate the status of legal matters in determining the probability of the incurrence of a loss and whether a loss is reasonably possible and estimable, along with evaluating the quarterly disclosures regarding such matters for compliance with ASC 450-20-50. We consider the facts and the applicable laws, and obtain the opinion of counsel, if applicable, in order to make this determination on a case by case basis.

With respect to the "Second Class Actions" and the defense and indemnity rights held by certain other defendants with respect thereto, a loss accrual has not been provided for in the historical financial statements because we believe we cannot reasonably estimate a possible range of potential loss at this time due to the excessive nature of the claims and damages sought by plaintiffs, the spectrum of remedies which may be available to the court in the event of an adverse ruling, and the difficulties at the current stage of the litigation of determining potential exposure related to each of the defendants in the matter. In future filings beginning with the Company's Quarterly Report on Form 10-Q for the fiscal quarter ended September 30, 2015, to the extent still applicable, we will expand the disclosure to state that an estimate of the additional loss or range of loss cannot be made with respect to the "Second Class Actions," which such disclosure may be similar to the following:

> *At this time, due to the spectrum of remedies which may result from the outcome of the matter and the difficulty in calculating and allocating damages (if any) among the defendants, we cannot reasonably assess the timing or outcome of this litigation and any related indemnification obligations, estimate the amount of loss, or assess their effect, if any, on our financial statements.*

Exhibits 31.1 and 31.2

4. The certifications do not conform exactly to the certification in Item 601(b)(31)(i) of Regulation S-K. Specifically, you have omitted the reference to internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d- 15(f)) in the introduction to paragraph 4 and omitted paragraph 4(b). Please amend your filings to include the introductory language required by paragraph 4 and to include paragraph 4(b) of Item 601(b)(31)(i) of Regulation S-K. Please note that this comment also applies to the Form 10-Q filed May 6, 2015.

Response: The Company respectfully advises the Staff that following resolution of the Staff's comments, each of Empire State Realty Trust, Inc. and Empire State Realty OP, L.P. will file amendments to their Annual Reports on Form 10-K for the fiscal year ended December 31, 2014, their Quarterly Reports on Form 10-Q for the fiscal quarter ended March 31, 2015 and their subsequently filed Quarterly Reports on Form 10-Q for the fiscal quarter ended June 30, 2015 to include revised officer certifications in the exact form as set forth in Item 601(b)(31)(i) of Regulation S-K. As discussed telephonically with the Staff, the amended filings will contain the cover page, explanatory note, signature page and certifications.

[Remainder of this page left intentionally blank]

Equity Commonwealth

June 26, 2015

VIA EDGAR

Ms. Jennifer Gowetski
Special Counsel
United States Securities and Exchange Commission
Division of Corporation Finance
100 F Street, N.E.
Washington, D.C. 20549

Re: Equity Commonwealth (the "Company")
Form 10-K for the fiscal year ended December 31, 2014
Filed February 19, 2015 (the "Filing")
File No. 1-9317

Dear Ms. Gowetski:

The Company is writing in response to your letter dated June 22, 2015. For your convenience, each of your original comments appears below in italicized text and is followed by the Company's response.

Form 10-K for fiscal year ended December 31, 2014

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations, page 51

Overview, Page 51

1. *We note your disclosure on page 52 that, effective October 1, 2014, you engaged CBRE to conduct your day-to-day property management services for your U.S. properties. We further note you pay CBRE a property-by-property management services fee and will reimburse CBRE for certain expenses incurred in the performance of its duties. In future Exchange Act periodic reports, please more specifically describe how such fees are determined and quantify the aggregate fees and reimbursements that you have paid or are payable to CBRE or advise.*

   Company Response: The Company respectfully requests the amounts and methodology for determining the fees and reimbursements that it pays to CBRE for property management services (the "Confidential Material") be afforded confidential treatment under the Freedom of Information Act ("FOIA") pursuant to 17 C.F.R. Section 200.83. Pursuant to Rule 12b-4 promulgated under the Securities Exchange Act of 1934, as

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amended, the Confidential Material is being provided to the Staff on a confidential, supplemental basis only and is not to be filed with or deemed part of the Company's SEC filings. Pursuant to Rule 12b-4, the Company hereby requests that the Confidential Material be returned using the self-addressed envelope included with this submission to the undersigned promptly following completion of the Staff's review of the Confidential Material.

   The amount of the fees payable were determined and negotiated with CBRE across the Company's portfolio. The specific amounts are commercially sensitive information for both the Company and CBRE and are the subject of confidentiality agreements. It would be detrimental to both the Company and CBRE for this information to be publicly disclosed. Furthermore, the Company believes that although this information is very commercially sensitive, the specific amount of fees payable on a property by property basis is not material to an investor's understanding of the Company's business or results of operations. As a result, the Company is seeking confidential treatment of the methodology and amount of the property management fees it pays to CBRE.

2. *We note your disclosure on page 51 that leases entered into during the year ended December 31, 2014, including both lease renewals and new leases, had weighted average cash rental rates that were approximately 1.7% lower than prior rental rates for the same space and weighted average GAAP rental rates that were approximately 3.4% higher than prior rental rates for the same space. In future Exchange Act periodic reports, please revise to separately compare rental rates for lease renewals and new leases as well as briefly explain the reasons for the difference between weighted average cash rental rates and weighted average GAAP rental rates.*

Company Response: The Company acknowledges this comment, understands the usefulness of these additional disclosures and intends to comply with the request.

3. *We note that leases representing approximately 11% of your annualized rental revenue and square footage will expire by the end of the current fiscal year. In future Exchange Act periodic reports, please discuss the relationship of market rents and expiring rents.*

Company Response: The Company acknowledges this comment, understands the usefulness of these additional disclosures and intends to comply with the request.

<u>*Funds From Operations (FFO) and Normalized FFO, page 69*</u>

4. *Please tell us why management did not exclude the excess redemption price over carrying value of preferred shares in calculating FFO attributable to Equity Commonwealth common shareowners.*

Company Response: It is our intent to calculate FFO in a manner consistent with National Association of Real Estate Investment Trusts' ("NAREIT"'s) *White Paper on Funds from Operations*, which provides the real estate industry standard for calculating FFO. This

publication does not contemplate an adjustment to FFO for the item mentioned in your letter. Thus, we use our judgment to adjust FFO for items we consider relevant to a common shareholder to arrive at FFO attributable to Equity Commonwealth common shareholders.

For the information of the staff of the Securities and Exchange Commission (the "Staff"), page F-27 of our 2014 Annual Report on Form 10-K describes the excess redemption price paid over carrying value of preferred shares. As described therein, a Fundamental Change Conversion Right (commonly referred to as a "change-in-control") event was triggered when the Company's Prior Trustees were removed on March 25, 2014. This event allowed our series D preferred shareholders to exchange their shares for Equity Commonwealth common shares between April 9, 2014 and May 14, 2014. As a result, holders of the series D preferred shares converted 10,263,003 series D preferred shares for 10,411,779 of the Company's commons shares. The *excess redemption price paid over carrying value of preferred shares* was the one-time, non-cash excess of the current market value of the Company's common shares issued above the carrying value of the series D preferred shares redeemed.

For the information of the Staff, page 68 of our Annual Report on Form 10-K describes the usefulness of FFO. As noted therein, we recommend FFO be considered in conjunction with GAAP measures such as net income attributable to Equity Commonwealth common shareholders. Such GAAP measures include excess redemption price paid over carrying value of preferred shares.

Given the nonrecurring and non-cash nature of the excess redemption price paid over carrying value of preferred shares, as well as the uses for FFO discussed above, the Company feels that the disclosure as presented is appropriate.

The Company acknowledges that:

- the Company is responsible for the adequacy and accuracy of the disclosure in the Filing;
- staff comments or changes to disclosure in response to staff comments do not foreclose the Commission from taking any action with respect to the Filing; and
- the Company may not assert staff comments as a defense in any proceeding initiated by the Commission or any person under the federal securities laws of the United States.

The Company appreciates your comments and welcomes the opportunity to discuss with you the responses provided above. Please call me at 312-646-2839 if you have any questions or require additional information.

Sincerely,

Equity Commonwealth

By: /s/ Adam Markman
Adam Markman
Treasurer & Chief Financial Officer

Equity Commonwealth

July 21, 2015

VIA EDGAR

Ms. Jennifer Gowetski
Special Counsel
United States Securities and Exchange Commission
Division of Corporation Finance
100 F Street, N.E.
Washington, D.C. 20549

Re: Equity Commonwealth (the "Company")
Form 10-K for the fiscal year ended December 31, 2014
Filed February 19, 2015 (the "Filing")
File No. 001-9317

Dear Ms. Gowetski:

The Company is writing in response to your letter dated July 20, 2015. For your convenience, your original comment appears below in italicized text and is followed by the Company's response.

Form 10-K for fiscal year ended December 31, 2014

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations, page 51

Overview, Page 51

1. *We considered your response to comment 1. Our comment was directed at eliciting additional disclosure of the aggregate fees and reimbursements paid or payable to CBRE and a general explanation how such fees are determined. Please confirm that you will include a disclosure of the aggregate fees and reimbursements paid or payable to CBRE and a general explanation of how such fees are determined or advise.*

   Company Response: The Company acknowledges this comment, understands the usefulness of these additional disclosures and hereby confirms that it will comply with the request.

The Company acknowledges that:

- the Company is responsible for the adequacy and accuracy of the disclosure in the Filing;

- staff comments or changes to disclosure in response to staff comments do not foreclose the Commission from taking any

ESSEX
PROPERTY TRUST, INC.

May 13, 2015

Securities and Exchange Commission
Division of Corporation Finance
100 F Street, N.E.
Washington, DC 20549
Attention: Wilson K. Lee, Senior Staff Accountant

Re: Essex Property Trust, Inc. and Essex Portfolio, L.P. (the "Companies")
Form 10-K for Fiscal Year Ended December 31, 2014 for each of the Companies
Filed March 2, 2015 for each of the Companies
File Nos. 1-13106 and 333-44467-01, respectively

Dear Mr. Lee:

Essex Property Trust, Inc. (the "Company" or "Essex") submits this letter in response to comments from the staff (the "Staff') of the Securities and Exchange Commission (the "SEC") received by a letter, dated April 28, 2015, related to the above filing. On May 8, 2015, we submitted a response to the Staff's April 28th comment letter. As a result of subsequent discussions with the Staff, we are hereby modifying our response to the Staff's comment. The response set forth below supersedes the response set forth in our May 8, 2015 letter.

In this letter, we have recited the comment from the Staff in italicized, bold type, and have followed the comment with the Company's response in regular type.

Form 10-K for the year ended December 31, 2014 for each of the Companies

Item 6. Selected Financial Data, pages 32-36

1. ***In arriving at Funds from operations, you start with Net income available to common stockholders. As a result, it appears Funds from operations is actually Funds from operations attributable to just common stockholders instead of all equity stockholders. In future periodic filings please re-title "Funds from operations" to the more appropriate "Funds from operations attributable to common stockholders".***

Response:

Funds from Operations ("FFO") includes net income attributable to the noncontrolling interest of limited partner unit holders of the Company's operating partnership, Essex Portfolio, L.P. ("EPLP"), and excludes net income attributable to other noncontrolling interests and dividends relating to preferred stockholders. Accordingly, we will re-title "Funds from operations" as "Funds from operations attributable to common stockholders and unitholders" in future periodic filings.

We acknowledge that the adjustment for noncontrolling interest attributable to the limited partner unitholders of EPLP was included, without specificity, as an "other" adjustment in the line item "Depreciation add back from unconsolidated co-investments, and other, net" on page 34 of the Form 10-K for the year ended December 31, 2014 and that our FFO table does not clearly set forth that the FFO amount also includes that noncontrolling interest adjustment. Accordingly, in future periodic filings, we will set forth in a separate line item, the add back of net income allocated to such noncontrolling interest.

* * *

ESSEX
PROPERTY TRUST, INC.

May 8, 2015

Securities and Exchange Commission
Division of Corporation Finance
100 F Street, N.E.
Washington, DC 20549
Attention: Wilson K. Lee, Senior Staff Accountant

Re: Essex Property Trust, Inc. and Essex Portfolio, L.P. (the "Companies")
Form 10-K for Fiscal Year Ended December 31, 2014 for each of the Companies
Filed March 2, 2015 for each of the Companies
File Nos. 1-13106 and 333-44467-01, respectively

Dear Mr. Lee:

Essex Property Trust, Inc. (the "Company" or "Essex") submits this letter in response to comments from the staff (the "Staff') of the Securities and Exchange Commission (the "SEC") received by a letter, dated April 28, 2015, related to the above filing.

In this letter, we have recited the comment from the Staff in italicized, bold type, and have followed the comment with the Company's response in regular type.

<u>Form 10-K for the year ended December 31, 2014 for each of the Companies</u>

<u>Item 6. Selected Financial Data, pages 32-36</u>

1. In arriving at Funds from operations, you start with Net income available to common stockholders. As a result, it appears Funds from operations is actually Funds from operations attributable to just common stockholders instead of all equity stockholders. In future periodic filings please re-title "Funds from operations" to the more appropriate "Funds from operations attributable to common stockholders".

<u>Response:</u>

In calculating Funds from operations, or "FFO", we add back the net income attributable to the noncontrolling interest of the limited partner unit holders of the Company's operating partnership, Essex Portfolio, L.P. (the "Operating Partnership"). This noncontrolling interest add back is included within the line item "Depreciation add back from unconsolidated co-investments and other, net" in the "Other Data" table on page 34 of the Form 10-K for the year ended December 31, 2014. By adding this amount back, it converts the "net income available to common stockholders" to an amount attributable to both the common stockholders and the Operating Partnership limited partners. Accordingly, the weighted average numbers of shares outstanding, diluted, used to calculate FFO and Core FFO per diluted share includes both common shares and Operating Partnership units outstanding for the year.

As the FFO amount also includes net income attributable to the noncontrolling interest of limited partner unit holders, we respectfully submit that it would not be appropriate to re-title "Funds from operations" as "Funds from operations attributable to common stockholders."

We acknowledge that the adjustment for non-controlling interest was included, without specificity, as an "other" adjustment in the line item "Depreciation add back from unconsolidated co-investments, and other, net" and that our FFO table does not clearly set forth that the FFO amount also includes that noncontrolling interest adjustment. Accordingly, in future periodic filings, we will set forth in a separate line item the add back of net income allocated to such noncontrolling interest.

* * *

The Company hereby acknowledges that:

- the Company is responsible for the adequacy and accuracy of the disclosure in the filing;
- Staff comments or changes to disclosure in response to Staff comments do not foreclose the Commission from taking action with respect to the filing; and
- the Company may not assert Staff comments as a defense in any proceeding initiated by the Commission or any person under the federal securities laws of the United States.

Please direct any questions or additional comments regarding this response to the undersigned.

Sincerely,

/s/ Michael T. Dance

Michael T. Dance
Executive Vice President, Chief Financial Officer
Essex Property Trust, Inc.
925 East Meadow Drive
Palo Alto, CA 94303

Phone: +1 650 494 3700
Fax: +1 650 494 8743
Email: mdance@essexpropertytrust.com

ESSEX
PROPERTY TRUST, INC.

May 13, 2015

Securities and Exchange Commission
Division of Corporation Finance
100 F Street, N.E.
Washington, DC 20549
Attention: Wilson K. Lee, Senior Staff Accountant

Re: Essex Property Trust, Inc. and Essex Portfolio, L.P. (the "Companies")
Form 10-K for Fiscal Year Ended December 31, 2014 for each of the Companies
Filed March 2, 2015 for each of the Companies
File Nos. 1-13106 and 333-44467-01, respectively

Dear Mr. Lee:

Essex Property Trust, Inc. (the "Company" or "Essex") submits this letter in response to comments from the staff (the "Staff') of the Securities and Exchange Commission (the "SEC") received by a letter, dated April 28, 2015, related to the above filing. On May 8, 2015, we submitted a response to the Staff's April 28th comment letter. As a result of subsequent discussions with the Staff, we are hereby modifying our response to the Staff's comment. The response set forth below supersedes the response set forth in our May 8, 2015 letter.

In this letter, we have recited the comment from the Staff in italicized, bold type, and have followed the comment with the Company's response in regular type.

Form 10-K for the year ended December 31, 2014 for each of the Companies

Item 6. Selected Financial Data, pages 32-36

1. In arriving at Funds from operations, you start with Net income available to common stockholders. As a result, it appears Funds from operations is actually Funds from operations attributable to just common stockholders instead of all equity stockholders. In future periodic filings please re-title "Funds from operations" to the more appropriate "Funds from operations attributable to common stockholders".

Response:

Funds from Operations ("FFO") includes net income attributable to the noncontrolling interest of limited partner unit holders of the Company's operating partnership, Essex Portfolio, L.P. ("EPLP"), and excludes net income attributable to other noncontrolling interests and dividends relating to preferred stockholders. Accordingly, we will re-title "Funds from operations" as "Funds from operations attributable to common stockholders and unitholders" in future periodic filings.

We acknowledge that the adjustment for noncontrolling interest attributable to the limited partner unitholders of EPLP was included, without specificity, as an "other" adjustment in the line item "Depreciation add back from unconsolidated co-investments, and other, net" on page 34 of the Form 10-K for the year ended December 31, 2014 and that our FFO table does not clearly set forth that the FFO amount also includes that noncontrolling interest adjustment. Accordingly, in future periodic filings, we will set forth in a separate line item, the add back of net income allocated to such noncontrolling interest.

* * *

545 E. JOHN CARPENTER FREEWAY, SUITE 1300
IRVING, TX 75062
PH: 972-444-4900
NYSE: FCH

JEFFREY D. SYMES
SENIOR VICE PRESIDENT
CHIEF ACCOUNTING OFFICER AND CONTROLLER

July 23, 2015

VIA EDGAR

U.S. Securities and Exchange Commission
Division of Corporation Finance
Mail Stop 3010
Washington, D.C. 20549

Re: FelCor Lodging Trust Incorporated
Form 10-K for the year ended December 31, 2014
File No. 001-14236

FelCor Lodging Limited Partnership
Form 10-K for the year ended December 31, 2014
File No. 333-39595-01

Ladies and Gentlemen:

On behalf of FelCor Lodging Trust Incorporated and FelCor Lodging Limited Partnership (together "FelCor"), we hereby file FelCor's response to comments contained in the letter from the U.S. Securities and Exchange Commission, Division of Corporation Finance (the "Commission"), dated July 21, 2015. For your convenience, we have repeated the comment prior to our response.

Form 10-K for the year ended December 31, 2014

Note 8 – Joint Venture Transaction, pages 78 – 79

1. **Given the significance of your gain on sale of investment in unconsolidated entities, please clarify how you determined the related unconsolidated entities were not significant to require separate financial statements pursuant to Rule 3-09 of Regulation S-X.**

In connection with preparing our Annual Report on Form 10-K for the year ended December 31, 2014 (our "2014 Form 10-K"), we evaluated the significance of our equity method investees to determine if separate financial statements pursuant to Rule 3-09 of Regulation S-X were required. We determined that each investee failed both the first and third significant subsidiary tests described in Rule 1-02(w) of Regulation S-X for all financial statement periods presented in our 2014 Form 10-K (substituting 20% for 10%). As provided for in the Division of Corporation Finance's Financial Reporting Manual Topic 2 - Sections 2020.4 and 2410.3, we excluded both our 2014 gain on the disposition of investment in unconsolidated entities and our 2014 gain from remeasurement to fair value of previously unconsolidated entities from the numerator when calculating each investee's share of our 2014 income from continuing operations.

FELCOR LODGING TRUST

545 E. JOHN CARPENTER FREEWAY, SUITE 1300
IRVING, TX 75062
PH: 972-444-4900
NYSE: FCH

JEFFREY D. SYMES
SENIOR VICE PRESIDENT
CHIEF ACCOUNTING OFFICER AND CONTROLLER

July 23, 2015

VIA EDGAR

U.S. Securities and Exchange Commission
Division of Corporation Finance
Mail Stop 3010
Washington, D.C. 20549

Re: FelCor Lodging Trust Incorporated
Form 10-K for the year ended December 31, 2014
File No. 001-14236

FelCor Lodging Limited Partnership
Form 10-K for the year ended December 31, 2014
File No. 333-39595-01

Ladies and Gentlemen:

On behalf of FelCor Lodging Trust Incorporated and FelCor Lodging Limited Partnership (together "FelCor"), we hereby file FelCor's response to comments contained in the letter from the U.S. Securities and Exchange Commission, Division of Corporation Finance (the "Commission"), dated July 21, 2015. For your convenience, we have repeated the comment prior to our response.

Form 10-K for the year ended December 31, 2014

Note 8 – Joint Venture Transaction, pages 78 – 79

1. **Given the significance of your gain on sale of investment in unconsolidated entities, please clarify how you determined the related unconsolidated entities were not significant to require separate financial statements pursuant to Rule 3-09 of Regulation S-X.**

In connection with preparing our Annual Report on Form 10-K for the year ended December 31, 2014 (our "2014 Form 10-K"), we evaluated the significance of our equity method investees to determine if separate financial statements pursuant to Rule 3-09 of Regulation S-X were required. We determined that each investee failed both the first and third significant subsidiary tests described in Rule 1-02(w) of Regulation S-X for all financial statement periods presented in our 2014 Form 10-K (substituting 20% for 10%). As provided for in the Division of Corporation Finance's Financial Reporting Manual Topic 2 - Sections 2020.4 and 2410.3, we excluded both our 2014 gain on the disposition of investment in unconsolidated entities and our 2014 gain from remeasurement to fair value of previously unconsolidated entities from the numerator when calculating each investee's share of our 2014 income from continuing operations.

FIRST POTOMAC
REALTY TRUST

September 25, 2015

VIA EDGAR

United States Securities and Exchange Commission
Division of Corporation Finance
100 F Street, N.E.
Washington, D.C. 20549

Attn: Wilson K. Lee, Senior Accountant
Peter McPhun, Staff Accountant

Re: First Potomac Realty Trust
Form 10-K for the fiscal year ended December 31, 2014
Filed February 20, 2015
File No. 001-31824

Dear Mr. Lee:

This letter is in response to the comments of the Staff of the Division of Corporation Finance (the "**Staff**") of the United States Securities and Exchange Commission (the "**Commission**"), received by e-mail on September 17, 2015, with respect to the Annual Report on Form 10-K for the fiscal year ended December 31, 2014 of First Potomac Realty Trust, a Maryland real estate investment trust (the "**Company**"), which was filed with the Commission on February 20, 2015.

For ease of review, the Staff comment contained in your September 17, 2015 letter is reprinted below in bold and is followed by the Company's corresponding response thereto.

Form 10-K for the year ended December 31, 2014

Form 10-Q for the three months ended March 31, 2015 and the three and six months ended June 30, 2015

Exhibit 31.2

1. **We note that paragraph 2 of the Executive Vice President and Chief Financial Officer certifications filed in Exhibit 31.2 duplicates paragraph 4 and excludes the language for paragraph 2 outlined within Item 601(b)(31) of Regulation S-K. Please amend your filings to include corrected certifications that contain the required statement.**

   RESPONSE: As discussed telephonically with the Staff, the Company will file abbreviated amendments to the above-referenced quarterly reports on Form 10-Q, which will include corrected certifications.

FRANKLIN
STREET PROPERTIES

September 23, 2015

VIA EDGAR

United States Securities and Exchange Commission
Division of Corporation Finance
100 F Street, N.E.
Washington, D.C. 20549
Attention: Tom Kluck – Legal Branch Chief
Mail Stop 4561

Re: Franklin Street Properties, Inc.
Form 10-K
Filed February 17, 2015
File No. 001-32470

Dear Mr. Kluck:

Franklin Street Properties Corp. (the "Company") has set forth below a response to the comment to the Company's Annual Report on Form 10-K for the year ended December 31, 2014 provided by you to Mr. John G. Demeritt in a letter dated September 15, 2015 (the "Letter"). The response is keyed to the numbering of the comment in the Letter and to the headings used in the Letter.

<u>Item 2. Properties</u>

1. In future Exchange Act periodic reports, please provide a lease expiration table for ten years, starting with the year in which the report is filed, stating (i) the number of tenants whose leases will expire, (ii) the total area in square feet covered by such leases, (iii) the annual rental represented by such leases, and (iv) the percentage of gross annual rental represented by such leases.

<u>Response</u>

In future Annual Reports on Form 10-K, the Company undertakes to include a lease expiration table for ten years, starting with the year in which the report is filed, stating (i) the number of tenants whose leases will expire, (ii) the total area in square feet covered by such leases, (iii) the annual rental represented by such leases, and (iv) the percentage of gross annual rental represented by such leases.

March 24, 2015

Via EDGAR
Mr. Kevin Woody
Branch Chief
Division of Corporation Finance
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

Re: ***General Growth Properties, Inc.***
Form 10-K for the year ended December 31, 2014 (the "Form 10-K")
Filed March 2, 2015
File No. 001-34948

Dear Mr. Woody:

I am writing on behalf of General Growth Properties, Inc. (the "Company", "we", "GGP" or "our") in response to comments of the staff (the "Staff") of the Securities and Exchange Commission ("the Commission") contained in your correspondence dated March 17, 2015. The heading and page number below from the Company's Annual Report on Form 10-K ("Annual Report") corresponds to the heading and page number referenced in your letter. In addition, for your convenience, I have reproduced your comments in this letter and included our responses directly below each comment. Capitalized terms not defined herein shall have the meanings given to them in the Company's periodic reports.

Note 2 – Summary of Significant Accounting Policies, page F-13

1. *In future filings, please disclose your accounting policy for dispositions of assets, and in particular, contributions of assets to joint ventures.*

Response: We acknowledge the Staff's comment and note that in future Exchange Act periodic reports, we will disclose our accounting policy for dispositions of assets, and in particular, contributions of assets to joint ventures. As an illustration of the disclosure approach we expect to take with respect to the December 31, 2015 10-K, below is a markup of our proposed changes to the disclosure on pages F-15 and F-16 of our Form 10-K for Year Ended December 31, 2014 (with the proposed addition in bold and brackets):

Revenue Recognition and Related Matters (F-16)

Tenant recoveries are established in the leases or computed based upon a formula related to real estate taxes, insurance and other property operating expenses and are generally recognized as revenues in the period the related costs are incurred.

[Real estate sales are recognized whenever (1) a sale is consummated, (2) the buyer has demonstrated an adequate commitment to pay for the property, (3) the Company's receivable is not subject to future subordination, and (4) the Company has transferred to the buyer the

risks and rewards of ownership and does not have continuing involvement. Unless all conditions are met, recognition of all or a portion of the profit shall be postponed.]

We provide an allowance for doubtful accounts against the portion of accounts receivable, including straight-line rents, which is estimated to be uncollectible. Such allowances are reviewed periodically based upon our recovery experience. The following table summarizes the changes in allowance for doubtful accounts:

Investment in Unconsolidated Real Estate Affiliates (F-15)

Partially owned, non-variable interest joint ventures over which we have controlling financial interest are consolidated in our consolidated financial statements. In determining if we have a controlling financial interest, we consider factors such as ownership interest, authority to make decisions, kick-out rights and substantive participating rights. Partially owned joint ventures where we do not have a controlling financial interest, but have the ability to exercise significant influence, are accounted for using the equity method.

[To the extent that the Company contributes assets to a joint venture accounted for using the equity method, the Company's investment in the joint venture is recorded at the Company's cost basis in the assets that were contributed to the joint venture. The Company will recognize gains and losses on the contribution of its real estate to joint ventures, relating solely to the outside partner's interest, to the extent the buyer is independent of the Company, the collection of the sales price is reasonably assured, and the Company will not be required to support the operations of the property or its related obligations to an extent greater than its proportionate interest.]

[The combined summarized financial information of unconsolidated joint ventures is disclosed in Note 6 to the Consolidated Financial Statements.]

We continually analyze and assess reconsideration events, including changes in the factors mentioned above, to determine if the consolidation treatment remains appropriate. Decisions regarding consolidation of partially owned entities frequently require significant judgment by our management.

The Company hereby acknowledges that the Company is responsible for the adequacy and accuracy of the disclosure in the filing; Staff comments or changes to disclosure in response to Staff comments do not foreclose the Commission from taking any action with respect to the filing; and the Company may not assert Staff comments as a defense in any proceeding initiated by the Commission or any person under the federal securities laws of the United States.

Please contact me at 312-960-5044 if you have any questions about the foregoing, or if you would like to further discuss any of the matters raised in this response letter.

Sincerely,

/s/ Michael Berman

Michael Berman
Chief Financial Officer

521 Fifth Avenue
30th Floor
New York, NY 10175

212.297.1000
www.gptreit.com

NYSE: GPT

GRAMERCY
PROPERTY TRUST

August 27, 2015

Eric McPhee
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

RE: Gramercy Property Trust Inc. (the "Company")
Form 10-K for the year ended December 31, 2014
Filed on March 9, 2015
File No. 001-32248

Dear Mr. McPhee:

We are transmitting for filing the Company's response to the comments of the Staff of the Securities and Exchange Commission (the "Commission") contained in your letter to Jon W. Clark of the Company, dated August 21, 2015 (the "August 21st Letter"). For convenience of reference, the Staff comments contained in the August 21st Letter are reprinted below in italics and are followed by the corresponding response of the Company.

Item 5. Market For Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities - Dividends

1. In future periodic filings, please disclose the tax status of distributions per unit pursuant to Rule 3-15(c) of Regulation S-X.

Response: In response to the Staff's comment, the Company undertakes to include this disclosure in future annual filings.

Funds from Operations, pages 72 – 73

2. We note that in your earnings release and supplemental information you discuss other Non-GAAP Financial Measures such as Core FFO, Adjusted FFO, and Net Operating Income. Please clarify whether you utilize these measures as key performance indicators. To the extent you do, in future periodic filing, please include such Non-GAAP financial measures, discussion of any related and relevant fluctuations, and the required Non-GAAP disclosures outlined within Item 10(e) of Regulation S-K for each respective measure.

Response: In response to the Staff's comment, the Company advises the Staff that for future filings, it will include Core FFO and Adjusted FFO in its periodic filings and provide related detailed reconciliations to GAAP net income (loss) as well as any relevant fluctuations, as the Company intends to utilize Core FFO and Adjusted FFO as key performance measures in addition to Funds from operations which has already been included in the Company's periodic filings. Net operating income is not utilized as a key performance indictor to evaluate the Company's performance as a whole. Net operating income is used only to provide additional information for specific property acquisitions and for individual properties owned in the Company's investment portfolio.

3. In arriving at Funds from operations, you start with Net income available to common stockholders. As a result, it appears Funds from operations is actually Funds from operations attributable to just common stockholders instead of all equity stockholders. In future periodic filings please re-title "Funds from operations" to the more appropriate "Funds from operations attributable to common stockholders".

Response: In response to the Staff's comment, the Company advises the Staff that for future periodic filings, it will retitle "Funds from operations" to "Funds from operations attributable to common stockholders and unitholders". Using the title "Funds from operations" and starting the table with net income available to common stockholders was only intended to present a performance indicator that excludes dividends that are attributable solely to preferred stockholders. The denominator for Funds from operations per share represents both common stockholders and operating partnership unit holders but excludes preferred stockholders.

Consolidated Statements of Operations, page 80

4. Please revise future periodic filings to clarify the types of expenses that are included in operating expenses and general and administrative expenses. Within your response, please provide an example of your proposed disclosure.

Response: In response to the Staff's comment, the Company advises the Staff that, for future periodic filings, the Company will revise footnote 2 of its financial statements, which describes the Company's significant accounting policies, to include additional detail regarding the types of costs included in property operating expenses and those included in general and administrative expenses. The following is an example of our proposed disclosure:

> "Property operating expenses include insurance, property management, repairs and maintenance, security, janitorial, landscaping and other administrative expenses incurred to operate the Company's properties as well as costs directly related to its asset management business on properties owned by third parties in both the United States and Europe.
>
> General and administrative expenses represent costs unrelated to property operations or acquisition related costs. These expenses primarily include corporate office expenses, employee compensation and benefits as well as costs related to being a listed public company including certain audit fees, directors and officer's insurance, legal costs and other professional fees."

In connection with the Company's response to the August 21st Letter, the Company acknowledges that:

- It is responsible for the adequacy and the accuracy of the disclosures in the filing;

Hatteras Financial Corp.
751 West Fourth Street, Suite 400
Winston Salem, North Carolina 27101

May 21, 2015

Via EDGAR

Jaime G. John, Branch Chief
Division of Corporation Finance
Securities and Exchange Commission
100 F Street, N.E., Mail Stop 3010
Washington, D.C. 20549

Re: Hatteras Financial Corp.
Form 10-K for the Fiscal Year Ended December 31, 2014
File No. 1-34030

Dear Jaime G. John:

This correspondence is our response to your comment letter dated May 13, 2015, regarding our Form 10-K for the fiscal year ended December 31, 2014. The attached Annex A itemizes each of your comments and our responses thereto.

We acknowledge the following:

- we are responsible for the adequacy and accuracy of the disclosure in the filing;
- staff comments or changes to disclosure in response to staff comments do not foreclose the Commission from taking any action with respect to the filing; and
- we may not assert staff comments as a defense in any proceeding initiated by the Commission or any person under the federal securities laws of the United States.

If you have any further questions concerning the response letter, please contact our outside counsel, Kerry E. Johnson at Hunton & Williams LLP at (212) 309-1040, or Kenneth A. Steele at (336) 760-9331.

Sincerely,

Hatteras Financial Corp.

/s/ Kenneth A. Steele
Kenneth A. Steele, Chief Financial Officer

cc: Securities and Exchange Commission
Isaac Esquivel, Staff Accountant
Hunton & Williams LLP
Kerry E. Johnson

Annex A

Item 8. Financial Statements and Supplementary Data

Consolidated Balance Sheets, page F-2

1. **We note that cash and cash equivalents include pledged cash of $323.8 million and $225.4 million as of December 31, 2014 and 2013, respectively. Please explain to us why pledged cash is not considered restricted and presented as such in the consolidated financial statements.**

   Response: Our cash and cash equivalents include cash pledged to derivative counterparties, which is held in margin accounts as collateral related to interest rate swap agreements, futures contracts and forward commitments to purchase to-be-announced mortgage-backed securities. Pursuant to the terms of the related ISDA, futures trading and MSFTA agreements, we are allowed to pledge cash or securities as collateral, and can actively manage the nature and amount of collateral pledged as margin requirements fluctuate. The pledged cash is held in demand deposit bank accounts to which we have direct access without restriction. We view the fact pattern as similar to "arrangements (that) exist but are not agreements which legally restrict the user of cash amounts shown on the balance sheet" (excerpted from Regulation S-X Rule 5.02). Accordingly, we disclose the nature of these arrangements and the amounts involved in the footnotes to our consolidated financial statements and include a parenthetical disclosure on the face of the balance sheet to further highlight the existence of these contractual arrangements.

Consolidated Statements of Comprehensive Income, page F-4

2. **Please tell us your basis for presenting comprehensive income (loss) per share on the face of this statement.**

   Response: Because fair value adjustments on our mortgage-backed securities portfolio flow through other comprehensive income while fair value adjustments on our derivatives flow through earnings, management considers comprehensive income to be a meaningful measure of our operating results, in addition to net income. As such, beginning with our Quarterly Report on Form 10-Q for the period ended September 30, 2014, we have included a discussion of comprehensive income in our results of operations. While we are not aware of any GAAP or SEC guidance validating comprehensive income per share as a formal GAAP measure, neither are we aware of any guidance precluding it. In addition, our calculation of comprehensive income per share directly mirrors the Financial Accounting Standards Board guidance for earnings per share calculations, in accordance with ASC 260-10-45-5. While ASC 260-10-45-5 states that per share amounts that are not required to be presented should not be shown on the face of the income statement, we did not interpret that provision as preventing comprehensive income per share from being shown on the face of the statement of comprehensive income. Further, we believe that the presentation of comprehensive income per share has practical benefits for users of our financial statements.

Hatteras Financial Corp.
751 West Fourth Street, Suite 400
Winston Salem, North Carolina 27101

June 8, 2015

<u>Via EDGAR</u>

Jaime G. John, Branch Chief
Division of Corporation Finance
Securities and Exchange Commission
100 F Street, N.E., Mail Stop 3010
Washington, D.C. 20549

Re: Hatteras Financial Corp.
Form 10-K for the Fiscal Year Ended December 31, 2014
Filed February 24, 2015
File No. 1-34030

Dear Jaime G. John:

This correspondence is our response to your comment letter dated June 4, 2015, regarding our Form 10-K for the fiscal year ended December 31, 2014, which references our May 21, 2015 response to your comment letter dated May 13, 2015. For convenience, we reproduced your comment before our response thereto below.

We acknowledge the following:

- we are responsible for the adequacy and accuracy of the disclosure in the filing;
- staff comments or changes to disclosure in response to staff comments do not foreclose the Commission from taking any action with respect to the filing; and
- we may not assert staff comments as a defense in any proceeding initiated by the Commission or any person under the federal securities laws of the United States.

<u>Consolidated Statements of Comprehensive Income, page F-4</u>

1. We note your response to prior comment 2. As discussed in ASC 260-10-45-2, per-share information relating to income from continuing operations and net income is required on the face of the income statement. Further, ASC 260-10-45-5 states that per-share amounts not required to be presented by this Subtopic shall be disclosed only in the notes to the financial statements. Therefore, please revise future filings to remove this measure from the face of your consolidated statements of comprehensive income.

   Response: In response to your comment, in future filings we will not present comprehensive income per share on the face of our statement of comprehensive income.

MARCH 27, 2015

VIA EDGAR AND FEDEX

Howard Efron
Staff Accountant
Division of Corporation Finance
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

Re: HCP, Inc.
Form 10-K for the fiscal year ended December 31, 2014
Filed on February 10, 2015
File Number: 1-08895

Dear Mr. Efron:

HCP, Inc. hereby submits this letter in response to the comment letter from the Staff of the Securities and Exchange Commission (the "Staff") dated March 19, 2015. For your convenience, the Staff's comment has been reprinted in italics below and our responses are in bold print. References to "we", "our" or the "Company" in this response are to HCP, Inc.

Form 10-K for the fiscal year ended December 31, 2014
Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations
Non-GAAP Financial Measures
Funds Available for Distribution, page 38

1. *We note your disclosure appears to indicate that FAD is a liquidity measure as management views it as a supplemental measure which meaningfully measures the ability to fund ongoing dividend payments. Please tell us how you have met the reconciliation requirement under Item 10(e) of Regulation S-K as you have reconciled the amount to net income applicable to common shares through FFO as adjusted applicable to common shareholders. Additionally, please tell us how you determined it was appropriate to provide FAD per share within your filing in light of Question 102.5 of Compliance and Disclosure Interpretations on Non-GAAP financial measures.*

Response: We respectfully advise the Staff that we view FAD primarily as a performance measure and not a liquidity measure. This is consistent with how real estate equity analysts and investors evaluate our performance as FAD represents one of the key supplemental benchmarks to measure our operating performance and profitability (along with NAREIT FFO). Further, FAD, as a performance measure, is: 1) included as part of our Annual Operating Plan presented to and approved by our Board of Directors; 2) reported in our quarterly earnings releases; 3) discussed on earnings calls and with investors as a performance benchmark; and 4) one of the performance criteria in determining a portion of our named executive officers' compensation, as described in our 2014 and 2015 Proxy Statements. Therefore, since the Company views FAD as a performance measure, we believe net income applicable to common shares is the most directly comparable GAAP measure.

While dividends can be analyzed in comparison to FAD, as much as they are analyzed in comparison to FFO or net income, it is not our intent to imply that this is the primary purpose of this measure.

For the avoidance of doubt, we respectfully advise the Staff that we will revise our disclosure in future periodic filings to state:

Other REITs or real estate companies may use different methodologies for calculating FAD, and accordingly, our FAD may not be comparable to those reported by other REITs. Although our FAD computation may not be comparable to that of other REITs, management believes FAD provides a meaningful supplemental measure of our performance and is frequently used by analysts, investors, and other interested parties in the evaluation of our performance as a REIT. FAD does not represent cash generated from operating activities determined in accordance with GAAP, is not necessarily indicative of cash available to fund cash needs, and should not be considered as an alternative to net income (determined in accordance with GAAP).

For the Staff's benefit, we have included an Appendix to this letter which outlines our revised disclosure, which is marked for changes from the disclosure included in our Form 10-K for the fiscal year ended December 31, 2014.

Response: We respectfully advise the Staff, because FAD is considered a performance measure (as clarified above), we believe it is appropriate to present FAD per share in our filings in accordance with Item 10(e) of Regulation S-K and Question 102.5 of Compliance and Disclosure Interpretations of Non-GAAP financial measures.

In connection with responding to your comment, we acknowledge that:

- we are responsible for the adequacy and accuracy of the disclosure in the filings;
- Staff comments or changes to disclosure in response to Staff comments do not foreclose the Commission from taking any action with respect to the filings; and
- we may not assert Staff comments as a defense in any proceeding initiated by the Commission or any person under the federal securities laws of the United States.

Thank you for your consideration of our responses. Should you have any questions, please call the undersigned at (949) 407-0707.

Very truly yours,

/s/ TIMOTHY M. SCHOEN

Timothy M. Schoen
Executive Vice President and
Chief Financial Officer

cc: James W. Mercer, Esq.
Scott A. Anderson
Rochelle Rausch
Troy E. McHenry, Esq.

Appendix

Other REITs or real estate companies may use different methodologies for calculating FAD, and accordingly, our FAD may not be comparable to those reported by other REITs. Although our FAD computation may not be comparable to that of other REITs, management believes FAD provides a meaningful supplemental measure of our ~~ability to fund our ongoing dividend payments~~ ***performance and is frequently used by analysts, investors, and other interested parties in the evaluation of our performance as a REIT***. ~~In addition, management believes that in order to further understand and analyze our liquidity, FAD should not be compared with net cash flows from operating activities as determined in accordance with GAAP and presented in our consolidated financial statements.~~ FAD does not represent cash generated from operating activities determined in accordance with GAAP, ***is not necessarily indicative of cash available to fund cash needs,*** and ~~FAD~~ should not be considered as an alternative to net income ~~(~~(determined in accordance with GAAP~~)~~), ~~as an alternative to net cash flows from operating activities (as~~

~~determined in accordance with GAAP), or as a measure of our liquidity.~~

June 5, 2015

VIA EDGAR

Mr. Daniel Gordon
Senior Assistant Chief Accountant
Division of Corporation Finance
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

Re: **Healthcare Trust of America, Inc.**
Form 10-K for the year ended December 31, 2014
Filed February 23, 2015
File No. 001-35568

Healthcare Trust of America Holdings, LP
Form 10-K for the year ended December 31, 2014
Filed February 23, 2015
File No. 333-190916

Dear Mr. Gordon:

On behalf of Healthcare Trust of America, Inc., a Maryland corporation ("**HTA**"), and Healthcare Trust of America Holdings, LP, a Delaware limited partnership (together with HTA, the "**Company**"), we hereby respond to the letter dated May 22, 2015 (the "**Letter**") setting forth comments of the staff (the "**Staff**") of the Securities and Exchange Commission (the "**Commission**") on the Company's above-referenced Form 10-K.

On behalf of the Company, we are responding below to the Staff's Letter. For the convenience of the Staff, the comment from the Letter is restated in **bold** prior to our response on behalf of the Company.

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations, page 37

1. On page 71, you disclose that you capitalized internal leasing related costs. Please tell us the amount of internal costs you capitalize to deferred leasing costs and real estate investments for all periods presented. If material, please confirm for us that you will disclose this information within future periodic filings and discuss any significant fluctuations in such capitalized internal costs within your MD&A.

In response to the Staff's comment, during the years ended December 31, 2014, 2013 and 2012, the Company capitalized $2.1 million, $1.6 million and $0.7 million, respectively, of internal costs to deferred leasing costs. In addition, during the years ended December 31, 2014, 2013 and 2012, the Company capitalized $0.7 million, $0.5 million and $0.4 million, respectively, of internal costs to real estate investments. The Company confirms that, to the extent material, it will disclose amounts capitalized in future periodic filings with the Commission, starting with our Form 10-Q for the six months ending June 30, 2015, and discuss in the Company's MD&A any significant fluctuations in the amount of internal costs capitalized to deferred leasing costs and real estate investments.

FFO and Normalized FFO, page 44

2. We note that your calculation of FFO starts with Net income attributable to common stockholders and as such, it appears that the resulting amount of FFO represents FFO attributable to common stockholders rather than FFO for the entire company. In future filings please re-label "Funds from operations" to "Funds from operations attributable to common stockholders".

In response to the Staff's comment, the Company confirms that it will add the above referenced "Funds from operations attributable to common stockholders" language in future filings with the Commission.

* * *

Hospitality Properties Trust

Two Newton Place, 255 Washington Street, Newton, Massachusetts 02458-1634
(617) 964-8389 tel (617) 969-5730 fax www.hptreit.com

May 28, 2015

VIA EDGAR

Kevin R. Woody
Branch Chief
United States Securities and Exchange Commission
Division of Corporation Finance
100 F Street, N.E.
Washington, D.C. 20549

Re: Hospitality Properties Trust (the "Company")
Form 10-K for the fiscal year ended December 31, 2014 (the "Filing")
Filed February 27, 2015
File No. 1-11527

Dear Mr. Woody:

We are in receipt of your letter dated May 14, 2015, regarding the above referenced Filing. For your convenience, each of your original comments appears in bold text and is followed by our response.

Form 10-K for the fiscal year ended December 31, 2014

Non-GAAP Measures, page 87

1. **In arriving at Funds from operations, you start with Net income available for common shareholders. As a result, it appears Funds from operations is actually Funds from operations attributable to just common shareholders instead of all equity shareholders. In future periodic filings please designate that FFO is attributable to common shareholders. Additionally, apply this comment to Normalized FFO as well.**

   Company Response:

   In future periodic filings, we will designate that FFO and Normalized FFO are attributable to common shareholders.

Financial Statements

6. Management Agreements and Leases, F-15

2. **We note the Morgan agreement expires in 2103 and that you recognize rents on a cash basis due to uncertainty with future rent collection. Please describe if there have been any significant changes or updates related to the future collection of rent under the Morgan lease. Additionally, tell us how your testing of impairment related to**

the Clift Hotel was adjusted related to rent collectability issues with the lessee.

Company Response:

In 2004, a subsidiary of Morgans Hotel Group, or the Morgans Subsidiary, entered into a 99 year lease for the Clift Hotel located in San Francisco, CA. We acquired the Clift Hotel in December 2012. As of the acquisition date, the lease provided for annual base rent to us of $6.0 million. The annual base rent due to us was scheduled to increase in October 2014 based on changes in the CPI, as defined, with a minimum increase of 20% of the current rent amount and a maximum increase of 40%. On each fifth anniversary thereafter during the lease term, the base rent due to us will increase further based on changes in the CPI, as defined, with minimum increases of 10% and maximum increases of 20%.

When performing our analysis to determine the appropriate accounting treatment of this acquired lease, we determined that the lease did not meet the collectability criteria under ASC 840-10-25-42(a) and classified it as an operating lease. When we acquired the hotel in 2012, the operations of the hotel were not generating sufficient cash flow to cover the rent payments required under the lease and the Morgans Subsidiary had no assets or other resources available to fund its cash flow deficit. Although Morgans Hotel Group had on occasion funded cash shortfalls sustained by the Morgans Subsidiary in order to enable it to make lease payments, it had no legal obligation under the terms of the lease to do so in the future. We also considered the impact that the scheduled 20% to 40% rent increase in 2014 would have on the Morgans Subsidiary's ability to meet its future payment obligations under the lease. For the above reasons, we concluded that the collectability of future rent payment under the lease was not reasonably assured.

Although operating results of the Clift Hotel have improved since we acquired the hotel, historical cash flows before capital expenditures and management fees have not been sufficient to cover the current annual base rent amount. In addition, we believe that the hotel will require a major renovation in the next few years (last renovated in 2001) at an estimated cost of $30 million to $35 million. If these renovations occur, the cost of this renovation is an obligation of the Morgans Subsidiary under the terms of the lease agreement. For the above reasons, we believe that the collectability of future rent payments under the lease continue to not be reasonably assured.

We regularly evaluate whether events or changes in circumstances have occurred that could indicate impairment in the value of our real estate properties. If there is an indication that the carrying value of a property is not recoverable, we estimate the future undiscounted cash flows of the property to determine if we should recognize an impairment loss. In performing our analysis for the Clift Hotel, we have not based our estimate of the future undiscounted cash flows of the hotel on the contractual rent payments required under our lease with the Morgans Subsidiary. Instead, we have estimated the future undiscounted cash flows of the hotel using a rent amount we believe a market participant would pay to lease the hotel. We considered the historical and projected operating performance of the hotel and the return expectations of market participants in developing our estimate of a market rent. Based on our analysis, we determined no impairment loss should be recognized for this property.

In connection with our responses above, we acknowledge that:

- the Company is responsible for the adequacy and accuracy of the disclosure in the Filing;
- staff comments or changes to disclosure in response to staff comments do not foreclose the Commission from taking any action with respect to the Filing; and
- the Company may not assert staff comments as a defense in any proceeding initiated by the Commission or any person under the federal securities laws of the United States.

We appreciate your comments and welcome the opportunity to discuss with you our responses provided above. If you have any

September 29, 2015

Via EDGAR

Mr. Robert F. Telewicz, Jr.
Accounting Branch Chief
Office of Real Estate and Commodities
United States Securities and Exchange Commission
Division of Corporation Finance
100 F Street, N.E.
Washington, D.C. 20549

RE: Iron Mountain Incorporated (the "Company")
Form 10-K for the fiscal year ended December 31, 2014
Filed February 27, 2015
File No. 1-13045 (the "Form 10-K")

Form 10-Q for the quarterly period ended June 30, 2015
Filed July 30, 2015
File No. 1-13045 (the "Form 10-Q")

Dear Mr. Telewicz:

The purpose of this letter is to respond to your letter of September 21, 2015. For your convenience, the original staff comments have been repeated in bold typeface, followed by our responses.

Form 10-K for the fiscal year ended December 31, 2014
Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations
Non-GAAP Measures, page 39

1. **We note the use of Funds from Operations Applicable to Iron Mountain, or FFO (NAREIT) in your earnings commentary and supplemental information. Please tell us whether you consider this measure to be a key performance indicator. To the extent this measure is considered a key performance indicator, in future periodic filings please include the measure as well as the required disclosures in accordance with Item 10(e) of Regulation S-K within your Management's Discussion and Analysis.**

RESPONSE:

1. In response to the staff's comment, we consider FFO (NAREIT) and FFO Applicable to Iron Mountain (Normalized) ("FFO (Normalized)"), to be key performance indicators of our business since our Board of Directors, in the second quarter of 2014, approved our conversion to a real estate investment trust for federal

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income tax purposes ("REIT") for the taxable year beginning January 1, 2014. Accordingly, commencing with our Form 10-Q for the quarterly period ending September 30, 2015, we will include FFO (NAREIT) and FFO (Normalized) within the Non-GAAP Measures section of Management's Discussion and Analysis of Financial Condition and Results of Operations for each of the current and prior periods presented therein. As required by Item 10(e) of Regulation S-K, our disclosure will include a reconciliation of FFO (NAREIT) and FFO (Normalized) to the most comparable generally accepted accounting principles measure, as well as disclosure regarding why we believe that FFO (NAREIT) and FFO (Normalized) provide useful information to investors regarding our financial condition and results of operations.

Financial Statements
Notes to Consolidated Financial Statements
Note 2. Summary of Significant Accounting Policies
g. Goodwill and Other Intangible Assets, page 86

2. **Please explain to us in greater detail the reason for the $32,265 fair value and other adjustment made to goodwill and deferred income taxes. Cite any relevant accounting literature in your response.**

RESPONSE:

2. In October 2013, we acquired Cornerstone Records Management, LLC and its affiliates ("Cornerstone"), a national, full solution records and information- management company with operations in the United States, in a cash transaction for approximately $191.0 million. At December 31, 2013, our purchase accounting for the Cornerstone acquisition was incomplete, as noted in Note 6. *Acquisitions* to our

Form 10-K for the fiscal year ended December 31, 2013 in which we state "The purchase price allocations of the 2013 acquisitions are subject to finalization of the assessment of the fair value of…income taxes (primarily deferred income taxes)." As of and for the year ended December 31, 2013, provisional purchase accounting amounts in accordance with Accounting Standards Codification ("ASC") No. 805, *Business Combinations* ("ASC 805") related to the Cornerstone acquisition were recorded.

Throughout the first half of fiscal year 2014 and within the applicable measurement period (as described in ASC 805), we were reconciling historical Cornerstone acquisition-date tax records and positions with Cornerstone's predecessor tax advisor associated with the 2013 Cornerstone tax return. In conjunction with that analysis, we obtained new additional detailed information and historical data regarding certain acquisition-date deferred income tax attributes. We determined that this information represented, in accordance with ASC 805-25-13, "*new information about facts that existed as of the acquisition date that, if known, would have affected the measurement of the amounts recognized as of that date.*" Accordingly, we

adjusted the provisional purchase accounting amounts related to the acquisition-date deferred income tax attributes for the Cornerstone acquisition by $33.3 million during the first and second quarters of fiscal year 2014, resulting in an increase in deferred tax assets (primarily associated with the valuation of net operating loss carryforwards) of $9.7 million and a net decrease in deferred tax liabilities (primarily associated with the identification of additional tax basis in certain assets) of $23.6 million. The effect of these adjustments to the deferred income tax attributes was a net decrease in goodwill associated with the Cornerstone acquisition of $33.3 million. This decrease in goodwill associated with the Cornerstone acquisition, which was partially offset by approximately $1.0 million of other deferred income tax fair value adjustments associated with other 2013 acquisitions, accounts for the $32,265 of fair value adjustments to deferred income taxes disclosed on page 89 of our Form 10-K.

Additionally, we assessed with contemporaneous documentation, both from a quantitative and qualitative perspective, whether the impact of the Cornerstone deferred income tax adjustments was material to our previously issued consolidated balance sheets as of December 31, 2013 or March 31, 2014, as well as our consolidated statements of operations for the year ended December 31, 2013 and the three months ended March 31, 2014 (collectively, the "Prior Period Financial Statements"). Based on this analysis, we concluded that the impact of the Cornerstone deferred income tax adjustments was not material to the Prior Period Financial Statements and, accordingly, we did not restate in accordance with ASC 805 any of the Prior Period Financial Statements as a result of the Cornerstone deferred income tax adjustments.

Financial Statements
Notes to Consolidated Financial Statements
Note 2. Summary of Significant Accounting Policies
q. Allowance for Doubtful Accounts and Credit Memo Reserves, page 100

3. Please tell us the reasons for your credit memo reserve. Your response should include a discussion of the types and frequency of disputes that arise that create the need for the reserve. Cite any relevant accounting literature in your response.

RESPONSE:

3. We maintain a credit memo reserve associated with disputes from our customers related to billing and service issues. Billings to our customers are based upon contractually agreed upon prices and represent a homogenous pool of a large volume of generally small billings associated with storage and service delivery (which includes pick-up, retrieval, refile, indexing, permanent removal, destruction and transportation of customer materials, among other services). Billing and service delivery issues include unit price, quantity, type of service (regular or expedited) and

quality of service (on-time or accuracy), among others. No one customer represents greater than 2% of our consolidated revenues and our customer billings are spread over more than 155,000 customer accounts on a global basis.

We issued customer credits totaling approximately $47.1 million, or approximately 1.5% of consolidated revenues, in the year ended December 31, 2014. Our credit memo reserve as of December 31, 2014 was approximately $18.1 million, or approximately 2.8% of gross accounts receivable and approximately 0.6% of consolidated revenues for the year ended December 31, 2014.

With respect to our accounting for the credit memo reserve, we analogize to the provisions of ASC 605-15-25, *Revenue Recognition — Products — Sales of Product when Right of Return Exists* ("ASC 605-15-25"), which states, in part:

> "*If an entity sells its product but gives the buyer the right to return the product, revenue from the sales transaction shall be recognized at time of sale only if all of the following conditions are met:*

a. *The seller's price to the buyer is substantially fixed or determinable at the date of sale.*

b. *The buyer has paid the seller, or the buyer is obligated to pay the seller and the obligation is not contingent on resale of the product…*

c. *The buyer's obligation to the seller would not be changed in the event of theft or physical destruction or damage of the product.*

d. *The buyer acquiring the product for resale has economic substance apart from that provided by the seller…*

e. *The seller does not have significant obligations for future performance to directly bring about resale of the product by the buyer.*

f. *The amount of future returns can be reasonably estimated."*

We assessed our credit memo reserve accounting based on the literature above and determined that revenue recognition is appropriate as we meet each of the necessary conditions. Specifically, we note that (a) our prices are fixed or determinable as our prices are based upon the terms of our contracts with our customers and (b) the customer is obligated to pay us for services rendered. Items "c" through "e" in ASC 605-15-25 above are not applicable to us, as our storage rental and related services are not subject to theft or destruction, nor are they subject to resale by our customers.

With respect to item "f" in ASC 605-15-25 above, our credit memo reserve represents a reasonable estimate of amounts recognized as revenue and billed to our customers as of the applicable reporting period which may subsequently be disputed by our customers for the issues noted above. The credit memo reserve is determined by calculating (a) the period for which credit memos are unissued, or the lag, multiplied by (b) the average amount of credit memos issued over the period of the lag (which is based upon a review of the type, volume and trending of historical

credit memo activity). With respect to our ability to reasonably estimate the amount of credit memos that will be issued in order to calculate our credit memo reserve, we believe that we have significant historical experience with respect to our credit memo activity as the volume of credit memos has historically not been subject to any significant volatility. Credit memos charged against consolidated revenue represented 1.3%, 1.6% and 1.5% of consolidated revenues for the fiscal years ended December 31, 2012, 2013 and 2014, respectively, and total credit memos have ranged from 1.3% to 1.6% of consolidated revenues over the past five fiscal years.

Form 10-Q for the quarterly period ended June 30, 2015
Notes to Consolidated Financial Statements
Note 5. Debt, page 30

4. We note that you entered into an accounts receivable securitization program in March 2015. In future filings, please revise your summary of significant accounting policies to include the accounting policy that you apply for the accounts receivable securitization program.

RESPONSE:

4. As disclosed in the Form 10-Q, in March 2015 we entered into an accounts receivable securitization program (the "AR Securitization Program") involving several of our wholly owned subsidiaries and certain financial institutions. Under the AR Securitization Program, certain of our subsidiaries sell substantially all of their United States accounts receivable balances to certain special purposes subsidiaries (the "Special Purposes Subsidiaries") which are also wholly owned by us. The Special Purpose Subsidiaries use these accounts receivable balances to collateralize loans obtained from financial institutions.

In response to the staff's comment and in order to provide users of our financial statements greater clarity with respect to our accounting for the AR Securitization Program, we will provide incremental disclosure in future filings regarding our accounting for the AR Securitization Program. However, we believe that providing such disclosure in the context of the description of the transaction itself within our Debt footnote, rather than within the significant accounting policies section of our filings, is more appropriate. We intend to revise the disclosure in our Debt footnote as it will appear in our Form 10-Q for the quarterly period ending September 30, 2015 to include the following incremental language:

"The Special Purpose Subsidiaries are consolidated subsidiaries of IMI. The Accounts Receivable Securitization Program is accounted for as a collateralized financing activity, rather than a sale of assets and, therefore: (a) accounts receivable balances pledged as collateral are presented as assets and borrowings are presented as liabilities on our consolidated balance sheet, (b) our consolidated statement of operations reflects the associated charges for bad debt expense related to pledged accounts receivable (a component of selling, general and administrative expenses) and reductions to revenue due to billing and service related credit memos issued to customers and related reserves, as well as, interest expense associated with the collateralized borrowings and (c) receipts from customers related to the underlying accounts receivable are reflected as operating cash flows and borrowings and repayments under the collateralized debt are reflected as financing cash flows within our consolidated statement of cash flows."

****

As requested, the Company acknowledges that:

- the Company is responsible for the adequacy and accuracy of the disclosure in the filing;
- staff comments or changes to disclosure in response to staff comments do not foreclose the Commission from taking any action with respect to the filing; and
- the Company may not assert staff comments as a defense in any proceeding initiated by the Commission or any person under the federal securities laws of the United States.

If you have any questions concerning the content of this letter, please do not hesitate to contact me.

Sincerely,
IRON MOUNTAIN INCORPORATED

By**:** /s/ Roderick Day
Roderick Day
Executive Vice President and Chief Financial Officer

September 23, 2015

Mr. Robert F. Telewicz, Jr.
Accounting Branch Chief
Division of Corporation Finance
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

Re: iStar Inc.
Form 10-K
Filed March 2, 2015
File No. 0001-15371

Dear Mr. Telewicz:

On behalf of iStar Inc. (the “Company” or “we”), set forth below are the responses of the Company to the comments of the staff of the Division of Corporation Finance (the “Staff”) of the Securities and Exchange Commission (the “Commission”), received by letter dated September 11, 2015 (the “September 11 Letter”), with respect to the Company's Form 10-K for the year ended December 31, 2014 (the “Form 10-K”). The responses to the Staff's comments are set out in the order in which the comments were set out in the September 11 Letter and are numbered accordingly.

Form 10-K for the fiscal year ended December 31, 2014

Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations

Liquidity and Capital Resources, page 37

1. *We note your disclosure that you generated approximately $1.1 billion of proceeds from loan repayments and asset sales within your portfolio during the year ended December 31, 2014. We further note that this amount is inclusive of amounts generated from consolidated and equity method investments. Please clarify for us whether this amount includes the total cash proceeds generated by equity method investments or your pro rata share.*

1114 Avenue of the Americas
New York, NY 10036

T 212 930 9400
www.istar.com

<u>Response</u>:

The $1.1 billion of proceeds from loan repayments and asset sales, which is inclusive of amounts generated from consolidated and equity method investments, includes only the Company's pro rata share of cash proceeds generated from equity method investments.

In future filings the Company will disclose that cash proceeds from equity method investments represent only the Company's pro rata share.

<u>Item 8. Financial Statements and Supplemental Data Note 6 - Other investments</u>

<u>Real Estate Equity Investments, page 69</u>

1. *Please tell us the following with respect to the unconsolidated entity you formed with a sovereign wealth fund during the year ended December 31, 2014*

1) *Explain to us how you determined the entity did not meet the definition of a VIE in accordance with ASC Topic 810-10-15-14. Your response should include, but not be limited to, an explanation of how you considered your promote and management fee when evaluating the criteria under ASC Topic 810-10-15-14c.*
2) *Please provide us a summary of the substantive participating rights of your partner. Your response should include a description of how any disputes that arise between you and your partner are resolved.*

<u>Response</u>:

1) The Company partnered with a sovereign wealth fund in 2014 to form a new entity to acquire and develop net lease assets. The Company determined that the entity did not meet the definition of a variable interest entity ("VIE") in accordance with ASC 810-10-15-14.

   The Company determined, in accordance with ASC 810-10-15-14(a), that the initial equity investment at risk for this entity, which was $34 million or 36% of the initial asset acquisition price, was sufficient to permit the legal entity to finance its activities without additional subordinated financial support provided by any parties, including equity holders. In addition, the governing documents of the venture preclude the entity leverage from exceeding 65% on a portfolio basis or 70% on an individual asset basis.

   The Company also determined in accordance with ASC 810-10-15-14(b), that the equity holders as a group do not lack the power, through voting rights or similar rights, to direct the activities of the entity that most significantly impact the entity's performance, and neither party can exercise kick out rights unilaterally. Additionally, the equity holders have the right to participate in earnings or obligation to absorb the expected losses of the entity and the right to receive residual returns.

In accordance with ASC Topic 810-10-15-14(c)(1), the Company determined that it does have disproportionate voting rights (50.0%) relative to its participation rights in earnings or losses (52.5% inclusive of related party interests). In addition, the Company is responsible for sourcing new opportunities and managing the venture and its assets in exchange for a management fee and potential promote payment. The management fee and promote structure for the services provided is commensurate with the level of effort required to provide those services and is consistent with market rates for similar services. The Company analyzed from a quantitative perspective, in accordance with ASC 810-10-15-14(c)(2), if the economics of the venture (e.g. capital at risk, participation in profits, etc.) would be heavily skewed towards the Company. The Company concluded that because our partner receives a 47.5% pari passu economic interest in the entity, after payment of management fees and promote the economics of the venture are not expected to be heavily skewed towards the Company. The Company then analyzed from a qualitative perspective, in accordance with ASC Topic 810-10-15-14(c)(2), whether substantially all of the activities of the venture are conducted on behalf of the member who has the disproportionately fewer voting rights. The Company did not identify any strong indicators that would indicate that substantially all of the activities of the venture were conducted on the Company's behalf. For example, the Company is not obligated to fund substantially all additional capital contributions to the venture, the principal purpose of this entity is to conduct business that is complementary to the business activities of all members and the Company did not sell non-performing assets to the venture.

Therefore, the Company concluded the venture is not a VIE.

1) The Company's partner has substantive participating rights over all major decisions of the venture. The venture cannot enter into a major decision without the consent of both the Company and its partner. Major decisions include, but are not limited to, approval of the business plan, acquiring any asset or making any investment, approval of operating plans and budgets, lease arrangements, the incurrence of indebtedness, transferring of membership interests, sales of a project, selection of contractors, bankruptcy matters and dissolution of the venture. Further, the members effectively participate in all significant decisions related to the venture through their approval of the initial business plan and the requirement that they vote on any major change to the business plan.

   If the Company and its partner do not agree on a major decision, the major decision is not consummated. However, both the Company and its partner are obligated to act in good faith and in the best interests of the venture, with each member reserving the right to elect to arbitrate and compel arbitration of any dispute through final and binding arbitration.

* * * * *

In connection with responding to the Staff's comments, we acknowledge the following:

- the Company is responsible for the adequacy and accuracy of the disclosure in the filing;

April 10, 2015

VIA EDGAR

Division of Corporation Finance
United States Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549

Attn: Mr. Eric McPhee
Staff Accountant

Re: Kimco Realty Corporation
Form 10-K for the Fiscal Year Ended December 31, 2014
Filed February 27, 2015
File No. 001-10899

Dear Mr. McPhee:

This letter sets forth the response of Kimco Realty Corporation (the "Company") to the comment letter from the Staff of the Division of Corporation Finance (the "Staff") of the Securities and Exchange Commission (the "Commission"), received by email on March 30, 2015, relating to the Company's Form 10-K for the year ended December 31, 2014, filed with the Commission on February 27, 2015 (the "2014 Form 10-K"). For your convenience, we have set forth each of the Staff's original comments immediately preceding our response.

Form 10-K for the year ended December 31, 2014

Combined Same Property net Operating Income, page 32

1. Please provide the disclosures required by Item 10(e) related to the non-GAAP measures Combined Same Property NOI, before foreign currency impact, and U.S. Same Property NOI, in future filings, including the reasons why you believe presentation of these measures provides useful information to investors and any additional purposes for which you use the measures.

Response

In response to the Staff's comment, in our future filings we will include additional disclosure related to the non-GAAP measures Combined Same Property NOI, before foreign currency impact, and U.S. Same Property NOI, including the reasons why the Company believes presentation of these measures provides useful information to the Company's analysis and investors. As an example of our expected future disclosure, the below excerpt from the 2014 Form 10-K has been revised to include the requested additional disclosure (for your convenience additions to our existing disclosure are shown in bold):

Combined Same Property Net Operating Income

Combined Same Property Net Operating Income ("Combined Same Property NOI") is a supplemental non-GAAP financial measure of real estate companies' operating performance and should not be considered an alternative to net income in accordance with GAAP or as a measure of liquidity. Combined Same Property NOI is considered by management to be an important performance measure of the Company's operations and management believes that it is helpful to investors as a measure of the Company's operating performance because it includes only the net operating income of properties that have been owned for the entire current and prior year reporting periods including those properties under redevelopment and excludes properties under development and pending stabilization. Properties are deemed stabilized at the earlier of (i) reaching 90% leased or (ii) one year following a projects inclusion in operating real estate. As such, Combined Same Property NOI assists in eliminating disparities in net income due to the development, acquisition or disposition of properties during the particular period presented, and thus provides a more consistent performance measure for the comparison of the Company's properties.

Combined Same Property NOI is calculated using revenues from rental properties (excluding straight-line rents, lease termination fees, above/below market rents and includes charges for bad debt) less operating and maintenance expense, real estate taxes and rent expense, plus the Company’s proportionate share of Combined Same Property NOI from unconsolidated real estate joint ventures, calculated on the same basis.

The Company also presents Combined Same Property NOI, before foreign currency impact, as it considers it an important supplemental non-GAAP financial measure of the Company's operations and believes it is frequently used by securities analysts and investors. Combined Same Property NOI, before foreign currency impact, derives an appropriate measure of period-to-period operating performance by removing the effect of foreign currency exchange rate movements from Combined Same Property NOI. The effect of foreign currency exchange rate movements is determined by using the current period exchange rate to translate from local currency into U.S. dollars for both periods.

Additionally, the Company presents U.S. Same Property Net Operating Income ("U.S. Same Property NOI"), which excludes the impact of foreign currency exchange rates and the Company's Canadian operations from Combined Same Property NOI. The Company provides U.S. Same Property NOI because it believes such measure is frequently used by securities analysts and investors as a valuable measure of period-to-period U.S. operating performance.

The Company's method of calculating Combined Same Property NOI, Combined Same Property NOI, before foreign currency impact and U.S. Same Property NOI may differ from methods used by other REITs and, accordingly, may not be comparable to such other REITs.

<u>Notes to Consolidated Financial Statements</u>

<u>Business, page 48</u>

2. We note your disclosure on page 48 that you believe you have a single reportable segment in part because you do not group your operations on a geographical basis for purposes of measuring performance. Please tell us how you considered your presentation of the non-GAAP measure U.S. Same Property NOI in coming to this determination.

<u>Response</u>

The Company currently evaluates performance on a property specific or transactional basis and does not distinguish its principal business or group its operations on a geographical basis for purposes of measuring performance. The Company's business activities, regardless of geographical location, involve owning and operating real estate. The Company provides U.S. Same Property NOI in its non-GAAP measures because this item has been requested by securities analysts to allow them to compare the Company's operating performance to other REITs that solely operate in the U.S.. Although the Company believes that the disclosure of U.S. Same Property NOI is an important measurement that allows for such a comparison the Company does not use these comparisons to make decisions about resources or to assess performance on a geographical basis.

* * *

The Company acknowledges that:

- the Company is responsible for the adequacy and accuracy of the disclosure in the filing;
- Staff comments or changes to disclosure in response to Staff comments do not foreclose the Commission from taking any action with respect to the filing; and
- the Company may not assert Staff comments as a defense in any proceeding initiated by the Commission or any person under the federal securities laws of the United States.

* * *

Should you have any questions or require further clarification with regard to our responses, please feel free to contact me directly at (516) 869-7290.

July 8, 2015

VIA EDGAR AND UPS

Mr. Daniel L. Gordon
Senior Assistant Chief Accountant
Division of Corporation Finance
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-3010

Re: Kite Realty Group Trust
Form 10-K for the fiscal year ended December 31, 2014
Filed February 27, 2015
File No. 1-32268

Dear Mr. Gordon:

This letter sets forth the responses of Kite Realty Group Trust (the "Company") to the comments contained in the letter from the Staff of the Division of Corporation Finance of the Securities and Exchange Commission, dated June 24, 2015, to the Company's Form 10-K for the fiscal year ended December 31, 2014. For your reference, we have set forth each of the Staff's original comments in italics immediately preceding our response.

General

1. *We note that you jointly filed with Kite Realty Group, L.P. ("Kite LP") a Form S-3 on March 11, 2015, and you jointly filed with Kite LP a Form 8-K on March 18, 2015. Please ensure that your Exchange Act periodic filings as well as those of Kite LP are filed under each respective CIK number or advise.*

In response to the Staff's comment, in future periodic filings, we will ensure our filings are filed under each respective CIK number.

Item 2. Properties
Lease Activity - New and Renewal, page 42

2. In future Exchange Act periodic reports, in this section or elsewhere as appropriate, please revise to discuss the relationship of market rents and expiring rents as well as leasing costs on a per square foot basis, for both renewals and new leases, to the extent material.

In response to the Staff's comment, in future filings beginning with the Company's Form 10-Q for the quarter ended June 30, 2015, we will expand the disclosures of new and renewal leasing activity to include material amounts of leasing-related costs per square foot. In addition, we will expand our disclosure of the rent spreads achieved in the current period to discuss any material changes in the market rents and the expiring rents.

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

Same Property Net Operating Income, page 54

3. In future Exchange Act periodic reports, please revise your narrative disclosure in this section to more specifically describe how you determine the properties that fall within the "same property" pool, including a discussion of any properties that were excluded from the pool that were owned in all periods compared and a description of how you classify properties within, and transfer properties from, operating portfolio to redevelopment status.

In response to the Staff's comment, in future filings beginning with the Company's Form 10-Q for the quarter ended June 30, 2015, we will expand our disclosure to explain how we determine the properties to include within the "same property" pool including a discussion of properties that were excluded from the pool that were owned in all periods and the reason for the exclusion. This disclosure will include more information to enable the reader to understand the factors we consider in deciding whether to classify a property in redevelopment status and transfers to/from such classification.

Funds From Operations, page 55

4. We note that your FFO reconciliation starts with consolidated net loss, but adjusts to exclude the impact of dividends on preferred shares; therefore your FFO allocable to the Company would appear to represent FFO attributable to common shareholders. Please revise future filings to clearly label your non-GAAP measure or tell us why that is not necessary.

In response to the Staff's comment, in future filings beginning with the Company's Form 10-Q for the quarter ended June 30, 2015, the Company will clearly label our non-GAAP measure as Funds From Operations attributable to common shareholders.

Results Of Operations

Comparison of Operating Results for the Years Ended December 31, 2014 and 2013, page 56

5. Given the significant increase in your portfolio from the acquisition of properties from Inland Diversified in July 2014, in future periodic filings please consider revising your disclosures to provide a discussion reflecting property operating expenses as a percentage of revenue for all periods presented. In addition, please also provide more robust disclosure regarding the changes in your specific expenses included within the property expense line items (e.g., maintenance, insurance, etc.).

In response to the Staff's comment, in future filings beginning with the Company's Form 10-Q for the quarter ended June 30, 2015, we will expand our disclosure to present operating expenses as a percentage of revenues and we will include a discussion of the causes of any material changes in these percentages. In addition, we will expand our discussion of property operating expenses to include material changes in property expense line items such as repairs and maintenance, landscaping, insurance, etc.

6. We note your reference in the Business section to period to period increase in same property net operating income and your disclosure on page 58 describing the increase in rental income. In future Exchange Act periodic reports, please revise your disclosure in this section to specifically discuss the relative contribution of same store occupancy changes and average base rent changes on the results.

In response to the Staff's comment, in future filings beginning with the Company's Form 10-Q for the quarter ended June 30, 2015, we will expand our disclosure to discuss the relative contribution of same property occupancy changes and average base rent changes on our results of operations.

Form 10-Q for the interim period ended March 31, 2015

7. In future periodic filings, please ensure that your officer certifications are in the exact format as prescribed by Item 601(b)(31) of Regulation S-K.

In response to the Staff's comment, in future periodic filings beginning with the Company's Form 10-Q for the quarter ended June 30, 2015, we will ensure our officer certifications are in the exact format as prescribed by Item 601(b)(31) of Regulation S-K.

The Company acknowledges that:

- It is responsible for the adequacy and accuracy of the disclosure in the filing.
- Staff comments or changes to disclosure in response to staff comments do not foreclose the Commission from taking any action with respect to the filing; and
- It may not assert Staff comments as a defense in any proceeding initiated by the Commission or any person under the federal securities laws of the United States.

LEXINGTON REALTY TRUST
One Penn Plaza, Suite 4015
New York, NY 10119-4015

July 16, 2015

VIA EDGAR

Securities and Exchange Commission
Division of Corporate Finance
100 F Street, N.E.
Washington, D.C. 20549
Attn: Eric McPhee, Staff Accountant

Re: Lexington Realty Trust
Lepercq Corporate Income Fund L.P.
Form 10-K for the fiscal year ended December 31, 2014
Filed February 26, 2015
File Nos. 001-12386 and 033-04215

Dear Mr. McPhee:

This letter sets forth the response of Lexington Realty Trust ("Lexington" or "we") to the Staff's comment letter, dated July 2, 2015, in connection with the Staff's review of the Form 10-Ks for the fiscal year ended December 31, 2014 of Lexington and Lepercq Corporate Income Fund L.P. ("Lepercq") (as applicable, the "Form 10-K"). Capitalized terms used herein and not otherwise defined herein have the meanings specified in the Form 10-K, as applicable. For your convenience, we have repeated the Staff's comment prior to our response below.

Form 10-K for the year ended December 31, 2014

Consolidated Balance Sheets, page 61

1. **Please tell us what gave rise to the significant increase in Rent receivable – deferred during 2014, and clarify how these amounts are accounted for.**

   Lexington and Lepercq invest in single-tenant net-leased assets many of which have annual fixed-rate escalation clauses. Due to these annual fixed-rate escalations, rent is not paid on a straight-line basis. Per Financial Accounting Standards Board ASC 840-20-25-1, lessors should account for leases with fixed-rate escalations on a straight-line basis, see footnote 2 in the respective Form 10-K for the revenue recognition policy. The difference between the rental revenue recognized on a straight-line basis and the current contractual rent due is accounted for on the balance sheet as Rent receivable – deferred.

The significant increase in Rent receivable – deferred at December 31, 2014 as compared to December 31, 2013 relates primarily to the impact of the acquisition of single-tenant net-leased assets subject to long-term leases (greater than 10 years) with fixed-rate escalation clauses in 2014 and the fourth quarter of 2013. See footnote 4 in Lexington's Form 10-K and footnote 3 in Lepercq's Form 10-K for the year ended December 31, 2014 for the disclosure of the acquisitions in 2014 and 2013.

* * *

At the request of the Staff, each of Lexington and Lepercq acknowledges that:

- it is responsible for the adequacy and accuracy of the disclosure in its filing;
- Staff comments or changes to disclosure in response to Staff comments do not foreclose the Commission from taking any action with respect to its filings; and
- it may not assert Staff comments as a defense in any proceeding initiated by the Commission or any person under the federal securities laws of the United States.

We would greatly appreciate your prompt attention in resolving any remaining open issues. If you have any questions regarding the responses to the Staff's comments, please call the undersigned at (212) 692-7215.

Sincerely,

/s/ Patrick Carroll
Patrick Carroll, Chief Financial Officer

cc: Elizabeth Noe, Esq., Paul Hastings LLP

July 21, 2015

Tom Kluck
Legal Branch Chief
United States Securities and Exchange Commission
Division of Corporation Finance
100 F Street, N.E.
Washington, D.C. 20549

Re: Mack-Cali Realty Corporation
Form 10-K for the year ended December 31, 2014
Filed on February 19, 2015
File No. 001-13274

Dear Mr. Kluck:

On behalf of Mack-Cali Realty Corporation (the "Registrant"), and in connection with the Annual Report on Form 10-K for the year ended December 31, 2014 of the Registrant (the "Report"), I respectfully submit this letter in response to the comments by the staff (the "Staff") of the Securities and Exchange Commission (the "Commission") contained in your letter dated July 16, 2015 (the "Comment Letter"). For convenience of reference, each comment is recited in bold face type and is followed by the Registrant's response thereto. Capitalized terms used herein and not defined shall have the meaning ascribed to such terms in the Report.

<u>Results from Operations, page 51</u>

1. **In future Exchange Act periodic reports, please discuss in greater detail how the company defines same-store properties. In this regard, please disclose whether the "in-service" properties exclude redeveloped or repositioned properties and, if so, how many have been removed for these reasons in the last year.**

Response: In future filings, the Registrant will disclose that its in-service same-store properties exclude redeveloped and repositioned properties. An example of which follows:

"…"Same-Store Properties" represent all in-service properties owned by the Company at December 31, 2012 (for the 2014 versus 2013 comparisons), and represent all in-service properties owned by the Company at December 31, 2011 (for the 2013 versus 2012 comparisons), excluding properties that were sold, disposed of, removed from service ***<u>or being redeveloped or repositioned,</u>*** *through December 31, 2014."*

Also in future filings, the Registrant will disclose the number of properties being redeveloped or repositioned that have been removed from in-service properties in the last year.

2. **In future Exchange Act periodic reports, please discuss in greater detail the relative impact of occupancy and rental rate changes in your period to period changes for your same-store properties.**

Response: In future filings, the Registrant will discuss in greater detail the relative impact of occupancy and rental rate changes for period to period changes of same-store properties in its MD&A discussion.

On behalf of the Registrant, I hereby confirm that the Registrant acknowledges that:

- It is responsible for the adequacy and accuracy of the disclosure in its filings;
- Staff comments or changes to disclosure in response to comments do not foreclose the Commission from taking any action with respect to the filing; and
- It may not assert Staff comments as a defense in any proceeding initiated by the Commission or any person under the federal securities laws of the United States.

Should you have any questions or wish to discuss this matter further, please do not hesitate to contact me at 732-590-1000.

Very truly yours,

/s/ Anthony Krug
Anthony Krug
Chief Financial Officer

Medical Properties Trust

April 23, 2015

Mr. Wilson K. Lee
Senior Staff Accountant
United States Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Re: Medical Properties Trust, Inc.
Form 10-K for the year ended December 31, 2014
Filed March 2, 2015
File No. 001-32559

Dear Mr. Lee:

The purpose of this letter is to respond to your letter dated April 9, 2015. To assist you in reviewing our responses, we will precede each response with a copy (in bold type) of the comment as stated in your letter.

Form 10-K for the fiscal year ended December 31, 2014

Financial Statements

3. Real Estate and Loans Receivable

Median Transaction, page 82

1. **It appears that you expect the second step of the Median Transaction to close in early 2015 and that this transaction is a sale/leaseback transaction where you will be acquiring the property subject to the transaction and then leasing it back to the seller. Please clarify whether you plan to account for the Median Transaction as a business combination or asset purchase. Your response should address the basis for your conclusion and cite the relevant facts, circumstances, and accounting literature relied upon. In addition, your response should outline all assets acquired and explain whether your acquisition will include any assets in addition to real estate property such as medical records, medical equipment, licenses, intangibles, and other components of the healthcare operations.**

All of the real estate assets expected to be acquired as part of Step 2 of the Median transaction will be simultaneously leased back to the seller (as required per the purchase/sale agreements) and will be accounted for as an acquisition of a business. As part of this transaction, we expect to acquire land (unless subject to ground lease), land improvements, buildings (including fixed furniture/fixtures) and related lease intangibles, if any. We will not acquire medical records, medical equipment, intangibles, or other components of the healthcare operations – those assets will stay with the operator of the properties.

In determining whether our real estate property acquisitions are acquisitions of a business or an asset purchase, we use the guidance provided in Topic 805, Business Combinations. A business is defined as "[a]n integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs, or other economic benefits directly to investors or other owners, members, or participants." In the case of the Median transaction, the real estate being acquired is the "Input" of the business, the lease which is effective at the acquisition date (and a requirement to close on the real estate as stated above) is the "Process", and the rent paid to us pursuant to the lease is the "Output". As such, we have determined that the real estate assets to be acquired as part of the Median Transaction and leased back to the seller meet the definition of a business and will be accounted for as acquisitions of a business.

Concentration of Credit Risks, page 90

2. **You have disclosed that Prime represented or exceeded 20% of your total assets as of December 31, 2014 and 2013. These assets are leased to Prime under master lease agreements on a long-term, triple net-lease basis. As a result, it appears that financial information related to Prime would be relevant to investors given Prime's concentration to your business. It appears such information was provided in previous years. Please clarify your basis for no longer providing such information and/or amend your 10-K to include such financial information.**

Our concentration disclosure about Prime on page 90 includes both our investment in properties leased backed to Prime on a triple net-lease basis and our investment in properties for which we hold a mortgage loan. In total, these investments made up 20.0% and 24.5% of our total assets at December 31, 2014 and 2013, respectively; however, our investment in properties leased to Prime on a triple net-lease basis represents, in the aggregate, significantly less than 20% of our total assets as follows:

	Concentration %	
Investment Type	***December 31, 2014***	***December 31, 2013***
Triple-net leases	*12.6 %*	*15.3 %*
Mortgage loans	*7.4 %*	*9.2 %*
Total	*20.0 %*	*24.5 %*

Pursuant to SEC Staff Training Manual, Topic II.B – Properties Subject to Net Lease, "the disclosure pertaining to a material lessee, including its audited financial statements if the investment exceeds 20% of total assets, should be provided in filings made under both the Securities Act and the Exchange Act." Since our investments under a triple-net lease basis to Prime are below 20% of our total assets at December 31, 2014 or 2013, we do not believe Prime's financial statements are required to be filed with our 2014 Form 10-K.

July 28, 2015

VIA EDGAR & FACSIMILE
Kevin Woody
Accounting Branch Chief
United States Securities and Exchange Commission
Division of Corporation Finance
100 F Street, N.E.
Washington, D.C. 20549

RE: National Health Investors, Inc.
Form 10-K
Filed February 17, 2015
File No. 1-10822

Dear Mr. Woody:

On behalf of National Health Investors, Inc. (the "Company"), this letter is written in response to your letter dated July 15, 2015 regarding the Company's filing referenced above. Our responses are keyed to the comments in your letter.

Form 10-K for the fiscal year ended December 31, 2014

SEC Comment

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

FFO, AFFO & FAD, page 47

1. It appears that your presentation of funds from operations is actually funds from operations attributable to common stockholders. Please revise your characterization of the non-GAAP measure in future filings.

Company Response

In our reconciliation of funds from operations, we begin with net income attributable to common stockholders. In future filings, we will revise our presentation of funds from operations to clearly characterize such measure as being attributable to common shareholders.

SEC Comment

Notes to consolidated financial statements, page 59

Note 2. Real Estate, page 63

Prestige, page 64

1. Please explain to us why you accounted for the acquisition of Prestige Senior Living's four facilities as an asset acquisition in light of the guidance contained in ASC 805-10-55-4.

Company Response

In the context of our practice of acquiring properties for our real estate portfolio, we follow Section 805, *Business Combinations* of the FASB Accounting Standards Codification in evaluating each purchase transaction to determine whether the acquired property meets the definition of a business as described in ASC 805-10-20 or is an asset purchase.

Applying the guidance in ASC 805-10-55-4 through 55-9, in an acquisition in which the selling party, who is not the operator or an affiliate of the operator, previously leased the property, we have determined that the essential elements of a business are present. We identify the real estate asset involved as inputs, the lease billing and collection cycle as processes, and the receipt and distribution of cash payments as outputs of the leasing business. As a result, we account for these transactions as business combinations. With the four facilities owned and operated by Prestige Senior Living, we have determined that the inputs, processes and outputs essential to the definition of a business are not present, and therefore, we consider the acquisition to be of assets alone.

Our approach to accounting for acquisitions is consistent with definitions contained in the SEC's *Financial Reporting Manual*, at ¶2330.10, where it is noted that property previously owner-occupied does not constitute real estate operations. We believe analogy to this guidance is relevant as, similar to what is described in 2330.10, "no prior rental history exists" with an owner/operator, and thus the "processes" - the second essential element of what constitutes a business - do not exist, and the conditions of §805 are not met.

The Company acknowledges that:

- the Company is responsible for the adequacy and accuracy of the disclosure in the filings;

August 13, 2015

VIA EDGAR

Jennifer Monick
Senior Staff Accountant
U.S. Securities and Exchange Commission
Division of Corporation Finance
100 F Street, NE
Washington, DC 20549-7010

Re: Newcastle Investment Corp.
Form 10-K for the Fiscal Year ended December 31, 2014
Filed March 2, 2015
File No. 001-31458

Dear Ms. Monick,

On behalf of Newcastle Investment Corp. (the "Company"), the undersigned submits this letter in response to comments from the staff (the "Staff") of the U.S. Securities and Exchange Commission (the "Commission") received by letter, dated July 28, 2015 (the "Comment Letter"), relating to the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2014 (File No. 001-31458) filed on March 2, 2015 (the "2014 10-K"). To facilitate your review, the undersigned has reproduced the text of the Staff's comments in italics below, and the headings and comment numbers in this letter correspond to the headings and comment numbers in the Comment Letter. In addition, capitalized terms used but not defined herein shall have the meanings assigned to such terms in the 2014 10-K.

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

Other Income, Net, page 58

1. *Please provide to us additional details of the nature of the restructuring of certain properties related to the Golf business that resulted in a $7.2 million gain, and tell us the accounting guidance upon you which you relied.*

Response

We respectfully advise the Staff that the $7.2 million gain is primarily related to the write-off of unfavorable leasehold interest intangible liabilities as a result of restructuring lease agreements for two properties in the Golf business which we acquired in 2013. We also terminated lease agreements of five properties in the Golf business in 2014, which contributed a net gain of less than $0.1 million.

In connection with the accounting for our acquisition of the Golf business, we recognized unfavorable leasehold interest intangibles on the consolidated balance sheet as of the date the Golf business was acquired in accordance with ASC 805-20-25-4 and ASC 805-20-25-12. This was appropriate as we assumed certain lease agreements with unfavorable leasehold interests, in which contracted rent payments were unfavorable relative to market rents at the date of the acquisition.

Subsequent to the acquisition, we initiated negotiations with course owners to restructure or terminate certain lease agreements with unfavorable terms. In the third and fourth quarters of 2014, we negotiated and amended two assumed lease agreements with net unfavorable leasehold interest intangible liabilities of $2.0 million and $5.2 million, respectively, to current market rates with substantially different terms and payment requirements. As a result of these amendments and the substantially different terms that the Company was able to secure, including pricing more representative of prevailing market rates, we concluded that the unfavorable terms under the previous lease agreements relative to market rates no longer existed, and that the write-off of the unfavorable leasehold interest intangible liabilities was appropriate in accordance with ASC 350-30-35-14. Consequently, we reported $5.2 million under "Other income, net" in the consolidated statement of income in the 2014 Form 10-K.

<u>Liquidity and Capital Resources, page 61</u>

2. *We note that you paid dividends of $145.3 million and had net cash provided by operating activities of $40.4 million during the year ended December 31, 2014. In future periodic filings, please discuss the source(s) of these distributions within your Management´s Discussion and Analysis of Financial Condition and Results of Operations, as this disparity raises concerns about the sustainability of distributions into the future. Please provide an example of your proposed disclosure.*

<u>Response</u>

We respectfully advise the Staff that the Company's dividend distributions are not exclusively impacted by net cash provided by operating activities. As a Real Estate Investment Trust ("REIT"), we are required, among other things, to distribute at least 90% of our annual taxable income to our shareholders. We have disclosed in the past and will continue to disclose differences between GAAP and taxable calculations, and the impact of timing differences between the receipt of cash and the recognition of taxable income, including in Risk Factors in the 2014 Form 10-K.

The Company's business model focuses on opportunistic investments in a wide range of real estate related debt and golf related real estate and operations, and, as a result, the sources of our dividends are, taken together, all cash inflows that represent our return on our portfolio of investments in real estate debt and golf related real estate and operations, which are reflected in our net cash provided by operating activities, net cash provided by investing activities and available cash equivalents. Our Board does not specifically match each use of funds with a particular source, but rather assesses all known or anticipated sources as a group when considering a dividend distribution.

In fiscal year 2014, the Company paid dividends of $145.3 million and had net cash provided by operating activities of $40.4 million, net cash provided by investing activities of $319.9 million and cash and cash equivalents of continuing operations of $42.1 million as of January 1, 2014. Thus far in fiscal year 2015, we have paid dividends of $15.9 million. For the six months ended June 30, 2015, the Company had net cash used in operating activities of $14.6 million and net cash provided by investing activities of $157.3 million, and cash and cash equivalents of $73.7 million as of December 31, 2014.

We respectfully acknowledge the Staff's comment and have revised our disclosures to include the following language in our Form 10-Q for the quarter ended June 30, 2015, and will include similar disclosures in future periodic filings:

> The sources of our distributions are net cash provided by operating activities, net cash provided by investing activities and cash equivalents as they represent the return on our portfolio of investments in real estate debt and golf related real estate and operations. The Company has paid dividends of $15.9 million thus far in fiscal year 2015. For the six months ended June 30, 2015, the Company reported net cash used in operating activities of $14.6 million and net cash provided by investing activities of $157.3 million, and cash and cash equivalents of $73.7 million as of December 31, 2014. The timing and amount of distributions are in the sole discretion of our board of directors, which considers our earnings, financial performance and condition, liquidity, debt service obligations and applicable debt covenants, contractual restrictions, REIT qualification requirements and other tax considerations, as well as capital expenditure requirements, business prospects and other factors that our board of directors may deem relevant from time to time. See "Risk Factors—Risks Related to Our REIT Status and the 1940 Act" for more information.

Repurchase Agreements, page 63

3. *With respect to your repurchase agreements, we note your presentation of the balance at end of period, the average daily amount outstanding and the maximum amount outstanding during the three months and year ended December 31, 2014. In future annual filings, please expand your disclosure to present this information for any quarterly periods within the most recent three years for which you have any repurchase agreement activity. In addition, your revised disclosure should also provide explanations for the significant variances among these amounts.*

Response

We respectfully acknowledge the Staff's comment and will expand our repurchase agreement disclosures in future annual filings to include the quarterly average daily amount outstanding and the maximum amount outstanding of repurchase agreements comparatively over each of the most recent three fiscal years. In addition, we will provide explanations for any significant variances among these amounts. Set forth below is an example of our proposed expanded disclosure, for 2014:

The following table summarizes the quarterly average daily amount outstanding and the maximum amount outstanding of repurchase agreements comparatively over each of the most recent three years as of December 31, 2014:

	Avg Daily Amount Outstanding	Maximum Amount Outstanding	Avg Daily Amount Outstanding	Maximum Amount Outstanding	Avg Daily Amount Outstanding	Maximum Amount Outstanding	Avg Daily Amount Outstanding	Maximum Amount Outstanding
	For the Three Months Ended							
	March 31, 2012		June 30, 2012		September 30, 2012		December 31, 2012	
FNMA/FHLMC	$ 228,708	$ 231,345	$ 259,472	$ 319,431	$ 459,495	$ 541,996	$ 637,434	$ 778,914
CDO Securities	$ 8,374	$ 8,728	$ 7,493	$ 7,525	$ 7,283	$ 7,384	$ 6,569	$ 7,118
Non-Agency RMBS	—	—	—	—	$ 52,058	$ 60,575	$ 71,866	$ 150,922

	For the Three Months Ended							
	March 31, 2013		June 30, 2013		September 30, 2013		December 31, 2013	
FNMA/FHLMC	$ 896,063	$ 1,330,432	$ 801,520	$ 1,351,728	$ 350,792	$ 378,624	$ 489,862	$ 547,366
CDO Securities	—	—	—	—	$ 3,272	$ 15,050	$ 15,054	$ 15,094
Non-Agency RMBS	$ 154,549	$ 158,029	$ 133,178	$ 302,033	—	—	—	—
Linked transaction	—	—	$ 3,954	$ 59,968	$ 59,968	$ 59,968	$ 60,064	$ 60,646
Residential Mortgage Loans	—	—	—	—	—	—	$ 13,359	$ 25,119

	For the Three Months Ended							
	March 31, 2014		June 30, 2014		September 30, 2014		December 31, 2014	
FNMA/FHLMC	$ 129,137	$ 516,134	—	—	—	—	$ 204,340	$ 385,282
CDO Securities	$ 44,325	$ 49,500	$ 52,380	$ 79,712	$ 71,701	$ 91,752	$ 63,265	$ 63,804
Linked transaction	$ 58,385	$ 60,646	$ 36,046	$ 58,563	—	—	—	—
Residential Mortgage Loans	$ 25,154	$ 25,363	$ 23,613	$ 25,363	$ 250	$ 22,965	—	—

During 2012, we purchased $626.3 million face amount of FNMA/FHLMC securities for approximately $663.3 million, which were financed with $628.9 million of repurchase agreements. We also purchased $456.0 million face amount of non-Agency RMBS for approximately $288.4 million, which were financed with $149.4 million of repurchase agreements.

In connection with the spin-off of New Residential in May 2013, $1.0 billion of repurchase agreements financing FNMA/FHLMC securities and $301.4 million of repurchase agreements financing non-Agency RMBS were transferred to New Residential. In June 2013, we purchased $116.8 million face amount of securities which were collateralized by certain repackaged Newcastle CDO VIII notes, and financed with $60.0 million of repurchase agreements. We accounted for this transaction as a linked transaction as we purchased and financed this transaction with the same counterparty contemporaneously. In November 2013, we financed a portfolio of residential mortgage loans with $25.1 million of repurchase agreements, which were previously unencumbered on Newcastle's balance sheet. In September 2013, we financed previously repurchased CDO debt with $15.1 million of repurchase agreements.

In January 2014, we sold $503.0 million face amount of the FNMA/FHLMC securities for total proceeds of $532.2 million and repaid $516.1 million of repurchase agreements. We also financed additional repurchased CDO debt with $30.8 million of repurchase agreements. In June 2014, we repaid $60.0 million of repurchase agreements associated with our linked transaction as the underlying assets were paid off. Additionally, in June 2014 we financed previously repurchased CDO debt with $26.3 million of repurchase agreements. In July 2014, we sold $37.4 million face amount of residential mortgage loans for total proceeds of $34.7 million and repaid $23.0 million of repurchase agreements associated with these loans.

Core Earnings, page 76

4. *Please tell us and revise future periodic filings to clarify how the components of "Impairment (reversal), other (income) loss and other adjustments from discontinued operations" presented on page 77 are reflected in your disclosure of discontinued operations on page 107.*

Response

We respectfully advise the Staff that the components of Impairment (reversal), other (income) loss and other adjustments from discontinued operations are detailed in the table below:

	Year Ended December 31,		
	2014	**2013**	**2012**
Depreciation and Amortization	$ 90,627	$ 30,969	$ 6,975
Depreciation and amortization non-controlling interest	(708)	2,121	0
Other income (loss)	(1,444)	(6,464)	(17,339)
Acquisition and spin-off related expenses	15,751	13,348	4,625
Impairment (reversal), other (income) loss and other adjustments from discontinued operations	$ 104,226	$ 39,974	$ (5,739)

Ms. Jennifer Monick
U.S. Securities and Exchange Commission
August 13, 2015
Page 5

We respectfully acknowledge the Staff's comment, and have revised our disclosures in our Form 10-Q for the quarter ended June 30, 2015 to add a footnote to the Core Earnings table detailing the components of this line item, and will include similar disclosures in future periodic filings (see underlined text for revisions to page 77):

Set forth below is a reconciliation of core earnings to the most directly comparable GAAP financial measure (in thousands).

	Three Months Ended June 30,		Six Months Ended June 30,	
	2015	**2014**	**2015**	**2014**
Income available for common stockholders	$ 17,019	$ 30,532	$ 14,927	$ 34,055
Add (Deduct):				
Impairment (reversal)	13,679	1,526	14,084	2,772
Other (income) loss(A)	(29,044)	(39,510)	(29,231)	(55,357)
Impairment (reversal), other (income) loss and other adjustments from discontinued operations(B)	(317)	26,634	(306)	60,758
Depreciation and amortization(C)	9,837	8,952	19,309	17,757
Acquisition, restructuring and spin-off related expenses	333	1,115	371	2,277
Core earnings	$ 11,507	$ 29,249	$ 19,154	$ 62,262

(A) Net of $1.9 million of deal expenses relating to the sale of the manufactured housing portfolio which were recorded to general and administrative expense under GAAP during 2014.

(B) Includes gain on settlement of investments of $0.3 million and $0.3 million and depreciation and amortization of $0 and less than $0.1 million for the three and six months ended June 30, 2015, respectively. Includes depreciation and amortization of $23.2 million and $50.7 million (gross of $0 and $0.7 million related to non-controlling interests), acquisition and spin-off related expenses of $3.4 million and $10.7 million, and other loss of less than $0.1 million and less than $0.1 million for the three and six months ended June 30, 2014, respectively.

(C) Including accretion of membership deposit liability of $1.5 million and $2.9 million and amortization of favorable and unfavorable leasehold intangibles of $1.2 million and $2.5 million in the three and six months ended June 30, 2015, respectively. Including accretion of membership deposit liability of $1.4 million and $3.1 million and amortization of favorable and unfavorable leasehold intangibles of $1.2 million and $2.5 million in the three and six months ended June 30, 2014, respectively. The accretion of membership deposit liability was recorded to interest expense and the amortization of favorable and unfavorable leasehold intangibles was recorded to operating expenses - golf.

We have also revised our disclosures in our Form 10-Q for the quarter ended June 30, 2015 to add a footnote to the discontinued operations disclosure detailing the portion of general and administrative expense that is related to acquisition and spin-off related expenses, and will include similar disclosures in future periodic filings (see underlined text for revisions to page 107):

Results from discontinued operations were as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2015	2014	2015	2014
Interest income	$ —	$ —	$ —	$ —
Interest expense	—	13,592	—	29,389
Net interest income (loss)	—	(13,592)	—	(29,389)
Media income	—	—	—	68,213
Rental income	50	54,595	549	107,485
Care and ancillary income	—	5,666	—	11,127
Gain on settlement of investments	318	—	318	—
Other income (loss)	—	(22)	—	(22)
Total media, rental and other income	368	60,239	867	186,803
Media operating expenses	—	—	—	65,826
Property operating expenses	(157)	26,459	187	52,419
General and administrative expenses (A)	1	4,911	30	12,463
Depreciation and amortization	—	23,245	11	50,733
Income tax (benefit) expense	—	536	—	(224)
Total expenses	(156)	55,151	228	181,217
Income (loss) from discontinued operations	$ 524	$ (8,504)	$ 639	$ (23,803)
Net income attributable to noncontrolling interests	$ —	$ —	$ —	$ 522

(A) Includes acquisition and spin-off related expenses of $3.4 million and $10.7 million for the three and six months ended June 30, 2014.

Depreciation and amortization and other (income) loss are reflected in the disclosure for discontinued operations. The acquisition and spin-off related expenses are included as a portion of general and administrative expense in the disclosure of discontinued operations.

Note 2 Summary of Significant Accounting Policies

Golf Revenues, page 94

5. *Please refer also to your disclosure on page 103 relating to Membership Deposit Liabilities and Deferred Revenue. Please tell us the guidance upon which you relied for your accounting treatment of refundable initiation fees including your consideration of SAB Topic 13. Tell us the amount of revenues recognized under this accounting policy.*

Response

We respectfully advise the Staff that private country club members generally pay an initiation fee upon their acceptance as a member to one of our country clubs. A member is contractually entitled to an unconditional refund of such initial member's non-interest bearing initiation fee deposit (the refund obligation) 30 years from the effective date of the membership, and at no point before 30 years.

The refund obligation component (the "Membership Deposit Liability") of the refundable initiation fee deposit from our private country club members is determined at the date of a member's payment of initiation fee deposits and is calculated as the present value of the refund obligation contractually due in 30 years, utilizing a market discount rate in accordance with ASC 835. It is important to note that the initiation fee deposits bear no interest, therefore requiring that the discount rate be applied over the 30 year contractual period as the terms of the refundable fees are not at market. No revenue is ever recognized on the Membership Deposit Liability. The initiation fee deposits received less the present value of the Membership Deposit Liability are recorded as deferred revenue. We believe that this amount represents the consideration paid by our members at contract inception for the right to access ongoing benefits during the membership, as long as each member continues to pay annual dues. As such, deferred revenue is recognized on a straight-line basis over the expected life of an active membership.

In recognizing deferred revenue, we considered SAB Topic 13.A.4.a, which provides for the recognition of refundable initiation fee deposits, net of estimated refunds (equal to the Membership Deposit Liability in this case), as unearned revenue to be recognized over the expected life of an active membership. SAB Topic 13.A.4.a further indicates that refunds need to be reliable estimates, made on a timely basis. At the inception of a member's initial membership and throughout the contract period, the amount of the refund at the end of the 30 year period is (i) fixed and determinable, (ii) only paid at its original amount and bears no interest and (iii) is only refundable upon the 30th anniversary of the membership effective date.

Pursuant to our Significant Accounting Policies disclosed on page 94 in the 2014 10-K, we recognized approximately $502,000 of revenue during fiscal year 2014, or approximately 0.2% of total revenues.

6. Please tell us how you estimate the present value of the refund obligation and the expected life of the active membership. Also, explain to us your basis for using a different amortization period for the refund obligation and the deferred revenue.

Response

As indicated in our response to the Staff's comment number 5, the present value of the refund obligation of the initiation fee deposit is recorded as a Membership Deposit Liability in the consolidated balance sheet. This liability is calculated as the present value of the refund obligation contractually due in 30 years utilizing a market discount rate in accordance with ASC 835. The initiation fee deposits bear no interest, therefore requiring that the discount rate be applied over the 30 year contractual period. As such, this liability accretes over 30 years when the refund obligation is contractually due using the effective interest method, and the accretion is recorded as interest expense in the consolidated statements of income.

As stated in our response to comment number 5, the initiation fee deposits received less the Membership Deposit Liability represent the consideration paid by members at contract inception for the right to access ongoing benefits during the membership, for as long as members continue to pay annual dues. Such difference is recorded as deferred revenue and is recognized as revenue over the expected life of an active membership. As there is no contractual membership period stipulated in the private club membership arrangement, revenue related to the initiation fee deposits is recognized over the expected term of active membership pursuant to SAB Topic 13.A.3.f.

Accordingly, deferred revenue related to the initiation fee deposits is recognized on a straight-line basis over the expected life of an active membership, which is calculated annually, using historical enrollment and attrition data. During fiscal year 2014, we performed our annual assessment of the estimated expected life of each of our private club memberships, and determined that our estimated expected life of a private club membership is approximately seven years.

We determined the expected life of an active membership by calculating a historical average of enrollment and attrition rates. Based on our history of operating country clubs, we believe that considering membership types is an important factor in estimating the expected life of a member, as attrition rates vary depending on the type of membership. Therefore, we analyze attrition rates on a disaggregated basis to consider various types of membership (e.g., social membership with no golf privileges as compared to full golf memberships). Depending on membership type, our historical experience is that the expected lives of various private club memberships ranged from six to seven years for 2012, 2013 and 2014. Based on our historical and periodic analysis, the Company has observed that average expected lives of private club memberships have been consistent over the years presented in the 2014 10-K.

Further, we have performed various sensitivity analyses and believe it is unlikely that changes in our expected life of an active membership would have a material impact on our financial statements. We have calculated the impact of the change in our estimated average membership lives and determined that the impact to revenue for a one year increase or decrease would be approximately $0.1 million, or less than 0.1% of total revenues for fiscal year 2014.

Because the accretion of the Membership Deposit Liability follows the specific terms of the membership agreement pursuant to ASC 835, which contractually sets the right to refund 30 years after inception, while deferred revenue related to initiation fee deposits are recognized over the expected term of active memberships pursuant to SAB Topic 13, the Company has concluded that the accretion period for Membership Deposit Liability and the amortization period for deferred revenue related to initiation fee deposits are appropriately distinct in nature and different in length, and applies a different basis for interest and revenue recognition.

We have revised our disclosures in our Form 10-Q for the quarter ended June 30, 2015, and will include similar disclosures in future periodic filings (see underlined text for revisions to page 55):

> Private country club members generally pay an advance initiation fee deposit upon their acceptance as a member to the country club. Initiation fee deposits are generally refundable, without interest, 30 years after the date of acceptance as a member. The difference between the initiation fee deposit paid by the member and the present value of the refund obligation is deferred and recognized into revenue in the consolidated statements of operations on a straight-line basis over the expected life of an active membership, which is estimated to be seven years.
>
> The present value of the refund obligation is recorded as a membership deposit liability in the consolidated balance sheet and accretes over a 30-year nonrefundable term using the effective interest method. This accretion is recorded as interest expense in the consolidated statements of operations.

Repurchase Agreements, page 103

7. *We note that you disclose that securities sold under repurchase agreements will be treated as collateralized financing transactions, unless they meet sale treatment. Please tell us whether any of those agreements were accounted for as sales for accounting purposes in your financial statements. If so, please:*

   a. *Quantify the amount of repurchase agreements qualifying for sales accounting at each quarterly balance sheet date for each of the past three years.*

   b. *Quantify the average quarterly balance of repurchase agreements qualifying for sales accounting for each of the past three years.*

   c. *Describe all the differences in transaction terms that result in certain of your repurchase agreements qualifying as sales versus collateralized financings.*

d. Provide a detailed analysis supporting your use of sales accounting for your repurchase agreements.

e. Describe the business reasons for structuring the repurchase agreements as sales transactions versus collateralized financings. To the extent the amounts accounted for as sales transactions have varied over the past three years, discuss the reasons for quarterly changes in the amounts qualifying for sales accounting.

f. Describe how your use of sales accounting for certain of your repurchase agreements impacts any ratios or metrics you use publicly, provide to analysts and credit rating agencies, disclose in your filings with the SEC, or provide to other regulatory agencies.

g. Tell us whether the repurchase agreements qualifying for sales accounting are concentrated with certain counterparties and/or concentrated within certain countries. If you have any such concentrations, please discuss the reasons for them.

h. Tell us whether you have changed your original accounting on any repurchase agreements during the last three years. If you have, explain specifically how you determined the original accounting as either a sales transaction or as a collateralized financing transaction noting the specific facts and circumstances leading to this determination. Describe the factors, events or changes which resulted in your changing your accounting and describe how the change impacted your financial statements.

Response

We respectfully advise the Staff that no securities sold under repurchase agreements have been accounted for as sales for accounting purposes in our consolidated financial statements.

As indicated under ASC 860-10-40-5(c)(1), the transferor is presumed to maintain effective control over the transferred financial asset if there is an agreement that both entitles and obligates the transferor to repurchase it before its maturity. Repurchase agreements are examples of typical arrangements containing such provisions. Therefore, we maintain effective control over the transferred securities in the transaction which results in a collateralized financing accounting treatment.

We have revised our disclosures to include the following language in our Form 10-Q for the quarter ended June 30, 2015, and will include similar disclosures in future periodic filings:

Securities sold under repurchase agreements are treated as collateralized financing transactions.

Note 6. Real Estate Related and Other Loans, Residential Mortgage Loans and Subprime Mortgage Loans, page 116

8. We note your disclosure on page 117 that the sale of your manufactured housing portfolio through a securitization was treated as a sale for accounting purposes. Please tell us how this transaction met all of the criteria of ASC 860-10-40-5 to be accounted for as sale.

Response

In connection with the securitization transaction of our manufactured housing portfolio, we performed an accounting analysis to determine whether the transfer of loans to trust would meet the conditions for sale accounting pursuant to ASC 860.

Pursuant to ASC 860-10-40-5, a transfer of an entire group of financial assets in which the transferor surrenders control over those financial assets shall be accounted for as a sale if all of the following conditions are met: (i) legal isolation of the transferred financial assets; (ii) transferee has the right to pledge or exchange the transferred financial assets; and (iii) the transferor does not maintain effective control over the transferred financial assets.

In our manufactured housing portfolio transaction, through a two-step securitization, we sold, transferred, assigned, and conveyed all of our rights, titles and interests in and to the loans to the trusts without recourse and with only standard representations and warranties as a seller of loans. As a result, we concluded that we achieved the conditions for sale accounting and derecognition of the transferred financial assets for this securitization.

The determination of whether the transferred financial assets have been isolated from the transferor is a legal determination rather than an accounting determination. We obtained and relied on true sale and non-consolidation legal opinions from nationally recognized external legal counsel to provide reasonable assurance that the transfer of financial assets is a true sale at law to a bankruptcy remote entity that would not be consolidated.

The transferee must have the right to pledge or exchange the transferred financial assets in order to obtain the benefits of ownership (i.e., the cash inflows) of the asset, and having the right to the economic benefits of such financial assets is considered to be indicative of control over the financial asset. We confirmed that as transferees, the securitization note-holders are not restricted or constrained from pledging or exchanging the transferred financial assets, with the only exception being Rule 144A of the Securities Act of 1933, which does not preclude sale accounting per ASC 860-10-40-18.

Determining whether the transferor maintains effective control over the transferred financial assets depends on if there is any continuing involvement by the transferor and whether the transferor has the ability to reclaim such transferred financial assets. We did not hold any direct or indirect legal beneficial ownership interest in the loans. In addition, the agreements governing the sale of financial assets did not contain terms with respect to transferor repurchase obligations, transferee put options or any other conditions whereby we could reclaim the transferred financial assets.

Based on the above analysis, we determined that we surrendered control over the transferred financial assets, and met all the conditions in ASC 860-10-40-5 to be accounted for as a sale.

Note 10. Fair Value of Financial Instruments

Recurring Fair Value Measurements – Real Estate Securities and Derivatives, page 130

9. *We note that you use the label “Market Quotations” for both Level 2 and Level 3 hierarchy. Please tell us, and disclosed in future filings, the difference between these inputs as used in each hierarchy, and reconcile with your disclosure on page 51-52 that broker and pricing service quotations that you receive are generally classified as Level 3 inputs.*

Response

We respectfully inform the Staff that we categorize broker and pricing service quotations received for real estate securities issued by government agencies, including the Federal National Mortgage Association (FNMA) and the Federal Home Loan Mortgage Corporation (FHLMC) and plain vanilla derivative instruments, including interest rate swaps based on LIBOR swap rate and to-be-announced securities (TBA) as level 2 inputs. Quotations received for all other real estate securities and derivative instruments are level 3 inputs.

Pursuant to ASC 820, the fair value hierarchy establishes three levels to classify inputs to the valuation techniques used to measure fair value. Level 1 inputs are quoted market prices (unadjusted) in active markets for identical assets or liabilities. Level 2 inputs are inputs other than quoted market prices included in Level 1 that are observable for the asset or liability, either directly (such as prices of similar asset or liability), or indirectly. Level 3 inputs are unobservable (supported by little or no market activity), such as non-corroborative indicative prices for a particular instrument provided by a third party.

Government agency securities as well as plain vanilla derivative instruments transact in active and liquid market which provides broker and pricing service with large volumes of pricing data (i.e., market observable inputs) on similar securities. Therefore, we categorized such market quotations as level 2 inputs. Conversely, the market quotations of all other real estate securities are quoted prices in generally inactive and illiquid markets for identical or similar securities. These quotations are generally based on models prepared by the brokers, and are indicative of market transactions. Therefore, we categorized such market quotations as level 3 inputs.

In response to the Staff's comment, in our Form 10-Q for the quarter ended June 30, 2015, we have added "Observable" and "Unobservable" to the "Market Quotations" columns for Levels 2 and 3, respectively, in the fair value table under Footnote 13 – Fair Value as of June 30, 2015, and will include similar disclosures in future filings. The table below illustrates the modifications to our tabular disclosure on fair value inputs.

	Fair Value		
Carrying Value	Level 2	Level 3	Total
	Market Quotations (Observable)	Market Quotations (Unobservable)	Internal Pricing Models

In addition, we have included in our Form 10-Q for the quarter ended June 30, 2015 the disclosure below, which refines our existing Level 2 and Level 3 disclosure (see underlined text for revisions to page 129):

Level 1 - Quoted prices in active markets for identical instruments.

Level 2 - Valuations based principally on observable market parameters, including

- quoted prices for similar assets or liabilities in active markets,

- inputs other than quoted prices that are observable for the asset or liability (such as interest rates and yield curves observable at commonly quoted intervals, implied volatilities and credit spreads), and

- market corroborated inputs (derived principally from or corroborated by observable market data).

Level 3 - Valuations determined using unobservable inputs that are supported by little or no market activity, and that are significant to the overall fair value measurement. Level 3 assets and liabilities include financial instruments whose value is determined using non-binding market quotations, pricing models, discounted cash flow methodologies, or similar techniques where significant inputs are unobservable, as well as instruments for which the determination of fair value requires significant management judgment or estimation.

We also included the revised disclosure below in our Form 10-Q for the quarter ended June 30, 2015 (see underlined text for revisions to pages 51-52):

> We generally classify non-binding broker and pricing service quotations we receive as level 3 inputs~~, except for certain liquid securities~~. Such quotations are quoted prices in generally inactive and illiquid markets for identical or similar securities. These quotations are generally received via email and contain disclaimers which state that they are "indicative" and "not actionable" - meaning that the party giving the quotation is not bound to actually purchase the security at the quoted price. These quotations are generally based on models prepared by brokers, and we have little visibility into the inputs they use. Based on quarterly procedures we have performed with respect to quotations received from such brokers, including comparison to the outputs generated from our internal pricing models and transactions we have completed with respect to these securities, as well as on our knowledge and experience of these markets, we have generally determined that these quotes represent a reasonable estimate of fair value. For the $631.5 million carrying value of securities valued using quotations as of December 31, 2014, a 100 basis point change in credit spreads would impact estimated fair value by approximately $24.0 million.

Pursuant to the Comment Letter, we acknowledge that:

- the Company is responsible for the adequacy and accuracy of the disclosure in the filing;
- Staff comments or changes to disclosure in response to Staff comments do not foreclose the Commission from taking any action with respect to the filing; and
- the Company may not assert Staff comments as a defense in any proceeding initiated by the Commission or any person under the federal securities laws of the United States.

* * *

Mike Ritz
Direct: (410) 427-1728

May 21, 2015

VIA EDGAR

Securities and Exchange Commission
Division of Corporation Finance
100 F Street, N.E.
Washington DC 20549
Attn: Jennifer Monick, Staff Accountant

Re: Omega Healthcare Investors, Inc.
Form 10-K for the Fiscal Year Ended December 31, 2014
Filed February 27, 2015
File No. 001-11316

Ladies and Gentlemen:

On behalf of Omega Healthcare Investors, Inc. ("Omega"), I am responding to the comment received from your office by letter dated May 12, 2015 (the "May Letter") with respect to the above-referenced Form 10-K (the "Form 10-K").

I have restated and responded to your comments in the May Letter below. Capitalized terms used in this letter have the meanings ascribed to them in the Form 10-K. All page references (excluding those in the headings and the staff's comment) refer to the pages of the Form 10-K.

Form 10-K for the fiscal year ended December 31, 2014

Item 2. Properties, page 33

1. *We note your disclosure on page 36 that your investments with New Ark Investments, Inc. represent 13% of your total investments. We also note your disclosure that the Ark leases are 50 year leases that expire in 2063. Please clarify and tell us whether all of your leases with New Ark are 50 year leases. In future Exchange Act periodic reports, please disclose the material terms of your agreements with new Ark or advise.*

Response: The New Ark investment is comprised of (i) four fifty-year direct financing leases that expire in 2063 and (ii) one twelve-year operating lease that expires in 2026. We note that Item 2 – Properties includes the total investment value of (i) $539,232 for our investment in the four New Ark direct financing leases under the section titled "Investment in Direct Financing Leases" and (ii) $34,600 for our investment in one New Ark operating lease under the section "Leased Facilities". The combined investment of $573,832 represents approximately 13% of our total investments.

In addition to our disclosure in Item 2 – Properties, we refer to our disclosure of our investments in direct financing leases in our consolidated financial statements. Note 5 Direct Financing Leases states the following:

> On November 27, 2013, we closed on an aggregate $529 million purchase/leaseback transaction in connection with the acquisition of Ark Holding Company, Inc. ("Ark Holding") by 4 West Holdings Inc. At closing, we acquired 55 SNFs and 1 ALF operated by Ark Holding and leased the facilities back to Ark Holding, now known as New Ark Investment Inc. ("New Ark"), pursuant to four 50-year master leases, with rental payments yielding 10.6% per annum over the term of the leases. The purchase/leaseback transaction is being accounted for as a direct financing lease.
>
> The lease agreements allow the tenant the right to purchase the facilities for a bargain purchase price plus closing costs at the end of term. In addition, commencing in the 41st year of each lease, the tenant will have the right to prepay the remainder of its obligations thereunder for an amount equal to the sum of the unamortized portion of the original aggregate $529 million investment plus the net present value of the remaining payments under the lease, and closing costs. In the event the tenant exercises either of these options, we have the right to purchase the properties for fair market value at the time.

In addition to the disclosure of our investment in direct financing leases, we disclosed the acquisition of the three facilities subject to the operating lease in Note 3 – Properties. The following is an excerpt from Note 3 – Properties:

> *Acquisition of Three SNFs in South Carolina and Georgia*
>
> On June 27, 2014, we purchased two SNFs from an unrelated third party for approximately $17.3 million and leased them to an existing operator of Omega. The SNFs, located in Georgia and South Carolina with a total of 213 beds, were combined into a new 12 year master lease with an initial annual cash yield of 9.5%.
>
> In the third quarter of 2014, we purchased a third SNF in South Carolina with 132 beds that was added to the master lease. The combined purchase price, including the third SNF was $34.6 million.

In our future periodic Exchange Act reports, we will disclose the material terms of all material leases with New Ark and will clarify that only the four direct financing leases with New Ark have 50 year terms.

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations, page 40

2. *In future Exchange Act periodic reports, for material properties or operators, please discuss occupancy for those facilities that are not materially occupied.*

Response: As of December 31, 2014 and 2013, the Company does not have any material properties or operators with facilities that are not materially occupied. In future periods if a material property or operator is not materially occupied, we will make appropriate disclosures regarding the occupancy of those facilities that are not materially occupied.

Notes to Consolidated Financial Statements

Note 2 – Summary of Significant Accounting Policies, page F-8

In-Place Leases, page F-10

3. *With respect to your below-market lease intangibles, please tell us how you considered any fixed rate renewal options in your estimate of the remaining term of the underlying leases and your basis for your determination.*

Response: For assumed leases with below market rents, the Company evaluates whether the term of the renewal option should be included or excluded in our estimate of the remaining term of the underlying lease by considering several factors, including (i) the comparison of the contractual rent renewal rate versus our estimate of projected future market rental rates coupled with the length of the renewal term, (ii) the length of time between the acquisition date and the renewal date(s) as well as (iii) the current and expected operating performance of the facility and/or lessee. If we determine that it is reasonably assured the renewal option will be exercised, we include the renewal period in our estimate of the remaining term of the underlying lease.

Note 6 – Mortgage Notes Receivable, page F-21

4. *Please tell us how you complied with paragraph 29 of ASC 310-10-50, or tell us how you determined it was not necessary to provide applicable disclosures regarding credit quality information for your mortgage notes receivables.*

Response: The objective of ASC 310-10-50 paragraph 29 is to provide information that enables the financial statement users to (i) understand how and to what extent management monitors the credit quality of its financing receivables in an ongoing manner and (ii) assess the quantitative and qualitative risks arising from the credit quality of its financing receivables.

We have one class of financing receivables.

We note the December 31, 2014 mortgage balance is approximately 17% of our total assets with the majority (92%) of the balance comprised of three mortgage notes.

We address the qualitative and quantitative provisions of paragraph 29 in different areas of our disclosures. Our evaluation process is largely focused on the qualitative risk factors. We refer to our disclosure in Note 2 to our consolidated financial statements "Loan and Direct Financing Lease Impairments" for our discussion regarding the credit quality of our mortgage notes and receivables in general. Within our Loan and Direct Financing Lease Impairments disclosure, we specifically discuss credit quality indicators similar to those set forth in ASC 310-10-55-19. Specifically, we evaluate the following when determining the collectability of our mortgage notes receivable such as (i) non-payment under the loan documents, (ii) impairment of the underlying collateral, (iii) financial difficulty of the operator or other circumstances that may impair full execution of the loan documents. The following is an excerpt from our Note 2 disclosure:

> Management evaluates our outstanding mortgage notes, direct financing leases and other notes receivable. When management identifies potential loan or direct financing lease impairment indicators, such as non-payment under the loan documents, impairment of the underlying collateral, financial difficulty of the operator or other circumstances that may impair full execution of the loan documents or direct financing leases, and management believes it is probable that all amounts will not be collected under the contractual terms of the loan or direct financing lease, the loan or direct financing lease is written down to the present value of the expected future cash flows. In cases where expected future cash flows are not readily determinable, the loan or direct financing lease is written down to the fair value of the collateral. The fair value of the loan or direct financing lease is determined by market research, which includes valuing the property as a nursing home as well as other alternative uses.

We also refer to our disclosure in Note 5 to our consolidated financial statements "Mortgage Notes Receivable" sub note (1) which states:

> As of December 31, 2013 and 2014, we have no allowance for loan loss for any of our mortgages.

We believe we have met the objectives of this disclosure requirement.

Note 20 – Consolidating Financial Statements, page F-40

5. *Please tell us how you determined it was not necessary to provide a consolidating statement of cash flows. Please refer to Rule 3-10 of Regulation S-X.*

Response: For the periods ending December 31, 2014 and 2013, 2012 we did not include the consolidating statement of cash flows in Note 20 - Consolidating Financial Statements because we determined the disclosure was immaterial given the limited nature of the non-guarantor subsidiaries activities. We note that the non-guarantor subsidiaries relate to the subsidiaries that have secured HUD debt associated with them. Due to the regulations regarding HUD debt, we have not historically engaged in investing activities with the subsidiaries. Accordingly, the cash flow activity of the non-guarantor subsidiaries has historically been limited primarily to operating activity or operating cash flows and financing activity primarily related to scheduled principal payments on the HUD debt, both of which we believe we have adequately disclosed. We note the following disclosure regarding our operating cash flow within Note 20:

> For the years ended December 31, 2014 and 2013, the operating cash flow of the non-guarantor subsidiaries approximated net income of the non-guarantor subsidiaries, adjusted for depreciation and amortization expense and rent recorded on a straight-line basis.

In addition, we note the following disclosure regarding the investing and financing activity within Note 20:

> For the years ended December 31, 2014, 2013 and 2012, the non-guarantor subsidiaries did not engage in investing or financing activities other than the principal payment of $4.4 million, $4.0 million and $3.1 million, respectively for the HUD mortgages on the facilities owned by the non-guarantor subsidiaries. All of the Subsidiary Guarantors of our outstanding Senior Notes and 2014 Credit Facilities, and all of our non-guarantor subsidiaries, are 100% owned by Omega.

We believe the above noted disclosures adequately reflect the cash flow activities of the non-guarantor subsidiaries for the periods presented. We also note that a significant portion of the HUD debt outstanding as of December 31, 2014 was retired in early 2015. As a result, in 2015, we will remove the unrestricted status of these subsidiaries resulting in us retroactively eliminating all assets, liabilities and operating activities associated with these non-guarantor subsidiaries from the non-guarantor subsidiaries column in our consolidating financial statements. In doing so, we will further reduce the materiality of the cash flow activities of the non-guarantor subsidiaries.

Effective April 1, 2015 we closed on the acquisition of Aviv REIT, Inc. (Aviv) via merger. The acquisition of Aviv creates increased complexities regarding our non-guarantor subsidiary activity, including the potential for investing activity. Accordingly, beginning with the second quarter of 2015, we will provide a consolidating statement of cash flows within our disclosures in future Exchange Act filings.

[Letterhead of Omega Healthcare Investors, Inc.]

June 10, 2015

VIA EDGAR AND OVERNIGHT DELIVERY

Securities and Exchange Commission
Division of Corporation Finance
100 F Street, N.E.
Washington DC 20549
Attn: Jennifer Monick, Staff Accountant

RE: Omega Healthcare Investors, Inc.
Form 10-K for the Fiscal Year Ended December 31, 2014
Filed February 27, 2015
File No. 001-11316

Ladies and Gentlemen:

On behalf of Omega Healthcare Investors, Inc. ("Omega" or the "Company"), I am responding to the comment received from your office by letter dated June 2, 2015 (the "June Letter") with respect to the above-referenced Form 10-K (the "Form 10-K") and in response to our response letter dated May 21, 2015.

I have restated and responded to your comments in the June Letter below. Capitalized terms used in this letter have the meanings ascribed to them in the Form 10-K. All page references (excluding those in the headings and the staff's comment) refer to the pages of the Form 10-K.

Form 10-K for the fiscal year ended December 31, 2014

Notes to Consolidated Financial Statements

Note 2 – Summary of Significant Accounting Policies, page F-8

In-Place Leases, page F-10

1. *We note your response to our prior comment three. Please address the following:*
   a. *Please provide more information regarding how you evaluate items (i) and (ii) noted in your response. Your response should address, but not necessarily be limited to, whether or not you use a threshold in your evaluation. To the extent you use thresholds, please tell us how you concluded that these thresholds are appropriate.*
   b. *Please tell us how you consider multiple factors in your evaluation. Your response should address, but not be limited to, if you consider all three factors noted in your response for each lease with a below market fixed rate renewal option, or if you only consider one or two of these items in certain circumstances.*

c. *Please tell us the potential impact to your financial statements, including the impact from the acquisition of Aviv, if you were to conclude that all below market fixed rate renewal options would be exercised.*

Response:

a. For each lease we assume through an acquisition of a property, we apply ASC 805-20-25-12 to determine whether the terms of the lease are favorable or unfavorable compared with the market terms of a lease for a similar property at the acquisition date. If the terms are favorable, an above-market lease intangible asset is recorded, and if the terms are unfavorable, a below-market lease liability is recorded. ASC 805-20-25-12 does not provide us with further guidance on how to arrive at the fair value of the above- or below-market lease intangible asset or liability, so we refer to ASC 820 and ASC 840 for the appropriate valuation guidance. We have historically used a discounted cash flow model to estimate the value of all assumed above and below market lease assets or liabilities based on the estimated difference between the projected future market rent and the contractual rent.

   ASC 820 provides detailed guidance for using management's judgment and other market participant considerations in assessing fair value when quoted prices are not available. We have extensive experience in underwriting and negotiating lease terms in the long-term healthcare and senior healthcare markets. Prior to the acquisition of Aviv on April 1, 2015, we had more than 500 facilities under lease, a significant portion of which were acquired from third parties and simultaneously leased to a new lessee, accordingly, no above or below market evaluation was required because no lease was assumed. We leverage our knowledge of acquiring these properties together with the knowledge gained through the countless lease transactions throughout our entire portfolio over the years as well as our understanding of market activities regarding the terms of other transactions that have recently closed in the long-term healthcare and senior housing industry to estimate the projected future market rent.

   Primarily all of our existing above and below market leases (with one exception of one below market lease assumed in 2013 which is not material) resulted from our 2009 and 2010 acquisition of a 143 facility portfolio that was comprised of 58 leases, including several master lease agreements that covered multiple facilities. We evaluated each assumed lease individually to determine if it was above or below market. Based on our evaluation, we determined that twenty-four of the assumed leases were below market.

For all leases determined to be below market, we do not use a “bright line” threshold in our evaluation of whether we should include any or all lease extension options in our in-place lease evaluation. We considered each lease individually based on a collective evaluation of the following factors: (i) the significance of the estimated rent differential between projected future market rent and contractual rent, in conjunction with (ii) the time between the acquisition closing date(s) and (iii) lease extension date(s). We also consider the length of the period covered by the lease renewal option as well as the current and expected operating performance of the facility and/or lessee to evaluate the likelihood of their ability to comply with the terms of the lease agreement, including any renewal periods that we may include in our below market lease analysis. We do not believe it is appropriate to limit our analysis to any one factor or using a “bright line” in applying our judgment to evaluate how a market participant would value the in place lease. Accordingly, we believe that a renewal option must be “reasonably assured” of being exercised under ASC 840-10-20 (which defines bargain renewal options).

In every lease we have assumed, the lease agreement requires the lessee to be in compliance with the terms of the lease agreement at the time of the renewal notification in order to extend the lease the additional term; accordingly, evaluating the current and expected operating performance is an important part of the evaluations process we use to determine whether or not to included renewal options in our below market lease evaluation. If we determine the lessee is experiencing or may experience operational issues that could cause them to fail to comply with the lease terms, we would likely excluded any renewal periods. We also consider our history with the operator. We have not typically excluded renewal terms due to operator performance issues in the past, but may do so in the future if we determine it appropriate to do so.

We use this approach because we believe it reflects quantitative and qualitative factors that our tenants typically reference in making renewal decisions.

Example 1:
For example, for a lease assumed with a modest projected below market rent, but a relatively close extension date (i.e., a renewal notification period with in a few years of the acquisition date), we would likely include the first lease extension in our evaluation because it is unlikely that the market conditions between the acquisition date and the renewal notification date would change dramatically enough to change our assumption of projected market rent at the time of the lease renewal notification, however, depending on the renewal terms (including the length of the additional lease term) we may or may not include additional renewals.

Example 2:
Assume the same facts in the previous example. Also assume that the lease includes two 10 year renewal options. As noted above, we may include the first renewal option that was due to be exercised in a few years of the date of acquisition because we would have a higher degree of confidence that the projected future market rent will not change significantly and therefore, believe it is reasonable assured that the renewal option will be exercised. However, it is less likely that we would include the second renewal option in our below market in-place lease evaluation because of the uncertainty regarding market rent more than a decade away.

Example 3:
Assume the same modest projected below market rent, but with a single lease renewal extension notification date that is 10 years from the date of acquisition, we would not include the extension in our evaluation for the same reason noted in example 2 (i.e., the uncertainty regarding market rent a decade away) unless there were other significant indicators present that led us to believe that renewal was reasonably assured.

In summary, to determine whether to include the lease renewal term(s) in our in-place lease evaluations we use all three of the factors collectively as noted above in our evaluation. Depending on the individual facts and circumstances of each lease, we assess whether to include any or all lease renewal periods.

b. As noted in our response to (a) above, we consider all three factors in our evaluation of each assumed leases.

c. We closed the Aviv acquisition on April 1, 2015. Due to the timing of the Aviv acquisition, we have not completed our evaluation of our preliminary purchase price accounting, including the determination of assumed below market leases. Accordingly, we are not in a position to estimate the impact of including all of the renewal options for below market leases of Aviv. However, as noted above, we will review each lease individually and include any renewal options that we believe are reasonably assured to be exercised in the lease term.

In response to your request, we quantified the incremental impact to our financial statements if we assumed all below market renewal options for in-place leases assumed in connection with all acquisitions through December 31, 2014. The following table summarizes the incremental impact of including all of the renewal options for below market leases ($ in millions):

Impact on financial statements	Projected incremental below market lease
Increase in acquired lease intangible liabilities	$ 22.3
Total assets as of December 31, 2014	$ 4,598.0
% of total assets as of December 31, 2014	0.48%

In addition to the above, we estimate the additional rental income related to amortizing the acquired lease intangible liabilities would have resulted in less than $0.1 million in additional rental income in 2014. The additional rental income if recorded would have been less than 0.01% of our consolidated total operating revenue and net income for the year ended December 31, 2014.

Based on the foregoing, we respectfully represent to the Staff that the projected impact from including all below market renewal options, as opposed to the below market renewal options that we have included in our below market in-place lease analysis, would not have a material impact on our consolidated 2014 financial statements.

* * * * *

We would respectfully request your prompt consideration of our responses to your comments. We sincerely hope that the staff views our responses as complete and would very much appreciate the staff contacting us as soon as possible by telephone if there are any remaining issues. Please note that because Omega's Form S-4 (SEC File No. 333-203447) was not declared effective on or before June 8, 2015, Omega is obligated to pay liquidated damages accruing at an annual rate of 0.25% on $250,000,000 of outstanding senior notes until such Form S-4 is declared effective. Accordingly, Omega is committed to promptly addressing any remaining questions you may have so that Omega may promptly request that the Form S-4 be declared effective.

If you have any questions or if we can be of further assistance to you in the review process, please contact me at 410/427-1728 (fax: 410/427-8828), or Eliot W. Robinson of our counsel Bryan Cave LLP at 404/572-6785.

OMEGA HEALTHCARE INVESTORS, INC.

By: /s/ Michael Ritz
Michael Ritz
Chief Accounting Officer

MDR/dmt

PARKWAY PROPERTIES, INC.
390 North Orange Avenue, Suite 2400
Orlando, FL 32801

September 9, 2015

BY EDGAR AND OVERNIGHT MAIL

Ms. Jaime G. John
Division of Corporation Finance
United States Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549

Re: Parkway Properties, Inc.
Form 10-K for the year ended December 31, 2014
Filed February 25, 2015
File No. 001-11533

Dear Ms. John:

This letter is submitted by Parkway Properties, Inc. (the "***Compan***y") in response to comments from the staff of the Division of Corporation Finance (the "***Staff***") of the Securities and Exchange Commission (the "***Commission***") in a letter dated August 25, 2015 (the "***Comment Letter***") with respect to the Company's Annual Report on Form 10-K for year ended December 31, 2014 (File No. 001-11533) filed with the Commission on February 25, 2015 (the "***Form 10-K***").

For your convenience, the Staff's numbered comments set forth in the Comment Letter have been reproduced in italics herein with responses immediately following each comment. Unless otherwise indicated, page references in the reproductions of the Staff's comments refer to the Form 10-K. Defined terms used herein but not otherwise defined herein have the respective meanings given to them in the Form 10-K.

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations, page 38

1. We note that you disclose NOI and same store NOI in your earnings releases and supplemental materials. Please tell us if you consider these measures to be key performance indicators. To the extent these measures are considered to be key performance indicators, in future filings please include the measures as well as the required disclosure in accordance with Item 10(e) of Regulation S-K within your Management's Discussion and Analysis. Include an example of any future disclosure in your response.

Response to Comment No. 1

In future filings under the Securities Exchange Act of 1934, as amended ("***Exchange Act periodic reports***"), the Company will disclose NOI and same-store NOI because it does consider these measures to be key performance indicators. Future Exchange Act periodic reports will include disclosure substantially along the lines of the following (except to the extent permitted to be excluded by Item 10(e)(iii) of Regulation S-K):

NOI and Same-Store NOI

We define net operating income ("NOI") as income from real estate operations less property operating expenses (before interest expense, impairment charges and depreciation and amortization). NOI excludes interest expense, depreciation and amortization, management company income and expenses, general and administrative expenses, acquisition costs, gain/loss on sale of real estate, impairments and other non-operating items. NOI measures 100% of the operating performance of Parkway Properties LP's real estate properties in which Parkway Properties, Inc. owns an interest. We consider NOI to be a useful performance measure to investors and management because it reflects the revenues and expenses directly associated with owning and operating our properties and the impact to operations from trends in occupancy rates, rental rates and operating costs not otherwise reflected in net income.

We also evaluate performance based upon same-store NOI ("SSNOI"). SSNOI reflects the NOI from properties that were owned for the entire current and prior reporting periods presented and excludes properties acquired or sold during those periods, which eliminates disparities in net operating income due to acquisitions and dispositions of properties during such period. We believe that this measure provides a more consistent metric for the comparison of our properties from period to period.

NOI and SSNOI as reported by us may not be comparable to similar measures reported by other REITs that do not define the measures as we do. NOI and SSNOI are not measures of operating results as measured by GAAP and should not be considered alternatives to net income.

The following table presents a reconciliation of our net income (loss) to NOI and SSNOI for [the periods to be provided in the filing] (in thousands):

Net income (loss) for Parkway Properties, Inc.
Add (deduct):
Interest expense
Loss on extinguishment of debt
Depreciation and amortization
Management company expenses
Income tax expense
General and administrative
Acquisition costs
Equity in (earnings) loss of unconsolidated joint ventures
Sale of condominium units
Cost of sales - condominium units
Net income (loss) attributable to noncontrolling interests
Loss from discontinued operations
Gains on sale of real estate
Impairment loss on real estate
Management company income
Interest and other income
Net operating income from consolidated office and parking properties
Less: Net operating income from non same-store properties
Same-store net operating income

Funds from Operations ("FFO"), page 62

2. *Please expand your disclosure to include a statement disclosing the reasons why you believe the presentation of "recurring funds from operations" provides useful information to investors in accordance with Item 10(e)(1)(i)(C) of Regulation S-K.*

Response to Comment No. 2

In future Exchange Act periodic reports, to the extent the Company uses recurring funds from operations ("***recurring FFO***") as a key performance indicator, it will include a statement substantially along the lines of the following (except to the extent permitted to be excluded by Item 10(e)(iii) of Regulation S-K) to disclose why it believes recurring FFO provides useful information to investors in accordance with Item 10(e)(1)(i)(C) of Regulation S-K:

> In addition to FFO, we also disclose recurring FFO, which excludes our share of non-cash adjustments for interest rate swaps, realignment expenses, adjustments for non-recurring lease termination fees, gains and losses on extinguishment of debt and acquisition costs. Although this is a non-GAAP measure that differs from NAREIT's definition of FFO, we believe it provides a meaningful presentation of operating performance because it allows investors to compare our operating performance to our performance in prior reporting periods without the effect of items that by their nature are not comparable from period to period and tend to obscure our actual operating results. Recurring FFO measures 100% of the operating performance of Parkway Properties LP's real estate properties in which Parkway Properties, Inc. owns an interest.

EBITDA, page 63

3. *We note your presentation of EBITDA and the definition in footnote 1 to the reconciliation on page 65, which differs from EBITDA as defined by Exchange Act Release No. 47226. To the extent that this non-GAAP measure is presented in future filings, please revise the label to distinguish this measure from EBITDA (e.g., "Adjusted EBITDA"). Refer to Question 103.01 of the C&DIs on Non-GAAP Financial Measures.*

Response to Comment No. 3

In future Exchange Act periodic reports, the Company will include a reconciliation of EBITDA as defined by Exchange Act Release No 47226, and show further adjustments to EBITDA as "Adjusted EBITDA." Future Exchange Act periodic reports will include disclosure substantially along the lines of the following (except to the extent permitted to be excluded by Item 10(e)(iii) of Regulation S-K):

EBITDA and Adjusted EBITDA

We believe that using EBITDA as a non-GAAP financial measure helps investors and our management analyze our ability to service debt and pay cash distributions. We define EBITDA as net income before interest expense, income taxes and depreciation and amortization. We further adjust EBITDA to exclude acquisition costs, gains and losses on early extinguishment of debt, impairment of real estate, share-based compensation expense and gains and losses on sales of real estate (“Adjusted EBITDA”).

Adjustments for Parkway’s share of partnerships and joint ventures are included in the computation of Adjusted EBITDA on the same basis.

However, the material limitations associated with using EBITDA and Adjusted EBITDA as non-GAAP financial measures compared to cash flows provided by operating, investing and financing activities are that EBITDA and Adjusted EBITDA do not reflect our historical cash expenditures or future cash requirements for working capital, capital expenditures or the cash required to make interest and principal payments on our outstanding debt. Although EBITDA and Adjusted EBITDA have limitations as an analytical tool, we compensate for the limitations by only using EBITDA and Adjusted EBITDA to supplement GAAP financial measures. Additionally, we believe that investors should consider EBITDA and Adjusted EBITDA in conjunction with net income and the other required GAAP measures of our performance and liquidity to improve their understanding of our operating results and liquidity. EBITDA and Adjusted EBITDA measure 100% of the operating performance of Parkway Properties LP’s real estate properties in which Parkway Properties, Inc. owns an interest.

We view EBITDA and Adjusted EBITDA primarily as a liquidity measure and, as such, the GAAP financial measure most directly comparable to them is cash flows provided by operating activities. Because EBITDA and Adjusted EBITDA are not measures of financial performance calculated in accordance with GAAP, they should not be considered in isolation or as a substitute for operating income, net income, or cash flows provided by operating, investing and financing activities prepared in accordance with GAAP. The following table reconciles cash flows provided by operating activities to EBITDA and Adjusted EBITDA for [the periods to be provided in the filing] (in thousands):

Cash flows provided by operating activities
Interest expense, net
Tax expense - current
EBITDA
Amortization of below market leases, net
Acquisition costs
Loss on extinguishment of debt
Change in deferred leasing costs
Change in condominium units
Change in receivables and other assets
Change in accounts payable and other liabilities
Adjustments for noncontrolling interests and unconsolidated joint ventures
Adjusted EBITDA

The following table reconciles net income (loss) for Parkway Properties, Inc. to EBITDA and Adjusted EBITDA for [the periods to be provided in the filing] (in thousands):

Net income (loss) for Parkway Properties, Inc.
Adjustments to net income (loss) for Parkway Properties, Inc.:
Interest expense, net
Income tax expense
Depreciation and amortization
EBITDA
EBITDA adjustments - noncontrolling interest in real estate partnerships and unconsolidated joint ventures
Impairment loss on real estate
Gains on sale of real estate (Parkway's share)
Loss on extinguishment of debt
Noncontrolling interest - unit holders
Acquisition costs
Amortization of share-based compensation
Adjusted EBITDA

Item 8. Financial Statements and Supplementary Data.

Note 13 - Noncontrolling Interests, page 101

4. *We note your disclosure on page 74 that you consolidate joint ventures where you are the sole general partner and the limited partners do not possess kick-out rights or other substantive participating rights. Please provide us with a detailed analysis to support your conclusion to consolidate Fund II and address any substantive participating rights held by TRST.*

Response to Comment No. 4

The Company respectfully submits that it has analyzed its interest in Fund II and determined that the Company controls Fund II and it is proper to consolidate this interest in its financial statements.

On May 14, 2008, the Company, through affiliated entities, entered into a limited partnership agreement forming a $750 million discretionary fund ("***Fund II***") with the Teacher Retirement System of Texas ("***TRST***") for the purpose of acquiring multi-tenant office properties. TRST is a 70% limited partner investor and the Company, through affiliated entities, is a 30% investor and serves as the general partner.

The Company first considered whether the entity was a variable interest entity under ASC 810. The Company's management concluded that the entity does not meet the definition of a variable interest entity under ASC 810-10 because it does not have any of the following characteristics:

a. the entity does not have enough equity to finance its activities without additional subordinated financial support;

b. the equity holders, as a group, lack the characteristics of a controlling financial interest; and

c. the legal entity is structured with non-substantive voting rights (i.e., an anti-abuse clause).

Pursuant to ASC 810-20-25-3, the general partner in a limited partnership is presumed to control that limited partnership regardless of the extent of the general partner's ownership interest in the limited partnership.

Furthermore, pursuant to ASC 810-20-25-5, the assessment of whether the rights of the limited partners overcome the presumption of control by the general partner is a matter of judgment that depends on facts and circumstances. The general partner does not control the limited partnership if the limited partners have either of the following:

a. the substantive ability to dissolve (liquidate) the limited partnership or otherwise remove the general partner without cause (as distinguished from with cause); or

b. substantive participating rights.

The Company's management evaluated these criteria and concluded neither criteria was met.

Criteria (a) was not met because the limited partner only has the ability to remove the general partner for cause or under a change in control. Section 13.1 of the limited partnership agreement of Fund II (the "***Fund II LPA***") states, in relevant part:

> "TRST shall have the right to remove the General Partner at any time for Cause upon thirty (30) days' prior written notice, except that in the event of potential material harm to the business or value of the Partnership, the General Partner shall be removed immediately upon written notice. In addition, TRST may remove the General Partner upon thirty (30) days' prior written notice in the event there is a Change of Control."

Criteria (b) was not met because the limited partner does not have substantive participating rights. ASC 810-20-20 defines participating rights as rights that allow the limited partners to participate in certain financial and operating decisions of the limited partnership that are made in the ordinary course of business.

Section 7.1 of the Fund II LPA, states, in relevant part:

"The management, operation, and control of the Partnership and its business and the formulation of its investment policy, including, by means of example and not limitation, the day-to-day responsibility for acquiring, operating, financing and managing the Investments, shall be vested exclusively in the General Partner…."

Section 7.1 of the Fund II LPA continues:

"The General Partner shall, in its sole discretion, exercise all powers necessary and convenient for the purposes of the Partnership and all of the power conferred by the [Delaware Revised Uniform Limited Partnership Act] on the general partner of a limited partnership, including the power to conduct the Partnership's business."

Furthermore Section 1.4 of the Fund II LPA, states, in relevant part:

"Subject to the limitations set forth herein, the business and purposes of the Partnership shall be to, directly and indirectly, acquire, hold, maintain, operate, improve, renovate, expand, originate, use, lease, finance, manage and dispose of Investments (as hereinafter defined) and to engage in any and all activities as are related or incidental to the foregoing, as determined by the General Partner in its sole discretion."

Finally, the Company's management evaluated ASC 810-20-25-13, which states that a limited partner's rights (whether granted by contract or by law) that would allow limited partners to effectively participate in the following actions of the limited partnership shall be considered substantive participating rights and would overcome the presumption that the general partner controls the limited partnership:

a. selecting, terminating and setting the compensation of management responsible for implementing the limited partnership's policies and procedures; and

b. establishing operating and capital decisions of the limited partnership, including budgets, in the ordinary course of business.

The Company's management concluded neither criteria was met by reference to the applicable sections noted above. Section 7.6 of the Fund II LPA explicitly states that:

"No Limited Partner, in its capacity as a Limited Partner, shall participate in the management of the business and affairs of the Partnership. No Limited Partner, in its capacity as a Limited Partner, shall have any right or power to sign for or to bind the Partnership in any manner or for any purpose whatsoever, or have any rights or powers with respect to the Partnership except those expressly granted to such Limited Partner by the terms of this Agreement or those conferred upon such Limited Partner by law, and no prior consent or approval of the Limited Partners shall be required in respect of any act or transaction to be taken by the General Partner on behalf of the Partnership unless otherwise provided in this Agreement."

Based on the guidance of ASC 810-20-25-3 and ASC 810-20-25-5, the Company's management concluded that the Company controls Fund II, the presumption of control by the general partner has not been overcome because the limited partner does not have kick-out rights or substantive participating rights, and, therefore, the Company properly consolidates Fund II.

****

September 18, 2015

VIA EDGAR

Kristi Marrone
Staff Accountant
Office of Real Estate and Commodities
United States Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

Re: **Pennsylvania Real Estate Investment Trust**
Form 10-K for the year ended December 31, 2014
Filed February 23, 2015
File No. 001-06300

Dear Ms. Marrone:

Pennsylvania Real Estate Investment Trust (the "Company") has considered carefully each of the comments in your letter dated September 8, 2015, and on behalf of the Company, I respectfully provide the Company's responses to your comments below. For your convenience, the text of each comment is reproduced below before the applicable response.

Form 10-K for the Year Ended December 31, 2014

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

Funds From Operations, page 56

Comment 1:

Please tell us how your definition of FFO is consistent with the NAREIT definition of FFO, specifically addressing your adjustments for extraordinary items (computed in accordance with GAAP) and significant non-recurring events that materially distort the comparative measurement of company performance over time.

Response:

In future filings, the Company will state only the main definition set forth in NAREIT's White Paper on Funds From Operations (April 2002) (the "White Paper"). The clause regarding "extraordinary items (computed in accordance with GAAP) and significant non-recurring events that materially distort the comparative measurement of company performance over time" was derived from Section III.B of the White Paper, "Treatment of Non-recurring and Extraordinary Items," but it is not part of the main definition, and will be omitted in the future.

The Company's calculation of FFO has always been entirely consistent with the main definition in the White Paper and was not affected by the inclusion of that clause as we have not excluded any extraordinary items or significant non-recurring events. We note that we do exclude impairment write-downs of depreciable real estate, in accordance with NAREIT's longstanding guidance that it is consistent with NAREIT's definition to exclude impairment write downs of depreciable real estate. In 2011, NAREIT reiterated its guidance that excluding such impairments is consistent with the NAREIT definition. Thus, the Company's definition of FFO and our determination of FFO in accordance with that definition are wholly consistent with the NAREIT definition.

Comment 2:

We note that your calculation of FFO includes an adjustment for preferred share dividends. Please revise your presentation in future filings to clearly label your FFO measure (e.g., FFO attributable to common shareholders). Also make similar revisions to your future earnings releases filed on Form 8-K, as appropriate.

Response:

In future filings, the Company will revise its presentation to clearly label the applicable FFO measure, including in future earnings releases furnished on Form 8-K, as follows:

FFO attributable to common shareholders and OP Unit holders

<u>Reconciliation of GAAP Net Income (Loss) to Non-GAAP Measures, page 58</u>

Comment 3:

We note your reconciliations on pages 59 - 60 where you have adjusted the GAAP financial information to allocate your share of revenue and expense from unconsolidated partnerships. Please tell us the consideration you gave to Question 102.10 of the Compliance and Disclosure Interpretations on Non-GAAP Financial Measures.

Response:

The Company has given consideration to that Question as follows: Question 102.10 of the Compliance and Disclosure Interpretations on Non-GAAP Financial Measures addresses the presentation of a "full non-GAAP income statement." In the Company's view, as noted in its June 3, 2011 response to the Commission's May 16, 2011 comment letter, the tables on pages 59 and 60 of the Form 10-K constitute a selected or summary income statement, not a full non-GAAP income statement.

As also noted in that prior response, in connection with the preparation of its Form 10-K a few years ago, the Company obtained feedback from shareholders and investment research analysts as part of a process designed to develop a presentation format for this reconciliation table that displayed the information in a user-friendly, logical, accessible and succinct manner. The Company believes that its presentation constitutes informative, useful and easily understandable disclosure. The Company also believes that showing the relationship among these measures as well as the contribution from consolidated properties and unconsolidated partnerships in a single table is helpful to investors. For the foregoing reasons, in the Company's view, the Company's presentation constitutes valuable, clear and meaningful disclosure and is not inconsistent with Question 102.10 of the Compliance and Disclosure Interpretations on Non-GAAP Financial Measures.

Comment 4:

To the extent that this non-GAAP measure and reconciliation format is presented in future filings, please provide the following additional disclosures:

- **clearly label the "total" column as a non-GAAP measure**
- **explain why the current presentation is useful to investors and any limitations to its use**
- **explain the process used to derive the amounts reported in the "share of unconsolidated partnerships" column**
- **include explicit disclosure that the company does not control the unconsolidated partnerships or have legal claim to the assets, liabilities, revenues or expenses of the unconsolidated partnerships**
- **explain the economics of the unconsolidated partnerships to which the company is entitled under the partnership agreements.**

Please provide us with your proposed revisions.

Response:

In future filings, the Company will revise the presentation and explanations of the non-GAAP measures and the reconciliation as follows:

- The Company will clearly label the "total" column as a non-GAAP measure
- We note that, in accordance with Item 10(e)(1)(i)(C) and (D) of Regulation S-K, the Company has previously included on pages 52-53 and 56-57 statements disclosing the reasons why management believes that presentation of the non-GAAP financial measures of Net Operating Income ("NOI")(the determination of which involves use of the proportionate-consolidation method) and FFO provide useful information to investors and, to the extent material, the additional purposes for which the registrant's management uses these non-GAAP financial measures, as well as the limitations on the use of such measures. The Company will include in this disclosure an explanation as to why the presentation of the Company's share of the revenue and expenses from unconsolidated partnerships is useful to investors, as follows:

  "We believe that this presentation is helpful to management and investors because it provides comparable information about the operating results of our unconsolidated partnerships and is thus indicative of the return on property investment and of operating performance over time. Results based on our share of the results of unconsolidated partnerships do not represent cash generated from operating activities of our unconsolidated partnerships and should not be considered to be an alternative to cash flow from unconsolidated properties' operating activities as a measure of our liquidity, because we do not have a direct legal claim to the revenues or expenses of the unconsolidated partnerships beyond our rights as an equity owner or tenant in common owner."

- The Company will explain the process used to derive the amounts reported in the "share of unconsolidated partnerships" column as follows:

  "The amounts presented in the 'Share of Unconsolidated Partnerships' column are derived using the 'proportionate-consolidation method' (a non-GAAP measure), which includes our share of the results of our unconsolidated partnerships based on our ownership percentage in each such unconsolidated partnership.

  Under the partnership agreements relating to our current unconsolidated partnerships with third parties, we own a 25% to 50% economic interest in such partnerships. As such, in general, we have an indirect economic interest in our proportionate share of the revenue and expenses of the unconsolidated partnership, and, if there were to be some type of distribution of the assets and liabilities of the partnership, our proportionate share of those items. There are generally no provisions in such partnership agreements relating to special non-proportionate allocations of income or loss, and there are no preferred or priority returns of capital or other similar provisions. Thus, we believe that the proportionate-consolidation method represents a valuable means of showing the share of the operating results of our unconsolidated partnership properties that would be allocated to us based on our economic interest under the partnership agreement."

- The Company will include explicit disclosure that the Company does not control the unconsolidated partnerships or have legal claim to the assets, liabilities, revenues or expenses of the unconsolidated partnerships, as follows:

  "We hold a non-controlling interest in each of our unconsolidated partnerships, and account for such partnerships using the equity method of accounting. We do not control any of these equity method investees for the following reasons:

  - Except for two properties that we co-manage with our partner, all of the other entities are managed on a day-to-day basis by one of our other partners as the managing general partner in each of the respective partnerships. In the case of the co-managed properties, all decisions in the ordinary course of business are made jointly.

  - The managing general partner is responsible for establishing the operating and capital decisions of the partnership, including budgets, in the ordinary course of business.

  - All major decisions of each partnership, such as the sale, refinancing, expansion or rehabilitation of the property, require the approval of all partners.

  - Voting rights and sharing of profits and losses are generally in proportion to the ownership percentages of each partner.

  We do not have a direct legal claim to the assets, liabilities, revenues or expenses of the unconsolidated partnerships beyond our rights as an equity owner, in the event of any liquidation of such entity, and our rights as a tenant in common owner of certain unconsolidated properties.

  We record the earnings from the unconsolidated partnerships using the equity method of accounting under the statements of operations caption entitled 'Equity in income of partnerships,' rather than consolidating the results of the unconsolidated partnerships with our results. Changes in our investments in these entities are recorded in the balance sheet caption entitled 'Investment in partnerships, at equity.' In the case of deficit investment balances, such amounts are recorded in 'Distributions in excess of partnership investments.

We hold legal title to properties owned by three of our unconsolidated partnerships through tenancy in common arrangements. For each of these properties, such legal title is held by us and another person or persons, and each has an undivided interest in title to the property. With respect to each of the three properties, under the applicable agreements between us and the other persons with ownership interests, we and such other persons have joint control because decisions regarding matters such as the sale, refinancing, expansion or rehabilitation of the property require the approval of both us and the other person (or at least one of the other persons) owning an interest in the property. Hence, we account for each of the properties like our other unconsolidated partnerships using the equity method of accounting. The balance sheet items arising from these properties appear under the caption entitled 'Investments in partnerships, at equity.'

For further information regarding our unconsolidated partnerships, see note 3 to our consolidated financial statements."

- With respect to the Company's explanation of the economics of the unconsolidated partnerships to which the Company is entitled under the partnership agreements, the Company has set forth its proposed revisions in response to the third bullet point under this Response to Comment 4.

***

In connection with the responses to your comments set forth above, the Company acknowledges that:

- The Company is responsible for the adequacy and accuracy of the disclosure in its filings;
- Staff comments or changes to disclosure in response to Staff comments do not foreclose the Securities and Exchange Commission from taking any action with respect to the filing; and
- The Company may not assert Staff comments as a defense in any proceeding initiated by the Securities and Exchange Commission or any person under the federal securities laws of the United States.

If you have any questions about any of the Company's responses to your comments or require further explanation, please do not hesitate to contact Robert McCadden, the Company's Chief Financial Officer, at (215) 454-1295 or Jonathen Bell, the Company's Chief Accounting Officer, at (215) 875-0426.

Sincerely,

/s/ Robert F. McCadden

Robert F. McCadden

Executive Vice President and Chief Financial Officer

cc: Bruce Goldman, Esq. (PREIT)
Daniel Pliskin, Esq. (PREIT)
Robert Juelke, Esq. (Drinker Biddle & Reath LLP)
Andrew Michal (KPMG LLP)

July 7, 2015

Jennifer Monick
Staff Accountant
United States Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549

SUBJECT: Response to your comment letter
PennyMac Mortgage Investment Trust
Form 10-K for the fiscal year ended December 31, 2014
Filed March 2, 2015
File No. 1-34416

Dear Ms. Monick:

I am writing in response to your letter dated June 22, 2015 regarding your review of the Annual Report on Form 10-K of PennyMac Mortgage Investment Trust (the "Company") for the fiscal year ended December 31, 2014 as filed on March 2, 2015.

Following are our responses to your comments. For ease of review, we have reprinted your comments in bold face followed by our responses.

General

1. Please tell us how you complied with Rule 5-04 of Regulation S-X, or tell us how you determined it was not necessary to provide a Schedule IV.

The Company provides mortgage loan concentration data in *Management's Discussion and Analysis of Financial Condition and Results of Operations – Investment Portfolio Composition – Mortgage Loans* that provides portfolio composition information for eight different attributions. The Company believes that its analysis provides more useful information than that required by Rule 5-04, given the nature of the assets acquired – distressed mortgage loans. The Company's presentation includes much of the information specified by Rule 12-29.

Specifically:

- the second table included in the Company's analysis groups its mortgage loans by categories (first or second trust deed);
- the first table included in the Company's analysis identifies mortgage loans between mortgage loans where principal and interest is payable at level amounts over life to maturity as well as those subject to balloon payments.

The tables also include information on:

- owner occupancy (the third table in the Company's presentation);
- loan seasoning (the fourth table in the Company's presentation);
- borrower creditworthiness as expressed by the borrower's FICO score (the fifth table in the presentation);
- current loan-to-value of the mortgage loans (the sixth table in the presentation);
- geographic distribution of the mortgage loans (the seventh table in the presentation); and
- the payment status of the mortgage loans (the eighth table in the presentation).

The Company does not group its mortgage loans at fair value by original loan amount as its mortgage loan investments are primarily comprised of distressed single-family mortgage loans that are carried at fair value, and the mortgage loans' fair values are generally significantly less than the mortgage loans' unpaid principal balances ("UPB"). Original loan amount and UPB are not significant indicators of risk. The Company believes that the attributes presented in Management's Discussion and Analysis of Financial Condition and Results of Operations are more relevant than the groupings of the portfolio's original mortgage loan amounts.

The Company supplements the loan attribution disclosures contained in Management's Discussion and Analysis of Financial Condition and Results of Operations in Note 8 – *Fair Value* and Note 12 – *Mortgage Loans at Fair Value* to its consolidated financial statements. In Note 8, the Company rolls forward its investment in distressed mortgage loans and discloses both the principal amount due upon maturity and the fair value of the mortgage loans. In Note 12 to its consolidated financial statements, the Company discloses the fair value and the unpaid principal balance by mortgage loan type.

The Company believes that its business operations have characteristics that are more similar to those of a bank holding company than those of a commercial company. Accordingly, the Company's financial statements in certain areas are prepared following the guidance of Article 9 of Regulation S-X. The Company also believes this position is supported by comment four of the staff's comment letter issued to the Company dated August 6, 2013 and in subsequent correspondence between the Company and staff relating thereto, whereby the Company was advised to conform with Rule 9-04 of Regulation S-X as it related to income statement presentation.

The Company therefore believes that the schedule specified in Rule 5-04 of Regulation S-X is rendered unnecessary as it is duplicative of much of the information provided by the Company and less relevant for understanding the Company's portfolio than the information provided in Management's Discussion and Analysis of Financial Condition and Results of Operations and the Notes to the consolidated financial statements.

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations – Liquidity and Capital Resources, page 84

2. **You indicated in a response to the SEC Staff dated July 31, 2014 that in future annual reports, you would provide the average quarterly balance for your asset repurchase agreements for each of the past three years, the period-end balance for each of those quarters, and the maximum balance outstanding during each quarter and explain the cause and business reasons for material variances of such repurchase agreements. We are unable to locate such disclosure; please advise.**

The Company respectfully advises the staff that it inadvertently omitted the data from the Liquidity and Capital Resources section of the Company's Annual Report on Form 10-K (the "Annual Report") for the year ended December 31, 2014. The Company will include the tables in future Annual Reports.

Data on the average annual balance for the Company's repurchase agreements, the fiscal year-end balance and the maximum balance outstanding during each fiscal year are provided in Note 17 to the consolidated financial statements contained in the Company's Annual Report for the fiscal year ended December 31, 2014 and in Notes 18 – 22 to the consolidated financial statements contained in the Company's Annual Reports for the fiscal years ended December 31, 2013 and 2012.

Information on average and maximum balances outstanding, including the cause and business reasons for material variances between average and maximum balances of repurchase agreements, has also been included on a voluntary basis in the Liquidity and Capital Resources section of every Quarterly Report on Form 10-Q and Annual Report filed by the Company since the period ended September 30, 2010.

In its future Annual Reports, the Company will include the tabular disclosure of the average quarterly balance of assets sold under agreements to repurchase for each of the past three years, the period-end balance for each of those quarters, and the maximum balance outstanding during each quarter, along with an explanation of the cause and business reason for material variances of such repurchase agreements. The quarterly information for 2014, 2013 and 2012 is presented below.

	2014 quarter ended			
Assets sold under agreements to repurchase:	**December 31**	**September 30**	**June 30**	**March 31**
Average balance outstanding	$ 2.462.496	$2,501,816	$2,253,127	$1,795,702
Maximum daily balance outstanding	$ 3,187,742	$2,815,572	$2,814,572	$2,079,090
Ending balance	$ 2,730,130	$2,416,686	$2,701,755	$1,887,778

	2013 quarter ended			
Assets sold under agreements to repurchase:	**December 31**	**September 30**	**June 30**	**March 31**
Average balance outstanding	$ 1,839,662	$1,755,850	$1,385,350	$1,221,766
Maximum daily balance outstanding	$ 2,362,467	$2,736,873	$2,108,956	$1,619,022
Ending balance	$ 2,039,605	$1,980,058	$1,565,896	$1,615,050

Assets sold under agreements to repurchase:	2012 quarter ended December 31	September 30	June 30	March 31
Average balance outstanding	$ 1,031,394	$ 886,601	$ 736,305	$ 564,170
Maximum daily balance outstanding	$ 1,394,732	$1,372,720	$1,017,397	$ 734,585
Ending balance	$ 1,256,102	$1,041,371	$1,007,712	$ 501,441

The difference between the maximum and average daily amounts outstanding was due to increasing volume and the timing of mortgage loan purchases and sales in our correspondent production business and timing of distressed mortgage loan acquisitions.

Contractual Obligations, page 86

3. **It does not appear that you include interest expense related to certain debt agreements. In future periodic filings, please confirm that you will disclose the amount of interest related to your debt in future filings, or tell us why such information is not meaningful. Refer to footnote 46 of SEC Interpretive Release 33-8350 dated December 19, 2003.**

In future filings, the Company will include anticipated interest expense relating to its long-term debt agreements in its tabular disclosure of contractual obligations.

Consolidated Financial Statements – Note 8—Fair Value, page F-27 – Financial Statement Items Measured at Fair Value on a Recurring Basis

4. **We note that the mortgage loans at fair value consisting of fixed-rate jumbo loans held in a VIE are categorized as level 2 in the fair value hierarchy. Please tell us the differences in the valuation characteristics of these mortgages to those that underlie the remaining amount of mortgage loans at fair value categorized as level 3.**

The fixed-interest rate jumbo mortgage loans held in a VIE are prime-credit quality mortgage loans that the Company securitized shortly after acquisition. The Company has been able to estimate these mortgage loans' fair values using broker indications of fair value for all of the individual securities issued by the securitization trust to derive a fair value for the mortgage loans. The Company validates the brokers' indications of fair value using pricing models and inputs that are similar to the models and inputs used by other market participants. The Company believes that such methods and inputs are market-observable and therefore has classified such mortgage loans as "Level 2" financial statement items.

The remaining mortgage loans at fair value — mortgage loans classified as "Level 3" financial statement items — represent mortgage loans that were both seasoned and either severely delinquent or at heightened risk of default at acquisition. The market for such loans is limited and difficult to observe. Valuation of such mortgage loans therefore relies on significant unobservable inputs. Accordingly, such loans are categorized as "Level 3" financial statement items and their fair values are estimated using a discounted cash flow approach.

In future filings the Company will enhance its disclosure of its valuation techniques and inputs in Note 8 – *Fair Value* to further clarify its basis for classifying its mortgage loans held at fair value held in a VIE by adding the following sentences: For the mortgage loans at fair value held in a VIE, the fair values of all of the individual securities issued by the securitization trust are used to derive a fair value for the mortgage loans. The Company obtains indications of fair value from nonaffiliated brokers based on observed transactions for comparable securities and validates the brokers' indications of fair value using pricing models and inputs the Investment Manager believes are similar to the models and inputs used by other market participants.

Plum Creek Timber Company, Inc.
601 Union Street, Suite 3100
Seattle, Washington 98101
(206) 467-3600

May 6, 2015

Ms. Erin E. Martin, Senior Counsel
Division of Corporation Finance
Securities and Exchange Commission
100 F Street NE
Washington, D.C. 20549-3010

Re: Plum Creek Timber Company, Inc. Form 10-K for the Fiscal Year Ended December 31, 2014

Dear Ms. Martin:

This letter is submitted on behalf of Plum Creek Timber Company, Inc. ("Plum Creek") in response to your letter dated April 23, 2015 ("Comment Letter") concerning Plum Creek's Form 10-K Annual Report for the Year Ended December 31, 2014 ("Form 10-K"). Plum Creek's response to the Comment Letter, along with certain requested acknowledgements, are hereby submitted below.

Segment Information, page 4

1. ***We note the disclosure of your aggregate standing timber inventory. Please tell us what consideration you have given to providing additional detail, to the extent available to management, regarding inventory data broken out by species and/or age of trees.***

Response: Plum Creek strives to provide meaningful and transparent disclosures in its periodic reports filed with the Securities and Exchange Commission. We try to strike a balance between providing enough details for our investors to understand the company's business while at the same time not overwhelming the reader with excess information that is not material to the company's results of operations or financial condition.

We believe that our current disclosure strikes that balance by providing investors with the most important information about our timber inventory: future harvest volume trends. By disclosing our current and forecasted harvest volumes, both short-term (5 years) and long-term (ten years and beyond), we provide our investors with one of the most important items of information necessary for estimating expected future cash flows from our timber segments. Coupled with price and cost information, harvest volume data is the key to understanding expected future cash flows, which we believe is of primary importance to our investors. That is why we focus on disclosure addressing these three items in our periodic reports filed with the Securities and Exchange Commission.

For example, on page 43 of our Form 10-K (Results of Operations, Northern Resources Segment), we explain why our 2014 northern sawlog and pulpwood harvest volumes have changed compared to the prior year. On page 44 of our Form 10-K (Results of Operations, Southern Resources Segment) we explain why our 2014 southern sawlog and pulpwood harvest volumes have changed compared to the prior year. Finally, on pages 41 and 42 of our Form 10-K (Events and Trends Affecting Operating Results, Harvest Plans), we explain how harvest levels in 2015 are expected to compare to 2014 and the reasons for the change, along with our expectations for short and long-term future harvest levels. In all cases, we provide this information for both our Northern Resources Segment and our Southern Resources Segment, broken out in each segment by sawlog and pulpwood data, because we believe this level of detail is most helpful to our investors to understand expected future harvest trends, and therefore, expected future cash flows from our timber segments. On the other hand, disclosing our timber inventory data by species and/or age class would not, in our opinion, help investors better assess expected future cash flows from our timber segments.

We believe that by disclosing our expected current and future harvest volume trends, we provide investors with material information that is more meaningful than disclosing our current timber inventory data broken out by species and/or age of trees. We hold quarterly calls with analysts, and we receive inquiry from analysts, investors, and prospective investors each day, and we are rarely asked about our inventory by species or age class. Each year we evaluate whether our periodic filings with the Securities and Exchange Commission provide investors with meaningful and material information. In the past, we have considered disclosing more detailed information about our timber inventory, but have concluded that disclosing future harvest levels is more meaningful to our investors because timber inventory is only one of many factors in determining future harvest levels.

In addition to the foregoing response to the Comment Letter, Plum Creek hereby acknowledges that:

- Plum Creek is responsible for the adequacy and accuracy of the disclosure in its Form 10-K;
- Staff comments or changes to disclosure in response to staff comments do not foreclose the Securities and Exchange Commission from taking any action with respect to the Form 10-K; and
- Plum Creek may not assert staff comments as a defense in any proceeding initiated by the Securities and Exchange Commission or any person under the federal securities laws of the United States.

If you have any questions regarding this matter, please contact Jose J. Quintana, our Assistant General Counsel, at (206) 467-3694.

Sincerely,

/s/ Rick R. Holley

Rick R. Holley
Chief Executive Officer
Plum Creek Timber Company, Inc.

May 1, 2015

Via E-mail

Mr. Daniel L. Gordon
Senior Assistant Chief Accountant
Division of Corporation Finance
U.S. Securities and Exchange Commission
Washington, D.C. 20549

Re: Potlatch Corporation
Form 10-K for the fiscal year ended December 31, 2014
Filed February 13, 2015
File No. 1-32729

Dear Mr. Gordon:

This letter is submitted on behalf of Potlatch Corporation (we and our) and responds to the Staff's comment letter of April 21, 2015 relating to our Form 10-K for our fiscal year ended December 31, 2014. For your convenience, we have reproduced the Staff's comments below and have provided our responses accordingly.

Form 10-K for the fiscal year ended December 31, 2014

Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer

Repurchases of Equity Securities, page 19

1. *We are unable to locate the summary of shares authorized for issuance under your equity compensation plans, as contemplated by Item 201(d) of Regulation S-K. Please advise.*

Response:

The summary of shares authorized for issuance under our equity compensation plans, as required by Item 201(d) of Regulation S-K, was inadvertently omitted in our Annual Report on Form 10-K for the year ended December 31, 2014. The following table provides the information with respect to our equity compensation plans as of December 31, 2014:

EQUITY COMPENSATION PLAN INFORMATION

Plan category	Number of securities to be issued upon exercise of outstanding options, warrants or rights [1]	Weighted average exercise prices of outstanding options, warrants or rights [2]	Number of securities remaining available for future issuance under equity compensation plans
Equity compensation plans approved by security holders	376,040	—	1,388,704
Equity compensation plans not approved by security holders	—	—	—
Total	376,040	—	1,388,704

[1] Includes 160,233 performance shares, 32,455 restricted stock units (RSUs), 60,570 deferred RSUs and 122,782 deferred compensation director stock equivalent units.

[2] Performance shares, RSUs, deferred RSUs and director stock equivalent units do not have exercise prices.

The information in the equity compensation plan table is substantially disclosed in footnote 15 of our 2014 Annual Report on Form 10-K, which includes the number of outstanding performance shares, RSUs and deferred compensation director stock equivalent units. In addition, footnote 15 discloses approximately 1.1 million shares authorized for future use, which is lower than the number of securities remaining available for future issuance because we apply the maximum number of contingent performance shares to the calculation.

We will include the summary of shares authorized for issuance under our equity compensation plans in accordance with Item 201 (d) of Regulation S-K in our 2015 Annual Report on Form 10-K or by incorporation by reference in our 2015 Proxy Statement.

Management's Discussion and Analysis of Financial Condition and Results of Operations

2. *We note your use of EBITDDA and FAD in your investor presentation filed on March 10, 2015. Please tell us if you consider these measures to be key performance indicators. To the extent a measure is considered to be a key performance measure, in future filings please include the measure as well as the required disclosure in accordance with Item 10(e) of Regulation S-K within your Management's Discussion and Analysis. Please include an example of any future disclosure in your response.*

Response:

We do not consider EBITDDA or FAD to be key performance indicators for Potlatch. Our internal segment reports and variance analyses provided to our chief operating decision maker focus on our GAAP results. External discussions of our results in our Management's Discussion and Analysis, earnings release and earnings scripts utilize these GAAP internal segment reports and variance analyses, which serve to provide a view through the eyes of management. Our internal segment reports include EBITDDA as supplementary information at the bottom of a table or the back of a report, without commentary or analysis, consistent with our view that EBITDDA is not a key performance indicator. FAD is not presented in reports provided to our chief operating decision maker. We do not believe that adding EBITDDA and FAD to our Management's Discussion and Analysis would improve the ability of investors to assess our financial condition or results of operations.

Consolidated Results Comparing 2014 and 2013

Cost of Goods Sold, page 29

3. *You indicate impacts to your cost of goods sold line item for the increase from 2013 to 2014 include higher logging costs and forest management expenses in your Resource segment and higher log costs and labor-related expenses for your Wood Products segment. In future filings please quantify for us the consolidated amounts applicable to the material components of cost of goods sold and provide explanations for variances at this lower level or tell us why this is not necessary.*

Response:

Commencing with our Quarterly Report for the three months ended March 31, 2015, which was filed contemporaneously with this letter, we will present in tabular format the material components of cost of goods sold for each segment, along with explanations for variances at this lower level. Due to the alignment with segment revenues, we believe this segment level detail is more meaningful than consolidated cost of sales balances. Our segment footnote remains unchanged.

We hereby acknowledge that:

- the company is responsible for the adequacy and accuracy of the disclosure in the filing;
- staff comments or changes to disclosure in response to staff comments do not foreclose the Commission from taking any action with respect to the filing; and
- the company may not assert staff comments as a defense in any proceeding initiated by the Commission or any person under the federal securities laws of the United States.

Please contact me at 509-835-1508 if you have any questions or comments relating to the matters referenced above. Thank you for your attention to this matter.

Sincerely,

/s/ Stephanie A. Brady

Stephanie A. Brady
Controller and Principal Accounting Officer

Prologis, Inc. and Prologis, L.P.
Pier 1, Bay 1
San Francisco, California 94111

April 6, 2015

VIA EDGAR

Jennifer Monick
Accountant
Division of Corporation Finance
U.S. Securities and Exchange Commission
100 F. Street, N.E.
Washington, D.C. 20549

Re: Prologis, Inc. and Prologis, L.P.
Form 10-K for the year ended December 31, 2014
Filed February 25, 2015
File No. 1-13545 and No. 1-14245

Dear Ms. Monick:

We are writing in response to your letter dated March 31, 2015, setting forth the comments of the staff of the Division of Corporation Finance (the "Staff") on the Form 10-K of Prologis, Inc. and Prologis, L.P. (together, the "Company") for the year ended December 31, 2014, filed with the Securities and Exchange Commission (the "SEC") on February 25, 2015 ("Form 10-K"). We have carefully considered the Staff's comments and our responses are set forth below. To facilitate the Staff's review, we have reproduced the Staff's comments in italicized text and added our response below.

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

Same Store Analysis, page 26

1. *In future annual filings, please reconcile same store portfolio – rental income, rental expenses and NOI on a full year basis. Additionally, please confirm for us and revise your disclosure in future periodic filings to reflect, if true, that the reconciling item for unconsolidated co-investment ventures represents your share of the unconsolidated co-investment. To the extent that the reconciling item for unconsolidated co-investment ventures represents total rental income, rental expenses and NOI for the unconsolidated co-investment ventures, please tell us how you determined that presentation is appropriate.*

We evaluate our operating properties in our same store pool on a quarterly basis and adjust the pool of properties to reflect dispositions for the quarter. We aggregate the net operating income

("NOI") for the same store pool for each of the four quarters to calculate a cumulative annual same store NOI. In our future annual filings, we will reconcile our same store rental income, rental expenses and NOI to amounts presented in our Consolidated Statements of Operations on an annual basis.

In our response dated June 26, 2008 (the "2008 Response") to the Staff's question regarding our Form 10-K for the year ended December 31, 2007, we had previously discussed with the Staff the appropriateness of our presentation of same store NOI with respect to our unconsolidated co-investment ventures. (Note that, ProLogis was the accounting acquirer in the 2011 merger between AMB Property Corporation and ProLogis. The 2008 Response was issued by ProLogis, the accounting predecessor of the combined companies.) The relevant sections from our 2008 Response are set forth below:

> "On June 16, 2008, Mr. Bill Sullivan and Mr. Jeff Finnin, the company's Chief Financial Officer and Chief Accounting Officer, respectively, spoke with Daniel Gordon and Jonathan Wiggins about the proposed disclosure of same store information in future filings. As we discussed, we include the results of our unconsolidated investees in our same store analysis due to our business model. We develop properties and then contribute such properties to unconsolidated investees but we continue to manage these properties after contribution and, as such, they are included in our same store analysis. We believe this presentation is more meaningful to investors because it more accurately represents our total portfolio of properties in which we invest and manage and it presents a more comprehensive and accurate reflection of the global rental markets in which we operate."

As further discussed in the 2008 Response

> "…we have separated the amounts included in the same store analysis and reflected them under the separate headings of "Consolidated" and "Unconsolidated Investees", we added Footnote (3) to the table to clearly disclose that the total amounts include the results of the properties owned by our unconsolidated investees and managed by us and we added the detail reconciliation to net operating income. As we agreed, we did not add a further reconciliation to operating income since we have reconciled to rental income, rental expenses and net operating income as disclosed in or computed from our consolidated statements of earnings, which are the most comparable measures included in our financial statements.
>
> A property that meets the definition to be included in the same store portfolio on an aggregate basis, would not always meet that definition if the same store portfolio was calculated on a stand alone basis for us or the unconsolidated investees. For example, if ProLogis contributed a property to an unconsolidated investee on January 1, 2008, the rental income and expenses of that property would be included in our consolidated rental income and expenses for the three months ended March 31, 2007 and in the rental income and expenses of the unconsolidated investee for the three months ended March 31, 2008. On a

combined basis it would be appropriate to include the results in a same store analysis, but on a ProLogis consolidated basis it would not be appropriate and would misrepresent the same store analysis, as the pools of properties are not consistent. We have further disclosed this in Footnote (1) to the table."

Since 2008, we have continued to disclose a reconciliation for same store NOI in a similar format as discussed in our 2008 Response. The explanation we provided to the Staff in our 2008 Response continues to be applicable to our business today. During the three year period ended December 31, 2014, we contributed 405 properties with more than 100 million aggregated square feet valued at $8.7 billion. We continue to monitor this disclosure to determine if additional information is necessary. To that end, we recently added additional disclosure by providing cumulative annual same store NOI in the Form 10-K, as discussed above. As stated above, in our future annual filings, we will reconcile our same store rental income, rental expenses and NOI to amounts presented in our Consolidated Statements of Operations on an annual basis.

Funds from Operations ("FFO"), page 37

2. *In the table on page 40, please tell us how the line items "Gains on dispositions of non-development properties and revaluation of equity investments upon acquisition of a controlling interest, net" and "Net gains on dispositions of development properties and land, net" are derived. For all periods presented, tell us how these line items reconcile to the line items "Gains on dispositions of investments in real estate and revaluation of equity investments upon acquisition of a controlling interest, net" and "Net gains on dispositions, including related impairment charges and taxes" from your consolidated statements of operations.*

In our FFO measure, we include "Gains (losses) from the contribution or sale of land and properties we develop." In our Core FFO measure, we exclude all gains. Prior to 2014, these gains could be reflected in continuing operations or discontinued operations. See below for a derivation of the line items "Gains on dispositions of non-development properties and revaluation of equity investments upon acquisition of a controlling interest, net" and "Net gains on dispositions of development properties and land, net" and a reconciliation to the amounts provided in our Statements of Operations.

	For the Year Ended December 31,		
	2014	2013	2012
Net gains per our Statements of Operations - by line item			
Continuing Operations			
Gains on dispositions of investments in real estate and revaluation of equity investments upon acquisition of a controlling interest, net	$ 725,790	$ 597,656	$ 305,607
Discontinued Operations			
Net gains on dispositions, including related impairment changes and taxes	—	116,550	35,098
Add back Impairment charges and taxes included in Discontinued Operations	—	1,187	30,828
Total gains included in our Statements of Operations	**$725,790**	**$715,393**	**$371,533**
Gains by type			
Net gains on dispositions of development properties and land, net (included in NAREIT and Prologis defined FFO, excluded from Core FFO)	$ 172,492	$ 428,738	$ 121,303
Gains on dispositions of non-development properties (excluded from FFO measures)	351,979	251,868	(36,105)
Gain on revaluation of equity investments upon acquisition of a controlling interest (excluded from FFO measures)	201,319	34,787	286,335
Total gains	**$725,790**	**$715,393**	**$371,533**
In our reconciliation from Net earnings (loss) to NAREIT defined FFO, we subtract gains not included in FFO.			
Gains on Dispositions of non-Development properties and revaluation of equity investments			
Gains on dispositions of non-development properties (excluded from FFO measures)	$ 351,979	$ 251,868	$ (36,105)
Gain on revaluation of equity investments upon acquisition of a controlling interest (excluded from FFO measures)	201,319	34,787	286,335
Adjustment for accumulated depreciation on development properties in discontinued operations	—	(15,340)	(43,197)
Total of adjustment "gains on dispositions of non-development properties and revaluation of equity investments upon acquisition of a controlling interest, net"	**$553,298**	**$271,315**	**$207,033**
In our reconciliation from FFO, as defined by Prologis, to Core FFO we subtract all gains and related items included in NAREIT and Prologis defined FFO.			
Net gains on dispositions of development properties and land, net			
Net gains of dispositions of development properties and land, net (included in NAREIT and Prologis defined FFO, excluded from Core FFO)	$ 172,492	$ 428,738	$ 121,303
Current tax expense recognized related to gains on dispositions of development properties and land (included in NAREIT and Prologis defined FFO, excluded from Core FFO)	(15,499)	(88,947)	—
Acquisition costs (included in NAREIT and Prologis defined FFO, excluded from Core FFO)	(4,195)	(2,976)	—
Total of adjustment "Net gains on dispositions of development properties and land, net"	**$152,798**	**$336,815**	**$121,303**

3. *In the table on page 40, please tell us the nature of the line item "Reconciling items related to noncontrolling interests." Further, please tell us how this adjustment is consistent with NAREIT defined FFO.*

In our calculation of NAREIT defined FFO, we make certain adjustments as outlined in the definition of FFO provided in our Form 10-K. For consolidated entities, these adjustments are made at 100% of the item included in our consolidated financial statements. In the line item "reconciling items related to noncontrolling interests" in the table on page 40 (the "FFO Reconciliation"), we remove the third-party share of the adjustments we made on a consolidated basis related to our consolidated co-investment ventures. For similar reasons we include a line item "our share of reconciling items included in earnings from unconsolidated entities" in the

FFO Reconciliation, which includes our share of the adjustments within the unconsolidated co-investment ventures. These adjustments primarily relate to depreciation expense and gains from disposition of properties in conformance with the NAREIT definition and result in a calculation of FFO that only includes our share of the FFO of these entities.

Financial Statements

Notes to Consolidated Financial Statements

17. Earnings/Loss per Common Share/Unit, page 86

4. *We note your disclosure on page 81 and 82 that RSUs and LTIP Units are considered participating securities. Please tell us how you considered these participating securities in your earnings per share calculation. Please refer to ASC 260-10-45-61A.*

We calculated earnings per share including participating securities in accordance with ASC 260-10-45-61A. The impact to earnings per share was less than $0.01 per share for both calculations and not considered significant to disclose. We will continue to calculate the impact each quarter and disclose the impact if it is significant.

* * * * *

In addition, we acknowledge that:

- the Company is responsible for the adequacy and accuracy of the disclosure in the filing;
- staff comments or changes to disclosure in response to staff comments do not foreclose the Commission from taking any action with respect to the filing; and
- the Company may not assert staff comments as a defense in any proceeding initiated by the Commission or any person under the federal securities laws of the United States.

Please contact the undersigned at (415) 733-9405 if you have any questions or require additional information.

Sincerely,

/s/ Thomas S. Olinger
Thomas S. Olinger
Chief Financial Officer

Prologis, Inc. and Prologis, L.P.
Pier 1, Bay 1
San Francisco, California 94111

April 24, 2015

<u>VIA EDGAR</u>

Jennifer Monick
Accountant
Division of Corporation Finance
U.S. Securities and Exchange Commission
100 F. Street, N.E.
Washington, D.C. 20549

Re: Prologis, Inc. and Prologis, L.P.
Form 10-K for the year ended December 31, 2014
Filed February 25, 2015
File No. 1-13545 and No. 1-14245

Dear Ms. Monick:

We are writing in response to your letter dated April 17, 2015, setting forth the comments of the staff of the Division of Corporation Finance (the "Staff") on the Form 10-K of Prologis, Inc. and Prologis, L.P. (together, the "Company") for the year ended December 31, 2014, filed with the Securities and Exchange Commission (the "SEC") on February 25, 2015 ("Form 10-K"). We have carefully considered the Staff's comments and our responses are set forth below. To facilitate the Staff's review, we have reproduced the Staff's comments in italicized text and added our response below.

<u>Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations</u>

<u>*Funds from Operations ("FFO"), page 37*</u>

1. *We note your response to prior comment 2. In the reconciliation, you adjust "Net gains on dispositions of development properties and land, net" for "Current tax expense recognized related to gains and dispositions of development properties and land (included in NAREIT and Prologis defined FFO, excluded from Core FFO)". Please clarify for us how you derived the 2014 and 2013 amounts for "Current tax expense recognized related to gains and dispositions of development properties and land*

(included in NAREIT and Prologis defined FFO, excluded from Core FFO)". Your response should include, but not necessarily limited to, a reconciliation of the "Current tax expense recognized related to gains and dispositions of development properties and land (included in NAREIT and Prologis defined FFO, excluded from Core FFO)" line item to your income statement and tell us the nature of any reconciling items.

Although we are a real estate investment trust ("REIT") under the Internal Revenue Code in the U.S., many of the foreign countries in which we have operations do not recognize REITs or do not accord REIT status under their respective tax laws to our entities that operate in their jurisdiction. In the United States, our taxable REIT subsidiaries are subject to taxation and we are taxed in certain states in which we operate.

When we dispose of a property, we may be required to pay a capital gains tax in the applicable jurisdiction based on the taxable gain. We derived the 2014 and 2013 current tax related to the sale of investments in real estate by totaling the taxes payable relating to property sales as well as the contributions of properties to our co-investment ventures in Mexico, Europe and Japan.

For purposes of calculating Core FFO, we exclude gains related to the sale of real estate and therefore, we adjust Prologis defined FFO to exclude any current tax specifically related to the sale of investments in real estate. To reconcile current tax expense related to the sale of investments in real estate to Current Income Tax Expense included in our Statements of Operations, we need to include the portion of current income tax expense that was offset by the deferred tax liability related to the real estate that was sold, plus other tax expense related to operating taxable income and state taxes.

Please see the below reconciliation of current tax expense related to the sale of investments in real estate (the amount we have excluded from Core FFO), to Current Income Tax Expense included in our Statements of Operations.

	2014	2013
Current tax expense related to the sale of investments in real estate (included in NAREIT and Prologis defined FFO, excluded from Core FFO) (1)	$ 15,499	$ 88,947
Current income tax expense offset by a deferred tax liability	30,521	20,722
All other current income tax expense	15,564	16,511
Current Income Tax Expense per our Statements of Operations	$ 61,584	$ 126,180

(1) In our letter to you dated April 6, 2015 we inadvertently referred to this line item as "Current tax expense recognized related to gains on dispositions of development properties and land (included in NAREIT and Prologis defined FFO, excluded from Core FFO").

2. *We note your response to prior comment 3. It appears that the measure you refer to as FFO is FFO attributable to common stockholders. In future periodic filings, please revise your disclosure to refer to this measure as FFO attributable to common stockholders. Additionally, please revise future periodic filings to clarify, as you have in your response, the nature of the adjustment "reconciling items related to noncontrolling interests."*

In future filings, we will refer to FFO as FFO attributable to common stockholders and we will clarify the nature of the adjustment “reconciling items related to noncontrolling interests” as we have in our response dated April 6, 2015.

* * * * *

In addition, we acknowledge that:

- the Company is responsible for the adequacy and accuracy of the disclosure in the filing;
- staff comments or changes to disclosure in response to staff comments do not foreclose the Commission from taking any action with respect to the filing; and
- the Company may not assert staff comments as a defense in any proceeding initiated by the Commission or any person under the federal securities laws of the United States.

Please contact the undersigned at (415) 733-9405 if you have any questions or require additional information.

Sincerely,

/s/ Thomas S. Olinger
Thomas S. Olinger
Chief Financial Officer

August 4, 2015

Securities and Exchange Commission
Washington, D.C. 20549
Division of Corporation Finance
Ms. Kim McManus, Staff Attorney

Re: PS Business Parks, Inc.
Form 10-K for the year ended December 31, 2014
Filed February 20, 2015
File No. 001-10709

Dear Ms. McManus:

On behalf of PS Business Parks, Inc. (the "**Company**"), I am responding to comments of the Staff of the Division of Corporation Finance (the "**Staff**") of the Securities and Exchange Commission (the "**Commission**") contained in the Staff's letter dated July 22, 2015 relating to the above-referenced filing.

I have recited the comment of the Staff in bold type below, and have followed the comment with the response of the Company. Capitalized terms used but not defined herein have the same meaning as defined in the above-referenced filing.

Item 2. Properties, page 17
1. We note that leases expiring by the end of the current and next fiscal year represent approximately 25.7% and 22.8% of annualized rental income. We also note disclosure on page 25 indicating that while new rental rates improved over expiring rental rates on an aggregate basis, you experienced declining rental rates in certain regions, including Virginia, Maryland and Orange County. In future filings, to the extent material, please address the relationship between market rents and expiring rents based on the regions in which you have material leases expiring at the end of the current fiscal year. In addition, to the extent material, please disclose if you have a concentration of expiring leases in particular regions.

We will include in our disclosures in future filings, to the extent material, (a) any known trend regarding the relationship of contractual rents on current year lease expirations and current market rents in those same markets and (b) if the Company has a concentration of expiring leases in particular regions.

701 Western Avenue, Glendale, CA 91201
t. 818.244.8080 f. 818.242.0566

March 31, 2015

VIA EDGAR AND FED EX

Mr. Jaime G. John
Branch Chief
Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549

Re: Public Storage
Form 10-K for the fiscal year ended December 31, 2014
Filed on February 25, 2015
File No. 001-33519

Dear Mr. John:

Set forth below is the response of Public Storage to the comments of the Staff that were set forth in your letter dated March 19, 2015, regarding our Form 10-K for the year ended December 31, 2014. The Staff's comments, indicated in bold, are followed by the response on behalf of Public Storage.

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

Self-Storage Operations Summary, page 29

1. **We note the line item in your table "Total net income" is not consistent with Net income included on your Statements of Income. In future filings, please revise the label for this line item to more accurately reflect the amount presented and provide clarifying disclosure to the extent necessary. Make similar adjustments to presentation in the tables on pages 30 and 38 and elsewhere throughout the filing, if necessary. In your response, tell us how you plan to revise your presentation in the future.**

Response:

In our future Exchange Act periodic reports, we will revise the line item labels on the tables in the following referenced pages of our Form 10-K for the year ended December 31, 2014: (i) "Total net income" on page 29 will be revised to "Operating income," (ii) "Net income" on pages 30 and 38 will each be revised to "Operating income," (iii) "Total ancillary net income" on page 43 will be revised to "Operating income," and (iv) "Self-storage net income" and "Total net income from self-storage" on page 47 will each be revised to "Operating income from self-storage." We will also ensure that the terminology in our future filings is otherwise consistent, where applicable, with our financial statement captions. We will also provide clarifying disclosure, as necessary.

In connection with Public Storage's response to the Staff's comments, Public Storage hereby acknowledges that:

? Public Storage is responsible for the adequacy and accuracy of the disclosure in the filing,
? Staff comments or changes to disclosure in response to Staff comments do not foreclose the Commission from taking any action with respect to the filing, and
? Public Storage may not assert Staff comments as a defense in any proceeding initiated by the Commission or any person under the federal securities laws of the United States.

Please contact me or Lily Hughes, our Chief Legal Officer, at 818-244-8080, ext. 1537, if you have additional questions on this matter.

Sincerely,

/s/ John Reyes
Senior Vice President and
Chief Financial Officer

cc: William Demarest

April 28, 2015

VIA EDGAR AND FED EX

Mr. Jaime G. John
Branch Chief
Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549

Re: Public Storage
Form 10-K for the fiscal year ended December 31, 2014
Filed on February 25, 2015
File No. 001-33519

Dear Mr. John:

Set forth below is the response of Public Storage to the comments of the Staff that were set forth in your letter dated April 15, 2015, regarding our Form 10-K for the year ended December 31, 2014. The Staff's comments, indicated in bold, are followed by the response on behalf of Public Storage.

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

Self-Storage Operations Summary, page 29

1. Your response to our prior comment one proposes changing the label associated with various line items to "Operating income". We note that these amounts are not consistent with Operating income presented on your Statements of Income. For example, we note that the line item references on Page 29 relates only to self-storage operations. Please clarify how your presentation in the future will address this matter for all instances where amounts presented as net income and operating income are not consistent with the amounts presented on the Statements of Income.

Response:

Please note that this response replaces our response dated March 31, 2015. It is meant to be responsive to your first letter dated March 19, 2015 as well as your letter dated April 15, 2015.

In our future Exchange Act periodic reports, we will ensure that the terminology in our future filings is consistent, when applicable, with our financial statement captions and that the amounts presented in our tables can be agreed to or reconciled by the reader to the applicable financial statement captions on our Statements of Income. In order to ensure that is the case, among other changes in narrative terminology and line-item labels, we will make the following changes in future filings, referenced to our Form 10-K for the year ended December 31, 2014:

(i) On page 29, the caption "Total net income" on the table will be revised to "Operating income from self-storage," and the revised caption will be footnoted as follows: See "Reconcilation of Depreciation and Amortization Expense and Operating Income" below for a reconciliation of the Operating Income from self-storage herein, to Operating Income on our Statements of Income. See (vii) below for an illustration of the referenced reconciliations.

(ii) Also on page 29, the caption "Total depreciation and amortization expense" will be footnoted as follows: See *"Reconcilation of Depreciation and Amortization Expense and Operating Income" below for a reconciliation of the Depreciation and Amortization expense from self-storage herein, to Depreciation and Amortization expense on our Statements of Income.* See (vii) below for an illustration of the referenced reconciliations.

(iii) Also on page 29, we will add a subtotal of "Operating income from self-storage" for the Same Store Facilities and Non Same Store Facilities, allowing Operating Income on the tables on pages 30 and 38, respectively, to be tied into this table, as they can be for the subtotals already provided for Revenues, Cost of operations, Net operating income, and Depreciation and amortization expense.

(iv) On pages 30 and 38, the current caption "Net income" on these tables will be revised to "Operating income from Same Store Facilities" and "Operating income from Non-Same Store Facilities", respectively.

(v) On page 43, the caption "Total ancillary net income" on the table will be revised to "Operating income from ancillary operations," and a footnote will be added to this caption and the existing caption entitled "commercial depreciation" as follows: *See "Reconciliation of Depreciation and Amortization Expense and Operating Income" below for a reconciliation of the Depreciation and Amortization Expense and Operating Income from ancillary operations herein, to the amounts on our Statements of Income.* See (vii) below for an illustration of the referenced reconciliations. The descriptor "Ancillary net income:" on this table will also be revised, to "Ancillary operating income:."

(vi) On page 47, the descriptor "Self-storage net income:" and the caption "Total net income from self-storage" on the table will be revised to "Self-storage operating income:" and "Operating income from self-storage", respectively.

(vii) Immediately following the section Net Operating Income, which begins on page 46, we will add the following section, which will allow the reader to reconcile from Depreciation and Amortization expense and Operating Income from self-storage and ancillary operations as mentioned in (i), (ii), and (v) above, to the amounts on our Statements of Income.

Reconciliation of Depreciation and Amortization Expense and Operating Income

In the tables above, we present "Depreciation and Amortization Expense" and "Operating Income" for our self-storage and ancillary operations. The table below reconciles from the amounts with respect to Self-Storage and Ancillary Operations to the aggregate amounts presented on our Statements of Income:

	Years ended December 31,		
	2014	2013	2012
	(Amounts in thousands)		
Depreciation and Amortization Expense			
Self-storage operations	$ 434,069	$ 384,623	$ 354,971
Ancillary (commercial) operations	3,045	2,779	2,810
Depreciation and amortization on our Statements of Income	$ 437,114	$ 387,402	$ 357,781
Operating Income			
Operating income from self-storage	$ 1,048,915	$ 941,174	$ 846,253
Operating income from ancillary operations	90,655	88,009	82,566
General and administrative expenses	(71,459)	(66,679)	(56,837)
Operating income on our Statements of Income	$ 1,068,111	$ 962,504	$ 871,982

In connection with Public Storage's response to the Staff's comments, Public Storage hereby acknowledges that:

Public Storage is responsible for the adequacy and accuracy of the disclosure in the filing,
Staff comments or changes to disclosure in response to Staff comments do not foreclose the Commission from taking any action with respect to the filing, and
Public Storage may not assert Staff comments as a defense in any proceeding initiated by the Commission or any person under the federal securities laws of the United States.

Please contact me or Lily Hughes, our Chief Legal Officer, at 818-244-8080, ext. 1537, if you have additional questions on this matter.

Sincerely,

/s/ John Reyes
John Reyes
Senior Vice President and Chief Financial Officer
cc: William Demarest

September 10, 2015

BY EDGAR AND OVERNIGHT MAIL

United States Securities and Exchange Commission
Division of Corporation Finance
100 F Street, NE
Washington, D.C. 20549
Attention: Jaime G. John

RE: QTS Realty Trust, Inc.
Form 10-K for the year ended December 31, 2014
Filed February 23, 2015
File No. 001-36109 ("Form 10-K")

Form 8-K/A
Filed June 5, 2015
File No. 001-36109 ("Form 8-K")

Form 10-Q for the quarterly period ended June 30, 2015
Filed August 7, 2015
File No. 001-36109 ("Form 10-Q")

Dear Ms. John:

This letter sets forth the responses of QTS Realty Trust, Inc. (the "Company") to the comments from the staff (the "Staff") of the Division of Corporation Finance of the United States Securities and Exchange Commission (the "Commission") in a letter dated August 28, 2015 (the "Comment Letter") regarding the above referenced filings.

For ease of review, the Company has set forth below in bold type the numbered comments of the Staff in the Comment Letter, with the Company's responses thereto immediately following each comment.

Form 10-K for the year ended December 31, 2014

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations, page 67

1. **We note that over half of your NRSF is currently in the redevelopment pipeline. Please expand your discussion in future filings to disclose the portion of this space, if any, for which leases have already been executed and if your rentable space is typically built out to customer specifications or for general use.**

Response to Comment No. 1:

The Company respectfully submits that in future filings it will expand its disclosures to include the portion of its development pipeline NRSF which relates to space for which customer leases have already been executed. The Company will also disclose in future filings that its development pipeline NRSF is built out both to support general use (colocation) and for executed leases that require significant amounts of space and power, depending on the needs of each facility at that time.

The Company's future filings will include disclosure substantially similar to the following:

"We operate 12 data centers located in eight states, containing an aggregate of approximately 4.7 million gross square feet of space (approximately 94% of which is wholly owned by us), including approximately 2.1 million "basis-of-design" raised floor square feet, which represents the total data center raised floor potential of our existing data center facilities. This represents the maximum amount of space in our existing buildings that could be leased following full build-out, depending on the configuration that we deploy. We build out our data center facilities for both general use (colocation) and for executed leases that require significant amounts of space and power, depending on the needs of each facility at that time. As of December 31, 2014, this space included approximately 927,000 raised floor operating net rentable square feet, or NRSF, plus approximately 1.1 million square feet of additional raised floor in our development pipeline, of which approximately 97,000 NRSF is expected to become operational by December 31, 2015. Of the total 1.1 million NRSF in our development pipeline, approximately 130,000 square feet was related to customer leases which had been executed but not yet commenced."

Item 8. Financial Statement and Supplementary Data

Note 12. Earnings per share of QTS Realty Trust, Inc., page F-28

2. We note that your basic EPS calculation discloses net income per share *available to common shareholders*. Please label accordingly in future filings. We also note that you have presented diluted EPS on an aggregate basis, inclusive of noncontrolling interests in the partnership. Tell us why you believe it is appropriate to present basic EPS per common shareholder and diluted EPS inclusive of noncontrolling interests. Also disclose the number of potentially dilutive securities, if any, that were not included in the calculation because their effect was antidilutive for the periods presented. Refer to ASC 260-10-50-1.

Response to Comment No. 2:

In future filings, the Company will modify the current label, "Net income per share – basic," to an expanded label which reads, "Net income per share attributable to common stockholders – basic."

Regarding the presentation of diluted EPS, the Company has presented diluted EPS inclusive of noncontrolling interests, as prescribed by ASC 260-10-55-20(b), which states that "securities of a subsidiary that are convertible into its parent company's common stock shall be considered among the potential common shares of the parent company for the purposes of computing consolidated diluted EPS." The noncontrolling interests are primarily comprised of Class A units of QualityTech, LP, the Company's operating partnership (the "Operating Partnership"), which are redeemable for shares of Class A common stock of the Company ("Common Stock") on a one-for-one basis, which is discussed in Note 8 to the Consolidated Financial Statements of QTS Realty Trust, Inc. and QualityTech, LP for the year ended December 31, 2014 included in the Form 10-K ("2014 Financial Statements"). As such, in accordance with ASC 260-10-55-20(b), the Company has included these units (and their associated net income) in its diluted EPS calculation. The Company believes that including these units in its diluted EPS calculation presents investors and users of its financial statements a complete picture of the total number of shares and units (i.e., potential shares) that are party to the Company's consolidated net income, which is consistent with the way that the Company views this calculation.

The Company respectfully submits that while it has disclosed in Note 12 to its 2014 Financial Statements (Earnings per share of QTS Realty Trust, Inc.) the number and description of each of the types of dilutive securities it included in its diluted EPS calculation, in future filings the Company will disclose this information in a tabular reconciliation format and will disclose the number, if any, of antidilutive securities that it excluded from its diluted EPS calculation in a manner substantially similar to the following:

"Basic income (loss) per share is calculated by dividing the net income (loss) attributable to common shares by the weighted-average number of common shares outstanding during the period. Diluted income (loss) per share adjusts basic income (loss) per share for the effects of potentially dilutive common shares.

The computation of basic and diluted net income per share is as follows (in thousands, except per share data):

	Year Ended December 31, 2014	For the period October 15, 2013 through December 31, 2013
Numerator:		
Net income available to common stockholders - basic	$ 15,072	$ 3,154
Effect of net income attributable to noncontrolling interests	4,031	848
Net income available to common stockholders - diluted	$ 19,103	$ 4,002
Denominator:		
Weighted average shares outstanding - basic	29,055	28,973
Effect of Class A units and Class RS units *	7,770	7,797
Effect of Class O units and options to purchase Class A common stock on an "as if" converted basis *	309	24
Weighted average shares outstanding - diluted	37,134	36,794
Net income per share attributable to common stockholders - basic	$ 0.52	$ 0.11
Net income per share attributable to common stockholders - diluted	$ 0.51	$ 0.11

* The Class A units, Class RS units and Class O units represent limited partnership interests in the Operating Partnership, and are described in more detail in Note 8.

The computation of diluted net income per share for the year ended December 31, 2013 does not include 1,113,169 Class O units with an exercise price of $25.00, as their inclusion would have been antidilutive for that period. No securities were antidilutive for the year ended December 31, 2014, and as such, no securities were excluded from the computation of diluted net income per share for that period."

Note 16. Quarterly Financial Information (unaudited), page F-30

3. **Please tell us why the net income per share attributable to common shares – diluted is equal to the net income per share attributable to common shares – basic. Your disclosure on page F-28 indicates that there is a significant amount of dilutive shares outstanding.**

Response to Comment No. 3:

The Company respectfully submits that these two numbers are presented as being equal solely due to the effect of rounding. As described in the response to Comment 2 above, the vast majority of shares included in diluted shares (approximately 96% for the year ended December 31, 2014) that are not also included in basic shares are represented by Class A units of the Operating Partnership. Because these units are redeemable for shares of Common Stock on a one-for-one basis and because the Company's diluted net income also includes the income attributable to these units, these units have no effect on the EPS calculation (i.e., are neutrally dilutive). The remaining shares included in diluted shares that are not also included in basic shares (i.e., Class O units of the Operating Partnership on an "as if" converted basis and options to purchase Class A common stock on an "as if" converted basis, which totaled 309,378 on an "as if" converted basis for the year ended December 31, 2014), are not significant enough to change the disclosed EPS values, as those values are rounded to the nearest cent in all periods presented in Note 16 to the 2014 Financial Statements.

<u>Form 8-K/A filed June 5, 2015</u>

<u>Exhibit 99.3</u>

4. **We note that your pro forma financial statements include adjustments for the acquisition of the Princeton, NJ facility, the issuance of $300 million of senior unsecured notes, the issuance of $165 million Class A common stock, the acquisition of the Chicago, IL facility and the modification of the unsecured credit facility and the credit facility secured by the Richmond Property resulting in decreased interest rates on both. Please tell us whether these events are related to your Carpathia acquisition. To the extent that these events are not related to your Carpathia acquisition, please tell us why you included these adjustments within the pro forma financial statements in your Form 8-K.**

<u>Response to Comment No. 4</u>:

The Company's acquisition of its Princeton and Chicago facilities, issuance of $300 million of senior unsecured notes, issuance of $165 million Class A common stock and modification of its unsecured and secured credit facilities (the "Events") are not directly related to the Carpathia acquisition. The Company believes, however, that in presenting its pro forma financial statements in accordance with Rule 11-01(a)(1) of Regulation S-X, it is appropriate to include separate adjustments giving effect to the Events. The Company believes these separate adjustments are appropriate due to the materiality of the Events to investors and because each of the Events occurred during the period covered by the pro forma financial statements. Therefore, in accordance with Rule 11-01(a)(8), the Company included these adjustments in its pro forma financial statements, explicitly disclosing each of the Events in the introduction and footnotes to Exhibit 99.3 and including each of these adjustments in a separate column on the pro forma financial statements to distinguish them from the adjustments related to the Carpathia acquisition, allowing investors to explicitly identify the effects of the Carpathia acquisition. The Company believes this presentation provides the most meaningful information to users of its financial statements.

<u>Form 10-Q for the quarterly period ended June 30, 2015</u>

<u>Note 3 – Acquisitions</u>

<u>Carpathia Acquisition, page 19</u>

5. **We note that your allocation on page 20 is based upon a purchase price of $295 million inclusive of $44 million of assumed capital lease liabilities. We further note in your Form 8-K filed on June 2, 2015 that the $326 million purchase price disclosed on page 19 includes the assumption of capital lease liabilities which would appear to result in a $282 million purchase price. Please provide additional details regarding your basis for the $295 million purchase price.**

<u>Response to Comment No. 5</u>:

The Company respectfully submits that the $326 million purchase price disclosed in the Form 8-K and in the first sentence to Note 3 to the Interim Condensed Consolidated Financial Statements of QTS Realty Trust, Inc. and QualityTech, LP for the quarter ended June 30, 2015 included in the Form 10-Q ("Second Quarter Financial Statements") represents the purchase price for Carpathia Hosting, Inc. ("Carpathia") as defined in the related Stock Purchase Agreement. The Stock Purchase Agreement, which was filed as Exhibit 2.1 to the Company's Form 8-K filed on May 12, 2015, calculated the purchase price using Carpathia's historical *book value* of assets acquired and liabilities assumed. As such, the $295 million of net assets acquired was calculated by subtracting the book value of the capital leases of $37.1 million from the $326 million purchase price and adding back the cash acquired of $5.8 million. For clarification purposes, the Company disclosed in Note 3 to the Second Quarter Financial Statements that the $326 million purchase price was *<u>as defined in the purchase and sale agreement</u>*.

The purchase price based on the assessment of the *fair value* of assets acquired and liabilities assumed, as prescribed by GAAP, was approximately $352.5 million, calculated by adding the fair value of capital leases assumed of $43.8 million and the fair value of deferred income tax liability assumed of $19.8 million to the $294.7 million (i.e. $295 million), and subtracting the cash acquired of $5.8 million. In future filings, the Company will explicitly disclose the purchase price based on the assessment of the fair value of assets acquired and liabilities assumed rather than the purchase price as defined in the Stock Purchase Agreement.

6. We note that the pro forma financial information on page 20 includes adjustments for the acquisition of the Princeton, NJ facility, the issuance of $300 million of senior unsecured notes, the issuance of $387 million Class A common stock, the acquisition of the Chicago, IL facility and the modification of the unsecured credit facility and the credit facility secured by the Richmond Property resulting in decreased interest rates on both. Please tell us whether these events are related to your Carpathia acquisition. To the extent that these events are not related to your Carpathia acquisition, please tell us your basis in GAAP for including adjustments within your pro forma financial information.

Response to Comment No. 6:

As stated in the response to Comment No. 4 above, the Events are not directly related to the Carpathia acquisition, with the exception of the issuance of 5,750,000 shares of Class A common stock in June 2015, the net proceeds of which were used to fund a portion of the Carpathia acquisition. The Company included adjustments for each of the Events in the pro forma financial information on page 20 of Form 10-Q for the reason described in the response to Comment No. 4 above and in order to provide a presentation that was consistent with the pro forma presentation in the Form 8-K. In future filings, the Company will disclose pro forma financial information in accordance with GAAP (ASC 805), calculating pro forma adjustments based solely on the combined results of the Company and Carpathia.

* * * * *

The Company acknowledges that (i) it is responsible for the adequacy and accuracy of the disclosure in the filings; (ii) Staff comments or changes to disclosure in response to Staff comments do not foreclose the Commission from taking any action with respect to the filings; and (iii) the Company may not assert Staff comments as a defense in any proceeding initiated by the Commission or any person under the federal securities laws of the United States.

VIA EDGAR

September 15, 2015

Kristi Marrone, Staff Accountant
Division of Corporation Finance
United States Securities and Exchange Commission
Washington, D.C. 20549

Re: Ramco-Gershenson Properties Trust
Form 10-K for the Fiscal Year Ended December 31, 2014
Filed February 27, 2015
File No. 1-10093

Dear Ms. Marrone:

We are writing in response to the letter of the Division of Corporation Finance, dated August 31, 2015, addressed to Ramco-Gershenson Properties Trust, a Maryland corporation (the "Company"), in connection with the above-referenced filing. For convenience we have incorporated each of the comments included in your letter in italicized text followed by our response.

Item 6. Selected Financial Data, page 25

Business Objectives, Strategies and Significant Transactions, page 2

1. *Please tell us and disclose in future filings how you define Property NOI, highlighting any differences between Property NOI and Same Property NOI as disclosed on page 37.*
We may have additional comments.

Response:

Property NOI includes all consolidated property income and expenses, including sold and acquired properties, and excluding management and other fee income, depreciation and amortization, acquisition costs, general and administrative expenses and provision for impairment. The difference between Property NOI and Same Property NOI is that Same Property NOI makes non-comparable adjustments related to acquired, development/redevelopment, non-retail and sold properties as well as certain income/expense amounts as described on page 37 of the Form 10-K.

In future filings, we intend to replace Property NOI in the Item 6 disclosure with Operating Income (as presented in accordance with GAAP.)

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

Comparison of the Year Ended December 31, 2014 to the Year Ended December 31, 2013 page 28

2. *We note that during 2014 you recorded impairment of $23.3 million to land available for development or sale due to changes to development plans and to estimated fair values. Please expand your disclosure in future filings to discuss how your plans changed and how this specifically impacted the carrying values of the subject properties.*

Response:

In future filings we will discuss how our plans changed and how this specifically impacted the carrying values of the subject properties

Funds From Operations, page 35

3. *Please tell us why you believe it is appropriate to include an adjustment for preferred share dividends only to the extent that they are dilutive when calculating FFO and Operating FFO. In that regard, it appears that the dilutive attribute of the preferred shares may only be relevant for calculating FFO per diluted share and Operating FFO per diluted share.*

Response:

The dilutive attribute of the preferred shares is only relevant for calculating FFO per diluted share and Operating FFO per diluted share. Therefore, in future filings we will exclude such adjustment when calculating FFO and Operating FFO. Instead, any adjustment required to FFO and to Operating FFO when computing such items per diluted share will be described in new footnotes to the table on page 36. In future filings, our presentation of the table will be as follows:

	Years Ended December 31,		
	2014	**2013**	**2012**
	(In thousands, except per share data)		
Net (loss) income available to common shareholders	$ (9,614)	$ 3,747	$ (46)
Adjustments:			
Rental property depreciation and amortization expense	80,826	56,316	39,240
Pro-rata share of real estate depreciation from unconsolidated joint ventures	4,719	3,689	6,584
Gain on sale of depreciable real estate	(10,022)	(2,120)	(336)
Loss on sale of joint venture depreciable real estate (1)	—	6,454	75
Provision for impairment on income-producing properties	4,580	9,342	2,355
Provision for impairment on joint venture income-producing properties (1)	—	—	50
Provision for impairment on equity investments in unconsolidated joint ventures	—	—	386
Deferred gain recognized on real estate	(117)	(5,282)	(845)
Noncontrolling interest in Operating Partnership (2)	(48)	465	353
FFO	$ 70,324	$ 72,611	$ 47,816
Provision for impairment for land available for development or sale	23,285	327	1,387
Loss on extinguishment of debt	860	340	—
Gain on extinguishment of joint venture debt, net of RPT expenses (1)	(106)	—	(178)
Acquisition costs (4)	1,890	1,322	314
Operating FFO	$ 96,253	$ 74,600	$ 49,339
Weighted average common shares	72,118	59,336	44,101
Shares issuable upon conversion of Operating Partnership Units (2)	2,250	2,257	2,509
Dilutive effect of securities	217	392	384
Subtotal	74,585	61,985	46,994
Shares issuable upon conversion of preferred shares (3) (5)	7,019	6,940	—
Weighted average equivalent shares outstanding, diluted	81,604	68,925	46,994
Funds from operations per diluted share (6)	$ 0.94	$ 1.16	$ 1.02
Operating FFO, per diluted share (7)	$ 1.27	$ 1.19	$ 1.05

(1) Amount included in earnings (loss) from unconsolidated joint ventures.

(2) The total noncontrolling interest reflects OP units convertible 1:1 into common shares.

(3) Series D convertible preferred shares were dilutive for FFO for the year ended December 31, 2013 and anti-dilutive for the comparable periods in 2014 and 2012.

(4) Prior periods have been restated to reflect the add back of acquisition costs beginning in 1Q14.

(5) Series D convertible preferred shares were dilutive for Operating FFO for years ended December 31, 2014 and 2013 and anti-dilutive for the comparable period in 2012

(6) FFO per diluted share calculated for the year ended December 31, 2013 includes the adjustment to FFO of $7.25 million in dividends related to convertible preferred shares

(7) Operating FFO per diluted share calculated for the years ended December 31, 2014 and 2013 include the adjustment to Operating FFO of $7.25 million in dividends related to convertible preferred shares

-

Same Property Operating Income, page 37

4. *We note that the adjustment for "properties excluded from pool" is significant to both operating income (loss) and Same Property NOI, though only twelve of your 68 properties are considered non-same property for purposes of calculating this measure. Please tell us why this adjustment is so large on a relative basis, and disclose in future filings to the extent material.*

Response:

The adjustment for "properties excluded from pool" is large on a relative basis primarily because it reflects six large acquisitions made during the periods being compared.

The significant adjustments for the three and the twelve months ended December 31, 2014 are attributable as follows:

Property Designation	Three Months Ended	Twelve Months Ended
	December 31, 2014	
Acquisitions	$ 7,070	$ 20,872
Dispositions	136	2,061
Development/Redevelopment	1,217	4,614
Non-Retail Properties	453	1,804
	$ 8,876	$ 29,351

In future filings, to the extent material, we will include an explanation for significant adjustments.

5. *Please expand your disclosure in future filings, and tell us supplementally, what is included in "non-comparable income/expense adjustments."*

Response:

As stated in our Form 10-K for the year ended December 31, 2014, in the first paragraph under the heading Same Property Operating Income on page 37, amounts included in “non-comparable income/expense adjustments” for the quarter and year ended December 31, 2014 and 2013 include: straight-line rents, lease termination fee, above/below market rents, and other non-comparable income and expense adjustments. Other non-comparable income and expense adjustments are public improvement fee income and prior-period recovery income adjustments.

In future filings, we will instead include a table footnote describing “non-comparable income/expense adjustments” for the reporting period.

Following is an example of the future table footnote disclosure:

(1) Includes adjustments for items that affect the comparability of the same property NOI results. Such adjustments include: straight-line rents, lease termination fee, above/below market rents, public improvement fee income and prior-period recovery income adjustments.

In connection with the response above, the Company acknowledges that (i) it is responsible for the adequacy and accuracy of the disclosure in the filing, (ii) Staff comments or changes to disclosure in response to Staff comments do not foreclose the Commission from taking any action with respect to the filing, and (iii) it may not assert staff comments as a defense in any proceeding initiated by the Commission or any person under the federal securities laws of the United States.

If you have any questions with regard to this letter or require additional information, please contact me at (248) 592-6200, or at gandrews@rgpt.com.

Sincerely,

/s/ GREGORY R. ANDREWS

Gregory R. Andrews
Chief Financial Officer and Secretary

REALTY INCOME
The Monthly Dividend Company®

Realty Income Corporation
11995 El Camino Real, San Diego, CA 92130
New York Stock Exchange Symbol "O"

March 13, 2015

VIA EDGAR

Mr. Mark Rakip
Staff Accountant
Division of Corporation Finance
United States Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

Re: **Realty Income Corporation**
Form 10-K for the fiscal year ended December 31, 2014
Filed February 18, 2015
File No. 1-13374

Dear Mr. Rakip:

We are writing in response to your comment letter dated March 11, 2015 (the "Comment Letter") provided by the staff (the "Staff") of the Securities and Exchange Commission (the "Commission"). The Comment Letter relates to Realty Income Corporation's (the "Company") Annual Report on Form 10-K for the year ended December 31, 2014 (the "2014 Form 10-K") filed with the Commission on February 18, 2015.

The material in italics below sets forth the Staff's comment, followed by our response.

Financial Statements and Supplementary Data

Allocation of the Purchase Price of Real Estate Acquisitions, page 59

1. Regarding your below-market lease intangible liabilities, please tell us how you consider any bargain renewal options in determining the amortization period.

Response: We do consider bargain renewal options in the determination of the amortization period of below-market lease intangible liabilities. When making this determination we compare the contractual rents for the option period to the expected market rents at the time of exercise. If the contractual rent is sufficiently lower than the expected market rent, such that the exercise of the option appears to be reasonably assured, then the option period is considered to be a bargain renewal option and the option period is included in the lease term used for purposes of amortization.

In future filings, we will add the italicized phrase below to the following paragraph currently included on page 60 of the 2014 Form 10-K:

Capitalized above-market lease values are amortized as a reduction of rental income over the remaining terms of the respective leases. Capitalized below-market lease values are amortized as an increase to rental income over the remaining terms, *including expected below-market renewal option periods*, of the respective leases.

***

In making this response, the Company acknowledges that (i) we are responsible for the adequacy and accuracy of the disclosure in the filing, (ii) the Staff's comments or changes to disclosure in response to the Staff's comments do not foreclose the Commission from taking any action with respect to the filing, and (iii) the Company may not assert the Staff comments as a defense in any proceeding initiated by the Commission or any person under the federal securities laws of the United States.

If you have any questions or comments to this letter, please do not hesitate to contact me at (858) 284-5109.

Sincerely,

Realty Income Corporation

/s/ Paul M. Meurer

Paul M. Meurer
Executive Vice President,
Chief Financial Officer and Treasurer

REALTY INCOME
The Monthly Dividend Company®

Realty Income Corporation
11995 El Camino Real, San Diego, CA 92130
New York Stock Exchange Symbol "O"

March 20, 2015

VIA EDGAR

Mr. Mark Rakip
Staff Accountant
Division of Corporation Finance
United States Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

Re: **Realty Income Corporation**
Form 10-K for the fiscal year ended December 31, 2014
Filed February 18, 2015
File No. 1-13374

Dear Mr. Rakip:

We are writing in response to your comment letter dated March 17, 2015 (the "Comment Letter") setting forth the additional comment of the staff (the "Staff") of the Securities and Exchange Commission (the "Commission"). The Comment Letter relates to Realty Income Corporation's Annual Report on Form 10-K for the year ended December 31, 2014 filed with the Commission on February 18, 2015.

The material in italics below sets forth the Staff's comment, followed by our response.

Financial Statements and Supplementary Data

Allocation of the Purchase Price of Real Estate Acquisitions, page 59

1. *We note your response to prior comment 1. Please tell us how you define sufficiently lower in determining the difference between the contractual and expected market rents. Also tell us how you determine that the exercise of a bargain renewal option is reasonably assured, including whether you consider historical experience in determining such exercises. Further, quantify for us the number of leases in your portfolio that have bargain renewal options. In your response, tell us the accounting literature relied upon and the basis for your conclusions.*

Response: The following bullet points summarize our internal "Valuation of Newly Acquired Properties" policy as it relates to the above question. As of December 31, 2014, we have 121 leases in our portfolio that have bargain renewal options.

- We refer to Accounting Standards Codification ("ASC") 840-10-20, when evaluating whether a below market option is considered a bargain renewal option. This accounting literature defines a bargain renewal option as:
  - A provision allowing the lessee, at his option, to renew the lease for a rental sufficiently lower than the fair rental of the property at the date the option becomes exercisable that exercise of the option appears, at the inception of the lease, to be reasonably assured.

- We define contractual option rents as being “sufficiently lower” when they are:

    - o 15% below expected market rents and the option exercise date is within 15 years from the date of acquisition,

    - o 20% below expected market rents and the option exercise date is between 15 and 20 years from the date of acquisition, or

    - o 25% below expected market rents and the option exercise date is between 20 and 25 years from the date of acquisition.

  We recognize that options with an exercise date 25 years or more from the date of acquisition or options resulting in an extension of the lease term to a date more than 25 years from the date of acquisition are uncertain by nature, due to market volatility, going concern and other uncertain factors, and therefore do not meet the burden of reasonable assurance.

- In determining whether the exercise of a bargain renewal option is “reasonably assured,” we take into account both the size of the discount to expected market rents as well as the length of time between the acquisition date and the option exercise date. Our policy acknowledges that contractual option rents that are only slightly discounted (i.e. less than 15%) from market do not sufficiently incentivize a tenant to exercise their option, due to factors such as the availability of newer buildings and location optimization. When considering the additional costs and efforts necessary to relocate, in addition to the 15% discount on rents realized when extending the lease, we believe that tenants then become economically compelled to exercise their option. Accordingly, we assume that a minimum 15% discount between contractual option rents and expected market rents is required for the bargain renewal option to be reasonably assured.

- Our policy also acknowledges the fact that the longer the period from inception of the lease to the option exercise date, the more difficult it is to determine whether the exercise of the option is reasonably assured. Accordingly, as more time elapses from the date of acquisition, a larger discount is required between contractual option rents and expected market rents in order to offer reasonable assurance that the tenant will exercise their option.

We do have extensive experience with lease expirations, having resolved over 1,800 lease rollovers in the past 20 years. This experience offers us additional insight as to whether a tenant will likely renew a lease upon expiration. However, our specific experience with bargain renewal option rollover is relatively limited. We believe that the parameters established in our policy, although not directly driven by historical data, are reflective of the insight obtained through our lease rollover history and allow us to objectively apply the accounting literature included in ASC 840 in our determination of bargain renewal options.

***

If you have any questions or comments to this letter, please do not hesitate to contact me at (858) 284-5109.

Sincerely,

Realty Income Corporation

/s/ Paul M. Meurer

Paul M. Meurer
Executive Vice President,
Chief Financial Officer and Treasurer

Realty Income Corporation
11995 El Camino Real, San Diego, CA 92130
New York Stock Exchange Symbol "O"

REALTY INCOME
The Monthly Dividend Company®

April 8, 2015

VIA EDGAR

Mr. Mark Rakip
Staff Accountant
Division of Corporation Finance
United States Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

Re: **Realty Income Corporation**
Form 10-K for the fiscal year ended December 31, 2014
Filed February 18, 2015
File No. 1-13374

Dear Mr. Rakip:

We are writing in response to your comment letter dated March 27, 2015 (the "Comment Letter") setting forth the additional comment of the staff (the "Staff") of the Securities and Exchange Commission (the "Commission"). The Comment Letter relates to Realty Income Corporation's Annual Report on Form 10-K for the year ended December 31, 2014 filed with the Commission on February 18, 2015.

The material in italics below sets forth the Staff's comment, followed by our response.

Financial Statements and Supplementary Data

Allocation of the Purchase Price of Real Estate Acquisitions, page 59

1. *We note your response to prior comment 1. Please tell us the basis for your use of discounts between expected market rents and the contractual option rents in assessing your bargain renewal option and how your policy complies with ASC 805-20-25-12. In your response, explain how you concluded that the parameters established in your policy are appropriate given your limited experience with bargain renewal option rollovers. Further, tell us the potential impact to your financial statements if you considered all bargain renewals exercised regardless of discount to expected market rents and duration between acquisition and renewal dates.*

Response:

For each lease we assume through acquisition of a property, we apply ASC 805-20-25-12 to determine whether the terms of the lease are favorable or unfavorable compared with the market terms of a lease for a similar property at the acquisition date. If the terms are favorable, an above-market lease intangible asset is recorded, and if the terms are unfavorable, a below-market lease liability is recorded. ASC 805-20-25-12 does not provide us with further guidance on how to arrive at the fair value of the above- or below-market lease intangible asset or liability, so we refer to ASC 820 and ASC 840 for the appropriate valuation guidance. Our reference to "discounts" in our prior response and as used below is in relation to the difference between our estimates of market rents at the time of the renewal in comparison to the rate available to the tenant under the renewal option. ASC 820 provides detailed guidance for using management's judgment and other market participant consideration in assessing fair value when quoted prices are not available.

As previously mentioned in our earlier responses, we have extensive experience in acquiring and managing operating properties over multiple business cycles throughout our 46-year history. During these 46 years, we have established in-house acquisition, portfolio management, asset management, credit research, and real estate research expertise. Within our portfolio management department, we have a leasing team that actively negotiates lease renewals with current and new tenants and has access to current market rental rate data in markets across the country where our properties are located. In fact, over the last several years, we have resolved over 1,800 lease rollovers.

Based on our experience with respect to pre-negotiated options to renew, we note that tenants typically make renewal decisions based upon a variety of both quantitative and qualitative factors. Our experience has shown that contractual option rents that are only slightly below market may not sufficiently incentivize a tenant to exercise their option, due to factors such as the availability of newer buildings and location optimization, among others. Accordingly, we believe that a renewal rate that is "sufficiently lower" than market rates is required for the threshold of "reasonably assured" to be met under ASC 840-10-20 (which defines bargain renewal options).

We have relied upon our extensive experience negotiating leases with tenants to both establish our "Valuation of Newly Acquired Properties" policy and to determine the parameters that we outlined in our previous response. We note that the authoritative guidance included in ASC 840-10-20 does not provide quantitative thresholds for us to use in making an assessment of whether rental rates are "sufficiently lower" so that exercise is reasonably assured; accordingly, we are required to apply professional judgment in determining whether this threshold is met. Therefore, based on our experience, our research of other real estate companies, and the methodologies utilized by third-party valuation experts, we believe and respectfully advise the Staff that our definition of "sufficiently lower", as described in our previous response letter, is in-line with how a market participant would consider such options.

Per our valuation policy referenced above, we define bargain renewal options as contractual rents being "sufficiently lower" (per ASC 840-10-20) than the estimated market rents for the property when they meet specific thresholds of between 15% to 25%, depending on the amount of time until the future option exercise date(s). However, we evaluate each real estate lease acquired to determine whether a renewal option is considered a bargain renewal option (i.e., reasonably assured of exercise) based on the facts and circumstances existing at the acquisition date. These factors include, but are not limited to, length of the in-place lease, the contractual ability of the tenant to sublease their space, financial performance of the property, financial performance of the individual tenant, the overall economic climate, and any other known facts or circumstances surrounding the tenant's business operations.

Based on our market knowledge and extensive leasing and re-leasing experience, we have developed our valuation policy in an attempt to reflect what an active market participant would consider as a "bargain" renewal option. Consequently, we have determined that the exercise of a bargain renewal option is "reasonably assured" when the lease renewal rate is at least 15% below expected market rents (we respectfully refer the Staff to our previous response for the various step parameters). Because we have determined that renewal rates that are less than 15% below estimated market rents are not reasonably assured of exercise and do not constitute a bargain renewal, we do not quantify the impact of such renewal options in our valuation models.

In response to your request, we quantified the incremental impact to our financial statements if we assumed that all renewal options would be exercised regardless of discount to expected market rents and duration between acquisition and renewal dates. For this quantification, we evaluated all 211 of our 2014 acquisitions that included the assumption of an in-place lease, which represents approximately 16% of the 1,291 in-place leases in our portfolio as of December 31, 2014. Of this population of 211 in-place leases, there were 87 with renewal options that were below the expected market rent. The following summarizes the overall incremental impact on our consolidated 2014 financial statements, assuming that all of the renewal options for these 87 in-place leases were exercised, regardless of discount to expected market rents and duration between acquisition and renewal dates. The "Projected incremental impact on financial statements" column below represents an extrapolation based on the 2014 impact from including renewal options less than 15% below estimated market rents, which, as described above, is something we do not include in our valuation models:

Impact on financial statement caption	Incremental impact from 2014 in-place lease acquisitions	Projected incremental impact on financial statements
Increase in acquired lease intangible liabilities, net	$22,000,000	$69,900,000
% of total assets as of December 31, 2014	0.20%	0.63%
Decrease to rental revenue (1)	$(800,000)	$(1,400,000)
% of total 2014 revenue	(0.09)%	(0.15)%

(1) When quantifying the income statement impact from the 2014 in-place lease acquisitions, we adjusted the amortization period to properly include all option periods considered to be exercised. The amortization impact of using this extended term outweighed the amortization impact from the incremental increase to acquired lease intangible liabilities, net, and resulted in a decrease to rental revenue on an annualized basis.

Based on the foregoing, we respectfully represent to the Staff that the projected impact from our in-place leases with renewal options that are below the expected market rents regardless of discount to expected market rents and duration between acquisition and renewal dates would not have a material impact on our consolidated 2014 financial statements.

***

If you have any questions or comments to this letter, please do not hesitate to contact me at (858) 284-5109.

Sincerely,

Realty Income Corporation

/s/ Paul M. Meurer

Paul M. Meurer
Executive Vice President,
Chief Financial Officer and Treasurer

REDWOOD TRUST

One Belvedere Place
Suite 300
Mill Valley, CA 94941

July 22, 2015

VIA EDGAR AND E-MAIL
Securities and Exchange Commission
Division of Corporation Finance
100 F Street, N.W.
Washington, D.C. 20549

Attn: Jaime G. John
Branch Chief
Division of Corporation Finance

Re: Redwood Trust, Inc.
Responses to Comments on:
Form 10-K for the Fiscal Year Ended December 31, 2014
Filed on February 25, 2015
Form 10-Q for the Quarterly Period Ended March 31, 2015
Filed May 7, 2015

File No. 1-13759

Dear Mr. John,

On behalf of Redwood Trust, Inc. ("Redwood"), I hereby provide the following response in reply to the Staff's comment letter dated June 24, 2015 (the "Comment Letter") in connection with the above-referenced Annual Report on Form 10-K (the "2014 Form 10-K") and Quarterly Report on Form 10-Q (the "2015 Q1 Form 10-Q"). For your convenience, each of my responses is preceded with an italicized recitation of the comment set forth in the Comment Letter.

Form 10-K for the fiscal year ended December 31, 2014

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

1. *Please provide us with additional details regarding your Mortgage Servicing Rights investments (MSRs) including whether you have retained the basic MSR and excess MSR. Additionally, tell us the weighted average yield that you have earned on these assets for all periods presented and whether you have any outstanding servicer advances. Please update your disclosure in future filings accordingly.*

We own MSRs associated with both jumbo and conforming residential mortgage loans, which we refer to as "Jumbo MSRs" and "Conforming MSRs," respectively. Our MSRs are retained from the sale of loans or are purchased on a stand-alone basis, as outlined on page 63 of the 2014 Form 10-K.

Base and excess MSR

We distinguish base (or "basic") and excess MSRs in accordance with IRS specified "safe harbor" levels of servicing fees they consider to be reasonable compensation (or "base" fees) for servicing various loan types. For conforming loans, the IRS considers fees up to 0.25% (of associated loan principal) to be base fees, and for jumbo loans, fees up to 0.375% (of associated loan principal) to be base fees.

Our Jumbo MSRs entitle us to a contractually specified servicing fee, with rates ranging from 0.25% to 0.375%, and are therefore all considered base fees under the IRS safe harbor. As of December 31, 2014 and 2013, the weighted average servicing fee rate on our Jumbo MSRs was 0.25%. Our Conforming MSRs entitle us to a contractually specified servicing fee, with rates ranging from 0.25% to 0.70%. As of December 31, 2014 and 2013, our portfolio of Conforming MSRs had a fair value of $81.3 million and $3.3 million, respectively, and of these amounts MSRs with fair values of approximately $100,000 and $30,000, respectively, had servicing fees in excess of 0.25%.

MSR Yields

Our gross cash yield on MSRs (calculated by dividing the annual gross servicing fees we received, by the weighted average notional balance of loans associated with MSRs we owned during the year) was 0.23%, 0.23%, and 0.18% for the years ended December 31, 2014, 2013 and 2012, respectively.

Servicer Advances

At both December 31, 2014 and December 31, 2013, we had approximately $1.0 million and $800,000, respectively, of servicer advances, primarily related to recoverable escrow advances, presented in “Other assets” on our balance sheet.

In accordance with the comment letter request, in future filings, we will update our disclosures to include the amount of MSRs we own with excess servicing and the amount of servicing advances associated with MSRs as of each balance sheet date presented, as well as the gross cash yield on our MSRs for each period presented in our statements of income.

Item 8. Financial Statements and Supplementary Data

2. *We note your disclosure on page F-36 that the fair value for residential loans is determined based on either an exit price to securitization or the whole loan market. Please tell us how you determine which of these two markets to use for your residential loans and how you have concluded that the market used in your valuation is the principal or most advantageous market.*

We carry our jumbo residential mortgage loans (“jumbo loans”) at fair value, as they have historically represented our loan inventory for our residential mortgage banking activities. Our jumbo loans held-for-sale have typically been held on balance sheet from 30-60 days, until they are sold or securitized. With the reasonably high turnover, quarter-end estimates of fair value for these loans are quickly realized in subsequent quarters.

Since prices or quotes from exchanges or listed markets are not available for jumbo loans, we estimate fair value for these loans using internal models that incorporate various observable and unobservable inputs, including the transactional activity noted above. We have not viewed the various purchasers of jumbo loans (e.g., whole loan investors, resellers, or securitization aggregators) as representative of separate markets, but rather as part of a single “secondary market” for jumbo loans. In fact, many purchasers fall into more than one of these categories and acquire jumbo loans for differing reasons. Similarly, sellers of jumbo loans typically seek bids for jumbo loans from many different types of purchasers, rather than solely from one category of purchasers. We view this single secondary market as the principal market, with various market participants providing varying pricing inputs each quarter. During 2014, the difference in fair value estimates implied by pricing inputs provided by different types of purchasers was minimal.

In considering the Staff’s comment, we plan to update our disclosures in future filings to clarify the existence of a single principal market for jumbo loans, as opposed to two distinct markets. The updated language we intend to use is as follows:

> Estimated fair values for residential loans are determined using models that incorporate various observable and unobservable inputs, including pricing information from recent securitizations and whole loan sales. Certain significant inputs in these models are considered unobservable and are therefore Level 3 in nature. Pricing inputs obtained from market securitization activity include indicative spreads to indexed TBA prices for senior RMBS and indexed swap rates for subordinate RMBS, which are adjusted as necessary for current market conditions (Level 3). Pricing inputs obtained from market whole loan transaction activity include indicative spreads to indexed swap rates, adjusted as necessary for current market conditions (Level 3). Other observable inputs include Agency RMBS pricing, indexed swap yields, credit rating agency guidance on expected credit support levels for newly issued RMBS transactions, benchmark interest rates, and prepayment rates. These assets would generally decrease in value based upon an increase in the credit spread, prepayment speed, or credit support assumptions.
>
> Estimated fair values for conforming loans are determined based upon quoted market prices (Level 2). Conforming loans are mortgage loans that conform to Agency guidelines. As necessary, these values are adjusted for servicing value, market conditions and liquidity.

Form 10-Q for the quarterly period ended March 31, 2015

Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations

3. *We note your disclosure on page 70 that you began to account for commitments to purchase jumbo loans as derivatives as a result of amendments to the agreements governing these commitments. Please provide to us additional details regarding the terms of the referenced amendments, how they qualify your loan purchase commitments to be accounted for as a derivative, and quantify the impact to your financial statements. Also, tell us the accounting guidance upon you which you relied.*

We purchase jumbo residential mortgage loans (“jumbo loans”) from various bank and non-bank loan originators, which we refer to as “Sellers.” Our purchases of jumbo loans from these Sellers are governed by mortgage loan purchase and sale agreements (or “MLPSAs”). Prior to January 1, 2015, our MLPSAs were drafted such that there was no legally enforceable commitment by us to purchase a jumbo loan that we and the Seller had specified until a purchase price and terms letter (“PPTL”) relating to that loan was executed by both parties. Once the PPTL was executed by both parties, a contractual purchase and sale commitment between the parties was established; and, consequently, it was only at the time the PPTL was executed that a commitment to purchase a jumbo loan could be assessed under derivatives accounting guidance. Of note, this commitment does not represent an “Interest Rate Lock Commitment” to a borrower as we do not originate any residential loans ourselves.

Prior to January 1, 2015, we generally entered into PPTLs on the same day we purchased the related jumbo loan – *i.e.*, on the same day we wired the purchase price to the Seller and the Seller conveyed ownership of the loan to us. Under this framework, even if an executed PPTL were to qualify as a derivative, we did not have open PPTLs at any quarter-end (because commitments to purchase jumbo loans were made and fulfilled on the same day) and, therefore, had no jumbo loan purchase commitments to assess as derivatives for financial reporting purposes.

During the latter part of 2014, we executed amendments to the MLPSAs we had in place with Sellers to affect certain new terms relating to purchase and sale commitments. Under the amendments, these new terms became effective on January 1, 2015. In addition, we changed our standard form MLPSA to affect the same new terms in new MLPSAs we entered into with new Sellers on and after January 1, 2015.

As of January 1, 2015, all of our MLPSAs specify that our commitment to purchase a jumbo loan (and the Seller's corresponding commitment to sell us that loan) is established when we deliver a confirmation to the Seller relating to that loan. We now typically deliver a confirmation 30-45 days prior to when we expect to fulfill our commitment to purchase a loan. Because a contractual commitment is established well before a jumbo loan will be purchased, beginning with the quarter ended March 31, 2015, we assessed our open commitments to purchase jumbo loans under derivative accounting guidance to determine if these open commitments qualified as derivatives.

In analyzing these open commitments, we looked to ASC 815-10-15, paragraphs 69-71, which discuss the accounting treatment for "Certain Loan Commitments." In accordance with paragraph 70 (formerly DIG C13), all commitments to purchase or sell mortgage loans must be evaluated under the definition of a derivative. Therefore, we have evaluated open commitments to purchase jumbo loans using the guidance in ASC 815-10-15-83, "Derivatives and Hedging – Definition of Derivative Instrument." In accordance with this guidance, we determined that our current MLPSAs and associated confirmations are contractual commitments and evaluated the following required criteria to assess whether they meet the definition of a derivative:

a. <u>Underlying, notional amount, payment provision requirement</u>

With respect to our jumbo loans, the related MLPSA and confirmation evidence a purchase and sale obligation (a settlement requirement), specify the principal amount of the loan to be purchased, and specify the purchase price for the loan.

This satisfies the first criterion under ASC 815-10-15-83's definition of a derivative.

b. <u>Initial net investment requirement</u>

With respect to our jumbo loans, the related MLPSA and confirmation require no initial net investment.

This satisfies the second criterion under ASC 815-10-15-83's definition of a derivative.

c. <u>Net settlement requirement</u>

ASC 815-10-15 paragraphs 99-139 discuss net settlement provisions. We evaluated each of the three means by which the net settlement criterion can be satisfied and determined that our underlying jumbo loans are readily convertible into cash.

This satisfies the third criterion under ASC 815-10-15-83's definition of a derivative.

Accordingly, as we meet the specified criteria in ASC 815-10-15, we concluded that our current jumbo loan purchase commitments are considered derivatives in accordance with GAAP and we began to account for commitments entered into under our amended MLPSAs as derivatives beginning on January 1, 2015.

At March 31, 2015, we had $5.3 million of derivative assets and $0.8 million of derivative liabilities associated with jumbo loan purchase commitments recorded on our balance sheet. These amounts are included in our disclosures on page 37 of our 2015 Q1 Form 10-Q.

* * *

As you have requested, we confirm that:

- Redwood is responsible for the adequacy and accuracy of the disclosure in the above-referenced filings;
- Staff comments or changes to disclosure in response to staff comments do not foreclose the Commission from taking any action with respect to the filings; and
- Redwood may not assert staff comments as a defense in any proceeding initiated by the Commission or any person under the federal securities laws of the United States.

Should you have any further comments or questions about this letter, please contact me by telephone at 415-384-3584, by fax at 415-381-1773, or by email at chris.abate@redwoodtrust.com.

Very truly yours,

Redwood Trust, Inc.

By: /s/ CHRISTOPHER J. ABATE
Christopher J. Abate
Chief Financial Officer

August 24, 2015

VIA EDGAR AND E-MAIL
Securities and Exchange Commission
Division of Corporation Finance
100 F Street, N.W.
Washington, D.C. 20549

Attn: Jaime G. John
Branch Chief
Division of Corporation Finance

Re: Redwood Trust, Inc.
Responses to Comments on:
Form 10-K for the Fiscal Year Ended December 31, 2014
Filed on February 25, 2015
Form 10-Q for the Quarterly Period Ended March 31, 2015
Filed on May 7, 2015

File No. 1-13759

Dear Mr. John,

On behalf of Redwood Trust, Inc. ("Redwood"), I hereby provide the following response in reply to the Staff's comment letter dated August 14, 2015 (the "Comment Letter") in connection with the above-referenced Annual Report on Form 10-K (the "2014 Form 10-K"). For your convenience, my response is preceded with an italicized recitation of the comment set forth in the Comment Letter.

Form 10-K for the fiscal year ended December 31, 2014

Item 8. Financial Statements and Supplementary Data

Note 5. Fair Value of Financial Instrument, F-29

1. *We note in your response to comment 2 that the difference in fair value estimates implied by pricing inputs obtained from market securitization activity versus from market whole loan transaction activity was minimal. Please clarify whether fair value estimates for your residential loans held-for-investment are based upon pricing inputs for both the securitization market and the whole loan market and if so, confirm that differences between fair value estimates based upon the two markets are minimal as it relates specifically to residential loans held-for-investment. Also, explain to us why you adjust the above pricing inputs and the nature of the adjustments.*

Fair value estimates for our residential loans held-for-investment are currently based only on whole loan pricing inputs. As such, there are not pricing differences between whole loan and securitization pricing inputs for our held-for-investment loans.

In the description of our determination of fair value in our Form 10-Q, we note that pricing inputs are "…adjusted as necessary for current market conditions." In certain cases, whole loan sales that provide comparative pricing inputs do not occur on the last day of the quarter and we must consider how spreads or other pricing inputs may have changed between the time of the most recent comparative sale and quarter-end. In certain cases, we will adjust pricing inputs from the most recent comparative sales to reflect changes in current market conditions that we observe. Generally speaking, adjustments made to pricing inputs for this purpose have been minimal as we have typically had sales that occurred close to quarter-end.

* * *

RETAIL OPPORTUNITY INVESTMENTS CORP.

June 29, 2015

VIA EDGAR & FEDEX

Ms. Jennifer Monick
Division of Corporation Finance
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

Re: Retail Opportunity Investments Corp.
Form 10-K for the Fiscal Year Ended December 31, 2014
Filed February 25, 2015
File No. 1-33749

Retail Opportunity Investments Partnership, LP
Form 10-K for the Fiscal Year Ended December 31, 2014
Filed February 25, 2015
File No. 333-189057-01

Dear Ms. Monick:

On behalf of Retail Opportunity Investments Corp. and Retail Opportunity Investments Partnership, LP (together, the "Company"), set forth below are the responses of the Company to the comments of the staff of the Division of Corporation Finance (the "Staff") of the Securities and Exchange Commission (the "Commission"), received by letter dated June 17, 2015 (the "June 17 Letter"), with respect to the Company's Form 10-K for the year ended December 31, 2014 (the "Form 10-K").

For the Staff's convenience, the responses to the Staff's comments are set out in the order in which the comments were set out in the June 17 Letter and are numbered accordingly. The text of the Staff's comments is set forth below in bold followed in each case by the response.

Form 10-K for the Fiscal Year Ended December 31, 2014

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

Funds From Operations, page 35

1. **We note you have recorded a gain on consolidation of joint venture for 2013 and 2012. In future periodic filings, please revise your reconciliation of Net income attributable to ROIC to FFO-basic and FFO-diluted to include an adjustment to exclude such gains.**

In response to the Staff's comment, the Company notes that during the respective periods in 2013 and 2012, the Company obtained control of two joint ventures and, following guidance from Accounting Standards Codification 805, *Business Combinations* ("ASC 805"), recorded gains on the consolidations. The Company also notes that in presenting funds from operations, or FFO, the Company follows the standard definition of FFO as set forth in the "White Paper" published by the National Association of Real Estate Investment Trusts ("NAREIT"), which defines FFO as "net income attributable to common stockholders (determined in accordance with GAAP) excluding gains or losses from debt restructuring, sales of depreciable property, and impairments, plus real estate related depreciation and amortization, and after adjustments for partnerships and unconsolidated joint ventures." The Company does not believe that the gains recorded on consolidation of joint ventures are of the type that under the White Paper should be excluded from net income in arriving at FFO.

Item 8. Financial Statements and Supplementary Data

Notes to Consolidated Financial Statements

1. Organization, Basis of Presentation and Summary of Significant Accounting Policies

Real Estate Investments, page 57

2. **We note your disclosure regarding your accounting policy for acquired intangible assets and liabilities. Specifically, we note your disclosure that the fair values associated with below-market rental renewal options are determined based on the Company's experience and the relevant facts and circumstances that existed at the time of the acquisitions. Please provide us with additional details regarding your evaluation of below-market rental renewal options. Your response should include, but not necessarily be limited to, whether or not you use a threshold in your evaluation. To the extent you use thresholds, please tell us how you concluded that these thresholds are appropriate and tell us the potential impact to your financial statements if you were to conclude that all below market fixed rate renewal options would be exercised.**

In response to the Staff's comment, the Company reviews each lease assumed through a property acquisition to determine whether the terms of the lease are favorable or unfavorable compared with market terms of a lease for a similar property. This review includes an evaluation of each lease acquired to determine whether renewal options, if any, are considered bargain renewal options, primarily based on comparing the contractual rents for the option period with the expected market rents at the time of option exercise. For this exercise, the Company uses a threshold of 5%. If a tenant's contractual rent is greater than 5% below expected market rent at the time of option exercise, our historical experience would indicate that it is probable that the tenant will choose to exercise their option and retain their space, thus avoiding business interruption and other costs associated with relocating their business. The Company believes, based on historical experience, that contractual option rents that are more than 5% below expected market rents provide sufficient reasonable assurance that the option will be exercised. The Company believes that contractual rents less than 5% below market may not be sufficiently below market to compel a tenant to exercise its option to extend.

In response to your request regarding the potential impact to the Company's financial statements, if the Company were to conclude that all below market fixed rate renewal options were to be exercised, the Company evaluated its 2014 acquisitions as a representative data set. During 2014 the Company acquired eight shopping centers. Of the 184 leases that were assumed, 35 were determined to have below market rental renewal options. Of these 35 leases, 30 were determined to have contractual option rents greater than 5% below expected market rents. Accordingly, the Company recorded intangible lease liabilities for these renewal options in the amount of $25,519,254. Five leases with below market rental renewal options were determined to have contractual rents that were less than 5% below expected market rents. The potential impact to the Company's financial statements of these five leases would be as follows:

Increase in acquired lease intangible liabilities, net	$	264,605
Total Liabilities as of December 31, 2014	$	888,914,167
% of Total Liabilities as of December 31, 2014		0.0003%
Increase to 2014 revenue due to amortization	$	423
Total Revenue for the year ending December 31, 2014	$	155,863,511
% of Total Revenue for the year ending December 31, 2014		inconsequential

Based on the foregoing, the Company believes that the potential impact, if it were to conclude that all below market fixed rate renewal options would be exercised, would not have a material impact on its consolidated financial statements for the year ending December 31, 2014.

Form 8-K filed April 29, 2015

Exhibit 99.1 Earnings Release, dated April 29, 2015

3. **We note that you present same-center cash net operating income (NOI) in your earnings releases. It appears that same-center cash NOI is a non-GAAP measure. Please revise future earnings releases to include all of the disclosures required by Item 10(e)(1)(i) of Regulation S-K for this measure. In your response, please provide an example of your proposed disclosure.**

In response to the Staff's comment, in future earnings releases, the Company will include all of the disclosures required by Item 10(e)(1)(i) of Regulation S-K. In addition, the following will be added to earnings releases using the quarter ending March 31, 2015 below as an example:

ACCOUNTING AND OTHER DISCLOSURES

The Company uses cash net operating income ("NOI") internally to evaluate and compare the operating performance of the Company's properties. The Company believes cash NOI provides useful information to investors regarding the Company's financial condition and results of operations because it reflects only those cash income and expense items that are incurred at the property level, and when compared across periods, can be used to determine trends in earnings of the Company's properties as this measure is not affected by non-cash revenue and expense recognition items, the cost of the Company's funding, the impact of depreciation and amortization expenses, gains or losses from the acquisition and sale of operating real estate assets, general and administrative expenses or other gains and losses that relate to the Company's ownership of properties. The Company believes the exclusion of these items from operating income is useful because the resulting measure captures the actual revenue generated and actual expenses incurred in operating the Company's properties as well as trends in occupancy rates, rental rates and operating costs.

Cash NOI is a measure of the operating performance of the Company's properties but does not measure the Company's performance as a whole and is therefore not a substitute for net income or operating income as computed in accordance with GAAP. The Company defines cash NOI as operating revenues (base rent and recoveries from tenants), less property and related expenses (property operating expenses and property taxes), adjusted for non-cash revenue and operating expense items such as straight-line rent and amortization of lease intangibles, debt-related expenses, and other adjustments. Cash NOI also excludes general and administrative expenses, depreciation and amortization, acquisition transaction costs, other expense, interest expense, gains and losses from property acquisitions and dispositions, extraordinary items, tenant improvements and leasing commissions. Other REITs may use different methodologies for calculating cash NOI, and accordingly, the Company's cash NOI may not be comparable to other REITs.

In this release, the Company has provided cash NOI information on a same-center basis. Same-center properties, which totaled 53 of the Company's 64 properties as of March 31, 2015, represent all operating properties owned by the Company during the entirety of both periods presented and consolidated into the Company's financial statements during such periods.

RECONCILIATION OF SAME-CENTER CASH NOI
TO OPERATING INCOME

(In thousands)

	Three months ended	
	3/31/2015	**3/31/2014**
Same-center cash NOI	$ 23,289	$ 22,401
Other adjustments (1)	(214)	875
Same-center cash NOI before adjustments	23,075	23,276
Non same-center cash NOI	6,987	750
Cash NOI	30,062	24,026
Straight-line rent adjustment	1,275	632
Amortization of above and below-market lease intangibles, net	2,330	1,997
Non-cash property operating expenses	(202)	(155)
Depreciation and amortization	(17,634)	(13,364)
General and administrative expenses	(2,641)	(2,561)
Acquisition transaction costs	(171)	(218)
Other expense	(149)	(217)
Operating Income	$ 12,870	$ 10,140

(1) Includes adjustments for items that affect the comparability of the same-center results. Such adjustments include: changes in estimates for common area maintenance costs and real estate taxes related to a prior period, lease termination fees, or other similar items that affect comparability.

Same-center cash NOI is a non-GAAP financial measure. The Company believes that same-center cash NOI is a widely used and appropriate supplemental measure of operating performance for REIT's and that it may provide a relevant basis for comparison among REITs. See also "Accounting and Other Disclosures" above.

4. **In addition to above, please tell us whether you consider same-center cash NOI a key performance indicator. To the extent you consider this measure to be a key performance indicator, please confirm that you will include this measure and the related Item 10(e) disclosures within your future periodic filings.**

In response to the Staff's comment, the Company advises the Staff that it considers same-center cash NOI to be a key performance indicator. In future periodic filings the Company will include this measure and the related disclosures required by Item 10(e) of Regulation S-K. The following will be added to future periodic filings using the quarter ending March 31, 2015 below as an example:

Cash Net Operating Income ("NOI")

Cash NOI is a non-GAAP financial measure of the Company's performance. The most directly comparable GAAP financial measure is operating income. The Company defines cash NOI as operating revenues (base rent and recoveries from tenants), less property and related expenses (property operating expenses and property taxes), adjusted for non-cash revenue and operating expense items such as straight-line rent and amortization of lease intangibles, debt-related expenses, and other adjustments. Cash NOI also excludes general and administrative expenses, depreciation and amortization, acquisition transaction costs, other expense, interest expense, gains and losses from property acquisitions and dispositions, extraordinary items, tenant improvements and leasing commissions. Other REITs may use different methodologies for calculating cash NOI, and accordingly, the Company's cash NOI may not be comparable to other REITs.

Cash NOI is used by management internally to evaluate and compare the operating performance of the Company's properties. The Company believes cash NOI provides useful information to investors regarding the Company's financial condition and results of operations because it reflects only those cash income and expense items that are incurred at the property level, and when compared across periods, can be used to determine trends in earnings of the Company's properties as this measure is not affected by non-cash revenue and expense recognition items, the cost of the Company's funding, the impact of depreciation and amortization expenses, gains or losses from the acquisition and sale of operating real estate assets, general and administrative expenses or other gains and losses that relate to the Company's ownership of properties. The Company believes the exclusion of these items from operating income is useful because the resulting measure captures the actual revenue generated and actual expenses incurred in operating the Company's properties as well as trends in occupancy rates, rental rates and operating costs.

Cash NOI is a measure of the operating performance of the Company's properties but does not measure the Company's performance as a whole and is therefore not a substitute for net income or operating income as computed in accordance with GAAP.

Same-Center Cash NOI

The following comparison for the three months ended March 31, 2015 compared to the three months ended March 31, 2014, makes reference to the effect of the same-center properties. Same-center properties, which totaled 53 of the Company's 64 properties as of March 31, 2015, represent all operating properties owned by the Company during the entirety of both periods presented and consolidated into the Company's financial statements during such periods.

The table below provides a reconciliation of same-center cash NOI to consolidated operating income for the three months ended March 31, 2015 and 2014 (in thousands).

	Three months ended	
	3/31/2015	**3/31/2014**
Same-center cash NOI	$ 23,289	$ 22,401
Other adjustments (1)	(214)	875
Same-center cash NOI before adjustments	23,075	23,276
Non same-center cash NOI	6,987	750
Cash NOI	30,062	24,026
Straight-line rent adjustment	1,275	632
Amortization of above and below-market lease intangibles, net	2,330	1,997
Non-cash property operating expenses	(202)	(155)
Depreciation and amortization	(17,634)	(13,364)
General and administrative expenses	(2,641)	(2,561)
Acquisition transaction costs	(171)	(218)
Other expense	(149)	(217)
Operating income	$ 12,870	$ 10,140

(1) Includes adjustments for items that affect the comparability of the same-center results. Such adjustments include: changes in estimates for common area maintenance costs and real estate taxes related to a prior period, lease termination fees, or other similar items that affect comparability.

During the three months ended March 31, 2015, the Company generated same-center cash NOI of approximately $23.3 million compared to same-center cash NOI of approximately $22.4 million generated during the three months ended March 31, 2014, representing a 4.0% increase.

In regards to the Form 10-K, the Company acknowledges that:

- the company is responsible for the adequacy and accuracy of the disclosure in the filing;
- staff comments or changes to disclosure in response to staff comments do not foreclose the Commission from taking any action with respect to the filing; and
- the company may not assert staff comments as a defense in any proceeding initiated by the Commission or any person under the federal securities laws of the United States.

July 9, 2015

VIA EDGAR & FEDEX

Ms. Jennifer Monick
Division of Corporation Finance
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

Re: Retail Opportunity Investments Corp.
Form 10-K for the Fiscal Year Ended December 31, 2014
Filed February 25, 2015
File No. 1-33749

Retail Opportunity Investments Partnership, LP
Form 10-K for the Fiscal Year Ended December 31, 2014
Filed February 25, 2015
File No. 333-189057-01

Dear Ms. Monick:

On behalf of Retail Opportunity Investments Corp. and Retail Opportunity Investments Partnership, LP (together, the "Company"), further to a telephonic discussion on July 7, 2015 between the Company and the staff of the Division of Corporation Finance (the "Staff") of the Securities and Exchange Commission (the "Commission") regarding the Staff's letter dated June 17, 2015 (the "June 17 Letter") with respect to the Company's Form 10-K for the year ended December 31, 2014 (the "Form 10-K"), set forth below is a supplemental response of the Company to the Staff's first comment set forth in the June 17 Letter.

For the Staff's convenience, the original comment set forth in the June 17 Letter is reproduced in bold below and is followed by the Company's supplemental response.

Form 10-K for the Fiscal Year Ended December 31, 2014

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

Funds From Operations, page 35

1. **We note you have recorded a gain on consolidation of joint venture for 2013 and 2012. In future periodic filings, please revise your reconciliation of Net income attributable to ROIC to FFO-basic and FFO-diluted to include an adjustment to exclude such gains.**

   As a supplemental response to the Staff's comment, and in response to the telephonic conversation with the Staff on July 7, 2015, in the Company’s Annual Report on Form 10-K for the year ending December 31, 2015, the Company will present the reconciliation of Net income attributable to ROIC to FFO-basic and FFO-diluted, for the year ended December 31, 2013, consistent with that which has been previously reported in periodic filings.

The Company currently does not have any unconsolidated joint ventures and does not anticipate recording any gains on consolidation of joint ventures in the future. Should opportunities arise that would result in recording of such gains, the Company will include an adjustment for such gains in the reconciliation of Net income to FFO and will also expand the definition the Company uses in determining FFO to read as follows:

The Company follows the standard definition of FFO as set forth in the "White Paper" published by the National Association of Real Estate Investment Trusts ("NAREIT"), which defines FFO as "net income attributable to common stockholders (determined in accordance with GAAP) excluding gains or losses from debt restructuring, sales of depreciable property, and impairments, plus real estate related depreciation and amortization, and after adjustments for partnerships and unconsolidated joint ventures." In addition, the Company also adjusts FFO to exclude gains recorded on the consolidation of joint ventures.

In regards to the Form 10-K, the Company acknowledges that:

- the company is responsible for the adequacy and accuracy of the disclosure in the filing;
- staff comments or changes to disclosure in response to staff comments do not foreclose the Commission from taking any action with respect to the filing; and
- the company may not assert staff comments as a defense in any proceeding initiated by the Commission or any person under the federal securities laws of the United States.

We hope the foregoing has been responsive to the Staff's comment. If you have any questions, please do not hesitate to contact the undersigned at (858) 255-4925 (telephone) or Jay Bernstein or Jacob Farquharson of Clifford Chance US LLP, counsel to the Company, at (212) 878-8527 (telephone) or (212) 878-3302 (telephone).

We thank the Staff in advance for its assistance.

Very truly yours,

/s/ Michael B. Haines
Michael B. Haines
Chief Financial Officer

cc:

Isaac Esquivel
Stuart A. Tanz
Jay L. Bernstein, Esq.
Jacob Farquharson, Esq.

May 22, 2015

By EDGAR

United States Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-0410

Attention: Mr. Wilson K. Lee, Senior Staff Accountant

RE: Retail Properties of America, Inc. (“RPAI”, “we” or the “Company”)
Form 10-K for the year ended December 31, 2014
Filed on February 18, 2015
File No. 001-35481

Dear Mr. Lee:

This letter responds to the letter from the staff of the Division of Corporation Finance (the “Staff”) of the Securities and Exchange Commission (the “Commission”) dated May 14, 2015 (the “Comment Letter”), providing a comment relating to the Company’s Form 10-K for the fiscal year ended December 31, 2014. In order to facilitate the Staff’s review of this letter, we have restated your numbered comment which required a response below and have included the Company’s response underneath the comment.

Form 10-K for the year ended December 31, 2014

Funds From Operations, pages 30-31

1. In arriving at Funds from operations, you start with Net income attributable to common shareholders. As a result, it appears Funds from operations is actually Funds from operations attributable to just common stockholders instead of all equity shareholders. In future periodic filings please re-title “Funds from operations” to the more appropriate “Funds from operations attributable to common shareholders”.

Response:

In future periodic filings, we will re-title “Funds from operations” to “Funds from operations attributable to common shareholders.”

As requested in the Comment Letter, the Company hereby acknowledges that:

- the Company is responsible for the adequacy and accuracy of the disclosure in the filing;
- Staff comments or changes to disclosure in response to Staff comments do not foreclose the Commission from taking any action with respect to the filing; and
- the Company may not assert Staff comments as a defense in any proceeding initiated by the Commission or any person under the federal securities laws of the United States.

RLJ LODGING TRUST
3 Bethesda Metro Center, Suite 1000
Bethesda, MD 20814

May 18, 2015

BY EDGAR AND OVERNIGHT MAIL

Ms. Jennifer Monick
Division of Corporation Finance
United States Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549

Re: RLJ Lodging Trust
Form 10-K for the year ended December 31, 2014
Filed February 26, 2015
File No. 001-35169

Dear Ms. Monick:

This letter is submitted by RLJ Lodging Trust (the "**Company**") in response to comments from the staff of the Division of Corporation Finance (the "**Staff**") of the Securities and Exchange Commission (the "**Commission**") in a letter dated May 11, 2015 (the "**Comment Letter**") with respect to the Company's Annual Report on Form 10-K for the year ended December 31, 2014 filed with the Commission on February 26, 2015 (the "**Form 10-K**").

For your convenience, the Staff's numbered comments set forth in the Comment Letter have been reproduced in italics herein with responses immediately following each comment. Unless otherwise indicated, page references in the reproductions of the Staff's comments refer to the Form 10-K. Defined terms used herein but not otherwise defined herein have the meanings given to them in the Form 10-K.

Notes to Consolidated Financial Statements

Note 9. Commitments and Contingencies, page F-23

Data Breach, page F-25

1. *Please tell us and revise future periodic filings to clarify if you expect any amounts you may be required to pay to be material to the financial statements as a whole, as opposed to only your results of operations.*

Response to Comment No. 1

The Company currently believes that any amounts that the Company may ultimately be required to pay as a result of this incident will not have a material impact on its financial position, results of operations or cash flows. In future filings, the Company will revise the disclosure to provide an assessment of the impact on the Company's results of operations as well as the impact on the Company's financial position and cash flows.

The Company also acknowledges that:

- the Company is responsible for the adequacy and accuracy of the disclosure in the filings;
- staff comments or changes to disclosure in response to staff comments do not foreclose the Commission from taking any action with respect to the filings; and
- the Company may not assert staff comments as a defense in any proceeding initiated by the Commission or any person under the federal securities laws of the United States.

18500 Von Karman Avenue
Suite 550
Irvine, CA 92612

September 29, 2015

VIA EDGAR

Ms. Jaime G. John
Accounting Branch Chief, Office of Real Estate and Commodities
Division of Corporation Finance
United States Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

Re: ***Sabra Health Care REIT, Inc.***
Form 10-K for the Fiscal Year Ended December 31, 2014
Filed February 19, 2015
File No. 1-34950

Dear Ms. John:

This letter sets forth the response of Sabra Health Care REIT, Inc. ("Sabra," the "Company" "we" or "our") to the comments of the staff (the "Staff") of the Securities and Exchange Commission (the "Commission") contained in your letter dated September 22, 2015 (the "Comment Letter"), regarding the above-referenced Form 10-K for the year ended December 31, 2014 (the "2014 Form 10-K"). For the convenience of the Staff, each of the Staff's comments is restated in italics prior to the response to such comment.

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

Funds from Operations and Adjusted Funds from Operations, page 37

1. *We note that your FFO and AFFO calculations exclude preferred stock dividends and thus appear to represent FFO and AFFO attributable to common shareowners. In future periodic filings, please revise to clearly label your non-GAAP measure as "FFO attributable to common stockholders". Also make a similar revision to properly label AFFO.*

Response: In our future periodic filings, we will revise to clearly label our non-GAAP measures as "FFO attributable to common stockholders" and "AFFO attributable to common stockholders."

Item 8. Financial Statements and Supplementary Data

General

1. *Please tell us the consideration you gave to the financial statement disclosure requirements regarding your dependence on significant customers Genesis Healthcare, Inc. and Holiday AL Holdings LP; refer to paragraph 42 of ASC 280-10-50.*

Response: We note that paragraph 42 of ASC 280-10-50 provides that "[a] public entity shall provide information about the extent of its reliance on its major customers," which is defined as a single external customer that amounts to 10% or more of a public entity's revenues.

In several locations in the 2014 Form 10-K, we disclosed information regarding our dependence on Genesis Healthcare, Inc. ("Genesis") and Holiday AL Holdings LP ("Holiday"). For example, (1) in the section captioned "Business-Significant Credit Concentrations" on page 8 of the 2014 Form 10-K, we noted that Genesis and Holiday are the relationships that represent more than 10% of our annualized revenues as of December 31, 2014 and provided the number of investments, percentage of total investments, gross, and percentage of annualized revenues represented by each of Genesis and Holiday; (2) in the section captioned "Risk Factors-Risks Related to Tenant Concentration" on pages 12-13 of the 2014 Form 10-K, we included a separate risk factor regarding our dependence on each of Genesis and Holiday; and (3) in the section captioned "Management's Discussion and Analysis of Financial Condition and Results of Operations-Concentration of Credit Risk" on pages 41-42 of the 2014 Form 10-K, we disclosed again the percentage of annualized revenues represented by Genesis and Holiday and noted that the obligations under the master leases with both such tenants are guaranteed by their respective parent entities.

In Note 4, "Real Estate Properties Held for Investment-Operating Leases" in the Notes to Consolidated Financial Statements on pages F-15 to F-16 in the 2014 Form 10-K, we also included disclosure regarding our efforts to monitor the creditworthiness of our tenants. In our future periodic filings, consistent with the disclosures described above, we will expand the disclosure in Note 4 to provide the information required by paragraph 42 of ASC 280-10-50 with respect to our tenants that represent more than 10% of our total revenues, including Genesis and Holiday if applicable. For example, we would include the following disclosure in Note 4 (to the extent applicable and updated for 2015 information): "As of December 31, 2014, our two largest tenants, Genesis and Holiday, represented 36.2% and 17.8%, respectively, of our annualized revenues. Other than these two tenants, none of our tenants individually represented 10% or more of our annualized revenues as of December 31, 2014."

****

As requested in the Comment Letter, Sabra acknowledges that:

- Sabra is responsible for the adequacy and accuracy of the disclosure in the filing;

SAUL CENTERS, INC.

7501 Wisconsin Avenue, Suite 1500E, Bethesda, Maryland 20814

(301) 986-6200

August 12, 2015

By EDGAR

Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Attention: Daniel L. Gordon

Re: Saul Centers, Inc.
Form 10-K for the year ended December 31, 2014
Filed March 6, 2015
File No. 001-12254

Ladies and Gentlemen:

This letter sets forth the response of Saul Centers, Inc., a Maryland corporation (the “Company”), to your letter dated July 31, 2015, with respect to the Company’s Annual Report on Form 10-K for the year ended December 31, 2014.

The Company hereby confirms that, in future filings after the date of this response letter, the Company will use the label “FFO available to common stockholders and non-controlling interests” instead of “FFO available to common shareholders.”

As requested by the Staff, we are providing the following acknowledgements:

- the Company is responsible for the adequacy and accuracy of the disclosure in its filings with the Commission;

- Staff comments or changes to disclosure in response to Staff comments do not foreclose the Commission from taking any action with respect to the filing; and

- the Company may not assert Staff comments as a defense in any proceeding initiated by the Commission or any person under the federal securities laws of the United States.

Thank you for your courtesy.

Very truly yours,
/s/ Scott V. Schneider
Scott V. Schneider
Senior Vice President and Chief Financial Officer

cc: Justin J. Bintrim
Christine Nicolaides Kearns

Saul Centers
www.SaulCenters.com

May 5, 2015

SL GREEN REALTY CORP.

VIA EDGAR

Securities and Exchange Commission
Division of Corporation Finance
100 F Street, N.E.
Washington, D.C. 20549

Attn: Daniel L. Gordon
Senior Assistant Chief Accountant

Re: SL Green Realty Corp.
Form 10-K for the year ended December 31, 2014
Filed February 24, 2015
File No. 001-13199

SL Green Operating Partnership, L.P.
Form 10-K for the year ended December 31, 2014
Filed February 24, 2015
File No. 33-167793-02

Dear Mr. Gordon:

Set forth below are responses to the comments of the staff (the "Staff") of the Securities and Exchange Commission (the "SEC") contained in your letter, dated May 1, 2015 (the "Comment Letter"), relating to the Annual Report on Form 10-K for the year ended December 31, 2014 filed by SL Green Realty Corp. (the "Company") and SL Green Operating Partnership, L.P. (the "Partnership") on February 24, 2015 (the "Form 10-K"). The headings and numbered paragraphs of this letter correspond to the headings and numbered paragraphs contained in the Comment Letter, and to facilitate your review, we have reproduced the text of the Staff's comments in italics below in the first paragraph of each response.

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations, page 41

Funds From Operations, page 63

1. *We note that you have calculated FFO based upon net income attributable to SL Green common stockholders and non-controlling interests. In future filings, please revise the label of this non-GAAP measure to indicate that it is attributable to SL Green common stockholders and non-controlling interests.*

The Company and the Partnership advise the Staff that in future filings it will label FFO to indicate that this is attributable to SL Green common stockholders and non-controlling interests.

Consolidated Statements of Equity, page 75

2. *Please include reconciliations for equity interests classified outside of permanent equity as required by ASC 810-10-50-1A in the consolidated statements of equity, or in a note thereto. In that regard, we note that you have provided a rollforward of the noncontrolling interests in the operating partnership in Note 11 but no such rollforward has been included for the preferred units.*

420 Lexington Avenue • New York, NY 10170 • (212) 594-2700 • Fax (212) 216-1790

The Company and the Partnership advise the Staff that the Company and the Partnership propose to revise the disclosure regarding reconciliations for equity interests classified outside of permanent equity in a note to the consolidated financial statements in the following manner in future filings:

Below is the rollforward analysis of the activity relating to the preferred units in the Operating Partnership as of December 31, 2014 and December 31, 2013 (in thousands):

	December 31, 2014	December 31, 2013
Balance at beginning of period	$ 49,550	$ 49,500
Issuance of preferred units	23,565	—
Redemption of preferred units	(2,000)	—
Balance at end of period	$ 71,115	$ 49,550

Note 3. Property Acquisitions, page 100

2014 Acquisitions, page 100

3. *Please disclose the acquisition-date fair value of your equity interest in 388-390 Greenwich Street immediately before the acquisition date and the valuation technique(s) used to measure fair value. Refer to ASC 805-10-50-1(g).*

The Company and the Partnership advise the Staff that the Company and the Partnership believe that it has met the disclosure requirements of ASC 805-10-50-2(g) in the Notes to the Financial Statements as follows:

1. The acquisition-date fair value of the equity interest in the acquiree held by the acquirer immediately before the acquisition date:

Refer to the calculation below. This information is also included in Note 3 to the Financial Statements.

($ in thousands)	388-390 Greenwich
Net purchase price (100%)	$ 1,585,000
Less amount paid to partner	(208,614)
Less debt assumed	(1,162,379)
Fair value of retained equity interest	214,007
SL Green equity interest	(148,025)
Purchase price fair value adjustment	$ 65,982

The remaining purchase price fair value adjustment balance of $5.5 million relates to the acceleration of a deferred leasing commission from the joint venture to the Company.

2. The amount of any gain or loss as a result of remeasuring to fair value the equity interest in the acquiree held by the acquirer immediately before the business combination (refer to paragraph 805-10-25-10) and the line item in the income statement in which that gain or loss is recognized:

Refer to the footnotes to the table in Note 3 to the Financial Statements for the gain recognized in connection with this transaction. The purchase price fair value adjustment is also discussed as a separate line item on the income statement.

3. The valuation technique(s) used to measure the acquisition-date fair value of the equity interest in the acquiree held by the acquirer immediately before the business combination:

The fair value of this property was determined to be the agreed upon purchase price.

4. Information that enables users of the acquirer's financial statements to assess the inputs used to develop the fair value measurement of the equity interest in the acquiree held by the acquirer immediately before the business combination:

The fair value of this property was determined to be the agreed upon purchase price.

* * *

In accordance with your request, the Company and the Partnership hereby acknowledge that:

- the Company and the Partnership are responsible for the adequacy and accuracy of the disclosure in the Form 10-K;
- Staff comments or changes to disclosure in response to Staff comments do not foreclose the SEC from taking any action with respect to the Form 10-K; and
- the Company and the Partnership may not assert Staff comments as a defense in any proceeding initiated by the SEC or any person under the federal securities laws of the United States.

* * *

If you have any questions with respect to the foregoing, please contact me at (212)-216-1714 or Andrew Levine, Esq., our Chief Legal

April 8, 2015

VIA EDGAR

Division of Corporation Finance
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549
Attention: Daniel L. Gordon, Senior Assistant Chief Accountant

Re: **Starwood Property Trust, Inc.**
Form 10-K
Filed February 25, 2015
File No. 001-34436

Ladies and Gentlemen:

Starwood Property Trust, Inc. ("Starwood") hereby responds to the comments of the staff (the "Staff") of the Division of Corporation Finance of the U.S. Securities and Exchange Commission (the "SEC") contained in your letter dated March 25, 2015 (the "Comment Letter") regarding Starwood's Annual Report on Form 10-K for the fiscal year ended December 31, 2014 (the "2014 Form 10-K"). For the convenience of the Staff, we have set forth below the comments contained in the Comment Letter followed by Starwood's response to each comment.

Form 10-K for the fiscal year ended December 31, 2014

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations, page 57

COMMENT:

1. *In future filings please disclose the weighted average yield on your assets and the weighted average borrowing costs, including related hedging costs.*

STARWOOD RESPONSE:

Beginning with our Form 10-Q filing for the quarter ended March 31, 2015, we will disclose the weighted average yield on our investment portfolio and our weighted average borrowing costs inclusive of related hedging costs.

Non-GAAP Financial Measures, page 65

COMMENT:

2. *Please reconcile the number of diluted weighted average shares used in Core Earnings per share to the number of diluted weighted average shares used in your GAAP EPS measures.*

STARWOOD RESPONSE:

In our 2014 Form 10-K, we disclosed the following in an effort to reconcile the number of diluted weighted average shares used in our earnings per share ("EPS") calculation as determined pursuant to generally accepted accounting principles ("GAAP") to the shares used in our Core EPS calculation:

> "In assessing the appropriate weighted average diluted share count to apply to Core Earnings for purposes of determining Core earnings per share ("EPS"), management considered the following attributes of our current GAAP diluted share methodology: (i) our participating securities were determined to be anti-dilutive and were thus excluded from the denominator of the EPS calculation; and (ii) the portion of the Convertible Notes that are "in-the-money" (referred to as the "conversion spread value"), representing the value that would be delivered to investors in shares upon an assumed conversion, is included in the denominator. Because compensation expense related to participating securities is added back for Core Earnings purposes pursuant to the definition above, there is no dilution to Core Earnings resulting from the associated expense recognition. As a result, our GAAP EPS methodology was adjusted to include (instead of exclude) participating securities. Further, conversion of the Convertible Notes is an event that is contingent upon numerous factors, none of

which are in our control, and is an event that may or may not occur. Consistent with the treatment of other unrealized adjustments to Core Earnings, our GAAP EPS methodology was adjusted to exclude (instead of include) the conversion spread value in determining Core EPS until a conversion actually occurs. For the year ended December 31, 2014, 3.4 million shares, representing the conversion spread value, were excluded from Core EPS."

Beginning with our Form 10-Q filing for the quarter ended March 31, 2015, in addition to the written reconciliation disclosed above, we will disclose a tabular reconciliation of diluted weighted average shares used in our calculation of Core Earnings per share to diluted weighted average shares used to calculate diluted GAAP earnings per share. A pro forma of this reconciliation for the year ended December 31, 2014 is as follows:

GAAP Diluted Weighted Average Shares	218,781
Add: Participating Securities	2,650
Less: Conversion Spread Value	(3,432)
Core Diluted Weighted Average Shares	217,999

Consolidated Balance Sheets, page 91

COMMENT:

3. *We note that you separately present the assets and liabilities held by variable interest entities on your balance sheet. In future filings, please recast your balance sheet to present the consolidated totals for each line item required by Rule 5-02 of Regulation S-X. Please note that you may state parenthetically after each line item the amount that relates to consolidated VIEs, or you may include a table following the consolidated balance sheets to present assets and liabilities of consolidated VIEs that have been included in the preceding balance sheet.*

STARWOOD RESPONSE:

We respectfully note to the Staff that, since the consolidation rules were contemplated, LNR Property LLC ("LNR"), our wholly-owned subsidiary that we acquired on April 19, 2013, and related parties have engaged in numerous discussions, both written and oral, with the Financial Accounting Standards Board ("FASB") and the SEC on this topic, with such discussions directed towards the seemingly unintended financial statement consequences of these standards on a unique business such as ours. In that regard, we are providing, under separate cover and with a request for confidential treatment, correspondence with the SEC's Office of the Chief Accountant of the Division of Corporation Finance describing the facts and circumstances surrounding our financial statement presentation of VIEs. We also note that, as a result of these discussions, we assisted the FASB in understanding the nature of commercial mortgage-backed securities ("CMBS") trusts and the impact of consolidation of these vehicles in order to arrive at the ultimate conclusions outlined in Accounting Standards Update ("ASU") 2014-13, "Measuring the Financial Assets and the Financial Liabilities of a Consolidated Collateralized Financing Entity."

In order to fully understand the presentation of our consolidated variable interest entities ("VIEs"), it is important to understand the nature of these vehicles and the careful consideration we have dedicated to determining the most appropriate presentation of the consolidation of these vehicles. Since our acquisition of LNR on April 19, 2013, Starwood owns one of the nation's largest commercial mortgage special servicers, which comprised approximately 44% of our 2014 net income on a GAAP basis. LNR services nearly one third of the nation's CMBS trusts, and is the only commercial mortgage special servicer whose financial results are included in a public filing. The nature of LNR's business is vastly different from the more typical residential mortgage servicers and other structures for which we believe the consolidation literature was intended and structured.

In the normal course of business, LNR, comprising our real estate investing and servicing ("REIS") segment, invests in investment grade, unrated and non-investment grade portions of various issues of CMBS. The securities are issued by special purpose trusts, which are structured as pass through entities. A significant portion of LNR's CMBS holdings are in the

lowest tranche of the issued debt of these CMBS trusts. This tranche is typically referred to as the "controlling class", which carries the right to name the special servicer of the trust.

In structuring these trusts, a third party (normally a financial institution) originates loans and then securitizes those loans into a special purpose vehicle. Once securitized into a CMBS trust structure, the loans do not trade. At that point, the loans become part of a closed system, with the special purpose structure effectively transforming the loans into a mathematical waterfall of liability cash flows. After securitization, the sole purpose of the loans is to provide cash flows to the bondholders of the structure. While the loans are restricted from being traded, the liabilities trade regularly, with observable market prices readily available. At inception, a CMBS trust consists only of commercial real estate loans as its assets and debt to bondholders as its liabilities. Over time, some of those loans default and are foreclosed upon, creating a second asset category of foreclosed real estate ("REO") within the trust prior to the asset being liquidated.

The CMBS trusts in which LNR invests are generally considered VIEs under ASC 810. The VIE is deliberately structured as passive whereby a pool of commercial real estate loans is selected for transfer into the VIE and then held constant over its life. No reinvestment is permitted and the entities are not actively managed. As a result, individual loans are not permitted to be sold from the trust or traded in the marketplace. These assets are restricted and can only be used to fulfill the obligations of the trust. The fair value of this type of loan is very different from a loan which would trade freely outside of such a structure.

Due to the difficulties in valuing loans within this type of structure, the guidance outlined in ASU 2014-13 permits an entity to use the financial liabilities of the VIE to value the overall pool of assets of a VIE. This guidance indicates that the financial assets and financial liabilities of a consolidated collateralized financing entity ("CFE", which is used synonymously with VIE for purposes of this letter) should be measured using the "more observable of the fair value of the financial assets and the fair value of the financial liabilities." In the case of our VIEs, the financial liabilities of a CMBS trust are more observable, and we thus apply this approach in consolidating these vehicles.

Other than loans, the only other potential assets of a CMBS trust are REO. In the context of CMBS trusts consolidated pursuant to ASC 810, an REO asset only appears on a reporting entity's balance sheet in one of two instances: (1) the new consolidation of a CMBS trust structure; and (2) the foreclosure of a loan in an already consolidated CMBS trust structure. When an asset becomes REO, it is due to nonperformance of the loan, which is already at fair value due to the election of the fair value option. The valuation of REO assets at fair value occurs quite often under the current ASC 810 model. As a result, the carrying value of an REO asset is generally fair value under existing GAAP. In addition, once an asset becomes REO, its disposition time is relatively short, and deconsolidation of the trust could occur during that time if we are terminated as special servicer of the trust. As a result, distinguishing an asset between a loan and an REO does not provide any incremental value in this context.

In addition, REO assets generally represent a very small percentage of the overall asset pool of a CMBS trust, and for our portfolio, are 4% of our VIE assets. In a new issue CMBS trust, REO is

zero. This is supported by the Basis of Conclusions section of ASU 2014-13, paragraph BC18, which states, in part, "… respondents to the proposed Update indicated that the value of any nonfinancial assets held by a collateralized financing entity is generally insignificant and nonfinancial assets are held temporarily." Consistent with Rule 5-02 of Regulation S-X, any balance sheet line item which does not exceed 5% of an entity's assets need not be separately presented.

In addition, ASC 810-10-45-25 requires that a reporting entity present each of the following separately on the face of the statement of financial position:

> "a. Assets of a consolidated variable interest entity (VIE) that can be used only to settle obligations of the consolidated VIE
>
> b. Liabilities of a consolidated VIE for which creditors (or beneficial interest holders) do not have recourse to the general credit of the primary beneficiary."

In its deliberations of ASC 810, the FASB considered, but rejected, a single-line-item display of assets and liabilities that meet the separate presentation criteria. In order to avoid potential inconsistency and comparability issues in a reporting entity's consolidated financial statements, the FASB decided to require separate presentation of elements of consolidated variable interest entities as described in the excerpt above. While some could interpret this requirement to mean that each consolidated VIE's assets and liabilities that qualify for disclosure must be separately presented, certain of the large accounting firms have issued guidance stating their understanding that this requirement means that the same or similar assets of all consolidated VIEs that meet this separate presentation criterion could be presented in the aggregate on the relevant balance sheet line item. This guidance states, in part:

> "The VIE model does not provide guidance on how assets and liabilities that meet the separate presentation criteria should be presented in the primary beneficiary's balance sheet. We believe that a reporting entity has presentation alternatives provided the assets and liabilities that meet the separate presentation criteria are separately presented on the face of the balance sheet. For example, a reporting entity that is the primary beneficiary of a VIE could present each asset element that meets the separate presentation criteria as one line item and parenthetically disclose the amount of the asset in a VIE. Alternatively, the reporting entity could present an asset element in two separate line items, one line item for the asset in a VIE that meet the separate presentation criteria and another line item for the reporting entity's corresponding asset. There may be other acceptable alternatives."

While on a dollars basis, REO assets are insignificant to VIE assets and to our consolidated assets overall, our VIE asset pool currently contains approximately 500 REO properties. As a result, determining fair value for each of these 500 properties on a quarterly basis would be an extremely time consuming effort. More importantly, it would result in no incremental utility to the users of our financial statements, and ultimately, would be less accurate than our current methodology, particularly since the assets of the VIE can only be used to settle the obligations of the VIE. This approach is consistent with the disclosure objectives of ASC 810, as published in ASC 810-10-50-10:

> "A reporting entity shall determine, in light of the facts and circumstances, how much detail it shall provide to satisfy the requirements of the Variable Interest Entities Subsections. A reporting entity shall also determine how it aggregates information to display its overall involvements with VIEs with different risk characteristics. The reporting entity must strike a balance between obscuring important information as a result of too much aggregation and overburdening financial statements with excessive detail that may not assist financial statement users to understand the reporting entity's financial position. For example, a reporting entity shall not obscure important information by including it with a large amount of insignificant detail."

Because CMBS trust financial liabilities are more observable, the methodology prescribed by ASU 2014-13 effectively results in a derived number for VIE assets as a pool. This makes sense because, in the case of a CMBS trust, all of the assets as a pool are used to satisfy the liabilities of the trust. This methodology is ultimately designed to arrive at the critical conclusion for investors, which is for the consolidated net income (loss) of a reporting entity to only reflect amounts that reflect changes in its own economic interests in the consolidated trust. Any segregation of the assets beyond the total pool would result in balances that are not meaningful because (i) a bondholder could not access those assets individually; and (ii) determining a precise value for these assets would be nearly impossible. Said another way, as two lines in our balance sheet, the numbers would be estimates and allocations of a total liability number, whereas in total, they agree to a market value that is observable.

As one of the nation's largest special servicers, servicing nearly one third of the nation's CMBS trusts, our entire business is predicated on owning the controlling class. As a result, consolidation of CMBS structures is commonplace; we regularly consolidate and deconsolidate CMBS trusts due to ordinary course transactions such as purchases and sales of CMBS and special servicer appointments. As a public company, we are concerned about creating any confusion for users beyond that which already exists as a result of consolidating these vehicles.

Based on the above, we arrived at our current presentation of including all of the assets of a VIE in a single line on our balance sheet. We believe this presentation is consistent with Rule 5-02 of Regulation S-X based on the insignificance of the REO balance generally, with the requirements of ASC 810-10-45-25, with certain public accounting firms' published interpretive guidance, with the above-referenced correspondence with the SEC, which we are providing to the Staff under separate cover and with a request for confidential treatment, and with the overall objective of financial reporting to provide meaningful information to investors. The liabilities of our VIEs consist solely of debt to bondholders of the CMBS trust, and are thus properly classified as a single line item in accordance with Rule 5-02 of Regulation S-X.

Consolidated Statements of Operations, page 92

COMMENT:

4. *We note your separate presentation of income of consolidated VIE's, net related to the assets and liabilities of your consolidated VIEs. Please tell us your basis for this*

presentation and specifically address how it complies with the requirements of Rule 5-03 of Regulation S-X which requires consolidated totals for each line item.

STARWOOD RESPONSE:

Similar to our response to Comment 3, we respectfully note to the Staff that the basis for our income statement presentation was determined after careful consideration of the impact of CMBS trust consolidation to our financial statements and which presentation would be most meaningful to the users of our financial statements. As noted in our response to Comment 3, the critical conclusion that is contained in ASU 2014-13 is that a reporting entity's consolidated net income (loss) should only reflect the reporting entity's own economic interests in the consolidated VIE. In the context of consolidated CMBS trusts, LNR's economic interest is its ownership of a CMBS security.

Because we elect the fair value option for initial and subsequent recognition of our consolidated VIE assets and liabilities, and because the fair value of the VIE assets equals the fair value of the liabilities pursuant to ASU 2014-13, the only change to VIE assets each period is the change in fair value of the liabilities. As a result, the two primary line items which would appear in our income statement on a gross basis would be the inflated change in fair value of VIE assets and the change in fair value of VIE liabilities, both of which would appear within the "other income" section of our consolidated statement of operations, consistent with Rule 5-03 of Regulation S-X. Before consolidation, these two numbers are the same because total VIE assets equal total VIE liabilities under ASU 2014-13. The numbers individually total in the billions, but net to zero. However, in consolidation, we would eliminate the portion of the change in fair value of VIE liabilities that pertains to our beneficial interest in the CMBS trust (i.e., the CMBS security asset we hold, which is reflected as debt on the VIE's balance sheet). The resulting net number is the portion that pertains to our economic interest in the consolidated VIE.

Additionally, as discussed above, we elected the fair value option for both our VIE assets and liabilities in the trust; therefore, interest income and interest expense presentation as separate line items are no longer relevant on a standalone basis. These amounts are effectively included in the total fair value changes period to period, but obviated because of the overlay of the fair value option. ASC 825-10 does not include guidance on geography for items measured at fair value under the fair value option. Rather, it implies that the presentation of such items is a policy election. Since adoption of ASC 810, our elected policy has been to present these items through the same line item on our statement of operations. Certain of the large accounting firms have published interpretive guidance supporting this. In discussing the segregation of interest income from other changes in fair value, one such publication states, "We encourage reporting entities to use the single line presentation because splitting the change in fair value creates an amount in a line item that is just a residual difference. In either case, reporting entities should select a policy for income statement presentation that is appropriate for their facts and circumstances, disclose the policy in the footnotes, and follow it consistently." In our case, the difference between the change in fair value of VIE assets and the change in fair value of VIE liabilities is simply the residual difference attributable to our beneficial interest in the VIE.

Similar to our response to Comment 3, we respectfully submit that we do not see any added benefit to providing the users of our financial statements with two inflated line items in our statement of operations, neither of which individually pertains to our beneficial interest in the VIE. In fact, we would view this presentation as somewhat distortive because our beneficial interest in the VIE would be eliminated and hidden in the residual difference between the change in fair value of assets and the change in fair value of liabilities. Consistent with the underlying purpose of ASU 2014-13, the consolidation of VIEs should result in a reporting entity only reflecting its own economic interest in the VIE. We believe that netting the changes in fair value of liabilities against the changes in fair value of assets on a consolidated basis accomplishes this objective. However, we will include in future filings additional disclosure in Footnote 2, *Summary of Significant Account Policies*, related to our financial statement presentation of consolidated VIEs.

COMMENT:

5. We note that a majority of your revenue is derived from interest on leveraged investments. Please tell us why interest expense has been presented as a component of costs and expenses, rather than as part of net interest margin. In this regard, a "net interest income" presentation is generally appropriate for companies with interest expense related to financing its investments earnings interest income. Please see ASC 942-10-S99-4 for reference.

STARWOOD RESPONSE:

As discussed in our response to Comment 3, on April 19, 2013, Starwood and its affiliates acquired LNR, a diversified real estate operating business which houses one of the nation's largest special servicers. Prior to the LNR acquisition, Starwood applied the "net interest income" presentation prescribed by ASC 942-10-S99-4. Because our operations at that time consisted principally of originating and acquiring commercial mortgage loans, the industry-specific accounting and reporting guidance for depository and lending financial institutions that is outlined in ASC 942 was appropriate. This was the same presentation followed by our competitors who were strictly mortgage real estate investment trusts ("REITs").

However, with the acquisition of LNR and our growing single-family residential real estate rental portfolio, our business became much more diversified, as did our operating results. As a result, we reevaluated the presentation of our statement of operations. In connection with that evaluation, we determined that the more general income statement presentation outlined in Rule 5-03 of Regulation S-X was more appropriate. We disclosed this change in presentation in our Form 10-Q for the quarter ended June 30, 2013, our Form 10-Q for the quarter ended September 30, 2013, and our Form 10-K for the year ended December 31, 2013.

The LNR acquisition set Starwood apart from its competitors, establishing it as a diversified commercial real estate finance operating business, which now includes not only a traditional commercial mortgage lending business, but also a special servicing operation, a conduit loan origination platform, a CMBS investment portfolio, a growing portfolio of real estate equity

investments and, until its spin-off in early 2014, a billion-dollar single-family residential real estate rental portfolio.

We respectfully note to the Staff that we believe the diverse nature of Starwood's operations justifies our use of the general income statement presentation outlined in Rule 5-03 versus the "net interest income" presentation in ASC 942-10-S99-4, which is intended for depository and lending financial institutions, such as traditional mortgage REITs. Referencing our segment disclosure, during the year ended December 31, 2014, only 56% of our net income on a GAAP basis came from our commercial mortgage lending business (i.e., our Lending Segment, as defined in our 2014 Form 10-K), while the remainder was sourced from our other operating businesses described above. For the latter 44%, we do not believe a "net interest income" presentation would be appropriate.

In addition, because we use corporate level debt to fund business acquisitions (i.e., LNR), investments other than loans, as well as construction and similar loans which cannot be leveraged with traditional repurchase financing, the interest expense associated with this debt would not be appropriate for a "net interest income" presentation. We believe a hybrid of "net interest income" presentation and the more traditional presentation which we currently provide for operating businesses would only further confuse our investors and the users of our financial statements. However, we do believe that net interest income disclosure for just our Lending Segment would be useful to investors. As a result, we will include this as a supplemental disclosure in future filings, beginning with our Form 10-Q filing for the quarter ended March 31, 2015.

* * * * *

Starwood hereby acknowledges that:

- Starwood is responsible for the adequacy and accuracy of the disclosures it has made in its filings, including the 2014 Form 10-K;
- Staff comments or changes to disclosure in response to Staff comments do not foreclose the SEC from taking any action with respect to Starwood's filings; and
- Starwood may not assert Staff comments as a defense in any proceeding initiated by the SEC or any person under the federal securities laws of the United States.

We acknowledge and appreciate that the discussion of VIEs, as outlined above and in various communications with the FASB and the SEC, is complex. As a result, we would welcome a discussion with you on this topic to assist you in better understanding the nature of these vehicles and the resulting impact to our consolidated financial statements. In the meantime, if you should need any further information, please contact Rina Paniry, Chief Financial Officer, by phone at 305-695-5470 or by email at rpaniry@starwood.com.

June 3, 2015

VIA EDGAR

Division of Corporation Finance
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549
Attention: Daniel L. Gordon, Senior Assistant Chief Accountant

Re: **Starwood Property Trust, Inc.**
Form 10-K
Filed February 25, 2015
File No. 001-34436

Ladies and Gentlemen:

Starwood Property Trust, Inc. ("Starwood") hereby responds to the comments of the staff (the "Staff") of the Division of Corporation Finance of the U.S. Securities and Exchange Commission (the "SEC") contained in your letter dated May 19, 2015 (the "Comment Letter") regarding Starwood's Annual Report on Form 10-K for the fiscal year ended December 31, 2014 (the "2014 Form 10-K"). For the convenience of the Staff, we have set forth below the comments contained in the Comment Letter followed by Starwood's response to each comment.

Form 10-K for the fiscal year ended December 31, 2014

Consolidated Balance Sheets, page 91

COMMENT:

1. *We have reviewed your responses to comments 3 and 4. We are considering your responses and we may have further comments.*

STARWOOD RESPONSE:

We acknowledge and appreciate that the discussion of our variable interest entities (VIEs) is complex. As a result, we would welcome a discussion with you on this topic to assist you in better understanding the nature of these vehicles and the resulting impact to our consolidated financial statements. In the meantime, if you should need any further information, please do not hesitate to contact us.

Consolidated Statements of Operations, page 92

COMMENT:

2. *We note your response to comment 4. Please confirm to us the nature of the $212,506 and $116,377 recorded as income of consolidated VIEs, net in 2014 and 2013, respectively. If this represents the change in fair value of your economic interest in consolidated VIEs, please consider using a more descriptive label in future filings.*

STARWOOD RESPONSE:

Amounts recorded as "income of consolidated VIEs, net" relate to the change in fair value of our economic interests in the VIEs which we consolidate. In future filings, we will use a more descriptive label for this line item.

Form 10-Q for the quarter ended March 31, 2015

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations, page 50

COMMENT:

3. *We note your response to comment 1. As previously requested, please disclose the weighted average yield on your investment assets, or tell us where this disclosure has been provided. Please also include a discussion of any trends in the weighted average yield on assets and weighted average borrowing costs for those assets.*

STARWOOD RESPONSE:

We have disclosed the weighted average yields on each of our investment assets within the table on page 62 of our Form 10-Q for the quarter ended March 31, 2015 under the column heading "Unlevered Return on Asset." Beginning with our Form 10-Q filing for the quarter ended June 30, 2015, we will include a discussion of any established trends in our weighted average yield on assets and weighted average borrowing costs for those assets.

* * * * *

June 22, 2015

VIA EDGAR

Division of Corporation Finance
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549
Attention: Daniel L. Gordon, Senior Assistant Chief Accountant

Re: **Starwood Property Trust, Inc.**
Form 10-K
Filed February 25, 2015
File No. 001-34436

Ladies and Gentlemen:

Starwood Property Trust, Inc. ("Starwood") hereby responds to the comments of the staff (the "Staff") of the Division of Corporation Finance of the U.S. Securities and Exchange Commission (the "SEC") contained in your letter dated June 9, 2015 (the "Comment Letter") regarding Starwood's Annual Report on Form 10-K for the fiscal year ended December 31, 2014 (the "2014 Form 10-K"). For the convenience of the Staff, we have set forth below the comments contained in the Comment Letter followed by Starwood's response to each comment.

Form 10-K for the fiscal year ended December 31, 2014

Consolidated Balance Sheets, page 91

COMMENT:

1. *We have reviewed your response to comment 3. We continue to believe that your balance sheet is not in compliance with Rule 5-02 of Regulation S-X. Please recast your balance sheet to present the consolidated totals for each line item required by Rule 5-02. Please note that you may state parenthetically after each line item the amount that relates to consolidated VIEs, or you may include a table following the consolidated balance sheets to present assets and liabilities of consolidated VIEs that have been included in the preceding balance sheet.*

STARWOOD RESPONSE:

We believe that Starwood is dissimilar to all other companies in the mortgage real estate investment trust ("MREIT") space. The reason for this is the acquisition by Starwood of LNR Property LLC ("LNR") on April 19, 2013, which appended a special servicer that invests in subordinate commercial mortgage backed securities ("CMBS") to a traditional MREIT, setting Starwood in a class by itself with no single competitor containing a comparative business model. At that point, Starwood began trading, and continues to trade, vastly different from its competitors.

Prior to the acquisition of LNR, Starwood was not meaningfully impacted by the amendments to Accounting Standards Codification ("ASC") 810, Consolidation, included in Accounting Standards Update ("ASU") 2009-17, and as a result, its financial statements looked very similar to traditional MREITs. However, LNR's financial statements were significantly impacted by these amendments due to its dual role as special servicer and investor in subordinate securities for the same trusts, which led to the consolidation of over 100 CMBS trusts. The nature of LNR's business is vastly different from the more typical residential mortgage servicers and other structures for which we believe the consolidation literature was intended and structured. These other structures are what we believe other MREITs are investing in.

However, Starwood now consolidates over 100 CMBS trusts due solely to LNR's dual role as CMBS investor and special servicer, a role that is not shared by any other public filer, let alone any filer in the MREIT space. It is important to note that the legacy Starwood business has no impact to the consolidation of these structures. In the normal course of business, LNR, comprising our real estate investing and servicing ("REIS") segment, invests in investment grade, unrated and non-investment grade portions of various issues of CMBS. A significant portion of LNR's CMBS holdings are in the lowest tranche of the issued debt of these CMBS trusts. This tranche is typically referred to as the "controlling class", which carries the right to name the special servicer of the trust. LNR's investment in the controlling class and its role as special servicer together trigger consolidation of these trusts.

In order to understand our presentation for these trusts, it is important to understand the nature of the vehicles themselves. In structuring these trusts, a third party (normally a financial institution) originates loans and then securitizes those loans into a special purpose vehicle. Once securitized into a CMBS trust structure, the loans do not trade. At that point, the loans become part of a closed system, with the special purpose structure effectively transforming the loans into a mathematical waterfall of liability cash flows. After securitization, the sole purpose of the loans is to provide cash flows to the bondholders of the structure. LNR is typically a bondholder at the most subordinate level within these structures. While the loans are restricted from being traded, the liabilities trade regularly, with observable market prices readily available.

At inception, a CMBS trust consists only of performing commercial real estate loans as its assets and debt to bondholders as its liabilities. Over time, some of those loans default, becoming nonperforming loans which LNR services, and relatively infrequently, nonperforming loans are foreclosed upon, creating a second asset category of foreclosed real estate ("REO") within the trust prior to the asset being liquidated.

The VIE is deliberately structured as passive whereby a pool of commercial real estate loans is selected for transfer into the VIE and then held constant over its life. No reinvestment is permitted and the entities are not actively managed. As a result, individual loans are not permitted to be sold from the trust or traded in the marketplace. These assets are restricted and can only be used to fulfill the obligations of the trust. The fair value of this type of loan is very different from a loan which would trade freely outside of such a structure.

Due to the difficulties in valuing loans within this type of structure, the guidance outlined in Accounting Standards Update ("ASU") 2014-13, "Measuring the Financial Assets and the Financial Liabilities of a Consolidated Collateralized Financing Entity," permits an entity to use the financial liabilities of the VIE to value the overall pool of assets of a VIE. This guidance indicates that the financial assets and financial liabilities of a consolidated collateralized financing entity ("CFE", which is used synonymously with VIE for purposes of this letter) should be measured using the "more observable of the fair value of the financial assets and the fair value of the financial liabilities." In the case of our VIEs, the financial liabilities of a CMBS trust are more observable, and we thus apply this approach in consolidating these vehicles.

This approach results in the fair value of the assets of the VIE equaling the liabilities of the VIE. Because VIE assets in total equal VIE liabilities in total, distinguishing an asset between a loan and an REO does not provide any incremental value and would result in assigning a residual number to either loans or REO. Further, distinguishing between loans and REO would be arbitrary given the VIE liabilities are measured by looking into securitization markets, while the unit of account for the loans and REO would be the individual asset level. The difficulties of reliably fair valuing the assets inside a CMBS structure was detailed in our comment letter to the FASB dated October 15, 2013. Relevant portions of that letter are repeated herein.

Upon our initial adoption of the provisions of ASU 2009-17, we attempted to implement the standard using a very similar methodology to what you are requesting. In doing so, we encountered numerous difficulties and significant limitations, some of which we found impossible to overcome. We spent significant resources, both in time and cost, in the over twelve months in which we attempted to implement the standard pursuant to this approach. We consulted with the most experienced experts in this space, and ultimately concluded that the results were unreliable measurements that could not be validated by management.

The reason the assets of a CMBS trust are difficult to value, particularly for a special servicer, are multifold. A special servicer has no visibility into the performing loans of a CMBS trust. The industry delinquency rate for U.S. issued conduit CMBS has averaged less than 10% historically. This is the only portion of the assets for which the special servicer has detailed knowledge. As such, in order to determine the value of the remaining 90% of the trust's assets that are performing, we engaged a nationally recognized third party pricing service. The results proved to be inconsistent and were formulated by a proprietary, statistical regression created by the third party pricing service that Starwood management had no ability to verify or observe.

The determination of fair value for the loans securitized by a securitization trust contains inherent limitations and is subject to significant judgment. As noted above, these loans are maintained in a static CMBS trust and are unable to be sold if the loans are performing. As such, there is no active market related to these assets. In order to properly fair value this pool of commercial real estate loans, certain factors related to the loans and the underlying real estate collateral must be considered. Certain of these factors are objective and observable such as loan vintage, loan interest rate, market interest rate, loan to value ratio at origination, debt service coverage ratio, payment history, collateral type and collateral location.

These are the factors which were utilized by the pricing service in valuing the loans. However, we have no visibility into the details behind the pricing service's calculation of each loan's fair value. The pricing service collects a standardized set of information which they believe to be predictive of a loan's selling price. Through a multiple regression analysis based on actual loan trade data, the pricing service determines a set of statistically relevant variables that affect an asset's price and estimates its corresponding coefficients. Fair value is estimated by applying these coefficients to an existing loan's relevant variables. This formula is inherently very subjective, and due to its proprietary nature, is invisible to management of the entity that has to report these values in its financial statements.

In addition to factors that may be deemed objective, other more subjective factors are often unobservable and unavailable, including borrower intent with respect to the asset, whether the asset is a "trophy" asset, the special servicer of the asset, the experience, expertise and sophistication of the property owner/manager, and the structure of the loan itself. In addition to these factors, other factors inherent in a securitization structure should ideally be considered, including diversification of the assets, credit enhancement, liquidity of the debt and desired yield of investors.

However, these factors are not considered in pricing an individual loan. Rather, pricing is based on inputs which are not necessarily all inclusive, with the determination of price made by a third party pricing service who may not have access to all relevant data related to the loan. While the pricing service maintains comparable data for both nonperforming loans inside the CMBS trust and values for the underlying collateral, the exact asset is not traded and the assets which do trade may not necessarily be deemed similar to the asset being priced. The evaluation of price is based on the perception of one market participant and lacks transparency in terms of the specific computation behind the regression analysis which ultimately determines the price. Many of the inputs discussed above are not able to be derived (or individually inferred) from transparent, market-based data.

The area where we as special servicer have some visibility is on the REO assets. However, on a dollars basis, the REO assets are insignificant to VIE assets, representing only 4% of such assets. From a practical standpoint, our VIE asset pool currently contains approximately 500 REO properties, and determining a fair value for each of these 500 properties on a quarterly basis would be an extremely time consuming effort because it would involve tracking each of these 500 real estate assets during a relatively short holding period. More importantly, it would not result in the most accurate information. Under ASU 2014-13, we would still have to fair value the liabilities for each VIE and subtract this number to arrive at a residual for the loan pool. Given the relatively small balance of REO and the short period until liquidation of this real estate, we do not believe this exercise would result in any incremental utility to the users of our financial statements, and ultimately, would be less accurate than our current methodology. It would force us to present a line item on our balance sheet for the loan pool that is simply a residual difference as opposed to a number that is meaningful and correct on a stand-alone basis.

Management would have to assert that each of the two line items for REO and loans is correct, knowing that VIE assets can only be correct in total.

Because CMBS trust financial liabilities are more observable, the methodology prescribed by ASU 2014-13 effectively results in a derived number for VIE assets as a pool. This makes sense because, in the case of a CMBS trust, all of the assets as a pool are used to satisfy the liabilities of the trust. This methodology is ultimately designed to arrive at the critical conclusion for investors, which is for the consolidated net income (loss) of a reporting entity to only reflect amounts that reflect changes in its own economic interests in the consolidated trust. Any segregation of the assets beyond the total pool would result in balances that are not meaningful because (i) a bondholder could not access those assets individually; and (ii) determining a precise value for these assets would be nearly impossible. Said another way, as two lines in our balance sheet, the numbers would be allocations of a total liability number, one of which is a residual difference, whereas in total, they agree to a market value that is observable.

Based on the above, we arrived at our current presentation of including all of the assets of a VIE in a single line on our balance sheet. We continue to believe this presentation is consistent with Rule 5-02 of Regulation S-X and results in the most accurate and reliable measure of assets, with the overall objective of financial reporting to provide meaningful information to investors. We suggest including as a supplemental disclosure in future filings, added disclosure to our footnotes describing the components of VIE assets and the reasons for which the presentation is more appropriate and correct as a single line item.

* * * * *

STARWOOD PROPERTY TRUST

August 13, 2015

VIA EDGAR

Division of Corporation Finance
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549
Attention: Daniel L. Gordon, Senior Assistant Chief Accountant

Re: **Starwood Property Trust, Inc.**
Form 10-K
Filed February 25, 2015
File No. 001-34436

Ladies and Gentlemen:

Starwood Property Trust, Inc. ("Starwood") hereby responds to the comments of the staff (the "Staff") of the Division of Corporation Finance of the U.S. Securities and Exchange Commission (the "SEC") contained in your letter dated July 30, 2015 (the "Comment Letter") regarding Starwood's Annual Report on Form 10-K for the fiscal year ended December 31, 2014 (the "2014 Form 10-K"). For the convenience of the Staff, we have set forth below the comment contained in the Comment Letter followed by Starwood's response.

Form 10-K for the fiscal year ended December 31, 2014

Consolidated Balance Sheets, page 91

COMMENT:

1. *We note your response to comment 1. In future filings please provide clear and robust footnote disclosure describing the components of VIE assets and liabilities recorded on your balance sheet, including the approximate relative values of each type of VIE asset. Please also include a discussion of the reasons why you believe the presentation of these assets as a single line item is more appropriate. Please provide us with your proposed disclosure in your response.*

STARWOOD RESPONSE:

Within the summary of significant accounting policies section of our Form 10-Q for the three months ended June 30, 2015, we included supplemental disclosure describing the components of VIE assets and the reasons why the presentation is more appropriate as a single line item. We propose enhancing this disclosure to incorporate the additional items you have requested.

The proposed disclosure in its entirety is as follows:

> "We separately present the assets and liabilities of our consolidated VIEs as individual line items on our consolidated balance sheets. The liabilities of our consolidated VIEs consist solely of obligations to the bondholders of the related CMBS trusts, and are thus presented as a single line item entitled "VIE liabilities." The assets of our consolidated VIEs consist principally of loans, but at times, also include foreclosed loans which have been temporarily converted into real estate owned ("REO"). These assets in the aggregate are likewise presented as a single line item entitled "VIE assets."
>
> Loans comprise the vast majority of our VIE assets and are carried at fair value due to the election of the fair value option. When an asset becomes REO, it is due to nonperformance of the loan. Because the loan is already at fair value, the carrying value of an REO asset is also initially at fair value. Furthermore, when we consolidate a CMBS trust, any existing REO would be consolidated at fair value. Once an asset becomes REO, its disposition time is relatively short. As a result, the carrying value of an REO generally approximates fair value under existing GAAP.
>
> In addition to sharing a similar measurement method as the loans in a CMBS trust, the VIE assets as a whole can only be used to settle the obligations of the consolidated VIE. The assets of our VIEs are not individually accessible by the bondholders, which creates inherent limitations from a valuation perspective. Also creating limitations from a valuation perspective is our role as special servicer, which provides us very limited visibility, if any, into the performing loans of a CMBS trust.
>
> REO assets generally represent a very small percentage of the overall asset pool of a CMBS trust. In a new issue CMBS trust, REO is zero. We estimate that REO assets constitute approximately 4% of our consolidated VIE assets, with the remaining 96% representing loans. However, it is important to note that the fair value of our VIE assets is determined by reference to our VIE liabilities as permitted under ASU 2014-13. In other words, our VIE liabilities are more reliably measurable than the VIE assets, resulting in our current measurement methodology which utilizes this value to determine the fair value of our VIE assets as a whole. As a result, these percentages are not necessarily indicative of the relative fair values of each of these asset categories if the assets were to be valued individually.
>
> Due to our accounting policy election under ASU 2014-13, separately presenting two different asset categories would result in an arbitrary assignment of value to each, with

one asset category representing a residual amount, as opposed to its fair value. However, as a pool, the fair value of the assets in total is equal to the fair value of the liabilities.

For these reasons, the assets of our VIEs are presented in the aggregate."

* * * * *

Starwood hereby acknowledges that:

- Starwood is responsible for the adequacy and accuracy of the disclosures it has made in its filings, including the 2014 Form 10-K;
- Staff comments or changes to disclosure in response to Staff comments do not foreclose the SEC from taking any action with respect to Starwood's filings; and
- Starwood may not assert Staff comments as a defense in any proceeding initiated by the SEC or any person under the federal securities laws of the United States.

We appreciate your time and attention to this complex matter. If you would like to discuss the above proposed disclosure or any matters related to our VIEs, please let us know. We would gladly accommodate an in-person or telephonic discussion at your convenience. In the meantime, should you need any further information, please contact Rina Paniry, Chief Financial Officer, by phone at 305-695-5470 or by email at rpaniry@starwood.com.

Very truly yours,

/s/ RINA PANIRY

Rina Paniry
Chief Financial Officer

July 24, 2015

VIA EDGAR AND OVERNIGHT COURIER

Securities and Exchange Commission
Division of Corporation Finance
100 F Street, N.E.
Washington, D.C. 20549

Attention: Ms. Jennifer Monick, Staff Accountant
Mr. Isaac Esquivel, Staff Accountant

Re: Starwood Waypoint Residential Trust Form
10-K for the fiscal year ended December 31, 2014
Filed March 6, 2015
File No. 1-36163

Form 8-K
Filed May 12, 2015
File No. 1-36163

Form 8-K/A
Filed May 14, 2014
File No. 1-36163

Dear Ms. Monick:

Starwood Waypoint Residential Trust (the "Company") hereby responds to the comments of the staff (the "Staff") of the U.S. Securities and Exchange Commission (the "Commission") contained in your letter dated July 10, 2015 (the "Comment Letter"), regarding the Company's Form 10-K for the fiscal year ended December 31, 2014 (the "2014 Form 10-K"), the Company's Form 8-K, filed with the Commission on May 12, 2015, and the Company's Form 8-K/A, filed with the Commission on May 14, 2014. For the convenience of the Staff, the Company has set forth below the comments contained in the Comment Letter followed by the Company's response to each comment.

Form 10-K for the year ended December 31, 2014

General

COMMENT:

1. We note you purchased $958 million of real estate during 2014. We further note you have provided Rule 3-14 financial statements in a Form 8-K/A for your purchase of 707 homes from Waypoint Fund XI, LLC. Please tell us if the additional real estate acquisitions during 2014 are significant to require Rule 3-14 financial statements and related pro forma financial information.

RESPONSE: Other than the acquisition of 707 homes from Waypoint Fund XI, LLC (the "Waypoint Fund Acquisition"), the Company had no acquisitions of real estate during 2014 that met the financial requirements of Rule 3-14. Other than the Waypoint Fund Acquisition, the Company only purchased approximately 177 homes in 2014 (totaling $21.1 million in gross purchase price, which represented 2.1% of the Company's total consolidated assets as of its last audited balance sheet) with leasing histories of more than three months. These acquisitions were not significant to require Rule 3-14 financial statements and related pro forma financial information. Other than Waypoint Fund Acquisition and the 177 homes mentioned above, the remaining real estate acquisitions in 2014 had leasing histories of less than three months and thus were not subject to the Rule 3-14 financial statement requirements pursuant to Section 2330.10 of the Staff's Financial Reporting Manual.

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations.

COMMENT:

2. Please tell us the amount of personnel costs you have capitalized to real estate and deferred leasing costs. To the extent material, in future periodic filings, please also separately quantify and disclose the costs capitalized to real estate and deferred leasing costs for all periods presented and discuss fluctuations in capitalized personnel costs for all periods presented within your MD&A. To the extent you do not believe these amounts are material, please tell us how you made that determination.

RESPONSE: As noted on page 72 of the Company's 2014 Form 10-K, the Company capitalizes costs associated with the successful acquisition and stabilization of homes, including certain personnel costs associated with the time spent by such personnel in connection with the planning and execution of all capital improvement activities at the property level. The Company also defers successful leasing costs and amortizes them over the life of the relevant lease. During the year ended December 31, 2014, the Company capitalized $12.8 million of personnel costs to real estate and $8.3 million of personnel costs to deferred leasing costs (other assets).

In the case of personnel costs capitalized to real estate, the $12.8 million the Company capitalized during the year ended December 31, 2014 represents approximately 0.65% of total investments in real estate, net as reported in the Company's 2014 Form 10-K. As a result, the Company does not view this amount to be material. The $8.3 million of personnel costs capitalized to deferred leasing costs (other assets) during the year ended December 31, 2014 represents approximately 46% of total deferred leasing costs (other assets) as reported in the Company's 2014 Form 10-K; however, the Company does not view the amount to be a material percentage of total assets, as it represented 0.28% of total assets as reported in the Company's 2014 Form 10-K.

In addition, the Company does not believe that information concerning capitalized personnel costs is material. The Company has not provided and investors have not inquired about these costs during the Company's past earnings calls or in other communications with investors, which the Company believes demonstrates that analysts and investors do not find information about such costs to be material. To the Company's knowledge, the other public single-family home companies do not disclose this information, which the Company believes also demonstrates that information about such costs is not material. Further, if the Company disclosed this information, the Company believes such disclosure would put the Company at a competitive disadvantage to the other public single-family home companies.

As a result, the Company respectfully submits that capitalized personnel costs are not material information that is required to be included in the Company's future Securities Exchange Act of 1934, as amended (the "Exchange Act"), periodic reports.

Our Portfolio, page 62

COMMENT:

3. In future periodic filings, please disclose the weighted average year of purchase in your tabular portfolio disclosure on page 62.

RESPONSE: The Company will revise the disclosure as requested in future Exchange Act periodic reports.

COMMENT:

4. We note the table that provides a summary of your leasing as of December 31, 2014 on page 63. In future periodic filings, please also include the weighted average original lease term and the weighted average remaining length of leases in your tabular disclosure.

RESPONSE: The Company advises the Staff that it does not currently track and report portfolio data in the manner requested. Therefore, modifications will need to be made to the Company's record keeping systems, which will take some time to implement. As a result, the Company will revise the disclosure as requested in future Exchange Act periodic reports beginning with its periodic report for the three months ended September 30, 2015.

Results of Operations

Property Operating and Maintenance, page 78

COMMENT:

5. Please revise future filings to provide a discussion reflecting property operating expenses as a percentage of revenues for all periods presented. Please explain any significant variances among these percentages.

RESPONSE: The Company will revise the disclosure as requested in future Exchange Act periodic reports.

Liquidity and Capital Resources, page 81

COMMENT:

6. We note that you paid dividends of $5.5 million and had net cash used in operating activities of $81.1 million during the year ended December 31, 2014. In future periodic filings, please discuss the source(s) of these distributions within your Management's Discussion and Analysis of Financial Condition and Results of Operations, as this disparity raises concerns about the sustainability of distributions into the future. Please provide an example of your proposed disclosure.

RESPONSE: The Company's dividend distributions are not directly impacted by net cash used in operating activities. As a real estate investment trust ("REIT"), the Company is required, among other things, to distribute at least 90% of its annual REIT taxable income to its shareholders. In normal course, the Company alerts the public to differences between U.S. generally accepted accounting principle ("GAAP") and taxable calculations, as illustrated in the "Risk Factors" section of the Company's 2014 Form 10-K, which includes the following:

> "We intend to make distributions to our shareholders to comply with the REIT requirements of the Code. From time to time, we may generate taxable income greater than our income for financial reporting purposes prepared in accordance with GAAP, or differences in timing between the recognition of taxable income and the actual receipt of cash may occur."

In response to the Staff's comment regarding the source(s) of distributions to the Company's shareholders, in future Exchange Act periodic reports, the Company will include the following disclosure in the "Management's Discussion and Analysis of Financial Condition and Results of Operations" section:

“***Distributions to Shareholders***

We seek to generate income for distribution to our shareholders, typically by earning a spread between the yield on our stabilized portfolio of single-family rental homes and the cost of our borrowings. Our REIT taxable income, which serves as the basis for distributions to our shareholders, is generated primarily from this spread. The negative net cash flows from operating activities reported in our consolidated statements of cash flows primarily relate to development period expenses. However, cash flows related to our stabilized portfolio of single-family rental homes are positive and sufficient to support distributions to our shareholders.”

Master Repurchase Agreement, page 82

COMMENT:

7. With respect to your repurchase agreements, please quantify the average quarterly balance for all quarterly periods for which you have repurchase agreements. In addition, quantify the period end balance for each of those quarters and the maximum balance at any month-end. Explain the causes and business reasons for significant variances among these amounts. This information should be provided in future periodic filings for any repurchase agreement activity in the past three years, as applicable.

RESPONSE: The table below represents the weighted-average quarterly balance, maximum month-end balance and quarter-end balance of the Company’s master repurchase agreement with Deutsche Bank AG, Cayman Islands Branch as of each quarter end since the execution of such repurchase agreement on February 5, 2014. The table represents all repurchase agreement activity since the Company was spun-off as a separate public company. The smaller balances included in the table for the quarter ended March 31, 2014 reflect the fact that the repurchase agreement was not in place for that entire quarter, and changes in the balances included in the table for subsequent quarters reflects normal course variances in the level of acquisition activity financed with the repurchase agreement in the applicable quarter. The Company will revise the disclosure as requested in future Exchange Act periodic reports.

Quarter Ended	**Weighted-Average Quarterly Balance ($000s)**	**Maximum Month-End Balance ($000s)**	**Quarter-End Balance ($000s)**
March 31, 2014	$ 31,140	$ 140,129	$ 140,129
June 30, 2014	$ 198,291	$ 251,599	$ 251,599
September 30, 2014	$ 351,023	$ 448,320	$ 448,320
December 31, 2014	$ 453,897	$ 454,249	$ 454,249
March 31, 2015	$ 438,371	$ 434,858	$ 422,972

Asset-Backed Securitization Transaction, page 83

COMMENT:

8. In future filings, please provide a summary of the portfolio of the 4,081 homes in your securitization transaction. The information provided should be similar to the information you have provided in your table on page 62.

RESPONSE: The following table summarizes certain information with respect to homes in the Company's securitization (the "Securitization Properties") transaction as of March 31, 2015:

Markets	Number of Homes	Percent Leased	Average Acquisition Cost per Home	Average Investment Per Home(1)	Average Home Size (square feet)	Weighted Average Age (years)	Average Monthly Rent Per Leased Home (2)
Atlanta	826	97%	$ 103,182	$ 130,288	1,882	22	$ 1,188
South Florida	646	100%	$ 133,342	$ 167,975	1,591	45	$ 1,591
Houston	602	98%	$ 128,567	$ 146,499	2,085	30	$ 1,510
Tampa	420	100%	$ 107,767	$ 133,675	1,510	41	$ 1,295
Dallas	444	97%	$ 128,555	$ 149,396	2,041	22	$ 1,495
Denver	126	96%	$ 173,457	$ 211,073	1,439	30	$ 1,723
Chicago	249	98%	$ 120,428	$ 146,259	1,526	39	$ 1,646
Orlando	183	100%	$ 121,371	$ 142,204	1,640	38	$ 1,289
Southern California	251	96%	$ 241,836	$ 252,228	1,622	35	$ 1,784
Northern California	166	95%	$ 218,784	$ 235,427	1,497	44	$ 1,756
Phoenix	182	97%	$ 142,453	$ 160,496	1,537	38	$ 1,187
Total / Average	**4,095**	**98%**	**$ 133,847**	**$ 158,104**	**1,752**	**33**	**$ 1,451**

(1) Includes acquisition costs and actual and estimated upfront renovation costs.
(2) Represents average monthly contractual cash rent.

Because the characteristics of the Securitization Properties other than occupancy are substantially similar to the Company's portfolio of properties (see for comparison the March 31, 2015 property information disclosed in the table on page 38 of the Company's Form 10-Q for the three months ended March 31, 2015 filed on May 13, 2015), the Company respectfully submits that additional property level information for the Securitization Properties is not material information that is required to be included in the Company's future Exchange Act periodic filings.

Cash Flows, page 84

COMMENT:

9. We note that you incur significant capital expenditures to renovate and maintain your homes. In future periodic filings, please disclose the amount of capital expenditures related to renovations on new acquisitions, redevelopments of stabilized properties, and other capital expenditures for the periods presented.

RESPONSE: The Company will revise the disclosure as requested in future Exchange Act periodic reports.

Aggregate Contractual Obligations, page 85

COMMENT:

10. It does not appear that you have included interest payments in your contractual obligations table. Please confirm, that you will disclose the amount of interest related to your debt in future filings. Please refer to footnote 46 in our Release 33-8350.

RESPONSE: The Company will revise the disclosure as requested in future Exchange Act periodic reports.

Consolidated Balance Sheets, page 90

COMMENT:

11. Please revise future period filings to disaggregate your repurchase agreement from your senior SFR facility, or advise. Please refer to Rule 5-02 of Regulation S-X. Please also disaggregate the related cash flow activity on your Consolidated Statements of Cash Flows.

RESPONSE: The Company will revise the disclosure as requested in future Exchange Act periodic reports.

Consolidated Statements of Operations, page 91

COMMENT:

12. We note you have classified gains on loan conversions, net, as realized gains. Please tell us if you sold the related real estate or if you continue to own the real estate. To the extent you continue to own the real estate, please tell us how you were able to determine that these gains are realized. Within your response, please reference the authoritative accounting literature management relied upon.

RESPONSE: As described below, the Company believes that loan conversions are nonmonetary exchange transactions and that the earnings process on the applicable loans have culminated, as the Company no longer has an ongoing transaction with the borrowers/customers and, instead, now has an investment in real property.

Realized gains on loan conversions, net as used in the Company's consolidated statements of operations represents non-performing loans ("NPLs") that were converted into real estate owned ("REO"). Generally, the Company purchases these NPLs at prices significantly below their unpaid principal balances. For the majority of the Company's NPLs, at the time of acquisition, the Company does not expect to receive the contractually required payments due under the terms of the NPLs. Upon acquisition, each NPL is reviewed to determine whether the NPL qualifies to be accounted for under Financial Accounting Standards Board Accounting Standards Codification Topic ("ASC") 310-30, *Receivables - Loans and Debt Securities Acquired with Deteriorated Credit Quality*, ("ASC 310-30") formerly SOP 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer*. As part of this assessment, the Company determines whether there is evidence of credit deterioration since the origination of the loan and whether it is probable that the Company will be unable to collect all of the contractually required payments.

Upon a foreclosure, the "asset" (i.e., the NPL) effectively converts from a financial instrument to real property (i.e., REO), and the Company records the newly received REO asset at its fair value as of the date the Company obtains title to the REO and removes the recorded investment in the NPL from the Company's balance sheet. While there is no explicit guidance in GAAP to account for REO obtained in full satisfaction of a loan when the value received is in excess of the recorded investment, the Company considered paragraph 75 of the *Basis for Conclusions of FAS 15* ("FAS 15"), which states, in part:

> "The Board concluded that a troubled debt restructuring that involves transfer of resources or obligations requires accounting for the resources or obligations transferred whether that restructuring involves an exchange transaction or a nonreciprocal transfer."

Both kinds of transfers are accounted for in the existing accounting framework on essentially the same basis (exchange price received or paid or fair value received or given). The foreclosure transactions that the Company undertakes involve the "transfer of resources or obligations" even though the transaction is technically not within the scope of a troubled debt restructure ("TDR"). The Company does not believe the board conclusions expressed in paragraph 75 of FAS 15 is predicated on the fact that the transfer involves a TDR and, therefore, believes that such conclusion supports that the foreclosure should also be accounted for as a non-monetary transaction. As such, the Company believes that, when the NPL is fully settled through a foreclosure and the fair value of the REO exceeds the recorded investment in the NPL, it is appropriate to apply the guidance for nonmonetary asset transactions under ASC 845, *Nonmonetary Transactions* ("ASC 845"). Pursuant to ASC 845, the difference between the fair value of the REO at the time of foreclosure and the recorded investment of the NPL should be recorded as a realized gain in the Company's income statement. The realization of the above described transaction results in the Company owning REO at fair value with a permanent basis adjustment from the Company's initial investment in the related NPL and represents ownership in a separate and distinct asset, and, therefore, the gain/loss from the exchange is a realization event as prescribed by GAAP.

In summary, when the Company purchases a NPL, the counterparty to the NPL is the underlying borrower, and, as discussed in FAS 15 and above, a foreclosure represents an exchange transaction. The future profitability of operating or selling the REO does not relate to the settlement/extinguishment with the borrower. As a result of the nonmonetary exchange transaction, the Company believes the earnings process on the NPL has culminated, as the Company no longer has an ongoing transaction with the borrower/customer and now has an investment in real property.

This conclusion is consistent with Section 5A, Other Real Estate Owned, of the September 2013 version of the Bank Accounting Advisory Series of the Office of the Comptroller of the Currency (the "OCC Guide"). Although not authoritative, the OCC Guide indicates that upon foreclosure, a bank should record the property acquired at its fair value less costs to sell with a resulting gain for the excess over the carrying value.

COMMENT:

13. We note that you characterize realized gain on loan conversions, net as revenue. Please tell us how you determined this gain meets the definition of revenue pursuant to paragraph 78 of CON 6.

RESPONSE: When determining the appropriate characterization of realized gains on loan conversions, net in the Company's consolidated statements of operations, the Company considered the nature of the Company's ongoing core operations and whether the conversions resulted in enhancements of assets, as defined within paragraph 78 of Statement of Financial Accounting Concepts No. 6 ("CON 6"). The realization on loan conversions represents the creation of value for the Company's shareholders through conversion of a NPL into REO that will generate rental income or is monetized through a sale process. The value creation reflects expected cash inflows that will result from the Company's ongoing major operations. To further evaluate the Company's classification, the Company considered paragraphs 82 and 83 of CON 6 and determined that an NPL conversion does not meet the criteria to be considered a below the line "gain," as the NPL conversion is not "incidental" or "peripheral." Rather, NPL conversions are the realization and execution of the Company's strategy and an important element of the Company's core business.

As described in the Company's 2014 Form 10-K, the core business strategy of the Company's Prime Asset Fund VI, LLC ("Prime") joint venture is to acquire NPLs and (1) convert the loans into REO that can then either be contributed to the Company's rental portfolio or sold or (2) modify and resell NPLs at higher prices if circumstances warrant (the "NPL Strategies"). The Company's core strategy is not, however, to be a long term holder of NPLs once they start to re-perform post modification, and, as such, the Company markets for sale or otherwise disposes (typically within 12 months) of loans once they are re-performing. The Company believes that both of the NPL Strategies create value for the Company's shareholders and are essential to the Company's core business. In addition, the Company believes the NPL conversion process provides a means to significantly grow its real estate portfolio, and the Company considers such conversions to be a significant business strategy.

Notes to Consolidated Financial Statements

Note 2. Basis of Presentation and Significant Accounting Policies

Investments in Real Estate, page 98

COMMENT:

14. We note that the fair value of your Real Estate is primarily determined using BPOs. We note your disclosure on page 103 regarding the nature of the brokers activities used to value the real estate. Please revise your disclosures to (1) Describe the process you undertake to validate the BPOs received; (2) Confirm the BPOs you receive provide you with sufficient detail such that you are able to assess whether the pricing methodology complies with ASC 820; and (3) Discuss any adjustments you make to brokers' valuation of real estate. Please provide us an example of your proposed disclosure.

RESPONSE: The Company will revise the disclosure as requested in future Exchange Act periodic reports. An example of the Company's proposed disclosure is as follows:

> "In order to validate the broker price opinions ("BPOs") received and used in our assessment of fair value of real estate, we perform an internal review to determine if an acceptable valuation approach was used to estimate fair value in compliance with guidance provided by ASC 820, *Fair Value Measurements*. Additionally, we undertake an internal review to assess the relevance and appropriateness of comparable transactions that have been used by the broker in its BPO and any adjustments to comparable transactions made by the broker in reaching its value opinion. As a further review, we order an independent valuation of the property from a third-party automated valuation model ("AVM") service provider and compare the AVM value to the BPO value. In cases where the AVM and BPO values differ beyond a tolerated threshold, an internal evaluation is performed by a licensed appraiser using the market approach, and the value from the internal evaluation is used as our estimated fair value."

COMMENT:

15. Please provide the following for all periods presented:

   a. Please tell us the gross realized gains and gross realized losses on sales of investments in real estate. Further, please compare the net proceeds for the real estate sold to the value assigned to the real estate based on the BPO. Please provide an explanation for any significant variances between the net proceeds and the fair value assigned.

   b. We note you have recorded impairment on real estate. Please clarify for us the change in circumstances that resulted in impairment from the initial fair value assessment.

We may have further comment.

RESPONSE:

a. The gross realized gains on sales of investments in real estate for the years ended 2014 and 2013 and the period from May 23, 2012 (inception) through December 31, 2012 were $3.4 million, $2.2 million and $0.9 million, respectively. The gross realized losses on sales of investments in real estate for years ended 2014 and 2013 and the period from May 23, 2012 (inception) through December 31, 2012 were $3.6 million, $1.0 million and $0.3 million, respectively.

The Company's experience is that the net proceeds for the real estate sold is generally in line with the BPO values of the real estate. However, the Company occasionally encounters differences between net sales proceeds and the fair value assigned due to a number of factors, including bulk sale discounts, changes in market conditions between the date of initial valuation and date of disposition, differences in the actual condition of the home and the perceived value of the home based on the BPO at the conversion date and the impact of broker commissions and other transaction related expenses.

b. Impairments on real estate mainly represent assets originally purchased as part of NPL pools that were subsequently converted to REO. When an NPL is converted to REO, the REO is recorded on the Company's balance sheet at the fair value as of the date the Company takes title to the REO. As part of the standard process of measuring fair value on NPLs, the Company relies in part on BPOs, which incorporate certain assumptions about the internal quality of the underlying home that cannot be fully verified due to the lack of access to the interior of the underlying home. Occasionally, after taking title to the REO, the Company will gain information about the REO that was not evident at the time of the REO conversion and that results in a downward adjustment in estimated fair value and the recognition of an impairment loss. Further, when the Company lists the REO for sale, the REO meets the criteria as held-for-sale under GAAP, and, also in accordance with GAAP, all held-for-sale assets are recorded at the lower of net sales value or carrying value. Due to the fact that REO is initially booked at gross fair value but impairment is tested using fair value net of estimated transaction costs, this can sometimes lead to the recording of impairment on assets held-for-sale.

Non-Performing Loans, page 99

COMMENT:

16. For NPLs for which you have not elected the fair value option, please tell us if these loans gave rise to an accretable yield and nonaccretable difference. Within your response, please refer to ASC 310-30.

RESPONSE: In evaluating the Company's NPL portfolio, the Company considered ASC 310-30 as it relates to NPLs in which the Company did not elect the fair value option. One of the Company's NPL Strategies is to modify and resell NPLs at higher prices if circumstances warrant; however, the Company's holding period for such NPLs is short. When a borrower demonstrates the intent and ability to make principal and interest payments, an NPL may be modified, first on a trial basis, and later on a permanent basis after a period of successful performance, which results in a so-called "re-performing loan." However, such re-performing loans are characterized by high re-default rates and sporadic pay performance. As a result, until an NPL has been permanently modified and the borrower shows a consistent payment history of 12 months or more, the Company does not have the ability to reasonably project the timing and amount of future cash flows to be collected as prescribed in ASC 310-30. For the small percentage of NPLs within the Company's portfolio that will ultimately become re-performing loans, the Company's strategy is to quickly dispose of such loans (typically within 12 months), and, as a result, the Company will not recognize the vast majority of any accretable yield on such loans. Therefore, the Company believes that the accretable yield is both quantitatively and qualitatively immaterial to the users of the financial statements.

Schedule IV, page 130

COMMENT:

17. We note your disclosure that the carrying value of your loans approximates the aggregate cost for federal income tax purposes. We further note that you have elected the fair value option on certain NPLs. Please confirm for us that you continue to believe that the carrying value of your loans approximates that aggregate cost for federal income tax purposes or revise future periodic filings.

RESPONSE: It is no longer the Company's belief that the carrying value of the Company's loans approximates their aggregate cost for federal income tax purposes. In the Company's future Exchange Act periodic reports, the Company will revise its disclosure accordingly.

<u>Form 8-K filed on May 12, 2015</u>

<u>Exhibit 99.1 Press Release, dated May 12, 2015</u>

<u>Estimated NAV, page 8</u>

COMMENT:

18. We note your non-GAAP disclosure related to your estimated NAV measure. Please explain to us and disclose in future filings the methodologies used to determine the fair value of the investments in real estate and non-performing loans, including a qualitative and quantitative description of the material assumptions and estimates used in the analysis.

RESPONSE: The fair value of investments in real estate is determined using a progressive method that incorporates three value sources: automated valuation model values ("AVMs"), BPOs and internal desktop evaluations. AVM values, which are value estimates provided by service providers based on their proprietary mathematical modeling platforms that utilize historical sales and public records data of comparable homes and are adjusted based on characteristics specific to the relevant home being valued, are ordered for each home, and the AVMs the Company receives are accompanied with a confidence index which provides a measure for the perceived reliability of the AVM value. When a home's AVM confidence index falls below a specified score, the Company will order a BPO, which is a value estimate provided by a local broker based on comparable sales data and adjusted based on characteristics specific to the relevant home being valued. If for some reason a current BPO is not available, an internal evaluation is performed by a licensed appraiser using the market approach as defined by the Appraisal Institute to estimate the fair value.

The fair value of investments in NPLs is determined using the net present values of the BPOs of the underlying homes discounted at the then current market discount rate. The net present values of the BPOs of the underlying homes are determined using estimates of the length of time to foreclose or convert the relevant homes, with such estimates made on a state-by-state basis pursuant to market data received from service providers as adjusted from time to time based on the Company's experience.

The Company will revise the disclosure as requested in future Exchange Act periodic reports.

<u>Form 8-K/A filed May 14, 2014</u>

COMMENT:

19. We note you have provided Rule 3-14 financial statement for the period from March 3, 2013 to December 31, 2013. Please tell us if there is a leasing history for these properties for the period from January 1, 2013 to March 2, 2013. To the extent these properties were leased during that time, please tell us how you complied with Rule 3-14 of Regulation S-X.

RESPONSE: For the Waypoint Fund Acquisition, the Company provided Rule 3-14 financial statements for the period from March 5, 2013 to December 31, 2013, because Waypoint Fund XI, LLC, the entity from which the Company acquired the properties, began operations on March 5, 2013. Prior to March 5, 2013, Waypoint Fund XI, LLC did not own the properties, and the properties were not leased.

September 14, 2015

VIA EDGAR

Securities and Exchange Commission
Division of Corporation Finance
100 F Street, N.E.
Washington, D.C. 20549

Attention: Ms. Jennifer Monick, Staff Accountant
Mr. Isaac Esquivel, Staff Accountant

Re: Starwood Waypoint Residential Trust Form 10-K for the fiscal year ended December 31, 2014
Filed March 6, 2015
File No. 1-36163

Dear Ms. Monick:

Starwood Waypoint Residential Trust (the "Company") hereby responds to the comments of the staff (the "Staff") of the U.S. Securities and Exchange Commission (the "Commission") contained in your letter dated August 31, 2015 (the "Comment Letter"), regarding the Company's Form 10-K for the fiscal year ended December 31, 2014 and the Company's Form 8-K, filed with the Commission on May 12, 2015. For the convenience of the Staff, the Company has set forth below the comments contained in the Comment Letter followed by the Company's response to each comment.

Form 10-K for the year ended December 31, 2014

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations.

COMMENT:

1. We note your response to prior comment two and the amount of personnel costs you have capitalized. It appears that these amounts are material to your financial statements taken as a whole and the amounts capitalized need to be disclosed. In future periodic filings, please separately quantify and disclose the costs capitalized to real estate and deferred leasing costs for all periods presented and discuss fluctuations in capitalized personnel costs for all periods presented within your MD&A or advise.

RESPONSE: The Company will revise the disclosure as requested in future Securities Exchange Act of 1934, as amended, periodic reports.

Investments in Real Estate, page 98

COMMENT:

2. We note your response to prior comment 14. In cases where the AVM and BPO values differ beyond a tolerated threshold, please define what is considered a tolerated threshold. Additionally, please tell us how often the AVM and BPO values differ beyond the tolerated threshold.

RESPONSE: The automated valuation models ("AVMs") the Company receives from its third-party AVM service provider (the "AVM Provider") include a corresponding confidence score. An AVM confidence score of 72 from the AVM Provider equates to a statistical error margin of roughly 5%, which the Appraisal Institute has determined is within the acceptable margin of error for an appraisal. Therefore, the Company accepts AVMs with a confidence score equal to or above 72 and discards those with a score below 72, as well as AVMs that appear to have abnormal values (e.g., a significant increase or decrease from the previous AVM value and/or purchase price of the home), and the Company replaces discarded AVMs with a current broker price opinion ("BPO"). Historically, approximately 90% of the AVMs provided to the Company have had a confidence score equal to or greater than 72.

In instances where the Company receives BPOs with valuation dates within 90 days of an available AVM (e.g., where a BPO is required for financing purposes and the Company already has AVMs on file for that particular home), the two are compared, and, historically, the variance in such cases has been approximately 2.5%. In instances where the variance between an AVM value and a BPO value is 10% (which the Appraisal Institute has determined is within the acceptable margin of error for valuations of the same property by different appraisers) or higher, a licensed staff appraiser of the Company performs an internal evaluation to determine the final value estimate. Historically, where current AVMs and BPOs have been compared, the variance between the two has differed beyond the 10% tolerated threshold in approximately 4% of the cases.

Form 8-K filed on May 12, 2015

Exhibit 99.1 Press Release, dated May 12, 2015

Estimated NAV, page 8

COMMENT:

3. We note your response to prior comment 18. Please address the following:

   a. Please tell us the differences between the processes used to arrive at a valuation using a BPO as compared to an AVM.

   b. Please tell us who provides the confidence index and how that confidence index is determined.

c. Please tell us what the "specified score" that the confidence index must fall below to require the Company to order a BPO. Additionally, please tell us how often the confidence index falls below the specified score.

d. Please tell us if you compare the AVMs to BPOs received when you initially converted the NPLs into real estate. To the extent that you do perform such a comparison, please provide us with detail about this process; your response should include, but not be limited to, any additional procedures that you perform as the length of time increases between the date of the BPO and the date of the AVM value. To the extent that you do not perform such a comparison, please tell us how you determined the valuations provided by the AVMs are reasonable.

e. Please tell us if you adjust the AVMs for the physical condition of the property. In your response, please tell us if a property manager, or similar, provides any additional information that is considered in assessing the need to adjust the AVM values.

RESPONSE:

a. An AVM for a home is a valuation generated from approximately 20 individual sub-valuation models, including (i) a number of hedonic or multiple regression models, (ii) an appraisal emulation model and (iii) a time adjustment model, and, after evaluating comparable sales, the AVM value for such home is adjusted by the AVM Provider as if such home was in "after repair" condition. Because not all of the Company's homes are in "after repair" condition, in order to arrive at a valuation using an AVM, the Company (i) for a non-stabilized home, deducts the average remaining estimated capital expense of the Company's non-stabilized homes from the AVM value or (ii) for a stabilized home, deducts the average cost to repair the Company's stabilized homes from the AVM value.

A BPO is an opinion of value given by a licensed real estate broker that inspects the exterior of the subject home in person and performs a form report valuation using the sales comparison approach. The sales comparison approach is a real estate appraisal method that compares the subject home to other homes with similar characteristics that have been sold recently. The BPOs received provide an "as-repaired" value and an "as-is" value. When using a BPO to arrive at a valuation, the Company utilizes the "as-is" value, and, as such, deductions for estimated capital expense or average cost to repair, as applicable, are not required.

b. The AVM confidence score is prepared by the AVM Provider and is a statistically based measurement of how similar or dissimilar the results of the approximately 20 individual sub-valuation models mentioned in the first paragraph of Response 3(a) above are to each other. The AVM confidence score is based on the covariance of the individual sub-valuation models.

c. An AVM confidence score of 72 from the AVM Provider equates to a statistical error margin of roughly 5%, which the Appraisal Institute has determined is within the acceptable margin of error for an appraisal. Therefore, the Company accepts AVMs with a confidence score equal to or above 72. Historically, approximately 90% of the AVM's provided to the Company have had a confidence score equal to or greater than 72. See Response 2 above.

d. Upon initial conversion of non-performing loans ("NPLs") into real estate ("REO"), the Company relies exclusively on BPOs to assess fair value. AVMs are used for subsequent measurements of REO fair value in periods after initial conversion and for the ongoing assessment of fair value of the Company's real estate portfolio. The Company does, however, periodically test for variances between AVMs and BPOs. In particular, in instances where the Company receives BPOs with valuation dates within 90 days of an available AVM (e.g., where a BPO is required for financing purposes and the Company already has AVMs on file for that particular home), the two are compared, and, historically, the variance in such cases has been approximately 2.5%. In instances where the variance between an AVM valve and a BPO value is 10% (which the Appraisal Institute has determined is within the acceptable margin of error for valuations of the same property by different appraisers) or higher, a licensed staff appraiser of the Company performs an internal evaluation to determine the final value estimate. See Response 2 above.

e. The AVM value for a home is adjusted by the AVM Provider as if such home was in "after repair" condition. Because not all of the Company's homes are in "after repair" condition, in order to arrive at a valuation using an AVM, the Company (i) for a non-stabilized home, deducts the average remaining estimated capital expense of the Company's non-stabilized homes from the AVM value or (ii) for a stabilized home, deducts the average cost to repair the Company's stabilized homes from the AVM value. See Response 3(a) above. In general, the Company has not relied on specific feedback from property managers, or similar persons, for the purpose of ongoing real estate valuation.

The Company acknowledges that:

- The Company is responsible for the adequacy and accuracy of the disclosure in the filing;
- Staff comments or changes to disclosure in response to Staff comments do not foreclose the Commission from taking any action with respect to the filing; and
- The Company may not assert Staff comments as a defense in any proceeding initiated by the Commission or any person under the federal securities laws of the United States.

May 18, 2015

VIA EDGAR & OVERNIGHT DELIVERY

U.S. Securities and Exchange Commission
Division of Corporation Finance
100 F Street, N.E.
Washington, D.C. 20549

Attention: Jennifer Monick, Staff Accountant

Re: Strategic Hotels & Resorts, Inc.
Form 10-K for the Fiscal Year Ended December 31, 2014
Filed February 24, 2015
File No. 001-32223

Dear Ms. Monick:

In connection with the Staff's comment letter dated May 14, 2015 regarding Strategic Hotels & Resorts, Inc.'s (the "Company") annual report on Form 10-K for the fiscal year ended December 31, 2014 (the "10-K") filed with the Securities and Exchange Commission (the "Commission") on February 24, 2015, I hereby submit the Company's response. The Staff's comments are reproduced in their entirety below, and the responses thereto are set forth in bold after each comment.

Form 10-K for the Fiscal Year Ended December 31, 2014 filed February 24, 2015

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

FFO, FFO-Fully Diluted, and Comparable FFO, page 53

1. We note that you reconcile Funds from Operations (FFO) from Net income (loss) attributable to SHR common shareholders. Based upon your reconciliation, it appears that FFO represents FFO attributable to common shareholders. Please revise your presentation in future filings to clearly label FFO as FFO attributable to common shareholders. Also make similar revisions to your future earnings releases filed on Form 8-K, as appropriate.

Response:

We advise the Staff that we will revise our presentation in future filings, including future earnings releases filed on Form 8-K, to clearly label FFO as 'FFO attributable to SHR common shareholders' or as 'FFO attributable to common shareholders,' as appropriate.

2. Please tell us the nature of the line item 'Adjustment from consolidated affiliates' in your FFO reconciliation. Additionally, please tell us how this adjustment is consistent with NAREIT defined FFO.

Response:

We advise the Staff that the line item 'Adjustment from consolidated affiliates' in our FFO reconciliation represents the portion of depreciation and amortization and gains or losses on the sale of assets that is attributable to the noncontrolling interests in affiliates that are consolidated but not wholly owned by us. The line items labeled 'Depreciation and amortization' and '(Gain) loss on sale of assets' in the FFO reconciliation include amounts attributable to both us and the noncontrolling interests in our consolidated affiliates. We make this adjustment to reflect only our portion of depreciation and amortization and gains or losses on the sale of assets related to our consolidated affiliates. Our FFO represents FFO attributable to common shareholders; therefore, we believe that reflecting only our portion of these items is appropriate and is consistent with the NAREIT definition of FFO.

We further advise the Staff that the 'Noncontrolling interests adjustments' line item in the FFO reconciliation represents the portion of depreciation and amortization attributable to the redeemable noncontrolling interests in our operating partnership.

We will revise our presentation in future filings, including future earnings releases filed on Form 8-K, to clearly distinguish adjustments related to redeemable noncontrolling interests in our operating partnership from adjustments related to noncontrolling interests in our consolidated affiliates.

Item 8. Financial Statements and Supplemental Data

2. Summary of Significant Accounting Policies

Intangible Assets, page 67

3. We note that you have recorded an intangible asset not subject to amortization in connection with the acquisition of the Hotel del Coronado. Please tell us more about the trade name and the factors you considered in determining that is has an indefinite life. In this regard, please tell us how you determined there are no legal, regulatory, contractual, competitive, economic, or other factors that limit the useful life of the trade name. See ASC 350-30-35-1 through -5.

Response:

We advise the Staff that the intangible asset not subject to amortization is the trade name, Hotel del Coronado. The hotel is an iconic beachfront resort located in Coronado, California that has garnered a strong reputation since it opened in 1888 under the Hotel del Coronado name. This trade name clearly adds value to the property. As noted in ASC 350-30-35-4, if no legal, regulatory, contractual, competitive, economic, or other factors limit the useful life of an intangible asset to the reporting entity, the useful life of the asset shall be considered to be indefinite. ASC 350-30-35-4 further states that the useful life of an intangible asset is indefinite if that life extends beyond the foreseeable horizon – that is, there is no foreseeable limit on the period of time over which it is expected to contribute to the cash flows of the reporting entity. We advise the Staff that we have not identified, after performing due diligence procedures customary with the acquisition of new properties, any legal, regulatory or contractual limitations related to the trade name, Hotel del Coronado. There are few comparable hotels with a similar history and unique reputation as the Hotel del Coronado, which limits any significant competitive factors. The Hotel del Coronado has endured many economic cycles throughout its history, which we believe is a strong indicator that there are no foreseeable economic factors that would limit the useful life of the name. The Hotel del Coronado name has been in existence for over 100 years and will continue to be used at the resort for the foreseeable future. Based on these factors, we have concluded that there is no foreseeable limit on the period of time over which the trade name is expected to contribute to our cash flows and have concluded that it has an indefinite life.

* * *

SUMMIT HOTEL PROPERTIES

12600 Hill Country Boulevard
Suite R-100
Austin, Texas 78738
512-538-2300

August 14, 2015

VIA EDGAR

United States Securities and Exchange Commission
Division of Corporate Finance
100 F. Street, N.E.
Washington, D.C. 20549
Attention: Mr. Daniel Gordon

RE: Summit Hotel Properties, Inc.
Form 10-K for the Year Ended December 31, 2014
Filed March 2, 2015
File No. 1-9044

Dear Mr. Gordon:

This letter is being submitted in response to the comment letter of the staff of the Division of Corporate Finance (the "Staff") of the United States Securities and Exchange Commission (the "SEC") regarding the above-referenced Annual Report on Form 10-K filed by Summit Hotel Properties, Inc. (the "Company").

For the Staff's convenience, the Staff's comment appears below in italics with the Company's response to the comment set out immediately below it.

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

Funds From Operations, page 35

1. We note that your reconciliation of FFO excludes the impact of preferred dividends. Therefore it appears your FFO measure represents FFO attributable to common shareholders and OP unitholders. Please revise your presentation in future filings to clearly label such measure.

RESPONSE: For future SEC filings beginning with the Company's Quarterly Report on Form 10-Q for the quarter ending September 30, 2015, the Company will clearly indicate that its FFO is applicable to common shareholders and OP unitholders and that its reconciliation of FFO begins with the Company's GAAP net income or loss applicable to common shareholders and OP unitholders.

The Company hereby acknowledges that:

- the Company is responsible for the adequacy and accuracy of the disclosure in its filings;
- Staff comments or changes to disclosure in response to Staff comments do not foreclose the Commission from taking any action with respect to the Company's filings;
- the Company may not assert Staff comments as a defense in any proceeding initiated by the Commission or any person under the federal securities laws of the United States.

This response has been shared with our Audit Committee and they concur with the Company's response.

If you have any questions or comments regarding our response above, please do not hesitate to call the undersigned at 512-538-2303.

Very truly yours,

/s/ Greg A. Dowell
Greg A. Dowell
Executive Vice President and Chief Financial Officer

Cc: Daniel P. Hansen, Chief Executive Officer
Christopher R. Eng, General Counsel and Chief Risk Officer
David Freed, Hunton & Williams, LLP

June 23, 2015

Daniel L. Gordon **VIA EDGAR**
Senior Assistant Chief Accountant
Division of Corporation Finance
United States Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

Re: Sun Communities, Inc.
Form 10-K for the year ended December 31, 2014
Filed March 2, 2015
File No. 1-12616

Dear Mr. Gordon:

This letter contains our response to the comment from the Staff of the Commission contained in your letter dated June 11, 2015. For convenience of reference, the comments contained in your letter are reprinted below in italics and are followed by our corresponding response.

1. *In future filings, please revise your disclosure on page 54 to identify the line items "Funds from Operations" and "FFO excluding certain items" as "Funds from operations attributable to Sun Communities, Inc. common stockholders" and "FFO excluding certain items attributable to Sun Communities, Inc. common stockholders".*

Company Response:

The Company respectfully requests the Commission's consideration of the following description of "Funds from operations" and "FFO excluding certain items":

"Funds from operations attributable to Sun Communities, Inc. common stockholders and dilutive convertible securities [(1)]"

"FFO attributable to Sun Communities, Inc. common stockholders and dilutive convertible securitiesexcluding certain items [(1)]"

The footnote ascribed to these line items will read as follows:

[(1)] The effect of certain anti-dilutive convertible securities is excluded from these items.

We will also change the description of "FFO per Share - fully diluted" and "FFO per Share excluding certain items - fully diluted" to:

FFO attributable to Sun Communities, Inc. common stockholders and dilutive convertible securities per Share - fully diluted

FFO attributable to Sun Communities, Inc. common stockholders and dilutive convertible securities per Share excluding certain items - fully diluted

As you requested in the original letter, the Company acknowledges that: it is responsible for the adequacy and accuracy of the disclosure in the filing; staff comments or changes to disclosure in response to staff comments do not foreclose the Commission from taking any action with respect to the filing; and the Company may not assert staff comments as a defense in any proceeding initiated by the Commission or any person under the federal securities laws of the United States.

TANGER FACTORY OUTLET CENTERS, INC.
TANGER PROPERTIES LIMITED PARTNERSHIP
3200 Northline Avenue, Suite 360
Greensboro, NC 27408

June 5, 2015

Mr. Daniel Gordon
Division of Corporation Finance
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

RE: Tanger Factory Outlet Centers, Inc.
Form 10-K
Filed February 24, 2015
Form 8-K
Filed February 10, 2015
File No. 001-11986

Tanger Properties Limited Partnership
Form 10-K
Filed February 24, 2015
File No. 333-3526-01

Dear Mr. Gordon:

Tanger Factory Outlet Centers, Inc. and Tanger Properties Limited Partnership (collectively, the “Company”) are responding to the comments of the staff of the Division of Corporation Finance (the “Staff”) of the U.S. Securities and Exchange Commission (the “Commission”) set forth in your letter dated May 22, 2015.

For your convenience, the Staff's comments are set forth below in bold, followed by the Company's response to each comment.

Form 10-K filed February 24, 2015

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

1. We note your disclosure of commitments related to construction and development activity as of December 31, 2014. Please reconcile the disclosed amounts to your table on page 48 which shows projected total net cost of Foxwoods, Grand Rapids and Southaven of $270.9 million and costs incurred to date of $93.1 million. Based upon this table, it appears that you are expecting to incur approximately $177.8 million in development costs for those three centers alone.

Response:

The purpose of our table on page 48 is to provide information regarding the estimated total net costs associated with our consolidated development projects. The $177.8 million represents an estimate of the projected total net costs remaining to complete the construction and leasing of the outlet centers. The projected total net cost of Foxwoods, Grand Rapids and Southaven includes projected expenditures for land, building, permits, professional services such as engineering and architects fees, tenant allowances, capitalized interest, and other miscellaneous costs. Many of these expenditures listed above are not, or will not, be subject to contracts which are legal binding agreements; thus, as of December 31, 2014, we had entered into legally binding agreements committing us to pay only a portion of these total net costs.

As a result, the disclosure on page 48 differs from our disclosure of commitments on page 52, which is intended to disclose only commitments related to construction and development activity that are enforceable and legally binding, as required under Item 303(a)(5) of Regulation S-K. At December 31, 2014, our legally binding contractual commitments included $54.6 million related to construction contracts and $25.7 million related to tenant improvement allowances associated with executed lease agreements for which the tenant improvements had not been constructed.

Notes to Consolidated Financial Statements

Note 6. Investments in Unconsolidated Real Estate Joint Ventures, page F-28

2. Please provide to us additional details regarding your Savannah joint venture. In this regard, we note that your ownership interest is only 50% yet your equity contribution was significantly higher than that of your joint venture partner.

Response:

Our ownership interest is stated in terms of our legal interest, which is generally based on our voting rights and/or our portion of the proceeds to be received upon a liquidation event after all partner contributions and required returns on those contributions have been paid. Please refer to footnote 1 to the table on page F-28 of our Notes to Consolidated Financial Statements where we state that we expect our economic interest in the joint venture to be greater than our legal interest due to the capital contribution and distribution provisions in the joint venture agreement. Further, please refer to our disclosure on Page F-30 of our Notes to Consolidated Financial Statements under the caption "Savannah, Georgia", where we state that contributions we make in excess of our partner's equity contributions earn a preferred rate of return of 8% from the date the contributions are made until the outlet center's grand opening date, and then 10% annually thereafter.

3. We note your disclosure on page 53 that indicates your joint venture agreements contain provisions by which a partner can force the other partners to either buy or sell their investment in the joint venture. Please describe to us the terms of these put and call options as they relate to each of the individual joint ventures.

Response:

Our joint ventures are generally subject to buy-sell provisions which are customary for joint venture agreements in the real estate industry. Either partner may initiate these provisions (subject to any applicable lock up period), which could result in either the sale of our interest or the use of available cash or additional borrowings to acquire the other party's interest. Under these provisions, one partner sets a price for the property, then the other partner has the option to either (1) purchase their partner's interest based on that price or (2) sell its interest to the other partner based on that price. Since the partner other than the partner who triggers the provision has the option to be the buyer or seller, we don't consider this arrangement to be a mandatory redeemable obligation. In future filings, we will expand our disclosure to include the discussion above.

Form 8-K filed February 10, 2015

Exhibit 99.2

Pro Rata Balance Sheet as of December 31, 2015, page 15

4. We note the Pro Rata Balance Sheet and Pro Rata Statement of Operations included on pages 15 and 16. As the pro rata information appears to include non-GAAP measures, please revise your presentation in future filings to include the disclosures required by Regulation G and Item 10(e)(1)(i) of Regulation S-K including identifying the Pro Rata Balance Sheet and Pro Rata Statement of Operations as non-GAAP. Provide us with a draft of the disclosure you intend to include.

Response:

We will revise our presentation in future filings to clearly identify the Pro Rata Balance Sheet and Pro Rata Statement of Operations as non-GAAP within the headings and columns of each statement. We will also provide an introduction that will provide explanatory and cautionary language similar to the example below:

"The following pro rata information is not, and is not intended to be, a presentation in accordance with GAAP. The pro rata balance sheet and income statement data reflect our proportionate economic ownership of each asset in our portfolio that we do not wholly own. These assets may be found in the table above entitled, “Unconsolidated Joint Venture Information.” The amounts shown in the column labeled “Consolidated” were derived from the Company's consolidated financial statements as filed with the SEC on Form 10-Q or 10-K, as applicable. The amounts in the columns labeled “Prorata” were derived on a property-by-property basis by applying to each financial statement line item the ownership percentage interest used to arrive at our share of net income during the period when applying the equity method of accounting. A similar calculation was performed for the amounts in the columns labeled “Noncontrolling interests” and “Company.”

We provide pro rata balance sheet and income statement information because we believe it assists investors and analysts in estimating our economic interest in our unconsolidated joint ventures when read in conjunction with the Company’s reported results under GAAP. The presentation of pro rata financial statements has limitations as an analytical tool. Some of these limitations include:

- The amounts shown on the individual line items were derived by applying our overall ownership interest percentage determined when applying the equity method of accounting and do not necessarily represent our actual claim to the individual assets and liabilities; and
- Other companies in our industry may calculate their pro rata interest differently than we do, limiting the usefulness as a comparative measure.

Because of these limitations, the pro rata balance sheet and income statement should not be considered in isolation or as a substitute for our financial statements as reported under GAAP, We compensate for these limitations by relying primarily on our GAAP results and using the pro rata balance sheet and income statement only supplementally.”

5. Further, this presentation may attach undue prominence to the non-GAAP information and may give investors the impression that the non-GAAP information represents a comprehensive basis of accounting. Please tell us the consideration you gave to Question 102.10 of the Compliance and Disclosure Interpretations on Non-GAAP Financial Measures.

Response:

We respectfully acknowledge the Staff’s comment. We note that Exhibit 99.2, which contained the pro rata balance sheet and income statement as well as other supplemental operating and financial data, was furnished pursuant to Item 7.01 of the Current Report on Form 8-K filed on February 10, 2015 (the “Form 8-K”). The Company believes that Item 7.01 is appropriate because it considers the information contained in Exhibit 99.2 to be supplemental to its reported GAAP financial results and key non-GAAP financial measures (Funds from Operations and Adjusted Funds from Operations) for the year ended December 31, 2014, which were furnished in Exhibit 99.1 pursuant to Item 2.02 of the Form 8-K.

As a result, we respectfully believe that Regulation G, and not Item 10(e)(1)(i) of Regulation S-K, applies to Exhibit 99.2 and the pro rata balance sheet and income statement contained therein. We note that unlike Item 10(e)(1)(i) of Regulation S-K, Regulation G does not contain the “equal or greater prominence” requirement when presenting the most directly comparable GAAP measure, and therefore we believe that Question 102.10 of the Compliance and Disclosure Interpretations on Non-GAAP Financial Measures does not apply to the pro rata balance sheet and income statement contained in Exhibit 99.2, and that the Company’s presentation of the pro rata balance sheet and income statement, as modified by the proposed additional disclosure contained in our response to Comment 4 above, is appropriate.

TANGER FACTORY OUTLET CENTERS, INC.
TANGER PROPERTIES LIMITED PARTNERSHIP
3200 Northline Avenue, Suite 360
Greensboro, NC 27408

July 16, 2015

Ms. Jaime G. John
Division of Corporation Finance
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

RE: Tanger Factory Outlet Centers, Inc.
Form 10-K
Filed February 24, 2015
Form 8-K
Filed February 10, 2015
File No. 001-11986

Tanger Properties Limited Partnership
Form 10-K
Filed February 24, 2015
File No. 333-3526-01

Dear Ms. Jaime G. John:

Tanger Factory Outlet Centers, Inc. and Tanger Properties Limited Partnership (collectively, the “Company”) are responding to the comment of the staff of the Division of Corporation Finance (the “Staff”) of the U.S. Securities and Exchange Commission (the “Commission”) set forth in your letter dated June 30, 2015.

For your convenience, the Staff's comment is set forth below in bold, followed by the Company's response.

Form 8-K filed February 10, 2015

Exhibit 99.2

Pro Rata Balance Sheet as of December 31, 2014, page 15

1. **We note your response to comment 4 and the proposed revisions. In the introductory paragraph to your Pro Rata Balance Sheet and Pro Rata Statement of Operations please also include language indicating that you do not control, nor do you have any legal claim to the revenues and expenses of the unconsolidated joint ventures. Additionally, expand your disclosure to provide details regarding your ownership and claims to the operations of the joint ventures.**

   Response:

   The introductory paragraph provided in our original response to comment 4 has been restated below in its entirety to incorporate the staff comment above.

   "The following pro rata information is not, and is not intended to be, a presentation in accordance with GAAP. The pro rata balance sheet and income statement data reflect our proportionate economic ownership of each asset in our portfolio that we do not wholly own. These assets may be found in the table above entitled, “Unconsolidated Joint Venture Information.” The amounts shown in the column labeled “Consolidated” were prepared on a basis consistent with the Company’s consolidated financial statements as filed with the SEC on the most recent Form 10-Q or 10-K, as applicable. The amounts in the columns labeled “Pro rata” were derived on a property-by-property basis by applying to each financial statement line item the ownership percentage interest used to arrive at our share of net income during the period when applying the equity method of accounting. A similar calculation was performed for the amounts in the columns labeled “Noncontrolling interests” and “Company.”

We do not control the unconsolidated joint ventures and the presentations of the assets and liabilities and revenues and expenses do not represent our legal claim to such items. The operating agreements of the unconsolidated joint ventures generally provide that partners may receive cash distributions (1) quarterly, to the extent there is available cash from operations, (2) upon a capital event, such as a refinancing or sale or (3) upon liquidation of the venture. The amount of cash each partner receives is based upon specific provisions of each operating agreement and vary depending on factors including the amount of capital contributed by each partner and whether any contributions are entitled to priority distributions. Upon liquidation of the joint venture and after all liabilities, priority distributions and initial equity contributions have been repaid, the partners generally would be entitled to any residual cash remaining based on the legal ownership percentage shown in the table above entitled “Unconsolidated Joint Venture Information”.

We provide pro rata balance sheet and income statement information because we believe it assists investors and analysts in estimating our economic interest in our unconsolidated joint ventures when read in conjunction with the Company’s reported results under GAAP. The presentation of pro rata financial statements has limitations as an analytical tool. Some of these limitations include:

- The amounts shown on the individual line items were derived by applying our overall economic ownership interest percentage determined when applying the equity method of accounting and do not necessarily represent our legal claim to the assets and liabilities, or the revenues and expenses; and

- Other companies in our industry may calculate their pro rata interest differently than we do, limiting the usefulness as a comparative measure.

Because of these limitations, the pro rata balance sheet and income statement should not be considered in isolation or as a substitute for our financial statements as reported under GAAP, We compensate for these limitations by relying primarily on our GAAP results and using the pro rata balance sheet and income statement only supplementally.”

Taubman Centers, Inc.
200 East Long Lake Road
Suite 300
Bloomfield Hills, Michigan
48304-2324

T 248.258.6800
www.taubman.com

Taubman

Via EDGAR

May 11, 2015

U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549
Attention: Ms. Jaime G. John

Re: Taubman Centers, Inc.
Form 10-K for the Fiscal Year Ended December 31, 2014
Filed February 24, 2015
File No. 001-11530

Dear Ms. John:

We refer to your letter dated April 22, 2015, in which you provided comments on behalf of the staff (the "Staff") of the U.S. Securities and Exchange Commission (the "Commission") to Taubman Centers, Inc. ("we" or the "Company") with respect to the Company's Annual Report on Form 10-K for the year ended December 31, 2014 filed on February 24, 2015 (the "2014 Form 10-K"). This letter responds to the Staff's comments as indicated below. For convenience of reference, each Staff comment contained in your April 22, 2015 comment letter is reprinted below in bold italics, numbered to correspond with the paragraph numbers assigned in your letter, and is followed by the corresponding response of the Company.

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

Reconciliation of Net Income Attributable to Taubman Centers, Inc. Common Shareowners to Funds from Operations and Adjusted Funds from Operations, page 53

1. We note that you reconcile Funds from Operations (FFO) from Net income attributable to TCO common shareowners - Basic. Based upon your reconciliation, it appears that the $280.5 million FFO represents FFO attributable to common shareowners, partnership unitholders and participating securities holders. Similarly, it appears that the $200.4 million FFO attributable to TCO represents FFO attributable to TCO common shareowners and participating securities holders. Please advise and revise your presentation in future filings to clearly label each measure. Also make adjustments to earnings releases filed on Form 8-K, as appropriate.

Response

We advise that in reconciling the Company's FFO from Net income attributable to TCO common shareowners, the Company first arrives at a measure of the Operating Partnership (TRG)'s FFO, which is the $280.5 million referenced by the Staff in its comment. This measure is attributable to partnership unitholders and participating securities holders of TRG.

As the controlling general partner of TRG, the majority of the FFO attributable to TRG's partnership unitholders ultimately flows through to the Company's common shareowners. Therefore, after arriving at TRG's FFO as described above, we calculate the FFO attributable to TCO's common shareholders, which is the $200.4 million referenced in the Staff's comment.

The Company takes the approach of first reconciling to TRG's FFO, as the Company conducts all of its operations through its only significant asset, its consolidated subsidiary TRG. This approach is consistent with the guidance provided by the National Association of Real Estate Investment Trusts ("NAREIT"), the real estate industry trade group that originally defined FFO. NAREIT reminded its members through its Financial Reporting Alert dated October 1, 2003 that "FFO…represents FFO applicable to all equity shares - not just FFO attributable to common shareholders." This Alert ultimately confirmed our strategy for this reconciliation, with the FFO of TRG and that allocable to the Company also previously having been the subject of correspondence with the Staff in April 2006.

We agree with the Staff that the captioning in the reconciliation could be enhanced to accurately distinguish and label the two measures of FFO referred to in the Staff's comment. In future filings, the Company will revise the caption of TRG's FFO (currently captioned simply as "Funds from Operations") to "Funds from Operations attributable to partnership unitholders and participating securities of TRG". Similarly, in future filings, the Company will caption the measure of TCO's FFO as "Funds from Operations attributable to TCO's common shareowners". These revised captions will also be used in earnings releases filed on Form 8-K.

Item 8. Financial Statements and Supplementary Data

Note 5 - Investments in Unconsolidated Joint Ventures, page F-22

> ***2. We note your disclosure of combined financial information for your unconsolidated joint ventures. Given the changes in ownership of your unconsolidated joint ventures during 2014, please tell us what consideration you gave to the requirement to file separate financial statements for significant equity method investments pursuant to Rule 3-09 of Regulation S-X.***

Response

The Company considered the requirements to file separate financial statements for significant equity method investments pursuant to Rule 3-09 of Regulation S-X, performing the required income and the investment tests set forth in Regulation S-X 1-02(w) using 20 percent thresholds. Pursuant to these tests, none of the Company's equity method investees qualified as significant and therefore no separate financial statements were filed.

The Company's significance tests considered the changes in our unconsolidated joint ventures during 2014, most notably the disposition of Arizona Mills in January 2014, the sale of a partial ownership interest, including certain governance rights, in International Plaza resulting in its recognition under the equity method starting in January 2014, and the start of operations of University Town Center in October 2014. The Company's income-based significance tests reflected the operations of these particular investees for the portions of the year during which the investments were accounted for using the equity method, consistent with guidelines in the Staff's Financial Reporting Manual. As additional information about the Company's significance tests, note that the unconsolidated joint ventures for which the ownership changed during 2014 would not qualify as significant even if the income-based tests included the entire annual period.

The Company acknowledges that:

- the Company is responsible for the adequacy and accuracy of the disclosure in the filing;
- Staff comments or changes to disclosure in response to Staff comments do not foreclose the Commission from taking any action with respect to the filing; and
- the Company may not assert Staff comments as a defense in any proceeding initiated by the Commission or any person under the federal securities laws of the United States.

If you have any questions or comments regarding the foregoing, or have additional comments or questions, please contact the undersigned at (248) 258-7610, or email lpayne@taubman.com, cc: rhogrebe@taubman.com.

Very truly yours,

/s/ Lisa A. Payne____________________________
Lisa A. Payne
Vice Chairman and Chief Financial Officer

cc:
Mr. Isaac Esquivel
Mr. Donald J. Kunz, Esq., Honigman Miller Schwartz and Cohn LLP
Mr. Michael S. Ben, Esq., Honigman Miller Schwartz and Cohn LLP

VENTAS®

May 18, 2015

VIA EDGAR AND FEDERAL EXPRESS

Sonia Gupta Barros
Assistant Director
Division of Corporation Finance
United States Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

Re: Ventas, Inc.
Form 10-K for the fiscal year ended December 31, 2014
Filed February 13, 2015
File No. 1-10989

Dear Ms. Barros:

Set forth below are the responses of Ventas, Inc., a Delaware corporation (together with its subsidiaries, the "Company"), to the comments of the staff (the "Staff") of the Securities and Exchange Commission (the "Commission") contained in the letter dated May 5, 2015 from you to Debra A. Cafaro, the Company's Chairman and Chief Executive Officer, with respect to the above-referenced filing.

For the convenience of the Staff, we have set forth below each of the Staff's comments in italics, immediately followed by our response thereto.

Form 10-K for the Year Ended December 31, 2014

Funds from Operations and Normalized Funds from Operations, page 61

1. *We note that you reconcile Funds from Operations (FFO) from Net income attributable to common stockholders and it appears FFO represents FFO attributable to common stockholders. In future filings please revise the label of this non-GAAP measure to indicate that it is FFO attributable to common shareholders or tell us why this is not necessary.*

   As requested, the Company will use the labels "FFO attributable to common stockholders" and "Normalized FFO attributable to common stockholders" and continue to reconcile such non-GAAP measures to net income attributable to common stockholders in its future Exchange Act periodic reports.

Triple-Net Lease Expirations, page 69

2. *We note your disclosure that you re-leased to Kindred, transitioned to new operators or sold 107 of the 108 licensed healthcare assets whose lease terms with Kindred were scheduled to expire on September 30, 2014. Please tell us in your response whether you incurred any material leasing costs with respect to the renewal or transition of these expired leases. In future Exchange Act periodic reports, to the extent material, please provide disclosure on the amount of leases signed with new tenants in the reporting period and the costs of such leasing.*

   The Company incurred aggregate leasing costs of $4.5 million in connection with the re-leasing to Kindred Healthcare, Inc. ("Kindred"), transition to new operators or sale of the 107 licensed healthcare assets whose lease terms with Kindred were scheduled to expire on September 30, 2014. These costs were deferred on our consolidated balance sheets and are being amortized over the respective lives of the new leases. These costs represented less than 0.025% of the Company's total assets as of December 31, 2014 and were, therefore, immaterial to the Company's financial condition. As requested, the Company will, to the extent material, provide disclosure on the amount of leases signed with new tenants and the costs incurred by the Company in connection with such leasing in its future Exchange Act periodic reports.

Definitive Proxy Statement on Schedule 14A

Transactions with Related Persons, page 17

3. *We note the disclosure of the aggregate annual rent Sutter Health paid in 2014. Please tell us how you determined that the company should disclose only the aggregate annual rent rather than the aggregate amount of lease payments based on Instruction 3(a) to Item 404(a) of Regulation S-K.*

   The Company determined that its ownership of two medical office buildings ("MOBs") that are 100% leased to Sutter Health, for whom Robert D. Reed served as Senior Vice President and Chief Financial Officer during 2014, did not constitute a transaction with a related person that was required to be disclosed in accordance with Item 404 of Regulation S-K. In particular, Mr. Reed did not have a material direct or indirect interest in the transaction, as the aggregate amount of all rent payments due to the Company from Sutter Health on or after January 1, 2014 was $63.5 million, or less than 0.7% of Sutter Health's annual revenues (Sutter Health reported $10.2 billion of operating revenues in 2014). However, the Company disclosed the lease transactions in its Definitive Proxy Statement because the transactions had been approved by the Company's Audit Committee pursuant to the Company's written Policy on Transactions with Related Persons.

We hope that the foregoing has been responsive to the Staff's comments. The Company hereby acknowledges that:

- it is responsible for the adequacy and accuracy of the disclosure in the above-referenced filing;
- Staff comments or changes to disclosure in response to Staff comments do not foreclose the Commission from taking any action with respect to the filing; and
- the Company may not assert Staff comments as a defense in any proceeding initiated by the Commission or any person under the federal securities laws of the United States.

Should any member of the Staff have any questions or comments or wish to discuss further the foregoing responses to your May 5, 2015 letter, please call me at (312) 660-3725.

Very truly yours,

/s/ Robert F. Probst

Robert F. Probst
Executive Vice President and Chief Financial Officer

cc: Debra A. Cafaro, Chairman and Chief Executive Officer of Ventas, Inc.
T. Richard Riney, Executive Vice President, Chief Administrative Officer and General Counsel of Ventas, Inc.

American Realty Capital Properties, Inc.
2325 East Camelback Road
Suite 1100
Phoenix, AZ 85016

May 21, 2015

VIA EDGAR

Mr. Kevin Woody
Branch Chief
Securities and Exchange Commission
100 F Street, N.E.
Washington D.C. 20549

RE: American Realty Capital Properties, Inc.
Form 10-K for the year ended December 31, 2014
Filed on March 30, 2015
File No. 001-35263

American Realty Capital Properties, Inc.
Form 10-K/A for the year ended December 31, 2014
Filed on April 30, 2015
File No. 001-35263

ARC Properties Operating Partnership, L.P.
Form 10-K for the year ended December 31, 2014
Filed on March 30, 2015
File No. 333-197780

ARC Properties Operating Partnership, L.P.
Form 10-K/A for the year ended December 31, 2014
Filed on April 30, 2015
File No. 333-197780

Dear Mr. Woody:

We are writing in response to your letter dated May 11, 2015, setting forth the comments of the staff of the Division of Corporation Finance (the "Staff") on the above mentioned filings for American Realty Capital Properties, Inc. and ARC Properties Operating Partnership, L.P. (together, the "Company"). We have considered the Staff's comments and our responses are set forth below. To facilitate the Staff's review, we have keyed our responses to the headings and numbered comments used in the Staff's comment letter, which we have reproduced in bold print.

<u>Form 10-K for the year ended December 31, 2015</u>

<u>Item 1. Business</u>

<u>Primary Investment Focus, page 8</u>

1. **We note your disclosure indicating that your business strategy includes receiving the majority of your revenue from "investment grade and creditworthy tenants," as well as your explanation of the term "creditworthy tenant" on page 4. In future Exchange Act periodic reports, please also include a discussion of how management monitors the tenant credit quality of its current portfolio.**

Response: In future Exchange Act periodic reports, the Company will include the following additional disclosure:

We consistently monitor the credit quality of our portfolio by seeking to lease space and/or acquire properties leased to creditworthy tenants that meet our underwriting and operating guidelines and we actively monitor tenant creditworthiness following the initiation of a lease. When we assess tenant credit quality, we: (i) review relevant financial information, including financial ratios, net worth, revenue, cash flows, leverage and liquidity; (ii) evaluate the depth and experience of the tenant's management team; and (iii) assess the strength/growth of the tenant's industry. On an on-going basis, we evaluate the need for an allowance for doubtful accounts arising from estimated losses that could result from the tenant's inability to make required current rent payments and an allowance against accrued rental income for future potential losses that we deem to be unrecoverable over the term of an applicable lease. The factors considered in determining the credit risk of our tenants include, but are not limited to: payment history; credit status and change in status (credit ratings for public companies are used as a primary metric); change in tenant space needs (i.e., expansion/downsize); tenant financial performance; economic conditions in a specific geographic region; and industry specific credit considerations. The credit risk of our portfolio is mitigated by the high quality of our existing tenant base, reviews of prospective tenants' risk profiles prior to lease execution and consistent monitoring of our portfolio to identify potential problem tenants.

<u>Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities</u>

<u>Securities Authorized for Issuance Under Equity Compensation Plans, page 46</u>

2. **We were unable to locate all of the disclosures required by Item 201(d) of Regulation S-K. In future Exchange Act periodic reports, please include tabular equity compensation plan information, or advise. Refer to Item 201(d) of Regulation S-K.**

Response: The Company included the tabular equity compensation plan information required by Item 201(d) of Regulation S-K on page 34 of the Form 10-K/A for the year ended December 31, 2014, which was filed with the U.S. Securities and Exchange Commission (the "SEC") on April 30, 2015. The Company will continue to provide the information required by Item 201(d) of Regulation S-K in its future Exchange Act periodic reports.

<u>Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations, page 47</u>

3. **We note your disclosure on page 13 that, following the announcement that certain of your financial statements could no longer be relied upon, various broker-dealers and clearing firms participating in offerings of Cole Capital's managed REITs suspended sales activity. In future Exchange Act periodic reports, please revise your disclosure in MD&A to more fully describe (i) the impact of such decline in revenue generated by Cole Capital, (ii) the general and administrative expenses associated with Cole Capital's capital raising activity and (iii) any known trends or uncertainties that have had or you reasonably expect will have a material impact on Cole Capital's revenues.**

Response: The Company added additional disclosure on the suspension of certain selling agreements on page 60 of its Quarterly Report on Form 10-Q for the quarter ended March 31, 2015, which was filed with the SEC on May 7, 2015. In response to the Staff's comment, the Company will add similar additional disclosure on such suspensions in future Exchange Act periodic reports to the extent such disclosure is still relevant to the Company.

<u>Funds from Operations and Adjusted Funds from Operations, page 63</u>

4. **We note you have labeled certain items as one time when presenting Company AFFO. Given the nature of these adjustments, it is not clear why they are one time. Please clarify and/or revise to remove the reference to one time from your disclosure in future filings. Reference is made to Question 102.03 of the Division´s Compliance and Disclosure Interpretations for Non-GAAP Financial Measures.**

Response: The Company was using the term "one time" to describe the nature of the adjustments as they related to a specific transaction and not as those adjustments pertained to the Company. In future Exchange Act periodic reports, the Company will revise its disclosure with respect to its adjustments to clarify the nature of such adjustments and replace the reference to one time with "non-routine."

5. We note your adjustment related to the deferred tax benefit to arrive at AFFO. Please provide further clarification as to why management believes this adjustment is appropriate.

Response: The Company's management uses AFFO to evaluate the Company's operating performance, and AFFO also allows for a comparison of the Company's operating performance with other REITs that utilize an equivalent measure. In order to determine the best practice regarding AFFO in the Company's industry, the Company assessed the methodology used by other companies within its peer group that utilize taxable REIT subsidiaries. After reviewing these peers' AFFO calculations, the Company believes that the most appropriate and prevalent practice is to adjust for the deferred portion of the tax provision/benefit. The Company believes that it is appropriate to adjust for the deferred portion of the tax provision/benefit so that only the current portion of the tax provision/benefit, which generally approximates the tax payable/receivable, respectively, attributable to the period, impacts the Company's AFFO.

Liquidity and Capital Resources

Availability of Funds from Credit Facilities, page 66

6. **We note that your credit facilities contain financial covenants. To the extent you have material sources of liquidity, such as a credit facility, that include financial covenants that may restrict future financing flexibility, please include a more detailed discussion of these covenants in future Exchange Act periodic reports.**

Response: In future Exchange Act periodic reports, to the extent the Company has material sources of liquidity that include financial covenants that may restrict future financing flexibility, the Company will include more detailed discussion of these covenants and note whether the Company is in compliance with such covenants.

Related Party Transactions and Agreements, page 69

7. **You state on page 70 that the audit committee investigation identified certain payments made by the company to the former manager and its affiliates that were not sufficiently documented or that otherwise warrant scrutiny. In future Exchange Act periodic reports, please revise to more fully describe and quantify these certain payments to the extent material and clarify whether you intend to seek recovery for such payments.**

Response: The Company is continuing to evaluate whether it has a right to seek recovery for any of these payments and, if so, its alternatives for seeking recovery. The Company has not concluded that recovery of any such payments is reasonably possible. The Company believes that further disclosure about these payments at this time may mislead investors about the likelihood of recovery of such payments. The Company will make additional disclosure in future periodic reports at such time, if any, as it concludes that recovery of any material amount of such payments is reasonably possible.

Contractual Obligations, page 68

8. In future filings, please include a footnote to the table that describes the significant assumptions used to determine the interest payments presented.

Response: In future Exchange Act periodic reports, the Company will include a footnote to the Contractual Obligations table that describes the significant assumptions used to determine the interest payments presented.

[Remainder of this page left intentionally blank]

American Realty Capital Properties, Inc.
2325 East Camelback Road
Suite 1100
Phoenix, AZ 85016

July 10, 2015

VIA EDGAR

Ms. Jennifer Gowetski
Special Counsel
Securities and Exchange Commission
100 F Street, N.E.
Washington D.C. 20549

RE: American Realty Capital Properties, Inc.
Form 10-K for the year ended December 31, 2014
Filed on March 30, 2015
File No. 001-35263

American Realty Capital Properties, Inc.
Form 10-K/A for the year ended December 31, 2014
Filed on April 30, 2015
File No. 001-35263

ARC Properties Operating Partnership, L.P.
Form 10-K for the year ended December 31, 2014
Filed on March 30, 2015
File No. 333-197780

ARC Properties Operating Partnership, L.P.
Form 10-K/A for the year ended December 31, 2014
Filed on April 30, 2015
File No. 333-197780

Dear Ms. Gowetski:

We are writing in response to your letter dated June 5, 2015, setting forth the additional comments of the staff of the Division of Corporation Finance (the "Staff") on the above mentioned filings for American Realty Capital Properties, Inc. and ARC Properties Operating Partnership, L.P. (together, the "Company"). We have considered the Staff's comments and our responses are set forth below. To facilitate the Staff's review, we have keyed our responses to the headings and numbered comments used in the Staff's comment letter, which we have reproduced in bold print.

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations, page 47

1. **We note your response to comment 3 of our letter. Additionally, we note the disclosure on page 60 of your Quarterly Report on Form 10-Q for the quarter ended March 31, 2015 that "[d]ue to the Restatement, selling agreements for the Managed REITs in their offering stages were suspended. Accordingly, our Cole Capital results of operations for the three months ended March 31, 2015, compared to the three months ended March 1, 2014, reflect decreases in most categories." In future Exchange Act periodic reports, please revise your disclosure to more specifically describe and quantify the effect of this suspension on (i) the revenue generated by Cole Capital, (ii) the general and administrative expenses associated with Cole Capital's capital raising activity and (iii) any known trends or uncertainties that have had or you reasonably expect will have a material impact on Cole Capital's revenues.**

Response: In future Exchange Act periodic reports, the Company will add disclosure to more specifically describe and quantify the effect of the suspension on (i) the revenue generated by Cole Capital, (ii) the general and administrative expenses associated with Cole Capital's capital raising activity and (iii) any known trends or uncertainties that have had or we reasonably expect will have a material impact on Cole Capital's revenues, to the extent such disclosure is still relevant to the Company.

Liquidity and Capital Resources

Availability of Funds from Credit Facilities, page 66

2. **We note your response to comment 7 of our letter. In future Exchange Act periodic reports, to the extent material, we continue to believe that you should revise your disclosure to more fully describe and quantify these certain payments made by the company to the former manager and its affiliates that were not sufficiently documented or that otherwise warrant scrutiny and clarify that you have not concluded that the recovery of such payments is reasonably possible. Please revise accordingly or advise.**

Response: As the Company's counsel advised you by telephone, we are still evaluating whether it would be appropriate to expand on our existing disclosure concerning potential claims arising from past transactions with the Former Manager and its affiliates. If we determine that additional disclosure is appropriate, we will advise you in advance of our upcoming quarterly filing.

[Remainder of this page left intentionally blank]

August 5, 2015

VIA EDGAR

Mr. Tom Kluck
Legal Branch Chief
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Re: Washington Real Estate Investment Trust
Form 10-K for the year ended December 31, 2014 filed March 2, 2015
File No. 001-06622

Dear Mr. Kluck:

This letter is in response to your comment letter received on August 3, 2015. We have set forth below your comment in italics, followed by our response.

Form 10-K for the year ended December 31, 2014

Part I, Page 4

Our Portfolio, Page 5

1. *We note your lease expiration table at the top of page 6. In future Exchange Act periodic reports, please provide this disclosure for 10 years and provide separate disclosure for your retail and office properties or advise.*

Response:

In future Form 10-K filings, we will disclose lease expirations for 10 years separately for our office and retail properties.

* * *

Pursuant to your request, in connection with responding to this comment, Washington Real Estate Investment Trust acknowledges that:

- the company is responsible for the adequacy and the accuracy of the disclosure in the filing;
- staff comments or changes to disclosure in response to staff comments do not foreclose the Commission from taking any action with respect to the filing; and
- the company may not assert staff comments as a defense in any proceeding initiated by the Commission or any person under the federal securities laws of the United States.

WEINGARTEN REALTY

2600 Citadel Plaza Drive
Suite 125
Houston, Texas 77008
800.688.8865
www.weingarten.com

May 27, 2015

VIA EDGAR

Ms. Jennifer Monick
Senior Staff Accountant
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

Re: Weingarten Realty Investors
Form 10-K for the Year Ended December 31, 2014
Filed February 19, 2015
File No. 001-09876

Dear Ms. Monick:

Weingarten Realty Investors (the “Company”, “we”, “us”, or “our”) is submitting this letter in response to the Staff’s comment letter, dated May 20, 2015, with respect to the Company’s Annual Report on Form 10-K for the year ended December 31, 2014.

Set forth below are the Company’s responses. For the convenience of the Staff, the Company has repeated each of the Staff’s comments followed by the Company’s responses.

Form 10-K for the year ended December 31, 2014

Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations

Funds from Operations, page 38

1. We note that your calculation of FFO starts with Net income attributable to common shareholders and as such, it appears that the resulting amount of FFO represents FFO attributable to common shareholders rather than FFO for the entire company. In future filings please re-label "Funds from operations" to "Funds from operations attributable to common shareholders".

Response:

In response to the Staff's comment, we will, in future fillings, use the label "Funds from operations attributable to common shareholders".

Item 8. Financial Statements and Supplementary Data

Consolidated Statements of Equity, page 47

2. We note that you recorded $144 million in Disposition of noncontrolling interests. Please provide to us additional details regarding this transaction. In addition, please disclose the nature of this adjustment within future periodic filings.

Response:

This transaction relates to the dissolution, which is disclosed on page 78 of our 10-K in Note 20 Related Parties, of a consolidated joint venture with Hines Retail REIT ("Hines"), of which we owned a 30% interest. (For additional information on this consolidated joint venture, please refer to our 10-K Note 22 Variable Interest Entities.) The joint venture owned 13 properties and upon dissolution, five were distributed to us, accounted for under ASC 810 and eight were distributed to Hines, accounted for under ASC 360. Upon the distribution of the eight properties, we reduced our remaining noncontrolling interests associated with the joint venture in the amount of $144 million.

The current disclosure in our 10-K, Note 20 regarding this transaction is as follows:

In 2014, we completed the dissolution of our consolidated real estate joint venture with Hines Retail REIT ("Hines"), in which we owned a 30% interest. At December 31, 2013, this joint venture held a portfolio of 13 properties located in Texas, Tennessee, Georgia, Florida and North Carolina with $172.9 million in total assets and $11.1 million of debt, net, which was assumed by Hines. This transaction was completed through the distribution of five properties to us, resulting in an increase to our equity of $11.0 million, and eight properties to Hines. The eight properties distributed to Hines were classified as held for sale at December 31, 2013, and we realized a $23.3 million gain in discontinued operations associated with this transaction.

We will, in future filings, update our Related Party Note to include the following disclosure:

"In 2014, we completed the dissolution of our consolidated real estate joint venture with Hines Retail REIT ("Hines"), in which we owned a 30% interest. At December 31, 2013, this joint venture held a portfolio of 13 properties located in Texas, Tennessee, Georgia, Florida and North Carolina with $172.9 million in total assets and $11.1 million of debt, net, which was assumed by Hines. This transaction was completed through the distribution of five properties to us and eight properties to Hines, resulting in an increase to our equity and a decrease to noncontrolling interests of $11.0 million.

Additionally, upon the distribution of the eight properties to Hines, we realized a $23.3 million gain in discontinued operations and a decrease in noncontrolling interest of $144.3 million associated with this transaction."

The Company acknowledges that:

- the Company is responsible for the adequacy and accuracy of the disclosure in the filing;
- staff comments or changes to disclosure in response to staff comments do not foreclose the Commission from taking any action with respect to the filing; and
- the Company may not assert staff comments as a defense in any proceeding initiated by the Commission or any person under the federal securities laws of the United States.

If you have any questions, please do not hesitate to contact me at 713-866-6054 should you require any additional information.

Sincerely,

/s/ Stephen C. Richter

Stephen C. Richter
Executive Vice President
and Chief Financial Officer

Weyerhaeuser PO BOX 9777
Federal Way, WA 98063-9777

Tel 253-924-7071
Fax 253-924-7624

April 24, 2015

Ms. Erin E. Martin
Senior Counsel
United States Securities and Exchange Commission
Division of Corporation Finance
100 F Street, N.E.
Washington, D.C. 20549

Re: Comment Letter Dated April 21, 2015
Regarding Weyerhaeuser Company
Form 10-K
Filed February 13, 2015
File No. 001-04825

Dear Ms. Martin:

We received your correspondence dated April 21, 2015 in which you commented on Weyerhaeuser Company's annual report on Form 10-K for the year ended December 31, 2014. We set forth below first the comments of the Staff of the U.S. Securities and Exchange Commission (the "Staff") in italics and follow with our responses.

Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A), page 33

1. *We note your use of adjusted EBITDA in your earnings release. Please tell us if you consider this measure to be a key performance indicator. To the extent this measure is considered to be a key performance measure, in future filings please include the measure as well as the required disclosure in accordance with Item 10(e) of Regulation S-K within your Management's Discussion and Analysis. Please include an example of any future disclosure in your response.*

Response: The Company considers this measure to be a key performance indicator and, accordingly, we will include this measure and the required disclosure in accordance with Item 10(e) of Regulation S-K in our future filing. An example of our future disclosure is as follows:

PERFORMANCE MEASURES

We use Adjusted Earnings before Interest, Taxes, Depreciation, Depletion and Amortization (Adjusted EBITDA) as a key performance measure to evaluate the performance of the consolidated company and our business segments. This measure should not be considered in isolation from and is not intended to represent an alternative to our results reported in accordance with U.S. generally accepted accounting principles (U.S. GAAP). However, we believe Adjusted EBITDA provides meaningful supplemental information about our operating performance, better facilitates period to period comparisons, and is widely used by analysts, lenders, rating agencies and other interested parties.

Our definition of Adjusted EBITDA may be different from similarly titled measures reported by other companies. Adjusted EBITDA, as we define it, is operating income from continuing operations adjusted for depreciation, depletion, amortization, pension and postretirement costs not allocated to business segments (primarily interest cost, expected return on plan assets, amortization of actuarial loss and amortization of prior service cost/credit), special items and discontinued operations.

ADJUSTED EBITDA BY SEGMENT

DOLLAR AMOUNTS IN MILLIONS	2014
Adjusted EBITDA by Segment:	
Timberlands	$ 820
Wood Products	446
Cellulose Fibers	447
	1,713
Unallocated Items	(79)
Total	**$ 1,634**

We reconcile Adjusted EBITDA to net earnings for the consolidated company and to operating income for the business segments, as those are the most directly comparable U.S. GAAP measures for each.

The table below reconciles Adjusted EBITDA to net income by segment during the year ended 2014:

DOLLAR AMOUNTS IN MILLIONS	Timberlands	Wood Products	Cellulose Fibers	Unallocated Items	Total
Adjusted EBITDA by Segment:					
Net earnings					$ 1,826
Earnings from discontinued operations, net of income taxes					(998)
Interest expense, net of capitalized interest					344
Income taxes					185
Net contribution to earnings	**$ 613**	**$ 327**	**$ 291**	**$ 126**	**1,357**
Interest income and other	—	—	1	(38)	(37)
Operating income	**613**	**327**	**292**	**88**	**1,320**
Depreciation, depletion and amortization	207	119	155	12	493
Non-operating pension and postretirement credits	—	—	—	(45)	(45)
Special items[1]	—	—	—	(134)	(134)
Adjusted EBITDA	**$ 820**	**$ 446**	**$ 447**	**$ (79)**	**$ 1,634**

(1) Special items include: a $151 million pretax gain related to a previously announced postretirement plan amendment, $39 million in restructuring and closure charges related to our selling, general and administrative cost reduction initiative and a $22 million pretax gain on the sale of a landfill in Washington State.

Economic and Market Conditions Affecting Our Operations, page 33

2. *We note your disclosure regarding the impact of the U.S. housing market, demand in China and Japan and the strength of the U.S. dollar on your operations in 2014. In future filings please expand your disclosure to describe how management expects such economic and market conditions will effect continuing operations in the next year or advise. Refer to Item 303(a)(3)(ii) of Regulation S-K for guidance.*

Response: The Company will include in its future filings disclosure that describes how management expects such economic and market conditions to affect continuing operations in the next year.

June 19, 2015

VIA HARD COPY AND EDGAR

Ms. Jennifer Monick
Staff Accountant
United States Securities and Exchange Commission
Division of Corporation Finance
100 F Street, N.E.
Washington, D.C. 20549

Re: Washington Prime Group Inc.
Form 10-K for the Year Ended December 31, 2014
Filed February 26, 2015
Form 10-Q for the Period Ended March 31, 2015
Filed May 7, 2015
Form 8-K/A
Filed March 17, 2015
File No. 001-36252

Dear Ms. Monick:

WP Glimcher Inc. (the "Company") is transmitting for filing the Company's responses to the comments of the staff of the Division of Corporation Finance (the "Staff") of the Securities and Exchange Commission (the "Commission") contained in your letter dated June 8, 2015 related to the filings listed above.

For convenience, each comment contained in your June 8, 2015 letter is reprinted below in italics, followed by the Company's response.

Form 10-K for the Year Ended December 31, 2014

Note 3. Summary of Significant Accounting Policies

Intangibles, page F-18

1. With respect to your below market lease intangibles, please tell us how you considered any fixed rate renewal options in your estimate of the remaining term of the underlying leases and your basis for your determination. Your response should address, but not necessarily be limited to, whether or not you use a threshold in your evaluation. To the extent you use thresholds, please tell us how you concluded that these thresholds are appropriate and tell us the potential impact to your financial statements, including the impact from the acquisition of Glimcher, if you were to conclude that all below market fixed rate renewal options would be exercised.

COMPANY RESPONSE:

For each lease assumed through the acquisition of a property, the Company applies Accounting Standards Codification ("ASC") 805-20-25-12 to determine whether the terms of the lease are favorable or unfavorable compared with the market terms of a lease for a similar property at the acquisition date. If the terms are favorable, an above market lease intangible asset is recorded, and if the terms are unfavorable, a below market lease liability is recorded. Because ASC 805-20-25-12 does not provide further guidance on how to arrive at the fair value of the above or below market lease intangible asset or liability, the Company refers to ASC 820 and ASC 840 for the appropriate valuation guidance. ASC 820 provides detailed guidance for using management’s judgment and other market participant consideration in assessing fair value when quoted prices are not available.

With respect to leases that are deemed to be below market, the Company considers fixed rate renewal options in its calculation of the fair value of resulting below market lease intangible liabilities and their remaining terms. Based on the Company's experience, tenants typically make renewal decisions based upon a variety of both quantitative and qualitative factors.

Per the Company's experience, contractual option rents that are only slightly below market may not sufficiently incentivize a tenant to exercise their option, due to factors such as the availability of newer buildings and location optimization, among others. Accordingly, the Company believes that a renewal option must qualify as a "bargain renewal option" (as defined below) with a renewal rate that is "sufficiently lower" than market rates in order for exercise to be "reasonably assured." ASC 840-10-20 defines a bargain renewal option as "a provision allowing the lessee, at his option, to renew the lease for a rental sufficiently lower than the fair rental of the property at the date the option becomes exercisable that exercise of the option appears, at the inception of the lease, to be reasonably assured." The authoritative guidance included in ASC 840-10-20 does not provide quantitative thresholds to use in making an assessment of whether rental rates are “sufficiently lower” so that exercise is reasonably assured. Therefore, the Company is required to apply professional judgment in determining whether this "reasonably assured" test is met.

The Company has developed its policy (included in its "Purchase Accounting Allocation" policy) in an attempt to reflect what an active market participant would consider a “bargain renewal option." Based on the Company's market knowledge and extensive leasing and re-leasing experience, its research of policies of other real estate companies, and the methodologies utilized by third-party valuation experts, the Company has determined that generally an option should be considered “sufficiently lower” if it is at least 10% below projected market rates, depending on the amount of time until future option exercise date(s). Generally, the further into the future the option exercise date, the less likely the tenant is to exercise the renewal option and the higher the threshold to be applied. The Company believes that this methodology is in-line with how a market participant would consider such an option, and therefore the 10% quantitative threshold represents a starting point for the Company's analysis.

In addition, the Company evaluates each real estate lease acquired from a qualitative perspective to determine whether a renewal option is considered a bargain renewal option (i.e., reasonably assured of exercise) based on the facts and circumstances existing at the acquisition date. These factors include, but are not limited to, length of the in-place lease, the contractual ability of the tenant to sublease their space, financial performance of the property, financial performance of the individual tenant, the overall economic climate, and any other known facts or circumstances surrounding the tenant’s business operations.

In summary, based on the factors described above, the Company has determined that generally the exercise of a bargain renewal option is “reasonably assured” when the lease renewal rate is at least 10% below expected market rents (as discussed above) and certain qualitative factors are met. The Company has determined that, in general, renewal rates that are less than 10% below estimated market rents are not reasonably assured of exercise and do not constitute a bargain renewal, and therefore, the Company generally does not quantify the impact of such renewal options in its valuation models. Similarly, the Company has determined that, in general, renewal rates that are more than 10% below estimated market rents are reasonably assured of exercise, absent qualitative factors that would suggest otherwise, and therefore, the Company records the impact of such an option as a below market lease liability. For all below market leases with fixed option renewals (regardless of threshold), the Company also analyzes all of the qualitative factors discussed above in determining whether the recording of an intangible below market lease liability related to such an option is appropriate.

In response to your comment, the Company has quantified the potential impact to its financial statements if it concluded that all below market fixed rate renewal options would be exercised, without considering the "reasonably assured" test described above. For this quantification as of December 31, 2014, the Company evaluated its 2014 acquisitions that included the assumption of in-place leases, which represent approximately 76% of the below market lease liability balance recorded in the Company's consolidated financial statements at that date. Because essentially all of the extension options on below market leases were deemed bargain renewal options (i.e., in excess of the 10% threshold described above, taking into consideration qualitative factors), the Company included all of the extension options when valuing the below market lease liabilities and determining the amortization periods for the 2014 acquisitions. Therefore, there would be no material impact to below market lease liabilities and rental revenue, based on the analysis of 2014 acquisitions and extrapolation to the remaining prior year leases as of and for the year ended December 31, 2014.

The Glimcher purchase price allocation, including our evaluation of the fair value of acquired leases, is preliminary as of March 31, 2015, and the Company continues to analyze the various assumptions and estimates utilized in the analysis of the fair value of acquired leases. The following analysis considers the Company's current best estimate of the below market lease liability as compared to the potential liability balance if all below market renewal options were to be valued as part of that liability. For the quantification of the potential impact to the financial statements as of March 31, 2015, the Company evaluated its 2014 acquisitions (zero impact as noted above) and its first quarter 2015 acquisitions including its acquisition of 23 properties in the merger with Glimcher on January 15, 2015. Because some extension options on below market leases were not deemed bargain renewal options (i.e., below the 10% threshold described above, taking into consideration qualitative factors), the Company excluded them when valuing the below market lease liabilities and determining the amortization periods for the first quarter 2015 acquisitions. After including all such extension options, there would be an increase to below market lease liabilities of approximately $7.8 million, with a corresponding increase to other real estate assets, as of March 31, 2015. There would be no resulting material change to rental revenue (due to longer amortization periods) or depreciation expense for the three months ended March 31, 2015. There would also be no resulting material annual change to rental revenue (due to longer amortization periods) or depreciation expense. Therefore, if the Company assumed that all below market fixed rate renewal options would be exercised, the impact of this assumption would not be material to the financial statements. Moreover, the Company believes the methodology it has used in its historical financial statements to value and amortize its below market lease liabilities (including consideration of whether the exercise of the related extension options is "reasonably assured") is proper for the reasons presented above.

Form 10-Q for the Period Ended March 31, 2015

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

Non-GAAP Financial Measures, page 41

2. In future filings, please revise your reconciliation to identify the line item "FFO allocable to shareholders" as "FFO allocable to common shareholders." This comment also applies to your presentation in future earnings releases such as the release furnished as an exhibit to your Form 8-K filed May 7, 2015.

COMPANY RESPONSE:

In future filings, the Company will label the line item "FFO allocable to common shareholders" to more accurately describe the item.

3. We note your adjustment for NOI from Glimcher properties prior to the Merger. Please revise future periodic filings to quantitatively and qualitatively disclose how you arrived at that adjustment. Your revision should include, but not necessarily be limited to, how you derived the related revenues and expenses, how you derived any adjustments to historical revenues and expenses, and your basis for any such adjustments. Please provide us with an example of your proposed disclosure.

COMPANY RESPONSE:

In future filings, the Company will more thoroughly describe the adjustment to NOI reflected by the line item "Add: NOI from Glimcher properties prior to the Merger," disclosing quantitatively and qualitatively how it arrived at the adjustment. The adjustment consists of the historical revenues and expenses from the 23 properties acquired in the Merger with no adjustments to the historical amounts. This adjustment is deemed necessary in order to provide comparability in the NOI calculations across all periods presented. An example of the Company's proposed disclosure, to be included in a footnote to the NOI table (renumbering other footnotes as needed), is as follows:

"(2) Represents an adjustment to add the historical NOI amounts from the 23 properties acquired in the Merger for periods prior to the January 15, 2015 Merger date. This adjustment is included to provide comparability across all periods presented."

Form 8-K/A Filed March 17, 2015

4. We note you have accounted for the JV transaction in the pro forma financial information using the equity method of accounting. We further note that you will retain a 51% ownership interest in the joint venture, you will retain management and leasing responsibilities, and that major decisions require mutual consent of the joint venture partners. Please tell us how you determined it was not necessary to consolidate this entity. Your response should include, but not necessary be limited to, how you resolve disagreements involving major decisions.

COMPANY RESPONSE:

As disclosed in Note 2 to the audited financial statements in its Form 10-K for the year ended December 31, 2014 filed with the Commission on February 26, 2015, the Company's financial statements "reflect the consolidation of properties that are wholly owned or properties in which we own less than a 100% interest but that we control." Per Note 2, "we also consolidate a variable interest entity, or VIE, when we are determined to be the primary beneficiary."

In determining whether or not to consolidate the JV Properties (as defined in the above referenced Form 8-K/A), the Company first tested to determine if the JV Properties would qualify as VIE's. In reviewing this, the Company tested to determine whether the equity at risk was sufficient upon its sale on June 1, 2015 (the "Sale Date") of the 49% economic interest in the JV Properties to O'Connor Mall Partners, L.P ("O'Connor"). The Company notes the following items:

A. As of the Sale Date, the JV Properties had total equity (fair value) of approximately $884.0 million which was in excess of 50% of the book value of the assets, and book value materially approximates fair value since the assets had been recorded at fair value in connection with the Glimcher acquisition on January 15, 2015.

B. The loans encumbering the JV Properties owned by the JV are non-recourse and do not require guarantees of financial performance.

Based upon the factors above and other considerations, the Company determined that the JV's equity is sufficient to permit the entity to finance its activities without additional subordinated financial support.

With respect to ASC 810-10-15-14b and 14c, there are no provisions in the governing documents that would cause the equity holders as a group to lack any of the characteristics of a controlling financial interest. That is, the equity holders as a group make all of the decisions and are exposed to all of the risks and rewards of ownership based upon the economic interest within the JV. Accordingly, the Company determined that the JV is not a VIE.

The Company then tested to determine which, if any, member effectively controlled the JV. As described below, ASC 810 -25-1 discusses when it is appropriate to consolidate an entity:

"Consolidation is appropriate if a reporting entity has a controlling financial interest in another entity and a specific scope exception does not apply (see Section 810-10-15). The usual condition for a controlling financial interest is ownership of a majority voting interest, but in some circumstances control does not rest with the majority owner."

The Company, as disclosed in Note 2 to the audited financial statements referenced above, determines that "control of a property is demonstrated by, among other factors, our ability to refinance debt and sell the property without the consent of any other member or owner and the inability of any other member or owner to replace us." The following decision items, which include the Company's major criteria for determining control, are viewed as major decisions within the JV ("Major Decisions"):

- The approval of debt refinancing related to the properties.
- The approval of the sale of property.
- The approval of the removal or replacement of a member.
- The approval of the operating budgets, including general leasing parameters.
- The approval of the capital expenditure budget.
- The approval of the property marketing plans.
- The approval of major leases or other leases outside of the general parameters.

All of these Major Decisions require the unanimous consent of both the Company and the O'Connor member.

Also as noted, the Company, through one of its subsidiaries, is responsible for the operational management and leasing of the JV Properties through separate agreements. However, in its capacity as manager, the Company is strictly executing upon the strategic direction and operating parameters previously approved by the JV members unanimously. Under the terms of the JV and related property management agreements, the property manager is not permitted to operate (e.g., allow the properties to incur operating or capital expenditures, enter into leasing arrangements, etc.) the properties outside of the terms of the previously approved budgets, marketing plans and leasing parameters, without obtaining the consent of each of the JV members.

The agreements that govern the JV (the “JV Agreements”) also provide a course of resolution for disagreements over Major Decisions, which requires both JV members, within set time frames, of a disagreement of a Major Decision, to negotiate in good faith. It further provides for escalating levels of management negotiations and extended timelines to negotiate in good faith. In the event no decision can be reached on certain operational Major Decisions, the JV Agreements provide for continued operation of the property or properties in accordance with the previous year’s budgets. This feature of the JV Agreements strongly encourages the JV members to negotiate and mutually resolve their disagreements over such Major Decisions, because continued operation under the previous year’s budget does not allow the property manager to adapt the operations of the properties to current market conditions, and thus provides an unsustainable approach to operating the properties in a manner that would allow the JV Properties to achieve their long-term strategic direction and maximize economic results. For non-operational Major Decisions, in the event an agreement cannot be reached, no action will be taken on a proposed Major Decision.

Therefore, since decisions over all of the criteria that the Company considers when determining whether financial control exists require unanimous consent with significant input from all JV members, the Company has concluded that joint control exists over the JV properties, precluding consolidation by the Company. The Company concluded, given its significant influence over the operations of the JV properties, that the equity method of accounting was the appropriate model to use within the pro forma financial information.

Additionally, the Company acknowledges the following:

- the Company is responsible for the adequacy and accuracy of the disclosures in the filing;

- Staff comments or changes to disclosure in response to Staff comments do not foreclose the Commission from taking any action with respect to the filing; and

- the Company may not assert Staff comments as a defense in any proceeding initiated by the Commission or any person under the federal securities laws of the United States.

If you have any questions or comments regarding the foregoing, or have additional questions or comments, please contact the undersigned at 614-887-5610.

Sincerely,

/s/ Mark E. Yale
Mark E. Yale
Executive Vice President and
Chief Financial Officer

cc: William Demarest

U.S. Securities and Exchange Commission

Securities Act of 1933
Rule 144

March 14, 2016

Response of the Office of International Corporate Finance
Division of Corporation Finance

Re: Bank of America, N.A., Merrill Lynch, Pierce, Fenner & Smith Incorporated
Incoming letter dated March 11, 2016

Based on the specific facts and representations in your letter, and without necessarily agreeing with your analysis, the Division's views are as follows. Capitalized terms have the same meanings as defined in your letter.

For purposes of Rule 144(d)(1) under the Securities Act of 1933, the holding period for the shares of REIT Common Stock issued in the transactions described in your letter commenced upon the acquisition of the OP Units. In reaching this conclusion, we note in particular your representations that the Unit Holders paid the full purchase price for the OP Units at the time they were acquired from the OP; an OP Unit is the economic equivalent of a share of REIT Common Stock, representing the same right to the same proportional interest in the same underlying pool of assets; the exchange of REIT Common Stock for OP Units is entirely at the discretion of the REIT; and no additional consideration is paid by the Unit Holders for the shares of REIT Common Stock.

Because this position is based upon the representations made in your letter, any different facts or conditions might require the Division to reach a different conclusion.

Sincerely,

David Fredrickson
Chief Counsel and Associate Director

Incoming Letter:

The Incoming Letter is in Acrobat format.

http://www.sec.gov/divisions/corpfin/cf-noaction/2016/bankofamerica-merrilllynch-pfs-031416-144.htm

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Concurrent Session: State and Local Taxes

Thursday, March 31st
11:15am – 12:30pm
Marriott Marquis, Washington DC

Moderator:
William DeKlerk, Sr. Director-Tax, Essex Property Trust

Panelists:
Darren Chesser, Director-Tax, RLJ Lodging Trust
Sam Melehani, Partner, PwC
Michele Randall, Partner-Tax, EY

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March 30 - April 1

2016

State and Local Tax

March 30-April 1, 2016

Presenters:

Moderator:

- William DeKlerk, Sr. Director-Tax, Essex Property Trust

Panelists:

- Darren Chesser, Director-Tax, RLJ Lodging Trust
- Sam Melehani, Partner, PwC
- Michele Randall, Partner-Tax, EY

Agenda

- Optimal State Tax Structures
- State Apportionment and Economic Nexus
- Combined Return Issues
- Indirect Tax Issues

Optimal state tax structures

- Choice of entity can impact franchise and entity level taxes
  - Planning for minimum taxes and fees

- Franchise Tax Planning
  - QRSs versus LLCs
  - Planning with business trusts
  - Benefits of an LP structure

Minimum and Franchise Taxes

- States with some form of minimum tax due include:
- AZ, CA, CT, DC, ID, KY, MA, MT, NJ, NY, OR, RI, UT, VT
- States that impose some form of franchise tax include:
- AL, AR, CA, CT, DC, GA, ID, IL, KY, LA, MA, MO (repealed), MS, NC, NE, NM, NY, OK, PA, RI, SC, SD, TN, TX, WV (repealed)

Minimum Tax and Fees

- Alabama imposes a business privilege tax (BPT) on LLCs and partnerships of up to $15,000 for most entities. SMLLCs doing business in Alabama are subject to BPT unless the sole member is qualified or doing business in Alabama. If a SMLLC's sole member is subject to tax, the SMLLC is subject to a $100 minimum tax.
    - Multiple SMLLCs could result in multiple fees of up to $15,000. The SMLLC fee can be limited to $100 by managing the sole members activities in Alabama

- California requires LLCs to file Form 568 and pay an $800 annual tax and a filing fee of up to $11,790 based on California gross receipts. California requires limited partnerships to file Form 565 and pay an $800 filing fee.

- California QRSs are not required to file or pay these fees.
    - LLCs and LPs that are wholly-owned by the REIT could make check-the-box elections to be taxed as corporations (Form 8832) and automatically become QRSs.

Minimum Tax and Fees

- New York
  - Corporate fixed dollar minimum ranges from $25 to $200,000 for 2015 tax year and forward based on gross receipts
  - Partnerships are subject to minimum tax of $25 to $5000
  - SMLLCs are subject to $25 minimum tax
- Oregon –
  - Partnerships subject to $150 minimum tax
  - Corporations are subject to minimum tax that ranges from $150 to $100,000 based on gross receipts

Franchise Tax Planning

- QRSs are subject to franchise tax in certain states can be used as blockers
  - Examples include LA, MS, NC and SC
- REIT and QRS business trusts may be exempt from franchise tax in certain states
  - Examples include LA, MO, SC and PA
- Limited partnership structure could be beneficial
  - States may not follow check the box for franchise tax (LA and NC)
  - Limited partner nexus – LA franchise tax
    - Utelcom, Inc. v. Bridges, Dkt. No. 535,407 (Division "D", Ct. App., First Dist., Sept. 12, 2011).
    - Bridges v. Polychim USA, Inc., Court of Appeal of Louisiana, First Circuit, No. 2014 CA 0307, April 24, 2015

QRS Business Trust –Example 1

- REIT is subject to SC income tax but not subject to SC license tax
- QRS business trust is exempt from license tax.

QRS Business Trust –Example 2

- REIT is subject to SC income tax but not subject to SC license tax.
- Operating partnership is flow through entity for both SC income and license tax.

Franchise Tax Planning

- North Carolina
  - Historically, North Carolina has imposed .15% franchise tax on the highest of the following three bases: (a) issued and outstanding capital stock, surplus, and undivided profits; (b) actual investment in tangible property in North Carolina; or (c) 55% of the appraised valuation of real and tangible personal property in North Carolina.
  - HB 97 replaces the capital stock, surplus, and undivided profits base with a "net worth" base. Generally, the legislation simplifies the capital base by defining it as a taxpayer's "net worth" is the entity's "[t]otal assets without regard to the deduction for accumulated depreciation, depletion, or amortization less its total liabilities" computed in accordance with GAAP as of the end of the corporation's taxable year. A deduction is allowed for accumulated depreciation, depletion, or amortization in accordance with the method used for federal income tax purposes. Note, there are changes to the affiliated debt add back that could broaden the tax base.

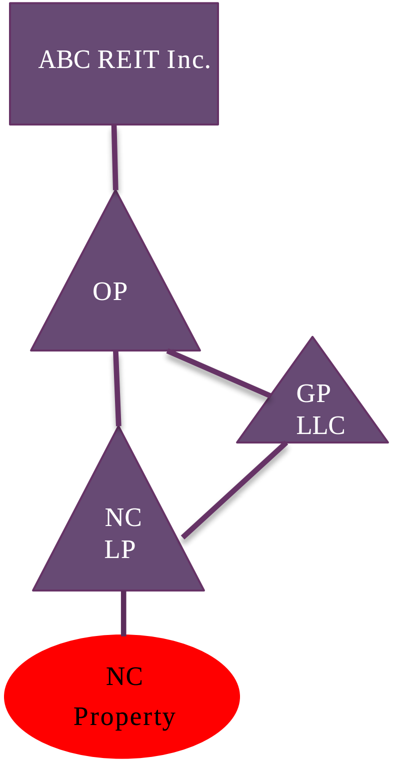
Franchise Tax Planning

- North Carolina continued
  - HB 97 appears to preserve the special deduction afforded REITs for the aggregate market value of investments in the stock, bonds, debentures, or other securities or evidences of debt of other corporations, partnerships, individuals, municipalities, governmental agencies or governments.
  - HB 97 eliminates the deduction for indebtedness incurred and existing for the purchase or improvement of North Carolina real estate. This change could be significant for REITs that directly/indirectly own SMLLCs holding North Carolina property, as these taxpayers often pay franchise tax based on actual investment in tangible property in North Carolina.

Limited Partnership Example

NC Example

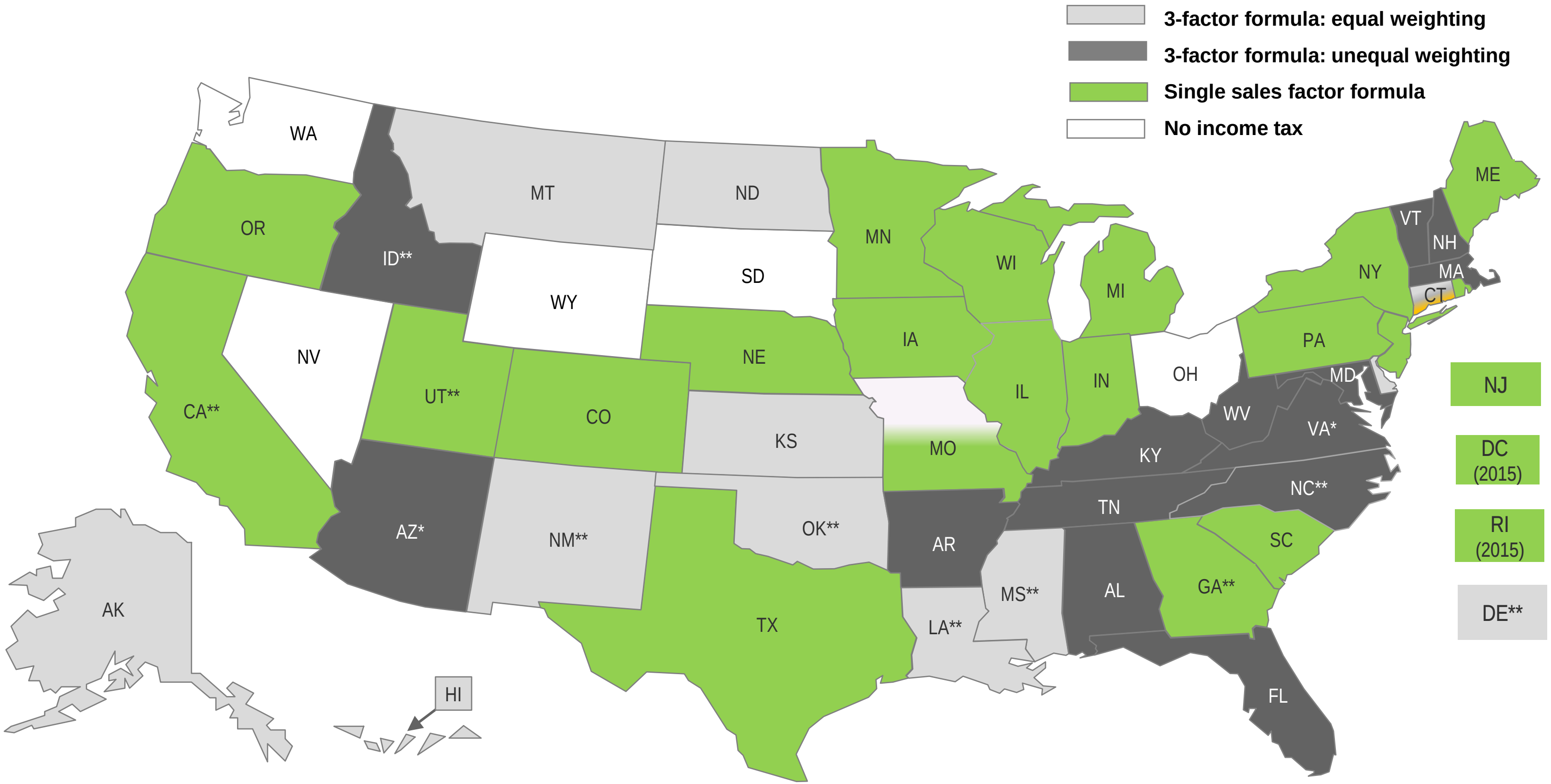
- REIT is subject to tax on higher of its apportioned net worth, investment in tangible property base or appraised value base.
- REIT is allowed a deduction for investment in stock, bonds and partnerships for its apportioned net worth base.
- Holding property in LP limits the flow up from the NC property for its investment in tangible property and appraised value base.



State apportionment

- Apportionment trends
  - Single sales factor
  - Market sourcing
    - What is market sourcing
    - Potential impact
      - Interest
      - Dividends
      - Management fees
- Economic Nexus

Single Sales Factor Adoption (thru Sept 2014)

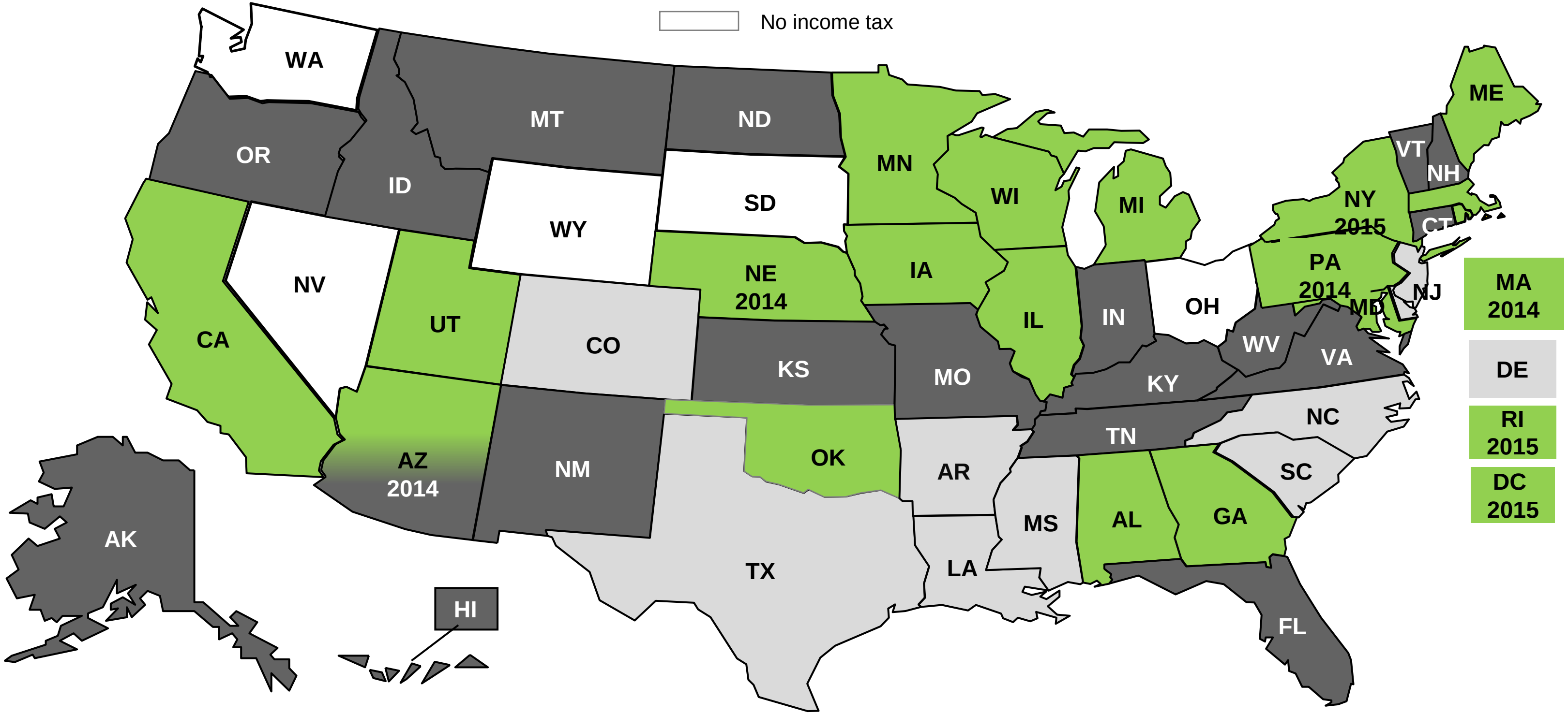


* Single sales factor is either electable or being phased-in

** Different apportionment rules apply to certain industries

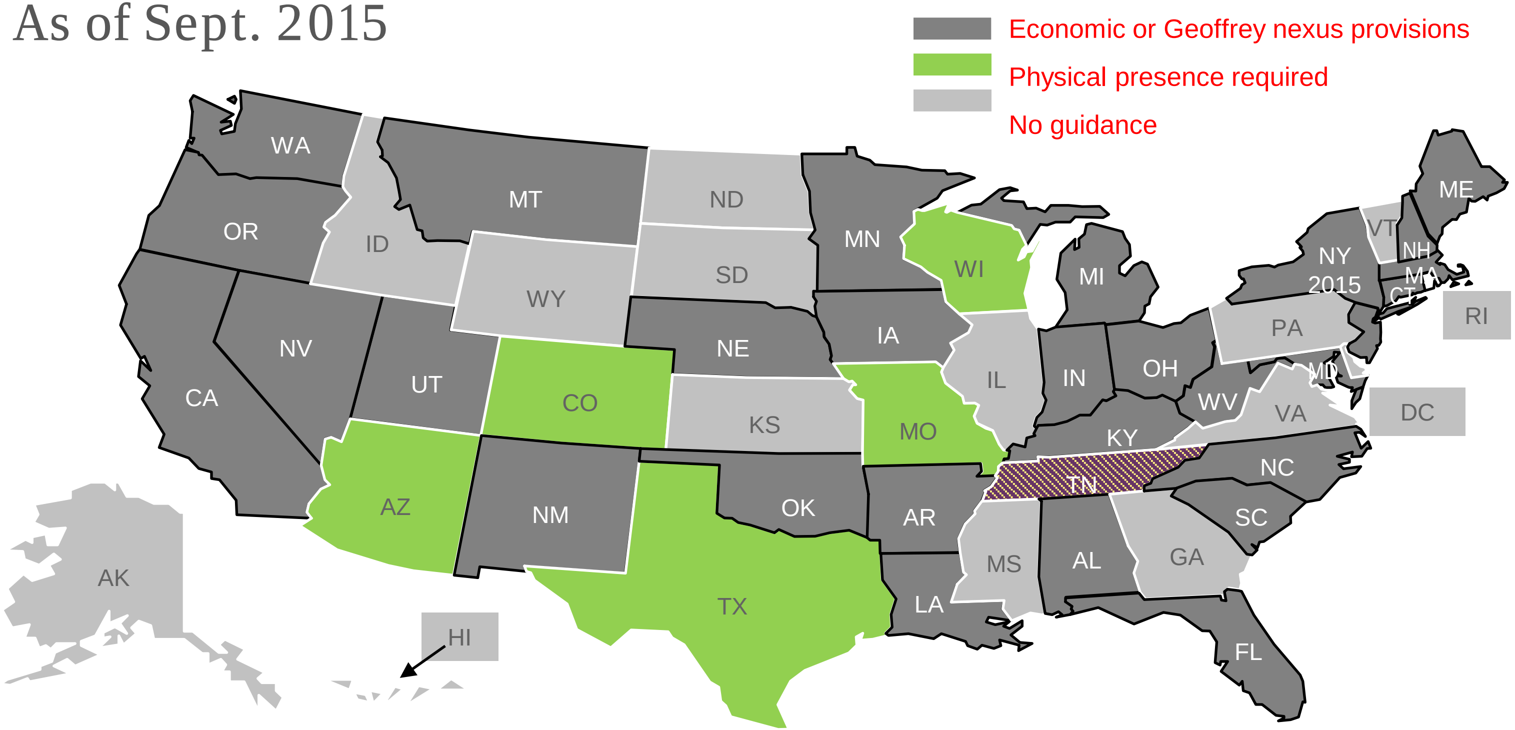
Market Sourcing (thru Sept 2014)

- Source to state where greater portion of income producing activity performed ("all or nothing")
- Source to state to the extent services performed in state ("to the extent of" or "direct")
- Source to state where benefit of service received ("benefit" or "market")
- No income tax



Economic nexus: non-financial

As of Sept. 2015



Combined return issues

- General mechanics of computing tax on combined basis
- What is a unitary business and who's included?
- W/E Elections and Inclusions
- REIT and TRS combinations
  - States that apply combined rules broadly
  - States that specifically address REITs and combination
  - States that exclude public or non-captive REITs
  - States that follow federal consolidated return rules in determining group
- NOL computation
- Foreign operations and impact to combined returns

Expansion of combined reporting***

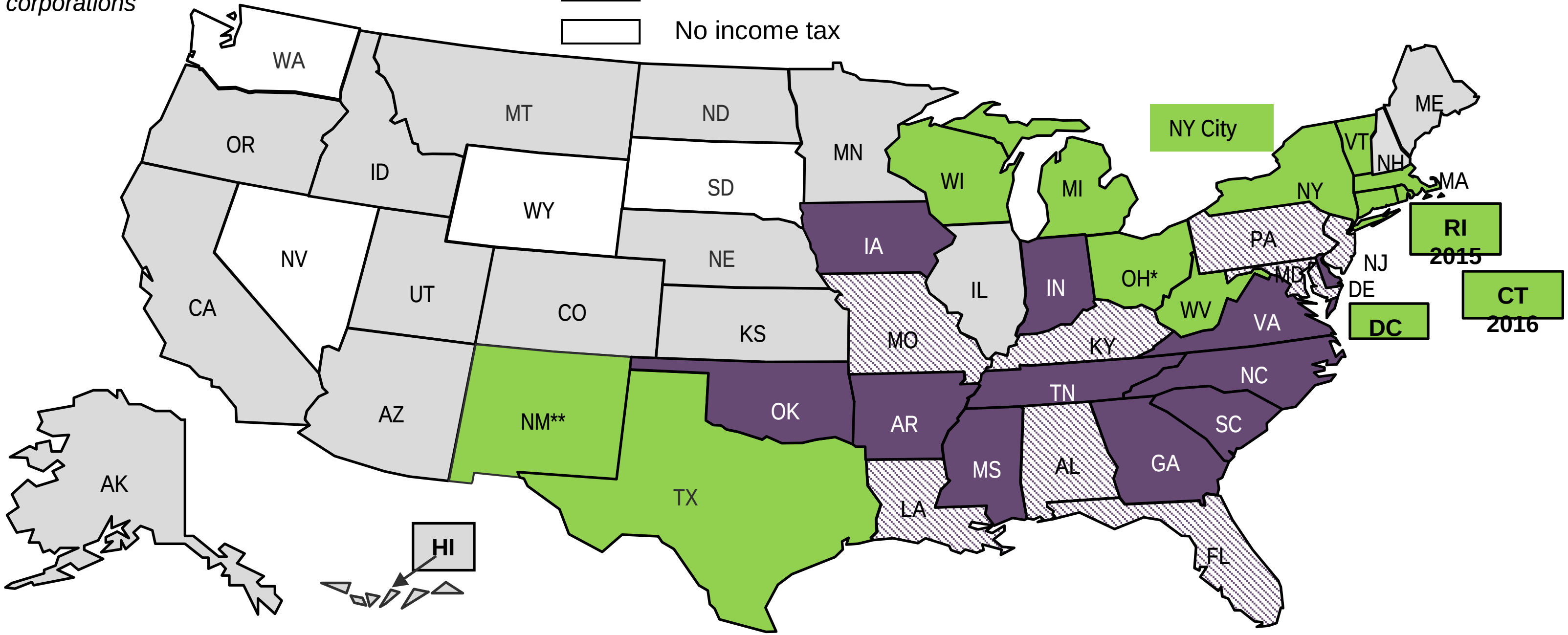
As of 08 December 2015

** For purposes of the CAT*

*** Limited to big box retailers*

****General corporations*

- Combined reporting/consolidated return required prior to 2004
- Combined reporting/consolidated return adopted for 2004 or later
- Combined reporting legislation proposed in 2015
- Separate return state
- No income tax



Other income tax reporting issues

- Non-conformity Issues
  - Tax Add backs
  - Depreciation
  - Related Party Interest Expense Add backs
  - NOLs
  - Recent Developments
    - New federal partnership procedures
    - Path Act
  - US Treaties

Indirect Taxes

- Sales and use taxes
  - Taxable income streams
    - Real property rental
    - Management fees
    - Real estate repair and maintenance
    - Construction
  - Intercompany transactions
    - Rental of tangible personal property
    - States may not exempt internal rent on real property lease (Hawaii)
  - Audit Issues

Indirect Taxes

- Sales & Use tax due on services, potentially taxable on:
- Janitorial services – AR, CT, DC, FL, HI, IA, MD, MN, NE, NJ, NM, NY, OH, PA, SD, TX & WV
- Repair services – AR, CT, DC, FL, HI, IA, KS, LA, MS, NE, NJ, NM, NY, OH, PA, SD, TN, TX, UT, WA, WI & WY

Indirect Taxes

- Locals may impose tax on real estate rental receipts
  - California
    - Los Angeles/Oakland
    - San Francisco has phased in new tax
    - Other city local taxes
  - Delaware
  - Kentucky
  - Michigan
  - Ohio
  - Philadelphia/Other Pennsylvania Cities
  - Virginia
  - West Virginia
  - Washington

Indirect tax issues

- Transfer Taxes
  - The taxability of real estate transactions is dependent on both the type of the transaction and the jurisdiction in which the property is located as states have taken different approaches.
  - Two types of real estate transfer tax transactions
    - Direct Asset Transfer
    - Controlling Interest Transfer
  - For example, both Texas and Arizona have opted to not impose any tax on the transfer of real property whether it is done directly or indirectly.
  - Alternatively, 17 states have elected to impose a tax on the indirect transfer of a controlling interest in real property.

Indirect tax issues

- Transfer Tax Compliance
  - Non-recorded transactions
    - Generally, filed with State Department of Revenue but can be required at the local level
    - Forms may not be available
    - County recorders may not understand non-recorded transactions
  - Buyer/seller tax responsibility
  - Timing of returns
    - Due dates can range from date of close to 45 days after close
  - Audits and other issues
    - Local non-conformity
    - Review of fair market value
    - California case law - *Ardmore*

General Session: State of the Capital Markets

Thursday, March 31st
8am – 9:30am
Marriott Marquis, Washington DC

Moderator:
Neil Wolitzer, Managing Director, Goldman Sachs & Co.

Panelists:
Thomas Carr, Managing Partner, Federal Capital Partners
Ronald Dickerman, President & Founder, Madison International Realty
Michael Nash, Executive Chairman of the Board of Directors, Blackstone Mortgage Trust, Inc.
Sarah Wade, SVP & Sr. Research Analyst, Nuveen Asset Management

NAREIT®

REITWatch®

A Monthly Statistical Report on the Real Estate Investment Trust Industry

March 2016

(Data as of February 29, 2016)

National Association of Real Estate Investment Trusts®

REITs: Building Dividends & Diversification®

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REITWATCH

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National Association of Real Estate Investment Trusts ®

REIT Industry Fact Sheet

Data as of February 29, 2016, except where noted.
Unless otherwise noted, all data are derived from, and apply only to, publicly traded US REITs.

Industry Size

- FTSE NAREIT All REITs equity market capitalization = $901 billion
- FTSE NAREIT All Equity REITs equity market capitalization = $846 billion
- REITs own approximately $1.8 trillion of commercial real estate assets, including listed and non-listed public Equity and Mortgage REITs
- 221 REITs are in the FTSE NAREIT All REITs Index
- 196 REITs trade on the New York Stock Exchange
- NYSE listed REITs equity market capitalization = $853 billion

Investment Performance

Year-to-date and compound annual total returns of the FTSE NAREIT All REITs Index, the FTSE NAREIT All Equity REITs Index, and leading US benchmarks for periods ending February 29, 2016:

	FTSE NAREIT					Dow Jones
	All REITs	All Equity REITs	S&P 500	Russell 2000	NASDAQ Composite	Industrial Average
2016: YTD	**-3.76**	-3.93	-5.09	-8.80	-8.76	-4.68
1-Year	-4.30	**-4.04**	-6.19	-14.97	-7.07	-6.55
3-Year	6.94	7.42	10.75	5.72	**14.38**	8.14
5-Year	8.99	9.14	10.13	6.11	**11.72**	8.94
10-Year	5.61	6.01	6.44	4.95	**8.27**	6.92
15-Year	10.46	**10.89**	5.06	6.74	*5.13*	5.63
20-Year	9.96	**10.50**	7.67	7.37	*7.37*	8.09
25-Year	10.79	**11.40**	9.10	9.25	*9.67*	*7.23*
30-Year	8.98	**10.29**	9.90	8.47	*8.83*	*7.85*
35-Year	10.23	**11.66**	10.89	9.62	*9.37*	*8.42*
40-Year	11.43	**13.11**	10.91	-	*10.30*	*7.34*
1972 - 2016	9.61	**11.85**	10.16	-	*8.59*	*6.84*

Data in percent; highest return for the period in bold.
Returns in italics are price-only.

Dividends

Yield Comparison

- FTSE NAREIT All REITs: 4.51%
- FTSE NAREIT All Equity REITs: 4.05%
- S&P 500: 2.24%

- Public listed REITs paid out approximately $42 billion and public non-listed REITs paid out approximately $4 billion in dividends during 2014.
- On average, 68 percent of the annual dividends paid by REITs qualify as ordinary taxable income, 13 percent qualify as return of capital and 19 percent qualify as long-term capital gains.

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REIT Industry Fact Sheet
Data as of February 29, 2016, except where noted.
Unless otherwise noted, all data are derived from, and apply only to, publicly traded US REITs.

Leverage and Coverage Ratios
(Data as of 2015: Q3)

Equity REITs

- Debt Ratio: 36.0%
- Coverage Ratio: 4.3x
- Fixed Charge Ratio: 3.9x
- 46 Equity REITs are rated investment grade, 68 percent by equity market capitalization.

All REITs

- Debt Ratio: 46.4%
- Coverage Ratio: 4.0x
- Fixed Charge Ratio: 3.7x
- 46 REITs are rated investment grade, 62 percent by equity market capitalization.

- Debt ratio equals total debt divided by total market capitalization. Total market capitalization is the sum of total debt and implied equity market capitalization (common shares plus operating partnership units).
- Coverage ratio equals EBITDA divided by interest expense.
- Fixed charge ratio equals EBITDA divided by interest expense plus preferred dividends.

Average Daily Dollar Trading Volume

- February 2016: $7.4 billion
- February 2011: $3.8 billion
- February 2006: $1.9 billion

Capital Offerings

	2016: YTD	
	Number of Offerings	Capital Raised ($M)
IPOs	0	0
Secondary Common	8	2,764
Secondary Preferred	1	300
Secondary Debt	13	7,700
Total	22	10,764

Exhibit 1
Investment Performance:
FTSE NAREIT US Real Estate Index Series

February 29, 2016

	FTSE NAREIT All REITs			FTSE NAREIT Composite			FTSE NAREIT Real Estate 50™ [1]			FTSE NAREIT All Equity REITs			FTSE NAREIT Equity REITs			FTSE NAREIT Mortgage REITs		
	Returns (%)		Dividend	Returns (%)		Dividend	Returns (%)		Dividend	Returns (%)		Dividend	Returns (%)		Dividend	Returns (%)		Dividend
Period	Total	Price	Yield[2]	Total	Price	Yield[2]	Total	Price	Yield[2]	Total	Price	Yield[2]	Total	Price	Yield[2]	Total	Price	Yield[2]
Annual (including current year to date)																		
2011	7.28	2.37	4.83	7.30	2.34	4.90	9.45	4.69	4.60	8.28	4.32	3.82	8.29	4.32	3.83	-2.42	-15.14	14.82
2012	20.14	14.98	4.38	19.73	14.54	4.46	18.05	13.37	4.09	19.70	15.61	3.51	18.06	13.86	3.70	19.89	5.83	12.93
2013	3.21	-1.15	4.43	2.34	-2.03	4.51	-0.53	-4.44	4.17	2.86	-0.80	3.91	2.47	-1.33	4.09	-1.96	-12.42	10.31
2014	27.15	21.93	4.00	27.23	22.00	4.06	28.73	23.86	3.77	28.03	23.44	3.56	30.14	25.25	3.65	17.88	6.30	10.66
2015	2.29	-1.95	4.30	2.05	-2.20	4.33	4.40	0.42	3.74	2.83	-0.98	3.85	3.20	-0.68	3.92	-8.88	-18.48	12.15
2016	-3.76	-4.10	4.51	-3.86	-4.21	4.54	-4.26	-4.59	3.95	-3.93	-4.28	4.05	-3.76	-4.15	4.11	-2.70	-3.07	12.47
Quarter (including current quarter to date)																		
2014: Q4	12.44	11.25	4.00	12.27	11.08	4.06	12.31	11.22	3.77	12.94	11.90	3.56	14.20	13.12	3.65	4.61	1.66	10.66
2015: Q1	4.05	3.11	3.80	3.86	2.92	3.84	4.18	3.31	3.55	3.98	3.14	3.37	4.75	3.87	3.43	2.35	-0.10	10.56
Q2	-8.93	-9.91	4.34	-8.95	-9.94	4.38	-9.40	-10.31	4.09	-9.06	-9.94	3.87	-9.95	-10.81	3.99	-7.27	-9.84	11.46
Q3	0.76	-0.35	4.44	0.73	-0.38	4.48	2.42	1.37	4.10	0.99	-0.02	3.97	2.00	0.97	4.03	-2.96	-5.46	12.00
Q4	7.13	5.92	4.30	7.13	5.92	4.33	7.99	6.91	3.74	7.68	6.61	3.85	7.26	6.17	3.92	-1.06	-4.26	12.15
2016: Q1	-3.76	-4.10	4.51	-3.86	-4.21	4.54	-4.26	-4.59	3.95	-3.93	-4.28	4.05	-3.76	-4.15	4.11	-2.70	-3.07	12.47
Month																		
2015: Sep	1.87	1.16	4.44	1.83	1.12	4.48	2.38	1.73	4.10	2.13	1.52	3.97	2.93	2.34	4.03	-2.37	-4.47	12.00
Oct	6.14	5.95	4.19	6.05	5.87	4.23	6.17	6.02	3.87	6.47	6.31	3.74	5.87	5.71	3.82	-0.17	-0.69	12.00
Nov	-0.26	-0.52	4.23	-0.11	-0.37	4.26	-0.32	-0.62	3.91	-0.17	-0.45	3.77	-0.52	-0.82	3.87	0.92	0.75	11.92
Dec	1.19	0.49	4.30	1.13	0.43	4.33	2.04	1.47	3.74	1.31	0.73	3.85	1.84	1.26	3.92	-1.80	-4.31	12.15
2016: Jan	-3.48	-3.61	4.47	-3.62	-3.74	4.50	-3.51	-3.61	3.87	-3.52	-3.64	4.00	-3.35	-3.49	4.07	-5.25	-5.44	12.78
Feb	-0.29	-0.51	4.51	-0.25	-0.49	4.54	-0.77	-1.02	3.95	-0.43	-0.66	4.05	-0.42	-0.68	4.11	2.69	2.51	12.47
Week (including current week to date)																		
29-Jan-16	1.29	1.23	4.47	1.22	1.16	4.50	0.78	0.72	3.87	1.05	1.00	4.00	0.84	0.78	4.07	4.13	3.97	12.78
5-Feb-16	-2.26	-2.33	4.58	-2.27	-2.34	4.61	-2.55	-2.64	3.99	-2.36	-2.44	4.11	-2.05	-2.14	4.16	-0.67	-0.67	12.87
12-Feb-16	-4.12	-4.20	4.78	-4.11	-4.19	4.82	-4.00	-4.09	4.16	-4.15	-4.24	4.30	-4.20	-4.30	4.35	-3.50	-3.53	13.34
19-Feb-16	4.08	4.05	4.60	4.09	4.05	4.63	3.99	3.96	4.00	4.09	4.05	4.13	4.31	4.26	4.18	4.08	4.08	12.81
26-Feb-16	2.34	2.31	4.50	2.33	2.30	4.53	2.06	2.04	3.94	2.28	2.26	4.04	2.04	2.01	4.09	3.15	3.00	12.44
29-Feb-16	-0.11	-0.12	4.51	-0.08	-0.08	4.54	-0.08	-0.08	3.95	-0.07	-0.07	4.05	-0.29	-0.29	4.11	-0.21	-0.21	12.47
Historical (compound annual rates at month-end)																		
1-Year	-4.30	-8.29		-4.59	-8.58		-3.03	-6.73		-4.04	-7.61		-3.57	-7.24		-12.53	-21.77	
3-Year	6.94	2.49		6.54	2.09		7.04	2.94		7.42	3.55		8.03	3.99		-2.83	-12.90	
5-Year	8.99	4.35		462.51	180.81		8.67	4.39		9.14	5.25		9.41	5.38		2.88	-8.66	
10-Year	5.61	0.72		137.17	67.57		5.74	1.18		6.01	1.74		6.06	1.72		-1.46	-12.63	
15-Year	10.46	4.70		77.85	41.08		10.67	5.46		10.89	5.67		10.92	5.65		6.07	-6.32	
20-Year	9.96	3.74		54.00	29.45		-	-		10.50	4.72		10.53	4.71		4.56	-6.95	
25-Year	10.79	4.05		41.26	22.94		-	-		11.40	5.21		11.42	5.20		5.77	-6.12	
30-Year	8.98	1.60		33.36	18.78		-	-		10.29	3.62		10.31	3.61		3.93	-7.83	
35-Year	10.23	2.41		27.99	15.89		-	-		11.66	4.57		11.67	4.56		5.49	-6.38	
40-Year	11.43	3.23		24.10	13.78		-	-		13.11	5.45		13.12	5.45		6.40	-5.38	

Source: FTSE™, NAREIT®.

Notes:

[1] The FTSE NAREIT Real Estate 50™ is designed to measure the performance of larger and more frequently traded REITs.

[2] Dividend yield quoted in percent for the period end.

Exhibit 2
Investment Performance by Property Sector and Subsector

February 29, 2016

Sector	Number of Constituents	Total Return (%) 2015	Total Return (%) February	Total Return (%) 2016: YTD	Dividend Yield (%)	Market Capitalization ($)[1] Equity	Market Capitalization ($)[1] Implied
FTSE NAREIT All Equity REITs	167	2.83	-0.43	-3.93	4.05	845,509,818	882,242,017
FTSE NAREIT Equity REITs	158	3.20	-0.42	-3.76	4.11	749,019,188	785,391,750
Industrial	11	2.64	0.12	-5.98	4.15	45,087,927	46,589,642
Office	26	0.29	-2.57	-10.52	3.64	81,180,120	89,914,250
Retail	32	4.56	0.59	0.74	3.71	204,818,343	219,640,917
Shopping Centers	18	4.72	-2.30	0.62	3.57	68,856,533	70,216,772
Regional Malls	8	4.23	1.79	-1.85	3.56	105,966,317	119,372,653
Free Standing	6	5.88	3.36	11.23	4.51	29,995,493	30,051,491
Residential	22	17.07	-1.53	-6.34	3.14	122,292,316	126,366,379
Apartments	15	16.45	-1.92	-6.77	3.19	106,026,570	108,595,539
Manufactured Homes	3	25.65	4.23	2.15	2.96	10,076,163	10,779,724
Single Family Homes	4	1.77	-3.87	-12.65	2.28	6,189,583	6,991,116
Diversified	14	-0.49	0.11	-8.29	5.47	41,307,221	43,375,889
Lodging/Resorts	17	-24.42	7.62	-2.77	5.56	40,580,607	40,999,413
Health Care	17	-7.25	-1.45	-5.83	6.09	84,952,921	85,702,666
Self Storage	5	40.65	-3.55	-0.98	2.79	62,602,929	63,918,415
Timber	4	-6.97	1.48	-11.93	4.79	24,717,824	24,717,824
Infrastructure	5	3.74	-1.17	-2.66	3.20	71,772,807	72,132,443
Data Centers	6	1.54	-0.82	2.94	3.10	40,227,665	42,915,042
Specialty	8	1.69	2.03	2.17	6.69	25,969,139	25,969,139
FTSE NAREIT Mortgage REITs	37	-8.88	2.69	-2.70	12.47	50,344,332	50,741,378
Home Financing	26	-9.75	5.44	1.17	13.26	38,313,970	38,349,313
Commercial Financing	11	-5.99	-5.18	-13.28	9.93	12,030,362	12,392,065

Source: FTSE™, NAREIT®.
Notes:
[1] Implied market capitalization is calculated as common shares outstanding plus operating partnership units, multiplied by share price. Data

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Exhibit 3
Selected Indicators of Equity Market Performance

(Period ending index levels and percent change)

February 29, 2016

Period	FTSE NAREIT All Equity REITs		S&P 500		Dow Jones Industrials		Russell 2000		NASDAQ Composite		US Treasury 10-Year Note[1]	
	Levels	Returns	Levels	Returns	Levels	Returns	Levels	Returns	Levels	Returns	Yield	Change
Annual (including current year to date)												
2006	9,709.31	35.06	2,186.13	15.79	20,164.25	19.05	3,328.90	18.37	2,468.60	10.28	4.71	0.32
2007	8,185.75	-15.69	2,306.23	5.49	21,955.77	8.88	3,276.77	-1.57	2,728.97	10.55	4.04	-0.67
2008	5,097.46	-37.73	1,452.98	-37.00	14,945.17	-31.93	2,169.65	-33.79	1,636.66	-40.03	2.25	-1.79
2009	6,524.25	27.99	1,837.50	26.46	18,335.23	22.68	2,759.17	27.17	2,378.33	45.32	3.85	1.60
2010	8,347.58	27.95	2,114.29	15.06	20,913.80	14.06	3,500.15	26.85	2,806.89	18.02	3.30	-0.55
2011	9,039.07	8.28	2,158.94	2.11	22,666.87	8.38	3,353.99	-4.18	2,783.67	-0.83	1.89	-1.41
2012	10,819.84	19.70	2,504.44	16.00	24,987.40	10.24	3,902.37	16.35	3,269.46	17.45	1.78	-0.11
2013	11,128.83	2.86	3,315.59	32.39	32,397.14	29.65	5,417.36	38.82	4,581.05	40.12	3.04	1.26
2014	14,247.97	28.03	3,769.44	13.69	35,650.39	10.04	5,682.50	4.89	5,256.55	14.75	2.17	-0.87
2015	14,650.51	2.83	3,821.60	1.38	35,726.03	0.21	5,431.67	-4.41	5,622.56	6.96	2.27	0.10
2016	14,074.39	-3.93	3,627.06	-5.09	34,054.29	-4.68	4,953.82	-8.80	5,129.98	-8.76	1.74	-0.53
Quarter (inlcuding current quarter to date)												
2014: Q2	12,937.07	7.13	3,552.18	5.23	33,263.97	2.83	5,590.12	2.05	4,864.35	5.31	2.53	-0.20
Q3	12,615.85	-2.48	3,592.25	1.13	33,887.13	1.87	5,178.71	-7.36	4,973.26	2.24	2.52	-0.01
Q4	14,247.97	12.94	3,769.44	4.93	35,650.39	5.20	5,682.50	9.73	5,256.55	5.70	2.17	-0.35
2015: Q1	14,815.12	3.98	3,805.27	0.95	35,766.56	0.33	5,927.72	4.32	5,455.74	3.79	1.94	-0.23
Q2	13,472.42	-9.06	3,815.85	0.28	35,661.51	-0.29	5,952.67	0.42	5,566.61	2.03	2.35	0.41
Q3	13,605.29	0.99	3,570.17	-6.44	33,172.48	-6.98	5,243.24	-11.92	5,171.97	-7.09	2.06	-0.29
Q4	14,650.51	7.68	3,821.60	7.04	35,726.03	7.70	5,431.67	3.59	5,622.56	8.71	2.27	0.21
2016: Q1	14,074.39	-3.93	3,627.06	-5.09	34,054.29	-4.68	4,953.82	-8.80	5,129.98	-8.76	1.74	-0.53
Month												
2015: Feb	14,666.73	-3.04	3,866.42	5.75	36,440.86	6.01	5,826.22	5.94	5,520.19	7.25	2.00	0.32
Mar	14,815.12	1.01	3,805.27	-1.58	35,766.56	-1.85	5,927.72	1.74	5,455.74	-1.17	1.94	-0.06
Apr	14,081.98	-4.95	3,841.78	0.96	35,926.96	0.45	5,776.54	-2.55	5,502.64	0.86	2.05	0.11
May	14,050.82	-0.22	3,891.18	1.29	36,412.59	1.35	5,908.42	2.28	5,654.68	2.76	2.12	0.07
Jun	13,472.42	-4.12	3,815.85	-1.94	35,661.51	-2.06	5,952.67	0.75	5,566.61	-1.56	2.35	0.23
Jul	14,144.31	4.99	3,895.80	2.10	35,848.13	0.52	5,883.49	-1.16	5,727.02	2.88	2.20	-0.15
Aug	13,321.15	-5.82	3,660.75	-6.03	33,627.04	-6.20	5,513.76	-6.28	5,343.22	-6.70	2.21	0.01
Sep	13,605.29	2.13	3,570.17	-2.47	33,172.48	-1.35	5,243.24	-4.91	5,171.97	-3.20	2.06	-0.15
Oct	14,485.70	6.47	3,871.33	8.44	36,022.77	8.59	5,538.65	5.63	5,660.04	9.44	2.16	0.10
Nov	14,461.00	-0.17	3,882.84	0.30	36,276.86	0.71	5,718.81	3.25	5,732.25	1.28	2.21	0.05
Dec	14,650.51	1.31	3,821.60	-1.58	35,726.03	-1.52	5,431.67	-5.02	5,622.56	-1.91	2.27	0.06
2016: Jan	14,134.87	-3.52	3,631.96	-4.96	33,801.70	-5.39	4,954.04	-8.79	5,183.11	-7.82	1.94	-0.33
Feb	14,074.39	-0.43	3,627.06	-0.13	34,054.29	0.75	4,953.82	0.00	5,129.98	-1.03	1.74	-0.20
Historical (compound annual rates)												
1-Year		-4.04		-6.19		-6.55		-14.97		-7.07		
3-Year		7.42		10.75		8.14		5.72		14.38		
5-Year		9.14		10.13		8.94		6.11		11.72		
10-Year		6.01		6.44		6.92		4.95		8.27		
15-Year		10.89		5.06		5.63		6.74		*5.13*		
20-Year		10.50		7.67		8.09		7.37		*7.37*		
25-Year		11.40		9.10		*7.23*		9.25		*9.67*		
30-Year		10.29		9.90		*7.85*		8.47		*8.83*		
35-Year		11.66		10.89		*8.42*		9.62		*9.37*		
40-Year		13.11		10.91		*7.34*		-		*10.30*		

Source: NAREIT®, FactSet.

[1] Ten-year constant maturity Treasury note

Returns in italics are price-only.

NAREIT®
REITWatch
National Association of Real Estate Investment Trusts®

Exhibit 4
Historical Offerings of Securities

February 29, 2016

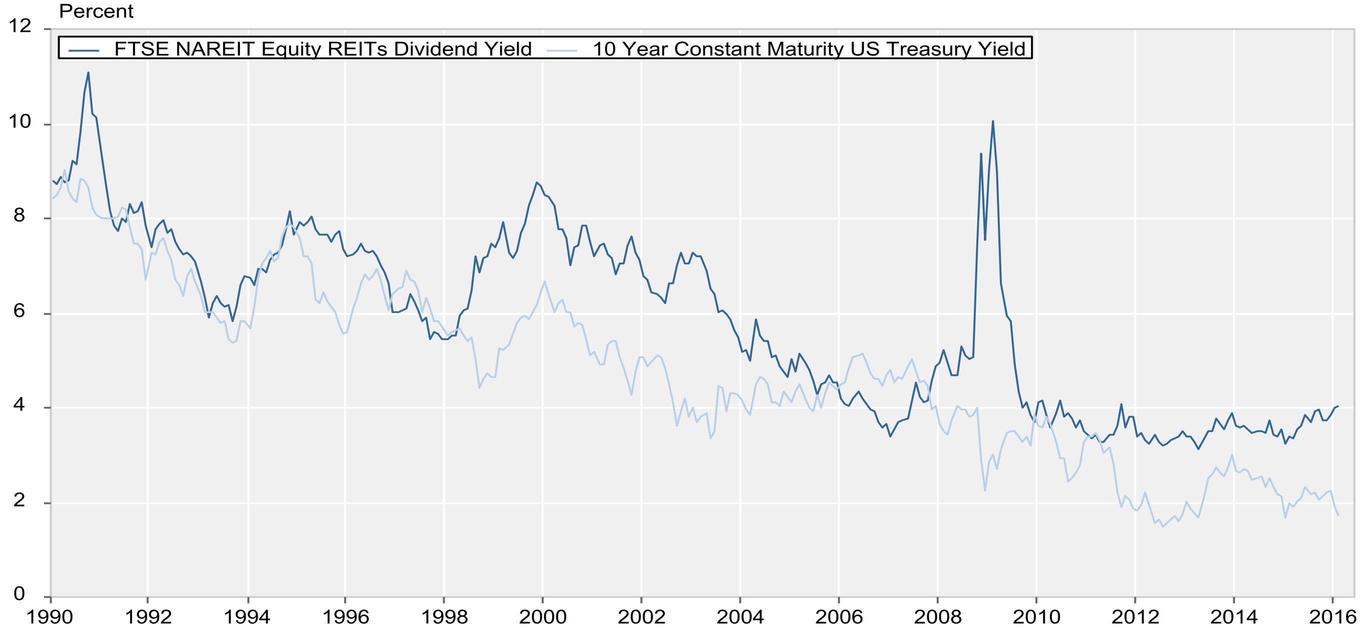
	Total		Initial Public Offerings		Secondary Equity: Common Shares		Secondary Equity: Preferred Shares		Secondary Debt: Unsecured	
Period	Number	Capital Raised[1]	Number	Capital Raised[1]	Number	Capital Raised[1]	Number	Capital Raised[1]	Number	Capital Raised[1]
Annual Totals (including current year to date)										
2008	82	17,991	2	491	60	11,132	9	1,195	11	5,173
2009	130	34,656	9	2,990	87	21,244	0	0	34	10,422
2010	173	47,450	9	1,975	91	23,629	17	2,617	56	19,230
2011	164	51,280	8	2,307	92	31,075	31	4,108	33	13,790
2012	254	73,326	8	1,822	106	35,143	71	10,631	69	25,730
2013	254	76,958	19	5,707	121	35,756	28	4,755	86	30,739
2014	218	63,642	5	3,984	102	24,106	24	4,618	87	30,934
2015	162	59,293	7	1,423	75	23,433	8	2,236	72	32,201
2016	22	10,764	0	0	8	2,764	1	300	13	7,700
Quarterly Totals										
2014: Q4	42	12,463	2	3,221	23	3,874	4	1,589	13	3,779
2015: Q1	53	22,087	4	932	24	11,114	3	1,441	22	8,600
Q2	54	18,284	2	436	29	7,438	2	391	21	10,020
Q3	24	8,678	0	0	8	1,740	1	288	15	6,650
Q4	31	10,244	1	55	14	3,141	2	117	14	6,931
2016: Q1	22	10,764	0	0	8	2,764	1	300	13	7,700
Monthly Totals										
2014: May	30	10,090	0	0	12	5,281	7	1,547	11	3,263
Jun	22	7,387	0	0	8	2,052	2	213	12	5,123
Jul	12	3,118	0	0	8	1,718	0	0	4	1,400
Aug	12	3,049	0	0	4	695	1	88	7	2,266
Sep	33	9,889	0	0	16	4,871	3	218	14	4,800
Oct	15	3,851	0	0	8	849	2	1,349	5	1,654
Nov	19	6,922	2	3,221	7	1,335	2	240	8	2,125
Dec	8	1,690	0	0	8	1,690	0	0	0	0
2015: Jan	26	8,518	1	529	11	2,723	2	66	12	5,200
Feb	9	7,245	2	288	6	5,581	1	1,375	0	0
Mar	18	6,324	1	115	7	2,809	0	0	10	3,400
Apr	17	6,259	1	299	10	3,409	2	391	4	2,160
May	17	6,594	1	137	5	163	0	0	11	6,295
Jun	20	5,430	0	0	14	3,865	0	0	6	1,565
Jul	6	2,010	0	0	3	910	0	0	3	1,100
Aug	10	2,968	0	0	5	830	1	288	4	1,850
Sep	8	3,700	0	0	0	0	0	0	8	3,700
Oct	14	4,470	1	55	4	1,098	2	117	7	3,200
Nov	11	5,209	0	0	4	1,478	0	0	7	3,731
Dec	6	566	0	0	6	566	0	0	0	0
2016: Jan	17	8,087	0	0	6	1,537	1	300	10	6,250
Feb	5	2,677	0	0	2	1,227	0	0	3	1,450

Source: SNL Financial, NAREIT®.

Notes:
[1] Data presented in millions of dollars.

Exhibit 5:
Equity REIT Dividend Yield vs. 10-Year Constant Maturity Treasury Yield

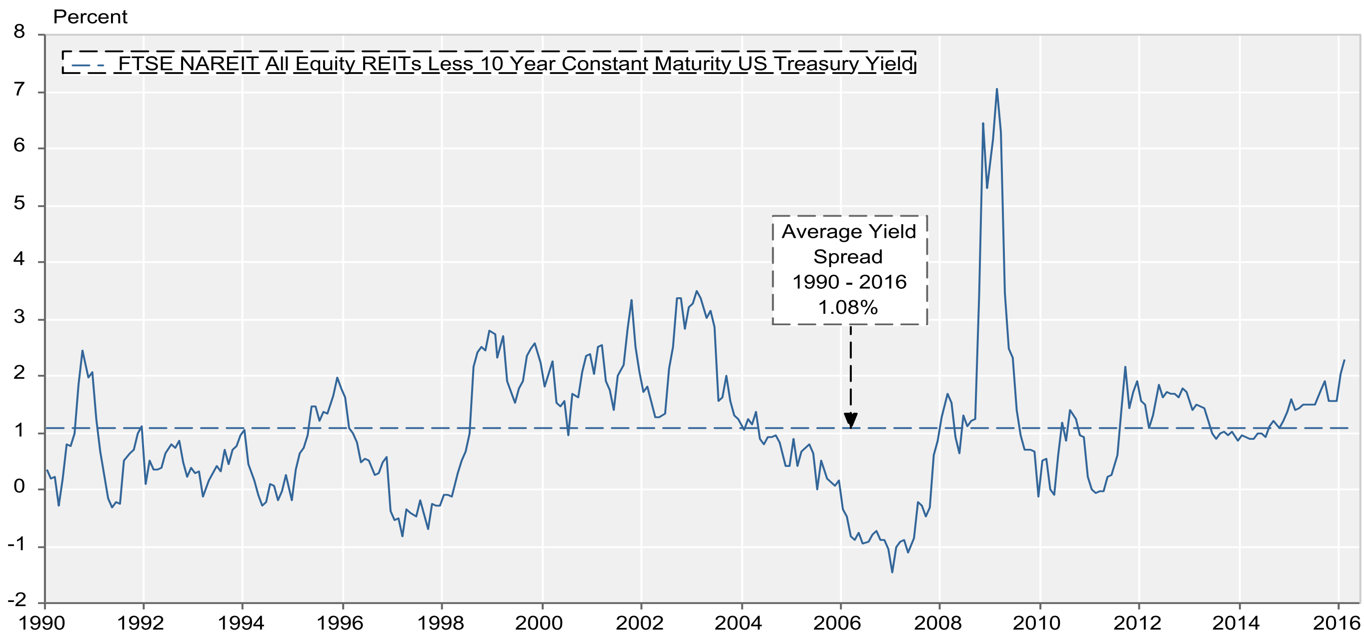
January 1990 - February 2016



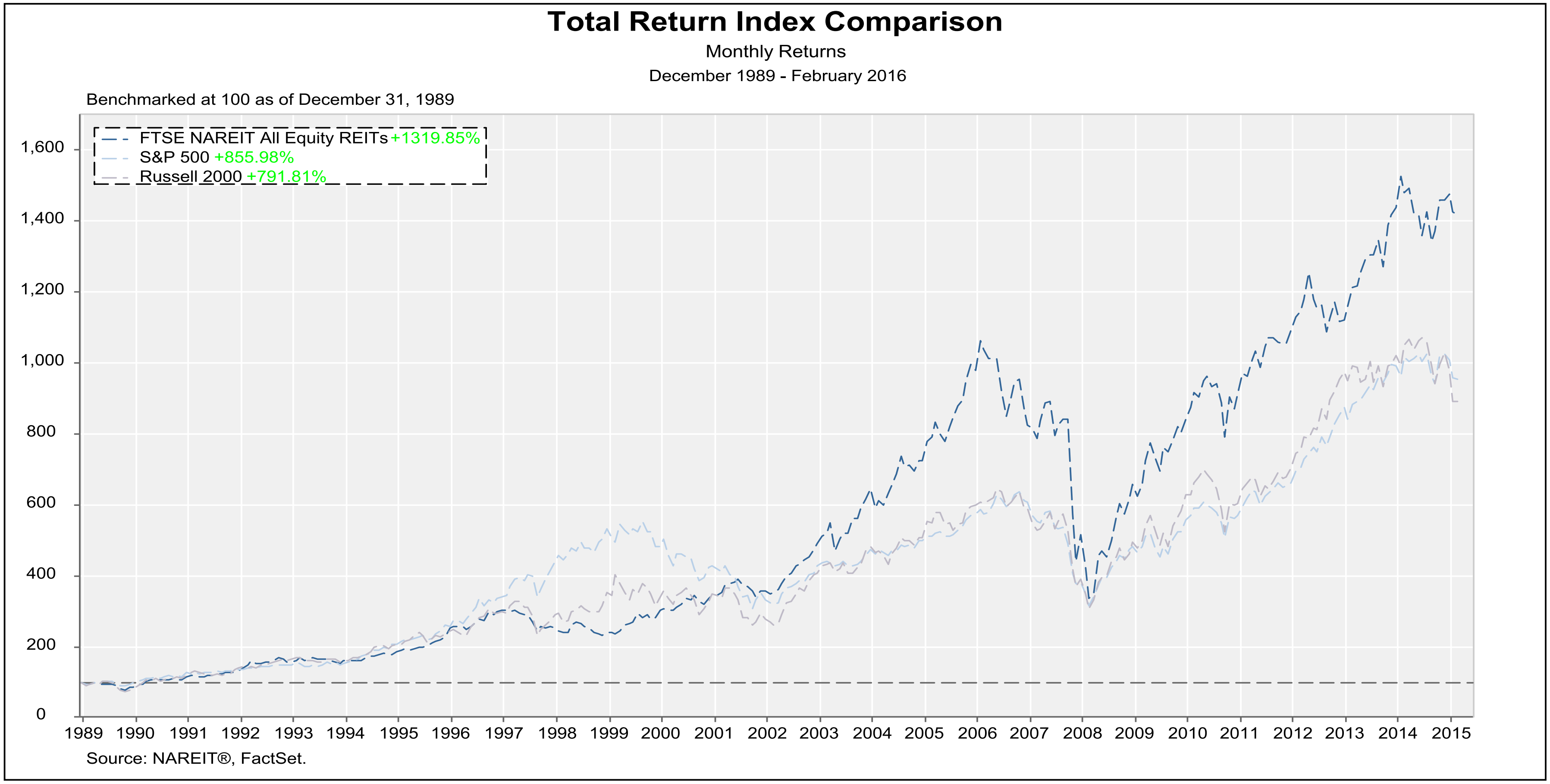
Source: NAREIT®, FactSet.

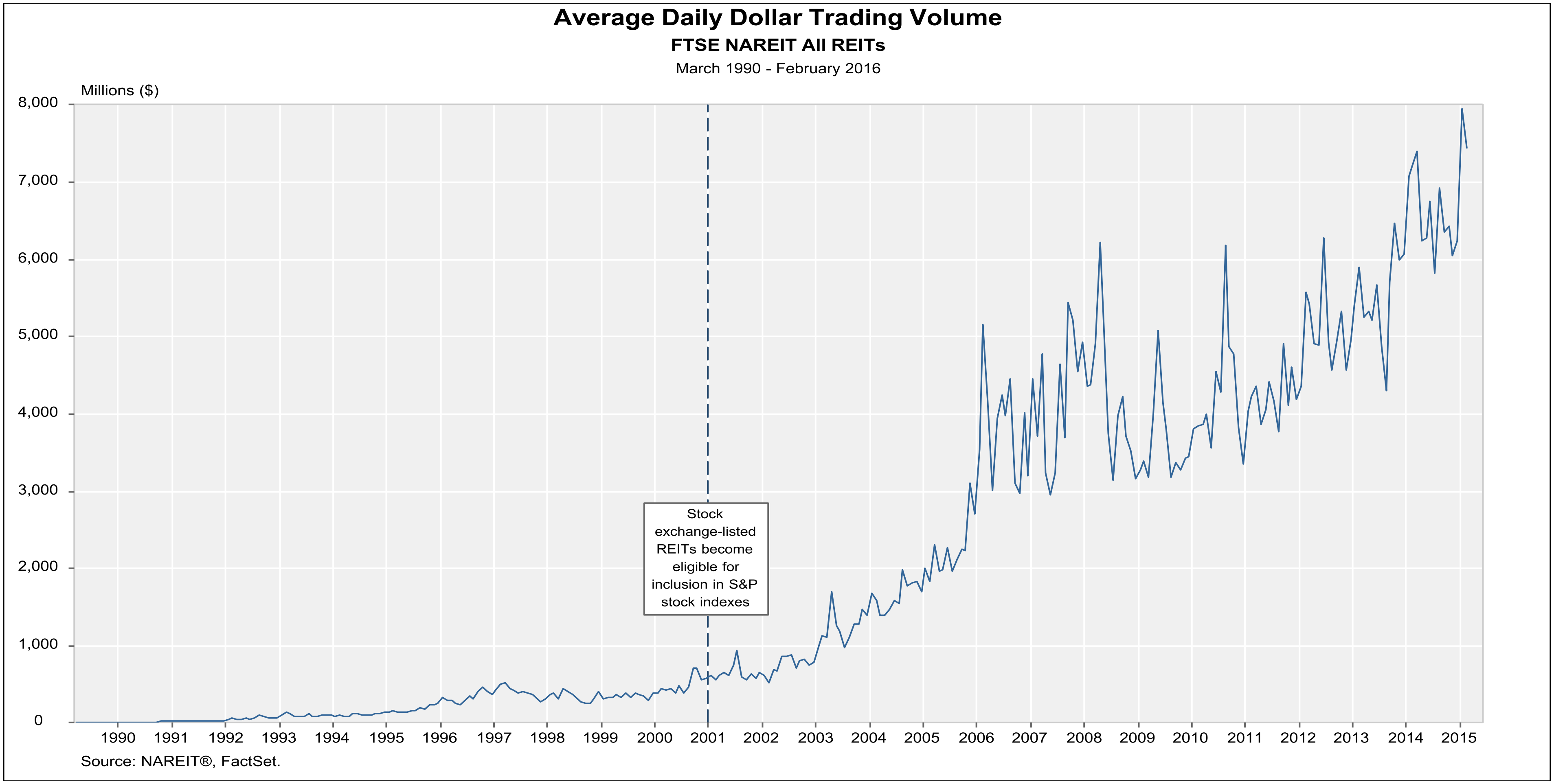
Exhibit 6:
Monthly Equity REIT Dividend Yield Spread

January 1990 - February 2016



Source: NAREIT®, FactSet.


Total Return Index Comparison
Monthly Returns
December 1989 - February 2016
Benchmarked at 100 as of December 31, 1989
FTSE NAREIT All Equity REITs +1319.85%
S&P 500 +855.98%
Russell 2000 +791.81%
1,600
1,400
1,200
1,000
800
600
400
200
0
1989 1990 1991 1992 1993 1994 1995 1996 1997 1998 1999 2000 2001 2002 2003 2004 2005 2006 2007 2008 2009 2010 2011 2012 2013 2014 2015
Source: NAREIT®, FactSet.


Average Daily Dollar Trading Volume
FTSE NAREIT All REITs
March 1990 - February 2016
Millions ($)
8,000
7,000
6,000
5,000
4,000
3,000
2,000
1,000
0
1990
1991
1992
1993
1994
1995
1996
1997
1998
1999
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011
2012
2013
2014
2015
Stock exchange-listed REITs become eligible for inclusion in S&P stock indexes
Source: NAREIT®, FactSet.

NAREIT® REITWatch
National Association of Real Estate Investment Trusts®

Comparative Total Return Investment Performance

February 29, 2016

(Data in percent)

	FTSE NAREIT	Dow Jones		NASDAQ[1]		Standard & Poor's				Russell 2000			Bond Indexes			NCREIF
Period	Equity	Industrials[1]	US Total Stock Market	Composite	100	Citigroup 500 Value	500	Citigroup 500 Growth	Utilities	Value	2000	Growth	ML Corp/Govt	ML Mortgage	Hi Yield Corp	NPI
Series Beginning>	(Jan. 1972)	(Dec. 1926)	(Jan. 1972)	(Jan. 1972)	(Feb. 1985)	(Jan. 1975)	(Jan. 1972)	(Jan. 1975)	(Sep. 1989)	(Jan. 1979)	(Jan. 1979)	(Jan. 1979)	(Dec. 1975)	(Jan. 1976)	(Jan. 1972)	(Dec. 1977)
Annual Returns (including current year to date)																
2006	35.06	16.29	15.77	9.52	6.79	20.80	15.79	11.01	20.99	23.48	18.37	13.35	3.81	5.30	11.85	16.60
2007	-15.69	6.43	5.62	9.81	18.67	1.99	5.49	9.13	19.38	-9.78	-1.57	7.05	7.30	6.99	1.87	15.85
2008	-37.73	-33.84	-37.23	-40.54	-41.89	-39.22	-37.00	-34.92	-28.98	-28.92	-33.79	-38.54	4.95	8.30	-26.16	-6.46
2009	27.99	18.82	28.57	43.89	53.54	21.18	26.46	31.57	11.91	20.58	27.17	34.47	4.84	5.76	58.21	-16.85
2010	27.95	11.02	17.49	16.91	19.22	15.10	15.06	15.05	5.46	24.50	26.85	29.09	6.83	5.67	15.12	13.11
2011	8.28	5.53	1.08	-1.80	2.70	-0.48	2.11	4.65	19.91	-5.50	-4.18	-2.91	8.61	6.14	4.98	14.26
2012	19.70	7.26	16.38	15.91	16.82	17.68	16.00	14.61	1.29	18.05	16.35	14.59	5.09	2.59	15.81	10.55
2013	2.86	26.50	33.47	38.32	34.99	31.99	32.39	32.75	13.21	34.52	38.82	43.30	-2.68	-1.39	7.44	10.98
2014	28.03	7.52	12.47	13.40	17.94	12.36	13.69	14.89	28.98	4.22	4.89	5.60	6.48	6.07	2.45	11.82
2015	2.83	-2.23	0.44	5.73	8.43	-3.13	1.38	5.52	-4.85	-7.47	-4.41	-1.38	0.30	1.46	-4.47	13.33
2016	-3.93	-5.21	-5.71	-8.98	-8.54	-4.36	-5.09	-5.79	6.97	-6.08	-8.80	-11.47	2.41	1.64	-1.04	-
Quarterly Returns																
2014: Q3	-2.48	1.29	-0.06	1.93	5.19	0.25	1.13	1.92	-3.96	-8.58	-7.36	-6.13	0.26	0.15	-1.87	2.63
Q4	12.94	4.58	5.23	5.40	4.61	4.78	4.93	5.06	13.19	9.40	9.73	10.06	1.90	1.79	-1.00	3.04
2015: Q1	3.98	-0.26	1.80	3.48	2.30	-0.69	0.95	2.47	-5.17	1.98	4.32	6.63	1.90	1.00	2.52	3.57
Q2	-9.06	-0.88	0.12	1.75	1.46	0.24	0.28	0.31	-5.80	-1.20	0.42	1.98	-2.05	-0.79	0.00	3.14
Q3	0.99	-7.58	-7.27	-7.35	-4.91	-8.25	-6.44	-4.83	5.40	-10.73	-11.92	-13.06	1.23	1.31	-4.86	3.09
Q4	7.68	7.00	6.27	8.38	9.86	6.05	7.04	7.86	1.07	2.88	3.59	4.32	-0.74	-0.06	-2.07	2.91
2016: Q1	-3.93	-5.21	-5.71	-8.98	-8.54	-4.36	-5.09	-5.79	6.97	-6.08	-8.80	-11.47	2.41	1.64	-1.04	-
Monthly Returns																
2015: Sep	2.13	-1.47	-2.95	-3.27	-2.19	-2.79	-2.47	-2.20	2.92	-3.46	-4.91	-6.32	0.70	0.58	-2.60	-
Oct	6.47	8.47	7.87	9.38	11.19	7.32	8.44	9.40	1.09	5.60	5.63	5.67	0.02	0.12	2.75	-
Nov	-0.17	0.32	0.55	1.09	0.34	0.51	0.30	0.12	-2.14	2.84	3.25	3.66	-0.33	-0.16	-2.22	-
Dec	1.31	-1.66	-2.02	-1.98	-1.53	-1.68	-1.58	-1.52	2.17	-5.27	-5.02	-4.77	-0.42	-0.03	-2.52	-
2016: Jan	-3.52	-5.50	-5.68	-7.86	-6.84	-4.88	-4.96	-5.04	4.93	-6.72	-8.79	-10.83	1.51	1.24	-1.61	-
Feb	-0.43	0.30	-0.03	-1.21	-1.82	0.55	-0.13	-0.79	1.94	0.68	0.00	-0.71	0.89	0.39	0.57	-
Compound Annual Returns																
Complete History	11.85	6.84	10.19	8.71	12.29	11.71	10.16	10.85	7.93	12.58	11.07	9.19	7.66	7.77	8.80	-
1-Year	-4.04	-8.91	-7.93	-8.17	-5.39	-8.10	-6.19	-4.61	6.22	-13.35	-14.97	-16.65	1.36	2.49	-8.30	-
3-Year	7.42	5.53	9.98	12.98	15.33	8.37	10.75	12.90	11.50	4.37	5.72	7.05	2.19	2.61	0.72	-
5-Year	9.14	6.20	9.57	10.38	12.31	8.49	10.13	11.66	11.99	5.27	6.11	6.90	3.91	3.21	4.09	-
10-Year	6.01	4.15	6.47	7.17	9.66	4.91	6.44	7.86	7.75	4.08	4.95	5.72	4.74	4.73	6.61	-
15-Year	10.89	3.07	5.68	5.13	5.40	4.54	5.06	5.43	5.02	7.53	6.74	5.66	5.01	4.94	6.90	-
20-Year	10.50	5.67	7.75	7.37	10.01	7.13	7.67	7.94	7.52	8.80	7.37	5.47	5.54	5.54	6.60	-
25-Year	11.40	7.23	9.25	9.67	11.95	8.72	9.10	9.21	8.23	10.75	9.25	7.30	6.24	6.12	8.39	-
30-Year	10.29	7.85	9.72	8.83	11.99	9.42	9.90	10.05	-	9.75	8.47	6.78	6.67	6.75	8.07	-
35-Year	11.66	8.42	10.68	9.37	-	10.83	10.89	10.65	-	11.57	9.62	7.33	8.17	8.46	-	-
40-Year	13.11	7.34	11.10	10.30	-	11.09	10.91	10.40	-	-	-	-	7.63	7.75	-	-
Annualized Volatility of Returns																
Complete History	17.04	15.20	15.75	21.24	24.83	14.92	15.25	16.00	14.88	17.38	19.54	22.74	6.00	6.26	8.44	-
1-Year	3.74	4.43	3.93	4.87	5.14	3.69	3.95	4.25	3.81	3.87	4.60	5.45	0.84	0.49	1.80	-
3-Year	13.69	10.92	10.98	12.88	13.18	10.62	10.80	11.31	13.90	13.76	14.69	16.13	3.45	2.37	5.31	-
5-Year	15.04	11.40	12.27	13.86	13.84	12.35	11.84	11.74	11.97	15.42	16.24	17.41	3.25	2.09	6.19	-
10-Year	25.16	14.11	15.54	17.70	18.12	16.28	15.09	14.59	13.67	19.68	19.74	20.35	3.94	2.61	10.56	-
15-Year	22.15	14.36	15.16	20.06	22.13	15.86	14.81	14.50	15.24	18.79	19.49	21.05	4.22	2.66	9.84	-
20-Year	20.27	14.92	15.70	23.97	26.44	15.97	15.34	15.94	15.76	17.86	20.00	23.53	4.14	2.66	9.08	-
25-Year	18.78	14.16	14.75	22.23	24.70	14.93	14.39	15.06	14.92	16.65	18.69	22.04	4.20	2.84	8.47	-
30-Year	17.94	15.09	15.47	22.16	24.89	15.44	15.20	15.99	-	17.40	19.41	22.53	4.44	3.38	8.58	-
35-Year	17.08	14.92	15.30	21.58	24.83	15.18	15.02	15.85	-	17.11	19.22	22.38	5.66	5.59	-	-
40-Year	16.83	14.77	15.26	21.13	24.83	14.90	14.87	15.84	-	-	-	-	6.03	6.27	-	-

[1] Price only returns

Source: NAREIT®, FactSet.

Comparative Total Return Investment Correlation

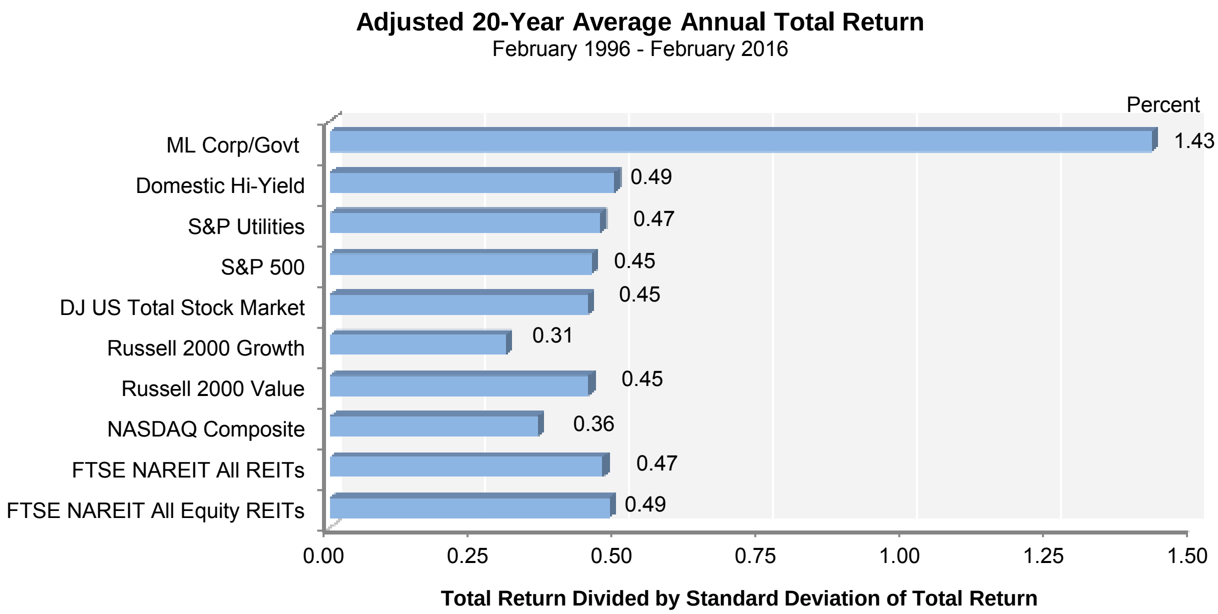
Period For Upper Right: February 2006 - February 2016

	FTSE NAREIT All Equity REITs	DJ US Total Stock Market	NASDAQ Composite[1]	NASDAQ 100[1]	S&P 500/ Citigroup Value	S&P 500	S&P 500/ Citigroup Growth	S&P Utilities	Russell 2000 Value	Russell 2000	Russell 2000 Growth	ML Corp/Govt Bond	ML Mortage	Domestic High Yield Corp Bond	Dow Jones Industrial Average[1]
FTSE NAREIT All Equity REITs	1.000	0.765	0.710	0.665	0.774	0.754	0.705	0.456	0.810	0.774	0.717	0.203	0.067	0.728	0.716
DJ US Total Stock Market	0.583	1.000	0.958	0.919	0.977	0.997	0.978	0.489	0.925	0.941	0.930	0.005	-0.109	0.747	0.964
NASDAQ Composite[1]	0.451	0.891	1.000	0.983	0.903	0.948	0.958	0.411	0.883	0.925	0.940	-0.042	-0.149	0.726	0.892
NASDAQ 100[1]	0.383	0.862	0.971	1.000	0.851	0.914	0.943	0.412	0.804	0.855	0.881	-0.026	-0.133	0.716	0.854
S&P 500/ Citigroup Value	0.616	0.949	0.746	0.718	1.000	0.981	0.923	0.465	0.921	0.910	0.874	-0.006	-0.113	0.700	0.970
S&P 500	0.557	0.989	0.842	0.831	0.963	1.000	0.980	0.500	0.905	0.916	0.902	0.015	-0.095	0.731	0.975
S&P 500/ Citigroup Growth	0.470	0.962	0.875	0.880	0.868	0.970	1.000	0.515	0.852	0.887	0.895	0.035	-0.072	0.734	0.942
S&P Utilities	0.378	0.406	0.202	0.201	0.481	0.420	0.334	1.000	0.388	0.396	0.391	0.348	0.243	0.429	0.478
Russell 2000 Value	0.734	0.852	0.742	0.658	0.842	0.806	0.723	0.385	1.000	0.985	0.943	-0.036	-0.141	0.684	0.869
Russell 2000	0.641	0.890	0.876	0.795	0.808	0.824	0.786	0.328	0.954	1.000	0.986	-0.056	-0.169	0.709	0.867
Russell 2000 Growth	0.539	0.875	0.925	0.855	0.750	0.801	0.796	0.276	0.871	0.977	1.000	-0.075	-0.191	0.715	0.840
ML Corp/Govt Bond	0.168	0.079	0.001	0.018	0.085	0.100	0.106	0.299	0.012	-0.016	-0.039	1.000	0.814	0.194	0.005
ML Mortgage	0.089	0.068	-0.006	0.014	0.074	0.090	0.097	0.223	-0.011	-0.034	-0.052	0.868	1.000	0.024	-0.083
Domestic High Yield Corp Bond	0.597	0.614	0.554	0.498	0.583	0.584	0.548	0.320	0.629	0.619	0.581	0.221	0.171	1.000	0.657
Dow Jones Industrial Average[1]	0.523	0.934	0.747	0.738	0.947	0.955	0.901	0.403	0.777	0.764	0.723	0.060	0.065	0.534	1.000

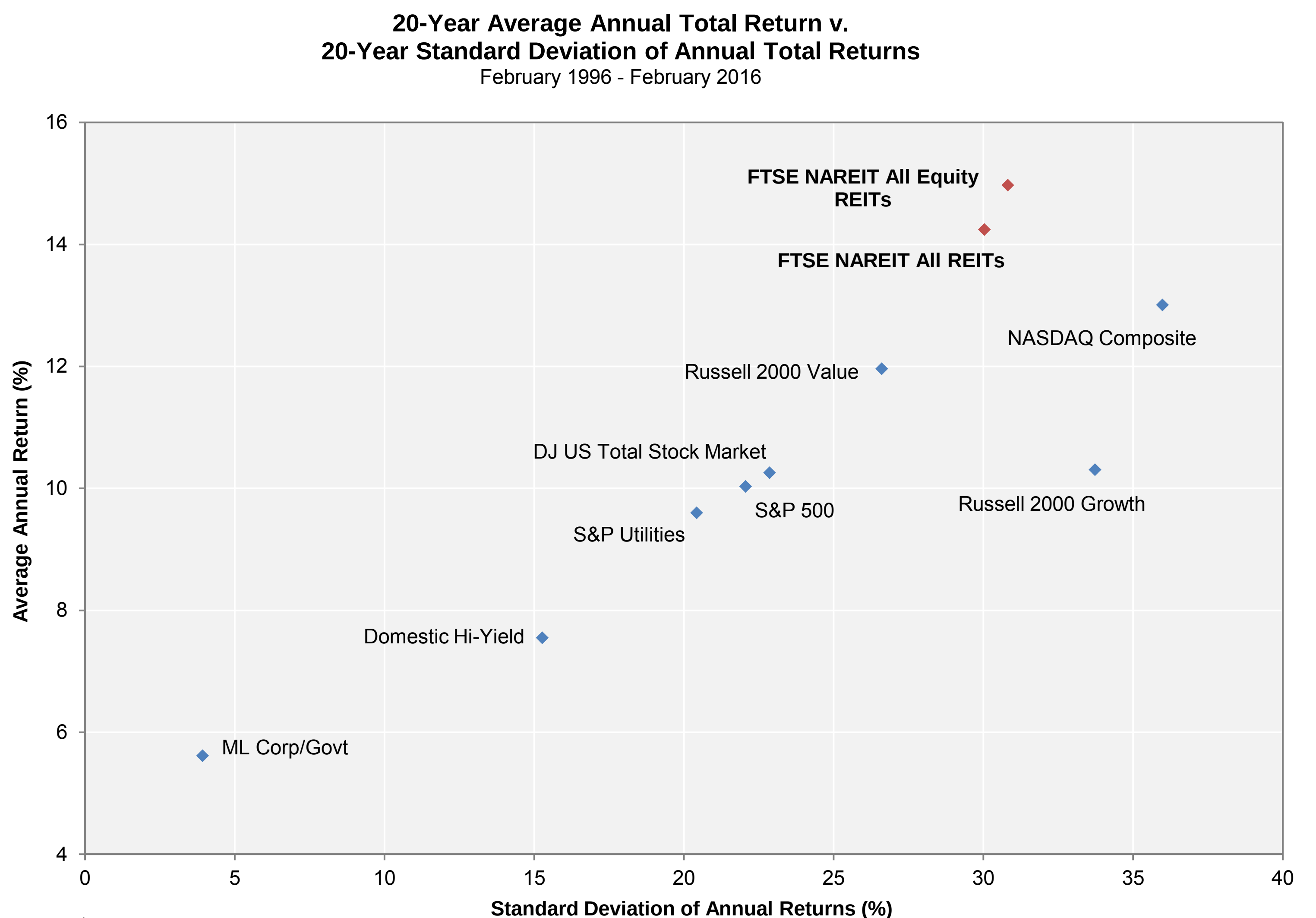
Period For Lower Left: February 1986 - February 2016

[1] Price only returns.
Source: NAREIT®, FactSet.

Note: NASDAQ Composite returns are price only.
Source: NAREIT®, FactSet.

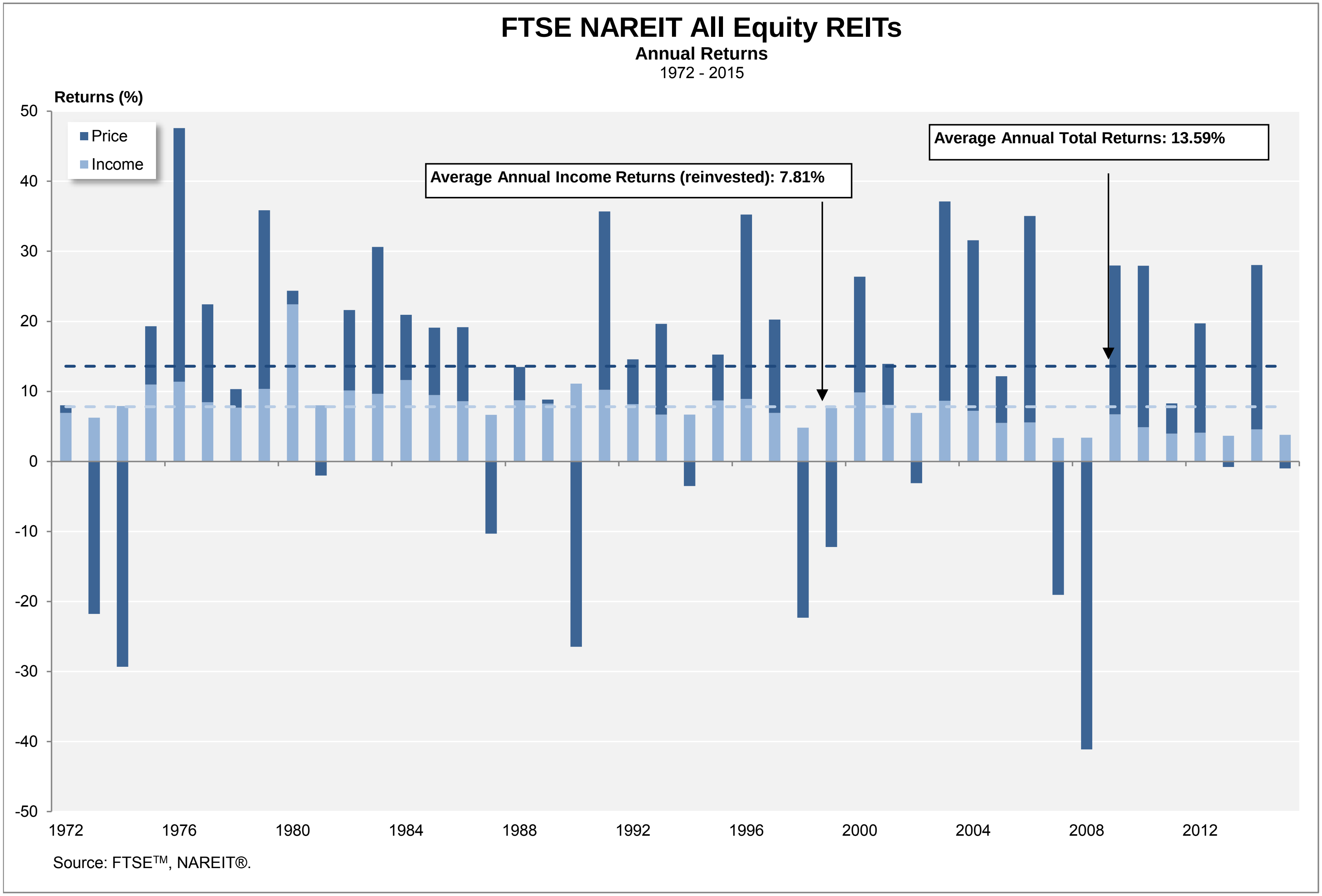


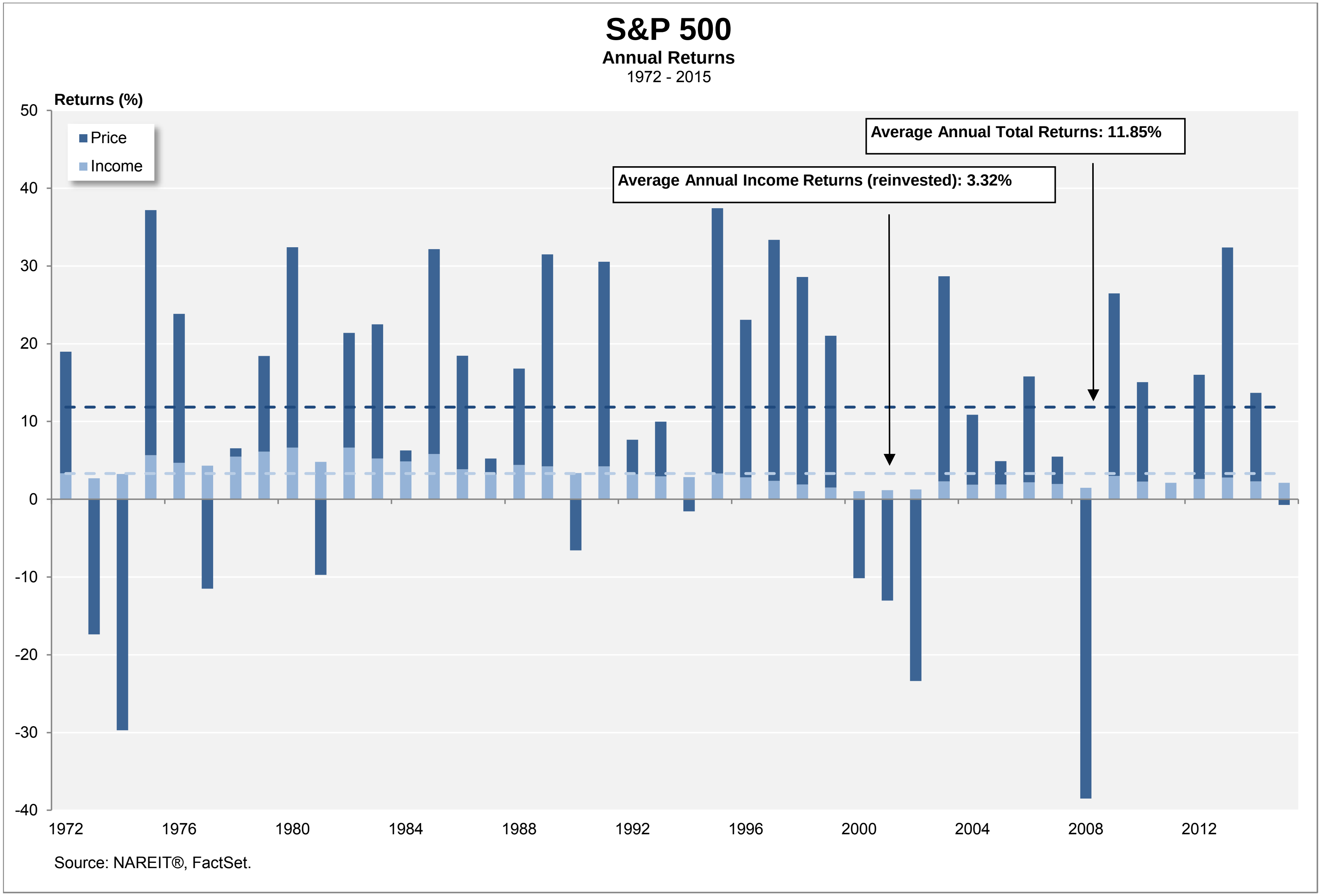
Note: NASDAQ Composite returns are price only.

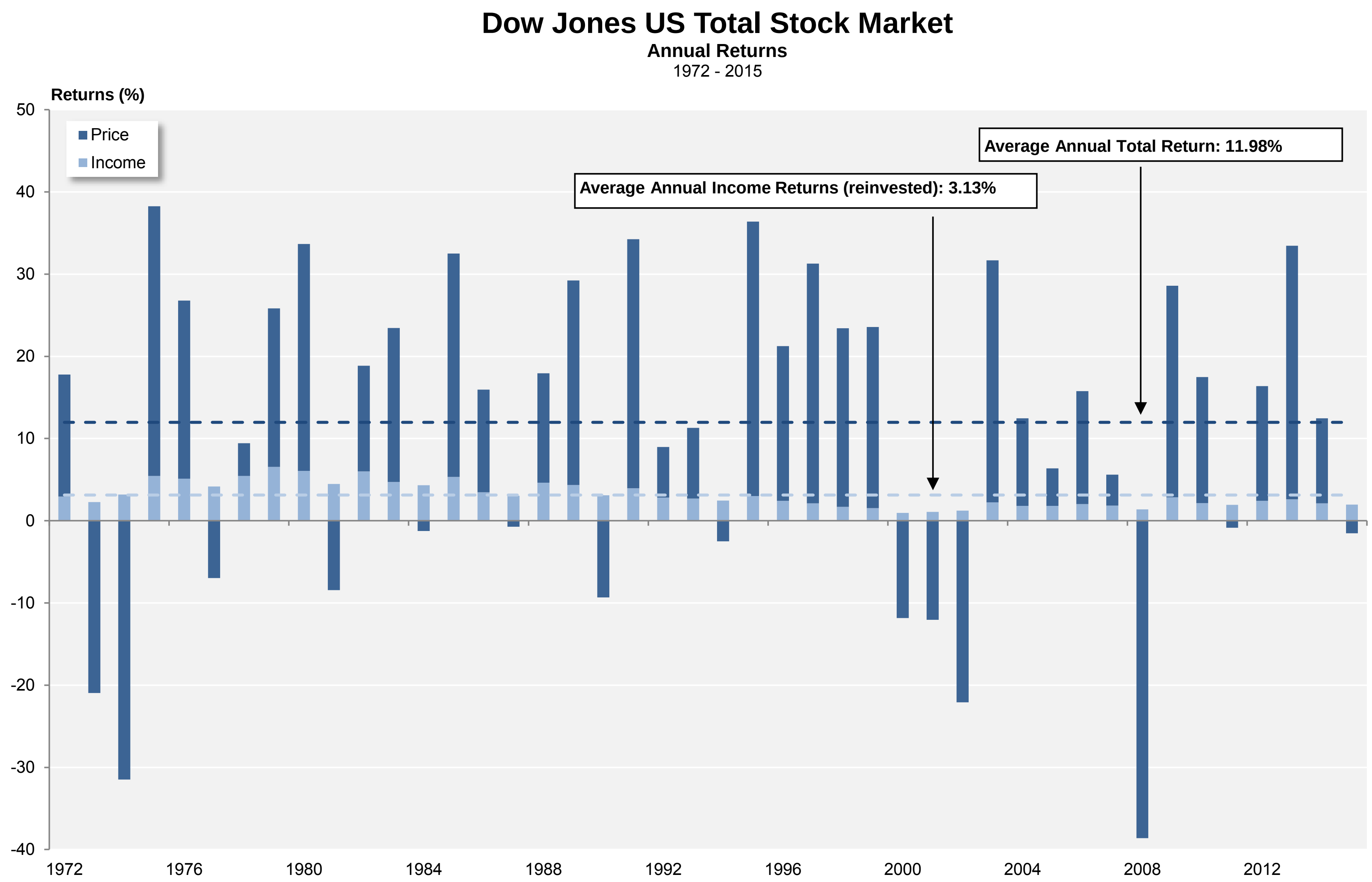


[1] Price only returns.
Source: NAREIT®, FactSet.

NAREIT® REITWatch
National Association of Real Estate Investment Trusts®




S&P 500
Annual Returns
1972 - 2015
Returns (%)
Price
Income
Average Annual Total Returns: 11.85%
Average Annual Income Returns (reinvested): 3.32%
50
40
30
20
10
0
-10
-20
-30
-40
1972
1976
1980
1984
1988
1992
1996
2000
2004
2008
2012
Source: NAREIT®, FactSet.



Source: NAREIT®, FactSet.

Annual Returns for the FTSE NAREIT US Real Estate Index Series

1972-2015

	FTSE NAREIT All REITs				FTSE NAREIT Composite			
	Total		Price		Total		Price	
Year	Return (%)	Index	Return (%)	Index	Return (%)	Index	Return (%)	Index
1971		100.00		100.00		100.00		100.00
1972	11.19	111.19	3.84	103.84	11.19	111.19	3.84	103.84
1973	-27.22	80.93	-33.11	69.46	-27.22	80.93	-33.11	69.46
1974	-42.23	46.75	-49.55	35.04	-42.23	46.75	-49.55	35.04
1975	36.34	63.74	22.20	42.82	36.34	63.74	22.20	42.82
1976	48.97	94.96	36.53	58.47	48.97	94.96	36.53	58.47
1977	19.08	113.07	10.10	64.37	19.08	113.07	10.10	64.37
1978	-1.64	111.21	-9.42	58.31	-1.64	111.21	-9.42	58.31
1979	30.53	145.16	19.35	69.59	30.53	145.16	19.35	69.59
1980	28.02	185.84	11.07	77.30	28.02	185.84	11.07	77.30
1981	8.58	201.78	-1.02	76.51	8.58	201.78	-1.02	76.51
1982	31.64	265.62	19.19	91.19	31.64	265.62	19.19	91.19
1983	25.47	333.28	15.11	104.97	25.47	333.28	15.11	104.97
1984	14.82	382.65	3.53	108.67	14.82	382.65	3.53	108.67
1985	5.92	405.30	-3.52	104.84	5.92	405.30	-3.52	104.84
1986	19.18	483.03	9.24	114.53	19.18	483.03	9.24	114.53
1987	-10.67	431.49	-19.01	92.76	-10.67	431.49	-19.01	92.76
1988	11.36	480.49	1.24	93.92	11.36	480.49	1.24	93.92
1989	-1.81	471.78	-12.06	82.59	-1.81	471.78	-12.06	82.59
1990	-17.35	389.95	-28.49	59.05	-17.35	389.95	-28.49	59.05
1991	35.68	529.08	23.10	72.69	35.68	529.08	23.10	72.69
1992	12.18	593.49	2.87	74.78	12.18	593.49	2.87	74.78
1993	18.55	703.57	10.58	82.69	18.55	703.57	10.58	82.69
1994	0.81	709.24	-6.41	77.39	0.81	709.24	-6.41	77.39
1995	18.31	839.09	9.12	84.45	18.31	839.09	9.12	84.45
1996	35.75	1,139.10	26.52	106.84	35.75	1,139.10	26.52	106.84
1997	18.86	1,353.94	11.85	119.50	18.86	1,353.94	11.85	119.50
1998	-18.82	1,099.09	-23.82	91.03	-18.82	1,099.09	-23.82	91.03
1999	-6.48	1,027.92	-14.06	78.23	-6.48	1,027.92	-14.06	78.23
2000	25.89	1,294.05	15.91	90.68	25.89	1,294.05	15.91	90.68
2001	15.50	1,494.65	7.05	97.07	15.50	1,494.65	7.05	97.07
2002	5.22	1,572.61	-2.15	94.98	5.22	1,572.61	-2.15	94.98
2003	38.47	2,177.53	29.34	122.85	38.47	2,177.53	29.34	122.85
2004	30.41	2,839.70	22.87	150.94	30.41	2,839.70	22.87	150.94
2005	8.29	3,075.06	2.51	154.73	8.29	3,075.06	2.51	154.73
2006	34.35	4,131.39	28.31	198.53	34.02	4,121.18	27.98	198.02
2007	-17.83	3,394.71	-21.39	156.07	-17.83	3,386.30	-21.42	155.60
2008	-37.34	2,127.27	-41.04	92.02	-37.84	2,104.93	-41.56	90.94
2009	27.45	2,711.15	19.90	110.33	27.80	2,690.12	20.15	109.26
2010	27.58	3,458.89	21.81	134.39	27.56	3,431.62	21.76	133.03
2011	7.28	3,710.61	2.37	137.57	7.30	3,682.29	2.34	136.14
2012	20.14	4,458.10	14.98	158.18	19.73	4,408.71	14.54	155.93
2013	3.21	4,601.14	-1.15	156.35	2.34	4,511.90	-2.03	152.76
2014	27.15	5,850.23	21.93	190.65	27.23	5,740.43	22.00	186.36
2015	2.29	5,984.18	-1.95	186.93	2.05	5,858.14	-2.20	182.27

	FTSE NAREIT Real Estate 50™				FTSE NAREIT All Equity REITs			
	Total		Price		Total		Price	
Year	Return (%)	Index	Return (%)	Index	Return (%)	Index	Return (%)	Index
1971						100.00		100.00
1972					8.01	108.01	1.08	101.08
1973					-15.52	91.25	-21.78	79.07
1974					-21.40	71.72	-29.33	55.88
1975					19.30	85.56	8.34	60.54
1976					47.59	126.28	36.21	82.46
1977					22.42	154.59	13.97	93.98
1978					10.34	170.57	2.66	96.48
1979					35.86	231.73	25.49	121.07
1980					24.37	288.20	1.95	123.42
1981					6.00	305.50	-2.03	120.92
1982					21.60	371.49	11.49	134.81
1983					30.64	485.30	21.01	163.13
1984					20.93	586.86	9.30	178.30
1985					19.10	698.93	9.62	195.45
1986					19.16	832.83	10.56	216.10
1987					-3.64	802.51	-10.31	193.82
1988					13.49	910.74	4.77	203.07
1989					8.84	991.26	0.58	204.24
1990					-15.35	839.09	-26.45	150.21
1991					35.70	1,138.61	25.47	188.47
1992					14.59	1,304.73	6.40	200.54
1993					19.65	1,561.17	12.95	226.51
1994					3.17	1,610.67	-3.52	218.55
1995					15.27	1,856.57	6.56	232.88
1996					35.27	2,511.32	26.35	294.24
1997					20.26	3,020.11	13.33	333.47
1998					-17.50	2,491.53	-22.33	259.00
1999		100.00		100.00	-4.62	2,376.42	-12.21	227.37
2000	28.66	128.66	19.98	119.98	26.37	3,002.97	16.51	264.90
2001	12.20	144.36	5.13	126.14	13.93	3,421.37	5.85	280.40
2002	1.86	147.05	-4.30	120.71	3.82	3,552.10	-3.12	271.66
2003	36.30	200.44	28.34	154.92	37.13	4,871.12	28.48	349.02
2004	35.00	270.58	28.31	198.79	31.58	6,409.30	24.35	434.01
2005	13.67	307.57	8.52	215.71	12.16	7,188.85	6.67	462.98
2006	35.64	417.18	30.28	281.03	35.06	9,709.31	29.51	599.59
2007	-16.34	349.00	-19.57	226.03	-15.69	8,185.75	-19.05	485.36
2008	-37.31	218.80	-40.78	133.85	-37.73	5,097.46	-41.12	285.79
2009	27.62	279.23	20.36	161.10	27.99	6,524.25	21.28	346.60
2010	26.72	353.83	21.13	195.14	27.95	8,347.58	23.07	426.55
2011	9.45	387.25	4.69	204.29	8.28	9,039.07	4.32	444.96
2012	18.05	457.14	13.37	231.60	19.70	10,819.84	15.61	514.43
2013	-0.53	454.71	-4.44	221.31	2.86	11,128.83	-0.80	510.33
2014	28.73	585.32	23.86	274.12	28.03	14,247.97	23.44	629.96
2015	4.40	611.08	0.42	275.27	2.83	14,650.51	-0.98	623.76

	FTSE NAREIT Equity REITs				FTSE NAREIT Mortgage REITs			
	Total		Price		Total		Price	
Year	Return (%)	Index	Return (%)	Index	Return (%)	Index	Return (%)	Index
1971		100.00		100.00		100.00		100.00
1972	8.01	108.01	1.08	101.08	12.17	112.17	4.34	104.34
1973	-15.52	91.25	-21.78	79.07	-36.26	71.50	-42.05	60.47
1974	-21.40	71.72	-29.33	55.88	-45.32	39.09	-53.96	27.84
1975	19.30	85.56	8.34	60.54	40.79	55.04	24.51	34.66
1976	47.59	126.28	36.21	82.46	51.71	83.50	38.41	47.97
1977	22.42	154.59	13.97	93.98	17.82	98.38	8.16	51.89
1978	10.34	170.57	2.66	96.48	-9.97	88.57	-17.86	42.62
1979	35.86	231.73	25.49	121.07	16.56	103.24	4.26	44.44
1980	24.37	288.20	1.95	123.42	16.80	120.58	3.29	45.90
1981	6.00	305.50	-2.03	120.92	7.07	129.11	-5.54	43.36
1982	21.60	371.49	11.49	134.81	48.64	191.91	31.27	56.91
1983	30.64	485.30	21.01	163.13	16.90	224.34	5.56	60.08
1984	20.93	586.86	9.30	178.30	7.26	240.64	-4.54	57.35
1985	19.10	698.93	9.62	195.45	-5.20	228.11	-15.33	48.55
1986	19.16	832.83	10.56	216.10	19.21	271.95	7.64	52.26
1987	-3.64	802.51	-10.31	193.82	-15.67	229.34	-25.70	38.83
1988	13.49	910.74	4.77	203.07	7.30	246.09	-5.12	36.84
1989	8.84	991.26	0.58	204.24	-15.90	206.95	-26.19	27.20
1990	-15.35	839.09	-26.45	150.21	-18.37	168.94	-29.18	19.26
1991	35.70	1,138.61	25.47	188.47	31.83	222.72	13.93	21.94
1992	14.59	1,304.73	6.40	200.54	1.92	226.99	-10.80	19.57
1993	19.65	1,561.17	12.95	226.51	14.55	260.01	-0.40	19.49
1994	3.17	1,610.67	-3.52	218.55	-24.30	196.82	-33.83	12.90
1995	15.27	1,856.57	6.56	232.88	63.42	321.65	46.80	18.94
1996	35.27	2,511.32	26.35	294.24	50.86	485.25	37.21	25.98
1997	20.26	3,020.11	13.33	333.47	3.82	503.80	-3.57	25.05
1998	-17.50	2,491.53	-22.33	259.00	-29.22	356.60	-34.29	16.46
1999	-4.62	2,376.42	-12.21	227.37	-33.22	238.15	-40.12	9.86
2000	26.37	3,002.97	16.51	264.90	15.96	276.15	3.33	10.19
2001	13.93	3,421.37	5.85	280.40	77.34	489.74	46.37	14.91
2002	3.82	3,552.10	-3.12	271.66	31.08	641.93	14.23	17.03
2003	37.13	4,871.12	28.48	349.02	57.39	1,010.33	38.19	23.54
2004	31.58	6,409.30	24.35	434.01	18.43	1,196.57	7.92	25.40
2005	12.16	7,188.85	6.67	462.98	-23.19	919.11	-30.88	17.56
2006	35.06	9,709.31	29.51	599.59	19.32	1,096.72	8.44	19.04
2007	-15.69	8,185.75	-19.05	485.36	-42.35	632.27	-47.69	9.96
2008	-37.73	5,097.46	-41.12	285.79	-31.31	434.31	-40.46	5.93
2009	27.99	6,524.25	21.28	346.60	24.63	541.28	8.26	6.42
2010	27.96	8,348.46	23.06	426.53	22.60	663.59	7.01	6.87
2011	8.29	9,040.81	4.32	444.95	-2.42	647.56	-15.14	5.83
2012	18.06	10,673.56	13.86	506.60	19.89	776.34	5.83	6.17
2013	2.47	10,936.91	-1.33	499.85	-1.96	761.12	-12.42	5.40
2014	30.14	14,233.18	25.25	626.05	17.88	897.23	6.30	5.74
2015	3.20	14,688.11	-0.68	621.76	-8.88	817.59	-18.48	4.68

Annual Price and Total Returns by Property Sector
1994 - 2015
(Returns in Percent)

	Office		Industrial		Retail		Residential		Diversified		Health Care		Lodging/Resorts		Self Storage		Timber		Infrastructure		Data Centers		Specialty		Mortgage	
	Total	Price	Total	Price	Total	Price	Total	Price	Total	Price	Total	Price	Total	Price	Total	Price	Total	Price	Total	Price	Total	Price	Total	Price	Total	Price
1994	2.86	-2.68	18.66	13.37	2.98	-3.94	2.31	-3.77	-6.04	-11.54	4.12	-3.54	-8.89	-12.79	8.90	1.31	-	-	-	-	-	-	-	-	-24.30	-33.81
1995	38.79	28.34	16.21	8.55	5.10	-3.20	11.99	3.80	21.16	12.54	24.88	13.93	30.79	22.35	34.40	25.42	-	-	-	-	-	-	-	-	63.42	46.82
1996	51.82	42.85	37.22	28.99	34.61	24.43	29.46	19.72	33.96	22.25	20.40	11.87	49.19	40.32	42.85	34.51	-	-	-	-	-	-	-	-	50.86	37.17
1997	29.01	22.56	19.02	12.76	16.95	9.83	16.31	9.04	21.67	13.15	15.76	7.56	30.09	23.30	3.41	-1.25	-	-	-	-	-	-	-	-	3.82	-3.58
1998	-17.35	-22.14	-11.74	-16.32	-4.74	-10.87	-8.11	-13.69	-22.11	-26.02	-17.45	-23.65	-52.83	-55.01	-7.20	-10.85	-	-	-	-	-	-	-	-	-29.22	-34.29
1999	4.26	-3.11	3.90	-4.03	-11.77	-18.89	9.48	1.81	-14.41	-23.71	-24.83	-31.98	-16.14	-24.05	-8.03	-14.20	-	-	-	-	-	-	-	-	-33.22	-40.10
2000	35.45	26.62	28.62	14.48	17.97	7.72	34.30	25.25	24.10	15.21	25.84	9.97	45.77	30.83	14.69	6.50	-	-	-	-	-	-	-	-	15.96	3.35
2001	6.65	-0.79	7.42	0.53	30.41	20.61	9.04	2.02	12.52	4.80	51.86	39.11	-8.63	-16.32	43.24	36.55	-	-	-	-	-	-	-	-	77.35	46.32
2002	-6.29	-12.74	17.32	10.23	21.07	13.11	-5.99	-12.63	4.24	-3.38	4.82	-3.08	-1.49	-7.04	0.56	-5.01	-	-	-	-	-	-	-	-	31.08	14.22
2003	34.01	24.84	33.13	25.76	46.77	38.46	25.90	17.65	40.25	27.87	53.59	41.65	31.69	26.57	38.14	30.75	-	-	-	-	-	-	-	-	57.39	38.23
2004	23.28	16.22	34.10	27.78	40.23	33.23	32.71	24.08	32.41	22.20	20.96	13.35	32.70	29.08	29.70	24.33	-	-	-	-	-	-	-	-	18.43	7.90
2005	13.11	6.76	15.41	10.76	11.80	6.60	13.69	8.31	9.87	4.04	1.79	-4.61	9.76	5.93	26.55	21.98	-	-	-	-	-	-	-	-	-23.19	-30.87
2006	45.22	39.76	28.92	24.46	29.02	24.00	38.93	33.80	38.03	32.10	44.55	35.81	28.16	22.75	40.94	36.66	-	-	-	-	-	-	-	-	19.32	8.43
2007	-18.96	-22.01	0.38	-3.17	-15.77	-18.97	-25.21	-28.08	-22.29	-25.40	2.13	-3.47	-22.37	-25.98	-24.82	-27.16	-	-	-	-	-	-	-	-	-42.35	-47.69
2008	-41.07	-44.02	-67.47	-69.38	-48.36	-51.28	-24.89	-29.08	-28.25	-31.84	-11.98	-17.06	-59.67	-62.72	5.05	1.44	-	-	-	-	-	-	-	-	-31.31	-40.46
2009	35.55	28.04	12.17	4.84	27.17	21.57	30.82	22.81	17.02	12.77	24.62	15.76	67.19	64.53	8.37	4.44	-	-	-	-	-	-	-	-	24.63	8.26
2010	18.41	14.50	18.89	13.60	33.41	28.43	46.01	40.87	23.75	19.03	19.20	12.71	42.77	40.51	29.29	25.20	-	-	-	-	-	-	-	-	22.60	7.01
2011	-0.76	-4.21	-5.16	-8.74	12.20	8.27	15.37	11.82	2.82	-1.32	13.63	7.62	-14.31	-16.38	35.22	31.04	7.65	3.77	-	-	-	-	-	-	-2.42	-15.14
2012	14.15	10.26	31.28	26.89	26.74	22.58	6.94	3.60	12.20	7.63	20.35	14.50	12.53	9.33	19.94	16.21	37.05	32.58	29.91	28.25	-	-	-	-	19.89	5.83
2013	5.57	2.06	7.40	4.05	1.86	-1.67	-5.36	-8.69	4.33	-0.29	-7.06	-11.41	27.18	23.07	9.49	5.92	7.86	4.54	4.80	3.30					-1.96	-12.42
2014	25.86	22.06	21.00	17.03	27.62	22.84	40.04	35.25	27.18	21.77	33.32	26.62	32.50	28.12	31.44	27.21	8.57	4.78	20.15	17.86					17.88	6.30
2015	0.29	-2.59	2.64	-1.27	4.56	0.89	17.07	13.55	-0.49	-5.27	-7.25	-12.07	-24.42	-27.52	40.65	36.23	-6.97	-10.64	3.74	0.58	1.54	1.35	1.69	1.36	-8.88	-18.48

Annual Price and Total Returns by Property Subsector
1994 - 2015
(Returns in Percent)

	Retail						Residential						Mortgage			
	Shopping Centers		Regional Malls		Free Standing		Apartments		Manufactured Homes		Single Family Homes		Home Financing		Commercial Financing	
	Total	Price	Total	Price	Total	Price	Total	Price	Total	Price	Total	Price	Total	Price	Total	Price
1994	1.33	-5.49	8.77	1.41	-5.46	-17.52	2.19	-3.91	3.31	-2.59			-	-	-	-
1995	7.40	-0.74	3.00	-5.74	31.56	20.28	12.26	3.94	10.68	2.87			-	-	-	-
1996	33.49	23.37	45.27	34.10	30.95	20.38	28.93	19.07	34.93	26.58			-	-	-	-
1997	21.44	14.36	13.69	6.58	17.70	10.22	16.04	8.77	16.17	9.33			-	-	-	-
1998	-6.99	-13.00	-2.62	-8.17	-6.25	-11.97	-8.77	-14.37	-0.86	-6.10			-	-	-	-
1999	-10.71	-18.03	-14.58	-21.22	-4.89	-12.31	10.72	2.87	-2.80	-8.77			-	-	-	-
2000	15.10	4.27	23.50	13.63	8.94	-0.34	35.53	26.40	20.94	12.62			9.16	-1.60	25.60	10.13
2001	29.89	19.83	31.87	22.87	23.95	12.06	8.66	1.68	13.72	6.37			102.02	68.36	37.37	10.17
2002	17.72	9.63	24.56	16.76	21.76	13.65	-6.15	-12.88	-4.05	-9.61			28.25	11.40	38.50	21.27
2003	43.12	34.99	52.24	43.75	35.92	27.70	25.49	17.22	29.99	21.51			42.73	22.74	84.67	68.53
2004	36.25	29.63	45.01	37.70	32.87	26.03	34.72	26.50	6.40	-8.40			24.91	12.89	7.45	-0.10
2005	9.27	3.59	16.54	11.76	-0.49	-5.44	14.65	9.12	-2.58	-6.04			-25.95	-33.94	-16.06	-22.82
2006	34.87	29.74	23.83	19.19	30.74	23.65	39.95	34.77	15.35	11.57			14.75	3.87	30.31	19.61
2007	-17.68	-20.98	-15.85	-18.80	-0.43	-5.26	-25.43	-28.30	-19.34	-22.24			-38.23	-43.41	-48.79	-54.29
2008	-38.84	-42.23	-60.60	-62.79	-15.09	-20.32	-25.13	-29.33	-20.18	-24.06			-20.02	-30.25	-74.84	-78.24
2009	-1.66	-7.44	62.99	59.53	25.93	16.15	30.40	22.37	40.92	33.33			28.19	11.18	-40.99	-46.15
2010	30.78	25.83	34.64	30.15	37.37	29.32	47.04	41.89	27.02	22.11			21.02	5.04	41.99	33.88
2011	-0.73	-4.48	22.00	18.23	0.43	-4.94	15.10	11.63	20.38	15.48			-0.87	-14.41	-11.34	-18.54
2012	25.02	20.40	28.21	24.56	22.46	16.57	6.93	3.62	7.10	3.22			16.38	1.94	42.98	31.06
2013	4.99	1.21	-0.98	-3.95	7.29	1.81	-6.20	-9.48	10.46	6.25			-12.69	-22.92	41.77	31.89
2014	29.96	25.39	32.64	28.46	9.66	3.22	39.62	34.88	46.20	40.62			19.38	6.68	14.46	5.78
2015	4.72	1.01	4.23	0.83	5.88	1.19	16.45	12.96	25.65	21.57	1.77	1.67	-9.75	-20.11	-5.99	-13.19

Equity Market Capitalization
(Millions of dollars at year end)

	All REITs		Equity			Mortgage			Hybrid[1]		
Year	Number of REITs	Market Capitalization	Number of REITs	Market Capitalization	Percent of All REITs	Number of REITs	Market Capitalization	Percent of All REITs	Number of REITs	Market Capitalization	Percent of All REITs
1971	34	1,494.3	12	332.0	22.2	12	570.8	38.2	10	591.6	39.6
1972	46	1,880.9	17	377.3	20.1	18	774.7	41.2	11	728.9	38.8
1973	53	1,393.5	20	336.0	24.1	22	517.3	37.1	11	540.2	38.8
1974	53	712.4	19	241.9	34.0	22	238.8	33.5	12	231.7	32.5
1975	46	899.7	12	275.7	30.6	22	312.0	34.7	12	312.0	34.7
1976	62	1,308.0	27	409.6	31.3	22	415.6	31.8	13	482.8	36.9
1977	69	1,528.1	32	538.1	35.2	19	398.3	26.1	18	591.6	38.7
1978	71	1,412.4	33	575.7	40.8	19	340.3	24.1	19	496.4	35.1
1979	71	1,754.0	32	743.6	42.4	19	377.1	21.5	20	633.3	36.1
1980	75	2,298.6	35	942.2	41.0	21	509.5	22.2	19	846.8	36.8
1981	76	2,438.9	36	977.5	40.1	21	541.3	22.2	19	920.1	37.7
1982	66	3,298.6	30	1,071.4	32.5	20	1,133.4	34.4	16	1,093.8	33.2
1983	59	4,257.2	26	1,468.6	34.5	19	1,460.0	34.3	14	1,328.7	31.2
1984	59	5,085.3	25	1,794.5	35.3	20	1,801.3	35.4	14	1,489.4	29.3
1985	82	7,674.0	37	3,270.3	42.6	32	3,162.4	41.2	13	1,241.2	16.2
1986	96	9,923.6	45	4,336.1	43.7	35	3,625.8	36.5	16	1,961.7	19.8
1987	110	9,702.4	53	4,758.5	49.0	38	3,161.4	32.6	19	1,782.4	18.4
1988	117	11,435.2	56	6,141.7	53.7	40	3,620.8	31.7	21	1,672.6	14.6
1989	120	11,662.2	56	6,769.6	58.0	43	3,536.3	30.3	21	1,356.3	11.6
1990	119	8,737.1	58	5,551.6	63.5	43	2,549.2	29.2	18	636.3	7.3
1991	138	12,968.2	86	8,785.5	67.7	28	2,586.3	19.9	24	1,596.4	12.3
1992	142	15,912.0	89	11,171.1	70.2	30	2,772.8	17.4	23	1,968.1	12.4
1993	189	32,158.7	135	26,081.9	81.1	32	3,398.5	10.6	22	2,678.2	8.3
1994	226	44,306.0	175	38,812.0	87.6	29	2,502.7	5.6	22	2,991.3	6.8
1995	219	57,541.3	178	49,913.0	86.7	24	3,395.4	5.9	17	4,232.9	7.4
1996	199	88,776.3	166	78,302.0	88.2	20	4,778.6	5.4	13	5,695.8	6.4
1997	211	140,533.8	176	127,825.3	91.0	26	7,370.3	5.2	9	5,338.2	3.8
1998	210	138,301.4	173	126,904.5	91.8	28	4,916.2	3.6	9	6,480.7	4.7
1999	203	124,261.9	167	118,232.7	95.1	26	4,441.7	3.6	10	1,587.5	1.3
2000	189	138,715.4	158	134,431.0	96.9	22	2,652.4	1.9	9	1,632.0	1.2
2001	182	154,898.6	151	147,092.1	95.0	22	3,990.5	2.6	9	3,816.0	2.5
2002	176	161,937.3	149	151,271.5	93.4	20	7,146.4	4.4	7	3,519.4	2.2
2003	171	224,211.9	144	204,800.4	91.3	20	14,186.5	6.3	7	5,225.0	2.3
2004	190	305,025.1	150	273,629.0	89.7	33	24,774.1	8.1	7	6,622.0	2.2
2005	197	330,691.3	152	301,491.0	91.2	37	23,393.7	7.1	8	5,806.6	1.8
2006	183	438,071.1	138	400,741.4	91.5	38	29,195.3	6.7	7	8,134.3	1.9
2007	152	312,009.0	118	288,694.6	92.5	29	19,054.1	6.1	5	4,260.3	1.4
2008	136	191,651.0	113	176,237.7	92.0	20	14,280.5	7.5	3	1,132.9	0.6
2009	142	271,199.1	115	248,355.1	91.6	23	22,103.2	8.2	4	740.8	0.3
2010	153	389,295.4	126	358,908.2	92.2	27	30,387.2	7.8	--	--	--
2011	160	450,500.6	130	407,528.9	90.5	30	42,971.7	9.5	--	--	--
2012	172	603,415.3	139	544,414.9	90.2	33	59,000.3	9.8	--	--	--
2013	202	670,334.1	161	608,276.6	90.7	41	62,057.4	9.3	--	--	--
2014	216	907,427.5	177	846,410.3	93.3	39	61,017.2	6.7	--	--	--
2015	223	938,852.0	182	886,487.5	94.4	41	52,364.6	5.6	--	--	--

Note:
Market capitalization equals share price multiplied by the number of shares outstanding and does not include Operating Partnership Units.
[1]The FTSE NAREIT Hybrid REIT Index was discontinued on December 17, 2010.
Source: NAREIT®

NAREIT®
REITWatch
National Association of Real Estate Investment Trusts®

REITs in the FTSE NAREIT All REITs Index and S&P Equity Indexes

February 29, 2016

Number of REITs (1)	Company (2)	Ticker Symbol (3)	Investment Sector (4)	Property Subsector (5)	Equity Market Capitalization ($M)[1] S&P REITs (6)	FTSE NAREIT All REITs (7)	Percent of Sector (8)	Percent of S&P REITs (9)	% of FTSE NAREIT All REITs (10)
	Summary by Investment Sector, Property Sector and Property Subsector								
27	Office				54,438.9	81,330.4		7.96	9.03
11	Industrial				35,781.4	45,087.9		5.23	5.00
34	**Retail**				**175,956.2**	**207,194.5**		**25.74**	**22.99**
19	Shopping Centers				51,094.1	68,935.1		7.47	7.65
8	Regional Malls				102,954.9	105,966.3		15.06	11.76
7	Free Standing				21,907.3	32,293.1		3.20	3.58
22	**Residential**				**103,475.2**	**122,292.3**		**15.14**	**13.57**
15	Apartments				103,475.2	106,026.6		15.14	11.77
3	Manufactured Homes				0.0	10,076.2		0.00	1.12
0	Single Family Homes				0.0	6,189.6		0.00	0.00
17	Diversified				19,751.1	42,715.0		2.89	4.74
20	Lodging/Resorts				22,239.1	40,681.8		3.25	4.51
5	Self Storage				57,028.3	62,602.9		8.34	6.95
17	Health Care				76,234.5	84,952.9		11.15	9.43
4	Timber				24,302.7	24,717.8		3.55	2.74
3	Infrastructure				70,695.2	71,779.7		10.34	7.97
6	Data Centers				22,745.4	40,227.7		3.33	4.46
10	Specialty				20,079.1	26,181.4		2.94	2.91
42	**Mortgage REITs**				**927.6**	**51,352.5**		**0.14**	**5.70**
28	Home Financing				927.6	38,456.6		0.14	4.27
14	Commercial Financing				0.0	12,895.9		0.00	1.43
221	**Industry Totals**				**683,654.8**	**901,116.9**		**100.00**	**100.00**
	Distribution of REITs by S&P Index								
26	**S&P 500 Large Cap**					**508,053**		**74.31**	**56.38**
33	**S&P 400 Mid Cap**					**131,727**		**19.27**	**14.62**
30	**S&P 600 Small Cap**					**43,875**		**6.42**	**4.87**
89	**Total S&P REITs**					**683,654.8**		**100.00**	**75.87**

REITs in the FTSE NAREIT All REITs Index and S&P Equity Indexes

February 29, 2016

Summary of REITs in S&P Equity Indexes

	S&P 500 Constituents	Equity Market Cap ($M)
1	Simon Property Group, Inc.	58,965.8
2	Public Storage	43,072.0
3	American Tower Corporation	38,959.9
4	Crown Castle International Corp	28,897.2
5	Equity Residential	27,113.5
6	General Growth Properties, Inc.	24,318.9
7	AvalonBay Communities, Inc.	23,493.6
8	Welltower, Inc.	22,363.0
9	Equinix, Inc.	20,770.1
10	Weyerhaeuser Company	20,528.0
11	Prologis, Inc.	20,154.9
12	Ventas, Inc.	18,416.2
13	Boston Properties, Inc.	17,509.9
14	Vornado Realty Trust	16,259.2
15	Realty Income Corporation	14,611.6
16	HCP, Inc.	13,755.9
17	Essex Property Trust, Inc.	13,729.2
18	Macerich Company	12,490.4
19	Host Hotels & Resorts, Inc.	11,576.0
20	Kimco Realty Corporation	10,995.8
21	Federal Realty Investment Trust	10,278.9
22	Extra Space Storage Inc.	10,142.0
23	UDR, Inc.	8,994.6
24	SL Green Realty Corp.	8,781.2
25	Iron Mountain, Inc.	6,153.8
26	Apartment Investment and Management Company Class A	5,721.3
26	**Subtotal**	**508,052.8**
	S&P 400 Mid Cap Constituents	
1	Duke Realty Corporation	7,135.6
2	Mid-America Apartment Communities, Inc.	6,768.4
3	Regency Centers Corporation	6,581.1
4	Camden Property Trust	6,457.4
5	Omega Healthcare Investors, Inc.	5,996.6
6	National Retail Properties, Inc.	5,988.4
7	Alexandria Real Estate Equities, Inc.	5,723.9
8	American Campus Communities, Inc.	5,702.8
9	Kilroy Realty Corporation	5,004.1
10	Lamar Advertising Company Class A	4,668.1
11	Weingarten Realty Investors	4,365.2
12	Liberty Property Trust	4,267.6
13	Taubman Centers, Inc.	4,265.7
14	Highwoods Properties, Inc.	4,151.5
15	Douglas Emmett, Inc	3,915.0
16	Equity One, Inc.	3,861.9
17	Sovran Self Storage, Inc.	3,814.3
18	EPR Properties	3,718.5
19	Senior Housing Properties Trust	3,705.8
20	Hospitality Properties Trust	3,678.1
21	Corrections Corporation of America	3,385.5
22	Tanger Factory Outlet Centers, Inc.	3,074.7
23	Post Properties, Inc.	3,020.3
24	Healthcare Realty Trust Incorporated	2,912.4
25	Communications Sales & Leasing Inc	2,838.0
26	LaSalle Hotel Properties	2,746.9
27	Rayonier Inc.	2,701.5
28	Urban Edge Properties	2,413.7
29	Care Capital Properties, Inc.	2,218.2
30	Corporate Office Properties Trust	2,212.2
31	Mack-Cali Realty Corporation	1,770.8
32	WP GLIMCHER, Inc	1,589.9
33	Potlatch Corporation	1,073.2
33	**Subtotal**	**131,727.4**
	S&P 600 Small Cap Constituents	
1	Medical Properties Trust, Inc.	2,751.8
2	Education Realty Trust, Inc.	2,474.0
3	PS Business Parks, Inc.	2,471.4
4	Acadia Realty Trust	2,274.8
5	Kite Realty Group Trust	2,232.7
6	GEO Group Inc	2,153.2
7	CoreSite Realty Corporation	1,975.3
8	Cousins Properties Incorporated	1,875.0
9	Lexington Realty Trust	1,826.2
10	Retail Opportunity Investments Corp.	1,815.4
11	DiamondRock Hospitality Company	1,786.3
12	EastGroup Properties, Inc.	1,751.8
13	American Assets Trust, Inc.	1,665.7
14	LTC Properties, Inc.	1,579.4
15	Chesapeake Lodging Trust	1,515.7
16	Parkway Properties, Inc.	1,487.9
17	Pennsylvania Real Estate Investment Trust	1,324.3
18	Sabra Health Care REIT, Inc.	1,297.1
19	Inland Real Estate Corporation	1,065.6
20	Government Properties Income Trust	1,054.9
21	Saul Centers, Inc.	1,033.5
22	Franklin Street Properties Corp.	952.8
23	Summit Hotel Properties, Inc.,	936.1
24	Capstead Mortgage Corporation	927.6
25	Agree Realty Corporation	699.8
26	Universal Health Realty Income Trust	689.6
27	Getty Realty Corp.	607.4
28	Cedar Realty Trust, Inc.	575.3
29	CareTrust REIT Inc	548.4
30	Urstadt Biddle Properties Inc. Class A	525.5
30	**Subtotal**	**43,874.6**
89	**Total**	**683,654.8**

REITs in the FTSE NAREIT All REITs Index and S&P Equity Indexes

February 29, 2016

	Property Sector: Office								
1	Boston Properties, Inc.	BXP	Equity		S&P 500	17,509.9	21.53	2.56	1.94
2	SL Green Realty Corp.	SLG	Equity		S&P 500	8,781.2	10.80	1.28	0.97
3	Alexandria Real Estate Equities, Inc.	ARE	Equity		S&P 400	5,723.9	7.04	0.84	0.64
4	Kilroy Realty Corporation	KRC	Equity		S&P 400	5,004.1	6.15	0.73	0.56
5	Highwoods Properties, Inc.	HIW	Equity		S&P 400	4,151.5	5.10	0.61	0.46
6	Douglas Emmett, Inc	DEI	Equity		S&P 400	3,915.0	4.81	0.57	0.43
7	Equity Commonwealth	EQC	Equity			3,364.7	4.14		0.37
8	Paramount Group, Inc.	PGRE	Equity			3,203.9	3.94		0.36
9	Gramercy Property Trust	GPT	Equity			3,165.6	3.89		0.35
10	Piedmont Office Realty Trust, Inc. Class A	PDM	Equity			2,673.0	3.29		0.30
11	Columbia Property Trust, Inc.	CXP	Equity			2,530.3	3.11		0.28
12	Hudson Pacific Properties, Inc.	HPP	Equity			2,282.0	2.81		0.25
13	Corporate Office Properties Trust	OFC	Equity		S&P 400	2,212.2	2.72	0.32	0.25
14	Brandywine Realty Trust	BDN	Equity			2,156.7	2.65		0.24
15	Cousins Properties Incorporated	CUZ	Equity		S&P 600	1,875.0	2.31	0.27	0.21
16	Select Income REIT	SIR	Equity			1,842.0	2.26		0.20
17	Empire State Realty Trust, Inc. Class A	ESRT	Equity			1,841.5	2.26		0.20
18	Mack-Cali Realty Corporation	CLI	Equity		S&P 400	1,770.8	2.18	0.26	0.20
19	New York REIT, Inc.	NYRT	Equity			1,569.0	1.93		0.17
20	Parkway Properties, Inc.	PKY	Equity		S&P 600	1,487.9	1.83	0.22	0.17
21	Government Properties Income Trust	GOV	Equity		S&P 600	1,054.9	1.30	0.15	0.12
22	Franklin Street Properties Corp.	FSP	Equity		S&P 600	952.8	1.17	0.14	0.11
23	TIER REIT, Inc.	TIER	Equity			616.6	0.76		0.07
24	NorthStar Realty Europe Corp.	NRE	Equity			593.5	0.73		0.07
25	First Potomac Realty Trust	FPO	Equity			489.2	0.60		0.05
26	Easterly Government Properties, Inc.	DEA	Equity			413.3	0.51		0.05
27	City Office REIT, Inc.	CIO	Equity			150.2	0.18		0.02
27	**Sector Totals**					**81,330.4**	**100.00**	**7.96**	**9.03**
12	**S&P Sector Total**					**54,438.9**			
	Property Sector: Industrial								
1	Prologis, Inc.	PLD	Equity		S&P 500	20,154.9	44.70	2.95	2.24
2	Duke Realty Corporation	DRE	Equity		S&P 400	7,135.6	15.83	1.04	0.79
3	Liberty Property Trust	LPT	Equity		S&P 400	4,267.6	9.47	0.62	0.47
4	DCT Industrial Trust Inc.	DCT	Equity			3,187.2	7.07		0.35
5	PS Business Parks, Inc.	PSB	Equity		S&P 600	2,471.4	5.48	0.36	0.27
6	First Industrial Realty Trust, Inc.	FR	Equity			2,366.4	5.25		0.26
7	EastGroup Properties, Inc.	EGP	Equity		S&P 600	1,751.8	3.89	0.26	0.19
8	STAG Industrial, Inc.	STAG	Equity			1,195.4	2.65		0.13
9	Terreno Realty Corporation	TRNO	Equity			952.3	2.11		0.11
10	Rexford Industrial Realty, Inc.	REXR	Equity			930.3	2.06		0.10
11	Monmouth Real Estate Investment Corporation Class A	MNR	Equity			675.0	1.50		0.07
11	**Sector Totals**					**45,087.9**	**100.00**	**5.23**	**5.00**
5	**S&P Sector Total**					**35,781.4**			
	Property Sector: Retail								
1	Kimco Realty Corporation	KIM	Equity	Shopping Centers	S&P 500	10,995.8	15.95	1.61	1.22
2	Federal Realty Investment Trust	FRT	Equity	Shopping Centers	S&P 500	10,278.9	14.91	1.50	1.14
3	Brixmor Property Group, Inc.	BRX	Equity	Shopping Centers		6,947.8	10.08		0.77
4	Regency Centers Corporation	REG	Equity	Shopping Centers	S&P 400	6,581.1	9.55	0.96	0.73
5	DDR Corp.	DDR	Equity	Shopping Centers		6,009.8	8.72		0.67
6	Weingarten Realty Investors	WRI	Equity	Shopping Centers	S&P 400	4,365.2	6.33	0.64	0.48
7	Equity One, Inc.	EQY	Equity	Shopping Centers	S&P 400	3,861.9	5.60	0.56	0.43
8	Retail Properties of America, Inc. Class A	RPAI	Equity	Shopping Centers		3,475.1	5.04		0.39
9	Tanger Factory Outlet Centers, Inc.	SKT	Equity	Shopping Centers	S&P 400	3,074.7	4.46	0.45	0.34
10	Urban Edge Properties	UE	Equity	Shopping Centers	S&P 400	2,413.7	3.50	0.35	0.27
11	Acadia Realty Trust	AKR	Equity	Shopping Centers	S&P 600	2,274.8	3.30	0.33	0.25
12	Kite Realty Group Trust	KRG	Equity	Shopping Centers	S&P 600	2,232.7	3.24	0.33	0.25
13	Retail Opportunity Investments Corp.	ROIC	Equity	Shopping Centers	S&P 600	1,815.4	2.63	0.27	0.20
14	Ramco-Gershenson Properties Trust	RPT	Equity	Shopping Centers		1,329.7	1.93		0.15
15	Inland Real Estate Corporation	IRC	Equity	Shopping Centers	S&P 600	1,065.6	1.55	0.16	0.12
16	Saul Centers, Inc.	BFS	Equity	Shopping Centers	S&P 600	1,033.5	1.50	0.15	0.11
17	Cedar Realty Trust, Inc.	CDR	Equity	Shopping Centers	S&P 600	575.3	0.83	0.08	0.06
18	Urstadt Biddle Properties Inc. Class A	UBA	Equity	Shopping Centers	S&P 600	525.5	0.76	0.08	0.06
19	Wheeler Real Estate Investment Trust, Inc.	WHLR	Equity	Shopping Centers		78.6	0.11		0.01
19	**Subsector Totals**					**68,935.1**	**100.00**	**7.47**	**7.65**
14	**S&P Subsector Total**					**51,094.1**			
1	Simon Property Group, Inc.	SPG	Equity	Regional Malls	S&P 500	58,965.8	55.65	8.63	6.54
2	General Growth Properties, Inc.	GGP	Equity	Regional Malls	S&P 500	24,318.9	22.95	3.56	2.70
3	Macerich Company	MAC	Equity	Regional Malls	S&P 500	12,490.4	11.79	1.83	1.39
4	Taubman Centers, Inc.	TCO	Equity	Regional Malls	S&P 400	4,265.7	4.03	0.62	0.47
5	CBL & Associates Properties, Inc.	CBL	Equity	Regional Malls		1,959.0	1.85		0.22
6	WP GLIMCHER, Inc	WPG	Equity	Regional Malls	S&P 400	1,589.9	1.50	0.23	0.18
7	Pennsylvania Real Estate Investment Trust	PEI	Equity	Regional Malls	S&P 600	1,324.3	1.25	0.19	0.15
8	Rouse Properties, Inc.	RSE	Equity	Regional Malls		1,052.4	0.99		0.12
8	**Subsector Totals**					**105,966.3**	**100.00**	**15.06**	**11.76**
6	**S&P Subsector Total**					**102,954.9**			
1	Realty Income Corporation	O	Equity	Free Standing	S&P 500	14,611.6	45.25	2.14	1.62
2	National Retail Properties, Inc.	NNN	Equity	Free Standing	S&P 400	5,988.4	18.54	0.88	0.66
3	Spirit Realty Capital, Inc.	SRC	Equity	Free Standing		4,686.5	14.51		0.52
4	STORE Capital Corporation	STOR	Equity	Free Standing		3,401.7	10.53		0.38
5	Seritage Growth Properties Class A	SRG	Equity	Free Standing		2,297.6	7.11		0.25
6	Agree Realty Corporation	ADC	Equity	Free Standing	S&P 600	699.8	2.17	0.10	0.08
7	Getty Realty Corp.	GTY	Equity	Free Standing	S&P 600	607.4	1.88	0.09	0.07
7	**Subsector Totals**					**32,293.1**	**100.00**	**3.20**	**3.58**
4	**S&P Subsector Total**					**21,907.3**			
34	**Sector Totals**					**207,194.5**		**25.74**	**22.99**
24	**S&P Sector Total**					**175,956.2**			

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REITWatch
National Association of Real Estate Investment Trusts®

REITs in the FTSE NAREIT All REITs Index and S&P Equity Indexes

February 29, 2016

	Property Sector: Residential								
1	Equity Residential	EQR	Equity	Apartments	S&P 500	27,113.5	25.57	3.97	3.01
2	AvalonBay Communities, Inc.	AVB	Equity	Apartments	S&P 500	23,493.6	22.16	3.44	2.61
3	Essex Property Trust, Inc.	ESS	Equity	Apartments	S&P 500	13,729.2	12.95	2.01	1.52
4	UDR, Inc.	UDR	Equity	Apartments	S&P 500	8,994.6	8.48	1.32	1.00
5	Mid-America Apartment Communities, Inc.	MAA	Equity	Apartments	S&P 400	6,768.4	6.38	0.99	0.75
6	Camden Property Trust	CPT	Equity	Apartments	S&P 400	6,457.4	6.09	0.94	0.72
7	Apartment Investment and Management Company Class A	AIV	Equity	Apartments	S&P 500	5,721.3	5.40	0.84	0.63
8	American Campus Communities, Inc.	ACC	Equity	Apartments	S&P 400	5,702.8	5.38	0.83	0.63
9	Post Properties, Inc.	PPS	Equity	Apartments	S&P 400	3,020.3	2.85	0.44	0.34
10	Education Realty Trust, Inc.	EDR	Equity	Apartments	S&P 600	2,474.0	2.33	0.36	0.27
11	Monogram Residential Trust Inc	MORE	Equity	Apartments		1,533.3	1.45		0.17
12	Independence Realty Trust, Inc.	IRT	Equity	Apartments		301.5	0.28		0.03
13	Preferred Apartment Communities, Inc.	APTS	Equity	Apartments		269.8	0.25		0.03
14	NexPoint Residential Trust Inc	NXRT	Equity	Apartments		253.4	0.24		0.03
15	Bluerock Residential Growth REIT, Inc. Class A	BRG	Equity	Apartments		193.4	0.18		0.02
15	**Subsector Totals**					**106,026.6**	**100.00**	**15.14**	**11.77**
10	**S&P Subsector Total**					**103,475.2**			
1	Equity LifeStyle Properties, Inc.	ELS	Equity	Manufactured Homes		5,886.4	58.42		0.65
2	Sun Communities, Inc.	SUI	Equity	Manufactured Homes		3,936.1	39.06		0.44
3	UMH Properties, Inc.	UMH	Equity	Manufactured Homes		253.6	2.52		0.03
3	**Subsector Totals**					**10,076.2**	**100.00**	**0.00**	**1.12**
0	**S&P Subsector Total**					**0.0**			
1	American Homes 4 Rent Class A	AMH	Equity	Single Family Homes		2,924.4	47.25		0.32
2	Colony Starwood Homes	SFR	Equity	Single Family Homes		2,258.4	36.49		0.25
3	American Residential Properties, Inc.	ARPI	Equity	Single Family Homes		510.7	8.25		0.06
4	Silver Bay Realty Trust Corp.	SBY	Equity	Single Family Homes		496.0	8.01		0.06
4	**Subsector Totals**					**6,189.6**	**100.00**	**0.00**	**0.69**
0	**S&P Subsector Total**					**0.0**			
22	**Sector Totals**					**122,292.3**		**15.14**	**13.57**
10	**S&P Sector Total**					**103,475.2**			
	Property Sector: Diversified								
1	Vornado Realty Trust	VNO	Equity		S&P 500	16,259.2	38.06	2.38	1.80
2	VEREIT, Inc. Class A	VER	Equity			7,259.2	16.99		0.81
3	W. P. Carey Inc.	WPC	Equity			5,862.5	13.72		0.65
4	NorthStar Realty Finance Corp.	NRF	Equity			2,166.1	5.07		0.24
5	Alexander's, Inc.	ALX	Equity			1,955.2	4.58		0.22
6	Lexington Realty Trust	LXP	Equity		S&P 600	1,826.2	4.28	0.27	0.20
7	Washington Real Estate Investment Trust	WRE	Equity			1,762.8	4.13		0.20
8	American Assets Trust, Inc.	AAT	Equity		S&P 600	1,665.7	3.90	0.24	0.18
9	Global Net Lease Inc	GNL	Equity			1,306.9	3.06		0.15
10	Investors Real Estate Trust	IRET	Equity			770.7	1.80		0.09
11	Winthrop Realty Trust	FUR	Equity			479.0	1.12		0.05
12	One Liberty Properties, Inc.	OLP	Equity			354.6	0.83		0.04
13	Gladstone Commercial Corporation	GOOD	Equity			328.3	0.77		0.04
14	Armada Hoffler Properties, Inc.	AHH	Equity			314.9	0.74		0.03
15	Whitestone REIT	WSR	Equity			302.7	0.71		0.03
16	BRT Realty Trust	BRT	Equity			91.0	0.21		0.01
17	HMG/Courtland Properties, Inc.	HMG	Equity			10.0	0.02		0.00
17	**Sector Totals**					**42,715.0**	**100.00**	**2.89**	**4.74**
3	**S&P Sector Total**					**19,751.1**			
	Property Sector: Lodging/Resorts								
1	Host Hotels & Resorts, Inc.	HST	Equity		S&P 500	11,576.0	28.46	1.69	1.28
2	Hospitality Properties Trust	HPT	Equity		S&P 400	3,678.1	9.04	0.54	0.41
3	Apple Hospitality REIT Inc	APLE	Equity			3,334.7	8.20		0.37
4	LaSalle Hotel Properties	LHO	Equity		S&P 400	2,746.9	6.75	0.40	0.30
5	Sunstone Hotel Investors, Inc.	SHO	Equity			2,692.0	6.62		0.30
6	RLJ Lodging Trust	RLJ	Equity			2,636.5	6.48		0.29
7	Ryman Hospitality Properties, Inc.	RHP	Equity			2,453.5	6.03		0.27
8	Pebblebrook Hotel Trust	PEB	Equity			1,951.6	4.80		0.22
9	DiamondRock Hospitality Company	DRH	Equity		S&P 600	1,786.3	4.39	0.26	0.20
10	Xenia Hotels & Resorts, Inc.	XHR	Equity			1,710.8	4.21		0.19
11	Chesapeake Lodging Trust	CHSP	Equity		S&P 600	1,515.7	3.73	0.22	0.17
12	FelCor Lodging Trust Incorporated	FCH	Equity			1,060.2	2.61		0.12
13	Summit Hotel Properties, Inc.,	INN	Equity		S&P 600	936.1	2.30	0.14	0.10
14	Hersha Hospitality Trust Class A	HT	Equity			926.8	2.28		0.10
15	Chatham Lodging Trust	CLDT	Equity			767.4	1.89		0.09
16	Ashford Hospitality Trust, Inc.	AHT	Equity			528.0	1.30		0.06
17	Ashford Hospitality Prime, Inc.	AHP	Equity			279.9	0.69		0.03
18	Sotherly Hotels Inc.	SOHO	Equity			77.7	0.19		0.01
19	InnSuites Hospitality Trust	IHT	Equity			19.7	0.05		0.00
20	Condor Hospitality Trust, Inc.	CDOR	Equity			3.7	0.01		0.00
20	**Sector Totals**					**40,681.8**	**100.00**	**3.25**	**4.51**
6	**S&P Sector Total**					**22,239.1**			
	Property Sector: Self Storage								
1	Public Storage	PSA	Equity		S&P 500	43,072.0	68.80	6.30	4.78
2	Extra Space Storage Inc.	EXR	Equity		S&P 500	10,142.0	16.20	1.48	1.13
3	CubeSmart	CUBE	Equity			5,158.6	8.24		0.57
4	Sovran Self Storage, Inc.	SSS	Equity		S&P 400	3,814.3	6.09	0.56	0.42
5	National Storage Affiliates Trust	NSA	Equity			416.1	0.66		0.05
5	**Sector Totals**					**62,602.9**	**100.00**	**8.34**	**6.95**
3	**S&P Sector Total**					**57,028.3**			
	Property Sector: Health Care								
1	Welltower, Inc.	HCN	Equity		S&P 500	22,363.0	26.32	3.27	2.48
2	Ventas, Inc.	VTR	Equity		S&P 500	18,416.2	21.68	2.69	2.04
3	HCP, Inc.	HCP	Equity		S&P 500	13,755.9	16.19	2.01	1.53
4	Omega Healthcare Investors, Inc.	OHI	Equity		S&P 400	5,996.6	7.06	0.88	0.67
5	Senior Housing Properties Trust	SNH	Equity		S&P 400	3,705.8	4.36	0.54	0.41
6	Healthcare Trust of America, Inc. Class A	HTA	Equity			3,533.0	4.16		0.39
7	Healthcare Realty Trust Incorporated	HR	Equity		S&P 400	2,912.4	3.43	0.43	0.32
8	Medical Properties Trust, Inc.	MPW	Equity		S&P 600	2,751.8	3.24	0.40	0.31
9	National Health Investors, Inc.	NHI	Equity			2,363.2	2.78		0.26
10	Care Capital Properties, Inc.	CCP	Equity		S&P 400	2,218.2	2.61	0.32	0.25
11	Physicians Realty Trust	DOC	Equity			1,865.7	2.20		0.21
12	LTC Properties, Inc.	LTC	Equity		S&P 600	1,579.4	1.86	0.23	0.18
13	Sabra Health Care REIT, Inc.	SBRA	Equity		S&P 600	1,297.1	1.53	0.19	0.14
14	New Senior Investment Group Inc	SNR	Equity			838.5	0.99		0.09
15	Universal Health Realty Income Trust	UHT	Equity		S&P 600	689.6	0.81	0.10	0.08
16	CareTrust REIT Inc	CTRE	Equity		S&P 600	548.4	0.65	0.08	0.06
17	Community Healthcare Trust, Inc.	CHCT	Equity			118.0	0.14		0.01
17	**Sector Totals**					**84,952.9**	**100.00**	**11.15**	**9.43**
12	**S&P Sector Total**					**76,234.5**			

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February 29, 2016

	Property Sector: Timber								
1	Weyerhaeuser Company	WY	Equity		S&P 500	20,528.0	83.05	3.00	2.28
2	Rayonier Inc.	RYN	Equity		S&P 400	2,701.5	10.93	0.40	0.30
3	Potlatch Corporation	PCH	Equity		S&P 400	1,073.2	4.34	0.16	0.12
4	CatchMark Timber Trust, Inc. Class A	CTT	Equity			415.1	1.68		0.05
4	**Sector Totals**					**24,717.8**	**100.00**	**3.55**	**2.74**
3	**S&P Sector Total**					**24,302.7**			
	Property Sector: Infrastructure								
1	American Tower Corporation	AMT	Equity		S&P 500	38,959.9	54.28	5.70	4.32
2	Crown Castle International Corp	CCI	Equity		S&P 500	28,897.2	40.26	4.23	3.21
3	Communications Sales & Leasing Inc	CSAL	Equity		S&P 400	2,838.0	3.95	0.42	0.31
4	InfraREIT, Inc.	HIFR	Equity			920.1	1.28		0.10
5	CorEnergy Infrastructure Trust, Inc.	CORR	Equity			157.5	0.22		0.02
6	Power REIT	PW	Equity			6.9	0.01		0.00
6	**Sector Totals**					**71,779.7**	**100.00**	**10.34**	**7.97**
3	**S&P Sector Total**					**70,695.2**			
	Property Sector: Data Centers								
1	Equinix, Inc.	EQIX	Equity		S&P 500	20,770.1	51.63	3.04	2.30
2	Digital Realty Trust, Inc.	DLR	Equity			10,701.7	26.60		1.19
3	CyrusOne, Inc.	CONE	Equity			2,626.0	6.53		0.29
4	DuPont Fabros Technology, Inc.	DFT	Equity			2,340.6	5.82		0.26
5	CoreSite Realty Corporation	COR	Equity		S&P 600	1,975.3	4.91	0.29	0.22
6	QTS Realty Trust, Inc. Class A	QTS	Equity			1,813.9	4.51		0.20
6	**Sector Totals**					**40,227.7**	**100.00**	**3.33**	**4.46**
2	**S&P Sector Total**					**22,745.4**			
	Property Sector: Specialty								
1	Iron Mountain, Inc.	IRM	Equity		S&P 500	6,153.8	23.50	0.90	0.68
2	Lamar Advertising Company Class A	LAMR	Equity		S&P 400	4,668.1	17.83	0.68	0.52
3	EPR Properties	EPR	Equity		S&P 400	3,718.5	14.20	0.54	0.41
4	Corrections Corporation of America	CXW	Equity		S&P 400	3,385.5	12.93	0.50	0.38
5	Gaming and Leisure Properties, Inc. WI	GLPI	Equity			2,999.2	11.46		0.33
6	OUTFRONT Media Inc.	OUT	Equity			2,791.8	10.66		0.31
7	GEO Group Inc	GEO	Equity		S&P 600	2,153.2	8.22	0.31	0.24
8	Farmland Partners, Inc.	FPI	Equity			127.4	0.49		0.01
9	American Farmland Company	AFCO	Equity			99.0	0.38		0.01
10	Gladstone Land Corp.	LAND	Equity			84.9	0.32		0.01
10	**Sector Totals**					**26,181.4**	**100.00**	**2.94**	**2.91**
5	**S&P Sector Total**					**20,079.1**			
	Investment Sector: Mortgage								
1	Annaly Capital Management, Inc.	NLY	Mortgage	Home Financing		9,595.6	24.95		1.06
2	American Capital Agency Corp.	AGNC	Mortgage	Home Financing		6,302.9	16.39		0.70
3	Two Harbors Investment Corp.	TWO	Mortgage	Home Financing		2,830.7	7.36		0.31
4	New Residential Investment Corp.	NRZ	Mortgage	Home Financing		2,698.2	7.02		0.30
5	MFA Financial, Inc.	MFA	Mortgage	Home Financing		2,522.2	6.56		0.28
6	Chimera Investment Corporation	CIM	Mortgage	Home Financing		2,462.9	6.40		0.27
7	Invesco Mortgage Capital Inc.	IVR	Mortgage	Home Financing		1,351.0	3.51		0.15
8	Hatteras Financial Corp.	HTS	Mortgage	Home Financing		1,328.5	3.45		0.15
9	CYS Investments, Inc.	CYS	Mortgage	Home Financing		1,213.7	3.16		0.13
10	Redwood Trust, Inc.	RWT	Mortgage	Home Financing		976.5	2.54		0.11
11	PennyMac Mortgage Investment Trust	PMT	Mortgage	Home Financing		970.8	2.52		0.11
12	Capstead Mortgage Corporation	CMO	Mortgage	Home Financing	S&P 600	927.6	2.41	0.14	0.10
13	ARMOUR Residential REIT, Inc.	ARR	Mortgage	Home Financing		766.9	1.99		0.09
14	American Capital Mortgage Investment Corp.	MTGE	Mortgage	Home Financing		691.1	1.80		0.08
15	Altisource Residential Corp. Class B	RESI	Mortgage	Home Financing		525.2	1.37		0.06
16	Anworth Mortgage Asset Corporation	ANH	Mortgage	Home Financing		470.5	1.22		0.05
17	New York Mortgage Trust, Inc.	NYMT	Mortgage	Home Financing		457.2	1.19		0.05
18	Western Asset Mortgage Capital Corporation	WMC	Mortgage	Home Financing		451.0	1.17		0.05
19	Apollo Residential Mortgage, Inc.	AMTG	Mortgage	Home Financing		413.3	1.07		0.05
20	AG Mortgage Investment Trust, Inc.	MITT	Mortgage	Home Financing		349.9	0.91		0.04
21	Dynex Capital, Inc.	DX	Mortgage	Home Financing		312.2	0.81		0.03
22	Orchid Island Capital, Inc.	ORC	Mortgage	Home Financing		209.4	0.54		0.02
23	Great Ajax Corp.	AJX	Mortgage	Home Financing		157.8	0.41		0.02
24	ZAIS Financial Corp.	ZFC	Mortgage	Home Financing		112.0	0.29		0.01
25	Ellington Residential Mortgage REIT	EARN	Mortgage	Home Financing		110.3	0.29		0.01
26	Cherry Hill Mortgage Investment Corp.	CHMI	Mortgage	Home Financing		106.7	0.28		0.01
27	JAVELIN Mortgage Investment Corp.	JMI	Mortgage	Home Financing		71.8	0.19		0.01
28	Five Oaks Investment Corp.	OAKS	Mortgage	Home Financing		70.9	0.18		0.01
28	**Subsector Totals**					**38,456.6**	**100.00**	**0.14**	**4.27**
1	**S&P Subsector Total**					**927.6**			
1	Starwood Property Trust, Inc.	STWD	Mortgage	Commercial Financing		4,145.2	32.14		0.46
2	Blackstone Mortgage Trust, Inc. Class A	BXMT	Mortgage	Commercial Financing		2,306.5	17.89		0.26
3	Colony Capital, Inc. Class A	CLNY	Mortgage	Commercial Financing		1,831.9	14.21		0.20
4	Apollo Commercial Real Estate Finance, Inc.	ARI	Mortgage	Commercial Financing		902.7	7.00		0.10
5	iStar Inc.	STAR	Mortgage	Commercial Financing		722.3	5.60		0.08
6	Hannon Armstrong Sustainable Infrastructure Capital, Inc.	HASI	Mortgage	Commercial Financing		673.9	5.23		0.07
7	Ladder Capital Corp. Class A	LADR	Mortgage	Commercial Financing		630.2	4.89		0.07
8	Resource Capital Corp.	RSO	Mortgage	Commercial Financing		351.7	2.73		0.04
9	Arbor Realty Trust, Inc.	ABR	Mortgage	Commercial Financing		346.5	2.69		0.04
10	Ares Commercial Real Estate Corporation	ACRE	Mortgage	Commercial Financing		277.6	2.15		0.03
11	RAIT Financial Trust	RAS	Mortgage	Commercial Financing		238.1	1.85		0.03
12	Newcastle Investment Corp.	NCT	Mortgage	Commercial Financing		233.7	1.81		0.03
13	Owens Realty Mortgage, Inc.	ORM	Mortgage	Commercial Financing		156.6	1.21		0.02
14	Jernigan Capital, Inc.	JCAP	Mortgage	Commercial Financing		78.6	0.61		0.01
14	**Subsector Totals**					**12,895.9**	**100.00**	**0.00**	**1.43**
0	**S&P Subsector Total**					**0.0**			
42	**Sector Totals**					**51,352.5**		**0.14**	**5.70**
1	**S&P Sector Total**					**927.6**			
26	**S&P 500 Large Cap**					**508,052.8**		**74.31**	**56.38**
33	**S&P 400 Mid Cap**					**131,727.4**		**19.27**	**14.62**
30	**S&P 600 Small Cap**					**43,874.6**		**6.42**	**4.87**
82	**S&P Index Total**					**683,654.8**		**100.00**	**75.87**
221	**Industry Total**					**901,116.9**			**100.00**

[1] Equity market capitalization does not include operating partnership units or preferred stock.

US REIT Merger and Acquisition Activity

Deal Value in Millions of Dollars

(2004 - 2016)

Year	Acquiror	Target	Acquiror Type	Deal Value		Announced	Completed	Status
2004	Ventas, Inc.	ElderTrust	Public REIT	191		19-Nov-03	5-Feb-04	Completed
	Aslan Realty Partners, LLC	Great Lakes REIT	Private Real Estate Company	252		21-Jan-04	27-Apr-04	Completed
	ProLogis/Eaton Vance Corporation	Keystone Property Trust	Public REIT/Investment Advisor	729		3-May-04	4-Aug-04	Completed
	Simon Property Group	Chelsea Property Group	Public REIT	3,000		21-Jun-04	14-Oct-04	Completed
	General Growth Properties, Inc.	The Rouse Company	Public REIT	7,000		19-Aug-04	12-Nov-04	Completed
	PL Retail LLC (Kimco Realty & DRA Advisors)	Price Legacy Corporation	Public REIT/Investment Advisor	3,500		24-Aug-04	21-Dec-04	Completed
	Total Public to Public			14,420	98%			
	Total Public to Private			252	2%			
	Total			**14,672**				
2005	Camden Property Trust	Summit Property Group	Public REIT	1,100		24-Oct-04	28-Feb-05	Completed
	iStar Financial, Inc.	Falcon Financial Investment Trust	Public REIT	120		20-Jan-05	2-Mar-05	Completed
	Colonial Properties Trust	Cornerstone Realty Income Trust	Public REIT	566		25-Oct-04	1-Apr-05	Completed
	Centro Properties Limited	Kramont Realty Trust	Australian LPT	120				Completed
	The Lightstone Group	Prime Group Realty Trust	Private Real Estate Company	1,500		17-Feb-05	1-Jul-05	Completed
	ProLogis	Catellus Development Corporation	Public REIT	3,819		6-Jun-05	15-Sep-05	Completed
	DRA Advisors LLC	CRT Properties, Inc.	Investment Advisor	890		17-Jun-05		Completed
	ING Clarion	Gables Residential Trust	Private Equity Joint Venture	4,900		7-Jun-05	30-Sep-05	Completed
	DRA Advisors LLC	Capital Automotive REIT	Investment Advisor	1,800		2-Sep-05	16-Dec-05	Completed
	Total Public to Public			5,725	39%			
	Total Public to Private			9,090	61%			
	Total			**14,815**				
2006	Brandywine Realty Trust	Prentiss Properties Trust	Public REIT	1,921		3-Oct-05	4-Jan-06	Completed
	CDP Capital-Financing Inc.	Criimi Mae Inc.	Investment Advisor/Pension Fund	1,700			19-Jan-06	Completed
	Morgan Stanley Property Fund	AMLI Residential Properties	Investment Advior/Brokerage Firm	2,100		23-Oct-05	7-Feb-06	Completed
	Duke Realty Corporation	The Mark Winkler Company	Public REIT	855		2-Mar-06	4-Mar-06	Completed
	CalEast Industrial Investors	CenterPoint Properties Trust	Real Estate Operating Partnership	2,436		7-Dec-05	8-Mar-06	Completed
	Morgan Stanley Real Estate and Onex Real Estate	Town and Country Trust	Private Real Estate Joint Venture	1,500		19-Dec-05	31-Mar-06	Completed
	Kimco Realty Corporation	Atlantic Realty Trust	Public REIT	83		1-Dec-05	31-Mar-06	Completed
	Host Marriott Corporation	Starwood Hotels and Resorts	Public REIT	4,040		14-Nov-05	7-Apr-06	Completed
	GE Real Estate, Inc. & Trizec Properties	Arden Realty Trust	Public non-REIT and REIT	3,032		21-Dec-05	2-May-06	Completed
	Blackstone Group LP	MeriStar Hospitality Corporation	Private Equity Firm	2,600		20-Feb-06	2-May-06	Completed
	LBA Realty LLC	Bedford Property Investors	Private Real Estate Company	432		10-Feb-06	5-May-06	Completed
	Spirit Finance Corporation	Sun Capital Partners, Inc. (ShopKo Stores)	Public REIT	815		10-May-06	2-Jun-06	Completed
	Mack-Cali Realty Corporation	Gale Real Estate Services Corp.	Public REIT	545		16-Feb-06	5-Jun-06	Completed
	Blackstone Group LP	CarrAmerica Realty Corp.	Private Equity Firm	5,600		6-Mar-06	13-Jul-06	Completed
	Archstone-Smith	Deutsche WohnAnlage GmbH	Public REIT	649		29-Jun-06	31-Jul-06	Completed
	Public Storage Inc.	Shurgard Storage Centers Inc.	Public REIT	3,200		7-Mar-06	23-Aug-06	Completed
	Westmont Hospitality and Cadim Inc. (Braveheart Holdings	Boykin Lodging Company	JV- Public Pension Fund	417		22-May-06	21-Sep-06	Completed
	Accredited Home Lenders Holding Co.	Aames Investment Corporation	Mortgage Banking Firm	340		14-Sep-06	1-Oct-06	Completed
	Brookfield Properties Corporation	Trizec Canada, Inc.	Real Estate Operating Company	2,670		5-Jun-06	5-Oct-06	Completed
	Blackstone Group LP and Brookfield Properties Co.	Trizec Properties, Inc.	JV- Private Equity Firm & REOC	6,500		5-Jun-06	5-Oct-06	Completed
	Health Care Property Investors	CNL Retirement Properties	Public REIT	5,300		2-May-06	6-Oct-06	Completed
	Centro Watt	Heritage Property Investment Trust Inc.	JV - Australian LPT & Private Equity Firm	3,200		9-Jul-06	19-Oct-06	Completed
	Kimco Realty Corporation	Pan Pacific Retail Properties	Public REIT	4,000		10-Jul-06	31-Oct-06	Completed
	Morguard Corporation	Sizeler Property Investors, Inc.	Canadian REIT	324		7-Aug-06	10-Nov-06	Completed
	Morgan Stanley	Glenborough Realty Trust, Inc.	Brokerage Firm	1,900		21-Aug-06	29-Nov-06	Completed
	Health Care REIT	Windrose Medical Properties Trust	Public REIT	877		13-Sep-06	20-Dec-06	Completed
	Koll/PER LLC	AmeriVest Properties	Real Estate Operating Partnership	273		18-Jul-06	29-Dec-06	Completed
	Lexington Corporate Properties	Newkirk Realty Trust, Inc.	Public REIT	1,080		25-Jul-06	3-Jan-07	Completed
	SL Green Realty Corp.	Reckson Associates Realty Corp.	Public REIT	6,000		3-Aug-06	25-Jan-07	Completed
	Morgan Stanley	Saxon Capital	Brokerage Firm	706		8-Aug-06	4-Dec-06	Completed
	Babcock & Brown Real Estate Investments	BNP Residential Properties Inc.	Investment Advisor/Brokerage Firm	766		31-Aug-06	28-Feb-07	Completed
	Hospitality Properties Trust	TravelCenters of America Inc.	Public REIT	1,900		1-Sep-06	31-Jan-07	Completed
	Geo Group	CentraCore Properties Trust	Correctional Facility Operator	428		19-Sep-06	24-Jan-07	Completed
	Crown Castle International Corporation	Global Signal Inc.	Public Tower Company	4,000		16-Oct-06	12-Jan-07	Completed
	Developers Diversified Realty Corp.	Inland Retail Real Estate Trust, Inc.	Public REIT	6,200		23-Oct-06	27-Feb-07	Completed
	Record Realty Trust	Government Properties Trust, Inc.	Australian LPT	223		24-Oct-06	13-Apr-07	Completed
	GE Capital Solutions	Trustreet Properties, Inc.	Financial Lending Company	3,000		30-Oct-06	27-Feb-07	Completed
	JP Morgan-Special Situation Property Fund	Columbia Equity Trust	Pension Trust Fund	502		6-Nov-06	1-Mar-07	Completed
	National HealthCare Corporation	National Health Realty	Health Care Provider (Public Company)	268		21-Dec-06	31-Oct-07	Completed
	Total Public to Public			47,182	57%			
	Total Public to Private			35,200	43%			
	Total			**82,381**				

US REIT Merger and Acquisition Activity
Deal Value in Millions of Dollars
(2004 - 2016)

Year	Acquiror	Target	Acquiror Type	Deal Value		Announced	Completed	Status
2007	Ventas, Inc.	Sunrise Senior Living REIT	Public REIT	1,036		14-Jan-07	26-Apr-07	Completed
	Simon Propery Group; Farallon Capital Management	Mills Corporation	Public REIT; Investment Advisor	1,350		17-Jan-07	3-Apr-07	Completed
	Morgan Stanley	CNL Hotels & Resorts Inc.	Brokerage Firm	6,702		19-Jan-07	12-Apr-07	Completed
	Brookfield Asset Management Inc.	Longview Fibre	Asset Management Firm	2,150		5-Feb-07	20-Apr-07	Completed
	Blackstone Group	Equity Office Properties Trust	Private Equity Firm	39,000		7-Feb-07	9-Feb-07	Completed
	Credit-Based Asset Servicing and Securitization LLC (C-BA	Fieldstone Investment Corporation	Mortgage Banking Firm	259		16-Feb-07	17-Jul-07	Completed
	Centro Properties Group	New Plan Excel Realty Trust, Inc.	Australian LPT	6,200		27-Feb-07	20-Apr-07	Completed
	Macquarie Bank Limited, Kaupthing Bank hf, et al.	Spirit Finance Corporation	Investment Advisor/Brokerage Firm	3,500		13-Mar-07	1-Aug-07	Completed
	Inland American Real Estate Trust Inc.	Winston Hotels, Inc.	Asset Management Firm	460		3-Apr-07	2-Jul-07	Completed
	Apollo Investment Corporation	Innkeepers USA Trust	Closed-End Investment Company	1,500		16-Apr-07	29-Jun-07	Completed
	JER Partners	Highland Hospitality	Private Equity Firm	2,000		24-Apr-07	28-Jul-07	Completed
	AP AIMCAP Holdings LLC	Eagle Hospitality Properties Trust, Inc.	Closed-End Investment Company	319		27-Apr-07	15-Aug-07	Completed
	Morgan Stanley	Crescent Real Estate Equity	Brokerage Firm	6,500		23-May-07	3-Aug-07	Completed
	Tishman Speyer/ Lehman Brothers	Archstone-Smith	Real Estate Company/ Brokerage Firm	22,200		29-May-07	5-Oct-07	Completed
	Whitehall Street Global Real Estate, LP	Equity Inns, Inc.	Investment Advisor/Brokerage Firm	2,200		21-Jun-07	25-Oct-07	Completed
	Sentinel Omaha LLC	America First Apartment Investors	Real Estate Advisory Firm	532		25-Jun-07	18-Sep-07	Completed
	Liberty Property Trust	Republic Property Trust	Public REIT	850		24-Jul-07	4-Oct-07	Completed
	Gramercy Capital Corp/New York	American Financial Realty Trust	Public REIT	1,094		5-Nov-07	1-Apr-08	Completed
	Total Public to Public			10,530	11%			
	Total Public to Private			87,321	89%			
	Total			**97,851**				
2008	American Campus Communities	GMH Communities Trust	Public REIT	1,400		12-Feb-08	11-Jun-08	Completed
	Hypo Real Estate Bank AG	Quadra Realty Trust	Brokerage Firm	179		29-Jan-08	14-Mar-08	Completed
	Boston Properties	Macklowe Properties (NYC Office Portfolio)	Public REIT	3,950		24-May-08	10-Jun-08	Completed
	American Land Lease	Green Courte Real Estate Partners	Private Equity Firm	113		10-Dec-08	16-Mar-09	Completed
	Total Public to Public			5,350	95%			
	Total Public to Private			292	5%			
	Total			**5,642**				
2009			*No Deals*					
2010	Brookfield Asset Management Inc.	Crystal River Capital, Inc.	Asset Management Firm	14		24-Feb-10	30-Jul-10	Completed
	Tiptree Financial Partners, LP	Care Investment Trust, Inc.	Real Estate Advisory Firm	97		16-Mar-10	13-Aug-10	Completed
	HCP, Inc.	HCR ManorCare, Inc.	Public REIT	6,080		14-Dec-10	8-Apr-11	Completed
	Total Public to Public			6,080	98%			
	Total Public to Private			111	2%			
	Total			**6,191**				
2011	AMB Property Corp.	ProLogis	Public REIT	16,517		31-Jan-11	3-Jun-11	Completed
	Ventas, Inc.	Nationwide Health Properties, Inc.	Public REIT	7,010		28-Feb-11	1-Jul-11	Completed
	Ventas, Inc.	Cogdell Spencer, Inc.	Public REIT	635		27-Dec-11	2-Apr-12	Completed
	Total Public to Public			24,162	100%			
	Total Public to Private				0%			
	Total			**24,162**				
2012	Realty Income Corp.	American Realty Capital Trust, Inc.	Public REIT	2,887		6-Sep-12	22-Jan-13	Completed
	HCP, Inc.	Emeritus; Blackstone JV (Portfolio Acquisition)	Public REIT	1,730		16-Oct-12	31-Oct-12	Completed
	AvalonBay Communities, Inc. / Equity Residential	Archstone-Smith Trust, Inc.	Public REIT	6,476		26-Nov-12	27-Feb-13	Completed
	American Realty Capital Properties, Inc.	American Realty Capital Trust III, Inc.	Public REIT	2,325		14-Dec-12	28-Feb-13	Completed
	Total Public to Public			13,418	100%			
	Total Public to Private			0	0%			
	Total			**13,418**				
2013	Cole Credit Property Trust II, Inc.	Spirit Realty Capital, Inc.	Non-traded REIT	2,835		22-Jan-13	17-Jul-13	Completed
	Annaly Capital Management, Inc.	CreXus Investment Corp.	Public REIT	876		30-Jan-13	23-May-13	Completed
	Brookfield Office Properties Inc.	MPG Office Trust, Inc.	Real Estate Operating Company	1,938		24-Apr-13	15-Oct-13	Completed
	American Realty Capital Properties, Inc.	CapLease, Inc.	Public REIT	2,048		28-May-13	5-Nov-13	Completed
	Mid-America Apartment Communities, Inc.	Colonial Properties Trust	Public REIT	4,112		3-Jun-13	1-Oct-13	Completed
	American Realty Capital Properties, Inc.	American Realty Capital Trust IV, Inc.	Public REIT	2,207		1-Jul-13	3-Jan-14	Completed
	W. P. Carey Inc.	Corporate Property Associates 16	Public REIT	4,041		25-Jul-13	31-Jan-14	Completed
	American Realty Capital Properties, Inc.	Cole Real Estate Investments, Inc.	Public REIT	10,281		23-Oct-13	7-Feb-14	Completed
	Essex Property Trust, Inc.	BRE Properties, Inc.	Public REIT	6,141		9-Dec-13	1-Apr-14	Completed
	Total Public to Public			29,706	86%			
	Total Public to Private			4,773	14%			
	Total			**34,479**				
2014	Ventas, Inc.	American Realty Capital Healthcare Trust, Inc.	Public REIT	2,297		2-Jun-14	16-Jan-15	Completed
	EDENS, Inc.	AmREIT, Inc.	Private Real Estate Company	620		31-Oct-14	18-Feb-15	Completed
	NorthStar Realty Finance Corp.	Griffin-American Healthcare REIT II, Inc.	Public REIT	3,881		5-Aug-14	3-Dec-14	Completed
	Select Income REIT	Cole Corporate Income Trust, Inc.	Public REIT	2,987		2-Sep-14	29-Jan-15	Completed
	GoldenTree Asset Management LP	Origen Financial, Inc.	Asset Manager	456		9-Sep-14	20-Jan-15	Completed
	Washington Prime Group Inc.	Glimcher Realty Trust	Public REIT	4,323		16-Sep-14	15-Jan-15	Completed
	Omega Healthcare Investors, Inc.	Aviv REIT, Inc.	Public REIT	2,822		31-Oct-14	1-Apr-15	Completed
	Griffin Capital Essential Asset REIT, Inc.	Signature Office REIT Inc.	Public REIT	-		24-Nov-14	10-Jun-15	Completed
	Total Public to Public			16,309	94%			
	Total Public to Private			1,076	6%			
	Total			**17,385**				
2015	The Blackstone Group LP	Excel Trust, Inc.	Asset Manager	1,021		10-Apr-15	31-Jul-15	Completed
	Brookfield Asset Management Inc.	Associated Estates Realty Corporation	Asset Manager	1,690		22-Apr-15	7-Aug-15	Completed
	Independence Realty Trust, Inc	Trade Street Residential, Inc.	Public REIT	287		11-May-15	17-Sep-15	Completed
	Extra Space Storage Inc.	SmartStop Self Storage, Inc.	Public REIT	855		15-Jun-15	1-Oct-15	Completed
	Lone Star Investment Advisors, LLC	Home Properties, Inc.	Asset Manager	5,156		22-Jun-15	7-Oct-15	Completed
	Chambers Street Properties	Gramercy Property Trust Inc.	Public REIT	1,489		1-Jul-15	17-Dec-15	Completed
	Global Logistic Properties Limited	Industrial Income Trust Inc.	Public REIT	4,555		29-Jul-15	4-Nov-15	Completed
	The Blackstone Group LP	Strategic Hotels & Resorts, Inc.	Asset Manager	5,648		8-Sep-15	11-Dec-15	Completed
	The Blackstone Group LP	BioMed Realty Trust	Asset Manager	7,866		8-Oct-15	27-Jan-16	Completed
	Harrison Street Real Estate Capital	Campus Crest Communities, Inc.	Private Equity Firm	1,900		16-Oct-15	2-Mar-16	Completed
	Starwood Capital Group / Milestone Apartments REIT	Landmark Apartment Trust, Inc.	Investor Group	1,900		22-Oct-15	27-Jan-16	Completed
	Weyerhaeuser Company	Plum Creek Timber Company, Inc.	Public REIT	8,462		8-Nov-15	19-Feb-16	Completed
	American Homes 4 Rent	American Residential Properties, Inc.	Public REIT	1,415		3-Dec-15	29-Feb-16	Completed
	Colony American Homes, Inc.	Starwood Waypoint Residential Trust	Public Real Estate Company	1,592		21-Sep-15	5-Jan-16	Completed
	Total Public to Public			15,648	36%			
	Total Public to Private			28,188	64%			
	Total			**43,836**				

Industry Totals: 2004-2016

Total Public to Public	188,529	64%
Total Public to Private	166,304	57%
Total	**293,612**	

NAREIT®

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National Association of Real Estate Investment Trusts®

		Share Price ($)			FFO per Share Estimates ($)		Price/FFO Estimates		FFO Growth (%)	FFO Payout (%)	Debt/ EBITDA	Total Return (%)						Dividend	Equity Market	Implied Market	Debt	Average Share	Average Dollar	Relative	Long-Term
			52 Week																						
Name	Ticker	29-Feb-2016	High	Low	2016	2017	2016	2017	2016 - 2017	2015: Q3	2015: Q3	Feb-16	QTD	YTD	1-Yr	3-Yr	5-Yr	Yield (%)	Cap ($M)	Cap ($M)	Ratio (%)	Volume	Volume	Liquidity	Issuer Rating
Office																									
Alexandria Real Estate Equity	ARE	79.16	102.42	71.65	5.52	5.93	14.34	13.36	7.41	56.49	7.85	-0.03	-12.39	-12.39	-14.65	7.50	3.11	3.89	5,723.9	5,723.9	39.3	469	35,454	0.619	BBB-
Boston Property	BXP	114.14	144.74	108.18	5.84	6.33	19.56	18.04	8.43	47.79	6.67	-1.78	-10.51	-10.51	-14.40	7.86	7.24	2.28	17,509.9	19,568.1	31.2	970	109,500	0.625	A-
Brandywine Rlty	BDN	12.31	16.44	11.29	1.28	1.38	9.59	8.91	7.70	46.88	7.32	-4.05	-8.88	-8.88	-18.85	0.56	4.91	4.87	2,156.7	2,175.6	51.7	2,081	25,349	1.175	BBB-
City Office REIT	CIO	12.10	13.44	10.35	1.35	1.47	8.96	8.23	8.89	167.86	11.47	2.98	1.28	1.28	3.98	-	-	7.77	150.2	185.4	66.5	22	260	0.173	
Columbia Property Trust Inc	CXP	20.27	27.67	19.81	1.59	1.63	12.74	12.41	2.60	56.60	6.33	-7.66	-12.42	-12.42	-17.58	-	-	5.92	2,530.3	2,530.3	38.9	802	16,741	0.662	BBB
Corporate Office Properties	OFC	23.40	30.75	20.04	2.01	2.09	11.65	11.17	4.27	57.29	7.07	4.93	7.19	7.19	-16.65	1.01	-3.66	4.70	2,212.2	2,298.3	50.1	947	21,135	0.955	BBB-
Cousins Property	CUZ	8.66	10.88	7.99	0.89	0.96	9.68	9.05	6.98	38.10	4.19	1.42	-7.29	-7.29	-16.48	-1.17	3.02	3.70	1,875.0	1,875.0	26.5	2,235	18,902	1.008	
Douglas Emmett	DEI	26.84	31.79	24.95	1.73	1.82	15.50	14.73	5.22	52.50	8.62	-9.26	-13.92	-13.92	-4.27	6.18	10.56	3.28	3,915.0	4,623.5	42.2	1,310	35,109	0.897	
Easterly Government Properties	DEA	17.10	18.27	15.29	1.15	1.18	14.84	14.52	2.22	42.31	2.23	-4.04	-0.47	-0.47	9.76	-	-	3.16	413.3	678.9	27.3	75	1,284	0.311	
Empire State Realty Trust	ESRT	15.68	18.96	14.67	1.00	1.09	15.70	14.45	8.66	34.00	4.81	-5.26	-13.23	-13.23	-9.67	-	-	2.17	1,841.5	4,220.8	26.5	939	14,611	0.793	
Equity Commonwealth	EQC	26.63	29.67	25.21	1.02	1.04	26.12	25.61	1.98	0.00	5.38	-0.97	-3.97	-3.97	0.68	3.26	2.96	3.76	3,364.7	3,364.7	32.8	991	26,351	0.783	BBB-
First Potomac Realty Trust	FPO	8.46	12.34	8.08	1.01	0.93	8.37	9.06	-7.61	60.00	7.70	-12.15	-24.55	-24.55	-25.07	-11.43	-7.34	7.09	489.2	511.4	52.0	421	3,631	0.742	
Franklin Street Properties	FSP	9.51	13.06	8.81	1.04	1.07	9.13	8.93	2.24	-	6.62	-2.56	-6.25	-6.25	-19.44	-5.94	-2.80	7.99	952.8	952.8	45.8	357	3,295	0.346	
Government Properties Income Trust	GOV	14.84	23.29	12.87	2.33	2.32	6.37	6.40	-0.34	-	-	8.08	-3.37	-3.37	-29.31	-10.44	-4.28	11.59	1,054.9	1,054.9	50.3	1,032	14,227	1.349	BBB-
Gramercy Property Trust	GPT	7.55	8.21	6.47	0.71	0.76	10.71	9.96	7.57	79.69	6.78	3.28	-2.20	-2.20	-2.39	-	-	3.27	3,165.6	3,165.6	59.6	2,615	18,861	0.596	BBB-
Highwoods Prop	HIW	43.55	46.98	36.82	3.24	3.47	13.45	12.57	7.00	55.19	5.26	4.04	0.91	0.91	-0.58	10.61	10.07	3.90	4,151.5	4,278.2	40.0	1,026	43,995	1.060	BBB
Hudson Pacific Properties	HPP	25.50	33.95	22.97	1.71	1.94	14.90	13.13	13.48	59.52	7.04	0.35	-9.38	-9.38	-18.65	6.33	13.96	3.14	2,282.0	3,717.6	35.0	819	19,972	0.875	BBB-
Kilroy Realty	KRC	54.27	78.86	47.38	3.40	3.66	15.96	14.84	7.57	42.68	4.79	-2.86	-14.24	-14.24	-25.11	3.34	9.98	2.58	5,004.1	5,101.4	26.8	1,135	59,390	1.187	BBB
Mack Cali Realty	CLI	19.90	24.12	16.90	2.04	2.08	9.76	9.58	1.88	32.61	4.77	-4.28	-14.21	-14.21	9.05	-7.44	-5.51	3.02	1,770.8	1,990.0	53.3	1,203	22,657	1.279	BB+
NEW YORK REIT INC	NYRT	9.60	11.76	8.90	0.39	0.43	24.62	22.33	10.26	95.83	10.50	-6.25	-15.91	-15.91	-3.40	-	-	4.79	1,569.0	1,694.3	33.0	1,063	10,110	0.644	
NorthStar Realty Europe	NRE	9.76	13.90	8.42	-	-	-	-	-	-	-	3.39	-17.36	-17.36	-	-	-	1.54	593.5	593.5	-	461	4,243	0.715	
Paramount Group	PGRE	15.12	19.58	14.38	0.85	0.99	17.77	15.34	15.91	0.00	5.79	-7.80	-16.46	-16.46	-15.63	-	-	2.51	3,203.9	3,985.0	40.7	1,113	16,854	0.526	
Parkway Properties	PKY	13.39	18.53	11.97	1.28	1.37	10.46	9.79	6.76	56.82	4.66	-0.59	-14.33	-14.33	-20.36	-3.65	-0.27	5.60	1,487.9	1,552.6	49.8	643	8,272	0.556	BBB-
Piedmont Office Realty Trust Cl A	PDM	18.37	19.82	16.74	1.62	1.70	11.34	10.78	5.20	53.85	5.86	0.41	-1.56	-1.56	5.02	2.63	3.56	4.57	2,673.0	2,673.0	42.8	1,215	21,812	0.816	BBB
Select Income REIT	SIR	20.62	25.57	17.82	2.95	3.03	7.00	6.80	2.88	49.91	6.81	9.10	6.96	6.96	-7.62	-1.88	-	9.70	1,842.0	1,842.0	58.3	510	9,964	0.541	BBB-
SL Green Realty	SLG	88.18	134.00	80.54	6.92	7.27	12.75	12.12	5.14	37.04	8.16	-8.73	-21.95	-21.95	-28.99	4.61	4.75	3.27	8,781.2	9,125.7	48.3	1,543	133,719	1.523	BB+
TIER REIT	TIER	13.00	18.30	12.78	-	-	-	-	-	-	6.91	-15.42	-11.86	-11.86	-14.30	-	-	4.15	616.6	617.6	60.7	193	2,707	0.439	
AVERAGE		**26.96**	**35.09**	**24.49**	**2.11**	**2.24**	**13.25**	**12.48**	**5.69**	**53.17**	**6.54**	**-2.06**	**-8.90**	**-8.90**	**-11.34**	**0.66**	**2.96**	**4.60**	**3,012.2**	**3,337.0**	**43.4**	**970**	**25,867**	**0.785**	
Industrial																									
DCT Industrial Trust	DCT	36.19	38.60	31.31	2.12	2.24	17.03	16.12	5.65	59.57	4.91	1.12	-3.16	-3.16	3.67	11.50	14.62	3.21	3,187.2	3,340.5	33.4	864	30,630	0.961	BBB-
Duke Realty Corp	DRE	20.68	22.49	17.61	1.18	1.25	17.46	16.56	5.41	-	5.61	3.72	-0.67	-0.67	1.41	13.14	12.95	3.48	7,135.6	7,208.1	33.5	2,359	47,083	0.660	BBB
Eastgroup Properties	EGP	54.23	61.85	50.11	3.96	4.20	13.68	12.92	5.91	61.96	5.88	1.57	-2.48	-2.48	-10.30	2.26	7.89	4.43	1,751.8	1,751.8	37.1	160	8,378	0.478	
First Industrial Realty Trust	FR	21.52	23.08	18.69	1.44	1.54	14.91	13.94	6.96	36.43	5.60	4.52	-2.76	-2.76	3.64	13.18	15.46	2.37	2,366.4	2,460.3	37.6	928	18,961	0.801	BBB-
Liberty Property Trust	LPT	28.88	37.13	27.30	2.47	2.53	11.71	11.41	2.58	70.90	6.08	-1.50	-6.99	-6.99	-17.80	-4.37	2.39	6.58	4,267.6	4,369.9	39.5	1,045	29,796	0.698	BBB
Monmouth REIT Cl A	MNR	11.08	11.48	9.10	0.69	0.81	16.12	13.76	17.09	107.14	6.67	9.42	7.54	7.54	4.57	5.90	12.73	5.78	675.0	675.0	45.7	309	3,295	0.488	
Prologis	PLD	38.46	44.73	35.57	2.56	2.63	15.00	14.62	2.61	-	6.42	-2.56	-10.39	-10.39	-6.49	2.95	4.42	4.16	20,154.9	20,466.3	36.0	3,768	143,296	0.711	BBB+
PS Business Parks	PSB	91.81	96.05	70.34	5.29	5.54	17.36	16.56	4.82	41.67	1.05	6.04	5.01	5.01	13.54	11.49	11.53	2.61	2,471.4	3,142.2	8.4	184	16,606	0.672	A-
Rexford Industrial Realty	REXR	16.85	17.62	12.69	0.85	0.95	19.75	17.76	11.19	63.16	5.73	3.44	3.00	3.00	8.67	-	-	3.20	930.3	967.0	34.6	476	7,983	0.858	
STAG Industrial	STAG	17.56	24.95	15.09	1.58	1.68	11.13	10.48	6.21	105.47	6.10	4.44	-3.50	-3.50	-24.47	0.11	-	7.92	1,195.4	1,256.5	43.1	735	11,978	1.002	
Terreno Realty	TRNO	22.14	23.48	19.39	1.05	1.17	21.07	18.97	11.09	59.26	3.55	-1.51	-2.12	-2.12	3.61	10.55	6.90	3.25	952.3	952.3	31.1	194	4,238	0.445	
AVERAGE		**32.67**	**36.50**	**27.93**	**2.11**	**2.23**	**15.93**	**14.83**	**7.23**	**67.28**	**5.24**	**2.61**	**-1.50**	**-1.50**	**-1.81**	**6.67**	**9.88**	**4.27**	**4,098.9**	**4,235.4**	**34.5**	**1,002**	**29,295**	**0.707**	

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National Association of Real Estate Investment Trusts®

Retail

Name	Ticker	Share Price ($) 29-Feb-2016	Share Price ($) 52 Week High	Share Price ($) 52 Week Low	FFO per Share Estimates ($) 2016	FFO per Share Estimates ($) 2017	Price/FFO Estimates 2016	Price/FFO Estimates 2017	FFO Growth (%) 2016 - 2017	FFO Payout (%) 2015: Q3	Debt/ EBITDA 2015: Q3	Total Return (%) Feb-16	Total Return (%) QTD	Total Return (%) YTD	Total Return (%) 1-Yr	Total Return (%) 3-Yr	Total Return (%) 5-Yr	Dividend Yield (%)	Equity Market Cap ($M)	Implied Market Cap ($M)	Debt Ratio (%)	Average Share Volume	Average Dollar Volume	Relative Liquidity	Long-Term Issuer Rating
Shopping Centers																									
Acadia Realty	AKR	33.05	35.60	28.46	1.57	1.68	21.05	19.66	7.10	50.00	3.01	-3.08	-0.30	-0.30	0.48	11.19	14.85	3.03	2,274.8	2,403.4	38.3	415	13,837	0.608	
Brixmor Property Group	BRX	23.43	27.01	21.10	2.09	2.20	11.21	10.63	5.48	45.92	6.76	-11.98	-8.37	-8.37	-4.23	-	-	4.18	6,947.8	7,084.1	45.7	3,029	72,378	1.042	BBB-
Cedar Realty Trust	CDR	6.83	7.64	5.90	0.55	0.59	12.46	11.61	7.29	35.71	7.35	-2.56	-2.83	-2.83	-6.00	9.31	6.74	2.93	575.3	577.9	56.3	400	2,795	0.486	
DDR Corp	DDR	16.73	19.33	14.75	1.23	1.29	13.61	13.00	4.69	59.48	7.29	-2.22	-0.65	-0.65	-7.91	2.67	6.58	4.12	6,009.8	6,033.9	48.1	2,316	38,213	0.636	BBB-
Equity One Inc	EQY	27.41	28.48	22.71	1.38	1.49	19.85	18.42	7.74	70.97	4.81	-1.12	0.96	0.96	6.03	9.28	11.99	3.21	3,861.9	3,861.9	30.3	1,039	28,448	0.737	BBB
Federal Realty Invs	FRT	148.06	152.34	124.96	5.71	6.19	25.94	23.94	8.39	82.08	5.79	-1.84	1.34	1.34	6.95	14.80	15.16	2.54	10,278.9	10,417.2	21.8	634	94,149	0.916	A-
Inland Real Estate	IRC	10.60	11.01	7.99	1.01	1.06	10.52	10.00	5.21	59.38	6.56	-0.58	0.71	0.71	5.01	9.03	8.76	5.38	1,065.6	1,065.6	49.9	570	6,059	0.569	
Kimco Realty Cp	KIM	26.75	27.81	22.26	1.57	1.66	17.02	16.15	5.34	54.55	5.41	-1.62	1.10	1.10	5.82	11.45	11.08	3.81	10,995.8	11,037.7	34.8	3,424	92,241	0.839	BBB+
Kite Realty Group Trust	KRG	26.92	28.96	22.93	2.05	2.16	13.13	12.47	5.28	50.46	6.46	1.58	4.96	4.96	-0.77	4.90	8.25	4.05	2,232.7	2,284.3	46.2	629	16,821	0.753	BBB-
Ramco-Gershenson Properties	RPT	16.80	19.30	14.84	1.37	1.45	12.24	11.60	5.47	62.50	5.82	-1.70	1.14	1.14	-5.79	6.91	9.83	5.00	1,329.7	1,367.4	47.0	447	7,566	0.569	
Regency Centers	REG	70.58	74.07	57.09	3.24	3.46	21.79	20.39	6.89	64.67	4.91	-1.81	4.35	4.35	10.75	14.46	13.31	2.83	6,581.1	6,592.0	24.4	969	68,763	1.045	BBB
Retail Opportunity	ROIC	18.38	19.25	15.43	1.02	1.08	17.94	17.05	5.23	73.91	6.84	-0.59	2.68	2.68	14.28	17.24	15.41	3.70	1,815.4	1,884.7	36.9	544	10,035	0.553	BBB-
Retail Properties of America	RPAI	14.69	16.34	13.19	1.03	1.03	14.24	14.27	-0.18	72.01	5.14	-5.29	-0.54	-0.54	-2.91	4.42	-	4.51	3,475.1	3,475.1	39.4	1,484	22,041	0.634	BBB-
Saul Centers	BFS	48.98	58.87	47.65	3.05	3.22	16.06	15.21	5.57	58.90	6.08	-3.72	-3.62	-3.62	-6.01	7.19	4.71	3.51	1,033.5	1,388.3	37.4	28	1,376	0.133	
Tanger Factory Outlet Center	SKT	32.08	36.29	29.67	2.33	2.49	13.76	12.88	6.88	52.78	5.93	0.28	-1.01	-1.01	-5.78	-0.10	6.87	3.55	3,074.7	3,237.6	32.0	729	23,011	0.748	BBB+
Urban Edge Properties	UE	24.32	24.93	20.12	1.27	1.37	19.12	17.77	7.59	66.67	6.94	0.08	3.71	3.71	5.31	-	-	3.29	2,413.7	2,563.3	35.2	528	12,643	0.524	
Urstadt Biddle Pptys	UBA	19.77	23.66	17.43	1.15	1.21	17.16	16.27	5.46	91.07	4.61	-2.61	2.75	2.75	-8.37	2.82	5.66	5.26	525.5	525.5	36.2	76	1,509	0.287	
Weingarten Realty Investors	WRI	35.23	37.19	30.43	2.30	2.41	15.34	14.60	5.11	75.00	5.34	0.97	1.88	1.88	1.35	9.34	11.13	3.92	4,365.2	4,416.7	33.7	687	24,092	0.552	BBB
Wheeler Real Estate Investment Trust Inc	WHLR	1.19	3.30	1.14	0.16	-	7.44	-	-	-	39.01	-17.24	-36.66	-36.66	-61.06	-35.65	-	17.65	78.6	83.4	58.3	153	193	0.246	
AVERAGE		31.67	34.28	27.27	1.79	2.00	15.78	15.33	5.81	62.56	7.58	-2.90	-1.50	-1.50	-2.78	5.84	10.02	4.55	3,628.2	3,700.0	39.6	953	28,219	0.625	
Regional Malls																									
CBL & Associates Properties	CBL	11.53	20.16	9.40	2.34	2.40	4.93	4.81	2.38	50.00	6.57	7.26	-6.79	-6.79	-38.25	-15.61	-3.31	9.19	1,959.0	2,296.4	63.2	1,352	14,183	0.724	BBB-
General Growth Properties	GGP	27.52	31.00	24.37	1.55	1.67	17.80	16.45	8.21	-	4.83	-1.85	1.14	1.14	-2.61	15.79	15.09	2.76	24,318.9	24,498.5	38.4	5,317	141,539	0.582	
Macerich	MAC	79.08	94.89	72.53	4.08	4.43	19.39	17.86	8.61	73.03	8.71	2.33	-1.12	-1.12	2.76	15.53	14.64	3.44	12,490.4	13,326.8	29.0	1,084	83,623	0.670	
Pennsylvania Real Estate Investment Trust	PEI	19.16	23.87	16.70	1.87	1.95	10.27	9.80	4.74	55.26	21.02	-1.07	-11.43	-11.43	-12.45	6.13	10.42	4.38	1,324.3	1,484.2	53.8	669	12,318	0.930	
Rouse Properties	RSE	18.24	19.95	13.12	2.00	2.21	9.10	8.26	10.22	-	9.63	4.23	26.98	26.98	10.35	7.00	-	3.95	1,052.4	1,052.4	65.5	1,693	29,669	2.819	
Simon Property Group	SPG	189.73	206.19	171.00	10.85	11.71	17.49	16.20	7.96	57.03	5.04	2.75	-1.56	-1.56	3.06	11.70	16.32	3.37	58,965.8	68,797.0	25.2	1,368	255,386	0.433	A
Taubman Centers	TCO	70.82	80.53	66.67	3.67	4.08	19.32	17.38	11.19	74.34	6.34	-0.31	-7.69	-7.69	0.96	2.34	9.40	3.19	4,265.7	6,040.7	30.8	471	32,578	0.764	
WP GLIMCHER	WPG	8.64	17.06	7.41	1.78	1.81	4.85	4.76	1.87	58.14	7.71	-4.85	-18.57	-18.57	-46.63	-	-	11.57	1,589.9	1,876.7	59.2	1,600	13,078	0.823	BBB-
AVERAGE		53.09	61.71	47.65	3.52	3.78	12.89	11.94	6.90	61.30	8.73	1.06	-2.38	-2.38	-10.35	6.13	10.43	5.23	13,245.8	14,921.6	45.7	1,694	72,797	0.968	
Free Standing																									
Agree Realty	ADC	37.05	37.75	27.80	2.59	2.74	14.31	13.55	5.60	72.58	4.29	0.35	9.00	9.00	19.72	16.23	14.63	5.02	699.8	712.7	36.6	150	5,568	0.796	
Getty Realty	GTY	18.19	18.71	15.26	1.53	1.66	11.89	10.99	8.18	40.00	3.10	1.73	6.06	6.06	7.81	2.48	-4.32	5.50	607.4	607.4	37.7	99	1,788	0.294	
National Retail Properties	NNN	43.98	45.29	33.99	2.35	2.47	18.75	17.78	5.49	76.36	4.49	2.42	10.95	10.95	14.18	13.39	16.89	3.96	5,988.4	5,988.4	28.9	1,440	63,926	1.068	BBB+
Realty Income	O	58.54	60.48	43.38	2.86	3.00	20.45	19.50	4.89	82.39	5.70	5.28	14.18	14.18	22.50	14.07	15.69	4.07	14,611.6	14,654.7	30.3	3,030	177,442	1.214	BBB+
Seritage Growth Properties	SRG	41.36	44.00	33.84	-	-	-	-	-	-	-	6.08	2.83	2.83	-	-	-	1.21	2,297.6	2,297.6	-	243	9,789	0.426	
Spirit Realty Capital	SRC	10.69	12.40	9.04	0.88	0.92	12.16	11.68	4.11	77.27	5.73	2.00	6.69	6.69	-6.67	7.50	-	6.55	4,686.5	4,686.5	50.5	6,873	73,231	1.563	BB+
Store Capital REIT	STOR	24.15	25.64	19.79	1.55	1.68	15.58	14.37	8.38	73.53	6.22	-2.58	4.09	4.09	11.85	-	-	4.47	3,401.7	3,401.7	40.8	1,641	41,180	1.211	
AVERAGE		33.42	34.90	26.16	1.96	2.08	15.52	14.64	6.11	70.36	4.92	2.18	7.69	7.69	11.56	10.73	10.72	4.40	4,613.3	4,621.3	37.5	1,925	53,275	0.939	

NAREIT®

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National Association of Real Estate Investment Trusts®

Residential

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Apartments																									
American Campus Communities	ACC	43.77	45.14	32.26	2.26	2.42	19.40	18.07	7.33	72.73	7.60	4.68	6.86	6.86	10.41	2.88	9.46	3.66	5,702.8	5,766.2	41.9	2,476	106,927	1.875	BBB-
Apartment Inv Management	AIV	36.61	41.19	34.85	2.33	2.50	15.68	14.64	7.16	53.57	5.17	-5.64	-7.71	-7.71	0.39	10.83	10.62	3.61	5,721.3	6,000.1	39.0	1,794	66,185	1.157	BBB-
Avalonbay Communities	AVB	171.64	185.54	159.08	8.27	8.94	20.77	19.20	8.14	57.34	4.84	0.09	-6.78	-6.78	4.96	14.76	10.54	2.91	23,493.6	23,494.9	22.1	845	141,921	0.604	A-
Bluerock Residential Growth REIT	BRG	10.26	13.93	9.18	0.82	1.04	12.51	9.87	26.83	-	11.07	0.06	-11.68	-11.68	-14.03	-	-	11.31	193.4	200.4	63.1	119	1,166	0.603	
Camden Property	CPT	74.74	81.28	69.45	4.85	5.09	15.41	14.69	4.91	62.50	5.36	-2.04	-2.63	-2.63	6.60	6.62	8.68	3.75	6,457.4	6,599.2	29.5	595	44,032	0.682	BBB+
Education Realty Trust	EDR	39.65	40.95	28.08	1.74	1.97	22.74	20.12	13.03	94.74	7.79	1.46	5.69	5.69	17.88	11.30	14.15	3.73	2,474.0	2,486.6	28.6	493	19,240	0.778	BBB-
Equity Residential	EQR	66.50	81.97	68.62	3.19	3.36	20.83	19.81	5.13	61.39	4.47	-3.37	-8.70	-8.70	-0.45	14.17	9.52	2.97	27,113.5	28,075.5	27.9	2,174	159,886	0.590	A-
Essex Prop Trust	ESS	209.28	244.29	192.26	10.97	11.87	19.07	17.63	8.16	60.50	6.28	-1.80	-12.59	-12.59	-3.49	15.22	14.39	2.75	13,729.2	14,185.7	26.0	555	113,541	0.827	BBB
Independence Realty Trust	IRT	6.43	9.72	6.18	0.83	0.89	7.76	7.26	6.96	100.00	10.63	-4.71	-12.82	-12.82	-24.18	-	-	11.20	301.5	309.6	73.8	215	1,396	0.463	
Mid-America Apartment Comm	MAA	89.94	95.54	72.81	5.85	6.23	15.37	14.43	6.50	54.61	3.47	-4.14	-0.05	-0.05	29.01	13.56	11.16	3.65	6,768.4	7,144.9	34.5	957	85,624	1.265	BBB
Monogram Residential Trust Inc	MORE	9.08	10.17	7.76	0.43	0.52	21.12	17.63	19.77	57.69	4.35	4.13	-6.97	-6.97	1.77	-	-	3.30	1,533.3	1,533.3	49.2	945	8,034	0.524	
NEXPOINT RESIDENTIAL	NXRT	11.84	15.30	10.81	1.66	1.83	7.15	6.49	10.27	64.38	12.84	-0.50	-9.55	-9.55	-	-	-	5.22	253.4	253.4	70.9	89	1,023	0.404	
Post Properties	PPS	55.73	62.37	53.58	3.15	3.34	17.68	16.67	6.06	54.05	4.52	-2.72	-5.80	-5.80	0.99	8.36	10.18	3.16	3,020.3	3,027.0	21.9	441	24,382	0.807	BBB
Preferred Apartment Communities	APTS	12.10	13.66	9.82	1.27	-	9.53	-	-	92.11	8.93	0.41	-7.49	-7.49	26.45	19.68	-	6.36	269.8	273.2	75.0	147	1,708	0.633	
UDR	UDR	34.33	37.89	31.14	1.79	1.90	19.21	18.07	6.30	67.68	4.21	-3.54	-7.93	-7.93	11.01	17.01	10.96	3.23	8,994.6	9,245.6	27.8	1,885	64,920	0.722	BBB+
AVERAGE		**58.13**	**65.26**	**52.39**	**3.29**	**3.71**	**16.28**	**15.33**	**9.75**	**68.09**	**6.77**	**-1.18**	**-5.88**	**-5.88**	**4.81**	**12.22**	**10.97**	**4.72**	**7,068.4**	**7,239.7**	**42.1**	**915**	**55,999**	**0.796**	
Manufactured Homes																									
Equity Lifestyle Properties	ELS	70.16	72.53	52.19	3.24	3.44	21.65	20.41	6.08	53.57	5.95	6.43	5.23	5.23	33.67	27.40	22.51	2.14	5,886.4	6,393.1	28.7	471	31,922	0.542	
Sun Communities	SUI	67.53	71.27	60.88	3.78	3.98	17.88	16.98	5.27	71.43	6.61	1.41	-1.46	-1.46	3.88	18.81	20.71	3.85	3,936.1	4,133.0	38.0	215	14,316	0.364	
UMH Properties	UMH	9.39	10.62	9.08	0.70	0.89	13.41	10.55	27.14	163.64	8.80	1.52	-5.40	-5.40	6.99	5.26	5.33	7.67	253.6	253.6	58.5	60	558	0.220	
AVERAGE		**49.03**	**51.47**	**40.72**	**2.57**	**2.77**	**17.65**	**15.98**	**12.83**	**96.21**	**7.12**	**3.12**	**-0.54**	**-0.54**	**14.84**	**17.16**	**16.18**	**4.55**	**3,358.7**	**3,593.2**	**41.7**	**249**	**15,599**	**0.375**	
Single Family Homes																									
American Homes 4 Rent	AMH	14.00	17.33	13.21	0.92	1.05	15.16	13.33	13.67	31.25	7.65	-6.60	-15.97	-15.97	-15.08	-	-	1.43	2,924.4	3,684.3	37.9	1,773	24,852	0.850	
Colony Starwood Homes	SFR	21.96	26.59	20.18	1.76	2.18	12.49	10.07	24.00	35.00	12.88	2.04	-3.00	-3.00	-10.34	-	-	3.46	2,258.4	2,258.4	67.8	624	13,492	0.597	
Silver Bay Realty Trust	SBY	13.75	16.88	12.22	0.77	0.92	17.86	15.00	19.05	75.00	12.09	-1.50	-12.20	-12.20	-12.45	-11.15	-	3.78	496.0	526.7	50.7	300	3,931	0.793	
AVERAGE		**16.57**	**20.27**	**15.20**	**1.15**	**1.38**	**15.17**	**12.80**	**18.91**	**47.08**	**10.88**	**-2.02**	**-10.39**	**-10.39**	**-12.62**	**-11.15**	**-**	**2.89**	**1,893.0**	**2,156.5**	**52.1**	**899**	**14,092**	**0.747**	

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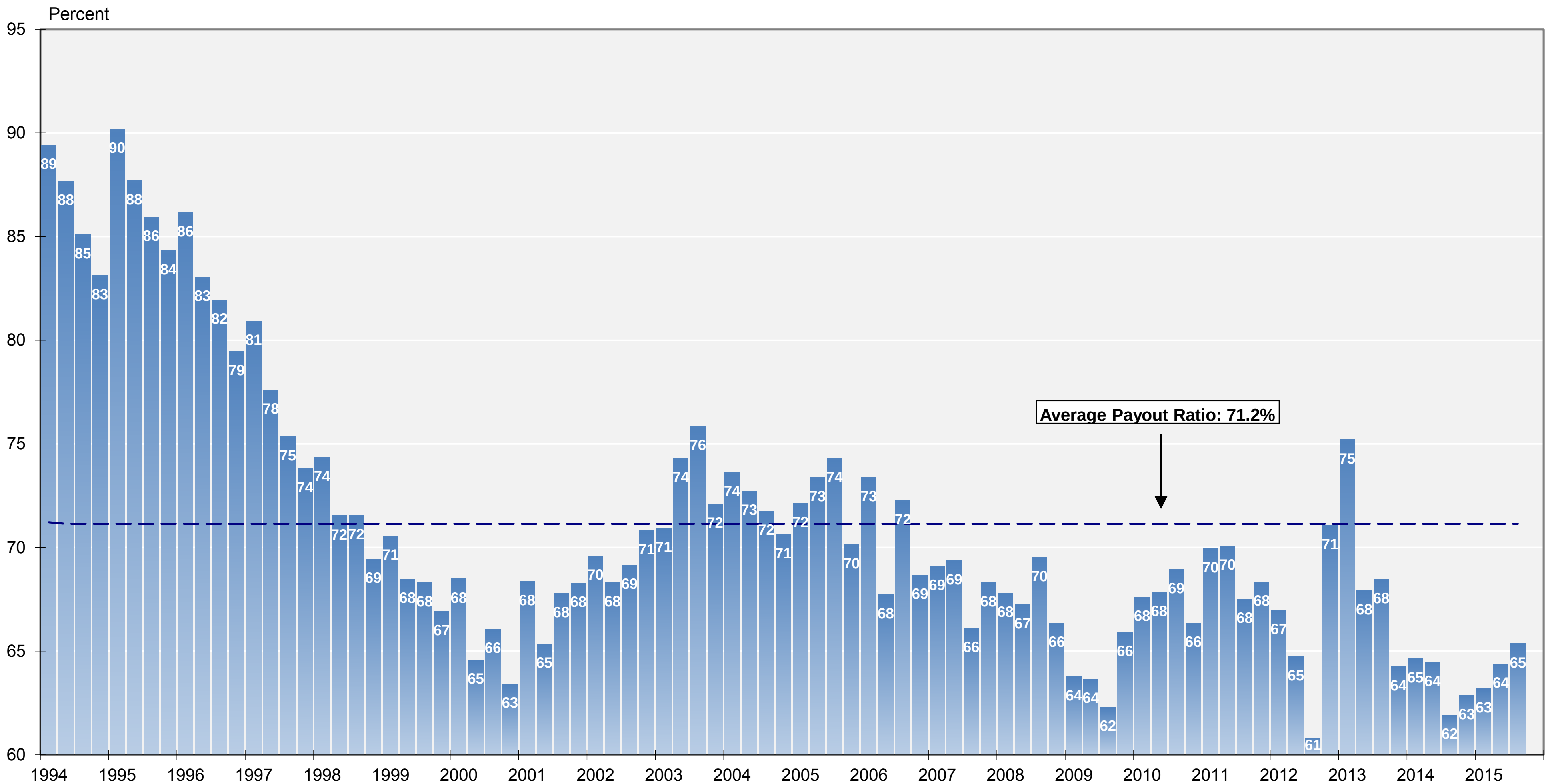
Name	Ticker	Share Price ($) 29-Feb-2016	52 Week High	52 Week Low	FFO per Share Estimates ($) 2016	FFO per Share Estimates ($) 2017	Price/FFO Estimates 2016	Price/FFO Estimates 2017	FFO Growth (%) 2016 - 2017	FFO Payout (%) 2015: Q3	Debt/ EBITDA 2015: Q3	Total Return (%) Feb-16	Total Return (%) QTD	Total Return (%) YTD	Total Return (%) 1-Yr	Total Return (%) 3-Yr	Total Return (%) 5-Yr	Dividend Yield (%)	Equity Market Cap ($M)	Implied Market Cap ($M)	Debt Ratio (%)	Average Share Volume	Average Dollar Volume	Relative Liquidity	Long-Term Issuer Rating
Diversified																									
Alexanders Inc	ALX	384.83	468.25	354.10	22.49	23.42	17.11	16.43	4.14	72.61	8.16	5.43	1.30	1.30	-9.33	9.67	9.55	4.16	1,955.2	1,955.2	35.7	5	1,931	0.099	
American Assets Trust Inc.	AAT	37.09	44.56	34.61	1.88	2.08	19.75	17.81	10.89	52.84	6.90	-0.80	-3.29	-3.29	-7.38	9.82	14.85	2.70	1,665.7	2,329.6	29.2	209	7,594	0.456	BBB-
Armada Hoffler Properties	AHH	10.63	11.54	9.51	0.93	1.03	11.41	10.34	10.30	77.27	4.95	-1.30	1.43	1.43	5.09	-	-	6.40	314.9	471.9	48.7	191	2,029	0.644	
BRT Realty Trust	BRT	6.45	7.35	5.41	-	-	-	-	-	0.00	18.55	13.76	1.74	1.74	-7.73	-4.00	-0.03	0.00	91.0	91.0	86.6	22	127	0.140	
Gladstone Commercial	GOOI	14.88	18.77	12.82	1.53	1.49	9.76	9.99	-2.30	101.35	8.22	5.00	3.92	3.92	-9.95	0.61	4.53	10.08	328.3	328.3	65.4	124	1,764	0.537	
GLOBAL NET LEASE	GNL	7.73	9.32	6.47	-	-	-	-	-	-	-	11.32	-1.24	-1.24	-	-	-	9.18	1,306.9	1,320.9	-	520	3,856	0.295	
HMG/Courtland Properties	HMG	9.62	14.57	9.33	-	-	-	-	-	-	-	-4.06	-9.50	-9.50	-20.71	24.36	18.16	5.20	10.0	10.0	13.8	10	96	0.960	
Investors Real Estate Trust	IRET	6.14	8.39	5.98	0.49	0.61	12.47	10.02	24.37	81.25	6.28	-5.83	-11.65	-11.65	-13.71	-7.79	-1.71	8.47	770.7	856.6	46.0	492	3,079	0.400	
Lexington Realty Trust	LXP	7.74	10.39	6.61	1.05	1.05	7.36	7.39	-0.33	58.62	4.60	5.59	-3.25	-3.25	-22.71	-6.35	2.27	8.79	1,826.2	1,856.0	53.2	1,293	9,296	0.509	BB+
NorthStar Realty Finance	NRF	12.49	38.20	8.57	3.10	3.10	4.03	4.03	-0.12	-	15.98	5.22	-26.66	-26.66	-56.44	3.23	15.14	24.02	2,166.1	2,188.7	70.9	6,175	65,507	3.024	
One Liberty	OLP	21.23	25.60	19.59	1.95	1.99	10.89	10.67	2.05	82.98	7.09	2.46	-1.07	-1.07	-3.82	6.15	15.27	7.72	354.6	354.6	50.6	34	684	0.193	
VEREIT	VER	8.02	10.09	7.07	0.78	0.78	10.31	10.35	-0.36	0.00	12.35	4.02	1.26	1.26	-15.37	-10.25	-	3.43	7,259.2	7,449.8	52.9	4,675	35,911	0.495	BB
Vornado Realty	VNO	86.36	113.44	80.15	5.26	5.53	16.42	15.61	5.22	36.84	6.78	-2.37	-12.98	-12.98	-19.42	9.00	3.82	2.92	16,259.2	17,173.7	38.2	1,419	119,674	0.736	BBB+
W. P. Carey Inc.	WPC	56.69	70.82	51.87	4.30	4.39	13.20	12.90	2.28	80.04	5.70	-2.68	-3.92	-3.92	-12.00	4.16	17.15	6.81	5,862.5	5,862.5	42.9	336	18,808	0.321	BBB
Washington Real Estate Inv	WRE	25.87	28.39	23.93	1.72	1.79	15.07	14.48	4.01	90.91	7.79	2.54	-4.40	-4.40	-4.38	2.43	1.27	4.64	1,762.8	1,762.8	42.7	477	12,038	0.683	BBB
Whitestone REIT	WSR	11.22	16.32	9.87	1.37	1.42	8.17	7.90	3.40	114.00	10.21	2.70	-5.00	-5.00	-22.80	-1.25	3.41	10.16	302.7	307.1	61.3	148	1,544	0.510	
Winthrop Realty Trust	FUR	13.16	17.04	12.62	-	-	-	-	-	-	-	-0.15	1.46	1.46	-5.10	14.73	11.83	4.94	479.0	479.0	-	130	1,675	0.350	
AVERAGE		42.36	53.71	38.74	3.60	3.74	11.99	11.38	4.89	65.29	8.83	2.40	-4.23	-4.23	-14.11	3.63	8.25	7.04	2,512.6	2,635.2	49.2	956	16,801	0.609	
Health Care																									
Care Capital Properties	CCP	26.51	35.61	24.19	3.14	3.33	8.45	7.96	6.16	-	-	-11.46	-13.28	-13.28	-	-	-	4.30	2,218.2	2,218.2	35.9	601	15,845	0.714	BB+
CareTrust REIT	CTRE	11.39	14.36	9.70	1.10	1.16	10.39	9.79	6.20	64.00	6.72	11.01	4.02	4.02	-5.60	-	-	5.62	548.4	548.4	43.0	319	3,399	0.620	B
Community Healthcare Trust	CHC1	17.97	20.15	15.90	1.73	1.92	10.38	9.38	10.57	-	-	-0.93	-0.45	-0.45	-	-	-	4.98	118.0	118.0	0.0	18	317	0.269	
HCP	HCP	29.58	44.59	26.13	2.87	2.83	10.30	10.45	-1.48	86.92	6.59	-16.38	-21.40	-21.40	-25.80	-10.76	0.14	7.78	13,755.9	13,933.7	38.9	5,783	175,906	1.279	BBB+
Healthcare Realty Trust	HR	29.01	29.92	22.11	1.67	1.75	17.39	16.55	5.09	-	5.55	0.94	3.51	3.51	6.51	7.93	9.97	4.14	2,912.4	2,912.4	36.5	1,043	29,848	1.025	BBB-
Healthcare Trust Of America Inc	HTA	27.81	29.02	22.69	1.63	1.72	17.02	16.21	5.00	76.32	6.19	-0.82	3.11	3.11	4.87	11.92	-	4.24	3,533.0	3,586.7	33.5	1,280	34,997	0.991	BBB
LTC Properties	LTC	44.44	46.74	38.89	3.00	3.16	14.80	14.08	5.13	77.27	2.92	0.22	3.87	3.87	4.53	10.15	14.59	4.86	1,579.4	1,579.4	27.4	266	11,647	0.737	
Medical Properties Trust	MPW	11.57	15.32	9.86	1.30	1.29	8.87	9.00	-1.42	122.22	7.98	5.18	0.52	0.52	-17.91	-1.10	6.93	7.61	2,751.8	2,755.2	56.2	1,766	19,117	0.695	BB+
National Health Investors	NHI	62.91	72.80	54.10	4.87	5.12	12.93	12.28	5.25	72.65	4.16	3.68	3.35	3.35	-6.74	4.15	11.57	5.40	2,363.2	2,363.2	30.0	322	19,283	0.816	
New Senior Investment Group	SNR	9.69	17.07	8.27	1.48	1.64	6.56	5.92	10.84	85.19	11.61	5.44	-1.72	-1.72	-38.98	-	-	10.73	838.5	838.5	71.0	583	5,313	0.634	
Omega Healthcare Investors	OHI	32.06	41.94	27.46	3.24	3.31	9.89	9.67	2.20	101.89	5.30	1.10	-6.70	-6.70	-14.81	10.86	13.07	7.11	5,996.6	6,284.8	34.5	1,841	56,019	0.934	BBB-
Physicians Realty Trust	DOC	17.18	17.85	14.06	1.08	1.18	15.98	14.57	9.62	125.00	3.50	0.64	3.32	3.32	10.43	-	-	5.24	1,865.7	1,931.9	30.1	1,233	21,060	1.129	
Sabra Health Care REIT	SBRA	19.92	34.02	15.16	2.29	2.35	8.71	8.48	2.70	86.67	6.29	11.40	1.11	1.11	-34.08	-3.29	8.88	8.23	1,297.1	1,297.1	48.1	696	12,181	0.939	BB-
Senior Housing Properties Trust	SNH	15.61	22.98	13.62	1.89	1.89	8.27	8.24	0.36	92.86	5.59	7.80	8.06	8.06	-22.77	-7.77	-1.71	9.99	3,705.8	3,705.8	47.7	1,822	26,787	0.723	BBB-
Universal Health Rlty Income	UHT	51.84	56.87	43.54	-	-	-	-	-	90.14	2.93	1.99	3.66	3.66	7.46	2.27	11.63	4.98	689.6	689.6	28.8	49	2,475	0.359	
Ventas Inc	VTR	55.67	76.90	48.43	4.19	4.24	13.30	13.13	1.33	68.10	5.94	0.63	-1.35	-1.35	-10.53	1.00	7.45	5.25	18,416.2	18,576.8	37.5	3,111	164,937	0.896	BBB+
Welltower Inc.	HCN	63.78	79.44	53.68	4.57	4.73	13.95	13.47	3.52	85.05	4.24	3.90	-4.97	-4.97	-13.01	4.78	9.45	5.39	22,363.0	22,363.0	35.3	3,538	211,946	0.948	BBB
AVERAGE		31.00	38.56	26.34	2.50	2.60	11.70	11.20	4.44	88.16	5.70	1.43	-0.90	-0.90	-10.43	2.51	8.36	6.23	4,997.2	5,041.3	37.3	1,428	47,710	0.806	
Lodging/Resorts																									
Apple Hospitality REIT	APLE	19.01	20.68	16.38	1.74	1.78	10.94	10.69	2.30	79.68	2.12	4.48	-3.78	-3.78	-	-	-	5.26	3,334.7	3,334.7	23.5	671	12,907	0.387	
Ashford Hospitality Prime	AHP	9.83	17.23	9.68	1.78	1.88	5.53	5.23	5.82	-	6.66	-10.56	-32.21	-32.21	-38.17	-	-	4.07	279.9	361.2	64.7	198	2,002	0.715	
Ashford Hospitality Trust	AHT	5.53	10.18	4.58	1.64	1.77	3.38	3.13	7.74	-	10.06	-0.54	-12.36	-12.36	-40.69	-2.57	2.97	8.68	528.0	633.8	84.2	718	3,757	0.712	
Chatham Lodging Trust	CLDT	20.06	30.88	16.91	2.54	2.72	7.89	7.37	7.02	-	4.12	6.87	-0.62	-0.62	-26.98	11.91	8.28	5.98	767.4	767.4	42.5	202	3,988	0.520	
Chesapeake Lodging Trust	CHSF	25.41	34.52	22.78	2.47	2.52	10.29	10.08	2.12	52.24	3.47	1.15	0.99	0.99	-24.72	10.54	11.56	6.30	1,515.7	1,515.7	33.3	437	10,988	0.725	
Condor Hospitality Trust	CDOI	0.75	3.07	0.73	-	-	-	-	-	-	-	-31.53	-39.74	-39.74	-52.63	-56.70	-44.44	0.00	3.7	4.3	86.4	9	8	0.206	
Diamondrock Hospitality	DRH	8.90	15.06	7.77	1.09	1.16	8.13	7.70	5.61	41.67	3.81	7.23	-7.77	-7.77	-35.89	3.49	-2.06	5.62	1,786.3	1,786.3	34.7	2,948	24,705	1.383	
FelCor Lodging	FCH	7.40	12.23	5.83	0.96	0.99	7.75	7.49	3.40	100.00	8.39	6.32	2.40	2.40	-29.74	15.13	0.24	3.24	1,060.2	1,064.8	58.4	1,151	8,176	0.771	B
Hersha Hospitality Trust	HT	20.13	28.28	16.51	2.73	2.89	7.38	6.97	5.84	39.44	5.11	14.57	-7.49	-7.49	-21.44	0.68	-0.84	5.56	926.8	973.7	50.9	728	13,768	1.486	
Hospitality Properties Trust	HPT	24.28	34.06	21.77	3.87	4.01	6.27	6.05	3.66	51.02	3.78	2.92	-5.02	-5.02	-14.52	4.03	8.64	8.24	3,678.1	3,678.1	45.9	1,143	26,468	0.720	BBB-
Host Hotels & Resorts	HST	15.31	21.72	12.82	1.66	1.72	9.24	8.88	4.07	46.51	2.19	10.54	-0.20	-0.20	-23.74	0.65	-1.00	5.23	11,576.0	11,719.9	24.9	10,299	149,666	1.293	BB+
Innsuites Hospitality Tr	IHT	2.37	2.95	2.03	-	-	-	-	-	-	4.50	8.10	15.83	15.83	-16.92	12.68	12.26	0.42	19.7	28.5	15.7	0	0	0.001	
LaSalle Hotel Properties	LHO	24.35	40.85	20.15	2.98	3.02	8.16	8.06	1.18	41.67	2.82	9.88	-3.22	-3.22	-33.88	2.95	0.55	7.39	2,746.9	2,750.4	31.6	2,251	52,111	1.897	
Pebblebrook Hotel Trust	PEB	27.16	49.15	21.99	2.76	2.92	9.83	9.31	5.60	47.69	4.01	11.22	-3.07	-3.07	-42.19	7.17	7.05	4.57	1,951.6	1,958.0	30.3	1,121	28,014	1.435	
RLJ Lodging Trust	RLJ	20.97	32.77	17.16	2.70	2.79	7.75	7.53	3.00	-	3.32	14.65	-3.05	-3.05	-30.74	3.43	-	6.29	2,636.5	2,655.2	32.2	1,352	25,623	0.972	
Ryman Hospitality Properties	RHP	47.87	63.84	43.53	5.36	5.67	8.93	8.45	5.74	48.15	4.34	1.96	-7.30	-7.30	-16.26	7.42	13.40	5.85	2,453.5	2,453.5	36.2	294	13,920	0.567	B+
Sotherly Hotels Inc	SOH(	5.44	8.47	4.97	1.15	1.14	4.73	4.77	-0.87	17.95	6.57	3.62	-11.69	-11.69	-25.28	12.16	18.12	5.88	77.7	90.8	74.6	16	86	0.110	
Summit Hotel Properties	INN	10.81	14.53	9.28	1.29	1.38	8.40	7.85	7.03	36.72	4.19	7.84	-8.40	-8.40	-14.32	8.61	6.83	4.35	936.1	943.3	39.9	437	4,374	0.467	
Sunstone Hotel Investors	SHO	12.90	17.29	10.13	1.27	1.36	10.17	9.50	7.08	11.63	3.11	8.59	3.28	3.28	-17.88	9.57	6.77	1.55	2,692.0	2,692.0	28.7	2,887	34,652	1.287	
XENIA HOTELS & RESORTS INC	XHR	15.32	24.33	12.73	2.56	2.66	5.98	5.76	3.91	-	3.79	4.72	-0.07	-0.07	-24.00	-	-	6.01	1,710.8	1,711.2	35.9	550	7,972	0.466	
AVERAGE		16.19	24.10	13.89	2.25	2.35	7.82	7.49	4.46	47.26	4.55	4.10	-6.17	-6.17	-27.89	3.01	3.02	5.02	2,034.1	2,056.1	43.7	1,371	21,159	0.806	
Self Storage																									
CubeSmart	CUBE	29.90	31.72	22.74	1.39	1.55	21.54	19.34	11.35	53.33	4.69	-4.44	-2.35	-2.35	32.30	30.14	27.38	2.81	5,158.6	5,226.3	21.3	1,621	47,662	0.924	BBB
Extra Space Storage	EXR	82.15	91.15	64.68	3.68	4.09	22.31	20.10	11.00	81.94	4.99	-9.42	-6.87	-6.87	28.81	34.33	37.12	2.87	10,142.0	10,629.5	26.4	1,386	116,398	1.148	
National Storage Affiliates Trust	NSA	18.09	19.86	11.61	1.03	1.13	17.56	15.97	9.95	0.00	8.61	4.03	5.60	5.60	-	-	-	2.99	416.1	1,099.4	40.9	197	3,353	0.806	
Public Storage	PSA	249.49	256.82	182.98	9.72	10.50	25.68	23.77	8.04	79.07	0.08	-1.61	0.72	0.72	30.60	22.08	21.14	2.73	43,072.0	43,129.9	0.9	892	218,989	0.508	A
Sovran Self Storage	SSS	106.44	112.88	86.13	5.51	6.09	19.33	17.49	10.54	61.48	3.92	-5.54	-0.04	-0.04	19.68	24.64	26.80	3.19	3,814.3	3,833.3	19.7	401	42,438	1.113	BBB
AVERAGE		97.21	102.49	73.63	4.26	4.67	21.28	19.33	10.18	55.16	4.46	-3.40	-0.59	-0.59	27.85	27.80	28.11	2.92	12,520.6	12,783.7	21.8	899	85,768	0.900	
Timber																									
CatchMark Timber Trust	CTT	10.65	12.20	9.74	0.69	0.76	15.43	14.01	10.14	-	6.86	-1.03	-4.71	-4.71	-8.11	-	-	4.69	415.1	415.1	30.8	104	1,099	0.265	
Potlatch Corp. REIT	PCH	26.44	40.60	24.54	-	-	-	-	-	-	11.06	-8.32	-12.57	-12.57	-30.80	-12.47	-3.38	5.67	1,073.2	1,073.2	35.2	434	11,713	1.091	BB
Rayonier	RYN	21.83	27.44	18.63	-	-	-	-	-	-	6.41	3.51	-1.67	-1.67	-16.96	-15.77	-2.56	4.58	2,701.5	2,701.5	23.1	714	14,797	0.548	BBB-
Weyerhaeuser	WY	25.98	34.46	22.22	-	-	-	-	-	-	3.37	1.44	-13.34	-13.34	-23.67	-1.04	4.31	4.77	20,528.0	20,528.0	27.6	8,999	218,239	1.063	BBB
AVERAGE		21.23	28.68	18.78	0.69	0.76	15.43	14.01	10.14	-	6.92	-1.10	-8.07	-8.07	-19.89	-9.76	-0.54	4.93	6,179.5	6,179.5	29.2	2,563	61,462	0.742	
Infrastructure																									
American Tower Corp	AMT	92.20	104.06	83.66	5.66	6.45	16.28	14.29	13.94	42.42	6.16	-2.27	-4.90	-4.90	-5.18	7.66	12.83	2.13	38,959.9	38,959.9	31.5	2,855	252,175	0.647	BBB-
Communications Sales & Leasing	CSAL	18.85	30.32	15.41	2.55	2.54	7.41	7.42	-0.20	0.00	-	-1.87	0.86	0.86	-	-	-	8.71	2,838.0	2,838.0	56.5	1,730	29,820	1.051	B+
CorEnergy Infrastructure Trust	CORI	13.21	35.25	11.50	3.19	3.86	4.14	3.42	21.09	103.85	3.89	-11.58	-5.86	-5.86	-55.27	-20.75	-14.97	22.71	157.5	157.5	46.2	240	3,271	2.076	
Crown Castle Intl Corp	CCI	86.50	88.41	76.58	4.67	5.00	18.51	17.30	7.03	67.21	5.27	0.35	0.06	0.06	4.31	9.75	16.96	4.09	28,897.2	28,897.2	31.7	2,318	196,878	0.681	BB+
InfraREIT	HIFR	21.12	33.94	15.10	1.16	1.41	18.29	14.98	22.08	-	6.09	9.26	14.16	14.16	-19.43	-	-	4.26	920.1	1,279.7	30.9	273	5,575	0.606	
Power REIT	PW	4.17	9.28	4.00	-	-	-	-	-	0.00	4.62	2.91	-1.80	-1.80	-50.39	-26.02	-16.38	0.00	6.9	6.9	56.5	1	6	0.090	
AVERAGE		39.34	50.21	34.37	3.44	3.85	12.93	11.48	12.79	42.70	5.20	-0.53	0.42	0.42	-25.19	-7.34	-0.39	6.98	11,963.3	12,023.2	42.2	1,236	81,288	0.859	
Data Centers																									
CoreSite Realty	COR	64.46	67.10	44.98	3.44	3.94	18.74	16.35	14.66	61.76	2.21	0.50	13.65	13.65	40.77	30.63	37.77	3.29	1,975.3	3,320.0	15.2	485	30,179	1.528	
CyrusOne	CONE	39.64	40.66	29.22	2.49	2.93	15.94	13.54	17.76	-	5.66	7.57	5.85	5.85	38.58	27.29	-	3.18	2,626.0	2,875.7	33.4	903	32,992	1.256	B+
Digital Realty Trust	DLR	79.07	85.65	61.52	5.54	5.97	14.28	13.25	7.79	67.46	3.84	-1.26	4.56	4.56	25.45	11.57	11.51	4.30	10,701.7	10,933.5	39.7	1,539	122,914	1.149	BBB
DuPont Fabros Technology	DFT	35.65	37.59	25.08	2.76	3.00	12.91	11.90	8.53	67.74	4.34	7.48	12.14	12.14	20.60	21.36	12.14	5.27	2,340.6	2,890.3	36.3	942	32,141	1.373	BB-
Equinix Inc	EQIX	303.69	318.00	227.86	13.47	15.95	22.54	19.04	18.40	58.89	4.35	-2.22	0.43	0.43	44.62	16.74	31.23	2.23	20,770.1	20,770.1	29.5	1,245	365,581	1.760	BB
QTS Realty Trust	QTS	44.52	47.29	35.19	2.59	2.98	17.18	14.95	14.97	65.31	6.39	-3.64	-1.31	-1.31	28.43	-	-	2.88	1,813.9	2,125.4	29.5	343	15,018	0.828	B+
AVERAGE		94.51	99.38	70.64	5.05	5.79	16.93	14.84	13.69	64.23	4.46	1.41	5.89	5.89	33.08	21.52	23.16	3.53	6,704.6	7,152.5	30.6	910	99,804	1.316	
Specialty																									
American Farmland	AFCC	5.86	7.74	5.09	0.49	0.57	11.97	10.30	16.29	-	-	0.51	-16.76	-16.76	-	-	-	1.07	99.0	99.0	-	30	178	0.180	
Corrections Corp of America	CXW	28.93	42.10	24.62	2.62	2.77	11.05	10.46	5.68	72.97	2.61	0.42	9.21	9.21	-22.39	2.86	11.36	7.47	3,385.5	3,385.5	30.2	715	20,658	0.610	BB+
EPR Properties	EPR	62.23	63.89	49.57	4.76	5.06	13.09	12.30	6.39	81.03	5.71	4.32	7.59	7.59	8.74	15.85	12.65	6.17	3,718.5	3,718.5	39.9	558	34,157	0.919	BB+
Farmland Partners REIT	FPI	10.96	12.37	9.85	0.21	0.41	53.46	26.73	100.00	-	25.69	4.78	-0.09	-0.09	2.28	-	-	4.65	127.4	163.5	54.8	68	715	0.561	
Gaming & Leisure Properties	GLPI	26.19	38.18	24.82	2.78	2.85	9.43	9.18	2.70	-	7.06	2.62	-3.73	-3.73	-15.21	-	-	8.55	2,999.2	2,999.2	42.5	951	24,723	0.824	BB+
Geo Group	GEO	29.04	45.19	26.08	2.89	3.07	10.05	9.47	6.13	106.90	6.00	0.62	2.95	2.95	-26.94	1.10	11.60	8.95	2,153.2	2,153.2	49.2	634	17,909	0.832	BB-
Gladstone Land	LAND	8.50	12.30	7.02	0.58	0.64	14.72	13.39	9.96	150.00	16.66	15.14	-0.68	-0.68	-25.00	-12.45	-	5.65	84.9	84.9	63.3	27	219	0.257	
Iron Mountain	IRM	29.38	38.65	24.56	2.18	2.34	13.50	12.56	7.51	103.26	5.51	6.68	8.77	8.77	-14.97	3.24	11.73	6.60	6,153.8	6,153.8	42.7	1,462	41,053	0.667	B+
Lamar Advertising	LAMF	57.13	61.50	50.13	4.94	5.25	11.57	10.88	6.33	-	3.29	1.82	-4.75	-4.75	3.18	10.81	10.16	4.83	4,668.1	4,668.1	31.0	895	48,508	1.039	BB-
Outfront Media	OUT	20.45	30.82	18.18	2.05	2.20	9.99	9.28	7.65	-	5.10	-5.98	-6.32	-6.32	-27.72	-	-	6.65	2,791.8	2,791.8	44.2	1,111	21,932	0.786	BB-
AVERAGE		27.87	35.27	23.99	2.35	2.52	15.88	12.45	16.86	102.83	8.63	3.09	-0.38	-0.38	-13.11	3.57	11.50	6.06	2,618.1	2,621.8	44.2	645	21,005	0.668	

Mortgage

Name	Ticker	Share Price ($) 29-Feb-2016	52 Week High	52 Week Low	FFO per Share Estimates ($) 2016	2017	Price/FFO Estimates 2016	2017	FFO Growth (%) 2016 - 2017	FFO Payout (%) 2015: Q3	Debt/ EBITDA 2015: Q3	Total Return (%) Feb-16	QTD	YTD	1-Yr	3-Yr	5-Yr	Dividend Yield (%)	Equity Market Cap ($M)	Implied Market Cap ($M)	Debt Ratio (%)	Average Share Volume	Average Dollar Volume	Relative Liquidity	Long-Term Issuer Rating
Home Financing																									
AG Mortgage Investment Trust	MITT	12.33	19.52	10.78	-	-	-	-	-	-	69.41	5.12	-3.97	-3.97	-24.88	-10.97	-	15.41	349.9	349.9	85.1	211	2,432	0.695	
Altisource Residential	RESI	9.26	22.01	8.65	0.12	0.63	77.16	14.70	425.00	-	7.53	-5.73	-24.42	-24.42	-49.51	-15.52	-	4.26	525.2	525.2	61.6	443	4,170	0.794	
American Capital Agency Corp.	AGNC	18.07	21.87	16.03	-	-	-	-	-	-	23.12	7.03	6.64	6.64	-4.11	-4.71	5.70	13.28	6,302.9	6,302.9	88.0	4,829	85,887	1.363	
American Capital Mortgage Investment	MTGE	13.82	18.51	12.26	-	-	-	-	-	-	-	6.06	-1.00	-1.00	-16.17	-7.22	-	11.58	691.1	691.1	85.3	754	10,020	1.450	
Annaly Capital Management	NLY	10.13	10.87	8.69	-	-	-	-	-	-	13.35	6.63	8.00	8.00	7.65	-2.55	0.88	11.85	9,595.6	9,595.6	86.7	8,898	87,677	0.914	
Anworth Mortgage Asset	ANH	4.70	5.36	3.89	0.57	0.55	8.30	8.57	-3.14	-	55.71	10.33	8.05	8.05	1.50	2.27	3.08	12.77	470.5	470.5	92.0	1,006	4,462	0.948	
Apollo Residential Mortgage	AMTG	12.90	16.46	9.66	-	-	-	-	-	-	-	18.89	7.95	7.95	-6.68	-5.91	-	14.88	413.3	413.3	87.8	620	6,495	1.572	
ARMOUR Residential REIT	ARR	19.25	25.92	17.53	-	-	-	-	-	-	14.00	0.56	-8.45	-8.45	-9.44	-16.44	-5.55	20.57	766.9	766.9	92.9	576	10,929	1.425	
Capstead Mortgage	CMO	9.71	12.30	7.87	-	-	-	-	-	-	69.14	3.96	11.10	11.10	-9.70	1.94	5.38	10.71	927.6	927.6	93.3	1,085	10,301	1.111	
Cherry Hill Mortgage Investment	CHMI	14.23	18.37	12.65	1.96	2.00	7.26	7.12	2.04	-	7.64	4.56	9.46	9.46	-8.89	-	-	13.77	106.7	106.7	82.4	26	353	0.331	
Chimera Investment	CIM	13.03	16.35	11.39	-	-	-	-	-	-	17.06	5.17	-4.47	-4.47	-7.26	10.17	4.48	14.74	2,462.9	2,462.9	81.0	1,546	19,153	0.778	
CYS Investments	CYS	7.84	9.22	6.26	1.02	0.90	7.65	8.69	-11.93	-	-	13.79	9.96	9.96	-1.27	0.33	6.47	13.27	1,213.7	1,213.7	90.6	1,882	13,751	1.133	
Dynex Capital	DX	6.35	8.50	5.50	-	-	-	-	-	-	22.49	5.83	0.00	0.00	-12.99	-5.30	1.87	15.12	312.2	312.2	89.9	225	1,343	0.430	
Ellington Residential Mortgage REIT	EARN	12.08	16.85	10.13	2.05	1.89	5.88	6.39	-7.89	-	-	5.41	-2.19	-2.19	-14.76	-	-	14.90	110.3	110.3	92.1	26	294	0.267	
Five Oaks Investment Corp	OAKS	4.82	11.04	3.96	-	-	-	-	-	-	26.18	5.00	-9.28	-9.28	-48.58	-	-	14.94	70.9	70.9	96.2	52	234	0.330	
Great Ajax	AJX	9.94	14.83	9.16	-	-	-	-	-	-	5.79	-9.80	-17.99	-17.99	-25.95	-	-	6.44	157.8	164.0	64.8	23	241	0.153	
Hatteras Financial	HTS	13.75	18.82	11.15	-	-	-	-	-	-	77.89	12.15	4.56	4.56	-15.70	-10.39	-3.39	13.09	1,328.5	1,328.5	90.3	1,491	19,042	1.433	
Invesco Mortgage Capital	IVR	11.31	16.14	9.81	-	-	-	-	-	-	20.98	-0.09	-8.72	-8.72	-20.27	-7.99	-0.77	14.15	1,351.0	1,367.2	90.3	1,327	14,245	1.054	
JAVELIN Mortgage Investment	JMI	5.98	8.61	5.17	-	-	-	-	-	-	11.80	-1.02	-1.64	-1.64	-21.59	-20.84	-	18.06	71.8	71.8	91.2	52	296	0.413	
MFA Financial	MFA	6.81	8.19	5.78	0.65	0.65	10.44	10.54	-0.93	-	20.43	7.24	3.18	3.18	-4.66	4.82	9.13	11.75	2,522.2	2,522.2	79.9	2,719	17,735	0.703	
New Residential Investment Corp.	NRZ	11.71	17.78	9.86	1.97	1.96	5.96	5.98	-0.41	-	11.13	2.81	-3.70	-3.70	-12.24	-	-	15.71	2,698.2	2,698.2	78.9	2,343	25,344	0.939	
New York Mortgage Trust	NYMT	4.18	8.11	3.98	0.77	0.81	5.45	5.13	6.23	-	-	-13.64	-21.58	-21.58	-38.68	-2.66	3.97	22.97	457.2	457.2	92.9	932	4,325	0.946	
Orchid Island Capital	ORC	9.62	14.22	7.77	-	-	-	-	-	-	-	9.93	-0.12	-0.12	-17.62	2.23	-	17.46	209.4	209.4	90.3	189	1,745	0.833	
PennyMac Mortgage Investment Trust	PMT	13.16	21.76	11.21	-	-	-	-	-	-	20.61	-2.88	-13.76	-13.76	-30.57	-10.27	3.83	14.29	970.8	970.8	78.4	1,307	15,919	1.640	
Redwood Trust	RWT	11.89	18.83	9.36	-	-	-	-	-	-	-	10.40	-9.92	-9.92	-33.05	-10.85	0.41	9.42	976.5	976.5	80.9	744	7,809	0.800	
Two Harbors Investment	TWO	7.75	10.97	7.07	-	-	-	-	-	-	15.63	1.97	-4.32	-4.32	-17.14	-3.66	7.37	13.42	2,830.7	2,830.7	77.0	3,614	27,182	0.960	
Western Asset Mortgage Capital	WMC	10.81	15.59	8.83	-	-	-	-	-	-	-	10.19	5.77	5.77	-12.96	-0.79	-	21.46	451.0	451.0	83.2	417	4,218	0.935	
ZAIS Financial Corp	ZFC	14.05	18.20	12.72	-	-	-	-	-	-	9.49	3.08	-6.83	-6.83	-12.71	-1.30	-	11.39	112.0	125.0	81.6	29	396	0.353	
AVERAGE		**10.70**	**15.19**	**9.18**	**1.14**	**1.17**	**16.01**	**8.39**	**51.12**	**-**	**25.97**	**4.39**	**-2.42**	**-2.42**	**-16.72**	**-5.03**	**2.86**	**13.99**	**1,373.5**	**1,374.7**	**85.2**	**1,335**	**14,143**	**0.882**	
Commercial Financing																									
Apollo Commercial Real Estate Finance	ARI	15.45	17.95	15.13	1.99	2.10	7.76	7.36	5.53	-	6.66	-2.83	-10.33	-10.33	0.42	6.50	8.49	11.91	902.7	902.7	58.5	771	12,285	1.361	
Arbor Realty Trust	ABR	6.80	7.29	6.04	0.63	0.55	10.79	12.36	-12.70	62.50	12.11	3.98	-4.90	-4.90	1.48	2.57	4.80	8.82	346.5	346.5	78.8	106	670	0.193	
Ares Commercial Real Estate	ACRE	9.75	13.08	9.02	-	-	-	-	-	-	12.42	-8.54	-14.77	-14.77	-11.52	-10.07	-	10.26	277.6	277.6	71.9	133	1,306	0.470	
Blackstone Mortgage Trust	BXMT	24.74	31.54	22.66	-	-	-	-	-	-	22.58	-0.16	-7.55	-7.55	-7.11	9.34	17.06	10.02	2,306.5	2,306.5	72.6	552	13,300	0.577	
Colony Capital	CLNY	16.40	26.78	15.17	2.12	2.20	7.74	7.46	3.78	59.68	4.99	-4.82	-15.81	-15.81	-30.28	-3.29	2.03	9.76	1,831.9	2,188.6	61.6	1,151	18,739	1.023	
Hannon Armstrong Sustainable Infrastructure C	HASI	17.61	21.32	16.36	-	-	-	-	-	-	-	-1.89	-6.92	-6.92	12.15	-	-	6.81	673.9	678.9	61.7	172	3,023	0.449	
iStar Inc.	STAR	8.46	14.77	7.64	-	-	-	-	-	-	20.42	-18.97	-27.88	-27.88	-36.15	-5.39	-3.27	0.00	722.3	722.3	80.0	1,140	10,042	1.390	B+
Jernigan Capital	JCAP	14.95	21.69	13.28	1.34	1.59	11.16	9.40	18.66	-	-	1.36	0.00	0.00	-	-	-	7.02	78.6	78.6	0.0	24	355	0.451	
Ladder Capital	LADR	10.34	18.92	9.60	-	-	-	-	-	-	9.33	-6.00	-16.75	-16.75	-34.33	-	-	7.50	630.2	630.2	-	270	2,927	0.464	
Newcastle Invt Corp	NCT	3.52	5.44	2.90	-	-	-	-	-	-	7.10	-1.12	-13.73	-13.73	-18.85	-0.18	9.93	13.64	233.7	233.7	77.1	252	851	0.364	
Owens Realty Mortgage Inc	ORM	15.17	15.40	12.98	-	-	-	-	-	29.17	0.61	10.33	12.96	12.96	24.95	-	-	2.11	156.6	156.6	25.3	19	270	0.172	
RAIT Financial Trust	RAS	2.62	7.27	1.90	0.84	0.58	3.12	4.54	-31.25	120.00	9.36	2.34	0.28	0.28	-59.85	-21.62	-17.71	13.74	238.1	238.1	88.2	903	2,064	0.867	
Resource Capital	RSO	11.09	19.12	9.32	1.53	1.62	7.26	6.85	6.06	-	-	6.43	-13.09	-13.09	-35.38	-14.25	-4.71	15.15	351.7	351.7	83.5	207	2,120	0.603	
Starwood Property Trust Inc.	STWD	17.54	24.67	16.93	-	-	-	-	-	-	7.19	-7.88	-14.69	-14.69	-21.49	-0.31	7.06	10.95	4,145.2	4,145.2	52.8	2,412	43,199	1.042	BB
AVERAGE		**12.46**	**17.52**	**11.35**	**1.41**	**1.44**	**7.97**	**7.99**	**-1.66**	**67.84**	**10.25**	**-1.98**	**-9.51**	**-9.51**	**-16.61**	**-3.67**	**2.63**	**9.12**	**921.1**	**947.0**	**62.5**	**579**	**7,939**	**0.673**	

REIT Payout Ratios:
Dividends as a Percent of FFO

1994: Q1 - 2015: Q3



Source: NAREIT®, SNL Financial.

FTSE NAREIT All REITs
Summary of Dividends and FFO by Property Sector
September 30, 2015

			2015: Q3			2015: YTD		
Sector	Number of Companies	Implied Market Cap ($M)	Total Dividends ($M)	Funds From Operations ($M)	Payout Ratio (%)	Total Dividends ($M)	Funds From Operations ($M)	Payout Ratio (%)
Industrial/Office	40	143,708	1,630	2,600	62.7	5,272	6,862	76.8
Office	24	94,134	933	1,655	56.4	3,476	4,410	78.8
Industrial	8	31,551	448	592	75.8	1,085	1,492	72.7
Mixed	8	18,024	249	354	70.3	710	960	74.0
Retail	34	205,373	2,079	3,196	65.0	6,161	9,078	67.9
Shopping Centers	19	65,313	685	1,057	64.8	2,123	2,943	72.1
Regional Malls	8	116,071	1,062	1,729	61.4	3,086	4,965	62.2
Free Standing	7	23,989	332	410	80.9	952	1,171	81.4
Residential	20	117,352	967	1,485	65.1	2,833	4,360	65.0
Apartments	17	107,854	882	1,355	65.1	2,587	4,007	64.6
Manufactured Homes	3	9,499	85	130	65.2	246	353	69.8
Diversified	34	113,513	1,432	1,814	78.9	4,371	5,490	79.6
Lodging/Resorts	21	44,166	625	1,145	54.5	1,902	3,245	58.6
Health Care	17	90,486	2,586	1,532	168.8	5,074	4,092	124.0
Self Storage	5	55,588	505	613	82.5	1,429	1,679	85.1
Timber	5	25,135	298	-	-	869	-	-
Infrastructure	6	67,972	588	858	68.6	1,568	2,534	61.9
Equity REITs	184	863,294	10,710	13,243	80.9	29,480	37,354	78.9
Commercial Financing	13	14,769	333	-	-	925	-	-
Home Financing	28	40,510	1,418	-	-	4,161	-	-
Mortgage REITs	41	55,279	1,751	-	-	5,086	-	-

Notes:
[1]Implied market cap is the sum of Operating Partnership units plus common shares outstanding, multiplied by share price.
Source: NAREIT®, SNL Financial.

NAREIT® REITWatch
National Association of Real Estate Investment Trusts®

U.S. Public REIT Industry Balance Sheet
Stock Exchange-Listed and Non-Listed REITs

(Based on financial reports as of December 31, 2013)

	Stock Exchange-Listed		Non-Listed		Industry Total	Listed	Non-Listed
	Equity	Mortgage	Equity	Mortgage		(Percent of total)	
Number of Firms	172	48	69	20	309	71.2	28.8
	(Billions of dollars)					(Percent of total)	
Total Assets	732	477	73	4	1,286	94.0	6.0
Total Liabilities plus Mezzanine	412	413	34	2	861	95.8	4.2
Total Shareholder Equity	320	64	39	2	425	90.4	9.6
Total Liabilities plus Shareholder Equity	732	477	73	4	1,286	94.0	6.0
As of June 30, 2014							
Estimated Gross Asset Value	1,099	477	105	4	1,685[1]	93.5	6.5
Equity Market Capitalization	743	71	-	-	814	100.0	-

Source: SNL Financial, NAREIT.
[1]Does not include assets of private REITs or non-consolidated joint ventures.

NAREIT®
REITWatch
National Association of Real Estate Investment Trusts®

Summary of Financial Leverage by Property Sector
2015: Q3

(Publicly Traded Real Estate Investment Trusts)

Sector	Number of Companies	Implied Market Capitalization	Debt Ratio	Interest Coverage	Fixed Charge Coverage
Industrial/Office	40	134,477,233	40.8	3.90	3.64
Office	24	84,843,159	42.1	3.54	3.36
Industrial	8	30,843,460	36.7	5.25	4.96
Mixed	8	18,790,614	41.1	4.21	3.65
Retail	34	192,535,834	36.5	4.10	3.77
Shopping Centers	19	63,690,003	37.1	4.04	3.55
Regional Malls	8	103,135,857	36.1	4.25	4.04
Free Standing	7	25,709,973	36.7	3.72	3.40
Residential	20	117,219,316	30.3	5.17	4.94
Apartments	17	108,438,370	29.7	5.43	5.25
Manufactured Homes	3	8,780,946	36.5	3.29	2.87
Diversified	34	106,530,519	43.1	3.47	3.10
Lodging/Resorts	21	47,940,173	37.7	5.71	4.97
Health Care	17	88,969,030	38.5	4.30	4.14
Self Storage	5	54,240,931	10.3	13.97	6.11
Timber	5	25,417,006	28.6	3.44	3.20
Infrastructure	6	67,596,315	33.2	3.98	3.57
Equity Totals	182	834,926,357	36.0	4.26	3.87
Commercial Financing	13	14,166,865	68.4	2.54	2.18
Home Financing	28	40,928,259	86.9	3.27	3.06
Mortgage Totals	41	55,095,124	84.6	3.12	2.86
Industry Totals	223	890,021,481	46.4	4.02	3.66

Notes:

[1] Implied market capitalization is the sum of Operating Partnership units plus common shares outstanding, multiplied by share price; data presented in thousands of dollars.

Source: NAREIT®, SNL Financial.

FTSE EPRA/NAREIT Global Real Estate Index Series

Developed Markets

(Percent change, as of February 29, 2016)

(All values based in US dollars)

	Global			North America			Asia			Europe		
	Return Components		Dividend	Return Components		Dividend	Return Components		Dividend	Return Components		Dividend
Period	Total	Price	Yield	Total	Price	Yield	Total	Price	Yield	Total	Price	Yield
Annual (including current year to date)												
2007	-6.96	-9.98	3.74	-14.92	-18.25	4.84	14.80	11.67	2.84	-24.50	-26.63	3.60
2008	-47.72	-50.21	6.86	-40.63	-43.88	7.79	-52.48	-54.43	5.72	-51.13	-53.30	7.15
2009	38.26	31.75	3.92	32.22	25.18	3.83	43.43	37.82	3.76	40.45	33.00	4.48
2010	20.40	15.88	3.66	28.65	23.63	3.70	17.21	13.23	3.42	9.23	4.41	4.16
2011	-5.82	-9.40	4.20	8.19	4.11	3.93	-19.61	-22.56	4.28	-12.34	-16.01	5.02
2012	28.65	23.79	3.62	18.14	13.82	3.79	45.52	40.35	3.14	30.70	24.51	4.29
2013	4.39	0.72	3.73	1.27	-2.56	4.18	4.37	1.21	3.01	16.21	11.64	3.87
2014	15.89	11.73	3.35	28.15	23.23	3.65	0.22	-2.97	2.84	10.41	6.49	3.22
2015	0.05	-3.41	3.60	1.81	-2.00	3.91	-7.25	-10.17	3.28	6.67	3.33	3.09
2016	-3.78	-4.17	3.76	-3.58	-4.02	4.10	-1.38	-1.86	3.32	-8.15	-8.26	3.32
Quarter (including current quarter to date)												
2015: Q1	4.17	3.37	3.17	4.35	3.47	3.45	2.68	2.04	2.79	6.13	5.29	2.86
Q2	-6.67	-7.62	3.57	-9.98	-10.83	4.01	-1.79	-2.66	2.98	-3.26	-4.67	3.15
Q3	-1.42	-2.25	3.63	1.56	0.54	4.03	-10.30	-10.95	3.22	3.80	3.26	3.03
Q4	4.40	3.48	3.60	6.71	5.64	3.91	2.54	1.58	3.28	0.09	-0.29	3.09
2016: Q1	-3.78	-4.17	3.76	-3.58	-4.02	4.10	-1.38	-1.86	3.32	-8.15	-8.26	3.32
Month												
2015: Sep	1.24	0.84	3.63	2.92	2.34	4.03	-1.30	-1.56	3.22	-0.16	-0.24	3.03
Oct	5.73	5.56	3.46	5.73	5.55	3.83	5.06	4.91	3.10	6.77	6.62	2.87
Nov	-2.17	-2.44	3.55	-0.49	-0.78	3.88	-3.35	-3.68	3.23	-5.60	-5.72	2.97
Dec	0.93	0.48	3.60	1.43	0.87	3.91	0.98	0.53	3.28	-0.71	-0.81	3.09
2016: Jan	-4.25	-4.39	3.75	-3.40	-3.56	4.06	-5.24	-5.35	3.44	-5.57	-5.64	3.22
Feb	0.49	0.23	3.76	-0.19	-0.47	4.10	4.07	3.68	3.32	-2.74	-2.77	3.32
Historical (compound annual rates at month-end)												
1-Year	-7.75	-10.99		-4.53	-8.17		-11.89	-14.75		-11.66	-14.34	
3-Year	3.88	0.22		6.92	2.87		-3.19	-6.23		8.37	4.53	
5-Year	6.24	2.38		8.56	4.49		2.48	-0.94		6.14	1.99	
10-Year	4.08	0.12		5.76	1.40		2.82	-0.67		1.76	-2.21	
15-Year	8.82	4.41		10.55	5.55		6.52	2.81		8.94	4.77	
20-Year	7.95	3.45		10.84	5.25		5.24	1.66		8.44	4.34	

Source: FTSE™, EPRA®, NAREIT®.

Glossary of REITWatch terms:

REIT Name:	Full name of the company.
Ticker:	The company's stock exchange symbol.
Share Price ($):	The closing price per share on the date noted.
52-Week Share Price ($):	The high and low closing prices for the shares over the previous 52 weeks.
Price/FFO Multiples:	Price on the date indicated divided by the FactSet mean FFO estimate for the current and following year.
FFO per Share Estimates ($):	FactSet mean FFO estimate for the current and following year.
FFO Growth (%):	The percentage change between the current and following year mean FFO estimate as reported by FactSet.
Debt/EBITDA Multiples	Average Total Debt over the prior 2 quarters divided by the the most recent quarter's annualized EBITDA.
FFO Payout (%):	Regular cash dividends paid on the company's primary issue of common stock as a percent of funds from operations, on a per-share basis.
Dividend Yield (%):	The current indicated dividend rate annualized and divided by the current stock price.
Dividend Spread (%):	The difference between the REIT dividend yield and the 10-year constant maturity treasury yield.
Total Returns (%):	Total returns are calculated by taking the closing price for the current period, adding any dividends with an ex-dividend date in that period then subtracting the closing price for the previous period and dividing the result by the closing price of the prior period.
Month:	The monthly total return as calculated at month-end.
Year to Date:	The total return for the calendar year through the latest month-end.
One Year:	The total return for the previous year.
Two Year:	The annualized total return for the previous 2 years.
Three Year:	The annualized total return for the previous 3 years.
Five Year:	The annualized total return for the previous 5 years.
Equity Market Capitalization ($ Millions):	Price on the date indicated times the number of common shares outstanding.
Implied Market Capitalization ($ Millions):	Price on the date indicated times the number of shares outstanding including Operating Partnership Units.
Debt Ratio (%):	A leverage ratio calculated by taking the REIT's total debt and dividing it by the total market capitalization. Total capitalization is the sum of implied market capitalization and total debt.
Long-Term Issuer Rating:	The long-term credit rating, as announced by Standard & Poors, and obtained from SNL Financial.
Average Share Volume:	The average number of shares traded daily over the past month, represented in thousands.
Average Daily Dollar Volume:	The average of the daily value of shares traded over the past month, represented in thousands. Daily value is computed by multiplying shares traded by the closing price on that date.
Relative Liquidity (%):	Average daily dollar volume divided by equity market capitalization.

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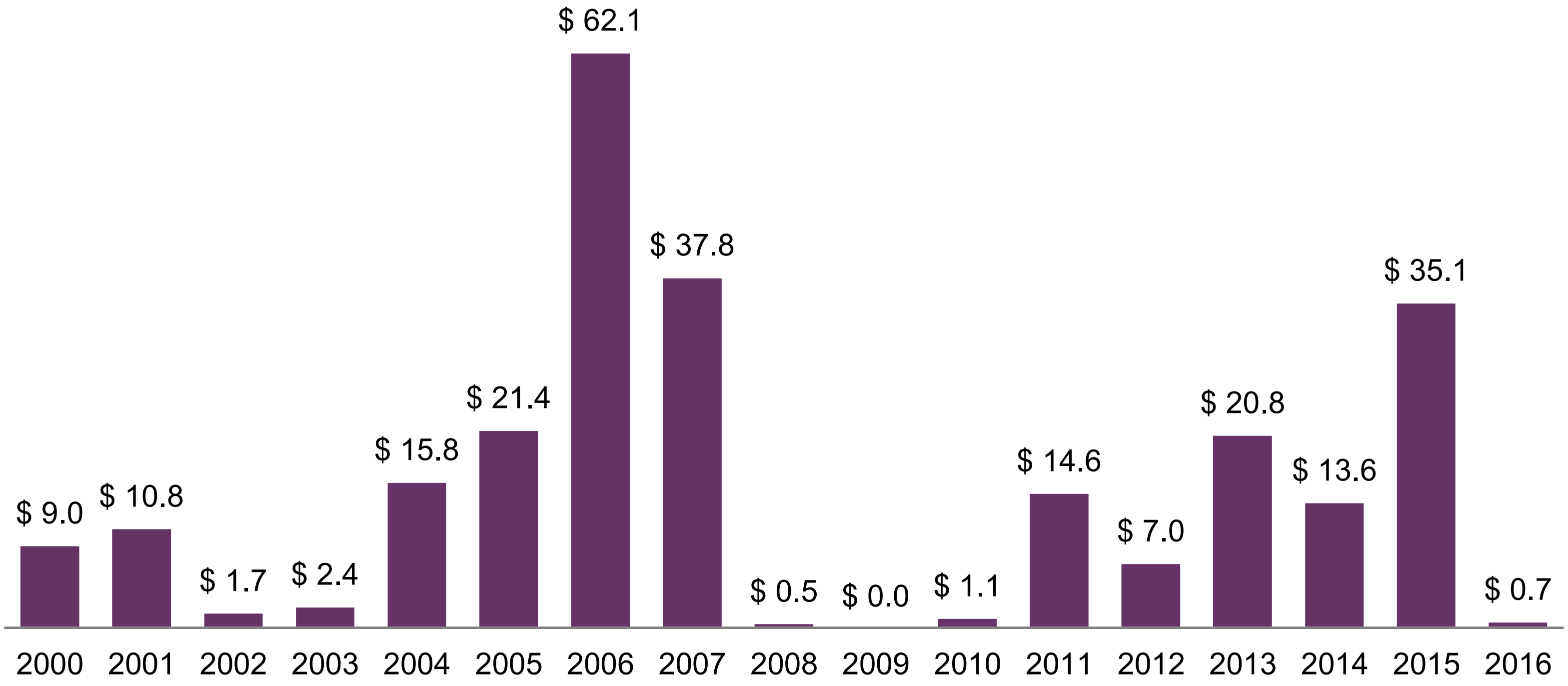
March 30 - April 1

2016

REIT M&A Overview

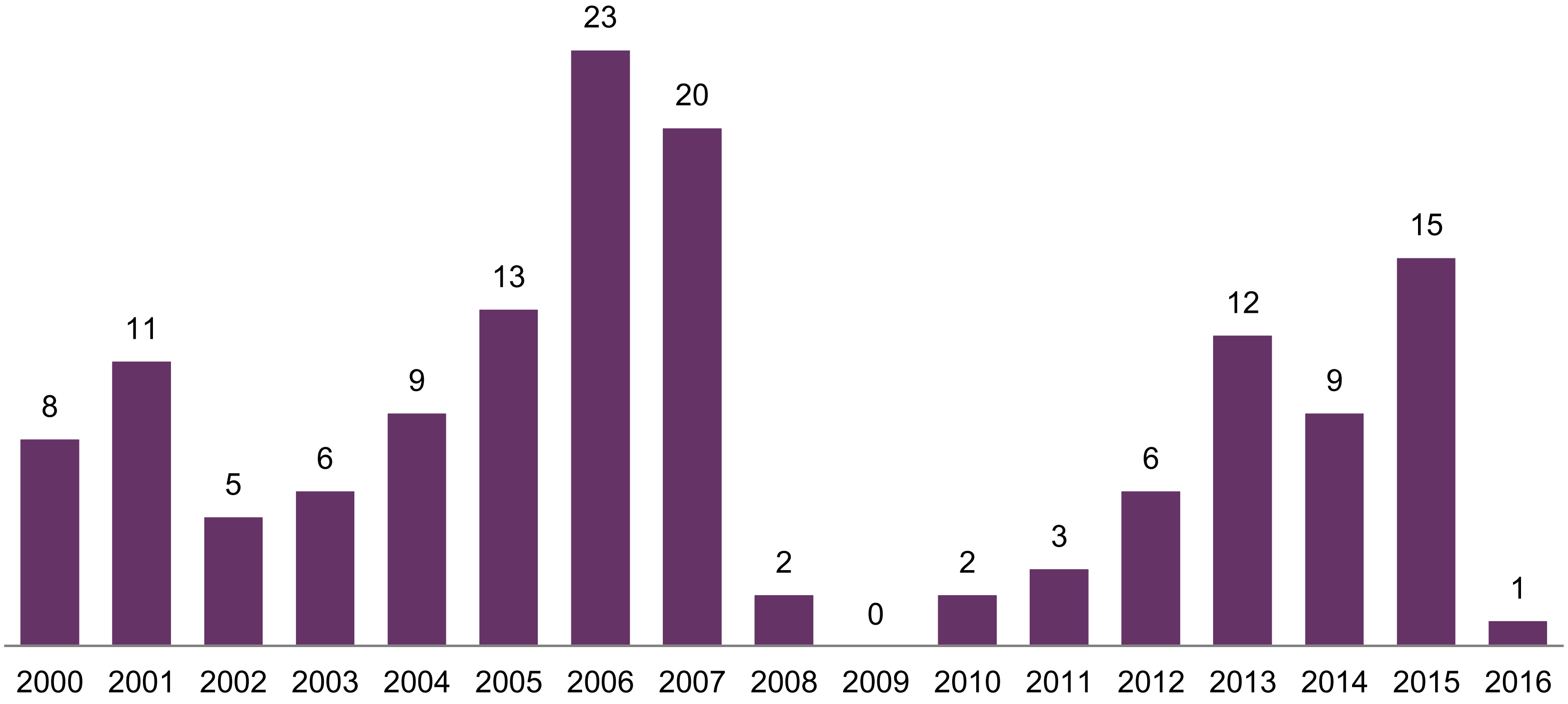
March 30-April 1, 2016

Deal Volume for REIT M&A Transactions Since 2000



Source: SNL Financial, a product of S&P Global Market Intelligence.
Note: Deal Value represents SNL Financial's calculation of the equity value of the deal as available.

Number of REIT M&A Transactions Since 2000



Source: SNL Financial, a product of S&P Global Market Intelligence.

REIT M&A Transactions Since 2015

Announcement Date	Buyer	Target	Deal Value
2/25/2016	Brookfield Asset Management Inc.	Rouse Properties, Inc.	$ 717
12/14/2015	DRA Advisors LLC	Inland Real Estate Corporation	$ 1,067
12/3/2015	American Homes 4 Rent	American Residential Properties, Inc.	$ 635
11/8/2015	Weyerhaeuser Company	Plum Creek Timber Company, Inc.	$ 8,777
10/22/2015	Investor group	Landmark Apartment Trust, Inc.	$ 559
10/16/2015	Harrison Street Real Estate Capital, LLC	Campus Crest Communities, Inc.	$ 545
10/8/2015	Blackstone Group L.P.	BioMed Realty Trust, Inc.	$ 4,955
9/21/2015	Colony American Homes, Inc.	Starwood Waypoint Residential Trust	$ 1,622
9/8/2015	Blackstone Group L.P.	Strategic Hotels & Resorts, Inc.	$ 4,070
7/29/2015	Global Logistic Properties Limited	Industrial Income Trust Inc.	$ 2,383
7/1/2015	Chambers Street Properties	Gramercy Property Trust Inc.	$ 1,489
6/22/2015	Lone Star Investment Advisors, LLC	Home Properties, Inc.	$ 5,156
6/15/2015	Extra Space Storage Inc.	SmartStop Self Storage, Inc.	$ 855
5/11/2015	Independence Realty Trust, Inc	Trade Street Residential, Inc.	$ 287
4/22/2015	Brookfield Asset Management Inc.	Associated Estates Realty Corporation	$ 1,690
4/10/2015	Blackstone Group L.P.	Excel Trust, Inc.	$ 1,021

Source: SNL Financial, a product of S&P Global Market Intelligence.
Note: Deal Value represents SNL Financial’s calculation of the equity value of the deal as available.

T-Tracker: NAREIT Total REIT Industry Tracker Series

Fourth Quarter 2015 Results

Funds From Operations (FFO) for All Listed U.S. Equity REITs

Millions of dollars	Annual 2012	2013	2014	2015	2014:Q4	2015:Q1	2015:Q2	2015:Q3	2015:Q4
Office	4,192	5,206	5,340	5,897	1,354	1,389	1,327	1,670	1,511
Industrial	1,630	2,138	2,400	2,871	633	674	651	830	716
Retail	7,694	9,415	11,041	12,346	3,039	2,744	3,137	3,196	3,268
Shopping Centers	2,436	2,913	3,539	3,977	867	863	1,023	1,057	1,035
Regional Malls	4,738	5,595	6,332	6,790	1,823	1,519	1,717	1,729	1,826
Free Standing	520	907	1,170	1,578	349	363	398	410	408
Residential	3,613	3,995	5,008	6,128	1,372	1,440	1,565	1,541	1,582
Apartments	3,302	3,642	4,530	5,428	1,236	1,277	1,375	1,355	1,421
Manufactured Homes	312	319	395	467	90	101	122	130	114
Single Family Homes	-	34	84	233	46	62	68	57	46
Diversified	1,598	1,287	2,342	3,081	498	785	840	795	662
Lodging/Resorts	2,157	2,943	3,701	4,278	954	831	1,269	1,145	1,033
Self Storage	1,717	1,768	1,985	2,269	532	503	564	613	589
Health Care	3,960	4,751	5,343	4,971	1,377	1,017	1,542	1,532	880
Timber	74	100	125	15	29	15	-	-	-
Infrastructure	1,898	2,121	2,982	3,602	768	749	927	858	1,068
Data Centers	817	1,411	1,340	1,892	73	526	477	484	406
Specialty	513	1,093	2,241	1,984	520	431	527	516	510
All Listed Equity REITs	29,864	36,229	43,849	49,333	11,148	11,102	12,826	13,180	12,225
Percent change Q/Q					-4.2	-0.4	15.5	2.8	-7.2
Percent change over year ago	10.3	21.3	21.0	12.5	15.1	10.7	16.2	13.3	9.7
FFO per share	1.923	1.996	2.073	2.179	0.527	0.508	0.575	0.585	0.540
Percent change, Q/Q, FFO per share					-7.3	-3.7	13.2	1.9	-7.8
Percent change over year ago, FFO per share	-1.5	3.8	3.9	5.1	-1.2	-3.1	4.7	2.9	2.4

Source: Company reports, SNL, NAREIT. For more information, visit: REIT.com/t-tracker

T-Tracker: NAREIT Total REIT Industry Tracker Series

Fourth Quarter 2015 Results

Net Operating Income (NOI) for All Listed U.S. Equity REITs

	Annual								
Millions of dollars	2012	2013	2014	2015	2014:Q4	2015:Q1	2015:Q2	2015:Q3	2015:Q4
Office	6,525	7,068	7,918	9,192	2,074	2,170	2,332	2,347	2,343
Industrial	3,372	3,288	3,462	3,910	898	900	958	1,013	1,038
Retail	11,966	13,506	15,465	16,788	4,099	4,049	4,118	4,214	4,407
Shopping Centers	3,881	4,374	5,521	6,102	1,427	1,493	1,521	1,535	1,553
Regional Malls	7,059	7,519	7,921	8,146	2,107	1,972	1,991	2,012	2,171
Free Standing	1,026	1,613	2,023	2,540	565	584	606	667	683
Residential	5,567	6,539	7,750	8,897	2,075	2,127	2,188	2,239	2,344
Apartments	5,010	5,838	6,739	7,492	1,803	1,793	1,850	1,861	1,988
Manufactured Homes	557	614	671	818	170	208	197	210	202
Single Family Homes	1	88	340	588	102	125	140	168	154
Diversified	2,689	3,394	4,808	5,489	1,288	1,315	1,394	1,400	1,381
Lodging/Resorts	4,202	4,587	5,433	6,431	1,323	1,348	1,868	1,664	1,551
Self Storage	1,878	2,143	2,459	2,897	662	648	709	753	787
Health Care	5,289	6,153	7,066	8,461	1,859	1,927	2,139	2,161	2,234
Timber	2,460	3,121	2,731	2,273	618	567	528	624	554
Infrastructure	3,850	4,501	5,324	6,487	1,343	1,466	1,585	1,682	1,755
Data Centers	1,180	2,433	3,165	3,560	822	830	861	898	972
Specialty	1,255	1,628	3,252	3,642	885	826	921	939	956
All Listed Equity REITs	50,234	58,359	68,833	78,027	17,946	18,173	19,600	19,932	20,323
Percent change Q/Q					2.2	1.3	7.9	1.7	2.0
Percent change over year ago	11.4	16.2	17.9	13.4	13.5	13.2	13.4	13.6	13.2
NOI per share	3.235	3.215	3.255	3.446	0.849	0.831	0.878	0.885	0.897
Percent change, Q/Q, NOI per share					-1.1	-2.1	5.6	0.8	1.4
Percent change over year ago, NOI per share	-0.5	-0.6	1.2	5.9	-2.6	-0.9	2.2	3.2	5.8

Source: Company reports, SNL, NAREIT. For more information, visit: REIT.com/t-tracker

T-Tracker: NAREIT Total REIT Industry Tracker Series

Fourth Quarter 2015 Results

Dividends Paid by All Listed U.S. Equity and Mortgage REITs

Millions of dollars	Annual 2012	2013	2014	2015	2014:Q4	2015:Q1	2015:Q2	2015:Q3	2015:Q4
Office	2,507	2,829	3,189	4,431	705	1,755	784	948	944
Industrial	1,430	1,633	2,135	2,213	580	483	482	616	631
Retail	5,247	6,049	8,752	8,331	2,321	2,029	2,054	2,079	2,170
Shopping Centers	1,953	2,062	2,613	2,824	666	736	701	685	701
Regional Malls	2,804	3,132	5,059	4,212	1374	991	1033	1062	1126
Free Standing	489	855	1,079	1,295	280	301	319	332	343
Residential	2,333	2,909	3,523	3,942	899	929	999	1,002	1,012
Apartments	2,132	2,702	3,163	3,479	797	822	883	882	892
Manufactured Homes	201	199	266	331	73	76	85	85	85
Single Family Homes	-	8	94	132	29	30	31	36	35
Diversified	2,211	2,163	3,288	2,739	820	661	640	651	788
Lodging/Resorts	1,408	1,531	2,008	2,589	564	661	617	625	687
Self Storage	1,371	1,404	1,622	1,965	422	428	496	505	536
Health Care	3,468	3,905	4,538	5,292	1,273	1,197	1,292	1,361	1,444
Timber	591	781	938	869	226	204	212	221	232
Infrastructure	363	448	1,108	2,192	440	477	503	588	624
Data Centers	477	632	891	1,578	180	435	329	337	477
Specialty	223	655	2,083	1,820	887	451	447	448	473
All Listed Equity REITs	21,628	24,939	34,075	37,962	9,317	9,709	8,854	9,382	10,017
Listed Mortgage REITs	7,211	8,074	7,027	6,901	1,943	1,634	1,701	1,751	1,815
All Listed REITs	28,840	33,013	41,102	44,862	11,261	11,343	10,555	11,133	11,832
Percent change Q/Q					14.8	0.7	-6.9	5.5	6.3
Percent change over year ago	25.9	14.5	24.5	9.1	29.7	18.9	0.6	13.5	5.1
Dividends per share	1.494	1.476	1.606	1.651	0.440	0.431	0.392	0.411	0.435
Percent change, Q/Q					11.6	-2.1	-9.0	4.8	6.0
Percent change over year ago	10.4	-1.2	8.8	2.8	13.3	5.8	-8.5	4.2	-1.0

Source: Company reports, SNL, NAREIT. For more information, visit: REIT.com/t-tracker

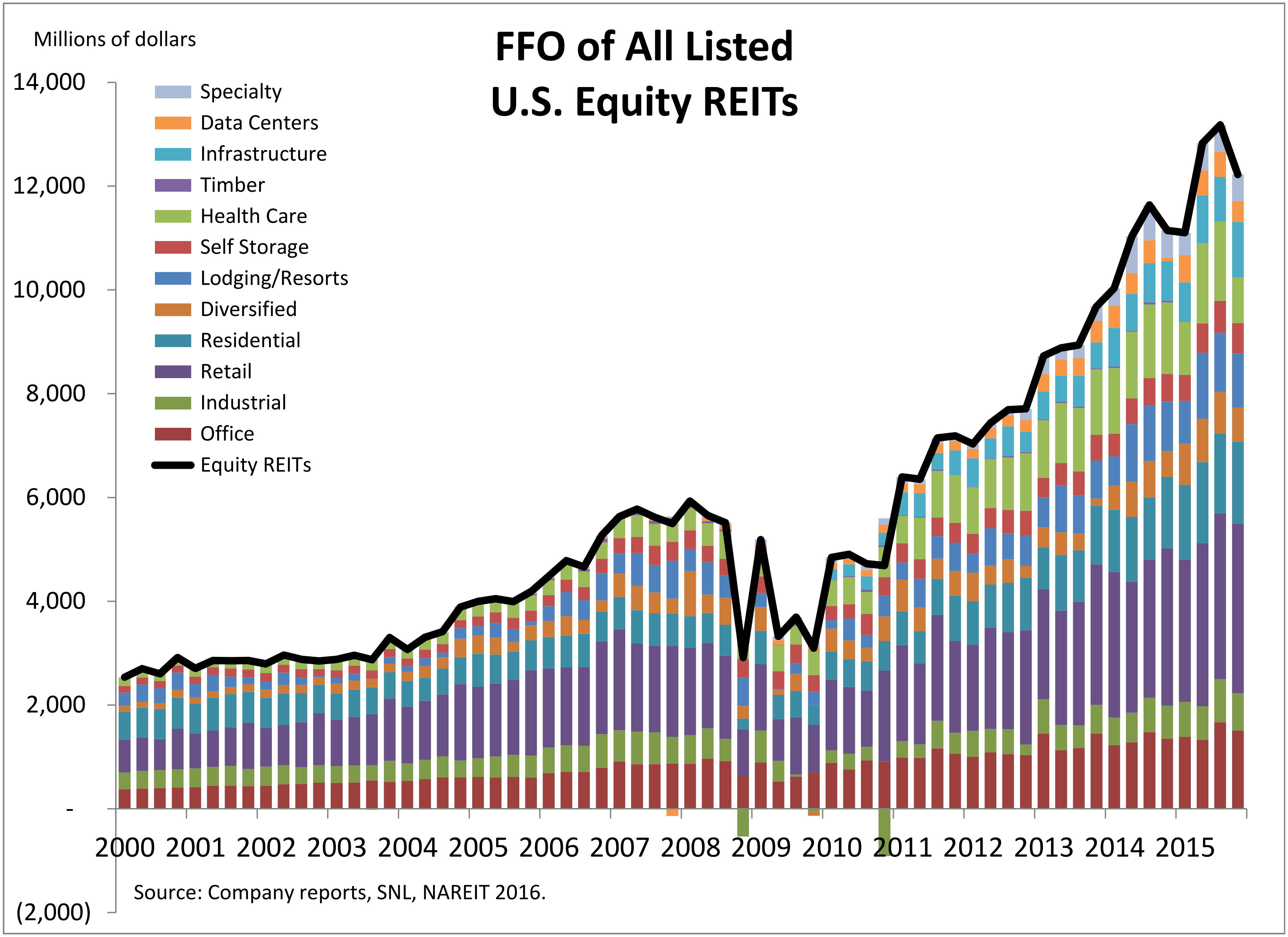
T-Tracker: NAREIT Total REIT Industry Tracker Series

Fourth Quarter 2015 Results

Same Store Net Operating Income (SS NOI) for All Listed U.S. Equity REITs

Percent change over year ago	2013.3	2013.4	2014.1	2014.2	2014.3	2014.4	2015.1	2015.2	2015.3	2015.4
Office	1.9	2.6	(0.1)	3.0	3.8	4.3	4.1	2.6	2.9	3.2
Industrial	2.1	2.5	2.6	3.9	3.8	4.0	4.2	4.6	3.6	3.4
Retail	4.2	4.4	3.2	4.3	4.3	3.6	3.4	3.3	3.8	3.6
Shopping Centers	3.5	3.5	3.1	3.4	3.3	3.4	3.3	3.4	3.1	3.0
Regional Malls	4.6	4.8	3.3	4.8	4.8	3.6	3.4	3.2	4.1	3.8
Free Standing	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Residential	4.8	4.4	4.2	4.6	5.5	5.6	5.9	6.3	6.5	6.7
Apartments	4.9	4.4	4.1	4.5	5.4	5.6	5.8	6.3	6.3	6.6
Manufactured Homes	3.8	4.8	5.0	5.5	6.4	5.2	7.4	6.8	7.0	6.8
Single Family Homes	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Diversified	1.8	2.5	1.7	(1.1)	3.0	2.5	0.2	3.0	2.2	3.4
Lodging/Resorts	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Self Storage	7.9	8.0	6.9	8.0	8.2	7.5	9.0	9.4	9.3	8.9
Health Care	3.4	3.5	3.7	3.6	3.4	3.5	3.1	1.7	2.2	1.5
Timber	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Infrastructure	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Data Centers	7.1	12.2	10.7	11.6	13.6	11.2	6.3	5.4	5.7	4.0
Specialty	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
All Listed Equity REITs	3.8	4.0	3.1	4.3	4.6	4.4	4.2	3.9	4.2	4.1

Source: Company reports, SNL, NAREIT. For more information, visit: REIT.com/t-tracker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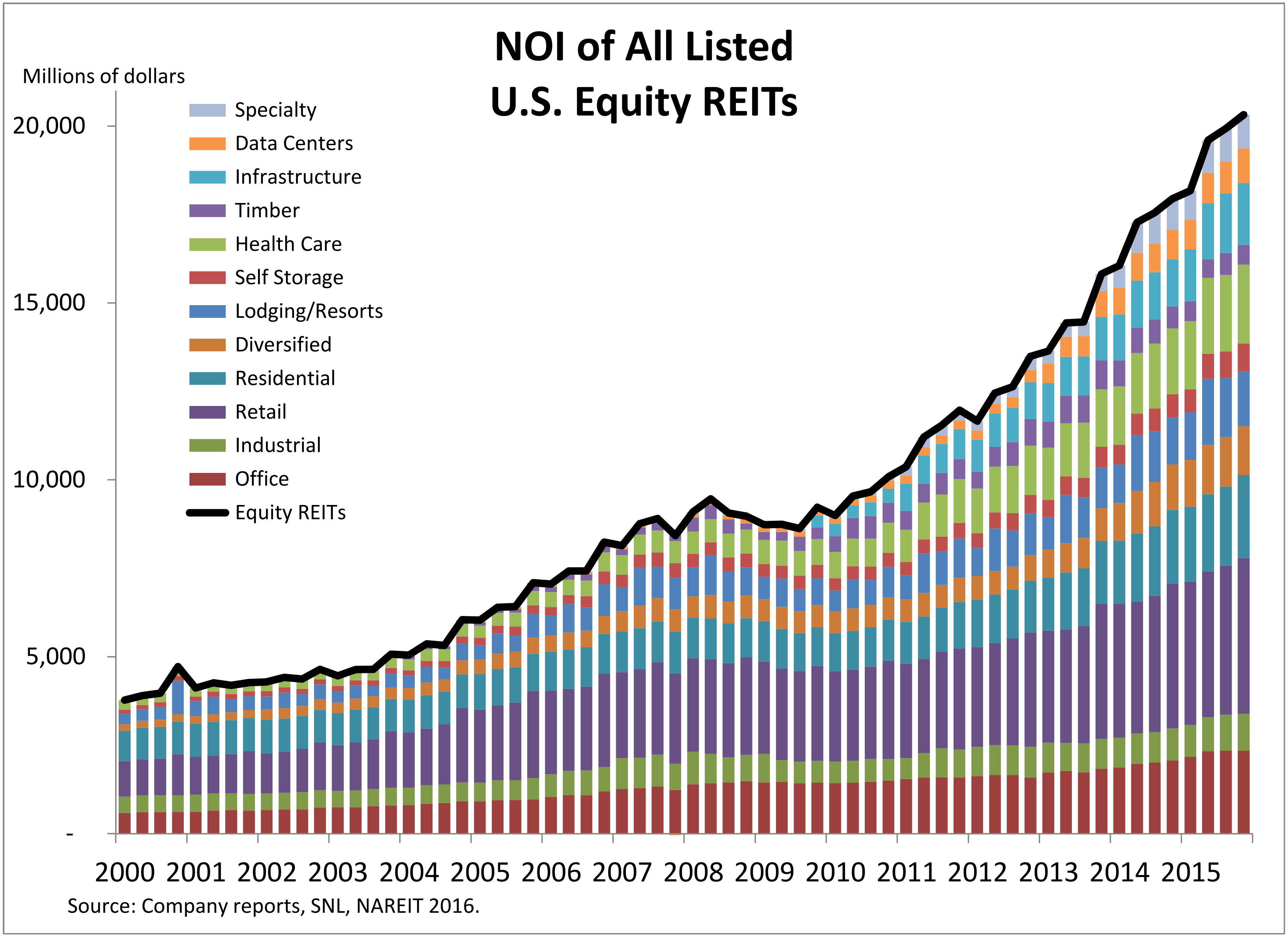
2000 2001 2002 2003 2004 2005 2006 2007 2008 2009 2010 2011 2012 2013 2014 2015
Source: Company reports, SNL, NAREIT 2016.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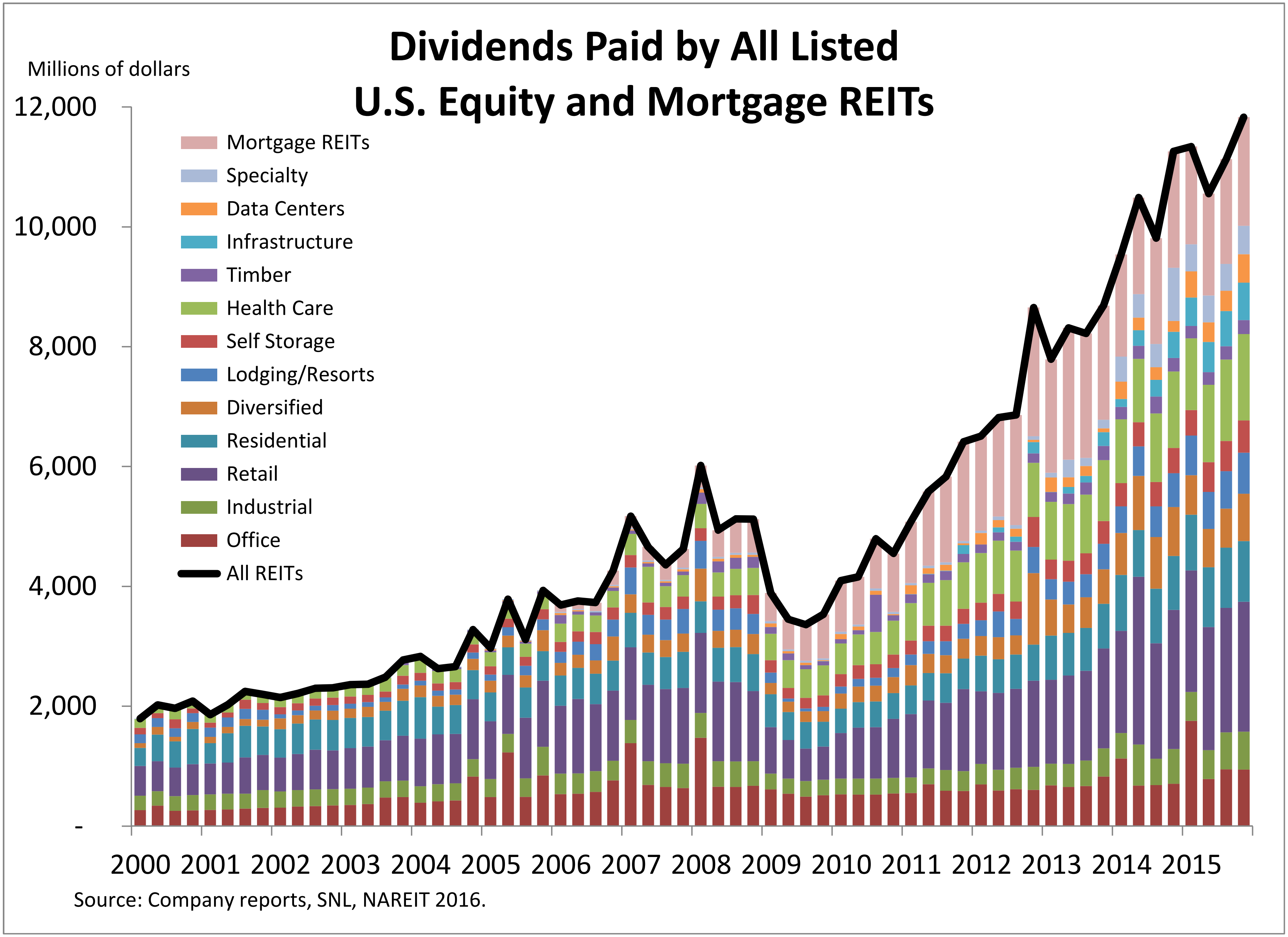
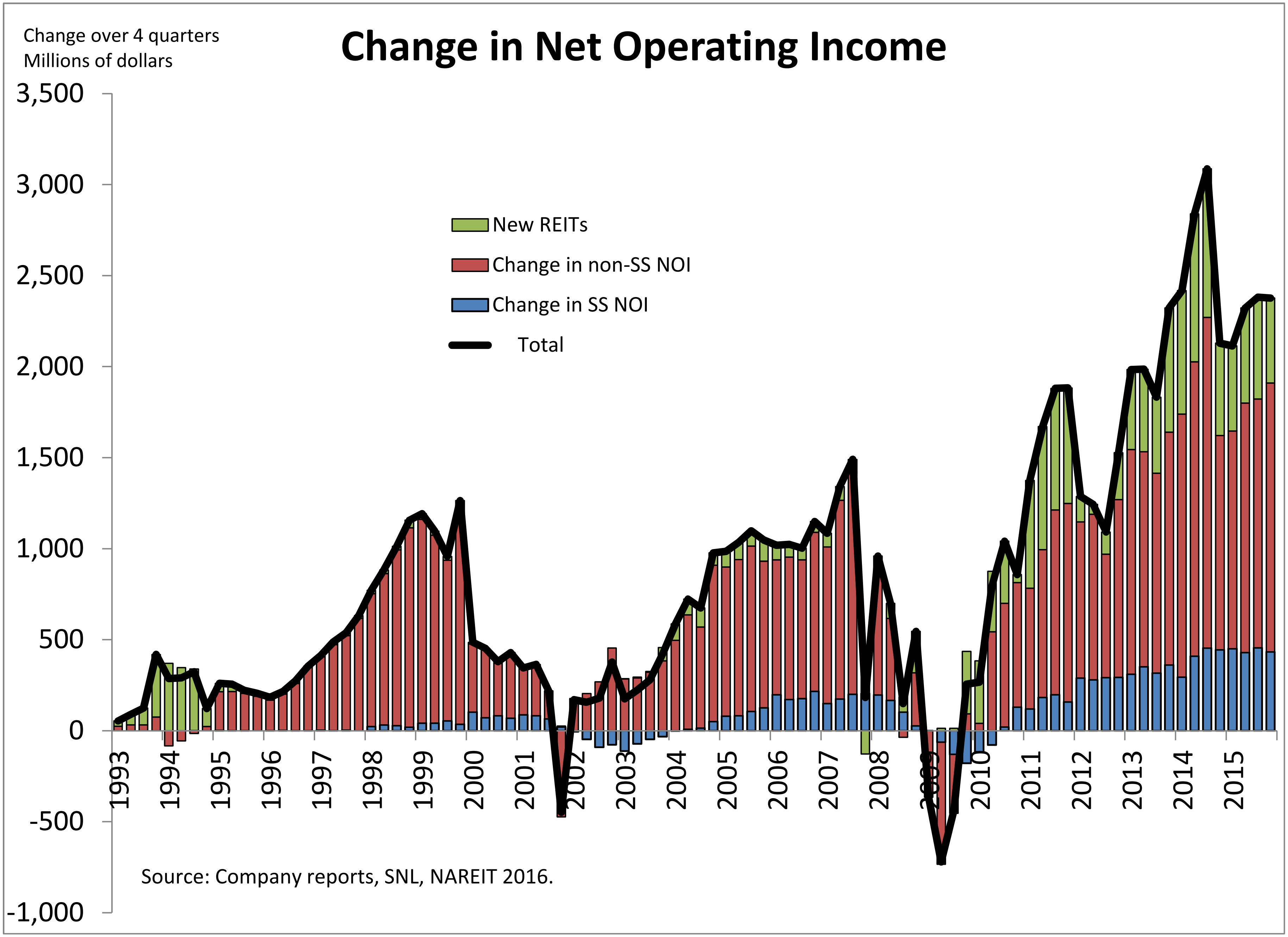
2015
Source: Company reports, SNL, NAREIT 2016.



Dividends Paid by All Listed
U.S. Equity and Mortgage REITs
Millions of dollars
12,000
10,000
8,000
6,000
4,000
2,000
-
Mortgage REITs
Specialty
Data Centers
Infrastructure
Timber
Health Care
Self Storage
Lodging/Resorts
Diversified
Residential
Retail
Industrial
Office
All REITs
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011
2012
2013
2014
2015
Source: Company reports, SNL, NAREIT 2016.



Change over 4 quarters
Millions of dollars
Change in Net Operating Income
3,500
3,000
2,500
2,000
1,500
1,000
500
0
-500
-1,000
New REITs
Change in non-SS NOI
Change in SS NOI
Total
1993
1994
1995
1996
1997
1998
1999
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011
2012
2013
2014
2015
Source: Company reports, SNL, NAREIT 2016.

Concurrent Session: Tax Reform Debate

Thursday, March 31st
11:15am – 12:30pm
Marriott Marquis, Washington DC

Moderator:
Cathy Barre, SVP-Policy & Politics, NAREIT

Panelists:
Kenneth Kies, Managing Director, The Federal Policy Group (former Chief of Staff, Joint Committee on Taxation)
Russell Sullivan, Partner, McGuire Woods (former Staff Director, Senate Finance Committee)

REIT Wise®

NAREIT's Law, Accounting & Finance Conference

March 30 - April 1

2016

Tax Reform Debate

March 31, 2016

Reality Check on the Federal Deficit

A Promising Start

“Congress passed a two-year bipartisan budget plan that avoids a default on U.S. debt… The 64-35 Senate vote early Oct. 30, following House passage two days earlier, sends President Barack Obama a bill that will extend U.S. borrowing authority until March 2017, after he leaves office.”

BNA
U.S. Avoids Debt Default as Congress Passes Fiscal Plan
October 30, 2015

A Promising Start

The Congressional Budget Office projects that the budget deal will cut the ten-year deficit by $79.9 billion.

A Surprising End

“In its final act of the year, the Senate sped to pass a $1.8 trillion bill that funds the government until October and extends sweeping tax breaks, many permanently.”

Huffington Post

Senate Passes $1.8 Trillion Spending, Tax Package To Fund Government

December 18, 2015

A Surprising End

The Congressional Budget Office projects that the year-end deal will increase the ten-year deficit by $679.5 billion.

Washington Ignores the Deficit Reality

Let me start with the economy, and a basic fact: The United States of America, right now, has the strongest, most durable economy in the world. We're in the middle of the longest streak of private sector job creation in history. More than 14 million new jobs, the strongest two years of job growth since the '90s, an unemployment rate cut in half. Our auto industry just had its best year ever. That's just part of a manufacturing surge that's created nearly 900,000 new jobs in the past six years. And we've done all this while cutting our deficits by almost three-quarters.

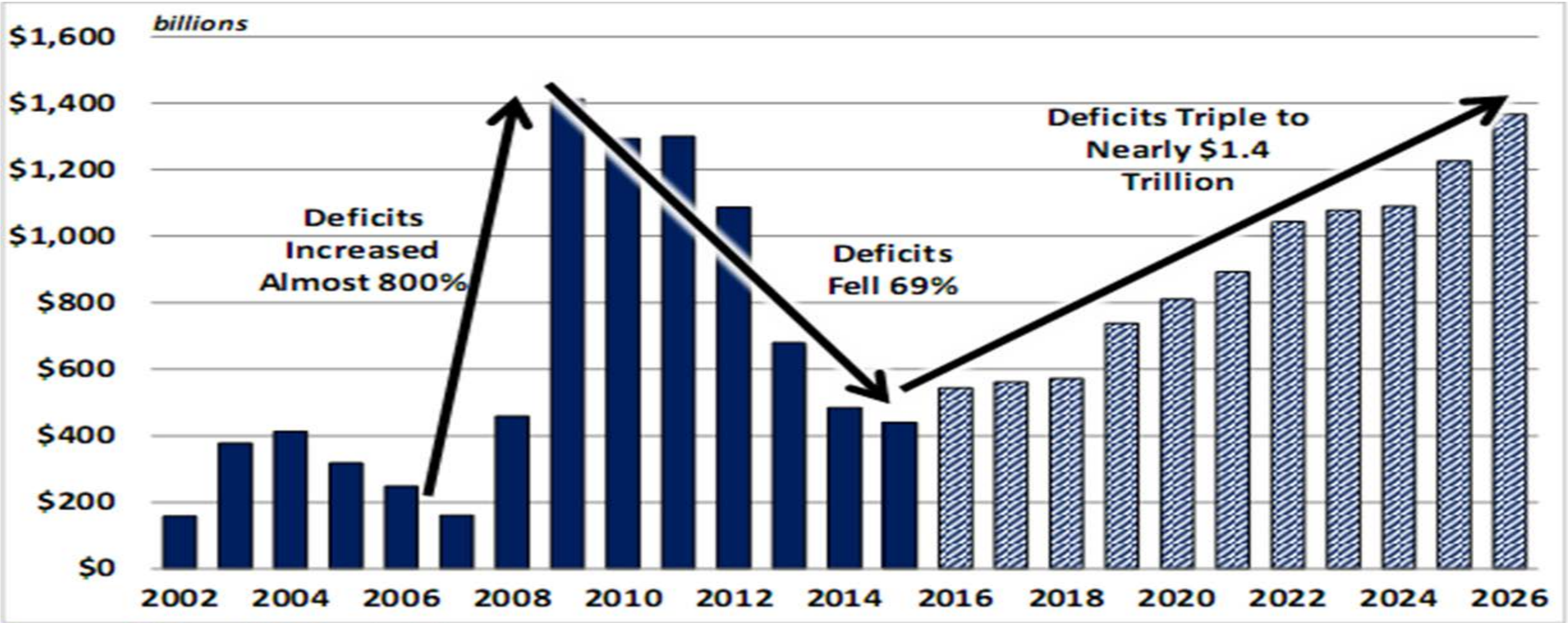
President Barack Obama
2016 State of the Union Address
January 12, 2016

Presidential Candidates are Equally Blind

“A fair summary of the debate over fiscal policy in the presidential campaign so far might go like this: Republicans spout apocalyptic but vague rhetoric about the federal debt, while proposing few if any specific spending cuts — and backing immense new tax cuts, skewed in favor of upper-income Americans. Democrats propose to expand existing entitlement programs and otherwise increase social spending, while treating deficits and the debt as yesterday’s problems, if at all.”

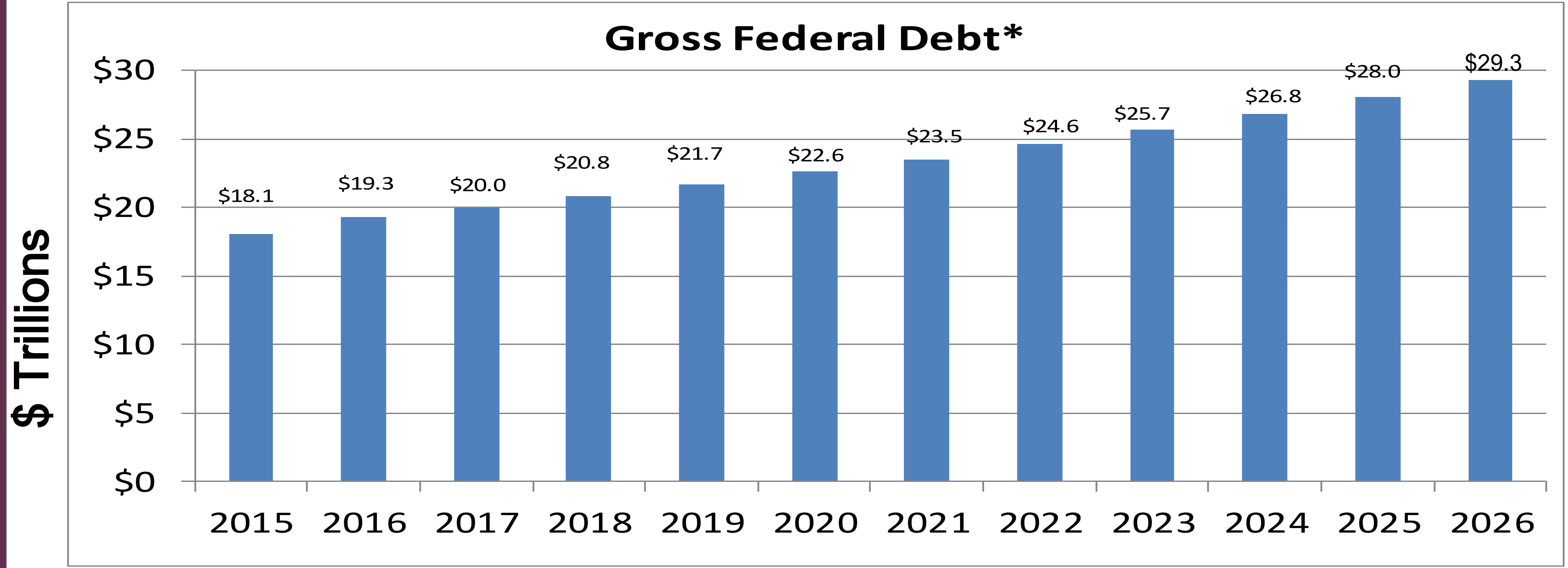
The Washington Post
The presidential candidates have one thing in common
— a disregard for our debt predicament
January 20, 2016

Trillion-Dollar Deficits Set to Return by 2022



Sources: CBO and CRFB calculations

Federal Debt Outlook: CBO



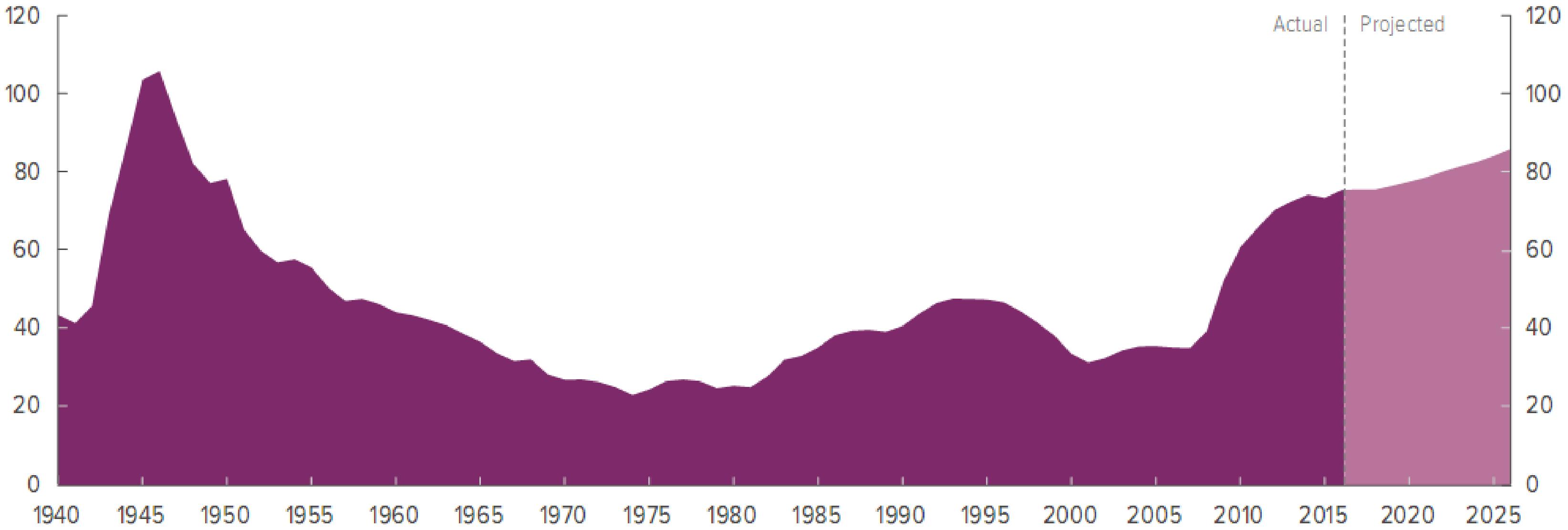
Source: CBO Baseline Budget Outlook, January, 2016

*Gross Federal Debt is Federal debt held by the public plus Treasury securities held by federal trust funds and other government accounts.

Trending Red

Federal Debt Held by the Public

Percentage of Gross Domestic Product



Source: Congressional Budget Office.

Congressional Budget Office:

83% of Total Increase in Outlays Comes from 3 Sources

Source	Percent of Total Increase From 2016 to 2026
Net Interest	**23%**
Social Security	**28%**
Major Health Programs	**32%**

Components of the Total Increase in Outlays in CBO’s Baseline Between 2016 and 2026, January, 2016

The Interest Expense Time Bomb

Percentage of Total Federal Spending that is Net Interest

	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026
Total Spending (in trillions)	**$3.6**	**$3.9**	**$4.0**	**$4.2**	**$4.4**	**$4.7**	**$4.9**	**$5.2**	**$5.4**	**$5.6**	**$6.0**	**$6.4**
Net Interest (in billions)	**$223**	**$255**	**$308**	**$369**	**$438**	**$498**	**$551**	**$607**	**$666**	**$719**	**$772**	**$830**
Percent	**6%**	**7%**	**8%**	**9%**	**10%**	**11%**	**11%**	**12%**	**12%**	**13%**	**13%**	**13%**

Percentage Rate of Ten Year Treasury Notes

	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026
Interest Rate	**2.1%**	**2.8%**	**3.5%**	**3.8%**	**4.0%**	**4.1%**	**4.1 %**	**4.1%**	**4.1%**	**4.1%**	**4.1%**	**4.1%**

Interest costs on federal debt are projected to grow rapidly: by 2022, they could exceed what the federal government has historically spent on R&D, infrastructure, and education combined, and could exceed them by more than three times by 2050

Source: CBO Updated Budget Projections: 2016– 2026: January, 2016

Putting the Debt in Perspective for Fiscal Year 2011

U.S. Tax Revenue:	$2,314,000,000,000
Federal Budget:	$3,597,000,000,000
New Debt:	$1,283,000,000,000
National Debt:	$14,698,625,550,307.37 (and counting)
Budget Cuts:	$38,500,000,000

Source: The Congressional Budget Office, Treasury Department's Bureau of Public Debt

Drop 8 Digits, the Debt becomes a Family Budget

Annual Family Income:	$23,140
Money Family Spent:	$35,970
New Credit Card Debt:	$12,830
Credit Card Balance:	$146,986.37 (and counting)
Budget Cuts:	$385

The Real Kicker

"A federal budget compromise that was hailed as historic for proposing to cut about $38 billion would reduce federal spending by only $352 million this fiscal year, less than one percent of the bill's advertised amount, according to the Congressional Budget Office."

- The Washington Post, April 14, 2011

Translation:

The Family Budget was cut by $3.85, not $385

Presidential Politics Commentary

Democratic Decline under President Obama

	2009	2015
Democratic Senate Seats	**60**	**46**
Democratic House Seats	**257**	**188**
Democratic Governors	**28**	**18**
Democratic State Legislative Chambers	**62**	**30**
States with Both Legislative Chambers Controlled by Democrats	**27**	**11**
Democrat State Seats Held	**4082**	**3163**
GOP State Seats Held	**3223**	**4111**

Notes:

- 2009 Senate totals as of June 2009, after Sen. Specter party switch and Sen. Frankin Seating
- Senate totals include Independents (Sens. Sanders and King) who caucus with Democrats
- House totals based on election results; total Democratic House seats varied in 111th Congress
- Nebraska's non-partisan legislature excluded from totals
- Source: National Conference of State Legislators

Democrats:

1. Clinton (67)
2. Other than Clinton, Sanders (73),

Republicans:

1. Donald Trump (69)
2. Ted Cruz (44)
3. Marco Rubio (44)
4. John Kasich (63)
5. Ben Carson (64)

Billionaires:

1. Michael Bloomberg (73)
2. Donald Trump (69)

"I'm not using donors because I'm really rich"

- Donald Trump, June 16, 2015

Tax Plans for the Presidential Candidates Still Alive

Marco Rubio Tax Reform Proposals

- Individual:
  - Three income tax brackets: 15%, 25%, and 35%
  - Eliminate itemized deductions, except charitable deduction and mortgage interest deduction
  - Cap mortgage interest deduction at $300,000 of mortgage debt
  - Enact $2,500 additional child tax credit
  - Replace standard deduction, personal exemption, and 10% tax bracket with refundable personal credit
  - Eliminate AMT
  - Reduce capital gain and QDI rate to 0%
  - Eliminate estate tax
  - Eliminate additional Medicare tax on compensation above $200,000
  - Eliminate head-of-household filing status
  - Exempt interest from income, and eliminate interest deduction (except mortgage interest), except for interest earned by financial firms

Marco Rubio Tax Reform Proposals

- Business:
  - Lower top corporate rate to 25%
  - Enact immediate investment cost expensing
  - Tax pass-through income at 25%
  - Enact credit for businesses that offer paid family leave
  - Enact territorial tax system
  - Enact one-time deemed repatriation at 6% rate
  - Excepting financial institutions, remove interest from tax base (*i.e.*, not taxable, not deductible)
  - Enact tax credit for businesses that offer paid family leave

John Kasich Tax Reform Proposals

- Individual:
  - Three income tax brackets, with a top rate of 28%
  - Retain charitable deduction and mortgage interest deduction (presumably, repeals other itemized deductions)
  - Increase EITC by 10%
  - Reduce long-term capital gain rate to 15%
  - Repeal estate tax

- Business:
  - Lower top corporate rate to 25%
  - Double value of R&D credit for businesses with less than $20 million in gross revenues
  - Enact immediate investment cost expensing
  - Enact one-time deemed repatriation at unspecified “low” rate
  - Enact territorial tax system

Donald Trump Tax Reform Proposals

- Individual:
  - Single filers earning less than $25,000 and married filers earning less than $50,000 will owe no taxes
  - Four tax brackets: 0%, 10%, 20%, and 25%
  - Eliminate AMT
  - Eliminate marriage penalty
  - Eliminate estate tax
  - Eliminate NIIT
  - Enhance personal exemption phase-out and “Pease” limitation
  - Phase-out all itemized deductions except for charitable deduction and mortgage interest deduction
  - Tax carried interest for “speculative partnerships” as ordinary income
  - Phase-out “tax exemption on life insurance interest for high-income earners” (presumably, tax “inside buildup”)

Donald Trump Tax Reform Proposals

- Business:
  - Lower top “business” rate to 15% (*i.e.*, corporate and pass-through business income)
  - Enact one-time deemed repatriation at 10% rate
  - End deferral of foreign source income
  - Phase-in “reasonable” cap of interest expense deductions
  - Eliminate unspecified deductions and “loopholes”

Bernie Sanders Tax Reform Proposals

- Individual:
  - Enact 4 new tax brackets of 37%, 43%, 48%, and 52%, and raise all existing tax brackets by 2.2%
  - Cap benefit of itemized deductions at 28% for high-earning households
  - Tax capital gains and dividends as ordinary income for households making more than $250,000
  - Eliminate AMT
  - Eliminate Pease limitation and personal exemption phase-out
  - Tax carried interest as ordinary income
  - Apply Social Security payroll tax to earnings over $250,000
  - Increase top estate tax rate to 65%; lower estate exclusion to $3,500,000
  - Increase net investment income surtax to 10%
  - Tax carried interest as ordinary income

Bernie Sanders Tax Reform Proposals

- Business:
  - Lower top corporate rate to 24%
  - Enact financial transactions tax (“FTT”) at a rate between 0.005% and 0.5%
  - Enact FTT credit for low-income investors
  - End deferral of foreign-source income
  - Enact additional limits on foreign tax credits
  - Revise inversion rules to make them more stringent
  - Revise rules with respect to foreign corporations operating in the U.S.
  - Increase employer payroll tax by 6.2%
  - Enact 0.2% payroll tax to fund paid family leave

Ted Cruz Tax Reform Proposals

- Individual:
  - Establish flat tax rate of 10%
  - Lower capital gain and dividend income rate to 10%
  - Increase standard deduction by $10,000 per filer
  - Eliminate all itemized deductions other than charitable deduction and deduction for mortgage interest
  - Eliminate all credits other than EITC and CTC
  - Expand EITC by 20%
  - Eliminate estate tax
  - Enact tax-free savings accounts for up to $25,000 per year

Ted Cruz Tax Reform Proposals

- Business:
  - Replace corporate income tax with 16% business transfer tax
  - Tax pass-through income at 10%
  - Enact immediate investment cost expensing
  - Eliminate payroll tax
  - Enact territorial tax system
  - Enact one-time deemed repatriation at 10% rate

Ben Carson Tax Reform Proposals

- Individual:
  - Enact flat tax at 14.9% rate, phased-in over time
  - Enhance standard deduction and personal exemption such that income under 150% of poverty level is exempt from tax
  - Eliminate tax on social security benefits
  - Eliminate all itemized deductions
  - Eliminate all tax credits except for FTC
  - Eliminate AMT
  - Lower tax rate on capital gains and dividends to 0%
  - Eliminate exclusion for fringe benefits
  - Eliminate interest deduction or inclusion of interest in income
  - Eliminate estate tax

Ben Carson Tax Reform Proposals

- Business:
  - Lower top corporate tax rate (and rate for pass-through businesses) to 14.9%
  - Enact immediate investment cost expensing
  - Enact territorial tax system
  - Allow corporations to repatriate offshore income tax-free for six months, provided that they use 10% of the repatriated funds to create jobs for the unemployed or in enterprise zones
  - Eliminate interest deduction or inclusion of interest in income for non-financial businesses

Hillary Clinton Tax Reform Proposals

- Individual:
  - Cap benefit of itemized deductions at 28%
  - Make American Opportunity Tax Credit permanent
  - Enact $1,200 caregiver tax credit
  - Increase capital gains rate for investments held for less than 6 years to between 24% and 39.6%
  - Enact new minimum tax at 30% rate for persons earning more than $1 million
  - Enact 4% surtax on income above $5 million
  - Tax carried interest as ordinary income
  - Increase top estate tax rate to 45% and lower the deduction to $3.5 million

- Business:
  - Enact business tax credits for profit-sharing and apprenticeships
  - Enact transaction tax on high-frequency financial transactions
  - Strengthen anti-inversion rules in some specified way
  - Enact “exit tax” on foreign earnings of inverting U.S. firms

A Difficult Path to Achieving Tax Reform

Revenue Considerations:

- How Much Revenue Should Be Raised?
  - Republicans support tax reform that is revenue neutral.
  - Democrats support tax reform that raises revenue.

- How Should Tax Reform be “Scored”?
  - Republicans think that “Dynamic Scoring” is a more realistic way to score tax reform.
    - Dynamic Scoring takes into account behavioral changes and their impact on the economy.
  - Democrats think that “Static Scoring” is a more realistic way to score tax reform.
    - Static Scoring takes into account behavior changes but not their impact on the economy.

Differing Viewpoints:

- Democrats speak of "fair share" and increasing revenues
  - "The primary goals of comprehensive tax reform should be to progressively raise sufficient revenue to (1) make investments that will grow the economy, and (2) set us on a path for long-term deficit reduction. The writing is on the wall: a revenue-neutral approach to tax reform – on either the corporate or individual side of the tax code – is not an option."[1]

- Republicans speak of lowering rates and pro-growth policies
  - "The first step we can take toward overall pro-growth tax reform is to permanently lower the tax gates to allow our U.S. companies to bring their profits back home to invest in our communities, in our jobs, in our research and development, in growth."[2]

1. CONG. PROGRESSIVE CAUCUS, PROGRESSIVE PRINCIPLES FOR TAX REFORM, http://cpc-grijalva.house.gov/progressive-principles-for-tax-reform/ (last visited Mar. 1, 2016).

2. H. WAYS AND MEANS COMM., Int'l Tax Reform = More Jobs, More Growth, More Opportunity at Home (Feb. 24, 2016) (statement of Chairman Kevin Brady), http://waysandmeans.house.gov/international-tax-reform-more-jobs-more-growth-more-opportunity-at-home/.

Actions Abroad: Impact of BEPS:

- BEPS spurs U.S. leaders to action, but also companies to respond
  - “American companies competing overseas are rightly concerned that the BEPS project will result in higher foreign taxes, higher compliance costs, and double taxation. As countries around the world incorporate the BEPS ideas into their tax systems, many more companies could be forced to restructure their business operations and move U.S. activities, such as research and development, overseas.”[1]

1. H. WAYS AND MEANS COMM., Chairman Brady Opening Statement at Hearing on the Global Tax Env’t in 2016 and Implications for Int’l Tax Reform (Feb. 24, 2016), http://waysandmeans.house.gov/chairman-brady-opening-statement-at-hearing-on-the-global-tax-environment-in-2016-and-implications-for-international-tax-reform/.

Entitlement Considerations:

- Some Argue that Tax Reform is not worth doing if it doesn't reform Entitlements.
  - Between 2017 and 2026 the Federal government will spend over $32 trillion on Entitlements.
  - Entitlements is primarily funded through the payroll tax. Between 2017 and 2026 this tax is projected to raise only $13.5 trillion.
  - Entitlement spending dwarfs "discretionary" spending, which is projected to be only $12 trillion between 2017 and 2026.
  - As a percent of GDP, between 2016 and 2026, Social Security outlays are expected to increase 28% and health programs like Medicare are expected to grow 32%. Meanwhile, outlays for "discretionary" programs are expected to increase only 17% over this same time period.

Source: Congressional Budget Office's Budget Outlook, January, 2016

Pathways to Tax Reform:

- Scenario 1: Republicans retain House and Senate, and win White House
  - Result: broad-based tax reform enacted during first year of new President's term in office.
- Scenario 2: Republicans retain House, but lose Senate and/or fail to win White House
  - Result: broad-based tax reform stalls, devolving into piecemeal "deals" to tinker with various aspects of the Code.

Concurrent Session: The Future of Financial Reporting

Thursday, March 31st
9:45am – 11am
Marriott Marquis, Washington DC

Moderator:
George Yungmann, SVP-Financial Standards, NAREIT

Panelists:
Russell Golden, Chair, Financial Accounting Standards Board
Wesley Bricker, Deputy Chief Accountant, U.S. Securities and Exchange Commission

15 December 2015

2015 AICPA National Conference on Current SEC and PCAOB Developments

Compendium of significant accounting and reporting issues

In this issue:

Summary

Representatives of the Securities and Exchange Commission (SEC or Commission), the Financial Accounting Standards Board (FASB or Board) and the International Accounting Standards Board (IASB) (collectively, the Boards) and the Public Company Accounting Oversight Board (PCAOB) shared their views on various accounting, financial reporting and auditing issues at the annual AICPA National Conference on Current SEC and PCAOB Developments (Conference) last week in Washington, DC.

Highlights included:

Internal control over financial reporting — SEC and PCAOB officials emphasized the importance of strong internal controls throughout the Conference. They observed that recent PCAOB inspection findings on internal control over financial reporting (ICFR) may indicate deficiencies in the design of management's controls, particularly the documentation of key management review controls, and said auditors must take a risk-based approach when auditing ICFR. They said auditors must discuss with management and audit committees their expectations about the extent of documentation management needs to support the effectiveness of key controls, which should be commensurate with the associated risk.

New revenue recognition standards — Representatives of the SEC, the FASB and the IASB discussed efforts to implement the new revenue recognition standards the Boards jointly developed. The SEC staff members stressed the objectives of achieving consistent application of the standards for similar fact patterns and resolving significant implementation issues that could result in diversity in practice when companies adopt the standards. The SEC staff also said it expects disclosures about the effects of the new revenue standards to be more robust as their effective date approaches.

Building a better working world

Disclosure effectiveness, including non-GAAP financial measures — Representatives of the SEC and the FASB provided updates on their disclosure effectiveness initiatives. The SEC representatives said they expect additional rulemaking in 2016 related to Regulations S-X and S-K, as well as improved search functionality for filings on the SEC's website. FASB representatives provided an update on the Board's disclosure framework project and its focus on material disclosures. SEC representatives said they were encouraged by recent efforts by companies to make voluntary improvements to their disclosures but highlighted several focus areas where they expect more meaningful disclosures. For example, they said the use and disclosure of non-GAAP financial measures requires close attention.

Segment reporting — SEC and PCAOB representatives said that segment reporting continues to be a critical focus area because investors continue to identify it as the most important disclosure area in SEC filings. They are focusing on whether companies are appropriately identifying and aggregating operating segments, as well as the design and operation of internal controls over these judgments.

Remarks of senior representatives

Remarks by Mary Jo White, SEC Chair

SEC Chair Mary Jo White highlighted the importance of reporting reliable financial information so that investors can make informed decisions. She talked about the shared responsibility of preparers, auditors, audit committees, standard setters and regulators for reliable financial reporting to investors and the vital role each plays in making sure that the US capital markets remain "the safest and strongest in the world."

'... ICFR must remain the strong bulwark of reliable financial reporting that it has become.'
— Mary Jo White, SEC Chair

Internal control over financial reporting

Chair White observed that preparers often make difficult judgments to meet the objectives of US GAAP or IFRS (e.g., revenue recognition, impairment, fair value) and said that reliable financial reporting depends on accounting staff and internal auditors challenging management's conclusions if they have questions about transactions, judgments and risk areas.

Chair White also said that management's ability to fulfill its financial reporting responsibilities depends on effective ICFR. She noted that there is still a debate about the extent of testing and related documentation that companies and auditors are required to perform related to the assessment of ICFR and said the SEC staff is monitoring discussions PCAOB officials are having with companies and auditors about these issues. She encouraged preparers, auditors and regulators to continue the dialogue to address any challenges in the operation and assessment of ICFR but said ICFR must remain "the strong bulwark of reliable financial reporting that it has become."

Non-GAAP measures

Chair White observed that non-GAAP financial measures are used extensively by companies and analysts but can be a source of confusion. Chair White said that the use of non-GAAP measures deserves close attention to make sure that the rules are being followed and to ask whether the rules are sufficient. She asked preparers to carefully consider the following questions when they use such measures:

- Why is the non-GAAP measure being used and how does it provide investors with useful information?
- Are any non-GAAP measures being given greater prominence than the GAAP measures?
- Is the explanation of the non-GAAP measure and its usefulness to investors, accurate and complete rather than boilerplate?
- Are there appropriate controls over the calculation of the non-GAAP measure?

How we see it

Chair White's comments suggest that the SEC is closely monitoring the expanding use of non-GAAP measures. Registrants should ensure that their non-GAAP measures are transparent, balanced and fully comply with the SEC's requirements.

Gatekeepers for high-quality audits

Chair White talked about the critical role of external audits performed by independent, knowledgeable and skeptical auditors in maintaining the strength of financial reporting. She said the PCAOB's inspection program and enhancements the PCAOB has made to its auditing standards have improved audit quality. However, Chair White expressed concern that PCAOB inspections still find significant deficiencies in various areas and that the SEC has had to bring enforcement actions against audit firms for missing or ignoring red flags.

Chair White expressed concerns about the increasing workload of some audit committees and questioned whether directors who serve on multiple boards and audit committees can effectively discharge their responsibilities. She said that only people who have the time, commitment and relevant experience should be selected to serve on audit committees. She said that audit committees of every public company should be able to properly oversee the auditors and adequately review how management is designing and implementing ICFR and how non-GAAP measures are being used. She noted that the SEC has issued a concept release on possible revisions to audit committee disclosures and said the audit committee report should evolve to meet the needs and expectations of investors.

Standard setters and regulators

Chair White said the FASB needs to preserve its independence and that accounting standards must provide objective, accurate and credible information that is useful for investor decisions. She commended the FASB and the IASB for working jointly in several areas to develop converged, high-quality globally accepted accounting standards (e.g., revenue recognition, business combinations, fair value measurements), even though certain priority projects did not result in completely converged guidance.

She also said that the SEC staff has developed a recommendation for the Commission's consideration on the possibility of allowing US issuers to voluntarily disclose supplemental IFRS information and that the staff will be discussing it with the Commissioners to help them determine a path forward. Chair White further added that she believes "it is important for the Commission, as a Commission, to make a further statement about its general views on the goal of a single set of high-quality global accounting standards."

Chair White observed that the SEC has seen "concrete progress" by companies in making their disclosures clearer and more understandable. However, she said that there is more work to be done. She said that while it may be beneficial to reduce the volume and complexity of disclosures to help investors focus on important matters, there are certain areas (e.g., foreign income taxes) where more transparency would be beneficial. She talked about the status of the SEC's disclosure effectiveness initiative and its request for comment on Regulation S-X requirements. She said that she expects the SEC to issue a release on Regulation S-K in 2016, as well as other changes related to financial statement disclosures and improvements to the presentation of filing information and search tools on the SEC's website (i.e., EDGAR).

Chair White also noted that one of the tools to ensure high-quality financial reporting is a strong enforcement program. She discussed several recent cases in which auditors and other gatekeepers did not meet requirements. She also noted that financial reporting will continue to be a high-priority area for the SEC's enforcement program.

Remarks by James Schnurr, Chief Accountant

ICFR and enforcement actions

Mr. Schnurr said management's ability to fulfill its financial reporting responsibilities depends on the effective design and operation of ICFR. He noted that the PCAOB continues to issue frequent inspection findings related to ICFR, which may reflect not only inadequate audit execution but also deficiencies in management's controls and assessments. He encouraged auditors, management and audit committees to have a robust discussion about the design and assessment of ICFR.

He also said that the SEC's Enforcement Division has focused on internal control matters and the role of gatekeepers, including audit firms and audit committee members. He highlighted recent enforcement actions brought against audit firms for dismissing red flags and failing to evaluate contrary evidence and exercise professional skepticism.

IFRS reporting by US registrants

As mentioned by Chair White, Mr. Schnurr said the SEC staff will soon discuss its recommendation with the Commissioners to allow US issuers to voluntarily disclose IFRS information as a supplement to their US GAAP financial statements. The SEC staff's recommendation would permit companies to voluntarily provide IFRS information without it being considered non-GAAP information subject to additional disclosures, including reconciliation to US GAAP.

The Commission will soon consider the SEC staff's recommendation to allow US issuers to voluntarily provide supplemental IFRS information.

In response to a question, Mr. Schnurr said that he believes there will be market demand for voluntary IFRS disclosures by certain US issuers, particularly if they have foreign peers that adopt new IFRS standards that are not converged with US GAAP.

In the near term, Mr. Schnurr emphasized the importance of continued convergence efforts in order to further the objective of a single set of a high-quality global accounting standards.

Disclosure effectiveness

Mr. Schnurr said that companies must have appropriate processes and internal controls to apply judgment about financial statement disclosures. He observed that these judgments might result in eliminating immaterial disclosures or adding disclosures beyond the specific requirements to avoid misleading investors. The process of making such judgments should include coordination between management and the audit committee as well as consideration of the perspective of a "reasonable investor." Mr. Schnurr also emphasized the need for registrants to reevaluate whether existing disclosures continue to be relevant.

As part of the SEC's disclosure effectiveness initiatives, Mr. Schnurr shared that the staff expects to coordinate with the FASB to reduce duplication in the SEC and FASB disclosure requirements in addition to making other recommendations to the Commission.

Mr. Schnurr supported the recent efforts by the FASB to develop a disclosure framework that emphasizes principles and materiality when communicating information to users rather than a checklist of required disclosures.

Auditor independence

Mr. Schnurr noted that the staff is focused on the growing consulting practices of accounting firms. He said that consulting practices may benefit accounting firms by fostering specialized skill sets and driving profits that can be invested in improving audit quality but said this trend may raise independence questions when there are not appropriate safeguards to mitigate "scope creep" in consulting engagements.

Audit committee oversight

Mr. Schnurr observed that many audit committees have assumed responsibilities beyond regulatory requirements, such as the oversight of cybersecurity risks, emerging technologies and other compliance risks. He suggested that audit committees may need to "get back to basics" in their oversight of financial reporting, including:

- The appointment, compensation and oversight of auditors
- Preparation and disclosure of the audit committee charter
- Audit committee reporting to shareholders

He stressed the need for audit committees to establish a culture of compliance, ask probing questions about management's significant judgments and estimates and require follow-up on corrective actions when necessary. He also said that the selection of the independent auditor should be based principally on audit quality not the audit fee. He encouraged audit committee members to consider the PCAOB's concept release on audit quality indicators, which can be used to help evaluate audit quality even without further PCAOB action.

PCAOB standard-setting activities

Mr. Schnurr commended the PCAOB for efforts to improve its standard-setting process, which included engaging an external consultant to review the process. While he noted that the PCAOB plans to adopt a final transparency rule and is moving ahead with its auditor reporting project, he emphasized the importance of finalizing auditor performance standards as the most effective way to improve audit quality.

Remarks by Russell Golden, Chairman of the FASB

FASB Chairman Russell Golden echoed SEC Chair White's remarks on the importance of maintaining independence from the influence of politics and special interests in setting financial accounting and reporting standards. For many FASB projects (e.g., impairment of financial instruments, leases, materiality), stakeholders and, in some cases, members of the Board, have expressed conflicting points of view. Mr. Golden said that it is the Board's job to sort through these views and to set standards that accurately reflect economic transactions and provide the most useful information to users of financial statements.

Mr. Golden commented on the ongoing implementation efforts for the revenue recognition standard and what has been learned during that process to prepare for the implementation of future standards. He also discussed the status of several other active projects and briefly discussed the future direction of the FASB's agenda.

Revenue recognition standard

The FASB and the IASB formed a transition resource group (TRG) to help manage implementation issues for the new revenue recognition standard in an effort to limit diversity in how preparers interpret the standard prior to its effective date. Mr. Golden indicated that this was a successful initiative and has helped the Boards promote global comparability in revenue. He said 98% of the 87 implementation questions raised by constituents have been discussed by the TRG or resolved with the FASB staff. Although most of the issues discussed by the TRG did not lead to additional standard-setting, the results of those discussions help to educate stakeholders about the new standard. The FASB also has issued three proposals based on feedback from the TRG. Mr. Golden said that the practical expedients and other proposals will reduce the cost and complexity of applying the standard without significantly changing the quality of the information reported to users of financial statements.

Impairment of financial instruments

Mr. Golden said that the Board intends to apply the lessons learned in implementing the revenue recognition standard to the implementation of the upcoming standard on the impairment of financial instruments. As a result, a TRG has been formed before the standard is issued to identify any significant issues requiring the FASB's attention.

One of the major issues that TRG is facing involves misconceptions about what the standard will require. Mr. Golden addressed and dispelled each of the following common misconceptions related to the credit impairment standard:

- The new standard will require businesses to develop and install costly, complex new systems.
- Bank examiners will take a more conservative view than the standard requires.
- The credit crisis involved only large banks.
- The standard takes an unrealistic view of the economics of loan financing.

Other projects

Disclosure framework

The FASB's two materiality proposals in its disclosure framework project have received a lot of attention. The first would amend the definition of materiality in the Conceptual Framework to conform to the definition that is used by the SEC and PCAOB. Mr. Golden indicated that this proposal would not change the legal definition of materiality, as the FASB does not have this authority. Mr. Golden also clarified that the amended Concepts Statement would only apply to the Board's observation of materiality as part of its standard-setting process and would not apply to preparers and auditors.

The second Exposure Draft is intended to clarify the process that preparers follow in assessing the materiality of information in notes to financial statements. Mr. Golden indicated that this proposal would clarify what the Board understands to be the predominant current practice related to the assessment of materiality by preparers.

Leases

The FASB plans to issue its new leases standard in early 2016. Mr. Golden said that the Board is not planning to create a TRG for the leases standard, but will carefully monitor discussions with stakeholders during the implementation process and will be prepared to increase its education efforts if needed.

The new leases standard will require lessees to recognize most leases on their balance sheets. One of the major concerns the FASB heard was that additional liabilities would affect compliance with debt covenants. Mr. Golden stated that lenders have told the FASB that the addition of lease liabilities to a company's balance sheet will not alter a lender's view of the organization's financial position because most lenders currently adjust financial statements to recognize lease liabilities when making lending decisions. However, to help mitigate concerns, the FASB decided that most lease liabilities should be characterized as operating obligations in the financial statements rather than obligations that are equivalent to debt.

Future agenda

Mr. Golden said the FASB recently conducted a survey to identify future projects that should be considered a priority for the Board. The top five areas for improvement in financial reporting identified in the survey were (1) financial performance reporting, (2) cash flow classification, (3) pensions and other post-retirement benefits, (4) liabilities and equity and

(5) intangible assets. He also said that segment reporting was the top area of improvement identified by investors. Stakeholders will be given an opportunity to comment on a discussion paper that includes these and other potential FASB projects. The FASB plans to issue the discussion paper in early 2016.

Remarks of PCAOB Chairman James Doty

PCAOB Chairman James Doty observed that the PCAOB's overall responsibility is to serve investors by setting audit and professional standards, performing inspections of audits and firms' quality control systems and, when necessary, taking disciplinary actions against auditors who fail to comply with the standards. He stated that the PCAOB focuses auditors on their role as gatekeepers to the capital markets when they determine and report on whether a company's financial statements comply with the relevant financial reporting framework.

He said the PCAOB's work has resulted in the following three trends:

- Auditor conduct has changed.
- Audit quality has improved.
- The audit has gained credibility from stakeholders due to credible regulation.

Inspections update

Mr. Doty noted that, for firms that are committed to remediating deficiencies and identifying root causes, inspection findings have started to decline. He believes the PCAOB has established an interactive, fair and transparent inspection process. The PCAOB plans further engagement with preparers and audit committee members to educate and inform them about the inspection process and the results of inspections and help the PCAOB better understand the effects of its inspection process.

Mr. Doty spoke about the PCAOB's inspections in 46 foreign jurisdictions and expressed optimism that the European Commission's Adequacy Decision will be renewed in 2016. The PCAOB continues to have challenges reaching an agreement to perform inspections in China. In June, a pilot inspection program was approved by the China State Council, but Mr. Doty said it has been difficult to finalize the details of the program.

Auditor incentives

Mr. Doty stated that the PCAOB's programs both deter bad conduct and incentivize exemplary conduct. He said the PCAOB works to recognize the effects of incentives, both systemic and personal, and implement countermeasures for those that adversely affect audit quality.

Mr. Doty stated that research by the PCAOB's Center for Economic Analysis indicates there is a statistically significant increase in effort by the engagement partner and quality reviewer in the year following a deficiency being identified through inspections, without a statistically significant change in fees. The research also indicates that there is a statistically significant decrease in effort and increase in restatement rate following inspections in which no significant deficiencies were identified.

Mr. Doty also said audit committees that see their job as negotiating the lowest audit fee may not always be promoting audit quality. In his view, highly competent and strong audit committees promote auditor objectivity and independence from management.

Standard-setting projects

Mr. Doty said the PCAOB's standard-setting considers appropriate audit procedures as well as mechanisms that provide appropriate auditor incentives, with the overriding objective of enhancing the relevance and reliability of the audit. Mr. Doty highlighted the status of several ongoing projects and said the Board soon will adopt a final rule related to the disclosure of the engagement partner.

Maintaining public confidence

Mr. Doty said this is an exciting time to be in or entering the audit profession but noted that the profession faces the challenge of maintaining public confidence in the audit. He observed that auditors' value to the capital markets resides in their ability to provide an independent, objective and skeptical mindset when evaluating a company's financial statements.

Internal control over financial reporting

As discussed earlier, ICFR continues to be a source of significant PCAOB inspection findings. The SEC Chair and Chief Accountant stressed the importance of ICFR in providing high-quality financial information to investors and said the level of PCAOB inspection findings likely indicated problems with companies' controls.

In his remarks, the PCAOB Chair acknowledged that PCAOB inspections of audits of internal control had raised concerns among preparers about the extent of the auditor's assessment of management review controls, including the assessment of their precision and the level of documentation needed to support their effective operation. A panel comprised of representatives of the SEC, the PCAOB, large accounting firms and preparers discussed these and related matters:

- *Management review controls* — Panelists noted that not all management review controls are created equal. Representatives from the SEC and PCAOB said the Commission's guidance for management[1] and the PCAOB's Auditing Standard (AS) No. 5 are aligned with respect to the assessment of financial reporting risks and the selection of controls that adequately address those risks. They reinforced the importance of management and auditors having an appropriate understanding of the design of the management review control in order to assess whether it operates at a sufficient level of precision to address the financial statement risk(s) or whether lower level controls also need to be tested. SEC staff noted that in a number of higher-risk areas, it is unlikely that management review controls alone would be sufficient to address the risk, given the number of judgments required and the inputs needed to make them.

- *Population of controls* — During their outreach, the SEC and PCAOB noted that, in some cases, auditors and management were testing different controls to address certain financial reporting risks. Panelists noted that, in some cases, auditors may be testing lower-level controls while management may be relying on higher-level review controls. The panelists noted that management and the auditor may reach different conclusions about the precision of controls and said it is important that auditors and management communicate to make sure they understand the reasons for any differences. These discussions can help both parties understand the controls and potentially lead to improvements in the design of the controls or the control-testing approach. Discussing these differences also could minimize the risk of auditors and management reaching different conclusions on the effectiveness of the controls.

- *Evaluation and evidence of effectiveness of controls* — Mr. Schnurr and Brian Croteau, SEC Deputy Chief Accountant, stressed that the Commission's guidance for management requires documentation of how the design of a control addresses the relevant financial reporting risk as well as evidence to support that the control is operating effectively. Importantly, Mr. Croteau said the Commission's guidance requires more evidence of the operating effectiveness of controls in higher-risk areas. Mr. Croteau also noted that this principle is integral to the performance of an assessment using a risk-based approach, supports effective and consistent operation of the company's controls over time and is consistent with the auditor's requirements under AS 5.

- *Auditor's use of templates and checklists* — Panelists observed that auditors frequently use templates and checklists to facilitate ICFR documentation. Staff members from the SEC and PCAOB said these templates and checklists can help auditors consistently consider and document important elements of their procedures, particularly in higher-risk areas. However, the panelists agreed that templates and checklists should not be used as substitutes for auditor judgment and understanding, and they encouraged management and auditors to discuss any questions regarding the nature and purpose of the auditor's procedures.

In other remarks regarding material weaknesses in ICFR, Mr. Croteau reminded management and auditors that evaluating the severity of a control deficiency requires consideration of the "could factor," meaning whether it is reasonably possible that a material misstatement "could" occur and not be prevented or detected on a timely basis. That is, management and the auditor should not just consider whether a material misstatement occurred. Mr. Croteau also discussed the importance of considering whether changes to internal controls in conjunction with the adoption of a new accounting standard require disclosure as material change in ICFR in the relevant quarter under Item 308(c) of Regulation S-K.

How we see it

- We support the efforts by the SEC and PCAOB to encourage dialogue between financial statement preparers and auditors in response to the number of PCAOB inspection findings involving audits of ICFR.

- Management and auditors should work together early in the audit process to understand and agree on the level of documentation that should be retained by both parties for the audit of ICFR.

Accounting and independence matters

Segment reporting

Courtney Sachtleben, a staff member in the Office of the Chief Accountant (OCA), said that over the past year, OCA has been working closely with the Division of Corporation Finance and others, including the PCAOB, to emphasize the objectives and principles outlined in the standard on segment reporting. Ms. Sachtleben and other members of the SEC staff shared their observations related to the identification of operating segments, aggregation into reportable segments and ICFR.

EY resources

- *Financial reporting developments, Segment reporting* (SCORE No. BB0698)

Identification of operating segments

Accounting Standards Codification (ASC) 280 requires entities to identify operating segments in a manner consistent with the way management organizes the segments (i.e., management's approach). Ms. Sachtleben observed that, as business operations evolve, registrants should reassess their identification of operating segments, particularly after a change in organizational structure, key personnel changes or significant acquisitions and dispositions.

Ms. Sachtleben said that the periodic financial reporting package provided to the Chief Operating Decision Maker (CODM) and the registrant's organizational structure will often provide insight into how management has organized the company for purposes of making operating decisions and assessing performance. However, she cautioned that neither is determinative in the identification of operating segments and that a variety of information sources can enhance and corroborate this analysis, including information about the basis on which budgets and forecasts are prepared and how executive compensation is determined.

Ms. Sachtleben said that if applying the guidance in ASC 280 results in the identification of a single operating segment, a registrant should disclose that it allocates resources and assesses financial performance on a consolidated basis and explain the basis for that management approach. However, she said that it would seem counter to the objectives of segment reporting if the business description indicates the company is diversified across businesses or products but is not managed in a disaggregated way.

Nili Shah, a Deputy Chief Accountant in the SEC's Division of Corporation Finance, also discussed segment reporting in a panel with other members of the Division. Regarding the identification of operating segments, she emphasized the following points:

- When identifying the CODM, companies should focus on which person or group in the organization is making the key operating decisions and not necessarily the person who has the ultimate decision-making authority (e.g., CEO). ASC 280 contemplates that a company's Chief Operating Officer may be the CODM.
- When determining whether discrete financial information is available, a company shouldn't conclude that such information is not available simply because certain costs are shared and not allocated specifically to each component. She said this view would not be persuasive. Gross profit information provided to the CODM and used to assess performance and make resource allocation decisions could be considered discrete financial information.

Aggregation of operating segments

While the identification of operating segments follows a management approach, the determination of reportable segments considers both aggregation criteria and quantitative thresholds. The aggregation of operating segments is one of the more judgmental areas of the segment reporting literature. Two or more operating segments may be aggregated into a single reportable segment only when all the following criteria are met: (1) aggregation is consistent with the objectives and principles of ASC 280, (2) the segments have similar economic characteristics and (3) the segments are similar in each of the five criteria specified in the standard.

Ms. Sachtleben reminded registrants that the guidance on determining whether two operating segments are "similar" requires the evaluation to be made relative to the range of the company's business activities and the economic environment in which it operates. She added that it would be helpful to consider similarity from the perspective of a reasonable investor and that it is important to consider information such as industry reports and other analyses by users of the financial statements that may provide evidence of how a reasonable investor would analyze the company.

Ms. Sachtleben also reminded registrants that once they identify segments that require separate reporting, they need to consider additional guidance on combining any remaining segments. She said that in performing this analysis, registrants should consider what additional level of detail would be useful to the users of the financial statements consistent with the first criterion above. She noted that registrants also may want to consider whether their reportable segments facilitate a consistent description of the company in its annual report and other published information such as its earnings releases, investor presentations and financial information on its website.

Ms. Shah also highlighted aggregation of operating segments as an area of focus in the review of filings by the staff in the Division of Corporation Finance, and she emphasized the following points:

- When responding to SEC staff comments on segment disclosures, companies should discuss why aggregation is consistent with the objectives and basic principles of ASC 280 (i.e., how aggregation helps users better understand the company's performance and assess its prospects for future net cash flows).
- When evaluating economic similarity, registrants should understand that there are no bright lines and significant judgment is required. In addition, the types of metrics considered and the acceptable level of differences in those metrics among the segments being evaluated for aggregation may differ across industries.
- An expectation that operating segments will have similar economic characteristics (e.g., long-term average gross margins) in the future does not take precedence over the lack of similarity in current and past performance.
- The SEC staff has increased its focus on the qualitative criteria in ASC 280. She reminded registrants of the requirement to meet all of the aggregation criteria in ASC 280 and said that at times the staff has objected to aggregation even when the quantitative economic characteristics were considered similar.

Effective internal control over financial reporting supports the judgments required in segment reporting.

Internal control over financial reporting

Ms. Sachtleben highlighted that the guidance on segment reporting requires the application of reasonable judgment and that effective ICFR supports those judgments, including the determination of operating segments, aggregation and entity-wide disclosures. Input from, and interaction with, the CODM may be an important element in the design of effective ICFR, specifically how the CODM allocates resources and assesses performance. She said that documenting the design and effective operation of management's controls over these judgments is an integral part of management's support for the effectiveness of its ICFR and will be essential to the auditor's ability to evaluate these controls.

Other segment reporting discussions and considerations

Wesley Bricker, Deputy Chief Accountant, observed that segment reporting was ranked in the top three consultation areas in OCA during 2015. Mr. Bricker observed that some registrants have contended in their consultations, including on segment reporting, that they should not be required to apply a US GAAP standard because the result would be "competitively harmful" or "misleading." He noted that these arguments are troubling because they disregard the thoughtful balance taken by the accounting standard setters in crafting reporting standards that provide transparent, useful information to investors. He concluded that a better approach starts with identifying what information is useful to investors, as well as why and how that information can be appropriately reported.

Ms. Shah also mentioned that when the SEC staff has objected to a company's segment reporting conclusions, it generally has permitted the registrant to reflect changes to its segment disclosure in future filings. However, she cautioned that if goodwill is impaired as a result of a change in the registrant's reporting units, the SEC staff likely would require restatement of prior periods.

Finally, Helen Munter, Director of the PCAOB's Division of Registration and Inspections, said that PCAOB inspections in 2016 will include a focus on segment reporting, including the identification of the CODM, the identification and aggregation of operating segments, and the continued assessment of an issuer's ICFR related to segment reporting.

How we see it

Segment reporting continues to be a top focus area by the SEC staff. Entities should continue to reassess their segment reporting conclusions and evaluate whether internal controls are designed to make sure that the CODM, operating segments and reportable segments are appropriately identified in accordance with ASC 280. Management review controls often will be an important element of a registrant's internal control over segment reporting.

EY resources

- *Financial reporting developments, Share-based payment* (SCORE No. BB1172)

Effect of post-vesting restrictions on the measurement of share-based awards

ASC 718-10-30-10[3] clarifies that "a restriction that continues in effect after an entity has issued instruments to employees, such as the inability to transfer vested equity share options to third parties or the inability to sell vested shares for a period of time, is considered in estimating the fair value of the instruments at the grant date."

Barry Kanczuker, a member of the OCA staff, addressed the effect of post-vesting restrictions on the measurement of share-based payment awards and noted that market participant assumptions used in the fair value measurement of a restricted share may result in some discount relative to the fair value of a similar but unrestricted share. However, Mr. Kanczuker noted the SEC staff looks to ASC 718-10-55-5 to evaluate the appropriateness of any discount. It states that "if shares are traded in an active market, post-vesting restrictions may have little, if any, effect on the amount at which the shares being valued would be exchanged." He encouraged registrants to consult with the SEC staff if they believe their post-vesting restrictions would result in a significant discount being applied to the grant-date fair value of an award.

EY resources

- *To the Point, Potential alternative to develop discount rates used to measure defined benefit plan costs* (SCORE No. BB3053)

Discount rates used to measure the interest cost of defined benefit pension plans

The interest cost component of net periodic pension cost is the increase in the projected benefit obligation due to the passage of time at a rate equal to the assumed discount rate. Many companies use a weighted average discount rate, developed using a yield curve, to calculate the interest cost.

Ashley Wright, a member of the OCA staff, discussed a recent consultation on an alternative approach (a spot rate approach) to determine the discount rate used in the interest cost calculation. Under a spot rate approach, a company that determines its discount rate from a yield curve uses the individual spot rates along the yield curve that correspond with the timing of each future cash outflow for benefit payments to calculate interest cost. Ms. Wright stated that the use of individual discount rates results in a different amount of interest cost compared with the interest cost calculated using a weighted-average discount rate.

Ms. Wright indicated that the SEC staff would not object to a registrant that employs the yield curve approach changing from using a weighted average discount rate approach to a spot rate approach for measuring interest cost and accounting for this change as either a change in estimate or a change in estimate inseparable from a change in accounting principle.

However, Ms. Wright shared the following observations about companies that use a different method for measuring the pension benefit obligation (e.g., hypothetical bond matching methodology) and are considering changing to a yield curve methodology and the spot rate approach:

- A company's decision to select, or change the selection of, a particular methodology for determining the discount rate should align with the requirement to select the best rate(s) for which the obligation could be effectively settled.
- A change in the methodology used to determine the discount rate should be made only if alternative market information (i.e., source data) results in better information being used in measuring the pension benefit obligation.
- The selection of a best estimate is generally not made on the basis of materiality.
- Any change in the method used to calculate the best estimate of those rates should be made when a change in the facts and circumstances may warrant the use of a different method.
- A registrant may need to consider its arguments when it previously changed from a yield curve approach to a bond matching approach (if applicable).
- A change in the approach to calculate interest cost would not seem persuasive to change the basis for selecting a different source of market information (i.e., the approach to determining the discount rate(s)) used for measuring the pension benefit obligation.

The SEC staff said the examples in the accounting standard about discontinued operations do not establish bright lines or safe harbors.

How we see it

A registrant that believes it has facts and circumstances that would support a change from the bond matching approach to the yield curve approach, considering the points above, should discuss its fact pattern with the SEC staff.

EY resources

- *Financial reporting developments, Discontinued operations* (SCORE No. BB2878)

Presentation of discontinued operations

The revised guidance in ASC 205-20 raises the threshold for reporting a discontinued operation by requiring that a component (or group of components) disposed of or classified as held for sale represent a strategic shift that has (or will have) a major effect on an entity's operations and financial results. Mr. Kanczuker discussed how ASC 205-20 allows for judgment to determine whether a disposal group meets the definition of a discontinued operation under the revised guidance.

He addressed concerns about which financial results should be considered in evaluating whether a disposal group is a discontinued operation. In his view, these metrics should be the primary metrics that are prominently presented in the financial statements and communicated to investors (e.g., revenue, net income) as well as other metrics that may be relevant from an investor's perspective, particularly when the company has used such measure(s) on a consistent basis for communicating operating and financial results. There is no single financial metric that is determinative of whether a disposal group meets the discontinued operations criteria. Instead, the totality of the evidence should be considered from the perspective of current, historical and forecast financial results.

In Mr. Kanczuker's view, entities should consider both quantitative and qualitative factors when determining whether a disposal group represents a strategic shift that has (or will have) a major effect on an entity's operations and financial results. ASC 205-20 provides examples that include quantitative thresholds (e.g., 15% of total revenue, 20% of total assets) of what may constitute a strategic shift that has or will have a major effect on an entity's operations and financial results. However, Mr. Kanczuker indicated that the quantitative thresholds included in these examples are illustrative and do not establish bright lines or safe harbors. The staff member also noted that the less significance a disposal group has to the financial results, the more qualitative evidence is needed to support discontinued operations presentation (e.g., entities should consider how the disposal group and related qualitative factors were disclosed in previous filings).

EY resources

- *Financial reporting developments, Fair value measurement* (SCORE No. BB1462)

Fair value measurements

Kris Shirley, a member of the OCA staff, discussed several considerations for companies determining fair value measurements.

Identifying the principal or most advantageous market

A fair value measurement assumes the transaction to sell an asset or transfer a liability takes place in either the principal market or, in the absence of the principal market, the most advantageous market for the asset or liability. If an entity cannot transact in a market on the measurement date, that market may not constitute the principal or most advantageous market.

Mr. Shirley said that the company may need to consider whether the characteristics of its asset or liability being measured at fair value differ from the asset or liability that transacts in an observable market, as differences may prevent the company from accessing this market. This determination could lead to a different conclusion about whether the observable market is the principal or most advantageous market. For example, restrictions that may be unique to the entity's asset or liability that are not embedded in the asset or liability in the observable market may prevent an entity from accessing the particular price within the market. He also said there may be situations in which the market where the initial transaction occurred will not be the principal or most advantageous market.

Mr. Shirley noted that even when a market does not constitute the principal or most advantageous market, a company may still use observable prices from that market as one input into its fair value measurement. However, appropriate adjustments should be made for any differences in the characteristics of the company's particular asset or liability and those for which there is an observable price. Mr. Shirley provided an example of a company that measures a loan at fair value and on the measurement date looks to the securitization market for observable prices. The company would need to make appropriate adjustments to reflect the fact that its loan has not been securitized as of the measurement date.

Use of cost basis as fair value

Mr. Shirley observed that some companies use the initial cost basis of certain illiquid assets or liabilities as their fair value measurement for a period of time following the initial transaction. He noted that in determining fair value of an asset or liability, the transaction price may be a good starting point, but fair value under ASC 820 is an exit price at the measurement date under current market conditions and those conditions likely will be different from when the initial investment was made. This may be due to a number of factors, including changes in macroeconomic conditions (e.g., changes in interest rates), a change in market participants or a change in the expectation of cash flows.

Mr. Shirley said that companies will need to obtain evidence to support a conclusion that cost basis approximates fair value at the measurement date or why the fair value may not have changed materially from the initial cost basis. This may be supported through quantitative evidence, such as observable market pricing for the asset or liability or for comparable assets or liabilities with observable market prices, or qualitative evidence in certain cases.

ICFR for fair value measurements

Mr. Shirley also provided reminders about the importance of having a system of internal control over financial reporting related to fair value measurements, including those for illiquid assets or liabilities. The nature of these controls may differ based on the complexity of the estimate and whether the estimate was derived internally or by using a third-party service provider, among other factors.

Allowance for loan losses

Christopher Rickli, a member of the OCA staff, provided several reminders on management's responsibility under the SEC staff guidance in Staff Accounting Bulletin (SAB) Topic 6.L[4] for determining the allowance for loan losses (ALL).

Mr. Rickli said SAB Topic 6.L establishes expectations for management related to the development, documentation and application of a systematic methodology for determining the ALL. This includes an expectation that management will provide written documentation on certain decisions, strategies and processes for its ALL methodology. These processes should include effective internal controls designed to ensure use of relevant, reliable and sufficient data on which to base the ALL estimate. Mr. Rickli noted that these controls should not only include management review controls, but also transaction level controls in order to satisfy SAB Topic 6.L's expectations of data relevance and reliability.

When adjustments are made to the allowance that are intended to capture factors not already included in the entity's loss estimation model (e.g., changes in risk selection and underwriting standards, lending policies and certain economic trends and conditions), Mr. Rickli said that there is an expectation that management maintain sufficient, objective evidence to support the amount of the adjustments and explain why the adjustments are necessary. Also, management is expected to have an adequate understanding of the data currently being used in the ALL estimation model in order to be able to evaluate the necessity and the reasonableness of proposed adjustments.

EY resources

- *Financial reporting developments, Consolidation and the Variable Interest Model: Determination of a controlling financial interest (following the adoption of ASU 2015-02, Amendments to the Consolidation Analysis)* (SCORE No. BB3099)

Determining whether fees are a variable interest

Mr. Semesky discussed several considerations when determining whether a decision maker's fee is a variable interest when applying Accounting Standards Update (ASU) 2015-02, *Amendments to the Consolidation Analysis.*[5]

Three conditions must all be met to conclude that fees received by an entity's decision maker or service provider do not represent variable interests in that entity:

- The fees are compensation for services provided and are commensurate with the level of effort required to provide those services (i.e., commensurate).
- The service arrangement includes only terms, conditions or amounts that are customarily present in arrangements for similar services negotiated at arm's length (i.e., customary).
- The decision maker or service provider (and its related parties or de facto agents) does not hold other interests in the variable interest entity (VIE) that individually, or in the aggregate, would absorb more than an insignificant amount of the VIE's expected losses or receive more than an insignificant amount of the VIE's expected residual returns.[6]

Customary and commensurate

Mr. Semesky said that the determination of whether fees are commensurate often can be accomplished with a qualitative evaluation of whether an arrangement was negotiated on an arm's-length basis when the decision maker had no obligations other than to provide the services to the entity being evaluated for consolidation. He cautioned that this analysis requires a careful consideration of the services to be provided in relation to the fees.

On the evaluation of whether terms, conditions and amounts included in an arrangement are customary, Mr. Semesky said that this may be accomplished in ways such as benchmarking the key characteristics of the arrangement against other market participants' arrangements negotiated on an arm's-length basis or, in some instances, against other arm's-length arrangements entered into by the decision maker. Mr. Semesky emphasized that there are no bright lines in evaluating whether an arrangement is customary, and reasonable judgment is required in such an evaluation.

How we see it

The SEC staff member's observations are consistent with our view that determining whether a fee is commensurate and customary requires the use of professional judgment and a qualitative evaluation of the purpose and design of each entity and the terms and conditions of the fee arrangement. The presence of unrelated investors may be helpful in performing this evaluation, but is not determinative; all facts and circumstances should be considered.

Interests held by related parties

ASU 2015-02[7] states that, when an entity evaluates whether the fees paid to a decision maker or service provider are a variable interest, "any interest in an entity that is held by a related party of the decision maker or service provider should be considered in the analysis. Specifically, a decision maker or service provider should include its direct economic interests in the entity and its indirect economic interests in the entity held through related parties, considered on a proportionate basis … Indirect interests held through related parties that are under common control with the decision maker should be considered the equivalent of direct interests in their entirety." Questions have arisen about how a decision maker (e.g., manager) should apply this guidance when the decision maker does not have an ownership interest in the related party under common control (i.e., when the decision maker does not have an indirect interest).

Mr. Semesky highlighted an example in which an entity has four investors that are unrelated to one another and has a manager that is under common control with one of the investors. The manager has no direct or indirect interests in any of the investors or the entity other than through its fee, and it has the power to direct the activities of the entity that most significantly impact its economic performance.

Mr. Semesky said that in this example, if the manager's fee would otherwise not meet the criteria to be considered a variable interest (i.e., it was customary and commensurate), the fact that an investor under common control with the manager has a variable interest would not by itself cause the manager's fee to be considered a variable interest. However, Mr. Semesky cautioned that when a controlling party in a common control group designs an entity to separate power from economics to avoid consolidation in the separate company financial statements of a decision maker, OCA has viewed such separation to be non-substantive.

Additionally, Mr. Semesky concluded that once the manager determined that its fee is not a variable interest, it would not be required to consolidate the entity as a result of applying the related party tiebreaker test.

How we see it

The SEC staff member's observations on evaluating interests held by parties under common control provide much needed clarity to entities as they adopt the new consolidation standard. Absent the clarification, in many cases, the manager would have considered the interest of the party under common control as its own interest, which may have caused the fee to be considered a variable interest. While such a conclusion may not have resulted in consolidation of the entity by the manager, it would have resulted in further analysis by the manager and may have subjected the manager to additional disclosures.

EY resources

- *Technical Line, New Venezuelan currency regime — same accounting and reporting considerations* (SCORE No. BB2970)

Foreign exchange restrictions and evaluating control

Mr. Semesky noted that OCA has observed registrants deconsolidating subsidiaries in Venezuela. He reminded registrants of the need to reassess that conclusion continuously. If the conclusion to deconsolidate was based on foreign exchange restrictions and the severity of government-imposed controls, an improvement in exchangeability or loosening of government-imposed controls may result in the restoration of control and consolidation. He said that he would expect consistency in a registrant's judgments of whether it has lost control or regained control of a subsidiary, and that registrants should have internal controls over the assessment.

Further, Mr. Semesky cautioned that careful consideration should be given to whether a Venezuelan subsidiary would be considered a VIE, because power may no longer reside with the equity-at-risk holders. As a result, Mr. Semesky stated that registrants should clearly disclose their judgments on, and the financial reporting effect of, deconsolidation. They should also consider the required disclosures for interests in VIEs that are not consolidated.

How we see it

The conclusion to deconsolidate a Venezuelan operation (or to change the accounting for an investment from the equity method to the cost method) should be based on entity-specific facts and circumstances and will require significant judgment.

Accounting consultation activities and restatements

Mr. Bricker commented that OCA's primary consultation activities included revenue recognition, business combinations and identification and reporting of segments (which interestingly are not in the top three areas of restatement, he noted). For consultations that come through the Division of Corporation Finance, he cautioned registrants against benchmarking other registrants' disclosures or responses to SEC comment letters to establish their accounting policies without management doing the necessary work to determine and support their own policies.

Mr. Bricker provided observations regarding the top three restatement areas, which relate to debt/equity accounting, statement of cash flows classification and income tax accounting. Because the guidance in these areas can be difficult to apply, Mr. Bricker reminded companies and audit committees about the need to continually assess whether they have resources with sufficient training and competence available to support high-quality financial reporting and make sure proper controls and processes exist.

Auditor independence matters

Michael Husich, Senior Associate Chief Accountant in OCA, and Mr. Croteau emphasized that compliance with the auditor independence rules is the shared responsibility of auditors, management and the audit committee. When non-audit services are provided, the SEC staff members encouraged management and the audit committee to have policies and procedures for ongoing monitoring of the services provided. Mr. Croteau further highlighted the risk of "scope creep" that could impair auditor independence, result in unplanned changes in auditors and the potential need for re-audits, which can be costly for companies and could adversely affect capital-raising activities.

Mr. Husich discussed prohibited services related to bookkeeping services and financial statement preparation for broker-dealer audit clients, which have led to recent SEC and PCAOB enforcement actions. He emphasized that prohibitions on these services are not intended to discourage two-way communications or further engagement between the auditor and its audit client, as long as management takes ultimate responsibility for the accounting conclusions and does not rely on the audit firm to design or implement the controls. For example, SEC staff noted that audit firms may provide guidance about the proper application of the revenue recognition standard, including important factors to be considered in making judgments important to the accounting process. However, SEC staff cautioned that audit firms should always be mindful to not put themselves in the position of auditing their own work or of acting as management by, for example, having direct involvement in the development of specific revenue recognition policies.

Financial reporting and disclosure matters

SEC staff from the Division of Corporation Finance discussed specific reporting matters it commonly focuses on in filing reviews and in which disclosures could be more effective.

Non-GAAP financial measures

Keith Higgins, Director of the SEC's Division of Corporation Finance, reiterated the SEC's focus on non-GAAP measures, which Chair White highlighted in her remarks. Cicely LaMothe, Associate Director in the Division of Corporation Finance, outlined the following general themes related to the staff's review of non-GAAP measures:

- **Prominence** — Non-GAAP measures should not be presented more prominently than the comparable GAAP measures.
- **Compliance with securities rules** — Depending on the presentation, non-GAAP measures must comply with the disclosure and presentation requirements of Regulation G or Item 10(e) of Regulation S-K. In particular, registrants must clearly disclose how the non-GAAP measures are useful to investors without using boilerplate language.
- **Labeling** — Registrants should clearly label non-GAAP measures and related adjustments so they are understandable and not misleading. For example, registrants sometimes identify non-GAAP measures or adjustments using terms that are used in US GAAP, or they use a non-GAAP measure that they define differently than other companies. Instead, registrants should accurately describe the non-GAAP measures in their disclosures to minimize confusion and foster comparability.
- **Consistency** — As registrants make changes to their non-GAAP measures (or GAAP measures used as a base for non-GAAP), appropriate disclosures should be made to describe how these changes affect comparability with the measure previously disclosed.

SEC staff members also made the following points about specific non-GAAP measures. They said adjustments to pension costs should provide enough information for a user to understand the nature of the adjustments made. For example, a label such as "pension adjustment" does not provide enough information. In addition, describing the adjustment as non-cash is inappropriate because pensions are generally cash settled. They also said registrants should provide robust disclosures when eliminating the actuarial gain or loss on pension assets to help users understand the ultimate pension cost reflected in the non-GAAP measure as well as how the expected rate of return reflected in the non-GAAP measure compares with the actual rate of return.

The SEC staff has recently allowed registrants to disclose a "system-wide sales" non-GAAP measure with appropriate disclosures, but the staff has objected to measures that eliminate the effect of commodity price volatility with a "normalized market price." Panelists discussing MD&A said constant currency is a useful non-GAAP measure because it describes one of the three factors affecting changes in revenue (i.e., price, quantity, the effect of currency changes) and referred the audience to the Compliance and Disclosure Interpretations (C&DI) issued by the staff in 2010 stating that a reconciliation was not necessary for such a measure.[8]

Income tax disclosures

Ms. Shah said that registrants should continue to focus on the quality and clarity of key income tax disclosures within MD&A, including those related to income tax rate reconciliations and indefinitely reinvested earnings. Consistent with prior years, the SEC staff has requested that companies disclose the amount of large cash balances held overseas when the indefinite reinvestment assertion is made. Ms. Shah discussed the following ways income tax disclosures could be improved:

- **Discussing the items and changes in the effective income tax rate reconciliation** — Using the income tax rate reconciliation as a starting point for the narrative income tax disclosures in MD&A and tying MD&A disclosures directly to the rate reconciliation helps reduce confusion about where the items discussed flow through the reconciliation. The narrative disclosures should include detailed discussion of what drove the change in the effective tax rate, and the overall susceptibility of the rate to changes. This helps users determine whether the past rate is indicative of the future rate.

- **Clarity and transparency** — The SEC staff may question registrants if there are material items in the rate reconciliations that are not clearly identified and discussed in MD&A. Also, reconciling items affected by multiple factors should be clarified and disaggregated so that users can understand factors driving the reconciling item. For example, reconciling items labelled "foreign rate differential" should be limited to only statutory tax rate differences and not include other differences within the foreign jurisdiction. As an example, the SEC staff suggested a multi-column reconciliation that separately presents the reconciling items and taxable income by material foreign jurisdictions in addition to domestically and on a consolidated basis.

Fair value disclosures

Craig Olinger, a Deputy Chief Accountant of the Division of Corporation Finance, said the adequacy of fair value disclosures required by ASC 820 continues to be an area of focus. Investors have said that disclosures that allow them to assess the quantitative techniques and inputs used, particularly for measurements categorized in levels 2 and 3 of the fair value hierarchy, are important for making informed investment decisions. Registrants can achieve this by challenging the level of aggregation and related description of each class of instrument[9] (e.g., mortgage backed, treasury, collateralized debt) and the related quantitative inputs used to value each class. Mr. Olinger reminded registrants to appropriately consider the nature, characteristics and risk in aggregating assets and liabilities for disclosure. The description of the valuation techniques and inputs used should be linked to each class and provide a detailed description of how the instruments were valued and the related inputs used, not merely list all potential valuation techniques or inputs.

How we see it

Earlier this year, the SEC staff issued several comment letters to registrants in the insurance industry about their basis for aggregating in their disclosures certain fixed maturity securities into defined classes and their descriptions of valuation techniques. Mr. Olinger's comments indicate that the SEC staff may be focusing on this topic more broadly.

EY resources

- *Technical Line, IPO financial statement accounting and disclosure considerations* (SCORE No. CC0423)

Predecessors in IPO registration statements

Initial public offering (IPO) structures may involve the combination of multiple entities in a "put-together" transaction or the carve-out or spin-off of operations from another company. In certain cases, the IPO registrant also may be a newly formed entity, or Newco, that has no significant activities but will acquire a business when or before the IPO becomes effective. The SEC staff said that these transactions require a careful evaluation of the facts and circumstances to determine whether an acquired entity represents a predecessor.

Identifying the predecessor is a matter of judgment and is based on whether an acquired business will constitute the main thrust of the business or operations of the combined entities. More information must be provided for a predecessor (i.e., the same as for a registrant) than for an acquired business under Rule 3-05 of Regulation S-X. For example, unlike a significant acquisition under Rule 3-05, separate schedules, selected financial data, MD&A and other disclosures required under Regulation S-K must be provided for each predecessor.

The SEC staff made the following observations about determining the predecessor:

- Factors to consider when identifying the predecessor may include the order in which the entities were acquired (i.e., which entity was acquired first), the size and fair value of the entities and the ongoing management structure. None of these factors is determinative, and all facts and circumstances should be evaluated.
- It is rare not to identify a predecessor, even if a Newco is determined to be the accounting acquirer.
- It is possible to identify more than one predecessor entity.

The SEC staff also reminded registrants that the predecessor's financial statements may reflect operations that will not be part of the IPO registrant. The SEC staff generally applies a legal entity concept when defining the predecessor. Therefore, if the IPO registrant or the predecessor is a legal entity that disposes or spins off businesses at or prior to the IPO, it may not be able to retroactively omit those businesses from the historical financial statements.

EY resources

- *Technical Line, Accounting risks related to the decline in oil prices* (SCORE No. BB3077)

Depressed oil and gas prices

The SEC staff said that it is focusing on changes in the reserve estimates of oil and gas registrants as well as potential asset impairment issues that may affect any registrant materially exposed to change in oil and gas prices.

The SEC staff noted that it commonly sees boilerplate language about the effects of the continued decline in oil and gas prices that do not address how the registrant is affected. The SEC staff has asked registrants to consider additional disclosures about material uncertainties and the range of potential outcomes related to their impairment estimates and judgments. For example, if management has projected a recovery in oil and gas prices that supports the valuation of the company's assets, the company should consider disclosure about whether a material impairment could result from a longer recovery period.

The SEC staff also said registrants should expand their disclosures if the depressed oil and gas prices materially affect the company's operational or growth prospects or if there is a reasonable likelihood that the reported results may not be indicative of future results.

Accounting, SEC and audit standard-setting update

EY resources

- *Financial reporting developments, Revenue from contracts with customers (ASC 606)* (SCORE No. BB3043)

SEC staff views about the revenue standard

In discussing implementation of the FASB's new revenue recognition standard, Mr. Bricker mentioned a recent survey that indicated "75% of responding companies had not completed their initial impact assessment and, of those, a third had not begun [the assessment]." This statistic is consistent with the results of a polling question posed to attendees during the conference. Mr. Bricker emphasized the need for audit committees to be involved and informed of management's detailed implementation plans and to make sure the company has sufficient resources to complete the work timely.

He said it is important for the TRG to continue its efforts as well as consider a global perspective to foster comparability among registrants. The SEC staff will interpret and expect consistent application among foreign private issuers (FPIs) and domestic registrants where the language in the FASB and IASB standards is the same. Mr. Bricker and others echoed statements previously made by Mr. Schnurr about the need to work through implementation issues in robust discussions with the AICPA's industry groups, the TRG, audit firms and SEC staff.

The SEC staff and other panelists further emphasized the need for registrants to give thoughtful consideration to the evolution of their SAB Topic 11.M[10] disclosures. Mr. Bricker emphasized that the SEC staff is looking forward to reviewing more detailed disclosures in upcoming filings about how companies expect to be affected by the new standard. He also said that companies that don't yet know how they will be affected should disclose that the effect is unknown, along with information about when they plan to complete their assessment of how they will be affected.

How we see it

As companies evaluate and determine the qualitative and quantitative effect of the new revenue recognition standard, their SAB Topic 11.M disclosures should evolve through the adoption date. These disclosures should provide users with detailed information relating to the adoption and should not include boilerplate language. We believe this may become a focus area for the SEC staff in its reviews of filings next year.

Ms. Wright shared some observations about the implementation of the new revenue standard. First, she said all companies will experience some degree of change, which may include changes to disclosures, processes, systems or controls, in adopting the new principles-based standard. She said management and audit committees should create a change management plan and should make sure that sufficient resources are allocated to the project. She also observed that some companies are achieving good results by taking a bottom-up approach to implementation, which begins with the identification of different revenue streams and contracts.

Ms. Wright also reiterated that one of the objectives of the new revenue standard is to improve comparability among companies with similar fact patterns. In this regard, she noted that the SEC staff is focused on achieving consistency in the application of the new revenue standard, even if diversity existed under prior revenue guidance. If different accounting conclusions are identified for similar facts and circumstances, companies should raise those differences during the implementation phase of the standard with the TRG, AICPA industry task forces or the SEC's OCA. Raising issues as soon as possible could potentially prevent companies from incurring costs to make changes to achieve consistent accounting conclusions (e.g., due to future interpretive standard setting by the Emerging Issues Task Force).

Mark Kronforst, Chief Accountant of SEC's Division of Corporation Finance, discussed questions the SEC has received about the requirement in Item 11(b) of Form S-3 to recast annual financial statements upon adoption of a new accounting principle, specifically how it applies to adoption of the new revenue recognition standard. Mr. Kronforst said that Item 11(b) is clear that retrospective revision of the annual financial statements in a new or amended registration statement is required for registrants applying a full retrospective method, if the change is material. For example, a calendar-year registrant filing a Form S-3 registration statement in 2018 after it adopts the revenue standard retrospectively in a Form 10-Q filing would be required to recast its prior-period annual financial statements (e.g., for 2015, 2016 and 2017). He acknowledged registrants' concerns of having to recast an additional year of financial statements, but said that any changes to the requirement would require rulemaking by the Commission. However, Mr. Olinger said the staff plans to issue guidance that would not require companies that adopt the revenue standard on a full retrospective basis to retest the significance of equity method investees for the periods that are revised.

How we see it

Given the continued uncertainty on this topic, companies should consider accelerating the timing for refreshing any shelf registration statements that expire in the year they will adopt the revenue recognition standard. Companies planning to register securities in the year of adoption for other reasons should consider how the need to recast the financial statements might affect their adoption and choice of transition method.

EY resources

- *To the Point, New legislation makes changes to JOBS Act and other SEC requirements* (SCORE No. CC0432)
- *To the Point, SEC proposes requiring 'clawback' policies and disclosures* (SCORE No. CC0413)

SEC rulemaking and other initiatives

Mr. Higgins discussed the new Fixing Americas Surface Transportation Act (FAST Act), which included amendments to the Jumpstart Our Business Startups Act (JOBS Act), many of which are effective upon enactment, and certain other mandates for the SEC (which we discuss in our To the Point, *New legislation makes changes to JOBS Act and other SEC requirements* (SCORE No. CC0432)). [11]

Under the FAST Act, in its IPO filing or confidential submission an EGC may omit the earlier of the two required years of annual financial statements if it reasonably believes it will provide an additional full year of annual financial statements by the effective date of its IPO. The SEC staff clarified that this relief extends to other entity financial statements (e.g., S-X Rule 3-05).

The SEC staff clarified that interim financial information for the current and prior year must be included in the EGC's IPO filing or submission because the interim periods are ***part of*** the financial information that will be required at effectiveness. For example, an EGC that is contemplating an IPO in 2016 could submit or file the registration statement for SEC staff review in early 2016 with only 2014 audited financial statements and the most recent interim period of 2015 (and comparable interim period of 2014) assuming it will include 2015 audited financial statements prior to distributing its preliminary prospectus.

Mr. Higgins said the SEC continues to focus on its remaining rulemaking under the Dodd-Frank Wall Street Reform and Consumer Protection Act, including rules relating to hedging, executive compensation and resource extraction payments, which the Commission recently re-proposed.

Audit committee reporting

In July 2015, the SEC issued a concept release seeking public comment on possible revisions to audit committee disclosures, with a focus on areas related to the audit committee's oversight of the independent auditor. Mr. Croteau observed that the Sarbanes-Oxley Act of 2002 (SOX) significantly expanded the audit committee's responsibilities, but that the SEC's disclosure requirements predate SOX. The concept release was developed in response to a desire by some investors to hear more from audit committees about how they perform their role as gatekeepers for the benefit of investors.

Mr. Croteau noted that many commenters support considering improvements to audit committee disclosure requirements. However, there were mixed views about the need for mandatory detailed disclosures, with some commenters suggesting that voluntary disclosures could be sufficient. Mr. Croteau noted that commenters were particularly interested in areas such as:

- The selection and appointment of the auditor
- The evaluation of the audit team
- Auditor compensation
- Composition of the audit committee

With respect to voluntary disclosure, both Chair White and Mr. Croteau observed that many audit committees have enhanced their disclosures beyond those required by today's rules in response to increased investor interest. Mr. Croteau encouraged audit committee members to consider the usefulness of their disclosures and whether additional insights could make the report more meaningful.

EY resources

- *To the Point, Our recommendations for changing Regulation S-X disclosures about entities other than the registrant* (SCORE No. CC0429)
- *Disclosure effectiveness – What companies can do now* (SCORE No. CC0403)
- *Disclosure effectiveness – What investors, company executives and other stakeholders are saying* (SCORE No. CC0404)

Disclosure effectiveness initiative

The Division staff continues to review the business and financial disclosures in Regulation S-K and S-X as part of the SEC's disclosure effectiveness initiative. The SEC staff also is considering how to leverage technology and the EDGAR delivery system to facilitate user access to meaningful information. Mr. Higgins said that the initiative continues to be a priority and he expects there will be significant progress in 2016.

Regulation S-X rulemaking

In October 2015, the SEC issued a request for comment on how it might enhance the effectiveness of disclosure requirements in Regulation S-X applicable to entities other than the registrant, including acquired businesses, equity method investees, subsidiary issuers and guarantors. Although the comment letter period has ended, the SEC staff said that it continues to accept and consider any comments submitted.

Mr. Kronforst said that the SEC received a wide range of recommendations from constituents, but comment letters highlighted several specific areas for improvements that the SEC staff is considering.

How we see it

The consistency of recommendations on some topics could enable the SEC staff to make recommendations to the Commission in a relatively short time frame about changes to the rules that could reduce complexity and costs for preparers and improve the usefulness of information for investors.

Regulation S-K requirements

The SEC staff is currently reviewing how to enhance the Regulation S-K requirements, including the following disclosure areas:[12]

- Eliminating overlapping and outdated requirements
- Determining the appropriate balance between bright lines and principles-based requirements
- Scaling disclosures for EGCs and smaller reporting companies
- Updating and incorporating the industry guides, particularly for bank holding companies

Technology improvements

Mr. Higgins cited a comment letter from the Center for Audit Quality and several trade organizations, including the US Chamber of Commerce, Financial Executives International and Business Roundtable, that suggested modernizing the SEC's website and the EDGAR system.[13] The SEC staff said that it plans to implement changes over the next couple of months in response to this letter.

Voluntary improvements by companies

In a panel, an SEC staff member and several company executives discussed voluntary efforts that registrants have made to improve their disclosures. The SEC staff member observed that more companies are considering their SEC filings to be communication documents, rather than merely compliance filings. Company executives summarized changes they have made to disclosures, including eliminating immaterial information, using charts and tables to highlight material information and reducing duplicative information by using cross-references.

The SEC staff said that it supports the use of cross-references to or from the financial statement notes and other sections of the Form 10-K as long as it is clear which disclosure has been audited. However, company executives said that they and their auditors rarely support cross-referencing from the financial statement notes (e.g., to MD&A) due to concerns about the clarity of audit responsibility.

PCAOB standard setting and other initiatives

Martin Baumann, PCAOB Chief Auditor and Director of Professional Standards, and Jay Hanson, PCAOB Board Member, provided an overview of the PCAOB's standard setting and other projects. They also discussed the evaluation of the PCAOB's standard-setting process that occurred during 2015 to create a more thorough, efficient approach to the standard-setting projects.

Recently approved standards

- *Related parties* — Mr. Baumann highlighted the Board's standard on related parties, AS 18, which is effective for audits of financial statements for fiscal years beginning on or after 15 December 2014. Mr. Hanson and Mr. Baumann noted concerns that have been raised by auditors and preparers as the standard has been implemented, particularly with respect to the requirement for auditors to obtain a representation from management that they have provided the auditor with a list of all related parties. Mr. Baumann observed that obtaining a list of all related parties is the starting point for an auditor's procedures. In response to a question, Mr. Hanson observed that this was not an area in which commenters raised concerns during standard setting.

- *Reorganization* — Mr. Baumann described the reorganization of the PCAOB's auditing standards that was completed this year and will be effective as of 31 December 2016. The PCAOB undertook this project to organize its auditing standards using a topical structure and a single numbering system for easier navigation.

Reporting standards

- *Transparency* — Mr. Baumann said the objective of this project was to provide important information to investors and promote accountability through disclosure of the name of the engagement partner and certain other participants in the audit. A supplemental request for comment was issued on 30 June 2015 to propose disclosing this information in a new PCAOB form, Form AP, rather than in the auditor's report. Mr. Baumann stated that this alternative would balance the benefits of such disclosure with the liability concerns raised by including the information in the auditor's report. The standard, which is subject to approval by the SEC, is expected to be approved by Board on 15 December 2015.

- *Auditor's reporting model* — Mr. Baumann said the PCAOB plans to re-propose a standard on the auditor's reporting model in the first half of 2016. It will reflect feedback the PCAOB received from comment letters and in public hearings on an earlier proposal. Mr. Baumann noted that expanded auditor reporting is already required in the United Kingdom and has been considered successful. Additionally, the International Auditing and Assurance Standards Board (IAASB) approved a new audit reporting standard, which includes the identification of key audit matters and how those matters were addressed during the audit, effective for 2016 listed company audits.

- *Audit quality indicators (AQIs)* — Mr. Hanson said that while constituents support the PCAOB's AQI concept release, they expressed diverse views on the next steps the PCAOB should take in the project. He said he believes the PCAOB should continue to monitor discussions between auditors and audit committees, encourage firms to issue quality reports and then assess whether to mandate the use of AQIs.

Performance standards

- *Supervision of other auditors* — Mr. Baumann said a proposal on supervision of other auditors in multinational audits would seek to strengthen the oversight of the other firms by the lead audit firm and provide improved guidance on directing, reviewing and using the work of other auditors.

- *Auditing estimates, including fair value measurements* — Mr. Baumann said the staff is planning to recommend that the PCAOB propose a single standard to replace the multiple existing standards that govern the auditor's work in this area. The proposal would address changes in the related accounting frameworks, the increased use of fair value measurements and pricing services and provide better linkage with the Board's risk assessment standards.

- *Specialists* — Mr. Baumann said the staff plans to recommend that the PCAOB propose general requirements for the oversight of specialists (whether used by the auditor or by management) and to develop more rigorous requirements on using the work of management's specialists.

Other projects requiring additional research or outreach

- *Going concern* — Mr. Baumann said that evaluating whether there is substantial doubt about a company's ability to continue as a going concern is important to investors. Following the FASB's adoption of a requirement for management to make an evaluation of substantial doubt, which it defined differently than existing PCAOB standards, the PCAOB reminded auditors that their evaluation of an entity's ability to continue as a going concern needed to comply with the PCAOB's existing auditing standards. The PCAOB is currently evaluating its next steps.

- *Other information accompanying the financial statements* — Mr. Baumann noted that in its 2013 proposal on the auditor's reporting model, the PCAOB proposed requirements for the auditor to read and evaluate the other information accompanying the financial statements and include a discussion of this evaluation in the auditor's report. Commenters expressed concerns about this proposed requirement, and the PCAOB is exploring its next steps.

- *Quality control standards* — Mr. Baumann said improved quality control standards could lead to improved audit quality and a reduction of inspection findings by the PCAOB and other global regulators. The IAASB has undertaken a similar project, and the PCAOB is planning to coordinate its efforts with the IAASB.

- *Other emerging issues* — The PCAOB's recently asked its Standing Advisory Group to identify the most important issues that could affect audits, auditors and the PCAOB. The issues identified included whistleblower activity, economic developments, use of data/data auditing, non-GAAP measures, the effect of FASB's materiality proposal, revenue recognition and cybersecurity.

International matters

The IFRS footprint and outlook for IFRS

Hans Hoogervorst, IASB Chairman, discussed the success of convergence efforts between the IASB and the FASB, including their revenue recognition and leases standards. He noted that the revenue standards are substantially the same and demonstrate that rules-based and principles-based cultures can be reconciled. He said the leases standards the Boards plan to issue early next year are converged on their main objective to put most operating leases on the balance sheet.

Mr. Hoogervorst said that 116 jurisdictions currently require the use of IFRS. He noted developments in Japan, India and China that advance the use of IFRS. He said these developments are clear progress for investors and preparers because companies will be able to use one accounting language in expanding parts of the world. However, Mr. Hoogervorst acknowledged that consistent application of IFRS requires "permanent attention and rigorous enforcement."

Mr. Hoogervorst also discussed the outlook for the IASB's standard setting over the next 12 months. The IASB and IFRS Foundation will conduct outreach on their standard-setting agenda and the effectiveness of their structure in 2016. He said the IASB needs to improve the communication value of financial reporting by addressing disclosure effectiveness and performance reporting. Other issues the IASB may address include how financial reporting relates to broader issues of corporate reporting (e.g., sustainability, value creation) and the effect of technology and Big Data on financial reporting. He encouraged entities to comment on the consultation papers that will be released in 2016.

Finally, Mr. Hoogervorst noted that the US has substantive interests at stake in IFRS due to its expanding use in the global economy. He gave an example of a recent high-profile IPO by an FPI that listed on a major US stock exchange using financial statements in accordance with IFRS as issued by the IASB. That's why, he said, regardless of its use by domestic companies, US constituents should stay engaged and help the IASB build IFRS in the future.

Considerations for IFRS in the US capital markets

Julie Erhardt, Deputy Chief Accountant in OCA, discussed the interaction between the US and IFRS and benefits of a single set of global accounting standards. She made the following points:

- **Shared origins** — The US was a strong supporter and active participant in the global accounting profession's decision to convert the International Accounting Standards Committee into the IASB, and there are many companies and organizations in the US with a connection to the IASB's work (e.g., US headquartered global corporations) suggesting that the US should continue to be actively involved with IFRS.
- **Shared knowledge** — The US is perceived as a leader on financial reporting policy matters. There is a potential benefit in US companies and standard setters sharing their experiences and views across borders.
- **Shared benefits** — A single recognizable/comparable set of standards benefits domestic companies and investors in the expanding global economy.

How we see it

While it appears that any SEC action in the short-term related to IFRS may be limited to acceptance of voluntary supplemental disclosures, there continues to be consistent support for continued convergence efforts and US engagement with the IASB and global standard setting.

Foreign private issuers

Mr. Olinger said that as of 31 December 2014, about 500 of the approximately 900 FPIs registered with the SEC prepared their financial statements in accordance with IFRS and about 400 prepared their financial statements in accordance with US GAAP. Very few FPIs prepare financial statements in accordance with local country GAAP reconciled to US GAAP.

Common issues and best practices related to foreign transactions

Mr. Olinger participated in an international reporting panel discussion with others on areas that are challenging in cross-border transactions. The panel highlighted the following reporting considerations for transactions that will be registered with the SEC:

- **Foreign status** — When contemplating a foreign transaction, a registrant needs to consider whether it and the target are US domestic filers, foreign businesses or FPIs. This distinction is important in understanding the basis (i.e., US GAAP, IFRS) of the financial information to be presented in the registration statement. Mr. Olinger clarified that a foreign incorporated joint venture that is 50% owned by a US-domiciled entity and 50% owned by a foreign entity does not qualify as a foreign business because neither entity controls the joint venture. When such a joint venture is consolidated by the non-US registrant for reasons other than voting rights under the consolidation rules, Mr. Olinger encouraged registrants to consult with the SEC staff to determine whether any of the foreign business accommodations could be used. Paul Dudek, Chief of the SEC's Office of International Corporate Finance, said that SEC rules do not specify the date on which the assessment must be made whether an acquiree meets the foreign business criteria; therefore, judgment is required, and registrants may consult with the SEC staff.

- **Auditor reporting framework** — The panel observed that, in an SEC filing, a target's financial statements must be audited under AICPA standards or PCAOB standards, but audits performed under International Standards of Auditing are not acceptable. Certain disclosures required by IFRS (e.g., market risks and critical accounting estimates) may be disclosed in MD&A and incorporated by reference in the notes to the financial statements. As a result, the audit report on IFRS financial statements must clearly extend to those disclosures.

Losing FPI status

Mr. Dudek discussed some considerations for a registrant that loses its FPI status when it makes the required assessment at the end of the second quarter of its fiscal year. For example, a calendar-year company that loses its FPI status as of 30 June 2015 may continue to file forms that are applicable to FPIs for the remainder of the year. The company will be subject to all of the requirements of a domestic company beginning 1 January 2016, including the requirement to file current reports and quarterly reports. The 2015 Form 10-K would need to include three years of audited financial statements prepared using US GAAP. The registrant must also reassess the significance of equity method investees under S-X Rule 3-09 of Regulation S-X using its US GAAP financial statements.

Considerations for certain Canadian companies

Certain Canadian companies listed in the US register with the SEC under the Multi-Jurisdictional Disclosure System (MJDS) and are afforded certain accommodations including the ability to provide two years of audited financial statements in their SEC filings. A public float of at least $75 million at year end is one of several eligibility criteria. Recent declines in energy prices and their effect on a company's stock price could result in a Canadian filer losing its MJDS status and having to comply with requirements as an FPI, including the requirement to provide three years of audited financial statements and comply with S-X Rule 3-09 for purposes of filing Form 20-F.

SEC enforcement and PCAOB inspection matters

Remarks of SEC enforcement staff

Andrew Ceresney, Director of the SEC's Division of Enforcement, and Michael Maloney, Chief Accountant in the Division of Enforcement, discussed the SEC's enforcement actions over the past year. The SEC filed more than 800 cases (a record) in fiscal 2015. In fiscal 2014, the SEC collected approximately $2 billion of disgorgements and penalties, which is either paid to wronged individuals or the US Department of Treasury (depending on the nature of the case).

Mr. Ceresney said the number of financial reporting and auditing cases continued to rise in fiscal 2015 to 114 from 79 in 2014 and 53 in 2013. The increase was driven in part by the Division of Enforcement's creation of a financial reporting and auditing task force and its use of data analytics. Mr. Maloney indicated the allegations in those enforcement actions stem from poor tone at the top, pressure to meet financial targets/earnings management, and growth outpacing infrastructure. The financial reporting actions focused on a variety of topics from revenue recognition (e.g., percentage of completion, accelerated/false revenues, bill and hold arrangements) to disclosure issues (e.g., missing or insufficient). The SEC also has filed enforcement actions against auditors for lack of professional skepticism, overreliance on management representations, failure to obtain audit evidence and having insufficient documentation.

Finally, Mr. Maloney discussed enforcement actions related to faulty valuations. He said these actions involved improper methodologies and unsupported or outdated assumptions, but the Division does not question valuations made in good faith. These actions often found that auditors did not obtain a sufficient understanding of the models/assumptions used or placed overreliance on outside specialists. He emphasized that management, auditors and valuation specialists need to remain vigilant in complying with their respective responsibilities.

PCAOB inspections

Ms. Munter said that she believes the state of audit quality is improving. Ms. Munter stated that audit firms and audit partners are more engaged, and firms are focusing on root cause analyses and on timely and substantive remedial actions. Specifically, the PCAOB has seen improvements in the tone at the top, the training on complex audit areas, new practice aids and checklists to help auditors consistently and thoroughly apply the PCAOB auditing standards, coaching and support to audit teams and monitoring activities of firms.

Ms. Munter said the goal of the inspection process is not to only to identify deficiencies on specific audits but to leverage any observations from specific audits to help identify any systemic problems that may exist. The identification and remediation of any potential systemic issues can lead to more significant improvements in audit quality.

Ms. Munter also noted that many inspections result in no deficiencies being identified, and the PCAOB is looking to further its understanding of the root causes of high-quality audits inspected.

However, Ms. Munter noted there are still opportunities for improvement in certain areas of recurring inspection findings, including internal control, fair value and revenue recognition. These recurring inspection findings are consistent with findings identified by the annual survey of inspection results produced by the International Forum of Independent Audit Regulators. Other areas noted for improvement by the PCAOB staff include effective remedial action, root cause analysis, consistent global execution of an audit methodology and monitoring of independence.

Ms. Munter said the PCAOB's 2016 inspections will likely focus on:

- Recurring deficiencies, including ICFR, assessing and responding to risks of material misstatement and auditing accounting estimates
- Challenges created by the appreciation of the US dollar
- Segment disclosures, including identifying the CODM and determining the operating and reportable segments
- Mergers and acquisitions
- Income taxes, including management's assertion of indefinite reinvestment outside of the US and the related internal controls
- Going concern evaluation
- Cybersecurity
- Implementation of AS 18

Finally, Ms. Munter highlighted the PCAOB's focus on increasing the inspection information that is shared with the public. Inspection reports have been expanded to include industry information, and the staff introduced Inspection Briefs to highlight important matters about inspections. The PCAOB staff plan to further expand the data available about inspections on the PCAOB website, beginning in 2016.

Endnotes:

[1] Commission guidance regarding *Management's Report on Internal Control Over Financial Reporting Under Section 13(a) or 15(d) of the Securities Exchange Act of 1934,* Release No. 33-8810 (June 20, 2007), is available at: https://www.sec.gov/rules/interp/2007/33-8810.pdf

[2] ASC 605-50, *Customer Payments and Incentives*.

[3] ASC 718, *Compensation-Stock Compensation*.

[4] SAB Topic 6.L, *Selected Loan Loss Allowance Methodology and Documentation Issues*.

[5] For public business entities, ASU 2015-02 is effective for annual and interim periods beginning after 15 December 2015. For all other entities, it will be effective for annual periods beginning after 15 December 2016, and interim periods beginning after 15 December 2017. Early adoption is permitted for annual and interim periods.

[6] ASC 810-10-55-37.

[7] ASC 810-10-55-37D.

[8] Refer to C&DI's on non-GAAP measures question 104.06 available at: http://www.sec.gov/divisions/corpfin/guidance/nongaapinterp.htm

[9] ASC 820 states that the appropriate classes of assets and liabilities are determined on the basis of the nature, characteristics and risks of the asset or liability, and the level of the fair value hierarchy within which the fair value measurement is categorized.

[10] SAB Topic 11.M addresses disclosure of the effect that recently issued accounting standards will have on the financial statements of the registrant when adopted in a future period.

[11] The SEC staff recently issued C&DIs related to the FAST Act, which can be found at: http://www.sec.gov./divisions/corpfin/guidance/fast-act-interps.htm

[12] The FAST Act requires the SEC to take action to revise Regulation S-K requirements within 180 days and conduct further study in consultation with the Investor Advisory Committee and the Advisory Committee on Small and Emerging Companies.

[13] The comment letter can be found at: http://www.sec.gov./comments/disclosure-effectiveness/disclosureeffectiveness-40.pdf

Appendix — Conference speeches

	Speech and link to source
SEC Chair, Mary Jo White	▸ Speech by SEC Chair: Keynote Address at the 2015 AICPA National Conference: "Maintaining High-Quality, Reliable Financial Reporting: A Shared and Weighty Responsibility"
SEC Chief Accountant, James Schnurr	▸ Speech by SEC Chief Accountant: Remarks before the 2015 AICPA National Conference on Current SEC and PCAOB Developments
SEC Deputy Chief Accountant, Wesley Bricker	▸ Speech by SEC Deputy Chief Accountant: Remarks before the 2015 AICPA National Conference on Current SEC and PCAOB Developments
SEC Deputy Chief Accountant, Julie Erhardt	▸ Speech by SEC Deputy Chief Accountant: Remarks before the 2015 AICPA National Conference on Current SEC and PCAOB Developments
SEC Deputy Chief Accountant, Brian T. Croteau	▸ Speech by SEC Deputy Chief Accountant: Remarks before the 2015 AICPA National Conference on Current SEC and PCAOB Developments
SEC Senior Associate Chief Accountant, Michael Husich	▸ Speech by SEC Senior Associate Chief Accountant: Remarks before the 2015 AICPA National Conference on Current SEC and PCAOB Developments
SEC Associate Chief Accountant, Barry Kanczuker	▸ Speech by SEC Associate Chief Accountant: Remarks before the 2015 AICPA National Conference on Current SEC and PCAOB Developments
SEC Professional Accounting Fellow, Kris Shirley	▸ Speech by SEC Professional Accounting Fellow: Remarks before the 2015 AICPA National Conference on Current SEC and PCAOB Developments
SEC Professional Accounting Fellow, Christopher Rickli	▸ Speech by SEC Professional Accounting Fellow: Remarks before the 2015 AICPA National Conference on Current SEC and PCAOB Developments
SEC Professional Accounting Fellow, Ashley Wright	▸ Speech by SEC Professional Accounting Fellow: Remarks before the 2015 AICPA National Conference on Current SEC and PCAOB Developments
SEC Professional Accounting Fellow, Christopher Semesky	▸ Speech by SEC Professional Accounting Fellow: Remarks before the 2015 AICPA National Conference on Current SEC and PCAOB Developments
SEC Professional Accounting Fellow, Courtney Sachtleben	▸ Speech by SEC Professional Accounting Fellow: Remarks before the 2015 AICPA National Conference on Current SEC and PCAOB Developments
PCAOB Chair, James R. Doty	▸ Speech by PCAOB Chair: Protecting the Investing Public's Interest in Informative, Accurate, and Independent Audit Reports
PCAOB Member, Jay D. Hanson	▸ Speech by PCAOB Member: PCAOB Standard-Setting Update — AICPA National Conference on Current SEC and PCAOB Developments
FASB Chairman, Russell G. Golden	▸ Speech by FASB Chairman: Remarks at the 2015 AICPA Conference on Current SEC and PCAOB Developments
IASB Chair, Hans Hoogervorst	▸ Speech by IASB Vice-Chairman: IFRS: 2015 and beyond
CAQ Executive Director, Cindy Fornelli	▸ Speech by CAQ Executive Director: Center for Audit Quality Update: Focus on the Future
AICPA Chair of the Board of Directors, Tim Christen	▸ Speech by AICPA Chair: Adapt, Evolve for Relevance: Driving Change to Preserve Our Future

Disclosure effectiveness

What companies can do now

October 2014

EY

Building a better working world

Table of contents

Introduction

Overview

With regulators and standard setters now looking at how to make corporate disclosures more effective, companies can take steps now to make their own disclosures more meaningful.

The problems with disclosures are well known. As the volume of disclosures has grown,[1] regulators and financial statement users have repeatedly said that disclosure documents contain too much boilerplate and are so repetitive that it is difficult for investors to find the most important information. Meanwhile, some investors and other users have called for new disclosures or improvements in existing ones.

Companies that have successfully streamlined their disclosures by focusing on relevant and material information cite many benefits, including:[2]

- Increased investor confidence due to communication of more meaningful information
- Greater efficiency in preparing investor communications and auditing disclosures
- Improved coordination throughout the organization, including the board of directors, and with regulators and external advisers
- Strengthened market reputation and leadership

Companies that want to make their disclosures more effective will need to consider time, cost and resource constraints, as well as regulatory disclosure requirements. Developing appropriate processes to enhance disclosures often requires planning and support from executive management and the Audit Committee; outreach to investors; and coordination with lawyers, auditors and other advisers.

It may be more productive for a company to target specific disclosure areas that are particularly complex or lengthy rather than start with a blank sheet to rewrite the financial statements and SEC reports. We believe both preparers and users are best served when there is sustained focus on improving the quality of information provided to investors.

This publication discusses how companies might consider making their disclosures more effective. It highlights our recommendations, along with illustrations that may help companies take steps to improve their disclosures.

> "When disclosure gets to be 'too much' or strays from its core purpose, it could lead to what some have called 'information overload' — a phenomenon in which ever-increasing amounts of disclosure make it difficult for an investor to wade through the volume of information she receives to ferret out the information that is most relevant."
>
> — SEC Chair Mary Jo White[3]

1 In an EY study, we found that the average number of pages devoted to footnotes and management's discussion and analysis in the annual reports of 20 well-known companies quadrupled from 1992 to 2011. See our To the Point publication, *Now is the time to address disclosure overload*

2 Center for Audit Quality, *Financial Statement Disclosure Effectiveness: Forum Observations Summary*

3 *The Path Forward on Disclosure*, National Association of Corporate Directors — Leadership Conference, 15 October 2013

Disclosure effectiveness initiatives

The Securities and Exchange Commission (SEC) staff is reviewing the requirements of both Regulations S-K and S-X to identify ways to reduce the costs and burdens on companies while still providing material information to investors.

The initiative grew out of a December 2013 study of disclosure requirements in Regulation S-K, which was required by the Jumpstart Our Business Startups Act. In this study, the staff of the SEC's Division of Corporation Finance recommended that the SEC undertake a comprehensive review of the existing disclosure requirements. SEC Chair Mary Jo White has called the disclosure effectiveness initiative a priority and has directed the SEC staff to make specific recommendations this year.

Reducing the volume of disclosures is not the SEC staff's sole objective. If the staff identifies potential gaps in disclosure or opportunities to increase transparency, it may recommend new or enhanced disclosure requirements. It also will consider how technology and cross-referencing can promote these objectives.

The SEC is encouraging companies, investors and other market participants to submit their views on how to make disclosures more effective. Suggestions can be submitted through the spotlight page on the SEC's website.[4] The SEC is expected to issue one or more concept releases later this year to seek public input.

The Financial Accounting Standards Board (FASB) and International Accounting Standards Board (IASB) also are seeking ways to improve disclosures in the financial statement notes.[5]

The FASB has proposed adding a new chapter to its conceptual framework in an effort to improve the process for establishing new disclosure requirements and evaluating existing ones. In addition, the FASB will be revisiting certain disclosure requirements (e.g., for pensions, fair value measurements, interim reporting) in narrow, short-term projects. The FASB also is working on a project to provide guidance on the decision process companies should employ for evaluating what disclosures to make.

The IASB also is taking steps to improve disclosures, including:

- Identifying a set of principles that would inform the organization, format and linkage of information in financial statement disclosures
- Reviewing existing disclosure requirements to identify duplication and overlap
- Researching how materiality is applied in practice and considering whether further guidance is necessary

The following EY publications provide more information on these initiatives:

EY resources

- SEC in Focus, Issue 4 (SCORE No. CC0402), October 2014
- Financial reporting briefs (SCORE No. BB2827), September 2014
- SEC in Focus, Issue 3 (SCORE No. CC0396), July 2014
- Applying IFRS – Improving disclosure effectiveness (EYG No. AU2513), July 2014
- To the Point – A framework to help the FASB establish effective disclosures (SCORE No. BB2707), March 2014
- To the Point – SEC staff recommends a comprehensive review of SEC disclosure requirements (SCORE No. CC0386), January 2014
- To the Point – The SEC's opportunity to consider disclosure overload (SCORE No. CC0359), October 2012

In addition, several other regulators, standard setters and organizations around the world are undertaking similar disclosure effectiveness projects. These projects are summarized in the appendix to this publication.

> "[O]ur goal is to both improve disclosure content – make it more useful to investors – and at the same time, where we can, reduce the amount of disclosure content … The framework is designed to lead to disclosures that clearly communicate the information that is most important to the users of the financial statements."
>
> – Russell G. Golden, FASB Chairman[6]

4 http://www.sec.gov/spotlight/disclosure-effectiveness.shtml

5 The primary advisory committees of the Boards, Financial Accounting Standards Advisory Council (FASAC) and IFRS Advisory Council, also have highlighted disclosure initiatives as top priorities.

6 *Remarks of Russell G. Golden, AICPA Conference on Current SEC and PCAOB Developments*, December 2013

The SEC call to action

While the SEC staff is reviewing the SEC's disclosure requirements, staff members also are asking companies to proactively enhance their disclosures by:

- Reducing repetition
- Tailoring the disclosure to focus on material information
- Eliminating outdated and immaterial information

In a recent speech at the US Chamber of Commerce, SEC Division of Corporation Finance Director Keith Higgins also invited companies that would like to discuss changes to their disclosures before including them in a filing to contact the SEC staff.

In this publication, we explore the staff's suggestions in greater detail and highlight areas where companies may apply them.

> "Our effort will truly succeed only if all of the stakeholders in our current disclosure system — companies, investors, legal and accounting professionals and other market participants — contribute to the dialogue about the improvements that could be made to the quality and effectiveness of disclosure so that it is less burdensome both for companies to prepare and for investors to read."
>
> — SEC Division of Corporation Finance Director Keith Higgins[7]

[7] *Disclosure Effectiveness: Remarks Before the American Bar Association Business Law Section Spring Meeting*, 11 April 2014

Materiality considerations

Materiality is one of the key principles of financial reporting. Efforts to make disclosures more effective typically focus on evaluating whether existing or proposed disclosures provide material information to financial statement users or merely add clutter.

The US Supreme Court ruled that a fact is material if there is "a substantial likelihood that the disclosure of the omitted fact ***would*** have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." (Emphasis added.) The Court rejected the view that a fact is material if an investor ***might*** find it important, concluding that "management's fear of exposing itself to substantial liability may cause it simply to bury the shareholders in an avalanche of trivial information — a result that is hardly conducive to informed decision making."[8]

Several SEC staff members and commissioners have questioned whether the Supreme Court's fear has become a reality. In a recent speech,[9] SEC Commissioner Daniel Gallagher stated, "Companies' disclosure documents are being cluttered with non-material information that can drown out or obscure the information that is at the core of a reasonable investor's investment decision."

We agree with the view that investors are not well-served if disclosure documents are filled with immaterial disclosures. Materiality should determine whether information is included in or excluded from a disclosure document. Materiality also should influence how prominently the information is presented.

Evaluating materiality, however, requires significant judgment. SEC Staff Accounting Bulletin (SAB) Topic 1.M, *Assessing Materiality*, provides further guidance about materiality and states that materiality judgments involve the consideration of both quantitative and qualitative factors. The SAB provides a list of quantitative and qualitative factors for evaluating the materiality of a misstatement. While this list is neither easily applied to disclosure considerations nor all-inclusive, companies must eventually evaluate whether omitted or misstated disclosures, individually or in the aggregate, would affect a reasonable investor. When evaluating materiality, companies may consider whether their disclosures:

- Affect the fair presentation of the financial statements
- Indicate potential areas of management bias
- Relate to sensitive matters (e.g., executive compensation disclosures, fraud, noncompliance with laws)
- Affect significant accounting policies in areas for which there is a lack of authoritative guidance or consensus
- Relates to accounts or disclosures for which significant judgment is used in the application of accounting principles, including critical accounting policies

Making and documenting materiality judgments will never be an easy task, but companies that take a fresh look at their disclosures often identify areas that could be eliminated or substantially reduced without significantly altering the total mix of information.

"After nearly a century in the making, our disclosure regime is not based entirely on line item requirements; rather, it is fundamentally grounded on the standard of 'materiality.' "

— SEC Chair Mary Jo White[10]

The FASB defines materiality differently than the US Supreme Court did. In defining materiality, the FASB says, "information is material if omitting it or misstating it ***could*** influence decisions that users make on the basis of the financial information of a specific reporting entity."[11] (Emphasis added.) We believe that the FASB's use of the word ***could***, may contribute to excessive footnote disclosures.[12]

8 *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449-450 (1976)

9 *Remarks at the 2nd Annual Institute for Corporate Counsel*, 6 December 2013

10 *The Path Forward on Disclosure*, National Association of Corporate Directors — Leadership Conference, 15 October 2013

11 FASB Concepts Statement 8, *Qualitative Characteristics of Useful Financial Information*

12 In our comment letter to the FASB on its Discussion Paper, *Disclosure Framework*, we recommended that the FASB amend its definition to be consistent with the Supreme Court's opinion.

Materiality of an item

FASB Accounting Standards Codification (ASC) 105-10-05-6 states that "the provisions of the Codification need not be applied to immaterial items." However, neither the FASB nor the SEC provides specific guidance clarifying how to consider the materiality of individual disclosure requirements. As a result, companies often provide every specified GAAP disclosure that relates to each area (e.g., stock compensation expense) that they determine is material to their financial statements.

We believe that companies should consider how individual disclosures affect the total mix of information available. That is, companies don't need to include all specified disclosures if they conclude that an individual disclosure is immaterial. We believe this view is consistent with the Supreme Court's definition of materiality.

Materiality considerations as part of SEC review process

Companies tend to retain disclosures that were material in a previous period but may no longer be material. This phenomenon is especially true when the disclosure was added in response to an SEC staff comment. The SEC staff has said publicly that companies should remove disclosures made in response to earlier SEC staff comment letters if those matters are no longer material.

The SEC staff also has said that just because it raises questions, companies should not assume that they need to add more disclosures to their filings, particularly immaterial information. The SEC staff often issues comments seeking clarification rather than additional disclosure. In some cases, registrants should respond by revising their disclosure to make it more effective rather than adding new disclosures.

The SEC staff is assessing whether its comment letter practices have contributed to the disclosure of immaterial information and will consider whether any changes to its filling review and comment practices are necessary.

Leading practices on structure and content

The SEC has said that companies can improve the relevancy of disclosures and reduce clutter by presenting information in a logical, easy-to-read manner.

In 2003, the SEC issued FR-72, *Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations*, which provides interpretive guidance concerning the preparation, format and content of management's discussion and analysis (MD&A). FR-72 states that MD&A should provide an explanation of the company's financial statements that enables investors to see the company through the eyes of management.

In addition, FR-72 says the primary purpose of MD&A is for management to communicate with investors in a straightforward manner. It states that companies should:

- Focus on material information, eliminate immaterial information and avoid unnecessary duplicative disclosure
- Use a "layered" approach to present their disclosure so that the most important material information is most prominent
- Present MD&A in a clear and understandable way by using tables and headings to help readers follow the flow of pertinent information
- Provide not only required disclosure but also an analysis that explains management's view of the implications and significance of that information

We encourage companies to revisit these principles when enhancing the effectiveness of their MD&A disclosures. We also believe companies should consider whether similar principles can be applied to the presentation of financial statement notes or other disclosures outside their financial statements. For example, these principles may guide how a company presents and discusses both financial and nonfinancial information, including operational and strategic goals, key performance indicators, and corporate and social responsibility information considered material to its investors.

In the following sections, we discuss these concepts and best practices based on our review of filings by companies that have already applied them.

Use of layering

Layering refers to emphasizing the most important information and providing additional details elsewhere. Layering can be accomplished in several ways.

FR-72 encourages companies to use an executive-level overview to provide context for their MD&A. The summary should present the important factors in evaluating the company's financial condition and operating performance without merely repeating the detailed discussion and analysis that follows.

The SEC staff expects an informative executive-level overview to provide insight into material opportunities, challenges and risks on which the company's executives are most focused for both the short and long term, as well as the actions they are taking to address them.

In our view, companies can apply this concept to other disclosures. They can use summaries, activity rollforwards or hyperlinks that emphasize or allow navigation to the most important information, provide additional context and details, or minimize redundancies.

See below for recommendations and illustrations of how layering can be used to make MD&A and footnote disclosures more effective.

Longer term, we expect technology to play an important role in disclosure reform. For several years, the SEC has contemplated using technology to structure disclosure and make it easier for investors to find material information.[13]

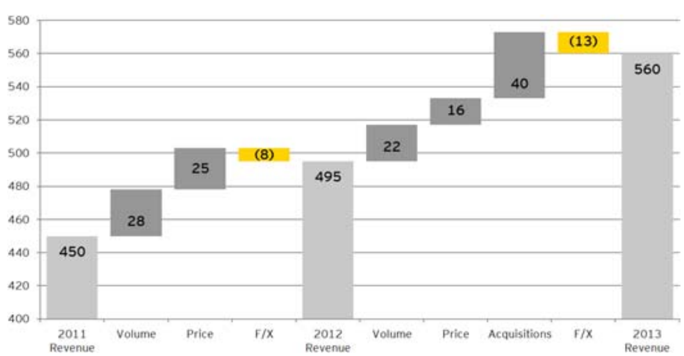
[13] For example, in 2008, the SEC formed the 21st Century Disclosure Initiative and released a report, *Toward Greater Transparency: Modernizing the Securities and Exchange Commission's Disclosure System*, with recommendations for comprehensive changes to the disclosure system.

Use of graphs, charts and tables

Information often can be presented more clearly and concisely in graphs, charts and tables than in text. In recent standards and rule releases, the FASB and SEC have encouraged and, in some cases, required tabular presentations of disclosure. For example, the rules related to executive compensation disclosures require tabular disclosures along with narrative discussion that supplements the tables.[14] Furthermore, FR-72 encourages the use of tables to compare and explain changes in results between different periods. The following is an example of a "waterfall" chart that some companies have used to depict changes in balances from one period to the next:

Illustration: Waterfall chart

Three-year comparison of total revenues (in millions)



As companies make greater use of charts and graphs in their disclosures, the presentation in annual reports is becoming more like that of investor-day presentations and internal managerial and board reporting.

As a leading practice, companies should avoid simply repeating in text information that is evident in the charts or tables. For example, some companies have stopped describing a change between periods that is reflected in a table and focused instead on discussing the reason(s) for the change. See our illustration under "MD&A — results of operations."

Use of cross-references

Regulators often point to duplicative disclosures as a factor contributing to information overload and investor confusion. When a company provides substantially similar disclosure in different areas of a filing, the document is longer than it needs to be and users aren't likely to understand why disclosure is repeated. Disclosures about significant accounting policies, loss and legal contingencies, and business descriptions are often repeated in different places in the disclosure documents (e.g., risk factors, MD&A, footnote disclosure).

Cross-referencing is an effective way to reduce repetition and direct the reader to a section that contains additional relevant information on a topic. There are valid concerns that cross-referencing from the financial statement notes to MD&A may result in confusion with respect to audit responsibility. Conversely, there are valid concerns that referencing from MD&A to the notes results in the loss of safe-harbor protections for forward-looking disclosures. Despite these concerns, we believe there are several areas where companies can use properly worded cross-references (e.g., from MD&A to the notes) to enhance their disclosure.

In addition, if information is complementary but not required content and could provide additional context, insight or detail, a company may point to such information outside the disclosure document (e.g., on the company's website) without making the information part of the SEC filing. A company also may consider, as appropriate, incorporating by reference disclosure from previous filings, thereby avoiding repetition.

[14] Executive Compensation and Related Person Disclosure, Release Nos. 33-8732A; 34-54302A; IC-27444A, 6 September 2006

> "Whatever is disclosed should be presented, when practicable, in a more accessible, straightforward manner — such as charts, graphs, tables, and summaries — so that the information is more digestible and understandable. A simpler presentation can make it easier for investors to focus on and process the information that matters most."
>
> — Former SEC Commissioner Troy A. Paredes[15]

Eliminating immaterial disclosures

We have seen companies effectively reduce the size of their filings by removing immaterial disclosures that have accumulated over time. For example, disclosures that were included for business conditions or events that are no longer material to understanding the company's operating results or financial condition may linger in filings for several periods.

As part of their financial reporting processes, companies should identify immaterial disclosures that can be omitted or substantially reduced. In conjunction with that, they should document their rationale. Contemporaneous documentation of the rationale for omitting immaterial disclosure items can be valuable if those omissions are later challenged by regulators or litigants.

In many cases, because the FASB does not list all specified disclosures in a single place,[16] companies use disclosure checklists that accumulate all individual SEC and FASB disclosure requirements to evaluate which disclosures are applicable and material. Companies should also use these checklists to document the relevant quantitative and qualitative factors they evaluated when deciding to exclude disclosures they deemed not material.

15 Remarks at The SEC Speaks in 2013, 22 February 2013

16 If the FASB accumulated all specified disclosures in one location, that list would represent approximately 400 pages of the Accounting Standards Codification.

Recommendations to improve disclosures

In this section, we explore how companies are making their disclosures more meaningful. The illustrations below reflect effective practices that we have seen in company filings. However, because every company's facts and circumstances are different, companies must tailor the structure and content of disclosure based on their needs.

Financial statement footnotes

Several companies have focused on making certain lengthy footnote disclosures more meaningful while still providing the required information.[17] Most commonly, we have seen companies change how disclosures about pensions and other postretirement benefits, stock-based compensation, loss contingencies, derivatives and hedging, and fair value measurements are presented such that required information is conveyed in a meaningful manner.

Order of financial statement notes

Most companies disclose their significant accounting policies in the first note to their financial statements. ASC 235, *Notes to Financial Statements*, encourages this format: "Disclosure is preferred in a separate summary of significant accounting policies preceding the notes to financial statements, or as the initial note, under the same or a similar title."

However, ASC 235 states that entities have the flexibility to disclose information about accounting policies differently. The FASB's Discussion Paper, *Disclosure Framework,* also considers other ways to organize these disclosures that may be more appropriate. For example, notes could be grouped (e.g., by related transaction or by operating, financing or investing activities) and organized from most to least relevant. The Discussion Paper acknowledges that grouping information may make it harder to compare a company's disclosures with those of other companies but could make the disclosures more relevant to users.

Some companies have grouped the disclosure of certain accounting policies with the more expanded disclosures for that particular area presented elsewhere in the footnotes to avoid discussion of financial statement line items in multiple footnotes. In most of these cases, the company includes an initial note with a discussion of some significant accounting policies and uses a table to link to the relevant footnote where there is a more complete discussion of other policies, along with the related estimates and other required disclosures:

Illustration: Summary of significant accounting policies

The following table includes other significant accounting policies that are described in other notes to the financial statements, including the number and page of the note:

Significant Accounting Policy	Note #	Page #
Accounts Receivable	4	34
Fair Value Measurements	5	35
Investments	6	40
Derivatives and Hedging Activities	7	43
Goodwill	8	50
Pension and Other Postretirement Benefit Plans	9	52
Income Taxes	14	60
Stock-Based Compensation	15	65
Legal Contingencies	16	70
Reportable Segments	17	73

[17] In our comment letter on the FASB's Proposed Statement of Financial Accounting Concepts, Chapter 8: Notes to Financial Statements, we support the FASB's decision to address disclosure effectiveness. While reducing the volume of disclosure is not the FASB's primary objective in its project, we believe the FASB should use the project as an opportunity to develop a roadmap to address disclosure overload.

In addition, we also have seen companies make other changes to the financial statement presentation, such as:

- Organizing the notes based on importance
- Listing the applicable note about certain financial statement captions on the face of the balance sheet or income statement for ease of reference
- Using a chart immediately before the notes that provides a brief description of each financial statement caption and related accounting policy as well as a link to the related footnote[18]

Quarterly disclosures

Registrants may presume that users of quarterly financial information have read previously filed annual reports.[19] Therefore, they are not required to repeat annual disclosures from the latest annual report unless necessary for a fair presentation or to comply with ASC 270, *Interim Reporting,* and other accounting standards that specify interim disclosure requirements. Some companies have eliminated or streamlined quarterly disclosures of items that are required only in annual financial statements such as when no material changes have occurred in significant accounting policies since the last annual report. However, some quarterly filings include disclosures beyond those specified in US GAAP.

In recent years, new FASB standards have required essentially the same disclosures in both interim and annual financial statements. As part of its disclosure framework project, the FASB is considering amendments to ASC 270 to clarify that updated disclosures are not required if they don't significantly alter the total mix of information available to investors.[20]

Disclosure of significant accounting policies

The significant accounting policies note should identify and describe the material accounting principles followed by the company, the methods of applying those principles and the important judgments made in applying them. In particular, ASC 235 requires disclosure of material accounting principles and methods that involve any of the following:

- A selection from existing acceptable alternatives
- Principles and methods peculiar to the industry in which the entity operates, even if such principles and methods are predominantly followed in that industry
- Unusual or innovative applications of US GAAP

We often see companies go well beyond this requirement and describe policies for every line item. For example, a company may disclose its accounting policy for prepaid expenses even when it has made no material judgments or policy elections in the periods presented. Companies should consider removing disclosures of accounting policies that are not currently applicable or material to the financial statements or that require little to no discretion to apply.

Furthermore, companies frequently cite the requirements in the FASB Codification when they describe their policies. In our view, disclosure should not repeat what a standard says about policy requirements if the standard does not permit alternative methods. Instead, companies should describe policy elections they have made and the related judgments and estimates required to apply the authoritative literature to their transactions, if relevant.

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[18] This presentation can be useful for a web-enabled version of the annual report that can be placed on a company's website and can replace the outdated pdf version of the Word file.

[19] Regulation S-X, Rule 10-01 *Interim financial statements*

[20] Our To the Point, *A framework to help the FASB establish effective disclosures*, provides an overview of the FASB's exposure draft. In our comment letter, we supported the FASB's objective of improving disclosure effectiveness by developing a framework the Board would apply when instituting new disclosure requirements and evaluating existing ones. However, we are concerned that the proposed framework would actually perpetuate the significant expansion in disclosure that has occurred over the past few decades. We suggested changes to the framework and recommended that the Board provide guidance on materiality and clearly distinguish between annual and interim requirements.

SAB 11-M disclosures

SAB Topic 11-M, *Disclosure Of The Impact That Recently Issued Accounting Standards Will Have On The Financial Statements Of The Registrant When Adopted In A Future Period,* requires a company to disclose the effect of new standards that are not yet adopted "unless the impact on its financial position and results of operations is not expected to be material."

However, companies commonly include in their disclosures a description of each new standard, the alternative methods of adoption permitted by the standard and the method that the company expects to use, if determined, followed by this or a similar statement:

> "The Company does not expect the adoption of this standard to have a material effect on its financial position or results of operations."

Because companies are not required to summarize or disclose when effects of new standards are immaterial, companies should consider condensing these disclosures into one paragraph or eliminating these disclosures entirely.[21] A company should consider including a discussion of only new standards that are reasonably likely to have a material effect on its financial statements. A table also could be used to provide SAB 11-M disclosure in a concise manner as shown in the following before and after illustration:

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[21] SAB Topic 11-M encourages, but does not require, the registrant to disclose that a standard has been issued and that its adoption will not have a material effect on its financial position or results of operations.

Recent accounting pronouncements

Existing disclosure:

In May 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2014-09, *Revenue from Contracts with Customers (Topic 606).* This ASU will replace existing revenue recognition standards and significantly expand the disclosure requirements for revenue arrangements. The provisions of ASU 2014-09 are effective for annual periods beginning after December 15, 2016, including interim periods within that reporting period, and early application is not permitted. The new standard may be adopted retrospectively for all periods presented, or adopted using a modified retrospective approach. Under the retrospective approach, the fiscal 2016 and 2015 financial statements would be adjusted to reflect the effects of applying the new standard on those periods. Under the modified retrospective approach, the new standard would only be applied for the period beginning January 1, 2017 to new contracts and those contracts that are not yet complete at January 1, 2017, with a cumulative catch-up adjustment recorded to beginning retained earnings for existing contracts that still require performance. Management is currently evaluating the methods of adoption allowed by the new standard and the effect the standard is expected to have on our financial statements and related disclosures.

In April 2014, the FASB issued ASU 2014-08, *Reporting Discontinued Operations and Disclosures of Disposals of Components of an Entity*. ASU 2014-08 changes the criteria for determining which disposals can be presented as discontinued operations and modifies the related disclosure requirements. Under the new guidance, a disposal of a component of an entity or a group of components of an entity is required to be reported in discontinued operations if the disposal represents a strategic shift that has (or will have) a major effect on an entity's operations and financial results and is disposed of or classified as held for sale. The standard also introduces several new disclosures. The guidance applies prospectively to new disposals and new classifications of disposal groups as held for sale after the effective date. ASU 2014-08 is effective for annual and interim periods beginning after December 15, 2014, with early adoption permitted. We do not expect that the adoption of this standard will have a material effect on our financial statements.

In July 2013, the FASB issued ASU 2013-11, *Income Taxes* (Topic 740): Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Exists. This update requires unrecognized tax benefits to be offset against a deferred tax asset for a net operating loss carryforward, similar tax loss or tax credit carryforward in certain situations. This update was issued due to the diversity in practice in presentation of unrecognized tax benefits in those instances. Some entities present unrecognized tax benefits as a liability unless the unrecognized tax benefit is directly associated with a tax position taken in a tax year that results in, or resulted in, the recognition of a net operating loss or tax credit carryforward for that year and the net operating loss or tax credit carryforward for that year has not been utilized. Other entities present unrecognized tax benefits as a reduction of a deferred tax asset for a net operating loss or tax credit carryforward in certain circumstances. The objective of this update is to eliminate this diversity in practice. The amendments in this update must be applied prospectively for reporting periods beginning after December 15, 2013. We adopted the standard on January 1, 2014. As a result of the adoption we decreased noncurrent deferred income tax assets by $95 million with a corresponding decrease in other noncurrent liabilities.

Alternative enhanced disclosure:

The following table provides a brief description of recent accounting pronouncements that could have a material effect on our financial statements:

Standard	Description	Date of adoption	Effect on the financial statements or other significant matters
Standards that are not yet adopted			
ASU 2014-09, *Revenue from Contracts with Customers (Topic 606)*	The standard will replace existing revenue recognition standards and significantly expand the disclosure requirements for revenue arrangements. It may be adopted either retrospectively or on a modified retrospective basis to new contracts and existing contracts with remaining performance obligations as of the effective date.	January 1, 2017	We are currently evaluating the alternative methods of adoption and the effect on our financial statements and related disclosures.[22]
Standards that were adopted			
ASU 2013-11, *Income Taxes (Topic 740): Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Exists*	The standard requires unrecognized tax benefits to be offset against a deferred tax asset for a net operating loss carryforward, similar tax loss or tax credit carryforward in certain situations.	January 1, 2014	The adoption of this standard resulted in a reduction in noncurrent deferred income tax assets of $95 million and a corresponding decrease in other noncurrent liabilities.

[22] The SEC staff expects that an entity's SAB 11-M disclosures will evolve in each reporting period as more information about the effects of the new standard becomes available.

MD&A disclosures

As discussed, FR-72 encourages companies to focus their MD&A on material information from management's perspective. However, MD&A continues to be the top area of focus in SEC staff comment letters.

EY resources

- SEC Comments and Trends: An analysis of current reporting issues (SCORE No. CC0398), September 2014

Executive overviews

While many companies include an MD&A overview in their filings, the SEC staff has emphasized that the overview should continue to evolve over time and avoid generic or boilerplate language. The overview should summarize the most important aspects of the company, including its performance and financial condition, and complement the more detailed discussions in the rest of the document. It should not repeat discussion about the company's business provided earlier in the filing or language from management's detailed analysis in the sections that follow.

We believe the executive overview is one area that could be improved if companies started with a clean sheet of paper each period and outlined the significant and new information affecting their operations and financial performance.

Results of operations

The SEC staff often requests that registrants explain the results of their operations with greater specificity, including identifying underlying drivers of each material factor that has affected their earnings or that is reasonably likely to have a material effect on future earnings. MD&A also should disclose key performance indicators, financial or nonfinancial, used to manage the business.

Companies should provide insightful analyses of items that are material to understanding their results and trends. They should focus on an effective presentation and ensure their analysis highlights the most important information while omitting discussions of items that are not material. Many companies have moved away from MD&A presentations that list every financial line item and include separate discussions of each period-over-period analysis (i.e., separate sections to discuss 2014 vs. 2013 and 2013 vs. 2012 changes in financial statement line items).

Instead, we have seen effective MD&A disclosures that incorporate some or all of the following:

- Combine the discussion and analysis of material financial statement line items over three years
- Provide tables or charts to compare the periods, including the components of changes (e.g., table showing the components of sales growth), as well as trends in key performance indicators
- Include narrative discussion that does not repeat information that is evident in the tables or charts
- Use bullet points to quantify and explain reasons for changes, including the offsetting factors
- Disclose activity rollforwards followed by a description of material known trends, events or uncertainties
- Analyze trends in financial and nonfinancial information in a separate MD&A section about key performance indicators

The example on the next page shows how to apply several of these best practices to MD&A disclosures to reduce repetition and structure the discussion to enhance the analysis of key drivers and trends.

MD&A — Results of operations

Existing disclosure:

	2013	2012	2011
Revenue	$ 415,000	$ 350,000	$ 335,000

[*other line items excluded for illustration purposes*]

Year ended December 31, 2013, compared to year ended December 31, 2012

Revenues

Total revenues increased by approximately $65 million, or 19%, to $415 million during the year ended December 31, 2013 as compared to $350 million for the year ended December 31, 2012. The revenue growth results from the acquisition of ABC, Inc. in the US which contributed $35 million during the year, and increased sales of customers primarily as a result of significant focus on selling new products. Excluding the ABC, Inc. acquisition, North America revenue increased $29 million to $285 million in 2013 from $256 million in 2012 due to the increased sales of our new routing and switch products. Revenue in Europe increased from $94 million in 2012 to $95 million in 2013 due to a slight increase in data center equipment sales offset by the unfavorable effects of foreign currency.

Year ended December 31, 2012, compared to year ended December 31, 2011

Revenues

Total revenues increased by approximately $15 million, or 4%, to $350 million during the year ended December 31, 2012, as compared to $335 million for the year ended December 31, 2011. The revenue growth is primarily attributed to increased sales volume from our routing and switch products. North America revenue increased $21 million to $256 million in 2012 from $235 million in 2011 due to stronger demand for our networking, router and switch products. Revenue in Europe declined from $100 million in 2011 to $94 million in 2012 due to lower sales of data center equipment as a result of intense competition and the unfavorable effects of foreign currency.

Alternative enhanced disclosure:

Revenues

	2013	2012	2011
North America	$ 320,000	$ 256,000	$ 235,000
Europe	95,000	94,000	100,000
Total revenue	415,000	350,000	335,000
$ Change	65,000	15,000	
% Change	19%	4%	

The following are components of revenue growth compared to the prior year:

	2013 vs. 2012	2012 vs. 2011
Volume	7%	4%
Price	3%	1%
Acquisitions	10%	–
Foreign currency effects	(1)%	(1)%
	19%	4%

Total revenue changes are due to:

- North America revenues in 2013 rose by $35 million, or 14%, due to the ABC, Inc. acquisition and by $29 million, or 11%, due to organic growth related primarily to sales of our new routing and switch products. Increases in 2012 were due to stronger demand for our networking, router and switch products.
- Europe revenues were relatively flat in 2013 as the slight increase in data center product sales was offset by unfavorable foreign currency effects. Decreases in 2012 resulted from lower volumes of 3%, primarily in data center products, resulting from increased competition. The remaining change was due to unfavorable foreign currency effects.

Critical accounting estimates

Critical accounting estimates are those that are most important to the financial statement presentation and that require the most difficult, subjective and complex judgments. FR-72 reminds SEC registrants that MD&A rules require disclosure of a critical accounting estimate in either of the following cases:

- The nature of the estimates or assumptions is material because of the levels of subjectivity and judgment needed to account for matters that are highly uncertain and susceptible to change
- The effect of the estimates and assumptions is material to the financial statements

Disclosures about critical accounting estimates should provide a robust analysis that supplements the description of accounting policies in the notes to the financial statements and (1) addresses why the accounting estimate or assumption may be susceptible to change and (2) analyzes the following:

- How the company arrived at the estimate/assumption
- How accurate the estimate/assumption has been in the past
- How much the estimate/assumption has changed in the past
- Whether the estimate/assumption is reasonably likely to change in the future

The SEC staff has commented that some registrants repeat verbatim in MD&A portions of the significant accounting policies footnote. While accounting policies in the notes to the financial statements generally describe the method used to apply significant accounting principles, the discussion in MD&A should be limited to only those areas that use assumptions and judgments that most materially affect the financial statements. That section of MD&A should provide insight into the uncertainties involved in applying the principle at a given time and the variability that is reasonably likely to result from its application.

SEC registrants should consider a cross-reference to footnote disclosure about significant accounting policies if necessary, but should limit the MD&A disclosure to an analysis of the specific underlying assumptions and judgments.

The following illustration uses cross-references and tailors the discussion of critical accounting estimates. While the enhanced disclosure in the illustration is roughly the same length, it uses cross-references, bullets and tables to make the disclosures more effective.

Critical accounting estimates

The following excerpt from the critical accounting estimates section about pensions illustrates improvements that tailor the discussion to provide appropriate insight into management's judgments and uncertainties and use cross-references, bullet points and tables for more effective presentation:

Existing disclosure:

The Company sponsors multiple defined benefit pension plans that cover certain US employees. The Company accounts for its pension plans in accordance with Accounting Standards Codification (ASC) 715, *Compensation — Retirement Benefits*. The funded status of the plans is measured as the difference between the fair value of the plan assets and the projected benefit obligation. Liabilities and expense for pension plans are actuarially determined using significant assumptions, including the rate used to discount the projected benefit obligation, the long-term rate of return on plan assets and several assumptions related to the employee workforce (salary increases, mortality rates and other factors). There are inherent uncertainties related to these assumptions and management's judgment in applying them. Consistent with the accounting guidance, the Company has policies that generally defer the effect of changes in actuarial assumptions and differences between the expected and actual return of plan assets over future periods. Unrealized gains or losses are recorded in other comprehensive income (OCI), a component of shareholders' equity.

A significant estimate in determining pension cost in accordance with accounting guidance is the expected return on plan assets. The Company estimated the expected long-term rate of return on plan assets was 7.25% and 7.50% as of December 31, 2013 and 2012, respectively. The expected return assumptions were developed by considering various factors, such as the plans' investment guidelines, mix of asset classes, historical returns of equities and bonds, and expected future returns. Management believes these assumptions are reasonable. If the plan assets earn an average return less than 7.25% over time, future pension cost likely would increase.

In addition, the Company estimates the discount rate by performing an analysis of the rates of return on high-quality, fixed-income investments. The Company estimated discount rates of 4.50% and 3.75% at December 31, 2013 and 2012, respectively. Management believes these assumptions are reasonable. However, an increase in the discount rate would decrease the plan obligations and the net periodic benefit cost, while a decrease in the discount rate would increase the plan obligations and the net periodic benefit cost.

Alternative enhanced disclosure:

We sponsor multiple defined benefit pension plans that cover certain US employees. For a description of our related accounting policies, refer to Note 2 in the consolidated financial statements. Changes in significant assumptions could materially affect the amounts, particularly the long-term rate of return on plan assets and the rate used to discount the projected benefit obligation:

- Return on plan assets — We determine the expected long-term rate of return on plan assets based on the building block method, which consists of aggregating the expected rates of return for each component of the plan's asset mix. Our assumed expected rate of return considers past returns on plan assets as well as various other factors, such as the plans' investment guidelines, the expected mix of asset classes and current market conditions. The expected long-term rate of return on plan assets was 7.25% and 7.50% as of December 31, 2013 and 2012, respectively. The decline in the expected long-term rate of return is primarily attributed to a shift in the plan asset mix to fixed income securities from equities, which comprised 42% and 37% of plan assets as of December 31, 2013 and 2012, respectively.
- Discount rate — In estimating this rate, we analyze the rates of return on high-quality, fixed-income investments that receive one of the two highest ratings from a recognized rating agency and the schedule of expected cash needs of the plans. We estimated discount rates of 4.50% and 3.75% at December 31, 2013 and 2012, respectively.

The following illustrates the sensitivity of the net periodic benefit cost and projected benefit obligation to a 1% change in the discount rate or return on plan assets (in millions):

Assumption	Change	2014 net periodic benefit cost	2013 projected benefit obligation
Discount rate	1% increase	$ (8)	$ (85)
	1% decrease	9	90
Return on plan assets	1% increase	(15)	N/A
	1% decrease	15	N/A

For 2015, we expect net periodic pension cost to decline by approximately $2 million due to the 75 basis point increase in the discount rate partially offset by the 25 basis point decline in the expected long-term rate of return due to the shift in plan asset mix.

Other disclosure areas

Business disclosures

Item 101 of Regulation S-K, *Description of Business*, specifies disclosure about the registrant's business, including its operating segments and geographic areas.

Many companies have identified the business section in Item 1 of Form 10-K as one of the first areas where disclosures can be improved. Although the business disclosures may be fairly static from period to period, the discussion becomes lengthy when disclosures are added over time. In addition, certain portions of the business discussion often are repeated in other sections of the filing, including MD&A and risk factors. The company's website also may provide significant information about the company's business.

Although the company's Form 10-K should comply with the requirements of Item 101 of Regulation S-K, we believe companies can reduce repetition throughout their filings by using cross-references to other areas of the document or to other publicly available information.

Risk factors

Item 503(c) of Regulation S-K requires a registrant to disclose its significant risks and how it is affected by each of them. Risk factors should be specific to the company's facts and circumstances and not merely general risks that could apply to any company.

Because of the safe harbor in the Private Securities Litigation Reform Act of 1995, many companies are hesitant to limit the number or length of risk factor disclosures. However, investors frequently have said that risk factors are generic and confusing. The most important risk factors often are not presented first, and readers have a hard time determining whether a risk is likely to become a reality. The SEC staff also has questioned risk factor disclosures that could apply to any public company, saying they are not sufficiently specific or detailed to address the facts and circumstances of a particular company.

At a minimum, we believe risk factor disclosures can benefit from better organization and tailoring the discussion of the risk to the business.

For example, Item 503(c) requires the discussion of risk factors to be "concise and organized logically." Some companies have used headers to group risks by the type of factors, such as the following:

- Risks related to operational factors
- Risks related to technology factors
- Risks related to economic or market factors
- Risks related to legal and regulatory factors

Companies then use sub-captions to describe the risk factor specific to them.

Companies also may want to emphasize recent trends or changes during the period in the likelihood that certain risk factors may occur as well as their approach to manage and mitigate these risks.

Legal proceedings

Companies may include loss contingency disclosures in several sections of the filing, including the legal proceedings section, risk factors, MD&A and loss contingencies footnote to the financial statements.

There is significant overlap between the disclosure requirements for loss contingencies under US GAAP and Regulation S-K. Accordingly, many filings duplicate disclosure of litigation matters.

However, the SEC staff has emphasized that the disclosure requirements are different. For example, Item 103 of Regulation S-K requires registrants to briefly describe any material pending legal proceedings to which the registrant or any of its subsidiaries is a party. US GAAP[23] requires disclosures based on the likelihood of loss, including an estimate of reasonably possible losses or a statement that such an estimate cannot be made.

To improve disclosures in this area, companies should consider using a bullet-point list of material legal proceedings with the descriptions required by Regulation S-K and appropriate cross-references to MD&A and the financial statements footnotes where each matter might be discussed.

EY resources

- SEC Comments and Trends: An analysis of current reporting issues (SCORE No. CC0398), September 2014

[23] ASC 450, *Contingencies*

Process to improve disclosures

It is important for companies to have a process in place to regularly review the effectiveness of their disclosures and a plan to make ongoing improvements to their financial reporting.

Key stakeholders

First, companies need to identify key stakeholders and confirm their commitment to improving the company's financial reporting process and SEC filings. The following individuals (and/or senior members of their functions) typically are the key participants and influencers:

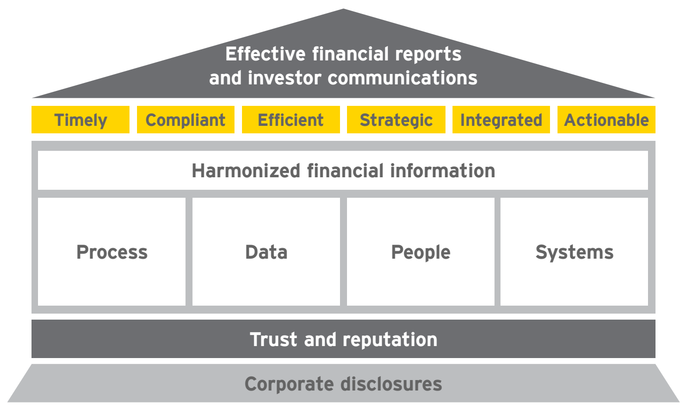
- Chief executive officer and chief financial officer (CFO)
- Controller, chief accounting officer, director of external reporting or equivalent roles
- Chair of the audit committee
- Head of the disclosure committee, if applicable
- General counsel
- Head of investor relations
- Chief risk officer and head of strategy
- Managers and CFOs of key operating business units or divisions

Depending on the nature of the business, input may be needed from other members of the management team (i.e., head of research of a pharmaceutical company, chief credit officer of a banking institution). Communication with the external auditor also is essential. In addition, companies can contact the SEC staff to discuss potential changes to their disclosures.

Process and plan

Companies should develop an overall plan with a clear timeline and project management support. Ideally, the focus should be the reporting process as a whole, not just the financial statement disclosures or MD&A in isolation. An effective plan integrates the company's processes, people, data and systems to:

- Address investor communications more holistically
- Identify and implement any necessary process, content and system changes
- Establish greater synergies between strategic, operational, financial, regulatory, and sustainability reporting and messaging
- Produce compliant SEC filings in a timely and efficient manner



Companies should consider benchmarking their disclosures against those of their peers. Benchmarking can identify best practices within the industry. Such an approach also can identify potential gaps that can be addressed with additional information or performance metrics to meet the needs and expectations of investors and/or analysts who follow the company or industry.

In addition, many companies are making meaningful improvements to their investor communications by developing web-enabled versions of financial reports that look better and are easier to navigate than traditional reports. These reports help readers focus more quickly on areas of interest, move from section to section, or find additional information using hyperlinks.

A journey, not an initiative

Companies may decide to make significant disclosure improvements all at once or incrementally by targeting one particular disclosure area at a time.

Some companies may start by focusing on making specific disclosures more effective as an initiative, but it is important to embed the objective of disclosure effectiveness into the company's financial reporting DNA to ensure that the changes are successful and sustainable.

Conclusion

As the SEC staff and the FASB work on their disclosure effectiveness initiatives, companies can take immediate action to make their disclosures more meaningful. These actions can go a long way toward enhancing disclosure and providing investors with information that is easier to understand.

We believe that companies that take the steps we describe in this publication will see a variety of benefits, including more efficient reviews by executives and directors and greater investor confidence.

While meaningful and lasting change to the disclosure regime will take time, we hope this publication has provided you with a road map of improvements you can follow in drafting your upcoming filings and financial statements.

Appendix

Current initiatives on disclosure effectiveness by standard setters, regulators and organizations include:

Standard setter/regulator/organization	Project/report/study
SEC	‣ Disclosure Effectiveness
FASB	‣ Disclosure Framework ‣ Conceptual Framework ‣ Simplification initiative
IASB	‣ Disclosure Initiative
Center for Audit Quality (CAQ)	‣ Financial Statement Disclosure Effectiveness: Forum Observations Summary
US Chamber of Commerce	‣ Corporate Disclosure Effectiveness: Ensuring a Balanced System that Informs and Protects Investors and Facilitates Capital Formation
UK Financial Reporting Council (FRC)	‣ Louder than Words ‣ Cutting clutter ‣ Financial Reporting Lab insight report: Towards Clear & Concise Reporting
UK Department for Business, Innovation & Skills (BIS)	‣ The future of narrative reporting
International Integrated Reporting Committee (IIRC)	‣ The International Integrated Reporting Framework
Joint oversight group of the Institute of Chartered Accountants of Scotland (ICAS) and the New Zealand Institute of Chartered Accountants (NZICA)	‣ Losing the excess baggage
European Securities and Markets Authority (ESMA)	‣ Consultation Paper – Considerations of materiality in financial reporting ‣ Feedback Statement – Considerations of materiality in financial reporting
European Financial Reporting Advisory Group (EFRAG)	‣ Discussion Paper – Towards a Disclosure Framework for the Notes
Australian Accounting Standards Board (AASB)	‣ Rethinking the Path from an Objective of Economic Decision Making to a Disclosure and Presentation Framework
Chartered Financial Analyst (CFA) Institute	‣ Financial Reporting Disclosures – Investor Perspectives on Transparency, Trust, and Volume ‣ Forward-Looking Information – A Necessary Consideration in the SEC's Review on Disclosure Effectiveness: Investor Perspectives
Enhanced Disclosure Task Force (EDTF)	‣ Enhancing the risk disclosures of banks
International Accounting and Assurance Standards Board (IAASB)	‣ The Evolving Nature of Financial Reporting: Disclosure and Its Audit Implications
Institute Of Chartered Accountants In England And Wales (ICAEW)	‣ Financial Reporting Disclosures: Market and Regulatory Failures

EY | Assurance | Tax | Transactions | Advisory

SCORE No. CC0403

ED None

No. 2015-43
2 July 2015

To the Point

SEC — concept release

SEC seeks feedback on possible changes to audit committee disclosures

'Effective audit committee oversight is essential to investor protection and the functioning of our capital markets.'

— SEC Chair Mary Jo White

What you need to know

- The SEC issued a concept release seeking public comment on whether there would be benefit from mandating more disclosures from audit committees about how they execute their existing audit oversight responsibilities.
- The concept release seeks comment on whether more audit committee disclosures would help close the expectation gap by providing investors with better insights into the responsibilities of the audit committee. It also asks whether new disclosures would inform their investment decisions and voting decisions about whether to ratify the selection of the auditor or re-elect members of the audit committee to the Board.
- Comments are due 60 days after the concept release is published in the Federal Register.

Overview

The Securities and Exchange Commission (SEC) issued a concept release on possible revisions to its audit committee disclosure rules that explores whether audit committees should provide more qualitative disclosures about how they execute existing responsibilities to oversee the audit. The audit committee report in the annual proxy statement currently must affirm only that the audit committee carried out certain specific responsibilities related to communications with the external auditor.[1]

The SEC observed that while the Sarbanes-Oxley Act of 2002 (the Act) codified the role of the audit committee in overseeing a company's financial reporting process and the audit, the SEC's disclosure requirements for audit committee reporting to shareholders have not changed significantly since 1999. The Act required the audit committee to be independent from management and made the audit committee directly responsible for the retention, compensation and oversight of the independent external auditor. The SEC noted that, in recent years, many audit committees have voluntarily provided more robust disclosures about their oversight of the external auditor. It also observed that investors have increased their focus on activities and transparency of audit committees.

The concept release is part of a broader effort by the SEC and the Public Company Accounting Oversight Board (PCAOB) to increase transparency of the audit process. The PCAOB has proposed that auditors name the engagement partner and other public accounting firms that participated in the audit in regulatory filings.[2] The PCAOB also issued a concept release on audit quality indicators it believes might be useful to various stakeholders, including audit committees, audit firms, investors, regulators and others.[3] The comment period for all of these initiatives is now open so stakeholders have the opportunity to consider them holistically.

In its concept release, the SEC said it is seeking to understand whether mandating additional disclosure about the audit committee's oversight of the auditor would provide useful information that would help investors to make better investment decisions and voting decisions about whether to ratify the selection of the auditor or re-elect members of the audit committee to the Board. While the concept release discusses the views of certain investors and groups that have called for more audit committee reporting, it acknowledges that others have expressed concerns about the potential usefulness of additional audit committee disclosures.

Key considerations

The concept release requests public comment on 74 questions about possible disclosure changes primarily in the following areas:

- Oversight of the auditor
- Process for appointing or retaining the auditor
- Evaluation of the audit firm and engagement team qualifications

Oversight of the auditor

The concept release questions whether the SEC should require additional qualitative disclosures about the nature, timing and frequency of the communications between the audit committee and the auditor.[4] For example, the SEC seeks input on whether the audit committee should report on its communications with the auditor about topics such as the overall audit strategy, significant risks, the nature and extent of specialized skills used in the audit and the use of a company's internal audit personnel.

The concept release also asks whether disclosure would be useful about how the audit committee assesses, promotes and reinforces the auditor's objectivity and professional skepticism. In addition, it seeks feedback on whether the audit committee should disclose how it considered the results of PCAOB inspection reports and the audit firm's internal quality control reviews.

Process for appointing or retaining the auditor

The concept release discusses possible disclosures about the process and criteria the audit committee used to assess the auditor and its rationale for selecting or retaining the auditor. It cites the PCAOB's concept release on possible indicators of audit quality and asks whether an audit committee that uses these or other indicators should disclose which indicators it used to evaluate the auditor.

The concept release also discusses possible disclosures about the number of firms that were asked to propose providing audit services and what information the audit committee considered in making its selection. And it requests feedback about disclosures of any policy on shareholder ratification of the auditor and how the results of these votes were considered in the audit committee's decision to retain the audit firm.

Evaluation of the audit firm and engagement team qualifications

The concept release asks whether the SEC should require disclosures about the length of the company's relationship with the auditor (which the PCAOB previously proposed requiring in the audit report) and how the audit committee considered the auditor's tenure in deciding to retain the auditor. It also asks whether the audit committees should name and report on the qualifications of certain individuals who perform the audit (e.g., the engagement partner, the engagement quality reviewer, additional individuals subject to PCAOB rotation requirements) and identify other public accounting firms that participated in the audit. As discussed above, the PCAOB has proposed requiring disclosure of the engagement partner and other participating public accounting firms, either in the auditor's report or a new form to be filed with the PCAOB.

Applicability and location of possible disclosures

The concept release also seeks input on whether new and existing audit committee disclosures should be required to appear in one location and whether the requirements should apply to smaller reporting companies and emerging growth companies. Disclosures required by existing SEC rules are included in proxy statements but they are not required in the prospectus delivered to investors for public offerings. The concept release asks whether investors would benefit from these disclosures being included in that prospectus.

The SEC is seeking input on whether and how additional reporting may be useful to investors.

How we see it

- Enhancing audit committee transparency can increase investors' confidence in financial reporting and their confidence in the role of the audit committee in overseeing the audit process and promoting audit quality in the interest of investors.
- Many audit committees have begun telling investors more about what they do in overseeing the audit and the independent auditor. Meaningful disclosure about what audit committees do and how they oversee auditors would provide a window into the work they perform, which could further the alignment among auditors, audit committees and investors, an outcome we strongly support. However, additional requirements that result in largely "boilerplate" disclosures would offer little value to investors.
- Commenters should consider the range of possible disclosures presented in the concept release to identify disclosures that would provide the most decision-useful information to investors.

Endnotes:

[1] The SEC's disclosure requirements are in Item 407 of Regulation S-K and Exchange Act Rule 10A-3.

[2] See PCAOB Release No. 2015-004, *Supplemental Request for Comment: Rules to Require Disclosure of Certain Audit Participants on a New PCAOB Form*.

[3] See PCAOB Release No. 2015-005, *Concept Release on Audit Quality Indicators*.

[4] Audit committee and auditor communications required by PCAOB Auditing Standard No. 16, *Communications with Audit Committees*.

U.S. Securities and Exchange Commission

STRATEGIC PLAN
FISCAL YEARS 2014–2018

Protecting investors, maintaining fair, orderly, and efficient markets, and facilitating capital formation

This document presents the U.S. Securities and Exchange Commission's Strategic Plan prepared in accordance with the Government Performance and Results Act Modernization Act of 2010. The plan sets out the Commission's mission, vision, values, and strategic goals for fiscal years 2014 through 2018. Furthermore, it discusses the SEC's environment, details the strategic objectives the Commission seeks to achieve, presents the strategies and initiatives that will be undertaken to accomplish those objectives, and lists the performance goals that will be used to gauge the agency's progress.

CONTENTS

The U.S. Securities and Exchange Commission is an independent federal agency established pursuant to the Securities Exchange Act of 1934 (Exchange Act). It is headed by a bipartisan five-member Commission, comprised of the Chair and four Commissioners, who are appointed by the President and confirmed by the Senate. The Chair is responsible for the executive and administrative functions of the Commission. The SEC employs over 4,100 people.

MISSION

The mission of the SEC is to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation.

VISION

The SEC strives to promote a securities market that is worthy of the public's trust and characterized by:

- Transparent disclosure to investors of the risks of particular investments;
- Oversight of key market participants, including exchanges, brokers and dealers, investment advisers, and others;
- Focus on strengthening market structure and systems;
- Promotion of disclosure of market-related information;
- Protection against fraud and abuse; and
- Evaluation, development and maintenance of appropriate rules and regulations.

VALUES

Integrity: As the SEC is the independent federal agency entrusted with regulating and conducting enforcement for the U.S. securities markets; each member of the Commission's workforce has a responsibility to demonstrate the highest ethical standards to inspire confidence and trust.

Excellence: The SEC is committed to the highest standards of excellence in pursuit of its mission. The investing public and the U.S. securities markets deserve nothing less.

Accountability: The SEC embraces the responsibility with which it is charged. In carrying out its mission, SEC employees hold themselves accountable to the public and take responsibility for achieving SEC goals.

Effectiveness: The SEC strives to work creatively, proactively, and effectively in assessing and addressing risks to the securities markets, the public, and other market participants. The staff is committed to finding innovative and flexible approaches to the SEC's work and using independent judgment to explore new ways to fulfill the SEC's mission in the most efficient and effective manner possible.

Teamwork: The SEC recognizes that its success depends on a diverse, coordinated team committed to the highest standards of trust, hard work, cooperation, and communication. The staff is committed to working together and coordinating effectively with investors, business, governments, and other organizations in the U.S. and abroad.

Fairness: The SEC treats investors, market participants, and others fairly and in accordance with the law. As an employer, the SEC seeks to hire and to retain a skilled and diverse workforce, and to ensure that all decisions affecting employees and applicants are fair and ethical.

STRATEGIC GOALS AND STRATEGIC OBJECTIVES

Strategic Goal 1: Establish and maintain an effective regulatory environment

- **Strategic Objective 1.1**
  The SEC establishes and maintains a regulatory environment that promotes high-quality disclosure, financial reporting and governance, and that prevents abusive practices by registrants, financial intermediaries and other market participants.

- **Strategic Objective 1.2**
  The SEC promotes capital markets that operate in a fair, efficient, transparent and competitive manner, fostering capital formation and useful innovation.

- **Strategic Objective 1.3**
  The SEC adopts and administers regulations and rules that are informed by robust economic analysis and public comment and that enable market participants to understand clearly their obligations under the securities laws.

- **Strategic Objective 1.4**
  The SEC engages with a multitude of stakeholders to inform and enhance regulatory activities domestically and internationally.

Strategic Goal 2: Foster and enforce compliance with the federal securities laws

- **Strategic Objective 2.1**
  The SEC fosters compliance with the federal securities laws.

- **Strategic Objective 2.2**
  The SEC promptly detects and deters violations of the federal securities laws.

- **Strategic Objective 2.3**
  The SEC prosecutes violations of federal securities laws and holds violators accountable through appropriate sanctions and remedies.

Strategic Goal 3: Facilitate access to the information investors need to make informed investment decisions

- **Strategic Objective 3.1**
  The SEC works to ensure that investors have access to high-quality disclosure materials that facilitate informed investment decision-making.

- **Strategic Objective 3.2**
  The SEC works to understand investor needs and educate investors so they are better prepared to make informed investment decisions.

Strategic Goal 4: Enhance the Commission's performance through effective alignment and management of human, information and financial capital

- **Strategic Objective 4.1**
  The SEC promotes a results-oriented work environment that attracts, engages, and retains a technically proficient and diverse workforce, including leaders who provide motivation and strategic direction.

- **Strategic Objective 4.2**
  The SEC encourages a collaborative environment across divisions and offices and leverages technology and data to fulfill its mission more effectively and efficiently.

- **Strategic Objective 4.3**
  The SEC maximizes the use of agency resources by continually improving agency operations and bolstering internal controls.

ENVIRONMENTAL PERSPECTIVE & OUTLOOK

The SEC's goals and priorities are influenced by a number of external environmental factors, including the demands of fulfilling its mission in an increasingly complex and globally interconnected securities market and the statutory structure within which the Commission works. In recent years, this environment has changed dramatically. While this Strategic Plan attempts to anticipate various ways in which the markets, regulated industries and legislative requirements may evolve over time, no plan can anticipate all possible scenarios. The following discussion outlines the agency's perspective and outlook on the most significant environmental factors that have influenced—and are expected to continue to influence—the SEC's fulfillment of its mission.

Increasingly Dispersed and Complex Financial Markets

Driven by competition, technology, regulation and market participants' innovation, today's financial markets offer more products, services, strategies and opportunities than ever before. Investors are confronted by a growing number of increasingly complex product offerings. Sophisticated technology brings remarkable speed and efficiency to the financial markets, making both routine trades and complex transactions easier and less expensive to execute. At the same time, this technology brings new risks of accidental or intentional disruptions which are capable of spreading across markets, international borders and institutional firewalls. In addition, market structure has become highly fragmented as trading volume is dispersed among many highly automated trading centers that compete for order flow of securities.

New Aspects of the Agency's Jurisdiction

The SEC's role has significantly expanded in recent years, as historic legislation like the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) and the Jumpstart Our Business Startups Act (JOBS Act) have increased the Commission's regulatory responsibility for advisers to hedge funds and other private funds, clearing houses, rating agencies, municipal advisers, crowdfunding portals and, together with the Commodity Futures Trading Commission (CFTC), the entire market structure surrounding swaps.

Actions designed to ease the acquisition of new capital by new and smaller enterprises—chiefly through crowdfunding and general solicitation—will increasingly demand SEC time and resources as well.

The Globally Interconnected Financial Markets

At the same time that domestic responsibilities are expanding, activities the SEC regulates increasingly have international implications. Traders in today's global financial market can move billions of dollars thousands of miles away in a fraction of a second; issuers can explore a whole world of choices as they decide where to list and raise new capital; and investor portfolios are more diverse and global than ever before. Engagement and appropriate coordination with foreign regulators, both bilaterally and multilaterally, on everything from enforcement strategies to swaps regulations, are necessary for the SEC to oversee today's markets, to combat fraud and to identify global risks that could impact U.S. securities markets.

Continuing Risks

Many of the initiatives outlined in this Strategic Plan are designed to address specific problems brought to light by the global financial crisis and its aftermath. Despite best efforts, however, it is impossible to predict and plan for all potential challenges. The degree of the SEC's success in achieving its goals and strategic objectives may depend upon factors such as those listed below.

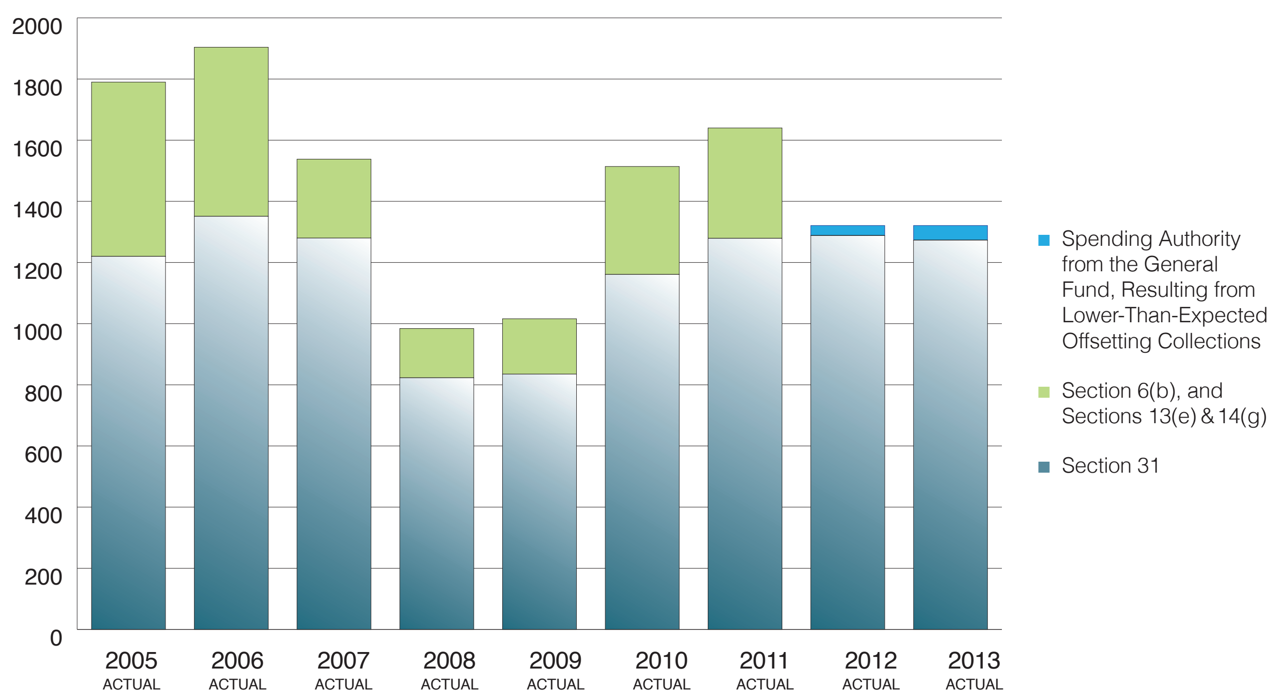
- The SEC's ability to meet its statutory mission and the performance goals and strategic objectives outlined in this Strategic Plan are inherently dependent upon the SEC obtaining sufficient resources, which the agency needs to keep pace with the growing size and complexity of the securities markets and the broad oversight and enforcement responsibilities. The SEC submits an annual budget request which outlines the funding it is seeking and the intended use of such funding. The appropriation that the SEC receives is fully offset by securities transaction fees and, accordingly, the SEC's funding is not borne by taxpayers. Budgetary constraints will impact the ability of the SEC to fulfill its goals and objectives as outlined in this Strategic Plan.
- Legislative and regulatory changes may not be successful in providing regulators with a comprehensive understanding of systemic risk or sufficient tools to manage that risk more effectively.
- Changes in financial industry regulation may unintentionally hamper behavior that would benefit the market and investors.
- Regulations may be perceived as a substitute for care and diligence on the part of investors in their own decision-making.
- Over-regulation or under-regulation may undermine the competitiveness of the U.S. capital markets in an increasingly competitive global marketplace.
- Over-regulation or under-regulation may chill innovation, entrepreneurship, and prudent risk taking.

RESOURCES

The SEC is an independent federal government agency funded through annual appropriations enacted by Congress and the President. Until FY 2012, the agency's appropriations were offset by transaction and registration fees collected by the agency. The Offsetting Collections and Spending Authority chart below presents the SEC's budgetary authority derived from offsetting collections from transaction fees collected pursuant to Section 31 of the Exchange Act and registration fees collected under Section 6(b) of the Securities Act of 1933, Sections 13(e) and 14(g) of the Exchange Act and Section 24(f) of the Investment Company Act of 1940 during the period FY 2005 through 2011. Pursuant to the Dodd-Frank Act and beginning in FY 2012, registration fee collections are no longer offsetting collections, and are now either deposited into the Securities and Exchange Commission Reserve Fund or the U.S. Treasury General Fund. Thus, the columns for FY 2012 through FY 2013 reflect only Section 31 transaction fee collections.

The SEC's appropriation is deficit-neutral since, under the Dodd-Frank Act, the Commission's appropriation is matched by anticipated collections of Section 31 securities transaction fees. Thus, each year, Congress and the President can decide the size of the SEC's appropriation without diverting resources from other priorities or adding to the nation's debt. Since personnel and technology typically comprise about 70 percent of the SEC's appropriation, constraints on the Commission's budget can have a direct and significant impact on the staff and systems the Commission has available to enforce and implement the federal securities laws.

OFFSETTING COLLECTIONS AND SPENDING AUTHORITY (Dollars in Millions)



"Effective regulation of the U.S. financial system requires us to grapple with a global financial system that transcends boundaries. And it demands that we match our regulatory and enforcement priorities with those of scores of jurisdictions around the world."

CHAIR MARY JO WHITE

STRATEGIC GOAL 1

Establish and Maintain an Effective Regulatory Environment

THE SEC IS RESPONSIBLE FOR ESTABLISHING a regulatory environment in which the agency's mission can be met and sustained. Most securities laws and regulations flow from two central principles. First, all investors should have equal access to accurate, complete and timely information about the investments they buy, sell, and hold. Second, investors should be able to rely upon self-regulatory organizations (SRO), exchanges, broker-dealers, investment advisers, investment companies and other market participants to conduct investors' securities transactions efficiently and according to the informed choices made by investors.

The SEC has broad authority to shape the regulatory framework for the securities industry. Rulemaking often is required to remedy abusive practices, to respond to Congressional mandates, to address changing economic conditions, to address risks in advances in technology or novel products or services. In general, rulemaking and policies are designed to improve disclosure, facilitate the flow of important information to investors and the public, improve governance, promote high-quality accounting standards and financial reporting, enhance the responsibilities and accountability of financial intermediaries and other market participants and strengthen the structure of the trading markets, among other goals. When properly crafted, these rules serve to further the SEC's mission. In addition, when existing laws are not sufficient to achieve this mission, the SEC also has a duty to advise Congress about necessary corrective measures. The SEC recognizes that regular reviews of Commission regulations and its rulemaking processes are necessary to confirm that intended results are being achieved as well as to identify gaps and redundancies in regulation.

In addition to promulgating its rules and regulations, the SEC provides guidance when, among other things, it sets forth the views of the Commission or its staff on questions of current concern without stating them in the form of legal requirements. The most prevalent form of this guidance is publicly available staff statements on a particular legal or accounting issue or on an interpretation of a rule or regulation. The staff also responds to inquiries from individuals and companies about whether an activity, undertaken in a specified manner, would violate the securities laws. The inquiries can take the form of written requests that the staff not recommend enforcement or other action to the Commission if the activity is completed as specified. The SEC also issues individual orders granting relief from provisions of the securities laws when the specific facts indicate that doing so is consistent with the protection of investors and the policy and purposes behind the laws. These orders can serve as a testing ground for useful innovation and may pave the way for rulemaking.

STRATEGIC OBJECTIVE 1.1

The SEC establishes and maintains a regulatory environment that promotes high-quality disclosure, financial reporting and governance, and prevents abusive practices by registrants, financial intermediaries and other market participants.

The investments of Americans and their families are dependent upon the maintenance of healthy capital markets. The greater availability of and access to investment opportunities can help Americans build their portfolios to create a better life for themselves and their children. Investment opportunities may include the potential for abuse by market intermediaries, and other market participants. Such abuses erode the investing public's trust and undermine investor confidence in markets as a whole.

To protect investors and to promote confidence in the integrity and fairness of the markets, the SEC uses its regulatory authority to deter potentially abusive behavior.

The federal securities laws entrust the SEC with authority to shape the regulatory framework so that investors are protected through the availability of high-quality disclosure about their investments. In addition, the agency develops regulations that promote and strengthen corporate and fund governance.

Initiatives

To accomplish this strategic objective, the SEC plans to implement the following initiatives:

- **Improve the quality and usefulness of disclosure:** The SEC will continue to evaluate and, where necessary, amend its requirements to improve the quality and usefulness of registrants' disclosures to investors, including continuing to modernize the collection and dissemination of timely, machine-readable, structured data to investors when appropriate. Areas of focus will include disclosure about registrants' financial condition, operations, risk management and executive compensation decisions and practices. Additionally, the SEC will continue to pursue data standards and methods that permit investors to more efficiently search for information within forms as well as aggregate and compare financial data across filers.

- **Engage in rulemaking mandated by Congress:** The SEC will continue to fulfill its obligations under the Dodd-Frank Act and the JOBS Act to develop and promulgate mandated rules and regulations with appropriate notice comment and economic analysis.
- **Analyze trends in new financial products and instruments, including exchange traded products, and market innovations:** The SEC will proactively seek out information from market experts both inside and outside the SEC to help inform the regulatory process, look for new risks, understand the impact of significant market events and ensure that rules and registrants' disclosures take into account the latest market environment and practices. When possible, the SEC will directly collect and analyze relevant market data to identify upcoming trends, patterns, or relationships among asset classes, instruments and market participants, and to identify areas of regulatory need. One area of focus will be to consider requiring mutual funds to provide additional information on portfolio holdings and other operations.
- **Strengthen proxy infrastructure:** The SEC will consider issues related to the mechanics of proxy voting and shareholder-company communications, including the role of proxy advisory firms.
- **Modernize beneficial ownership reporting:** The SEC will consider how to modernize its beneficial ownership reporting requirements to, among other things, address the disclosure obligations relating to the use of equity swaps and other derivative instruments.
- **Analyze regulatory structures for investment advisers and broker-dealers providing personalized investment advice:** The SEC will continue to analyze whether the different regulatory obligations that apply to broker-dealers and investment advisers providing personalized investment advice should be changed for the protection of investors.
- **Modernize the regulatory treatment and valuation of certain portfolio holdings of registered investment companies:** The SEC will consider regulatory initiatives and/or guidance needed to update and improve the current regulatory regime for the use of derivatives by mutual funds, exchange-traded funds and other registered investment companies. A related initiative is consideration of updated guidance for registered investment companies regarding the valuation of their portfolio securities and other assets.
- **Promote high-quality accounting standards:** The SEC will continue to promote the establishment of high-quality accounting standards by independent standard setters in order to meet the needs of investors. In overseeing the Financial Accounting Standards Board (FASB), the SEC will strengthen and support the FASB's independence and maintain the focus of financial reporting on the needs of

investors. Due to the increasingly global nature of the capital markets, the agency will work to promote higher quality financial reporting worldwide and will consider, among other things, whether a single set of high-quality global accounting standards is achievable.

- **Foster high-quality audits through the oversight of the accounting profession:** The SEC will continue to oversee the Public Company Accounting Oversight Board (PCAOB) and its regulation of independent auditors through the PCAOB's inspection and disciplinary programs. The SEC also will work closely with the PCAOB on the promulgation and interpretation of auditing standards to address current issues in the capital markets.
- **Enhance the regulation of broker-dealers, clearing agencies, and other major market participants:** The SEC will continue to enhance its oversight of broker-dealers, clearing agencies, and other major market participants by, among other things, evaluating the current regulatory structure related to financial responsibility, customer protection and governance.
- **Monitor disclosures related to asset-backed securities:** The SEC is considering revising its rules and forms to improve registration and disclosure requirements for asset-backed securities, and will monitor disclosures and compliance with current and any revised rules that have been promulgated by the Commission. The SEC will continue to fulfill its statutory mandate to work with other federal regulators in the promulgation of joint rules concerning credit risk retention in securitized transactions.
- **Strengthen oversight of municipal advisors and consider guidance for private fund advisers:** The SEC will continue to enhance the program for registration and oversight of municipal advisors, with a particular focus on registering municipal advisors under the permanent registration rules and reviewing rule filings by the Municipal Securities Rulemaking Board (MSRB) to implement the permanent municipal advisor registration rules. Another area of focus will be the application of rules under the Investment Advisers Act to private fund advisers and the need to provide guidance regarding the application of those rules.

Related Indicator

The following indicator is useful for understanding the SEC's activities, but should not be considered a performance metric. As this indicator is not used to assess performance, it does not require a target or timeframe.

INDICATOR	DESCRIPTION
Number of investor testing research projects	This metric tracks the number of research initiatives used to gather feedback from investors on the usefulness of disclosures and other input on SEC rulemaking.

STRATEGIC OBJECTIVE 1.2
The SEC promotes capital markets that operate in a fair, efficient, transparent, and competitive manner, fostering capital formation and innovation.

Through rulemaking and other initiatives, the Commission works to assure that investors have fair access to securities markets; that their orders are handled in an efficient and transparent manner throughout the order entry, execution, clearing, and settlement process; that securities laws and regulations do not promote regulatory arbitrage; and that U.S. securities markets remain vibrant, competitive and resilient. These efforts help to promote markets in which investors have the necessary information to make investment decisions, the price discovery process is fair and free from manipulation, and trades can be executed efficiently. The Commission also fosters capital formation by facilitating market access for novel products and innovative and competitive investment company structures when consistent with investor protection.

Self-regulation is a fundamental component of the regulation of U.S. securities markets and market intermediaries. SROs must balance multiple interests and responsibilities. The SEC oversees SROs to ensure that securities markets operate in a fair, efficient and orderly manner; that they are competitive; and that they promote capital formation. The SEC has authority over the rulemaking and other activities of SROs, which include national securities exchanges, the Financial Industry Regulatory Authority (FINRA) and clearing agencies. In approving SRO rules, the SEC must determine, among other things, that these rules are designed to prevent fraudulent and manipulative practices, promote just and equitable principles of trade, and foster cooperation in the clearing and settling of trades, and that they do not impose an unnecessary or inappropriate burden on competition. At the same time, SROs face unique challenges balancing their regulatory responsibilities with business and other interests. In this respect, the SEC's oversight over SROs provides it with the ability to monitor conflicts of interest by, among other things, ensuring that an SRO's rules, as well as any changes to those rules, assure a fair representation among members and participants in the selection of an SRO's directors and administration of its affairs, and also are not designed to permit unfair discrimination between customers and other participants.

Initiatives

To accomplish this strategic objective, the SEC plans to implement the following initiatives:

- **Foster a fair and efficient market structure:** The SEC will continue to pursue initiatives that promote the goals of the national market system in the trading of securities, such as enhancing price transparency, facilitating best execution, assuring fair access to trading systems and fostering fair competition. These may include:
  - Reviewing the impact of algorithmic and other automated trading on the markets, including its potential contribution to market volatility and, if warranted, developing an appropriate policy response;
  - Strengthening the incentives for investors to display trading interest, and thereby contribute to the price discovery process;
  - Enhancing the post-trade transparency of alternative trading systems (including dark pools) in order to address market fragmentation and facilitate best execution;
  - Continuing and expanding a comprehensive review of equity market structure; and
  - Considering a comprehensive review of the structure and operation of the listed options markets to promote fair, efficient, transparent, and competitive markets.
- **Oversee the system of self-regulation:** Through its review of SRO proposed rule changes, ongoing dialogue with SROs, and rulemaking and other initiatives, the SEC will appropriately oversee the system of self-regulation. This is particularly important in light of conflicts of interests.
- **Enhance the technological resilience of securities markets:** The SEC is working with securities markets, securities firms and other key market participants to ensure the development of adequate policies and procedures with regard to their automated systems and to guard against technological failures. The SEC recently proposed rulemaking to require securities markets, clearing agencies, and plan processors to assure that their systems have adequate levels of capacity, integrity, resiliency, availability and security to maintain their operational capability and

that those markets operate in the manner intended. The SEC anticipates continuing its work on this rulemaking proposal and continuing its dialogue with securities markets to assure a robust and sound U.S. market infrastructure.

- **Reduce reliance on credit ratings references in SEC rules:** The SEC will continue to work to implement the credit rating reference removal provisions required by the Dodd-Frank Act and insert appropriate substitutes as required by law.
- **Enhance oversight of derivatives:** The SEC will continue to implement the derivatives provisions of Title VII of the Dodd-Frank Act, including through cooperative measures with foreign counterparts. The SEC will work with the CFTC to seek to harmonize futures and securities laws for economically equivalent instruments.
- **Help prevent market manipulation:** As part of this initiative, the SEC will review recent changes to the regulation of short sales to assess their effectiveness and determine whether additional modifications are warranted. The agency also intends to explore ways to enhance the transparency of trading activities to better deter and detect manipulation. In addition, the SEC will pursue initiatives to update and enhance the anti-manipulation rules that address the activities of underwriters, issuers, selling security holders and others in connection with securities offerings, as well as update and enhance the anti-manipulation rules that address issuer repurchases and timely public notice of dividends and other distributions.
- **Improve transparency and oversight of small capitalization securities:** The SEC will pursue initiatives focused on the special characteristics of the market for small capitalization securities, in order to enhance the transparency of this market and promote vigorous oversight. Goals of these initiatives will include assuring appropriate investor protections and promoting market efficiency. The SEC also will review its rule that governs the publication of quotations for securities that are not listed on a national securities exchange, to ensure that it adequately addresses securities and situations most likely to raise concerns about fraud and manipulation.
- **Consider implementing further money market fund reforms:** The SEC plans to consider final amendments to its rule regulating money market funds (MMFs), which would be designed to reduce their susceptibility to runs, improve their ability to manage the effects of high levels of shareholder redemptions in times of stress, increase the transparency of risk in MMF portfolios and preserve, as much as possible, the benefits of MMFs for investors and the short-term financing markets.
- **Enhance the market structure for fixed income securities:** The SEC plans to pursue many of the recommendations highlighted in the July 2012 Report on the Municipal Securities Market through a combination of SEC, MSRB, and FINRA initiatives, in an effort to enhance the market structure for all fixed income securities,

including taxable and tax-exempt securities. This effort will include initiatives aimed at promoting transparency and the development of new mechanisms to facilitate the provision of liquidity, as well as initiatives to improve the execution quality of investor orders.

- **Consider streamlining the process for introducing new exchange-traded funds:** The SEC will consider whether or not to permit certain exchange-traded funds to be introduced to the market without first submitting an application under the Investment Company Act of 1940 and receiving an exemptive order from the Commission.
- **Improve clearance and settlement:** The SEC will pursue initiatives to develop registration practices that facilitate appropriate access to U.S. financial markets for different types of clearing agencies and transfer agents, and supervisory resources and practices that allow the SEC to appropriately consider the systemic and other risks of registered and exempt clearing agencies and transfer agents performing payment, clearance and settlement activity in the U.S. and for U.S. persons. The SEC also will consider whether and how to modify existing rules covering clearing agencies and transfer agents to enhance the safety and efficiency of securities clearance and settlement practices and ensure that such practices are harmonized with the broader U.S. financial system.

Performance Goal

The SEC intends to use the following performance metric to gauge its progress in achieving this strategic objective:

PERFORMANCE GOAL	DESCRIPTION
Time to complete SEC review of SRO rules that are subject to SEC approval	The SEC reviews SRO rule proposals for consistency with the Exchange Act standards of investor protection, fair and orderly operation of the markets and market structure, as well as other statutory requirements. This metric gauges the timeliness of those reviews.

Related Indicators

The following indicators are useful for understanding the SEC's activities, but should not be considered performance metrics. As these indicators are not used to assess performance, they do not require targets or timeframes.

INDICATOR	DESCRIPTION
Percentage of SRO rule filings submitted for immediate effectiveness	This indicator gauges the proportion of SRO rule proposals that are submitted for immediate effectiveness.
Percentage of transaction dollars settled on time each year	This indicator measures the efficiency of the U.S. clearance and settlement system for equity securities.
Percentage and number of market outages at SROs and electronic communications networks (ECNs) that are corrected within targeted timeframes	Market outages reflect problems in the systems underlying the securities markets that could have an adverse effect on the markets' ability to function as required. The SEC assesses the reliability and resiliency of these systems to minimize the number and duration of outages. This indicator gauges how quickly outages are resolved, so that market activity can resume.

STRATEGIC OBJECTIVE 1.3

The SEC adopts and administers regulations and rules that are informed by robust economic analysis and public comment and that enable market participants to understand their obligations under the securities laws.

The process of developing and administering rules and regulations is one of the primary functions of the SEC and involves staff from virtually every division and office. One of the agency's primary objectives is to maintain a regulatory framework that enables market participants to understand their obligations.

The success of this strategic objective requires collaboration and coordination among staff members who bring a variety of different perspectives, with appropriate tools and support. In addition, the agency must continually reevaluate its regulatory framework so that it provides sufficient protections to investors as new products and services enter the market. In addition to drafting its own rules, the SEC often coordinates with other federal regulators in joint rulemaking to ensure consistency and clarity throughout the market.

The SEC's economic analysis supports a wide spectrum of activities, including policy-making and rulemaking. The SEC integrates robust economic analysis into the rule-making process and rule releases, so that its rules and regulations are appropriately informed by economic reasoning and impacts. The SEC also identifies developing risks and trends in the financial markets and engages in long-range planning and training to address such developments.

The SEC plans to continue to encourage investor participation and comments on proposed rules, regulations and other issues materially affecting investors through a variety of methods, including supporting the work of the Investor Advisory Committee, staffing the Office of the Investor Advocate and working with the Office of Investor Education and Advocacy to highlight issues that may be of particular interest to investors.

Initiatives

To accomplish this strategic objective, the SEC plans to implement the following initiatives:

- **Improve agency-wide coordination of the rulemaking process:** The SEC will seek additional ways to foster greater and earlier collaboration among divisions and offices on rulemaking initiatives. The agency will establish collaboration tools to more effectively gather and analyze data from across the SEC and manage rulemaking activities.
- **Enhance the process for no-action, interpretive, and exemptive regulatory requests:** The SEC will continue reviewing its process for handling written requests for no-action, interpretive, and exemptive relief, so that the agency's responses are completed in a timely and efficient manner.
- **Respond accurately and promptly to informal guidance requests from market participants and others:** The SEC will strive to respond to informal requests for guidance regarding the laws and rules it administers to provide appropriate informal guidance as quickly as possible.

Performance Goals

The SEC intends to use the following performance metrics to gauge its progress in achieving this strategic objective:

PERFORMANCE GOAL	DESCRIPTION
Length of time to respond to written requests for no-action letters (NAL), exemptive applications, and written interpretive requests	The SEC staff responds to requests for guidance from individuals and market participants about specific provisions of the federal securities laws. These queries may seek interpretations of the securities laws or regulations, or assurances that no enforcement action will be taken if the individual or market participant engages in a specified activity. The staff also reviews applications for exemptions from the securities laws. Written responses to such requests for guidance, when provided, generally are publicly available, as are applications and related notices and orders, when issued. This metric gauges the timeliness of initial comments issued by the Divisions of Trading and Markets, Investment Management, and Corporation Finance.
Timeliness of responses to requests for informal guidance received by the Devision of Trading & Markets dedicated hotline or email box	The Division of Trading and Markets maintains a dedicated phone line and an email account to provide market participants with avenues to request information and informal guidance regarding the Exchange Act and rules thereunder. This metric will reflect the timeliness of the staff's responses to these requests.

Related Indicators

The following indicators are useful for understanding the SEC's activities, but should not be considered performance metrics. As these indicators are not used to assess performance, they do not require targets or timeframes.

INDICATOR	DESCRIPTION
Number of amendments to national securities exchange registrations (Form 1)	This indicator provides information about the volume of material filed with the SEC that involves amendments to exchange registrations.
Number of Alternative Trading System registrations (Form ATS)	This indicator provides information about the volume of material filed with the SEC that involves filings related to ATS registrations.
Number of new investment product submissions	This indicator provides information about the volume of material filed with the SEC that involves new product submissions pursuant to Rule 19b-4(e) of the Exchange Act.
Number of published economic reports	This indicator gauges the number of economic reports that staff of the Division of Economic and Risk Analysis publishes annually on the SEC's website.

STRATEGIC OBJECTIVE 1.4

The SEC engages with a multitude of stakeholders to inform and enhance regulatory activities domestically and internationally.

In today's markets, capital can cross jurisdictional boundaries with the click of a mouse. It is more important than ever to coordinate with other U.S. and foreign regulatory authorities and stakeholders on the best regulatory responses to the changing market landscape. Failure to effectively coordinate can significantly hamper the SEC's ability to achieve its policy objectives or avoid significant unintended consequences.

Domestically, the Chair of the SEC will continue to participate actively in the Financial Stability Oversight Committee (FSOC) with the heads of others FSOC member agencies, such as the Board of Governors of the Federal Reserve, the Department of the Treasury and the CFTC.

The SEC also will actively participate in international multilateral organizations, including the International Organization of Securities Commissions (IOSCO), the Financial Stability Board, the Organization for Economic Cooperation and Development, and the Financial Action Task Force. These efforts will be complemented by direct bilateral consultations with foreign regulatory counterparts on enforcement and regulatory cooperation matters. In addition, the SEC continues to promote international coordination and cooperation through its technical assistance programs for foreign regulators.

The SEC will continue to coordinate with domestic stakeholders including investors, industry representatives, technical experts and other market participants. The SEC will also continue to work with the Investor Advisory Committee on a variety of regulatory issues.

Initiatives

To accomplish this strategic objective, the SEC plans to implement the following initiatives:

- **Collaborate with other authorities on enforcement and market oversight matters:** In order to create a more effective and coordinated regulatory environment, the SEC will partner with U.S. federal and state regulatory authorities to share data, information, and expertise on regulatory issues as appropriate. The SEC will similarly utilize arrangements to share appropriate and relevant data, information, and expertise with foreign authorities about cross-border issues.

- **Continue global coordination and assistance:** The SEC will continue to work closely with its regulatory counterparts abroad, as well as with relevant international organizations, to promote high-quality securities regulation worldwide and regulatory convergence where appropriate. The SEC will conduct technical assistance programs that promote emerging and recently-emerged markets' capacity to take steps to minimize the likelihood of regulatory arbitrage and promote cross-border enforcement and supervisory assistance.
- **Facilitate input from stakeholders in rulemaking initiatives:** The SEC will continue to seek input from stakeholders to inform its rulemaking initiatives through a variety of methods including, as appropriate to the initiative, meeting with investors, industry representatives, technical experts and other market participants, holding roundtables and issuing concept releases.
- **Coordinate closely with the Investor Advisory Committee:** The SEC will continue to work closely with the Investor Advisory Committee, which was established to present the views and experience of a wide variety of investors and to advise the Commission on regulatory priorities and practices. The Investor Advisory Committee is authorized by statute to submit findings and recommendations to the Commission for review and consideration.

Performance Goals

The SEC intends to use the following performance metrics to gauge its progress in achieving this strategic objective:

PERFORMANCE GOAL	DESCRIPTION
Supervisory cooperation requests from foreign authorities for SEC assistance and SEC requests for assistance on supervisory cooperation from foreign authorities	The SEC makes requests to foreign authorities for supervisory cooperation assistance and responds to such requests from foreign regulators both through formal mechanisms, such as supervisory memoranda of understanding, and on an ad hoc basis.
Number of non-U.S. regulators trained	This metric shows the reach of the SEC's technical assistance programs for regulators around the world. The SEC conducts these training sessions to assist countries in developing and maintaining robust protections for investors and promoting cross-border enforcement and supervisory assistance.

"The ability to identify and bring timely, high-quality enforcement actions when violations of the federal securities laws occur is integral to the SEC's core mission. The SEC must enhance its enforcement function not only to send strong messages to wrongdoers that misconduct will be swiftly and aggressively addressed, but also to adapt to the highly automated, high-speed markets of today and tomorrow."

CHAIR MARY JO WHITE

STRATEGIC GOAL 2

Foster and Enforce Compliance with the Federal Securities Laws

FOSTERING COMPLIANCE WITH FEDERAL SECURITIES LAWS is interwoven through all of the Commission's programs and is central to fulfilling its mission of protecting investors; maintaining fair, orderly and efficient markets; and facilitating capital formation. Through disclosure reviews and examinations of broker-dealers, investment advisers, SROs and other market participants, the SEC seeks both to detect violations of the securities laws and rules and to foster strong compliance and risk management practices within these firms and organizations.

When violations do occur, the SEC strives to take prompt action to stop the misconduct, penalize the wrongdoers and, where possible, return funds to harmed investors. These actions span the broad spectrum of the securities laws including, among others, matters of financial reporting, disclosure, accounting fraud, securities offerings, insider trading and market manipulation. These critical investor protection functions contribute to investors' confidence in our capital markets.

The SEC will continue to enhance its National Examination and Enforcement programs. As discussed further below, these improvements include expanding the SEC's training programs, hiring staff with new skill sets, streamlining processes, enhancing information-sharing, leveraging the knowledge of third parties, improving the processing of the thousands of tips the agency receives annually and improving risk assessment techniques. These, and other significant efforts, contribute to the SEC's objective of creating an enduring structure for improved protection of investors and markets.

STRATEGIC OBJECTIVE 2.1
The SEC fosters compliance with the federal securities laws.

While detecting violations of the federal securities laws is an integral aspect of the SEC's programs (see Strategic Objective 2.2), working to prevent future violations can be even more important to protecting investors and enhancing market integrity. The SEC's goal is to encourage regulated entities and reporting companies to do all that they reasonably can to identify possible compliance pitfalls and take preventive action before a violation occurs.

Initiatives designed to foster greater compliance with securities laws run throughout this Strategic Plan. They include efforts designed to provide investors with information they need so that they can wisely select and monitor their investments and professional intermediaries (see Strategic Objective 3.1); to ensure that rules are written in an understandable way, so that those charged with compliance clearly understand their responsibilities (see Strategic Objective 1.3); to create, as appropriate, prophylactic rules that prevent abusive trading or marketing practices (see Strategic Objective 1.2); and to deter regulated entities and reporting companies from engaging in unlawful conduct (see Strategic Objective 2.2).

The SEC seeks to encourage within organizations of all sizes that participate in the securities markets a strong "culture of compliance"—an environment that fosters, from top leadership down, ethical behavior and decision-making. This philosophy should underpin all that the organization does, so that when employees make decisions, large and small, they are guided by a culture that reinforces acting in both a legal and ethical manner.

Initiatives

To accomplish this strategic objective, the SEC plans to implement the following initiatives:

- Expand outreach efforts for promoting compliance practices: The SEC will enhance efforts to promote compliance by engaging in more proactive communications with registrants and their personnel, including chief compliance officers, senior executives and board members. These efforts will include expanding participation in compliance outreach events; disseminating targeted materials to firms by means of risk alerts; detailing areas where examiners have identified significant compliance deficiencies, best practices identified by examiners or industry groups, and rule changes; and raising registrant awareness of the seriousness of certain exam findings by holding post-examination compliance conferences.

Performance Goals

The SEC intends to use the following performance metrics to gauge its progress in achieving this strategic objective:

PERFORMANCE GOAL	DESCRIPTION
Number of industry outreach and education programs targeted to areas identified as raising particular compliance risks	Targeted communication with industry participants on topics shaping the examination program is intended to enhance compliance practices and prevent violations before they occur. This metric identifies the number of major outreach efforts conducted including the SEC's national and regional compliance outreach events, published risk alerts, and other educational programs and initiatives.
Percentage of firms receiving deficiency letters that take corrective action in response to all exam findings	At the conclusion of examinations, the staff communicates identified deficiencies to registrants in the form of a deficiency letter. Registrants are then given a chance to respond to staff findings and often take action to remedy any problems and potential risks, including monetary compensation to clients and enhancements to disclosures, policies and procedures. Most often, registrants respond that they have corrected the deficiencies and implemented measures to prevent recurrence.

STRATEGIC OBJECTIVE 2.2

The SEC promptly detects and deters violations of the federal securities laws.

Violations of the securities laws have a tremendous impact on investors. Accordingly, prompt detection of potential securities law violations is important in limiting the harm caused to investors. By identifying violations early, the SEC seeks to punish wrongdoers promptly, correct violative behavior in the financial markets before it proliferates, stop fraud and manipulation before it affects a large number of investors, and locate and preserve investors' assets before they are lost or dissipated.

Detecting violations of the federal securities laws is a difficult but critical function, and one in which the agency continuously seeks to enhance its efforts. In the midst of constantly evolving financial markets, the SEC seeks to strengthen its oversight of the large number of registrants by focusing its resources on the areas of greatest risk. This risk-based approach, which the Commission continually seeks to refine, is implemented across agency programs through various methodologies aimed at identifying, assessing and managing risks to investors.

In addition, each year the SEC receives thousands of tips and complaints, as well as referrals from SROs, that staff analyze to determine matters requiring investigation. The Commission works closely with others—SROs, the Department of Justice and other criminal authorities, and state, federal, and foreign regulators—to maximize the breadth and depth of its combined efforts. As described below, the SEC will continue working to improve its detection and deterrence efforts.

Initiatives

To accomplish this strategic objective, the SEC plans to implement the following initiatives:

- **Enhance surveillance and risk assessment capabilities:** The SEC will continue to enhance the methods and tools for more effectively identifying and assessing risks in the markets and focusing surveillance efforts on entities, persons, and practices that pose a high risk to investors and financial markets. As part of this effort, the SEC will seek to obtain greater access to data and insights from a variety of sources including data from registrants, SROs, commercial vendors, and other sources. In addition, the SEC will expand the use of analytics to enhance the ability of examination and enforcement staff to detect potentially violative activity.
- **Improve management of tips, complaints, and referrals:** The SEC will enhance the process for receiving, processing, and acting upon tips, complaints and referrals so they can continue to be handled consistently and appropriately, including through examinations or enforcement investigations. This effort will also enhance the SEC's data on tips, complaints, and referrals, to help the agency spot trends and patterns about potential issues or violations that may warrant further Commission action.
- **Build upon the establishment and successes of the Office of the Whistleblower:** The SEC will continue to encourage individuals and entities with timely, credible and specific information about potential securities law violations to provide information to the Commission to further investigations and promote more efficient use of the Commission's limited resources. Pursuant to the Dodd-Frank Act, the SEC is required to compensate eligible whistleblowers with an award of 10 to 30 percent of amounts collected as a result of original information provided by a whistleblower that leads to a successful enforcement action resulting in monetary sanctions exceeding $1,000,000.
- **Bolster the expertise of SEC staff:** The SEC will continue to develop and implement specialized teams focusing on particular market issues that directly affect investors and the functioning of the markets, by enhancing the expertise of SEC staff through targeted training in critical and emerging areas, and enabling staff to obtain additional training resulting in certifications, such as "Certified Fraud Examiners" and "Chartered Financial Analysts."

- **Build upon Enforcement's Cooperation Program:** The staff will use a variety of tools—including cooperation agreements, deferred prosecution agreements and non-prosecution agreements—to encourage individuals and companies to promptly report violations and provide assistance to the agency.
- **Enhance sharing, cooperation, and joint initiatives both within the agency and with other regulators:** The SEC will focus on improving the sharing of information between divisions and offices of the Commission and with other regulators. This type of communication will help ensure that expertise is shared and that areas of mutual interest are addressed in an efficient and effective manner. This includes continuing the use of joint specialized working groups within the agency that are focused on market issues and entities presenting significant risks. This would also include continuing efforts to collaborate and share information with other regulators, such as FINRA, state regulators, the CFTC, international counterparts and many others.

Performance Goals

The SEC intends to use the following performance metrics to gauge its progress in achieving this strategic objective:

PERFORMANCE GOAL	DESCRIPTION
Percentage of investment advisers, investment companies, and broker-dealers examined during the year	This metric indicates the number of registrants examined by the SEC or an SRO as a percentage of the total number of registrants. This metric includes all types of examinations: risk priority examinations, cause inspections to follow up on tips and complaints, limited-scope special inspections to probe emerging risk areas, oversight examinations of broker-dealers to test compliance and the quality of examinations by FINRA.
Percentage of compliance exams that are concluded in accordance with the Office of Compliance Inspections and Examination's (OCIE) statutory deadline	The staff conducts examinations each year of registered entities, including investment advisers, investment company complexes, transfer agents, and broker-dealers. The staff strives to complete its examinations and communicate findings in the most efficient and effective manner and within its statutory deadline. This metric reflects the percentage of examinations concluded within the statutory deadline.
Number of joint exams, information sharing agreements, and formal meetings with other regulators	The SEC attempts to coordinate and collaborate with other regulators on areas of mutual interest. This helps to ensure that all regulators are informed of ongoing risks and issues related to broad market practices as well as specific entities of mutual interest. This cooperation is critical to the exam program to ensure that certain higher risk firms and activities are addressed in the most efficient and effective manner. This metric tracks critical cooperation activities that are occurring between the SEC's exam program and other regulators.

Related Indicators

The following indicators are useful for understanding the SEC's activities, but should not be considered performance metrics. As these indicators are not used to assess performance, they do not require targets or timeframes.

INDICATOR	DESCRIPTION
Percentage of exams that identify deficiencies, the percentage that result in a "significant finding," and the percentage referred to the Division of Enforcement	Examiners find a wide range of deficiencies during examinations. Some of the deficiencies are more technical in nature, such as failing to include all information that is required to be in a record. However, other deficiencies may cause harm to customers or clients of a firm, have a high potential to cause harm, or reflect recidivist misconduct. The latter deficiencies are among those categorized as "significant." This indicator identifies the percentage of exams that identified deficiencies, that resulted in significant deficiency findings, and that were referred to Enforcement.
Number of cause exams that result from tips, complaints and referrals	Analysis of a tip can support the request for a cause exam. This indicator would identify the number of SEC cause exams that result from tips collected through outreach efforts.
Number of rule-making initiatives assisted by the National Exam Program	The examination program interacts with registrants on a regular basis and this work provides feedback critical to ensuring effective and practical rulemaking and policy efforts. This indicator tracks how frequently the examination program assists with rulemaking initiatives.
Number of investigations or inquiries originating from a tip or complaint	Analysis of a tip or complaint can result in the need for an enforcement investigation. The indicator identifies the number of SEC investigations that result from tips and complaints received by the SEC.
SEC investigations in which requests for access to information were granted by the SEC to other authorities, such as SROs or other state, federal, and foreign enforcement authorities	The SEC works closely with other regulators and authorities. This metric identifies the number of investigations in which the SEC granted one or more authorities access to information concerning an investigation during the fiscal year. This may include requests for access to SEC investigative files concerning investigations that the SEC continues to pursue, as well as those in which the SEC has completed its investigation.
Requests from foreign authorities for SEC assistance and SEC requests for assistance from foreign authorities	Each year, the SEC makes hundreds of requests for enforcement assistance to foreign regulators, while responding to hundreds of such requests from other nations. To facilitate this type of assistance, and encourage other countries to enact laws necessary to allow regulators to cooperate with their foreign counterparts, the SEC has entered into bilateral information-sharing arrangements, as well as the Multilateral Memorandum of Understanding, an information-sharing arrangement negotiated through IOSCO.

STRATEGIC OBJECTIVE 2.3

The SEC prosecutes violations of federal securities laws and holds violators accountable through appropriate sanctions and remedies.

Investors are not truly protected unless those who prey on them are swiftly and appropriately sanctioned. The enforcement staff strives to obtain swift and firm sanctions, while remaining fair and reasonable. The breadth of the enforcement program's capabilities in this area derives, in part, from its close cooperation with the other SEC divisions that perform regulatory functions and also have deep knowledge of the market and its participants.

To improve the quality and efficiency of its investigations, the SEC is committed to streamlining internal processes wherever possible. In pursuing potential violations of the securities laws, the SEC regularly works closely with other regulators and law enforcement agencies. The enforcement program also has seen a dramatic increase in its coordination efforts with foreign authorities, including requests for assistance to and from foreign regulators under bilateral and multilateral information-sharing arrangements. These efforts also include requests to trace proceeds of fraud to foreign countries, and actions to obtain asset freezes. The SEC is committed to further expanding its coordination with these entities in order to strengthen the Commission's ability to hold wrongdoers accountable.

Initiatives

To accomplish this strategic objective, the SEC plans to implement the following initiatives:

- **Continue utilizing specialty groups within the enforcement program:** The SEC will continue to use specialized groups and task forces to move quickly and to centralize expertise on the most critical issues emerging in the markets. As market conditions and market events dictate, Enforcement will evaluate the need to add, eliminate or implement changes to specialized groups and task forces.
- **Enhance timeliness of distributions to wronged investors:** The SEC will improve timeliness and efficiency of its efforts to return money collected in enforcement actions to harmed investors.
- **Enhance communications among SEC divisions and offices and the enforcement program:** The SEC will improve communication and sharing of information between the enforcement program and other divisions and offices to bring to bear the collective expertise of the Commission in a timely and efficient manner, such as continuing meetings of the Cross-Border Working Group.

- **Review approach for enforcement penalties:** The SEC will continue to assess its approach to the use of penalties in connection with enforcement recommendations/actions so that penalties have the appropriate punitive and deterrent effect, having in mind avoiding unnecessary harm to shareholders.
- **Broaden the range of enforcement sanctions:** The SEC will develop alternative approaches to sanctions to gain greater flexibility in bringing actions to conclusions that benefit investors.

Performance Goals

The SEC intends to use the following performance metrics to gauge its progress in achieving this strategic objective:

PERFORMANCE GOAL	DESCRIPTION
Percentage of enforcement actions in which the Commission obtained relief on one or more claims	This metric identifies, as to all parties to enforcement actions that were resolved in the fiscal year, the percentage against whom the Commission obtained a judgment or order entered on consent, a default judgment, a judgment of liability on one or more charges, and/or the imposition of monetary or other relief. The Division of Enforcement is currently assessing this metric, and evaluating how to incorporate qualitative considerations of the results of its enforcement actions.
Percentage of first enforcement actions filed within two years of the opening of an investigation	This metric concerns the pace of investigations that lead to the filing of enforcement actions. Specifically, this metric captures the rate at which the first enforcement action arising out of an investigation was filed within two years of the opening of the investigation. If the investigation was preceded by a matter under inquiry, the metric draws on the date of the opening of the matter under inquiry. In conducting investigations, the Enforcement program continually strives to balance the need for complete, effective and fair investigations with the need to file enforcement actions in as timely a manner as possible.
Average months between opening a matter under inquiry or an investigation and commencing an enforcement action	This metric captures the average number of months between the opening of an investigation and the filing of the first enforcement action arising out of that investigation. If the investigation was preceded by a matter under inquiry, the metric draws on the date of opening of the matter inquiry. In conducting investigations, the enforcement program continually strives to balance the need for complete, effective, and fair investigation with the need to file enforcement actions in as timely a manner as possible. While not all investigations result in the filing of enforcement actions, this metric provides information concerning the pace of investigations that do lead to such actions and supplements the previous goal, which measures the percentage of first enforcement actions filed within two years.

PERFORMANCE GOAL	DESCRIPTION
Percentage of debts where either a payment has been made or a collection activity has been initiated within 180 days of the due date of the debt	The SEC can seek a wide range of remedies for failure to comply with the securities laws. These remedies include civil monetary penalties and disgorgement. When the remedies are imposed by the SEC or the federal district court, payments must be made by a certain date. This metric identifies the percentage of debts where debtors have made payments or the SEC has initiated a collection activity within 180 days of the due date. Such collection activities include, among other things, demand letters, negotiation of payment plans, enforcing the payment of the debt through the courts or other judicial remedies.
Percentage of Fair Fund and disgorgement fund plans that have distributed 80 percent of the available funds for distribution within twenty four (24) months of the approval of the distribution plan	In addition to other types of relief, the SEC may seek orders requiring parties to disgorge any money obtained through wrongdoing. The SEC also is empowered to seek civil penalties for violations of the securities laws. Where appropriate, the SEC has sought to return disgorged funds to harmed investors and, as a result of the Fair Funds provisions of the Sarbanes-Oxley Act and the Dodd-Frank Act, to combine amounts paid as penalties with disgorged funds, or to create a Fair Fund from penalties only, to reduce losses to injured parties and to maximize funds available for distribution. This metric identifies the percentage of distribution plans that reached a critical mass during the fiscal year and within twenty four (24) months of the approval of the distribution plan. The distribution plan includes the timeline and procedures required to return the funds to injured investors. This reflects Commission-wide efforts to implement plans to return money to investors quickly. Any funds not returned to investors are sent to the U.S. Treasury or the Investor Protection Fund established pursuant to Section 21F(g) of the Securities Exchange Act of 1934. Neither disgorgement nor penalties are used for the SEC's own expenses.

Related Indicators

The following indicators are useful for understanding the SEC's activities, but should not be considered performance metrics. As these indicators are not used to assess performance, they do not require targets or timeframes.

INDICATOR	DESCRIPTION
Percentage of filed enforcement actions reflecting characteristics that present enhanced risk to investors and markets, as measured by the nature of the investigation, conduct, parties and impact.	This indicator assesses the quality of the cases filed by the Division of Enforcement. The indicator focuses on cases filed by the SEC that involve factors reflecting enhanced risk to investors and markets. Such cases may involve: (i) those identified through risk analytics and cross-disciplinary initiatives to reveal difficult-to-detect or early stage misconduct, thus minimizing investor loss and preventing the spread of unlawful conduct and practices; (ii) particularly egregious or widespread misconduct and investor harm; (iii) vulnerable victims; (iv) a high degree of scienter; (v) involvement of individuals occupying substantial positions of authority, or having fiduciary obligations or other special responsibilities to investors; (vi) involvement of recidivists; (vii) high amount of investor loss prevented; (viii) misconduct that is difficult to detect due to the complexity of products, transactions, and practices; (ix) use of innovative investigative or analytical techniques; (x) effective coordination with other law enforcement partners; and/or (xi) whether the matter involves markets, transactions or practices identified as an enforcement priority, or that advances the programmatic priorities of other SEC divisions or offices.
Total amount distributed within the fiscal year, and the number of Fair Funds from which those distributions came	In its enforcement actions, the SEC may seek to return funds to harmed investors through disgorgement of ill-gotten gains or through the Fair Funds provision of the Sarbanes-Oxley Act. This provision permits the SEC to combine amounts paid as penalties with disgorged funds, or to create a Fair Fund from penalties only, to reduce losses to injured parties. This reflects the SEC's efforts to return funds to injured investors. This indicator identifies the total amount distributed within the fiscal year, and the number of Fair Funds from which those distributions came. This indicator may increase or decrease in dollar amount and number of distribution funds based on the number of SEC enforcement actions brought involving distributions, amounts ordered and paid in those actions, and other factors. Due to the variation in reporting timelines established for each individual distribution, reported amounts are based on the agency's best available information. Reported amounts do not include those funds distributed through receiverships. Any funds not returned to investors are sent to the U.S. Treasury or the Investor Protection Fund established pursuant to Section 21F(g) of the Securities Exchange Act of 1934. Neither disgorgement nor penalties are used for the Commission's own expenses.

INDICATOR	DESCRIPTION
Percent of enforcement actions filed that arose out of national priority investigations	The Division of Enforcement brings many enforcement actions each year that can be characterized as high impact and of national priority. High impact or national priority investigations include those investigations which are significant for one or more of the following reasons: (i) presents an opportunity to send a particularly strong and effective message of deterrence, including with respect to markets, products and transactions that are newly developing, or that are long established but which by their nature present limited opportunities to detect wrongdoing and thus to deter misconduct; (ii) involves particularly egregious or extensive misconduct; (iii) involves potentially widespread and extensive harm to investors; (iv) involves misconduct by persons occupying positions of substantial authority or responsibility, or who owe fiduciary or other enhanced duties and obligations to a broad group of investors or others; (v) involves potential wrongdoing as prohibited under newly-enacted legislation or regulatory rules; (vi) concerns potential misconduct that occurred in connection with products, markets, transactions or practices that pose particularly significant risks for investors or a systemically important sector of the market; (vii) involves a substantial number of potential victims and/or particularly vulnerable victims; (viii) involves products, markets, transactions or practices that the Division of Enforcement has identified as priority areas (i.e., conduct relating to the financial crisis; fraud in connection with mortgage-related securities; financial fraud involving public companies whose stock is widely held; misconduct by investment advisers; and matters involving priorities established by particular regional offices or the specialized units); and/or (ix) provides an opportunity to pursue priority interests shared by other law enforcement agencies on a coordinated basis.
Criminal actions related to conduct under investigation by the SEC	In some instances, conduct may involve both civil and criminal violations and may be investigated by both the SEC and the criminal authorities. This indicator identifies the number of criminal actions that are related to conduct under investigation by the SEC.
Disgorgement and penalties ordered and the amounts collected	In addition to other types of relief, the SEC may seek orders requiring parties to disgorge any money obtained through wrongdoing. The SEC is also empowered to seek civil penalties for violations of the securities laws. In some cases, the SEC will seek to obtain large monetary sanctions even in instances where the prospects of collecting on a judgment are slight. The rationale for seeking monetary relief in these circumstances is that such relief, even when likely uncollectible, might become collectible in the future based on the defendant's changed circumstances, and also because such relief can serve to deter others from violating the securities laws. Where appropriate, the SEC has sought to return disgorged funds to harmed investors. Funds not returned to investors are sent to the Treasury or the Investor Protection Fund established pursuant to Section 21F(g) of the Securities Exchange Act of 1934. This indicator lists disgorgement and penalties ordered as a result of SEC cases and the amounts collected in those actions. This indicator could increase or decrease based on various factors.

"Increasing investor understanding should always be one of our primary goals. But it is not enough merely to make accurate, timely, and useful information available; we also have to make it accessible. We have to provide information in the ways that investors want to receive it. Investor outreach is crucial to success. Finding out what is on investors' minds will improve the overall quality of the information we provide."

CHAIR MARY JO WHITE

STRATEGIC GOAL 3

Facilitate Access to the Information Investors Need to Make Informed Investment Decisions

THE FEDERAL SECURITIES LAWS require that corporations, investment companies, and other entities provide investors with timely and meaningful information about, among other things, their operations and financial condition. Because an educated and informed investor ultimately provides the best defense against fraud and costly mistakes, these laws place great emphasis on providing material information to the investing public.

The SEC promotes informed investment decisions through two main approaches. The first is to require that investors have accurate, useful, and timely public access to disclosure materials that can be easily understood and analyzed. The second is to implement a variety of investor education initiatives aimed at providing investors with a better understanding of the operations of the nation's securities markets.

In administering its disclosure program, the SEC requires reporting entities to disclose financial and non-financial information to the investing public, thereby providing a common pool of knowledge for all investors to use to judge for themselves whether a security is an appropriate investment. Similarly, SEC rules require that investors have access to certain information about the financial intermediaries they rely upon for investment advice and other services. SEC staff reviews the disclosure and other filings that corporations, investment companies, and other entities submit to assess whether the disclosures appear adequate and accurate under the relevant rules and regulations.

The goal of the SEC's investor education program is to give investors the information they need to evaluate current and potential investments, while also providing agency staff with critical insight about emerging trends and factors shaping investor decision-making. The SEC staff aims to collect investor-focused data from a variety of sources and use it both to track trends in the securities industry and to identify, among other things, problematic brokers, investment advisers, firms, and sales practices.

STRATEGIC OBJECTIVE 3.1

The SEC works to ensure that investors have access to high-quality disclosure materials that facilitate informed investment decision-making.

Investors who have access to information and know what questions to ask are more likely to invest wisely, and to choose professional intermediaries that will best meet their objectives. The SEC understands that not all investors need the same information and that those needs are affected by their backgrounds, resources and goals. The SEC seeks to structure disclosure requirements so that investors are armed with timely and useful information they need to make informed investment decisions.

As technology and the complexity of financial instruments change, so too do the needs of modern day investors. Providing investors with information in concise, easy-to-use formats that are tailored to their needs helps investors to help themselves. On a recurring basis, the Commission examines its filing review program to explore whether its disclosure requirements, review criteria, approach to comments, and professional and technology resources provide maximum impact to benefit investors. As described below, the SEC will engage in a number of initiatives to further enhance its programs in this key area.

Initiatives

To accomplish this strategic objective, the SEC plans to implement the following initiatives:

- **Update disclosure and reporting requirements to reflect the informational needs of today's investors:** The SEC will continue its efforts to enhance disclosure requirements for the benefit of investors, including a reassessment of current core corporate disclosure requirements. In proposing changes for the Commission to consider, the staff will seek to modernize disclosure requirements and eliminate redundant reporting requirements. The staff's efforts will continue to include a review of proxy voting and shareholder communications to identify ideas and proposals for potential improvement to those rules.
- **Evaluate the effectiveness of filing review programs for reporting entities so that investors receive material information in a timely manner without imposing undue regulatory burdens on filers:** The staff will continue to evaluate the Commission's filing review processes and make changes in response to evolving trends or market developments. The staff will also work to ensure that the SEC has reliable risk management tools to identify material issues in offering documents and periodic reports for review, and obtain enhancements in disclosure. This assessment will explore the criteria used to identify filings for review, the process of issuing comments to reporting entities and new ways for technology to help improve the Commission's programs.

- **Design and implement new disclosure regimes for specialized categories of issuers so that investors in these products have relevant and useful information to make informed investment decisions:** The SEC will continue to evaluate and improve the disclosure requirements for securitized financial products and other complex financial instruments. The SEC plans to consider rules designed to provide variable annuity investors with more user-friendly disclosure and to improve the delivery of information about variable annuities through increased use of the internet and other electronic means of delivery. In addition, the SEC will continue work on proposed amendments to its advertising rules that would require target date retirement funds' marketing materials to provide investors enhanced information about those funds.
- **Design and implement enhancements to EDGAR and SEC.gov to facilitate investor and market participant access to and utilization of disclosure documents and other information:** The SEC will continue to modernize its IT systems and the dissemination and rendering of electronic disclosure documents to improve investor access to relevant information and the ease of interacting with the SEC. The SEC is working on enhancements to data standards and XBRL filing requirements that improve the quality of structured data and reduce burdens on filers.

Performance Goals

The SEC intends to use the following performance metrics to gauge its progress in achieving this strategic objective:

PERFORMANCE GOAL	DESCRIPTION
Percentage of public companies and investment companies with disclosures reviewed each year	The Sarbanes-Oxley Act requires that the SEC review, at least once every three years, the disclosures of all companies and investment company portfolios reporting under the Exchange Act. These reviews help improve the information available to investors and may identify possible violations of the federal securities laws. This metric gauges the number of public companies and investment companies reviewed each year.
Time to issue initial comments on Securities Act filings	The target of 30 days or less has become a de facto industry standard for issuers and underwriters' expectations for the maximum time to receive initial comments on Securities Act registration statements. This metric will measure the Commission's frequency in meeting this 30-day target.
Percentage of investment company disclosure reviews for which initial comments are completed within timeliness goals	For initial registration statements, the SEC's goal is for staff to issue initial comments within 30 days after they are filed (60 days for registration statements of insurance product separate accounts and related mutual funds). The SEC also aims for staff comment on post-effective amendments within 45 days and preliminary proxy statements within 10 days after they are filed. This metric will show how often the Commission is meeting this goal.

Related Indicator

The following indicator is useful for understanding the SEC's activities, but should not be considered a performance metric. As this indicator is not used to assess performance, it does not require a target or timeframe.

INDICATOR	DESCRIPTION
Total digital audience including website, social media and mobile media	Digital media has become the dominant channel for investors seeking to access information. These statistics will help evaluate the extent to which investors are turning to the SEC, identify the channels they use, and quantify the amount of information they receive.

STRATEGIC OBJECTIVE 3.2

The SEC works to understand investor needs and educate investors so they are better prepared to make informed investment decisions.

Understanding the interests and concerns of investors is critical to carrying out the Commission's investor protection mission. The SEC advances this mission by regularly communicating with investors, responding to their complaints and inquiries, and providing educational programs and materials.

The SEC will obtain more comprehensive information about the views and perspectives of investors. It will seek more robust information regarding the behavioral characteristics of investors and the types of information investors need and use as they make informed investment decisions. It will compile and provide this information to the Commission to help in the development of rules and educational programs that address investors' views and concerns.

The SEC is exploring ways to encourage investor input by presenting investors with clear, easily understandable explanations of Commission rules and rule proposals and other activities through a variety of communication channels, including social media. These efforts will complement those of the Investor Advisory Committee, which was constituted to present the views and experience of a broad spectrum of investors, and which will serve as an additional source of information concerning investors' priorities and perspectives on the Commission's regulatory agenda.

More comprehensive data about investors also will drive the Commission's investor education efforts. Working in partnership with other federal and state agencies, financial industry associations, consumer groups and educational organizations, the SEC will develop investor education initiatives that are targeted to specific audiences.

Initiatives

To accomplish this strategic objective, the SEC plans to implement the following initiatives:

- **Use feedback from individual investors to improve investor education resources:** In addition to responding to investor complaints and inquiries and conducting in-person outreach, the SEC will use informational surveys to evaluate whether investors are engaging in prudent investing behaviors and to gauge the usefulness of its investor education materials and responsiveness of its investor assistance program.
- **Inform rulemaking with investors' views:** The SEC will use investor testing and other outreach efforts, as appropriate, to gather input from investors on rulemaking initiatives and better understand their informational needs.
- **Address Investor Advisory Committee input:** The SEC will consider information and respond to recommendations from the Investor Advisory Committee regarding investors' perspectives and priorities.
- **Expand collaborative partnerships:** The SEC will partner with other federal and state agencies, securities regulators and non-profit organizations to shape and target educational initiatives to maximize their impact on specific communities of interest.
- **Promote investor awareness:** The SEC staff will issue Investor Alerts and other educational materials designed to both arm investors to be their own first line of defense against fraud and assist them in understanding new products and the role of financial intermediaries.

Performance Goals

The SEC intends to use the following performance metrics to gauge its progress in achieving this strategic objective:

PERFORMANCE GOAL	DESCRIPTION
Number of page views of online investor education content, and number of in-person events, including those with specifically targeted communities and organizations	The Office of Investor Education and Advocacy (OIEA) initiates investor education campaigns on key strategies for making informed investment decisions, including publicizing online resources for researching investment professionals and investments, understanding fees, and identifying fraud. OIEA staff also participates in in-person events for investors generally and those targeted to specific investors, such as seniors, service members, and other affinity groups. This metric tracks page views of SEC online investor education materials and the number of investor events in which OIEA staff participated.
Timeliness of responses to investor contacts	OIEA serves the tens of thousands of investors each year who contact the SEC with investment-related complaints and questions. The staff aims to close out as many new investor assistance matters as possible within seven and thirty business days.
Customer satisfaction rating of OIEA's online investor education resources	This metric gauges the effectiveness, helpfulness, and usability of OIEA's online investor education resources.
Number of new investor education materials designed primarily to help investors protect themselves from fraud	Through OIEA, and often in conjunction with other organizations, the staff issues Investor Alerts and other forms of educational material that inform investors about different permutations of fraud, new investment products, and other topical issues. This metric measures the number of new investor education materials issued by OIEA.

Related Indicators

The following indicators are useful for understanding the SEC's activities, but should not be considered performance metrics. As these indicators are not used to assess performance, they do not require targets or timeframes.

INDICATOR	DESCRIPTION
Number of investor testing research projects	This indicator tracks the number of research initiatives used to gather feedback from investors on the usefulness of disclosures and other input on SEC rulemaking.
Number of sets of recommendations prepared by the investor advisory committee	This indicator tracks the recommendations from the Investor Advisory Committee regarding investors' perspectives and priorities.

"The SEC's hardworking and dedicated staff is the core component of the agency's strength."

CHAIR MARY JO WHITE

STRATEGIC GOAL 4

Enhance the Commission's Performance Through Effective Alignment and Management of Human, Information, and Financial Capital

THE PUBLIC AND THE SECURITIES MARKETS are best served by an efficient, effective, and agile SEC. Given the immense size of the securities markets the SEC regulates, the SEC's success in fulfilling its mission and in achieving the goals and objectives outlined in this Plan is highly dependent upon whether it's adequately funded and its ability to continually direct its resources towards the most productive uses. The SEC also is extremely mindful of its responsibility to optimize the use of its resources because it is a government agency entrusted with public funds.

The SEC continuously strives to enhance its performance by making sound investments in human capital and new technologies and by employing strong financial management and operational risk management practices. With respect to its workforce, the SEC must be able to attract and retain high-performing staff, continually update their skills so they are abreast of the latest developments in the industry and create organizational structures and work processes that are efficient and effective. The Commission's information technology environment must give employees the tools they need to view, analyze and act upon the enormous volume of financial data and other information relevant to oversight of the securities markets. The SEC must demonstrate a continued commitment to maintaining strong internal controls to support effectiveness and efficiency of Commission operations. Finally, the SEC must continually direct its financial resources to their highest and best use, always subject to strong internal controls.

STRATEGIC OBJECTIVE 4.1

The SEC promotes a results-oriented work environment that attracts, engages, and retains a technically proficient and diverse workforce, including leaders who provide motivation and strategic direction.

The SEC is committed to being an employer of choice by consistently attracting, hiring, developing, and retaining a high-quality, diverse, and results-oriented workforce. The SEC is continually refining a series of programs to enhance its human capital, such as rewarding high performance, promoting high employee satisfaction and updating staff skills.

The SEC continues to build and maintain an effective training program to deepen expertise and skills, not only in the rapidly evolving nature of the markets, but also in areas of new responsibility for the Commission. The training supports development for employees directly involved in examinations, investigations, fraud detection, litigation, and other core mission responsibilities of the SEC. The training consists of specialized in-depth topics concerning new trends in the securities industry and changing market conditions, as well as analytics and forensics. It also allows staff to obtain certain specialized financial certifications and regulatory credentials, as well as the advanced continuing education credits required for maintaining legal and financial credentials.

The SEC's success at fulfilling its strategic goals depends upon effective leadership at all levels. From branch chiefs to the Commission's senior leadership, the SEC's leaders must not only motivate and manage employees effectively, but also play a critical role in identifying the key areas on which staff should focus their attention to generate the greatest benefit for investors. Through leadership and employee development programs, the Commission seeks to maintain a diverse cadre of technically proficient leaders that can conduct their supervisory responsibilities effectively and meet the dynamic challenges of market oversight.

Initiatives

To accomplish this strategic objective, the SEC plans to implement the following initiatives:

- **Increase employee engagement and retention:** To retain high caliber and diverse talent, the SEC will implement programs and initiatives focused on employee engagement and retention. In response to employee viewpoint survey results, the SEC has conducted numerous interviews and focus groups with its workforce at every level. The recommendations derived from this information will form the basis for action plans aimed at improving the Commission's organizational climate and workforce morale. These plans will be implemented and evaluated in a manner designed to promote continuous improvement. Improvements in organizational climate and workforce morale should lead to greater employee engagement and increased retention, particularly of high-performing employees.
- **Enhance employee development program:** For the SEC to fulfill its mission it must attract and select a diverse cadre of highly talented and accomplished people and provide them with opportunities to develop the knowledge and skills to achieve high levels of performance and address changes in market conditions, securities laws, federal regulations, best practices and technology. The Office of Human Resources (OHR) will work to identify training and learning needs within each division and office and to procure or develop high-quality training that will develop employee skills. OHR will utilize, encourage and monitor the use of individual development plans so that employee-specific needs are met and that progress can be tracked.
- **Leadership development program:** To ensure the SEC has the caliber of leadership commensurate with its mission, the SEC will continue the construction and implementation of a comprehensive leadership development program that will address the needs of a diverse group of supervisors, managers, and leaders. Specific aspects of the program include improving training for new supervisors, building skills in change management, enhancing cultural awareness and inclusiveness, increasing the number and scope of developmental opportunities for all leaders, and instituting a succession planning program to prepare non-supervisors to assume supervisory roles and supervisors to assume key executive positions.

Performance Goals

The SEC intends to use the following performance metrics to gauge its progress in achieving this strategic objective:

PERFORMANCE GOAL	DESCRIPTION
Turnover	When employee morale and engagement are high, high-performing employees tend to remain in the organization. Although turnover can fluctuate based on a variety of factors, the SEC aims to keep its turnover rate relatively low, below 8% per year.
Expanding staff expertise	Internal training and hiring programs are designed to help the agency recruit and develop a diverse and qualified staff with the key skills, industry knowledge, and expertise to support the SEC mission. In particular, there is a need to train examiners, attorneys, economists, and other experts for subject matter expertise relevant to the marketplace and investment and trading practices. This metric tracks whether certain areas requiring significant training are being addressed. The agency will track the number of SEC staff participants in mission-focused training and development programs and will report on specific items through the use of post-course evaluations to assess the impact and results of this training on a five-point scale.
Number of diversity-related partnerships/alliances	Increased numbers of diversity-related partnerships or alliances with professional associations and educational organizations provide opportunities to educate students about the SEC's work and to recruit career professionals from all segments of society. The SEC will track the number of partnerships and/or alliances with diverse professional associations and educational organizations.
Survey rankings	Annual and other rankings, together with other metrics and indicators of federal government agencies will be used as one kind of metric to determine the SEC's overall success in improving employee morale and employee engagement.
Bench strength	To maintain mission effectiveness, it is essential that attrition in the leadership ranks is quickly addressed by having a highly qualified and diverse pool of candidates ready to assume those critical roles. Success is measured by the percentage of key leadership positions for which the SEC has identified a pool of qualified candidates.

STRATEGIC OBJECTIVE 4.2

The SEC encourages a collaborative environment across divisions and offices and leverages technology and data to fulfill its mission more effectively and efficiently.

The SEC's divisions and offices collaborate in a variety of ways, both formal and informal, to advance the Commission's mission. Such coordination is essential for any organization as large and complex as the SEC to bring together different perspectives, decide on the best course of action, and implement that course in the most effective way. Given the importance and complexity of the SEC's mission, it is imperative that the Commission continuously improve its ability to break down silos, share information and work jointly towards a common purpose.

Information technology plays a crucial role in the mission of the SEC and its ability to share information and data both internally and externally. The SEC gathers a wide variety of data and other information from a variety of sources, including corporate disclosures, equity exchange feeds, investigations and examinations, tips, complaints, and referrals, and commercial vendors. The SEC is working to develop systems that will allow more of this information to be quickly shared, analyzed, and joined with other information about the same entity or individual. These efforts should save staff time, provide better information about the firms the SEC regulates and enhance the ability to uncover hidden risks to investors.

The increasing size and complexity of the U.S. markets require that the SEC continue to leverage technology to improve its productivity, as well as identify and address the most significant threats to investors. Information technology is an increasingly vital function to the SEC in modernizing filing practices, disseminating the vast quantity of regulatory filings, managing the large number of internal business processes and work products and protecting the Commission's information assets.

Initiatives

To accomplish this strategic objective, the SEC plans to implement the following initiatives:

- **Work smarter to achieve the SEC mission:** A multi-year technology transformation plan called "Working Smarter" will ensure the SEC's business processes are streamlined, integrated, and implemented with the best technology to reduce costs and increase efficiencies and effectiveness; deliver better services to both employees and the public; and provide greater accountability, transparency, and security. Leveraging modern, reliable, and innovative technologies and predictive analytics will transform the way the SEC performs its mission and provide a proactive view into how technology impacts capital markets. By ensuring people "work smarter," the SEC will derive significant and measurable performance improvements in core operations and increase value through the use of automated processes.
- **Make disclosure information more useful for analysis:** Disclosure documents are submitted to the Commission electronically and, as appropriate, disseminated electronically to the investing public. This initiative will review the current disclosure systems and processes and identify ways to optimize the use of technology to improve the way disclosure documents are constructed and submitted with more emphasis on data collection. A new filing system that is optimized for data retrieval and analysis will provide features that help users create filings that are appropriate to their purpose and that allow computers to extract data from the filings for automated analysis. The system will be more flexible, so that, as new disclosure documents are defined, they can be implemented much more quickly, with all of the features of a modern, web-based filing system. Eventually, new filings structured for automated data retrieval and analysis will replace all filings submitted through the EDGAR system.
- **Improve SEC's information management and analysis functions:** The SEC aims to provide its staff with the access to information and effective analytical capabilities needed to perform their duties. To accomplish this outcome, the SEC will work on several fronts to improve its abilities to acquire, store, manage, and deliver data and information in support of its critical business functions. Among the steps in this effort are standardization of enterprise-wide platforms, knowledge management, seamless integration of structured and unstructured data sources, cloud computing, modernization of SEC.gov and EDGAR filer systems, cataloging the SEC's data and its interrelationships in an electronic data warehouse (EDW); ensuring data quality; and establishing new methods for capturing information, including from SEC staff themselves as they conduct examinations, investigations, and other activities.

- **Enhance workflow and document management:** Virtually all business processes within the Commission involve the acquisition, creation, review, and editing of documents. These processes are conducted informally, without the benefit of automated tracking, notification and auditing capabilities. Under this initiative, the SEC will assess its critical business processes and apply document management tools to increase productivity, enhance collaboration and create a shared repository of essential documents and data. Among the business areas that would benefit from this effort are enforcement case management, disgorgement and penalties, examination management, management of Commission actions, filing of administrative proceedings and rulemaking.
- **Enhance the SEC's electronic discovery program:** The SEC must have the technical capability to electronically organize and retrieve an extraordinary volume of documents obtained in the conduct of investigations. Under this initiative, the SEC will enhance its current electronic discovery tools and improve its document storage, organization, and analytic capabilities. The SEC also will create a repository of documents and data that is more widely available across cases and with other Commission business functions as appropriate.
- **Enhance operational resiliency:** The SEC will support a reliable computing environment that provides high performance, security and cost effectiveness. The Commission also will enhance the computing infrastructure, including through server virtualization and clustering, to eliminate down time if systems at one site fail, enhance security, and achieve cost savings.
- **Enhance internal communications to staff:** Led by the Offices of Public Affairs and Chief Operating Officer, the SEC will track and recognize exceptional staff achievements, awards and other successful outcomes to promote a sense of pride and accomplishment throughout the Commission. Additionally the SEC will initiate a program leveraging technology and best practices to centralize all administrative, technology, financial, procurement, human capital and other operational information, news and resources so that staff can easily "self-service" and find the tools, forms, guidance and support they need.

Performance Goals

The SEC intends to use the following performance metrics to gauge its progress in achieving this strategic objective:

PERFORMANCE GOAL	DESCRIPTION
Ensure SEC's systems and applications are available	The SEC aims to enhance its computing infrastructure to eliminate down time if systems at one site fail, among other objectives. This metric will capture the percentage of systems and applications that can fail over or within 8 hours.
Equip the SEC with an enhanced enterprise infrastructure	The SEC aims to promote collaboration and information sharing across the enterprise. To improve efficiency and knowledge management, the SEC will consolidate and centralize its collaborative technologies to a commonly used enterprise set by 2020. This metric will measure the percentage of the SEC's offices and divisions that utilize centralized enterprise collaboration solutions.
Expand the SEC's video teleconferencing (VTC) capabilities to support an increasingly geographically dispersed workforce	The SEC seeks to develop a state-of-the-art video teleconference solution that allows users to conduct a video/teleconference meeting between HQ, regional offices and multiple endpoints simultaneously; collaborate and share presentation materials; and use VoIP technology to host video teleconferences from their offices/workspaces with other SEC users or conference rooms. This metric will measure the average "uptime" or availability of all VTC systems.
Pursue continuous technology cost reductions and efficiencies	Recent technology enhancements- e.g., data center consolidation, virtualization and maintenance contract reductions- are producing technical efficiencies and cost savings. This metric will measure the amount of these costs savings.
Enhance the SEC's enterprise data warehouse infrastructure and performance	The Enterprise Data Warehouse (EDW) infrastructure will enable the provisioning of data to Commission staff for search and analysis through a virtual data warehouse platform. This metric will measure the availability of EDW and data sources.

STRATEGIC OBJECTIVE 4.3

The SEC maximizes the use of agency resources by continually improving agency operations and bolstering internal controls.

As an agency of the federal government entrusted with public funds, the SEC must always strive to enhance the value for investors it creates from every budget dollar. The SEC continually strives to allocate the resources approved by Congress and the President towards the highest and best use. The SEC also constantly reevaluates its operations to identify cost savings and maximize their benefit.

The SEC will strive to maintain strong financial management practices and robust internal controls. The SEC is placing great emphasis on bolstering its processes and systems in its budgeting, accounting, and internal control functions over operations. In addition, the SEC continues to focus on delivering complete, concise, and meaningful information about the financial and operating performance of the Commission that supports management decision-making.

Initiatives

To accomplish this strategic objective, the SEC plans to implement the following initiatives:

- **Better integrate data from SEC operational functions into management decisions:** To accomplish the SEC's mission it is essential that management decisions are based on the best available information from multiple sources. This requires SEC leaders to consider information from human resources, financial management, information technology and support operations functions when making management decisions. To improve decision-making and reporting capabilities, the SEC will examine its data collection, analysis and reporting methods to determine areas for improvement.
- **Further enhance financial systems to achieve operational efficiency and effectiveness:** The SEC is in the early stages of building a financial datamart as part of a broader Commission-wide EDW initiative. The datamart is expected to integrate data from various systems to provide more comprehensive management and financial reporting on a regular basis, to facilitate better decision-making. The SEC also will participate in the federal government-wide deployment of a new travel system, work to replace the system supporting budget execution and formulation, and focus on reforming the systems related to filing fees and registrant deposits.

- **Continue enhancing internal controls:** Although the SEC has made significant progress in strengthening internal controls over financial reporting, the Commission is still focused on further optimizing its controls to enhance financial accounting, reporting and operations. Many of these areas are interdisciplinary and involve collaboration between different offices within the SEC. Such areas include accounting for property and contract obligations, as well as disgorgements, penalties, and filing fees. The SEC also will continue to focus on areas that are highly manual and therefore more at risk for error, with a view towards further automation where possible.
- **Further enhance management assurance to achieve operational efficiency and effectiveness via an agency-wide operational risk management program:** The SEC will continue to build its Operational Risk Management program to manage internal risks that may impact its ability to successfully fulfill its mission. Risk management processes and procedures will be institutionalized and consistently applied within all operating units to ensure that internal operating risks are identified, analyzed, and managed at all levels of the organization. The SEC is in the early stages of formalizing governance structures through the Operational Risk Management Oversight Committee (RMOC). The RMOC will provide oversight of the development and implementation of operational risk policies, framework, methodologies, and provide leadership and monitoring of Commission-wide operational risks.
- **Enhance consideration of diverse sources in SEC's business activities:** For the SEC to enhance the diversity of its suppliers to ensure that it is procuring the best goods and services to meet its contracting needs, the SEC actively will engage in outreach to diverse vendors to evaluate and consider their capabilities, and publicize procurement opportunities in diverse sources.

Performance Goals

The SEC intends to use the following performance metrics to gauge its progress in achieving this strategic objective:

PERFORMANCE GOAL	DESCRIPTION
Financial audit results	Under the Accountability of Taxpayer Dollars Act of 2002, the SEC is required to meet all proprietary and budgetary accounting guidelines for federal agencies and to undergo annual audits. The SEC's audits are conducted by the Government Accountability Office (GAO).
Assurance statement on internal control over operations	In accordance with OMB A-123 and Section 961 of the Dodd-Frank Act, the SEC conducts an annual assessment of the effectiveness of internal controls. The SEC will continue to develop its Operational Risk program and enhance cross-organizational processes to support all division and office management assurance statements. Success is measured by the quality of risk and control assessments and management self-identification and resolution of improvement opportunities.
Timely completion of corrective action on Office of Inspector General (OIG)	Timely completion of audit recommendations is an important SEC priority. This metric measures how well the Commission is doing in completing corrective action on OIG audit recommendations within established timeframes.

PROGRAM EVALUATION

The SEC values independent, high-quality assessments of the agency's performance against its goals and desired strategic objectives. Such assessments are critical to the Commission's ability to evaluate its work, refine its programs and redirect resources accordingly. The more than 150 audits, studies, and evaluations of SEC programs and securities industry-related issues completed since the release of the agency's previous Strategic Plan have served as an important resource in the development of this Strategic Plan. Over the next five years, the SEC will continue to draw on evaluations from a variety of sources to improve its programs.

Annual Performance Report

In February 2013, the SEC published an Annual Performance Report (APR) describing the agency's accomplishments and presenting the results of the agency's performance metrics for FY 2012. The most recent version of the SEC's APR can be found on the agency's website, at http://www.sec.gov/about/secreports.shtml.

Consultation with Outside Groups

The SEC frequently seeks the input of investors, industry groups, academia, and other experts to gain outside perspectives about its programs and various issues in the securities industry. These efforts include the SEC's Investor Advisory Committee; Commission-sponsored roundtables focused on specific issues; the agency's Annual Government-Business Forum on Capital Formation, focused particularly on the needs of new, small, medium-sized, and independent businesses; the SEC's annual conference with the North American Securities Administrators Association; and solicitations of public comments on Commission rule proposals.

Government Accountability Office

The Government Accountability Office conducts dozens of studies or investigations related to the SEC's programs every year. In FY 2013, GAO's reports covered internal supervisory controls, requirements and costs associated with newly developed SEC rules, and the criteria for qualifying as an accredited investor, among other areas. In addition, GAO performs an annual audit of the SEC's financial statements and internal controls over financial reporting.

Office of the Inspector General

The Office of Inspector General (OIG) is an independent office within the SEC that conducts audits of programs and operations of the Commission and investigations into allegations of misconduct by staff or contractors. The mission of the OIG is to detect fraud, waste and abuse, and to promote integrity, economy, efficiency and effectiveness in the Commission's programs and operations.

U.S. SECURITIES AND EXCHANGE COMMISSION

100 F STREET NE | WASHINGTON, DC 20549 | WWW.SEC.GOV

Concurrent Session: Treasurer Takeaways

Thursday, March 31st
11:15am – 12:30pm
Marriott Marquis, Washington DC

Moderator:
Kelly Shiflett, VP-Finance & Treasurer-Capital Markets, Washington REIT

Panelists:
Gregory Andrews, CFO, CyrusOne Inc.
Mark Wallace, CFO & Treasurer, Communications Sales & Leasing, Inc.

REIT Wise®

NAREIT's Law, Accounting & Finance Conference

March 30 - April 1 2016

Treasurer Takeaways

March 31, 2016

Faculty

- Moderator -- Kelly Shiflett, VP Finance and Treasurer, Washington REIT
- Panelists:
- Greg Andrews, Chief Financial Officer, Cyprus One
- Mark Wallace, SVP – Chief Financial Officer and Treasurer, CS&L Inc.

Topics to be Discussed

- Cybersecurity: strategies to reduce risk
- Protecting the organization against phishing fraud
- Controlling bank fees
- Considering implementing “same day ACH”
- Transaction costs for A/P and A/R processes and outsourcing possibilities
- Use of positive pay, UPIC

Topics to be Discussed

- Payment automation
- Cash forecasting – systems and other tools
- eBAM – electronic bank account management
- Managing divided responsibilities between treasury function and other related functions, *e.g.* investor relations and acquisitions

Concurrent Session: Timberland REIT Roundtable

Thursday, March 31st
9:45am – 11am
Marriott Marquis, Washington DC

Discussion Leaders:
Karen Balek, Sr. Director-Tax, Weyerhaeuser
Scott Winer, VP-Taxes, Rayonier Inc.

Internal Revenue Service

Number: **201602003**
Release Date: 1/8/2016

Index Number: 856.01-00, 856.02-00

Department of the Treasury
Washington, DC 20224

Third Party Communication: None
Date of Communication: Not Applicable

Person To Contact:
, ID No.

Telephone Number:

Refer Reply To:
CC:FIP:B01
PLR-115789-15

Date:
October 13, 2015

LEGEND:

Taxpayer

Initial Lenders

Administrative Agent

Lenders

Voting Participants

Date 1

Date 2

A

B

C

D

Dear :

This is in reply to a letter dated April 30, 2015, requesting a ruling that the patronage dividends described below do not constitute gross income to Taxpayer for purposes of § 856(c)(2) or § 856(c)(3).

FACTS

Taxpayer is a domestic corporation whose common stock is publicly traded. Taxpayer elected to be treated as a real estate investment trust ("REIT") beginning with its taxable year ending Date 1. Taxpayer is a calendar year taxpayer that uses an overall accrual method of accounting. Taxpayer's primary business is to own and manage timberland properties.

The Lenders are subchapter T (§§ 1381-1388) cooperatives owned by the patrons who borrow from them. The Lenders make distributions to their patrons in the form of "patronage dividends." The amounts of patronage dividends are based on the quantity or value of business done with the patron.

Taxpayer entered into a seven year credit agreement dated Date 2, (the "Credit Agreement") with the Initial Lenders to borrow $A from the Initial Lenders. Prior to closing the Credit Agreement, one of the Initial Lenders assigned $B of its commitment under the Credit Agreement to the Administrative Agent and Administrative Agent together with the Initial Lenders became the Lenders under the Credit Agreement. Administrative Agent sold participating shares in its share of the loan under the Credit Agreement to the Voting Participants in the cumulative amount of $C.

Taxpayer receives annual patronage dividends from the Lenders (and not from any Voting Participants), the terms of which are set by each Lender in its respective bylaws and other relevant documents (the patronage dividends received specifically by Taxpayer with respect to amounts borrowed under the Credit Agreement are "Patronage Dividends"). The amount of any Patronage Dividend depends on the amount borrowed and the time such amount is outstanding. Administrative Agent pays part of its Patronage Dividends in the form of equity. Per its bylaws, Administrative Agent targets D% of its total patronage dividends to be paid in equity until the target equity percentage has been met by the patron (in this case the Taxpayer).

REPRESENTATIONS

The following representations are made by Taxpayer:

(a) Taxpayer has used the proceeds of the Credit Agreement to pay off a mortgage of an affiliate secured by real estate assets described in § 856(c)(4)(A).

(b) The Patronage Dividends will be patronage dividends within the meaning of § 1388(a) and will be included on the tax return of Taxpayer as gross income.

(c) For financial accounting purposes, Taxpayer will treat the Patronage Dividends as a reduction in the interest expense related to Borrowings under the Credit Agreement.

LAW AND ANALYSIS

Section 856(c)(2) provides that in order for a corporation to qualify as a REIT, at least 95 percent of the corporation's gross income (excluding gross income from prohibited transactions) must be derived from sources that include dividends, interest, rents from real property, and gain from the sale or other disposition of stock, securities, and real property (other than property in which the corporation is a dealer).

Section 856(c)(3) provides that in order for a corporation to qualify as a REIT, at least 75 percent of the corporation's gross income (excluding gross income from prohibited transactions) must be derived from rents from real property, interest on obligations secured by real property, gain from the sale or other disposition of real property (other than property in which the corporation is a dealer), dividends from REIT stock and gain from the sale of REIT stock, abatements and refunds of taxes on real property, income and gain derived from foreclosure property, commitment fees to make loans secured by mortgages on real property or to purchase or lease real property, gain from certain sales or other dispositions of real estate assets, and qualified temporary investment income.

Section 856(c)(5)(J) provides that to the extent necessary to carry out the purposes of part II of subchapter M of the Code, the Secretary is authorized to determine, solely for purposes of such part, (i) whether any item of income or gain which does not otherwise qualify under §§ 856(c)(2) or (c)(3) may be considered as not constituting gross income for purposes of §§ 856(c)(2) or (c)(3), or (ii) whether any item of income or gain which otherwise constitutes gross income not qualifying under §§ 856(c)(2) or (c)(3) may be considered as gross income which qualifies under §§ 856(c)(2) or (c)(3).

Section 301(a) provides that except as otherwise provided in chapter 1 of subtitle A of the Code (which chapter includes §§ 301, 316, 317, 856, and 1388), a distribution of property (as defined in § 317(a)) made by a corporation to a shareholder with respect to its stock shall be treated in the manner provided in § 301(c).

Section 301(c) provides, in part, that in the case of a distribution to which § 301(a) applies, that portion of the distribution which is a dividend (as defined in § 316) shall be included in gross income.

Section 316(a) provides that for purposes of subtitle A (which subtitle includes §§ 856 and 1388), the term “dividend” means any distribution of property made by a corporation to its shareholders (1) out of its earnings and profits accumulated after February 28, 1913, or (2) out of its earnings and profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

Section 316(a) provides in the flush language that, except as otherwise provided in subtitle A, every distribution is made out of earnings and profits to the extent thereof, and from the most recently accumulated earnings and profits. It provides further that to the extent that any distribution is, under any provision of subchapter C of chapter 1 of subtitle A, treated as a distribution of property to which § 301 applies, such distribution shall be treated as a distribution of property for purposes of this subsection.

Section 1388(a) provides that, for purposes of subchapter T, the term “patronage dividend” means an amount paid to a patron by an organization to which part I of subchapter T applies (1) on the basis of quantity or value of business done with or for such patron, (2) under an obligation of such organization to pay such amount, which obligation existed before the organization received the amount so paid, and (3) which is determined by reference to the net earnings of the organization from business done with or for its patrons. For this purpose, net earnings shall not be reduced by amounts paid during the year as dividends on capital stock or other proprietary capital interests of the organization to the extent that the articles of incorporation or bylaws of such organization or other contract with patrons provide that such dividends are in addition to amounts otherwise payable to patrons which are derived from business done with or for patrons during the taxable year.

Section 1388(a) further provides that the term patronage dividend does not include any amount paid to a patron to the extent that (A) such amount is out of earnings other than from business done with or for patrons, or (B) such amount is out of earnings from business done with or for other patrons to whom no amounts are paid, or to whom smaller amounts are paid, with respect to substantially identical transactions.

Section 1385(a)(1) provides, that, except as otherwise provided, each person shall include in gross income the amount of any patronage dividend which is paid in money, a qualified written notice of allocation, or other property (except a nonqualified written notice of allocation), and which is received by him during the taxable year from an organization described in § 1381(a).

The legislative history underlying the tax treatment of REITs indicates that a central concern behind the gross income restrictions is that a REIT's gross income should largely be composed of passive income. For example, H.R. Rep. No. 2020, 86th Cong., 2d Sess. 4 (1960) at 6, 1960-2 C.B. 819, at 822-23 states, "[o]ne of the principal purposes of your committee in imposing restrictions on types of income of a qualifying real estate investment trust is to be sure the bulk of its income is from passive income sources and not from the active conduct of a trade or business."

Patronage dividends paid by a subchapter T cooperative are a return of earnings to its cooperative patrons based on the amount of business that the patron transacts with the cooperative. The patronage dividends paid by a subchapter T financing cooperative effectively reduce the costs that its patrons incur to borrow funds from the cooperative. The amounts paid by Lenders as Patronage Dividends represent earnings that the cooperatives are able to refund to Taxpayer based on the average amounts that Taxpayer borrowed from Lenders during the prior year. Thus, while Taxpayer must include Patronage Dividend income in its gross income under § 1385(a)(1), the Patronage Dividends effectively reduce Taxpayer's interest expense paid during the prior year. Under the facts of the instant case, exclusion of the Patronage Dividends from gross income for purposes of §§ 856(c)(2) and (c)(3) does not interfere with Congressional policy objectives in enacting the income tests under those provisions.

CONCLUSION

Accordingly, pursuant to § 856(c)(5)(J)(i), we conclude that the Patronage Dividends included in Taxpayer's gross income under § 1385 are excluded from its gross income for purposes of §§ 856(c)(2) and (c)(3).

Except as specifically ruled upon above, no opinion is expressed concerning any federal income tax consequences related to the facts herein under any other provisions of the Code. Specifically, we do not rule whether Taxpayer qualifies as a REIT under Part II of Subchapter M of Chapter 1 of the Code. Additionally, we are not ruling on the tax treatment of the Credit Agreement and whether the agreement is a loan for federal income tax purposes.

This ruling is directed only to the taxpayer requesting it. Taxpayer should attach a copy of this ruling to each tax return to which it applies. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

The rulings contained in this letter are based upon information and representations submitted by the Taxpayer under a penalties of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely,

____

Steven Harrison
Chief, Branch 1
Office of Associate Chief Counsel
(Financial Institutions & Products)

cc:

Internal Revenue Service

Number: **201605005**
Release Date: 1/29/2016

Index Number: 856.01-00

Department of the Treasury
Washington, DC 20224

[Third Party Communication:
Date of Communication: Month DD, YYYY]

Person To Contact:
, ID No.

Telephone Number:

Refer Reply To:
CC:FIP:B1
PLR-114627-15
Date: October 26, 2015

Legend:

Taxpayer =

State =

Dear :

This is in reply to a letter dated April 21, 2015, in which Taxpayer requests rulings in connection with its real estate investment trust ("REIT") foreign income under section 856 of the Internal Revenue Code of 1986, as amended (the "Code").

Facts:

Taxpayer is a corporation organized under the laws of State that has elected to be taxed as a REIT. Taxpayer was organized for the purpose of making direct and indirect investments in commercial timberland businesses. Taxpayer realizes profits from the harvest and sale of timber and the long-term appreciation of the underlying timber properties.

Taxpayer operates in foreign countries through one or more foreign subsidiaries and associated intermediate holding companies (each, a "Foreign Sub"). Some Foreign Subs are qualified REIT subsidiaries ("QRSs") under section 856(i), partnerships, or disregarded entities. Taxpayer has jointly elected section 856(l) taxable REIT subsidiary ("TRS") status with other Foreign Subs that are corporations for federal income tax purposes (each, a "Foreign TRS").

Taxpayer expects that its Foreign TRSs will be either (i) controlled foreign corporations ("CFCs") within the meaning of section 957(a), with respect to which Taxpayer will be a United States shareholder within the meaning of section 951(b) (a "United States Shareholder"), (ii) passive foreign investment companies ("PFICs") within the meaning of section 1297(a), for which Taxpayer has made or intends to make elections under section 1295(a) to treat as qualified electing funds ("QEFs") for all taxable years during which the corporation was a PFIC that are included in the Taxpayer's holding period of the PFIC stock ("pedigreed QEFs"), or (iii) PFICs for which Taxpayer has not made a mark-to-market election and which are not pedigreed QEFs with respect to Taxpayer.

As a United States Shareholder with respect to the CFCs, Taxpayer is required under section 951(a)(1)(A)(i) to include in gross income its pro rata share of the CFCs' subpart F income, as defined in section 952(a). Taxpayer expects that the subpart F income of the CFCs will consist of items that are foreign personal holding company income ("FPHCI") within the meaning of section 954(c). Taxpayer's inclusions under section 951(a)(1)(A) that are attributable to the CFCs' deriving (i) interest; (ii) dividends; (iii) gains from the sale or other disposition of stock, securities, or real property that is not property described in section 1221(a)(1); and (iv) items that also would constitute "rents from real property" under section 856(d) if received by a REIT are referred to hereinafter as the "Subpart F Inclusions."

As a shareholder in PFICs for which Taxpayer has made QEF elections, Taxpayer is required under section 1293(a) to include in gross income its pro rata share of the earnings and profits of each QEF. Taxpayer expects to include amounts in income under section 1293(a) with respect to numerous PFICs for which it has made (or will make) QEF elections. Taxpayer's inclusions under section 1293(a) that are attributable to the QEFs' deriving (i) interest; (ii) dividends; (iii) gains from the sale or other disposition of stock, securities, or real property that is not property described in section 1221(a)(1); and (iv) items that also would constitute "rents from real property" under section 856(d) if received by a REIT are referred to hereinafter as the "QEF Inclusions."

As a shareholder in PFICs for which Taxpayer has not made mark-to-market elections and which are not pedigreed QEFs with respect to Taxpayer, Taxpayer is required under section 1291(a)(1)(B) to include certain amounts in gross income. Taxpayer expects to include amounts in income under section 1291(a)(1)(B) with respect to PFICs for which it has not made (and will not make) a QEF or mark-to-market elections (the "Non-QEF Inclusions" and, together with QEF Inclusions, the "PFIC Inclusions"). Taxpayer represents that the majority of the gross income that each of these PFICs will derive while owned by Taxpayer will be comprised of one or more of the following items: (i) interest; (ii) dividends; (iii) gains from the sale or other disposition of stock, securities, or real property that is not property described in section

1221(a)(1); and (iv) items that also would constitute “rents from real property” under section 856(d) if received by a REIT.

Taxpayer expects to recognize foreign currency gains with respect to distributions of previously taxed earnings and profits (“PTI”) as described in section 986(c)(1) attributable to the Subpart F Inclusions and QEF Inclusions (the “Section 986(c) Gains”).

Taxpayer requests the following rulings:

1) The Subpart F Inclusions and the PFIC Inclusions will be treated as qualifying income under section 856(c)(2).

2) The Section 986(c) Gains will not be taken into account for purposes of section 856(c)(2).

Law and Analysis:

Ruling #1: Whether the Subpart F Inclusions and PFIC Inclusions will be treated as qualifying income under section 856(c)(2).

Section 856(c)(2) provides that, in order for a corporation to qualify as a REIT, at least 95 percent of the corporation’s gross income must be derived from certain enumerated sources, which include dividends, interest, rents from real property, gain from the sale or other disposition of stock, securities, and real property (other than property in which the corporation is a dealer), abatements and refunds of taxes on real property, income and gain derived from foreclosure property, and certain commitment fees.

Section 856(c)(5)(J) provides that to the extent necessary to carry out the purposes of part II of subchapter M of the Code, the Secretary is authorized to determine, solely for purposes of such part, (i) whether any item of income or gain that does not otherwise qualify under sections 856(c)(2) or (3) may be considered as not constituting gross income for purposes of sections 856(c)(2) or (3), or (ii) whether any item of income or gain that otherwise constitutes gross income not qualifying under sections 856(c)(2) or (3) may be considered as gross income which qualifies under sections 856(c)(2) or (3).

The legislative history underlying the tax treatment of REITs indicates that a central concern behind the gross income restrictions is that a REIT’s gross income should largely be composed of passive income. For example, H.R. Rep. No. 2020, 86th Cong., 2d Sess. 4 (1960) at 6, 1960-2 C.B. 819, at 822-23 states, “[o]ne of the principal purposes of your committee in imposing restrictions on types of income of a qualifying real estate investment trust is to be sure the bulk of its income is from passive income sources and not from the active conduct of a trade or business.”

Subpart F Inclusions

Section 957 defines a CFC as a foreign corporation in which more than 50 percent of the total combined voting power of all classes of stock entitled to vote, or the total value of the stock is owned by United States Shareholders on any day during the corporation’s taxable year. A United States Shareholder is defined in section 951(b) as a United States person who owns 10 percent or more of the total voting power of the foreign corporation.

Section 951(a)(1)(A)(i) generally provides that if a foreign corporation is a CFC for an uninterrupted period of 30 days or more during a taxable year, every person who is a United States Shareholder of the corporation and who owns stock in the corporation on the last day of the taxable year in which the corporation is a CFC shall include in income the shareholder’s pro rata share of the CFC’s subpart F income for the taxable year.

Under section 952, subpart F income includes foreign base company income. Under section 954(a)(1), foreign base company income includes FPHCI, which is defined under section 954(c)(1) to mean certain enumerated types of income. Subject to certain exceptions, FPHCI includes (i) dividends, interest, royalties, rents, and annuities under section 954(c)(1)(A); and (ii) the excess of gains over losses from the sale or exchange of certain property under section 954(c)(1)(B).

Taxpayer’s Subpart F Inclusions will be attributable to subpart F income of CFCs that consists of: (i) interest; (ii) dividends; (iii) gains from the sale or other disposition of stock, securities, or real property that is not property described in section 1221(a)(1); and (iv) items that also would constitute “rents from real property” under section 856(d) if received by a REIT. Therefore, treatment of the Subpart F Inclusions attributable to such income as qualifying income for purposes of section 856(c)(2) does not interfere with or impede the policy objectives of Congress in enacting the income test under section 856(c)(2).

PFIC Inclusions

Section 1297(a) provides that a foreign corporation is a PFIC if either (1) 75 percent or more of the gross income of such corporation for the taxable year is passive income, or (2) the average percentage of assets (as determined in accordance with section 1297(e)) held by such corporation during the taxable year which produce passive income or which are held for the production of passive income is at least 50 percent. Section 1297(b) defines the term “passive income” as income of a kind that would be FPHCI under section 954(c), subject to certain exceptions.

Section 1295(a) provides that a PFIC will be treated as a QEF with respect to a shareholder if (1) an election by the shareholder under section 1295(b) applies to such PFIC for the taxable year; and (2) the PFIC complies with such requirements as the Secretary may prescribe for purposes of determining the ordinary earnings and net capital gains of such company and otherwise carrying out the purposes of the PFIC provisions. Section 1293(a) provides that every United States person who owns (or is treated under section 1298(a) as owning) stock of a QEF at any time during the taxable year of such fund shall include in gross income (A) as ordinary income, such shareholder's pro rata share of the ordinary earnings of such fund for such year, and (B) as long-term capital gain, such shareholder's pro rata share of the net capital gain of such fund for such year.

Section 1291(a)(1) provides that if a United States person receives an excess distribution (as defined in section 1291(b)) in respect of stock in a PFIC that is a section 1291 fund (as defined in §1.1291-1T(b)(2)(v)), then (A) the amount of the excess distribution shall be allocated ratably to each day in the shareholder's holding period for the stock, (B) with respect to such excess distribution, the shareholder's gross income for the current year shall include (as ordinary income) only the amounts allocated under section 1291(a)(1)(A) to (i) the current year, or (ii) any period in the shareholder's holding period before the 1st day of the 1st taxable year of the company which begins after December 31, 1986, and for which it was a PFIC, and (C) the tax imposed by chapter 1 of the Code for the current year shall be increased by the deferred tax amount (determined under section 1291(c)). Under section 1291(a)(2), the rules of section 1291(a)(1) apply to any gain recognized on the disposition of stock of a section 1291 fund as if the gain were an excess distribution.

Taxpayer's QEF Inclusions will be attributable to income of PFICs (with respect to which a QEF election has been or will be made) that consists of: (i) interest; (ii) dividends; (iii) gains from the sale or other disposition of stock, securities, or real property that is not property described in section 1221(a)(1); and (iv) items that also would constitute "rents from real property" under section 856(d) if received by a REIT. Taxpayer's Non-QEF Inclusions are derived with respect to PFICs that will generate the same types of passive income. Therefore, treatment of the PFIC Inclusions as qualifying income for purposes of section 856(c)(2) does not interfere with or impede the policy objectives of Congress in enacting the income test under section 856(c)(2).

Ruling #2: Whether the Section 986(c) Gains will be taken into account for purposes of section 856(c)(2).

In general, sections 959(d) and 1293(c) provide that when a taxpayer includes in income a Subpart F Inclusion or QEF Inclusion, the subsequent distribution to the shareholder of the PTI attributable to the inclusion is not treated as a dividend for purposes of chapter 1 of the Code.

Section 986(c)(1) provides that foreign currency gain or loss with respect to distributions of PTI (as described in section 959 or section 1293(c)) attributable to movements in exchange rates between the times of the deemed and actual distribution shall be recognized and treated as ordinary income or loss from the same source as the associated income inclusion.

Section 856(n)(1)(A) provides that “passive foreign exchange gain” for any taxable year will not constitute gross income for purposes of section 856(c)(2).

Section 856(n)(3) defines passive foreign exchange gain as: (A) real estate foreign exchange gain (as defined in section 856(n)(2)); (B) foreign currency gains (as defined in section 988(b)(1)) which is not described in subparagraph A and is attributable to (i) any item of income or gain described in section 856(c)(2), (ii) the acquisition or ownership of obligations (other than foreign currency gains attributable to any item described in clause (i)), or (iii) becoming or being the obligor under obligations (other than foreign currency gain attributable to any item of income or gain described in clause (i)); and (C) any other foreign currency gains determined by the Secretary.

While the Section 986(c) Gains are not foreign currency gains defined in section 988(b)(1), such Section 986(c) Gains are attributable to the Subpart F Inclusions and QEF Inclusions, items of income that are qualifying income for purposes of section 856(c)(2). This Section 986(c) Gain is substantially similar to passive foreign exchange gain described in section 856(n)(3)(B)(i). Therefore, pursuant to section 856(n)(3)(C), the Section 986(c) Gains are excluded from gross income for purposes of section 856(c)(2) because these foreign currency gains are considered passive foreign exchange gain that is excluded from gross income for purposes of section 856(c)(2).

Conclusion:

Based on the facts and representations set forth above, we rule that (i) under section 856(c)(5)(J)(ii), the Subpart F Inclusions are considered gross income that qualifies for purposes of section 856(c)(2), (ii) under section 856(c)(5)(J)(ii), the PFIC Inclusions are considered gross income that qualifies for purposes of section 856(c)(2), and (iii) under section 856(n)(3)(C), the Section 986(c) Gains are excluded from gross income for purposes of section 856(c)(2).

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. In particular, no opinion is expressed concerning whether Taxpayer otherwise qualifies as a REIT under subchapter M of the Code.

This ruling is directly only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representatives.

Sincerely,

Steven Harrison
Branch Chief, Branch 1
Office of Associate Chief Counsel
(Financial Institutions and Products)

[JOINT COMMITTEE PRINT]

GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN 2015

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

MARCH 2016

JCS–1–16

pitalization. Accordingly, the collection period expires 10 years after assessment, plus the actual time spent in a combat zone, regardless of the length of the postponement period available for hospitalized taxpayers to comply with their tax obligations.

Effective Date

The provision applies to taxes assessed before, on, or after the date of the enactment (December 18, 2015).

B. Real Estate Investment Trusts

Overview

In general

A real estate investment trust ("REIT") is an entity that otherwise would be taxed as a U.S. corporation but elects to be taxed under a special REIT tax regime. To qualify as a REIT, an entity must meet a number of requirements. At least 90 percent of REIT income (other than net capital gain) must be distributed annually;[848] the REIT must derive most of its income from passive, generally real estate-related, investments; and REIT assets must be primarily real estate-related. In addition, a REIT must have transferable interests and at least 100 shareholders, and no more than 50 percent of the REIT interests may be owned by five or fewer individual shareholders (as determined using specified attribution rules). Other requirements also apply.[849]

If an electing entity meets the requirements for REIT status, the portion of its income that is distributed to its shareholders as a dividend or qualifying liquidating distribution each year is deductible by the REIT (whereas a regular subchapter C corporation cannot deduct such distributions).[850] As a result, the distributed income of the REIT is not taxed at the entity level; instead, it is taxed only at the investor level. Although a REIT is not required to distribute more than the 90 percent of its income described above to retain REIT status, it is taxed at ordinary corporate rates on amounts not distributed or treated as distributed.[851]

A REIT may designate a capital gain distribution to its shareholders, who treat the designated amount as long-term capital gain when distributed. A REIT also may retain net capital gain and pay corporate income tax on the amount retained, while the shareholders include the undistributed capital gain in income, obtain a credit for the corporate tax paid, and step up the basis of their

[848] Even if a REIT meets the 90-percent income distribution requirement for REIT qualification, more stringent distribution requirements must be met in order to avoid an excise tax under section 4981.

[849] Secs. 856 and 857.

[850] Liquidating distributions are covered to the extent of earnings and profits, and are defined to include redemptions of stock that are treated by shareholders as a sale of stock under section 302. Secs. 857(b)(2)(B), 561, and 562(b).

[851] An additional four-percent excise tax is imposed to the extent a REIT does not distribute at least 85 percent of REIT ordinary income and 95 percent of REIT capital gain net income within a calendar year period. In addition, to the extent a REIT distributes less than 100 percent of its ordinary income and capital gain net income in a year, the difference between the amount actually distributed and 100 percent is added to the distribution otherwise required in a subsequent year to avoid the excise tax. Sec. 4981.

REIT stock for the amount included in income.[852] In this manner, capital gain also is taxed only once, whether or not distributed, rather than at both the entity and investor levels.

Income tests

A REIT is restricted to earning certain types of generally passive income. Among other requirements, at least 75 percent of the gross income of a REIT in each taxable year must consist of real estate-related income. Such income includes: rents from real property; gain from the sale or other disposition of real property (including interests in real property) that is not stock in trade of the taxpayer, inventory, or other property held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business; interest on mortgages secured by real property or interests in real property; and certain income from foreclosure property (the "75-percent income test").[853] Qualifying rents from real property include rents from interests in real property and charges for services customarily furnished or rendered in connection with the rental of real property,[854] but do not include impermissible tenant service income.[855] Impermissible tenant service income includes amounts for services furnished by the REIT to tenants or for managing or operating the property, other than amounts attributable to services that are provided by an independent contractor or taxable REIT subsidiary, or services that certain tax exempt organizations could perform under the section 512(b)(3) rental exception from unrelated business taxable income.[856] Qualifying rents from real property include rent attributable to personal property which is leased under, or in connection with, a lease of real property, but only if the rent attributable to such personal property for the taxable year does not exceed 15 percent of the total rent for the taxable year attributable to both the real and personal property leased under, or in connection with, the lease.[857]

In addition, rents received from any entity in which the REIT owns more than 10 percent of the vote or value generally are not qualifying income.[858] However, there is an exception for certain rents received from taxable REIT subsidiaries (described further below), in which a REIT may own more than 10 percent of the vote or value.

In addition, 95 percent of the gross income of a REIT for each taxable year must be from the 75-percent income sources and a sec-

[852] Sec. 857(b)(3).

[853] Secs. 856(c)(3) and 1221(a)(1). Income from sales that are not prohibited transactions solely by virtue of section 857(b)(6) also is qualified REIT income.

[854] Sec. 856(d)(1)(A) and (B).

[855] Sec. 856(d)(2)(C).

[856] Sec. 856(d)(7)(A) and (C). If impermissible tenant service income with respect to any real or personal property is more than one percent of all amounts received or accrued during the taxable year directly or indirectly with respect to such property, then the impermissible tenant service income with respect to such property includes all such amounts. Sec. 856(d)(7)(B). The amount treated as received for any service (or management or operation) shall not be less than 150 percent of the direct cost of the trust in furnishing or rendering the service (or providing the management or operation). Sec. 856(d)(7)(D). For purposes of the 75-percent and 95-percent income tests, impermissible tenant service income is included in gross income of the REIT. Sec. 856(d)(7)(E).

[857] Sec. 856(d)(1)(C).

[858] Sec. 856(d)(2)(B).

ond permitted category of other, generally passive sources such as dividends and interest (the "95-percent income test").[859]

A REIT must be a U.S. domestic entity, but it is permitted to hold foreign real estate or other foreign assets, provided the 75-percent and 95-percent income tests and the other requirements for REIT qualification are met.[860]

Asset tests

At least 75 percent of the value of a REIT's assets must be real estate assets, cash and cash items (including receivables), and Government securities[861] (the "75-percent asset test").[862] Real estate assets are real property (including interests in real property and interests in mortgages on real property) and shares (or transferable certificates of beneficial interest) in other REITs.[863] No more than 25 percent of a REIT's assets may be securities other than such real estate assets.[864]

Except with respect to securities of a taxable REIT subsidiary, not more than five percent of the value of a REIT's assets may be securities of any one issuer, and the REIT may not possess securities representing more than 10 percent of the outstanding value or voting power of any one issuer.[865] In addition, not more than 25 percent of the value of a REIT's assets may be securities of one or more taxable REIT subsidiaries.[866]

The asset tests must be met as of the close of each quarter of a REIT's taxable year. However, a REIT that has met the asset tests as of the close of any quarter does not lose its REIT status solely because of a discrepancy during a subsequent quarter between the value of the REIT's investments and such requirements, unless such discrepancy exists immediately after the acquisition of any security or other property and is wholly or partly the result of such acquisition.[867]

Taxable REIT subsidiaries

A REIT generally cannot own more than 10 percent of the vote or value of a single entity. However, there is an exception for ownership of a taxable REIT subsidiary ("TRS") that is taxed as a corporation, provided that securities of one or more TRSs do not represent more than 25 percent of the value of REIT assets.

A TRS generally can engage in any kind of business activity except that it is not permitted directly or indirectly to operate either a lodging facility or a health care facility, or to provide to any other person (under a franchise, license, or otherwise) rights to any

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[859] Sec. 856(c)(2).

[860] See Rev. Rul. 74–191, 1974–1 C.B. 170.

[861] Government securities are defined for this purpose under section 856(c)(5)(F), by reference to the Investment Company Act of 1940. The term includes securities issued or guaranteed by the United States or persons controlled or supervised by and acting as an instrumentality thereof, but does not include securities issued or guaranteed by a foreign, state, or local government entity or instrumentality.

[862] Sec. 856(c)(4)(A).

[863] Temporary investments in certain stock or debt instruments also can qualify if they are temporary investments of new capital, but only for the one-year period beginning on the date the REIT receives such capital. Sec. 856(c)(5)(B).

[864] Sec. 856(c)(4)(B)(i).

[865] Sec. 856(c)(4)(B)(iii).

[866] Sec. 856(c)(4)(B)(ii).

[867] Sec. 856(c)(4). In the case of such an acquisition, the REIT also has a grace period of 30 days after the close of the quarter to eliminate the discrepancy.

brand name under which any lodging facility or health care facility is operated.[868]

However, a TRS may rent a lodging facility or health care facility from its parent REIT and is permitted to hire an independent contractor[869] to operate such facility. Rent paid to the parent REIT by the TRS with respect to hotel, motel, or other transient lodging facility operated by an independent contractor is qualified rent for purposes of the REIT's 75-percent and 95-percent income tests.[870] This lodging facility rental rule is an exception to the general rule that rent paid to a REIT by any corporation (including a TRS) in which the REIT owns 10 percent or more of the vote or value is not qualified rental income for purposes of the 75-percent or 95-percent REIT income tests.[871] There is also an exception to the general rule in the case of a TRS that rents space in a building owned by its parent REIT if at least 90 percent of the space in the building is rented to unrelated parties and the rent paid by the TRS to the REIT is comparable to the rent paid by the unrelated parties.[872]

REITs are subject to a tax equal to 100 percent of redetermined rents, redetermined deductions, and excess interest. These are defined generally as the amounts of specified REIT transactions with a TRS of the REIT, to the extent such amounts differ from an arm's length amount.[873]

Prohibited transactions tax

REITs are subject to a prohibited transaction tax ("PTT") of 100 percent of the net income derived from prohibited transactions. For this purpose, a prohibited transaction is a sale or other disposition of property by the REIT that is "stock in trade of a taxpayer or other property which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held for sale to customers by the taxpayer in the ordinary course of his trade or business"[874] and is not foreclosure property. The PTT for a REIT does not apply to a sale if the REIT satisfies certain safe harbor requirements in section 857(b)(6)(C) or (D), including an asset holding period of at least two years.[875] If the conditions are met, a REIT may either (1) make no more than seven sales within a taxable year (other than sales of foreclosure property or involuntary conversions under section 1033), or (2) sell either no more than 10 percent of the aggregate bases, or no more than 10

[868] The latter restriction does not apply to rights provided to an independent contractor to operate or manage a lodging or health care facility if such rights are held by the corporation as a franchisee, licensee, or in similar capacity and such lodging facility or health care facility is either owned by such corporation or is leased by such corporation from the REIT. Sec. 856(l)(3).

[869] An independent contractor will not fail to be treated as such for this purpose because the TRS bears the expenses of operation of the facility under the contract, or because the TRS receives the revenues from the operation of the facility, net of expenses for such operation and fees payable to the operator pursuant to the contract, or both. Sec. 856(d)(9)(B).

[870] Sec. 856(d)(8)(B).

[871] Sec. 856(d)(2)(B).

[872] Sec. 856(d)(8)(A).

[873] Sec. 857(b)(7).

[874] This definition is the same as the definition of certain property the sale or other disposition of which would produce ordinary income rather than capital gain under section 1221(a)(1).

[875] Additional requirements for the safe harbor limit the amount of expenditures the REIT can make during the two-year period prior to the sale that are includible in the adjusted basis of the property, require marketing to be done by an independent contractor, and forbid a sales price that is based on the income or profits of any person.

percent of the aggregate fair market value, of all its assets as of the beginning of the taxable year (computed without regard to sales of foreclosure property or involuntary conversions under section 1033), without being subject to the PTT tax.[876]

REIT shareholder tax treatment

Although a REIT typically does not pay corporate level tax due to the deductible distribution of its income, and thus is sometimes compared to a partnership or S corporation, REIT equity holders are not treated as being engaged in the underlying activities of the REIT as are partners or S corporation shareholders, and the activities at the REIT level that characterize its income do not generally flow through to equity owners to characterize the tax treatment of REIT distributions to them. A distribution to REIT shareholders out of REIT earnings and profits is generally treated as an ordinary income REIT dividend and is treated as ordinary income taxed at the shareholder's normal rates on such income.[877] However, a REIT is permitted to designate a "capital gain dividend" to the extent a distribution is made out of its net capital gain.[878] Such a dividend is treated as long-term capital gain to the shareholders.[879]

REIT shareholders are not taxed on REIT income unless the income is distributed to them (except in the case of REIT net capital gain retained by the REIT and designated for inclusion in the shareholder's income as explained in the preceding footnote). However, since a REIT must distribute 90 percent of its ordinary income annually, and typically will distribute or designate its income as capital gain dividends to avoid a tax at the REIT level, REIT income generally is taxed in full at the shareholder level annually.

REIT shareholders are not entitled to any share of REIT losses to offset against other shareholder income. However, if the REIT itself has income, its losses offset its income in determining how much it is required to distribute to meet the distribution requirements. Also, REIT losses that reduce earnings and profits can cause a distribution that exceeds the REIT's earnings and profits to be treated as a nontaxable return of capital to its shareholders.

Tax exempt shareholders

A tax exempt shareholder is exempt from tax on REIT dividends, and is not treated as engaging in any of the activities of the REIT. As one example, if the REIT borrowed money and its income at the REIT level were debt-financed, a tax exempt shareholder would not

[876] Sec. 857(b)(6).

[877] Because a REIT dividend is generally paid out of income that was not taxed to the distributing entity, the dividend is not eligible for the dividends received deductions to a corporate shareholder. Sec. 243(d)(3). A REIT dividend is not eligible for the 20 percent qualified dividend rate to an individual shareholder, except to the extent such dividend is attributable to REIT income from nondeductible C corporation dividends, or to certain income of the REIT that was subject to corporate level tax. Sec. 857(c).

[878] Sec. 857(b)(3)(C). Net capital gain is the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for the taxable year. Sec. 1222.

[879] A REIT may also retain its net capital gain without distribution, while designating a capital gain dividend for inclusion in shareholder income. In this case, the REIT pays corporate-level tax on the capital gain, but the shareholder includes the undistributed capital gain in income, receives a credit for the corporate level tax paid, and steps up the basis of the REIT stock for the amount included in income, with the result that the net tax paid is the shareholder-level capital gain tax. Sec. 857(b)(3)(D).

have debt-financed unrelated business income from the REIT dividend.

Foreign shareholders

Except as provided by the Foreign Investment in Real Property Tax Act of 1980 ("FIRPTA"),[880] a REIT shareholder that is a foreign corporation or a nonresident alien individual normally treats its dividends as fixed and determinable annual and periodic income that is subject to withholding under section 1441 but not treated as active business income that is effectively connected with the conduct of a U.S. trade or business, regardless of the level of real estate activity of the REIT in the United States.[881] A number of treaties permit a lower rate of withholding on REIT dividends than the Code would otherwise require.

Although FIRPTA applies in many cases to foreign investment in U.S. real property through a REIT, REITs offer foreign investors some ability to invest in U.S real property interests without subjecting gain on the sale of REIT stock to FIRPTA (for example, if the REIT is domestically controlled).[882] In general, if any class of stock of a corporation is regularly traded on an established securities market, stock of such class is subject to FIRPTA only in the case of a person who, at some time during the testing period, held more than 5 percent of such class of stock.[883] Also, if the REIT stock is publicly traded and the foreign investor does not own more than five percent of such stock, the investor can receive distributions from the sale by the REIT of U.S. real property interests without such distributions being subject to FIRPTA.[884]

1. Restriction on tax-free spinoffs involving REITs (sec. 311 of the Act and secs. 355 and 856 of the Code)

Present Law

A corporation generally is required to recognize gain on the distribution of property (including stock of a subsidiary) to its shareholders as if the corporation had sold such property for its fair market value.[885] In addition, the shareholders receiving the distributed property are ordinarily treated as receiving a dividend equal to the value of the distribution (to the extent of the distributing corporation's earnings and profits),[886] or capital gain in the case of an acquisition of its stock that significantly reduces the shareholder's interest in the parent corporation.[887]

An exception to these rules applies if the distribution of the stock of a controlled corporation satisfies the requirements of section 355.

[880] Pub. L. No. 96–499. FIRPTA treats income of a foreign investor from the sale or disposition of U.S. real property interests as effectively connected with the operation of a trade or business in the United States. Such income is taxed at regular U.S. rates and withholding obligations are imposed on payors of the income. Secs. 897 and 1445.

[881] As noted above, REITs are not permitted to receive income from property that is inventory or that is held for sale to customers in the ordinary course of the REIT's business. However, REITs may engage in certain activities, including acquisition, development, lease, and sale of real property, and may provide "customary services" to tenants.

[882] Sec. 897(h)(2).

[883] Sec. 897(c)(3).

[884] Sec. 897(h)(1).

[885] Sec. 311(b).

[886] Sec. 301(b)(1) and (c)(1).

[887] Sec. 302(a) and (b)(2).

If all the requirements are satisfied, there is no tax to the distributing corporation or to the shareholders on the distribution.

One requirement to qualify for tax-free treatment under section 355 is that both the distributing corporation and the controlled corporation must be engaged immediately after the distribution in the active conduct of a trade or business that has been conducted for at least five years and was not acquired in a taxable transaction during that period (the "active business test").[888]

For this purpose, the active business test is satisfied only if (1) immediately after the distribution, the corporation is engaged in the active conduct of a trade or business, or (2) immediately before the distribution, the corporation had no assets other than stock or securities in the controlled corporations and each of the controlled corporations is engaged immediately after the distribution in the active conduct of a trade or business.[889] For this purpose, the active business test is applied by reference to the relevant affiliated group rather than on a single corporation basis. For the parent distributing corporation, the relevant affiliated group consists of the distributing corporation as the common parent and all corporations affiliated with the distributing corporation through stock ownership described in section 1504(a)(1) (regardless of whether the corporations are otherwise includible corporations under section 1504(b)),[890] immediately after the distribution. The relevant affiliated group for a controlled distributed subsidiary corporation is determined in a similar manner (with the controlled corporation as the common parent).

In determining whether a corporation is directly engaged in an active trade or business that satisfies the requirement, IRS ruling practice formerly required that the value of the gross assets of the trade or business being relied on must ordinarily constitute at least five percent of the total fair market value of the gross assets of the corporation directly conducting the trade or business.[891] The IRS suspended this specific rule in connection with its general administrative practice of moving IRS resources away from advance rulings on factual aspects of section 355 transactions in general.[892]

Section 355 does not apply to an otherwise qualifying distribution if, immediately after the distribution, either the distributing or the controlled corporation is a disqualified investment corporation and any person owns a 50 percent interest in such corporation and did not own such an interest before the distribution. A disqualified investment corporation is a corporation of which two-thirds or more

[888] Sec. 355(b).
[889] Sec. 355(b)(1).
[890] Sec. 355(b)(3).
[891] Rev. Proc. 2003–3, sec. 4.01(30), 2003–1 I.R.B. 113.
[892] Rev. Proc. 2003–48, 2003–29 I.R.B. 86. Since then, the IRS discontinued private rulings on whether a transaction generally qualifies for nonrecognition treatment under section 355. Nonetheless, the IRS may still rule on certain significant issues. See Rev. Proc. 2016–1, 2016–1 I.R.B. 1; Rev. Proc. 2016–3, 2016–1 I.R.B. 126. Recently, the IRS announced that it will not rule in certain situations in which property owned by any distributing or controlled corporation becomes the property of a RIC or a REIT; however, the IRS stated that the policy did not extend to situations in which, immediately after the date of the distribution, both the distributing and controlled corporation will be RICs, or both of such corporations will be REITs, and there is no plan or intention on the date of the distribution for either the distributing or the controlled corporation to cease to be a RIC or a REIT. See Rev. Proc. 2015–43, 2015–40 I.R.B. 467.

of its asset value is comprised of certain passive investment assets. Real estate is not included as such an asset.[893]

The IRS has ruled that a REIT may satisfy the active business requirement through its rental activities.[894] More recently, the IRS has issued a private ruling indicating that a REIT that has a TRS can satisfy the active business requirement by virtue of the active business of its TRS.[895] Thus, a C corporation that owns REIT-qualified assets may create a REIT to hold such assets and spin off that REIT without tax consequences to it or its shareholders (if the newly-formed REIT satisfies the active business requirement through its rental activities or the activities of a TRS). Following the spin-off, income from the assets held in the REIT is no longer subject to corporate level tax (unless there is a disposition of such assets that incurs tax under the built in gain rules).

Explanation of Provision

The provision makes a REIT generally ineligible to participate in a tax-free spin-off as either a distributing or controlled corporation under section 355. There are two exceptions, however. First, the general rule does not apply if, immediately after the distribution, both the distributing and the controlled corporations are REITs.[896] Second, a REIT may spin off a TRS if (1) the distributing corporation has been a REIT at all times during the 3-year period ending on the date of the distribution, (2) the controlled corporation has been a TRS of the REIT at all times during such period, and (3) the REIT has had control (as defined in section 368(c)[897] applied by taking into account stock owned directly or indirectly, including through one or more partnerships, by the REIT) of the TRS at all times during such period. For this purpose, control of a partnership means ownership of at least 80 percent of the profits interest and at least 80 percent of the capital interests.

A controlled corporation will be treated as meeting the control requirements if the stock of such corporation was distributed by a TRS in a transaction to which section 355 (or so much of section 356 as relates to section 355) applies and the assets of such corporation consist solely of the stock or assets held by one or more TRSs of the distributing corporation meeting the control requirements noted above.

If a corporation that is not a REIT was a distributing or controlled corporation with respect to any distribution to which section 355 applied, such corporation (and any successor corporation) shall not be eligible to make a REIT election for any taxable year beginning before the end of the 10-year period beginning on the date of such distribution.

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[893] Sec. 355(g).

[894] Rev. Rul. 2001–29, 2001–1 C.B. 1348.

[895] Priv. Ltr. Rul. 201337007. A private ruling may be relied upon only by the taxpayer to which it is issued. However, private rulings provide some indication of administrative practice.

[896] As long as a REIT election for each corporation is effective immediately after the distribution, the elections may be made after that time.

[897] Under section 368(c), the term "control" means the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation.

Effective Date

The provision generally applies to distributions on or after December 7, 2015,[898] but does not apply to any distribution pursuant to a transaction described in a ruling request initially submitted to the Internal Revenue Service on or before such date, which request has not been withdrawn and with respect to which a ruling has not been issued or denied in its entirety as of such date.

2. Reduction in percentage limitation on assets of REIT which may be taxable REIT subsidiaries (sec. 312 of the Act and sec. 856 of the Code)

Present Law

A REIT generally is not permitted to own securities representing more than 10 percent of the vote or value of any entity, nor is it permitted to own securities of a single issuer comprising more than 5 percent of REIT value.[899] In addition, rents received by a REIT from a corporation of which the REIT directly or indirectly owns more than 10 percent of the vote or value generally are not qualified rents for purposes of the 75-percent and 95-percent income tests.[900]

There is an exception from these rules in the case of a TRS.[901] No more than 25 percent of the value of total REIT assets may consist of securities of one or more TRSs.[902]

Explanation of Provision

The provision reduces to 20 percent the permitted percentage of total REIT assets that may be securities of one or more TRSs.

Effective Date

The provision applies to taxable years beginning after December 31, 2017.

3. Prohibited transaction safe harbors (sec. 313 of the Act and sec. 857 of the Code)

Present Law

REITs are subject to a prohibited transaction tax ("PTT") of 100 percent of the net income derived from prohibited transactions. For this purpose, a prohibited transaction is a sale or other disposition of property by the REIT that is "stock in trade of a taxpayer or other property which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held for sale to customers by the taxpayer in the ordinary

[898] The provision does not apply to distributions by a corporation pursuant to a plan under which stock constituting control (within the meaning of section 368(c)) of the controlled corporation was distributed before December 7, 2015.

[899] Sec. 856(c)(4)(B)(iii).

[900] Sec. 856(d)(2)(B).

[901] Sec. 856(d)(8).

[902] Sec. 856(c)(4)(B)(ii).

course of his trade or business"[903] and is not foreclosure property. The PTT for a REIT does not apply to a sale if the REIT satisfies certain safe harbor requirements in section 857(b)(6)(C) or (D), including an asset holding period of at least two years.[904] If the conditions are met, a REIT may either (1) make no more than seven sales within a taxable year (other than sales of foreclosure property or involuntary conversions under section 1033), or (2) sell either no more than 10 percent of the aggregate bases, or no more than 10 percent of the aggregate fair market value, of all its assets as of the beginning of the taxable year (computed without regard to sales of foreclosure property or involuntary conversions under section 1033), without being subject to the PTT tax.[905]

The additional requirements for the safe harbor limit the amount of expenditures the REIT or a partner of the REIT can make during the two-year period prior to the sale that are includible in the adjusted basis of the property. Also, if more than seven sales are made during the taxable year, substantially all marketing and development expenditures with respect to the property must have been made through an independent contractor from whom the REIT itself does not derive or receive any income.

Explanation of Provision

The provision expands the amount of property that a REIT may sell in a taxable year within the safe harbor provisions, from 10 percent of the aggregate basis or fair market value, to 20 percent of the aggregate basis or fair market value. However, in any taxable year, the aggregate adjusted bases and the fair market value of property (other than sales of foreclosure property or sales to which section 1033 applies) sold during the three taxable year period ending with such taxable year may not exceed 10 percent of the sum of the aggregate adjusted bases or the sum of the fair market value of all of the assets of the REIT as of the beginning of each of the 3 taxable years that are part of the period.

The provision clarifies that the determination of whether property is described in section 1221(a)(1) is made without regard to whether or not such property qualifies for the safe harbor from the prohibited transactions rules.

Effective Date

The provision generally applies to taxable years beginning after the date of enactment (December 18, 2015). However, the provision clarifying the determination of whether property is described in section 1221(a)(1) has retroactive effect, but does not apply to any sale of property to which section 857(b)(6)(G) applies.

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[903] This definition is the same as the definition of certain property the sale or other disposition of which would produce ordinary income rather than capital gain under section 1221(a)(1).

[904] Additional requirements for the safe harbor limit the amount of expenditures the REIT can make during the two-year period prior to the sale that are includible in the adjusted basis of the property, require marketing to be done by an independent contractor, and forbid a sales price that is based on the income or profits of any person.

[905] Sec. 857(b)(6).

4. Repeal of preferential dividend rule for publicly offered REITs; authority for alternative remedies to address certain REIT distribution failures (secs. 314 and 315 of the Act and sec. 562 of the Code)

Present Law

A REIT is allowed a deduction for dividends paid to its shareholders.[906] In order to qualify for the deduction, a dividend must not be a "preferential dividend."[907] For this purpose, a dividend is preferential unless it is distributed pro rata to shareholders, with no preference to any share of stock compared with other shares of the same class, and with no preference to one class as compared with another except to the extent the class is entitled to a preference.

Similar rules apply to regulated investment companies ("RICs").[908] However, the preferential dividend rule does not apply to a publicly offered RIC (as defined in section 67(c)(2)(B)).[909]

Explanation of Provision

The provision repeals the preferential dividend rule for publicly offered REITs. For this purpose, a REIT is publicly offered if it is required to file annual and periodic reports with the Securities and Exchange Commission under the Securities Exchange Act of 1934.

For other REITs, the provision provides the Secretary of the Treasury with authority to provide an appropriate remedy to cure the failure of the REIT to comply with the preferential dividend requirements in lieu of not considering the distribution to be a dividend for purposes of computing the dividends-paid deduction where the Secretary determines the failure to comply is inadvertent or is due to reasonable cause and not due to willful neglect, or the failure is a type of failure identified by the Secretary as being so described.

Effective Date

The provision to repeal the preferential dividend rule for publicly offered REITs applies to distributions in taxable years beginning after December 31, 2014.

The provision granting authority to the Secretary of the Treasury to provide alternative remedies addressing certain REIT distribution failures applies to distributions in taxable years beginning after December 31, 2015.

5. Limitations on designation of dividends by REITs (sec. 316 of the Act and sec. 857 of the Code)

Present Law

A REIT that has a net capital gain for a taxable year may designate dividends that it pays or is treated as paying during the

[906] Sec. 857(b)(2)(B).
[907] Sec. 562(c).
[908] Sec. 852(b)(2)(D).
[909] Sec. 562(c).

year as capital gain dividends.[910] A capital gain dividend is treated by the shareholder as gain from the sale or exchange of a capital asset held more than one year.[911] The amount that may be designated as capital gain dividends for any taxable year may not exceed the REIT's net capital gain for the year.

A REIT may designate dividends that it pays or is treated as paying during the year as qualified dividend income.[912] Qualified dividend income is taxed to individuals at the same tax rate as net capital gain, under rules enacted by the Taxpayer Relief Act of 1997.[913] The amount that may be designated as qualified dividend income for any taxable year is limited to qualified dividend income received by the REIT plus some amounts subject to corporate taxation at the REIT level.

The IRS has ruled that a RIC may designate the maximum amount permitted under each of the provisions allowing a RIC to designate dividends even if the aggregate of all the designated amounts exceeds the total amount of the RIC's dividends distributions.[914]

The IRS also has ruled that if a RIC has two or more classes of stock and it designates the dividends that it pays on one class as consisting of more than that class's proportionate share of a particular type of income, the designations are not effective for federal tax purposes to the extent that they exceed the class's proportionate share of that type of income.[915] The Internal Revenue Service announced that it would provide guidance that RICs and REITs must use in applying the capital gain provision enacted by the Taxpayer Relief Act of 1997.[916] The announcement referred to the designation limitations of Revenue Ruling 89–91.

Explanation of Provision

The provision limits the aggregate amount of dividends designated by a REIT for a taxable year under all of the designation provisions to the amount of dividends paid with respect to the taxable year (including dividends described in section 858 that are paid after the end of the REIT taxable year but treated as paid by the REIT with respect to the taxable year).

The provision provides the Secretary of the Treasury authority to prescribe regulations or other guidance requiring the proportionality of the designation for particular types of dividends (for example, capital gain dividends) among shares or beneficial interests in a REIT.

Effective Date

The provision applies to distributions in taxable years beginning after December 31, 2015.

[910] Sec. 857(b)(3)(C).
[911] Sec. 857(b)(3)(B).
[912] Sec. 857(c)(2).
[913] Sec. 1(h)(11) enacted in Pub. L. No. 105–34.
[914] Rev. Rul. 2005–31, 2005–1 C.B.1084.
[915] Rev. Rul. 89–81, 1989–1 C.B. 226.
[916] Notice 97–64, 1997–2 C.B. 323. Recently, the IRS modified Notice 97–64 and provided certain new rules for RICs; the designation limitations in Revenue Ruling 89–81, however, continue to apply. Notice 2015–41, 2015–24 I.R.B. 1058.

6. Debt instruments of publicly offered REITs and mortgages treated as real estate assets (sec. 317 of the Act and sec. 856 of the Code)

Present Law

At least 75 percent of the value of a REIT's assets must be real estate assets, cash and cash items (including receivables), and Government securities (the "75-percent asset test").[917] Real estate assets are real property (including interests in real property and mortgages on real property) and shares (or transferable certificates of beneficial interest) in other REITs.[918] No more than 25 percent of a REIT's assets may be securities other than such real estate assets.[919]

Except with respect to a TRS, not more than five percent of the value of a REIT's assets may be securities of any one issuer, and the REIT may not possess securities representing more than 10 percent of the outstanding value or voting power of any one issuer.[920] No more than 25 percent of the value of a REIT's assets may be securities of one or more TRSs.[921]

The asset tests must be met as of the close of each quarter of a REIT's taxable year.[922]

At least 75 percent of a REIT's gross income must be from certain real estate related and other items. In addition, at least 95 percent of a REIT's gross income must be from specified sources that include the 75 percent items and also include interest, dividends, and gain from the sale or other disposition of securities (whether or not real estate-related).

Explanation of Provision

Under the provision, debt instruments issued by publicly offered REITs are treated as real estate assets, as are interests in mortgages on interests in real property (for example, an interest in a mortgage on a leasehold interest in real property). Such assets therefore are qualified assets for purposes of meeting the 75-percent asset test, but are subject to special limitations described below.

As under present law, income from debt instruments issued by publicly offered REITs that is interest income or gain from the sale or other disposition of a security is treated as qualified income for purposes of the 95-percent gross income test. Income from debt instruments issued by publicly offered REITs that would not have been treated as real estate assets but for the new provision, however, is not qualified income for purposes of the 75-percent income

[917] Sec. 856(c)(4)(A).

[918] Such term also includes any property (not otherwise a real estate asset) attributable to the temporary investment of new capital, but only if such property is stock or a debt instrument, and only for the one-year period beginning on the date the REIT receives such capital. Sec. 856(c)(5)(B).

[919] Sec. 856(c)(4)(B)(i).

[920] Sec. 856(c)(4)(B)(iii).

[921] Sec. 856(c)(4)(B)(ii).

[922] Sec. 856(c)(4). However, a REIT that has met the asset tests as of the close of any quarter does not lose its REIT status solely because of a discrepancy during a subsequent quarter between the value of the REIT's investments and such requirements, unless such discrepancy exists immediately after the acquisition of any security or other property and is wholly or partly the result of such acquisition. Sec. 856(c)(4).

test, and not more than 25 percent of the value of a REIT's total assets is permitted to be represented by such debt instruments.

Effective Date

The provision is effective for taxable years beginning after December 31, 2015.

7. Asset and income test clarification regarding ancillary personal property (sec. 318 of the Act and sec. 856 of the Code)

Present Law

75-percent income test

Among other requirements, at least 75 percent of the gross income of a REIT in each taxable year must consist of real estate-related income. Such income includes: rents from real property; income from the sale or exchange of real property (including interests in real property) that is not stock in trade, inventory, or held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business; interest on mortgages secured by real property or interests in real property; and certain income from foreclosure property (the "75-percent income test"). Amounts attributable to most types of services provided to tenants (other than certain "customary services"), or to more than specified amounts of personal property, are not qualifying rents.

The Code definition of rents from real property includes rent attributable to personal property which is leased under, or in connection with, a lease of real property, but only if the rent attributable to such property for the taxable year does not exceed 15 percent of the total rent for the taxable year attributable to both the real and personal property leased under, or in connection with, such lease.[923]

For purposes of determining whether interest income is from a mortgage secured by real property, Treasury regulations provide that where a mortgage covers both real property and other property, an apportionment of the interest must be made. If the loan value of the real property is equal to or exceeds the amount of the loan, then the entire interest income is apportioned to the real property. However, if the amount of the loan exceeds the loan value of the real property, then the interest income apportioned to the real property is an amount equal to the interest income multiplied by a fraction, the numerator of which is the loan value of the real property and the denominator of which is the amount of the loan.[924] The remainder of the interest income is apportioned to the other property.

The loan value of real property is defined as the fair market value of the property determined as of the date on which the commitment by the REIT to make the loan becomes binding on the REIT. In the case of a loan purchased by a REIT, the loan value

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[923] Sec. 856(d)(1)(C).

[924] Treas. Reg. sec. 1.856–5(c)(1). The amount of the loan for this purpose is defined as the hightest principal amount of the loan outstanding during the taxable year. Treas. Reg. sec. 1.856–5(c)(3).

of the real property is the fair market value of the real property determined as of the date on which the commitment of the REIT to purchase the loan becomes binding.[925]

75-percent asset test

At the close of each quarter of the taxable year, at least 75 percent of the value of a REIT's total assets must be represented by real estate assets, cash and cash items, and Government securities.

Real estate assets generally mean real property (including interests in real property and interests in mortgages on real property) and shares (or transferable certificates of beneficial interest) in other REITs.

Neither the Code nor regulations address the allocation of value in cases where real property and personal property may both be present.

Explanation of Provision

The provision allows certain ancillary personal property leased with real property to be treated as real property for purposes of the 75-percent asset test, applying the same threshold that applies under present law for purposes of determining rents from real property under section 856(d)(l)(C) for purposes of the 75-percent income test.

The provision also modifies the present-law rules for determining when an obligation secured by a mortgage is considered secured by a mortgage on real property if the security includes personal property as well. Under the provision, in the case of an obligation secured by a mortgage on both real property and personal property, if the fair market value of such personal property does not exceed 15 percent of the total fair market value of all such property, such personal property is treated as real property for purposes of the 75-percent income and 75-percent asset test computations.[926] In making this determination, the fair market value of all property (both personal and real) is determined at the same time and in the same manner as the fair market value of real property is determined for purposes of apportioning interest income between real property and personal property under the rules for determining whether interest income is from a mortgage secured by real property.

Effective Date

The provision is effective for taxable years beginning after December 31, 2015.

8. Hedging provisions (sec. 319 of the Act and sec. 857 of the Code)

Present Law

Except as provided by Treasury regulations, income from certain REIT hedging transactions that are clearly identified, including gain from the sale or disposition of such a transaction, is not included as gross income under either the 95-percent income or 75-

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[925] Special rules apply to construction loans. Treas. Reg. sec. 1.856–5(c)(2).
[926] Sec. 856(c)(3)(B) and (4)(A).

percent income test. Transactions eligible for this exclusion include transactions that hedge indebtedness incurred or to be incurred by the REIT to acquire or carry real estate assets and transactions entered primarily to manage risk of currency fluctuations with respect to items of income or gain described in section 856(c)(2) or (3).[927]

Explanation of Provision

The provision expands the scope of the present-law exception of certain hedging income from gross income for purposes of the income tests, under section 856(c)(5)(G). Under the provision, if (1) a REIT enters into one or more positions described in clause (i) of section 856(c)(5)(G) with respect to indebtedness described therein or one or more positions described in clause (ii) of section 856(c)(5)(G) with respect to property that generates income or gain described in section 856(c)(2) or (3); (2) any portion of such indebtedness is extinguished or any portion of such property is disposed of; and (3) in connection with such extinguishment or disposition, such REIT enters into one or more transactions which would be hedging transactions described in subparagraph (B) or (C) of section 1221(b)(2) with respect to any position referred to in (1) above, if such position were ordinary property,[928] then any income of such REIT from any position referred to in (1) and from any transaction referred to in (3) (including gain from the termination of any such position or transaction) shall not constitute gross income for purposes of the 75-percent or 95-percent gross income tests, to the extent that such transaction hedges such position.

The provision is intended to extend the current treatment of income from certain REIT hedging transactions as income that is disregarded for purposes of the 75-percent and 95-percent income tests to income from positions that primarily manage risk with respect to a prior hedge that a REIT enters in connection with the extinguishment or disposal (in whole or in part) of the liability or asset (respectively) related to such prior hedge, to the extent the new position qualifies as a section 1221 hedge or would so qualify if the hedged position were ordinary property.

The provision also clarifies that the identification requirement that applies to all hedges under the hedge gross income rules is the requirement described in section 1221(a)(7), determined after taking account of any curative provisions provided under the regulations referred to therein.

Effective Date

The provision is effective for taxable years beginning after December 31, 2015.

[927] Sec. 856(c)(5)(G).

[928] Such definition of a hedging transaction is applied for purposes of this provision without regard to whether or not the position referred to is ordinary property.

9. Modification of REIT earnings and profits calculation to avoid duplicate taxation (sec. 320 of the Act and secs. 562 and 857 of the Code)

Present Law

For purposes of computing earnings and profits of a corporation, the alternative depreciation system, which generally is less accelerated than the system used in determining taxable income, is used in the case of the depreciation of tangible property. Also, certain amounts treated as currently deductible for purposes of computing taxable income are allowed as a deduction ratably over a period of five years for computing earnings and profits. Finally, the installment method is not allowed in computing earnings and profits from the installment sale of property.[929]

In the case of a REIT, the current earnings and profits of a REIT are not reduced by any amount which is not allowable as a deduction in computing its taxable income for the taxable year.[930] In addition, for purposes of computing the deduction for dividends paid by a REIT for a taxable year, earnings and profits are increased by the total amount of gain on the sale or exchange of real property by the trust during the year.[931]

These rules can by illustrated by the following example:

Example.—Assume that a REIT had $100 of taxable income and earnings and profits in each of five consecutive taxable years (determined without regard to any energy efficient commercial building deduction[932] and without regard to any deduction for dividends paid). Assume that in the first of the five years, the REIT had an energy efficient commercial building deduction in computing its taxable income of $10, reducing its pre-dividend taxable income to $90. Assume further that the deduction is allowable at a rate of $2 per year over the five-year period beginning with the first year in computing its earnings and profits.

Under present law, the REIT's earnings and profits in the first year are $98 ($100 less $2). In each of the next four years, the REIT's current earnings and profits are $100 ($98 as computed for the first year plus an additional $2 under section 857(d)(1) for the $2 not deductible in computing taxable income for the year).

Assume the REIT distributes $100 to its shareholders at the close of each of the five years. Under present law, the shareholders have $98 dividend income in the first year and a $2 return of capital and $100 dividend income in each of the following four years, for a total of $498 dividend income, notwithstanding that the REIT had only $490 pre-dividend taxable income over the period. The dividends paid by the REIT reduce its taxable income to zero in each of the taxable years.

Explanation of Provision

Under the provision, the current earnings and profits of a REIT for a taxable year are not reduced by any amount that (1) is not

[929] Sec. 312(k)(3) and (n)(5).
[930] Sec. 857(d)(1). This provision applies to a REIT without regard to whether it meets the requirements of section 857(a) for the taxable year.
[931] Sec. 562(e).
[932] Sec. 179D.

allowable as a deduction in computing its taxable income for the current taxable year and (2) was not so allowable for any prior taxable year. Thus, under the provision, if an amount is allowable as a deduction in computing taxable income in year one and is allowable in computing earnings and profits in year two (determined without regard to present-law section 857(d)(1)), section 857(d)(1) no longer applies and the deduction in computing the year two earnings and profits of the REIT is allowable. Thus, a lesser maximum amount will be a dividend to shareholders in that year. This provision does not change the present-law determination of current earnings and profits for purposes of computing a REIT's deduction for dividends paid.

In addition, the provision provides that the current earnings and profits of a REIT for a taxable year for purposes of computing the deduction for dividends paid are increased by any amount of gain on the sale or exchange of real property taken into account in determining the taxable income of the REIT for the taxable year (to the extent the gain is not otherwise so taken into account). Thus, in the case of an installment sale of real property, current earnings and profits for purposes of the REIT's deduction for dividends paid for a taxable year are increased by the amount of gain taken into account in computing its taxable income for the year and not otherwise taken into account in computing the current earnings and profits.

The following illustrates the application of the provision:

Example.—Assume the same facts as in the above example. Under the provision, as under present law, in the first taxable year, the earnings and profits of the REIT were $98 and the shareholders take into account $98 dividend income and $2 is a return of capital. Under the provision, in each of the next four years, the earnings and profits are $98 (i.e., section 857(d)(1) does not apply) so that the shareholders take into account $98 of dividend income in each year and $2 is a return of capital each year.

For purposes of the REIT's deduction for dividends paid, present law remains unchanged so that the REIT's taxable income will be reduced to zero in each of the taxable years.

Effective Date

The provision is effective for taxable years beginning after December 31, 2015.

10. Treatment of certain services provided by taxable REIT subsidiaries (sec. 321 of the Act and sec. 857 of the Code)

Present Law

Taxable REIT subsidiaries

A TRS generally can engage in any kind of business activity except that it is not permitted directly or indirectly to operate either a lodging facility or a health care facility, or to provide to any other person (under a franchise, license, or otherwise) rights to any brand name under which any lodging facility or health care facility is operated.

REITs are subject to a tax equal to 100 percent of redetermined rents, redetermined deductions, and excess interest. These are defined generally as the amounts of specified REIT transactions with a TRS of the REIT, to the extent such amounts differ from an arm's length amount.

Prohibited transactions tax

REITs are subject to a prohibited transaction tax ("PTT") of 100 percent of the net income derived from prohibited transactions.[933] For this purpose, a prohibited transaction is a sale or other disposition of property by the REIT that is stock in trade of a taxpayer or other property that would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held for sale to customers by the taxpayer in the ordinary course of his trade or business and is not foreclosure property. The PTT for a REIT does not apply to a sale of property which is a real estate asset if the REIT satisfies certain criteria in section 857(b)(6)(C) or (D).

Section 857(b)(6)(C) provides that a prohibited transaction does not include a sale of property which is a real estate asset (as defined in section 856(c)(5)(B)) and which is described in section 1221(a)(1) if (1) the REIT has held the property for not less than two years; (2) aggregate expenditures made by the REIT, or any partner of the REIT, during the two year period preceding the date of sale which are includible in the basis of the property do not exceed 30 percent of the net selling price of the property; (3) either: (A) the REIT does not make more than seven sales of property[934] during the taxable year, or (B) the aggregate adjusted bases (as determined for purposes of computing earnings and profits) of property[935] sold during the taxable year does not exceed 10 percent of the aggregate bases (as so determined) of all of the assets of the REIT as of the beginning of the taxable year, or (C) the fair market value of property[936] sold during the taxable year does not exceed 10 percent of the aggregate fair market value of all the assets of the REIT as of the beginning of the taxable year; (4) in the case of land or improvements, not acquired through foreclosure (or deed in lieu of foreclosure), or lease termination, the REIT has held the property for not less than two years for production of rental income; and (5) if the requirement of (3)(A) above is not satisfied, substantially all of the marketing and development expenditures with respect to the property were made through an independent contractor (as defined in section 856(d)(3)) from whom the REIT does not derive or receive any income.

Section 857(b)(6)(D) provides that a prohibited transaction does not include a sale of property which is a real estate asset (as defined in section 856(c)(5)(B)) and which is described in section 1221(a)(1) if (1) the REIT has held the property for not less than two years in connection with the trade or business of producing timber; (2) the aggregate expenditures made by the REIT, or any partner of the REIT, during the two year period preceding the date

[933] Sec. 857(b)(6).
[934] Sales of foreclosure property or sales to which section 1033 applies are excluded.
[935] Sales of foreclosure property or sales to which section 1033 applies are excluded.
[936] Sales of foreclosure property or sales to which section 1033 applies are excluded.

of sale which (A) are includible in the basis of the property (other than timberland acquisition expenditures), and (B) are directly related to operation of the property for the production of timber or for the preservation of the property for use as a timberland, do not exceed 30 percent of the net selling price of the property; (3) the aggregate expenditures made by the REIT, or a partner of the REIT, during the two year period preceding the date of sale which (A) are includible in the basis of the property (other than timberland acquisition expenditures), and (B) are not directly related to operation of the property for the production of timber or for the preservation of the property for use as a timberland, do not exceed five percent of the net selling price of the property; (4) either: (A) the REIT does not make more than seven sales of property [937] during the taxable year, or (B) the aggregate adjusted bases (as determined for purposes of computing earnings and profits) of property [938] sold during the taxable year does not exceed 10 percent of the aggregate bases (as so determined) of all of the assets of the REIT as of the beginning of the taxable year, or (C) the fair market value of property [939] sold during the taxable year does not exceed 10 percent of the aggregate fair market value of all the assets of the REIT as of the beginning of the taxable year; (5) if the requirement of (4)(A) above is not satisfied, substantially all of the marketing expenditures with respect to the property were made through an independent contractor (as defined in section 856(d)(3)) from whom the REIT does not derive or receive any income, or, in the case of a sale on or before the termination date, a TRS; and (6) the sales price of the property sold by the trust is not based in whole or in part on income or profits derived from the sale or operation of such property.

Foreclosure property

Under current law, certain income and gain derived from foreclosure property satisfies the 95-percent and 75-percent REIT income tests.[940] Property will cease to be foreclosure property, however, if used in a trade or business conducted by the REIT, other than through an independent contractor from which the REIT itself does not derive or receive any income, more than 90 days after the day on which the REIT acquired such property.[941]

Explanation of Provision

For purposes of the exclusion from the prohibited transactions excise tax, the provision modifies the requirement of section 857(b)(6)(C)(v), that substantially all of the development expenditures with respect to the property were made through an independent contractor from whom the REIT itself does not derive or receive any income, to allow a TRS to have developed the property.[942]

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[937] Sales of foreclosure property or sales to which section 1033 applies are excluded.
[938] Sales of foreclosure property or sales to which section 1033 applies are excluded.
[939] Sales of foreclosure property or sales to which section 1033 applies are excluded.
[940] Sec. 856(c)(2)(F) and (3)(F).
[941] Sec. 856(e)(4)(C).
[942] The requirement limiting the amount of expenditures added to basis that the REIT, or a partner of the REIT, may make within two years prior to the sale, as well as other requirements for the exclusion, are retained.

The provision also allows a TRS to make marketing expenditures with respect to property under section 857(b)(6)(C)(v) or 857(b)(6)(D)(v) without causing property that is otherwise eligible for the prohibited transaction exclusion to lose such qualification.

The provision allows a TRS to operate foreclosure property without causing loss of foreclosure property status, under section 856(e)(4)(C).

The items subject to the 100-percent excise tax on certain non-arm's-length transactions between a TRS and a REIT are expanded to include "redetermined TRS service income." Such income is defined as gross income of a TRS of a REIT attributable to services provided to, or on behalf of, such REIT (less the deductions properly allocable thereto) to the extent the amount of such income (less such deductions) would be increased on distribution, apportionment, or allocation under section 482 (but for the exception from section 482 if the 100-percent excise tax applies). The term does not include gross income attributable to services furnished or rendered to a tenant of the REIT (or deductions properly attributable thereto), since that income is already subject to a separate provision of the 100-percent excise tax rules.

Effective Date

The provision is effective for taxable years beginning after December 31, 2015.

11. Exception from FIRPTA for certain stock of REITs; exception for interests held by foreign retirement and pension funds (secs. 322 and 323 of the Act and secs. 897 and 1445 of the Code) [943]

Present Law

General rules relating to FIRPTA

A foreign person that is not engaged in the conduct of a trade or business in the United States generally is not subject to any U.S. tax on capital gain from U.S. sources, including capital gain from the sale of stock or other capital assets.[944]

However, the Foreign Investment in Real Property Tax Act of 1980 ("FIRPTA") [945] generally treats a foreign person's gain or loss from the disposition of a U.S. real property interest ("USRPI") as income that is effectively connected with the conduct of a U.S. trade or business, and thus taxable at the income tax rates applica-

[943] The Senate Committee on Finance reported S.915 on April 14, 2015 (S. Rep. No. 114–25). Section 2 of that bill contained a provision similar to section 322 of the Protecting Americans from Tax Hikes Act of 2015 (Division Q of Pub. L. No. 114–113).

[944] Secs. 871(b) and 882(a). Property is treated as held by a person for use in connection with the conduct of a trade or business in the United States, even if not so held at the time of sale, if it was so held within 10 years prior to the sale. Sec. 864(c)(7). Also, all gain from an installment sale is treated as from the sale of property held in connection with the conduct of such a trade or business if the property was so held during the year in which the installment sale was made, even if the recipient of the payments is no longer engaged in the conduct of such trade or business when the payments are received. Sec. 864(c)(6).

[945] Pub. L. No. 96–499. The rules governing the imposition and collection of tax under FIRPTA are contained in a series of provisions enacted in 1980 and subsequently amended. See secs. 897, 1445, 6039C, and 6652(f).

ble to U.S. persons, including the rates for net capital gain.[946] With certain exceptions, if a foreign corporation distributes a USRPI, gain is recognized on the distribution (including a distribution in redemption or liquidation) of a USRPI, in an amount equal to the excess of the fair market value of the USRPI (as of the time of distribution) over its adjusted basis.[947] A foreign person subject to tax on FIRPTA gain is required to file a U.S. tax return under the normal rules relating to receipt of income effectively connected with a U.S. trade or business.[948]

The payor of amounts that FIRPTA treats as effectively connected with a U.S. trade or business ("FIRPTA income") to a foreign person generally is required to withhold U.S. tax from the payment.[949] Withholding generally is 10 percent of the sales price, in the case of a direct sale by the foreign person of a USRPI (but withholding is not required in certain cases, including on any sale of stock that is regularly traded on an established securities market[950]), and 10 percent of the amount realized by the foreign shareholder in the case of certain distributions by a corporation that is or has been a U.S. real property holding corporation ("USRPHC") during the applicable testing period.[951] The withholding is generally 35 percent of the amount of a distribution to a foreign person of net proceeds attributable to the sale of a USRPI from an entity such as a partnership, REIT, or RIC.[952] The foreign person can request a refund with its U.S. tax return, if appropriate, based on that person's total U.S. effectively connected income and deductions (if any) for the taxable year.

USRPHCs and five-percent public shareholder exception

USRPIs include not only interests in real property located in the United States or the U.S. Virgin Islands, but also stock of a USRPHC, generally defined as any domestic corporation, unless the taxpayer establishes that the fair market value of the corporation's USRPIs was less than 50 percent of the combined fair market value of all its real property interests (U.S. and worldwide) and all its assets used or held for use in a trade or business, at all times during a "testing period," which is the shorter of the duration of the taxpayer's ownership of the stock after June 18, 1980, or the five-year period ending on the date of disposition of the stock.[953]

Under an exception, even if a corporation is a USRPHC, a shareholder's shares of a class of stock that is regularly traded on an established securities market are not treated as USRPIs if the shareholder holds (applying attribution rules) no more than five percent

[946] Sec. 897(a).
[947] Sec. 897(d). In addition, such gain may also be subject to the branch profits tax at a 30-percent rate (or lower treaty rate).
[948] In addition, section 6039C authorizes regulations that would require a return reporting foreign direct investments in U.S. real property interests. No such regulations have been issued, however.
[949] Sec. 1445(a).
[950] Sec. 1445(b)(6).
[951] Sec. 1445(e)(3). Withholding at 10 percent of a gross amount may also apply in certain other circumstances under regulations. See sec. 1445(e)(4) and (5).
[952] Sec. 1445(e)(6) and Treasury regulations thereunder. The Treasury Department is authorized to issue regulations that would reduce the 35 percent withholding on distributions to 20 percent during the time that the maximum income tax rate on dividends and capital gains of U.S. persons is 20 percent.
[953] Sec. 897(c)(1) and (2).

of that class of stock at any time during the testing period.[954] Among other things, the relevant attribution rules require attribution between a corporation and a shareholder that owns five percent or more in value of the stock of such corporation.[955] The attribution rules also attribute stock ownership between spouses and between children, grandchildren, parents, and grandparents.

FIRPTA rules for foreign investment through REITs and RICs

Special FIRPTA rules apply to foreign investment through a "qualified investment entity," which includes any REIT and certain RICs that invest largely in USRPIs (including stock of one or more REITs).[956]

Stock of domestically controlled qualified investment entities not a USRPI

If a qualified investment entity is "domestically controlled" (defined to mean that less than 50 percent in value of the qualified investment entity has been owned (directly or indirectly) by foreign persons during the relevant testing period[957]), stock of such entity is not a USRPI and a foreign shareholder can sell the stock of such entity without being subject to tax under FIRPTA, even if the stock would otherwise be stock of a USRPHC. Treasury regulations provide that for purposes of determining whether a REIT is domestically controlled, the actual owner of REIT shares is the "person who is required to include in his return the dividends received on the stock."[958] The IRS has issued a private letter ruling concluding that the term "directly or indirectly" for this purpose does not require looking through corporate entities that, in the facts of the ruling, were represented to be fully taxable domestic corporations for U.S. federal income tax purposes "and not otherwise a REIT, RIC, hybrid entity, conduit, disregarded entity, or other flow-through or look-through entity."[959]

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[954] Sec. 897(c)(3). The constructive ownership attribution rules are specified in section 897(c)(6)(C).

[955] If a person owns, directly or indirectly, five percent or more in value of the stock in a corporation, such person is considered as owning the stock owned directly or indirectly by or for such corporation, in that proportion which the value of the stock such person so owns bears to the value of all the stock in such corporation. Sec. 318(c)(2)(C) as modified by section 897(c)(6)(C). Also, if five percent or more in value of the stock in a corporation is owned directly or indirectly, by or for any person, such corporation shall be considered as owning the stock owned, directly or indirectly, by or for such person. Sec. 318(c)(3)(C) as modified by section 897(c)(6)(C).

[956] Sec. 897(h)(4)(A)(i). The provision including certain RICs in the definition of qualified investment entity previously expired December 31, 2014. Section 133 of the Protecting Americans from Tax Hikes Act of 2015 (Division Q of Pub. L. No. 114–113) reinstated the provision and made it permanent as of January 1, 2015, as described above in item 22 of Title I.A.

[957] The testing period for this purpose if the shorter of (i) the period beginning on June 19, 1980, and ending on the date of disposition or distribution, as the case may be, (ii) the five-year period ending on the date of the disposition or distribution, as the case may be, or (iii) the period during which the qualified investment entity was in existence. Sec. 897(h)(4)(D).

[958] Treas. Reg. sec. 1.897–1(c)(2)(i) and –8(b).

[959] PLR 200923001. A private letter ruling may be relied upon only by the taxpayer to which it is issued. However, private letter rulings provide some indication of administrative practice.

FIRPTA applies to qualified investment entity (REIT and certain RIC) distributions attributable to gain from sale or exchange of USRPIs, except for distributions to certain five-percent or smaller shareholders

A distribution by a REIT or other qualified investment entity, to the extent attributable to gain from the entity's sale or exchange of USRPIs, is treated as FIRPTA income.[960] The FIRPTA character is retained if the distribution occurs from one qualified investment entity to another, through a tier of REITs or RICs.[961] An IRS notice (Notice 2007–55) states that this rule retaining the FIRPTA income character of distributions attributable to the sale of USRPIs applies to any distributions under sections 301, 302, 331, and 332 (i.e., to dividend distributions, distributions treated as sales or exchanges of stock by the investor, and both nonliquidating and liquidating distributions) and that the IRS will issue regulations to that effect.[962]

There is an exception to this rule in the case of distributions to certain public shareholders. If an investor has owned no more than five percent of a class of stock of a REIT or other qualified investment entity that is regularly traded on an established securities market located in the United States during the one-year period ending on the date of the distribution, then amounts attributable to gain from entity sales or exchanges of USRPIs can be distributed to such a shareholder without being subject to FIRPTA tax.[963] Such distributions that are dividends are treated as dividends from the qualified investment entity,[964] and thus generally would be subject to U.S. dividend withholding tax (as reduced under any applicable treaty), but are not treated as income effectively connected with the conduct of a U.S. trade or business. An IRS Chief Counsel advice memorandum concludes that such distributions which are made in complete liquidation of a REIT are not treated as dividends from the qualified investment entity and thus generally would not be subject to U.S. dividend withholding tax (in addition to not being treated as income effectively connected with the conduct of a U.S. trade or business).[965]

Explanation of Provision

Exception from FIRPTA for certain REIT stock

In the case of REIT stock only, the provision increases from five percent to 10 percent the maximum stock ownership a shareholder may have held, during the testing period, of a class of stock that is publicly traded, to avoid having that stock be treated as a USRPI on disposition.

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[960] Sec. 897(h)(1).

[961] In 2006, the Tax Increase Prevention and Reconciliation Act of 2005 ("TIPRA"), Pub. L. No. 109–222, sec. 505, specified the retention of this FIRPTA character on a distribution to an upper-tier qualified investment entity, and added statutory withholding requirements.

[962] Notice 2007–55, 2007–2 C.B.13. The Notice also states that in the case of a foreign government investor, because FIRPTA income is treated as effectively connected with the conduct of a U.S. trade or business, proceeds distributed by a qualified investment entity from the sale of USRPIs are not exempt from tax under section 892. The Notice cites and compares existing temporary regulations and indicates that Treasury will apply those regulations as well to certain distributions. See Temp. Treas. Reg. secs. 1.892–3T, 1.897–9T(e), and 1.1445–10T(b).

[963] Sec. 897(h)(1), second sentence.

[964] Secs. 852(b)(3)(E) and 857(b)(3)(F).

[965] AM 2008–003, February 15, 2008.

The provision likewise increases from five percent to 10 percent the percentage ownership threshold that, if not exceeded, results in treating a distribution to holders of publicly traded REIT stock, attributable to gain from sales of exchanges of USRPIs, as a dividend, rather than as FIRPTA gain.

The attribution rules of section 897(c)(6)(C) retain the present-law rule that requires attribution between a shareholder and a corporation if the shareholder owns more than five percent of a class of stock of the corporation. The attribution rules now apply, however, to the determination of whether a person holds more than 10 percent of a class of publicly traded REIT stock.

The provision also provides that REIT stock held by a qualified shareholder, including stock held indirectly through one or more partnerships, is not a U.S real property interest in the hands of such qualified shareholder, except to the extent that an investor in the qualified shareholder (other than an investor that is a qualified shareholder) holds more than 10 percent of that class of stock of the REIT (determined by application of the constructive ownership rules of section 897(c)(6)(C)). Thus, so long as the "more than 10 percent" rule is not exceeded, a qualified shareholder may own and dispose of any amount of stock of a REIT (including stock of a privately-held, non-domestically controlled REIT that is owned by such qualified shareholder) without the application of FIRPTA.

If an investor in the qualified shareholder (other than an investor that is a qualified shareholder) directly, indirectly, or constructively holds more than 10 percent of such class of REIT stock (an "applicable investor"), then a percentage of the REIT stock held by the qualified shareholder equal to the applicable investor's percentage ownership of the qualified shareholder is treated as a USRPI in the hands of the qualified shareholder and is subject to FIRPTA. In that case, an amount equal to such percentage multiplied by the disposition proceeds and REIT distribution proceeds attributable to underlying USRPI gain is treated as FIRPTA gain in the hands of the qualified shareholder.

The provision is intended to override in certain cases one of the conclusions reached in AM 2008–003. Specifically, the provision contains special rules with respect to certain distributions that are treated as a sale or exchange of REIT stock under section 301(c)(3), 302, or 331 with respect to a qualified shareholder. Any such amounts attributable to an applicable investor are ineligible for the FIRPTA exception for qualified shareholders, and thus are subject to FIRPTA. Any such amounts attributable to other investors are treated as a dividend received from a REIT for purposes of U.S. dividend withholding tax and the application of income tax treaties, notwithstanding their general treatment under the Code.

A qualified shareholder is defined as a foreign person that (i) either is eligible for the benefits of a comprehensive income tax treaty which includes an exchange of information program and whose principal class of interests is listed and regularly traded on one or more recognized stock exchanges (as defined in such comprehensive income tax treaty), or is a foreign partnership that is created or organized under foreign law as a limited partnership in a jurisdiction that has an agreement for the exchange of information with respect to taxes with the United States and has a class of limited partnership units representing greater than 50 percent of the value of all the partnership units that is regularly traded on the NYSE or NASDAQ markets, (ii) is a qualified collective investment vehicle (as defined below), and (iii) maintains records on the identity of each person who, at any time during the foreign person's taxable year, is the direct owner of 5 percent or more of the class of interests or units (as applicable) described in (i), above.

A qualified collective investment vehicle is defined as a foreign person that (i) would be eligible for a reduced rate of withholding under the comprehensive income tax treaty described above, even if such entity holds more than 10 percent of the stock of such REIT,[966] (ii) is publicly traded, is treated as a partnership under the Code, is a withholding foreign partnership, and would be treated as a USRPHC if it were a domestic corporation, or (iii) is designated as such by the Secretary of the Treasury and is either (a) fiscally transparent within the meaning of section 894, or (b) required to include dividends in its gross income, but is entitled to a deduction for distributions to its investors.

The provision also contains rules with respect to partnership allocations of USRPI gains to applicable investors. If an applicable investor's proportionate share of USRPI gain for the taxable year exceeds such partner's distributive share of USRPI gain for the taxable year then such partner's distributive share of non-USRPI income or gain is recharacterized as USRPI gain for the taxable year in the amount that the distributive share of USRPI gain exceeds the proportionate share of USRPI gain. For purposes of these partnership allocation rules, USRPI gain is defined to comprise the net of gain recognized on disposition of a USRPI, distributions from a REIT that are treated as USRPI gain, and loss from the disposition of USRPIs. An investor's proportionate share of USRPI gain is determined based on the applicable investor's largest proportionate share of income or gain for the taxable year, and if such proportionate amount may vary during the existence of the partnership, such share is the highest share the applicable investor may receive.

Domestically controlled qualified investment entity

The provision redefines the term "domestically controlled qualified investment entity" to provide a number of new rules and presumptions relating to whether a qualified investment entity is domestically controlled. First, a qualified investment entity shall be permitted to presume that holders of less than five percent of a class of stock regularly traded on an established securities market in the United States are U.S. persons throughout the testing period, except to the extent that the qualified investment entity has actual knowledge that such persons are not U.S. persons. Second, any stock in the qualified investment entity held by another qualified investment entity (I) which has issued any class of stock that is regularly traded on an established stock exchange, or (II) which is a RIC that issues redeemable securities (within the meaning of section 2 of the Investment Company Act of 1940) shall be treated

[966] The qualified collective investment vehicle must be eligible for a reduced rate of withholding under a provision in the dividends article of the relevant treaty dealing specifically with dividends paid by REITs. For example, the U.S. income tax treaties with Australia and the Netherlands provide such a reduced rate of withholding under certain circumstances.

as held by a foreign person unless such other qualified investment entity is domestically controlled (as determined under the new rules) in which case such stock shall be treated as held by a U.S. person. Finally, any stock in a qualified investment entity held by any other qualified investment entity not described in (I) or (II) of the preceding sentence shall only be treated as held by a U.S. person to the extent that the stock of such other qualified investment entity is (or is treated under the new provision as) held by a U.S. person.

Exception for interests held by foreign retirement and pension funds

The provision exempts from the rules of section 897 any USRPI held directly (or indirectly through one or more partnerships) by, or to any distribution received from a real estate investment trust by, a qualified foreign pension fund or by a foreign entity wholly-owned by a qualified foreign pension fund. A qualified foreign pension fund means any trust, corporation, or other organization or arrangement [967] (A) which is created or organized under the law of a country other than the United States, (B) which is established to provide retirement or pension benefits to participants or beneficiaries that are current or former employees (or persons designated by such employees) of one or more employers in consideration for services rendered,[968] (C) which does not have a single participant or beneficiary with a right to more than five percent of its assets or income, (D) which is subject to government regulation and provides annual information reporting about its beneficiaries to the relevant tax authorities in the country in which it is established or operates, and (E) with respect to which, under the laws of the country in which it is established or operates, (i) contributions to such organization or arrangement that would otherwise be subject to tax under such laws are deductible or excluded from the gross income of such entity or taxed at a reduced rate, or (ii) taxation of any investment income of such organization or arrangement is deferred or such income is taxed at a reduced rate.

The provision also makes conforming changes to section 1445 to eliminate withholding on sales by qualified foreign pension funds (and their wholly-owned foreign subsidiaries) of USRPIs.

The Secretary of the Treasury may provide such regulations as are necessary to carry out the purposes of the provision.

Effective Date

The provision to extend exceptions from FIRPTA for certain REIT stock applies to dispositions and distributions on or after the date of enactment (December 18, 2015).

The provision to modify the definition of a domestically controlled qualified investment entity is effective on the date of enactment (December 18, 2015).

[967] Foreign pension funds may be structured in a variety of ways, and may comprise one or more separate entities. The word "arrangement" encompasses such alternative structures.

[968] Multi-employer and government-sponsored public pension funds that provide pension and pension-related benefits may satisfy this prong of the definition. For example, such pension funds may be established for one or more companies or professions, or for the general working public of a foreign country.

The exception for interests held by foreign retirement and pension funds generally applies to dispositions and distributions after the date of enactment (December 18, 2015).

12. Increase in rate of withholding of tax on dispositions of United States real property interests (sec. 324 of the Act and sec. 1445 of the Code)[969]

Present Law

A purchaser of a USRPI from any person is obligated to withhold 10 percent of gross purchase price unless certain exceptions apply.[970] The obligation does not apply if the transferor furnishes an affidavit that the transferor is not a foreign person. Even absent such an affidavit, the obligation does not apply to the purchase of publicly traded stock.[971] Also, the obligation does not apply to the purchase of stock of a nonpublicly traded domestic corporation, if the corporation furnishes the transferee with an affidavit stating the corporation is not and has not been a USRPHC during the applicable period (unless the transferee has actual knowledge or receives a notification that the affidavit is false).[972]

Treasury regulations[973] generally provide that a domestic corporation must, within a reasonable period after receipt of a request from a foreign person holding an interest in it, inform that person whether the interest constitutes a USRPI.[974] No particular form is required. The statement must be dated and signed by a responsible corporate officer who must verify under penalties of perjury that the statement is correct to his knowledge and belief. If a foreign investor requests such a statement, then the corporation must provide a notice to the IRS that includes the name and taxpayer identification number of the corporation as well as the investor, and indicates whether the interest in question is a USRPI. However, these requirements do not apply to a domestically controlled REIT or to a corporation that has issued any class of stock which is regularly traded on an established securities market at any time during the calendar year. In such cases a corporation may voluntarily choose to comply with the notice requirements that would otherwise have applied.[975]

In addition to these exceptions that might be determined at the entity level, even if a corporation is a USRPHC, its stock is not a USRPI in the hands of the seller if the stock is of a class that is publicly traded and the foreign shareholder disposing of the stock has not owned (applying attribution rules) more than five percent of such class of stock during the relevant period.

[969] The Senate Committee on Finance reported S.915 on April 14, 2015 (S. Rep. No. 114–25). Section 3 of that bill contained an identical provision.

[970] Sec. 1445.

[971] Sec. 1445(b)(6).

[972] Sec. 1445(b)(3). Other exceptions also apply. Sec. 1445(b).

[973] Treas. Reg. Sec. 1.897–2(h).

[974] As described previously, stock of a U.S. corporation is not generally a USRPI unless it is stock of a USRPHC. However, all U.S. corporate stock is deemed to be such stock, unless it is shown that the corporation's U.S. real property interests do not amount to the relevant 50 percent or more of the corporation's relevant assets. Also, even if a REIT is a USRPHC, if it is domestically controlled its stock is not a USRPI.

[975] Treas. Reg. sec. 1.897–2(h)(3).

Explanation of Provision

The provision generally increases the rate of withholding of tax on dispositions and certain distributions of URSPIs, from 10 percent to 15 percent. There is an exception to this higher rate of withholding (retaining the 10 percent withholding tax rate under present law) for sales of residences intended for personal use by the acquirer, with respect to which the purchase price does not exceed $1,000,000. Thus, if the present law exception for personal residences (where the purchase price does not exceed $300,000) does not apply, the 10 percent withholding rate is retained so long as the purchase price does not exceed $1,000,000.

Effective Date

The provision applies to dispositions after the date which is 60 days after the date of enactment (December 18, 2015).

13. Interests in RICs and REITs not excluded from definition of United States real property interests (sec. 325 of the Act and sec. 897 of the Code)[976]

Present Law

An interest in a corporation is not a USRPI if (1) as of the date of disposition of such interest, such corporation did not hold any USRPIs and (2) all of the USRPIs held by such corporation during the shorter of (i) the period of time after June 18, 1980, during which the taxpayer held such interest, or (ii) the five-year period ending on the date of disposition of such interest, were either disposed of in transactions in which the full amount of the gain (if any) was recognized, or ceased to be USRPIs by reason of the application of this rule to one or more other corporations (the so-called "cleansing rule").[977]

Explanation of Provision

Under the provision, the cleansing rule applies to stock of a corporation only if neither such corporation nor any predecessor of such corporation was a RIC or a REIT at any time during the shorter of the period after June 18, 1980 during which the taxpayer held such stock, or the five-year period ending on the date of the disposition of such stock.

Effective Date

The provision applies to dispositions on or after the date of enactment (December 18, 2015).

[976] The Senate Committee on Finance reported S.915 on April 14, 2015 (S. Rep. No. 114–25). Section 6 of that bill contained an identical provision.
[977] Sec. 897(c)(1)(B).

14. Dividends derived from RICs and REITs ineligible for deduction for United States source portion of dividends from certain foreign corporations (sec. 326 of the Act and sec. 245 of the Code) [978]

Present Law

A corporation is generally allowed to deduct a portion of the dividends it receives from another corporation. The deductible amount is a percentage of the dividends received. The percentage depends on the level of ownership that the corporate shareholder has in the corporation paying the dividend. The dividends-received deduction is 70 percent of the dividend if the recipient owns less than 20 percent of the stock of the payor corporation, 80 percent if the recipient owns at least 20 percent but less than 80 percent of the stock of the payor corporation, and 100 percent if the recipient owns 80 percent or more of the stock of the payor corporation.[979]

Dividends from REITs are not eligible for the corporate dividends received deduction.[980] Dividends from a RIC are eligible only to the extent attributable to dividends received by the RIC from certain other corporations, and are treated as dividends from a corporation that is not 20-percent owned.[981]

Dividends received from a foreign corporation are not generally eligible for the dividends-received deduction. However, section 245 provides that if a U.S. corporation is a 10-percent shareholder of a foreign corporation, the U.S. corporation is generally entitled to a dividends-received deduction for the portion of dividends received that are attributable to the post-1986 undistributed U.S. earnings of the foreign corporation. The post-1986 undistributed U.S. earnings are measured by reference to earnings of the foreign corporation effectively connected with the conduct of a trade or business within the United States, or received by the foreign corporation from an 80-percent-owned U.S. corporation.[982] A 2013 IRS chief counsel advice memorandum advised that dividends received by a 10-percent U.S. corporate shareholder from a foreign corporation controlled by the shareholder are not eligible for the dividends-received deduction if the dividends were attributable to interest income of an 80-percent owned RIC.[983] Treasury regulations section 1.246–1 states that the deductions provided in sections "243 . . . 244 . . . and 245 (relating to dividends received from certain foreign corporations)" are not allowable with respect to any dividend received from certain entities, one of which is a REIT.

[978] The Senate Committee on Finance reported S.915 on April 14, 2015 (S. Rep. No. 114–25). Section 7 of that bill contained an identical provision.

[979] Sec. 243.

[980] Secs. 243(d)(3) and 857(c)(1).

[981] Secs. 243(d)(2) and 854(b)(1)(A) and (C).

[982] Sec. 245

[983] IRS CCA 201320014. The situation addressed in the memorandum involved a controlled foreign corporation that had terminated its "CFC" status before year end, through a transfer of stock to a partnership. The advice was internal IRS advice to the Large Business and International Division. Such advice is not to be relied upon or cited as precedent by taxpayers, but may offer some indication of administrative practice.

Explanation of Provision

Under the provision, for purposes of determining whether dividends from a foreign corporation (attributable to dividends from an 80-percent owned domestic corporation) are eligible for a dividends-received deduction under section 245, dividends from RICs and REITs are not treated as dividends from domestic corporations.

Effective Date

The provision applies to dividends received from RICs and REITs on or after the date of enactment (December 18, 2015). No inference is intended with respect to the proper treatment under section 245 of dividends received from RICs or REITs before such date.

C. Additional Provisions

1. Provide special rules concerning charitable contributions to, and public charity status of, agricultural research organizations (sec. 331 of the Act and secs. 170(b) and 501(h) of the Code)[984]

Present Law

Public charities and private foundations

An organization qualifying for tax-exempt status under section 501(c)(3) of the Internal Revenue Code of 1986, as amended (the "Code") is further classified as either a public charity or a private foundation. An organization may qualify as a public charity in several ways.[985] Certain organizations are classified as public charities per se, regardless of their sources of support. These include churches, certain schools, hospitals and other medical organizations (including medical research organizations), certain organizations providing assistance to colleges and universities, and governmental units.[986] Other organizations qualify as public charities because they are broadly publicly supported or support specific public charities. First, a charity may qualify as publicly supported if at least one-third of its total support is from gifts, grants or other contributions from governmental units or the general public.[987] Alternatively, it may qualify as publicly supported if it receives more than one-third of its total support from a combination of gifts, grants, and contributions from governmental units and the public plus revenue arising from activities related to its exempt purposes (*e.g.*, fee for service income). In addition, this category of public charity must not rely excessively on endowment income as a source of support.[988] A supporting organization, i.e., an organization that

[984] The Senate Committee on Finance reported S. 906 on April 14, 2015 (S. Rep. No. 114–19).

[985] The Code does not expressly define the term "public charity," but rather provides exceptions to those entities that are treated as private foundations.

[986] Sec. 509(a)(1) (referring to sections 170(b)(1)(A)(i) through (iv) for a description of these organizations).

[987] Treas. Reg. sec. 1.170A–9(f)(2). Failing this mechanical test, the organization may qualify as a public charity if it passes a "facts and circumstances" test. Treas. Reg. sec. 1.170A–9(f)(3).

[988] To meet this requirement, the organization must normally receive more than one-third of its support from a combination of (1) gifts, grants, contributions, or membership fees and (2) certain gross receipts from admissions, sales of merchandise, performance of services, and fur-

Continued

COMMITTEE ON
WAYS AND MEANS
CHAIRMAN KEVIN BRADY

SECTION-BY-SECTION SUMMARY OF THE PROPOSED "PROTECTING AMERICANS FROM TAX HIKES ACT OF 2015"

TITLE I – EXTENDERS

Subtitle A –Permanent Extensions

PART 1 – Tax Relief for Families and Individuals

Section 101. Enhanced child tax credit made permanent. The child tax credit (CTC) is a $1,000 credit. To the extent the CTC exceeds the taxpayer's tax liability, the taxpayer is eligible for a refundable credit (the additional child tax credit) equal to 15 percent of earned income in excess of a threshold dollar amount (the "earned income" formula). Until 2009, the threshold dollar amount was $10,000 indexed for inflation from 2001 (which would be roughly $14,000 in 2015). Since 2009, however, this threshold amount has been set at an unindexed $3,000 and is scheduled to expire at the end of 2017, returning to the $10,000 (indexed for inflation) amount. The provision permanently sets the threshold amount at an unindexed $3,000.

Section 102. Enhanced American opportunity tax credit made permanent. The Hope Scholarship Credit is a credit of $1,800 (indexed for inflation) for various tuition and related expenses for the first two years of post-secondary education. It phases out for AGI starting at $48,000 (if single) and $96,000 (if married filing jointly) – these amounts are also indexed for inflation. The American Opportunity Tax Credit (AOTC) takes those permanent provisions of the Hope Scholarship Credit and increases the credit to $2,500 for four years of post-secondary education, and increases the beginning of the phase-out amounts to $80,000 (single) and $160,000 (married filing jointly) for 2009 to 2017. The provision makes the AOTC permanent.

Section 103. Enhanced earned income tax credit made permanent. Low- and moderate-income workers may be eligible for the earned income tax credit (EITC). For 2009 through 2017, the EITC amount has been temporarily increased for those with three (or more) children and the EITC marriage penalty has been reduced by increasing the income phase-out range by $5,000 (indexed for inflation) for those who are married and filing jointly. The provision makes these provisions permanent.

Section 104. Extension and modification of deduction for certain expenses of elementary and secondary school teachers. The provision permanently extends the above-the-line deduction (capped at $250) for the eligible expenses of elementary and secondary school teachers. Beginning in 2016, the provision also modifies the deduction to index the $250 cap to inflation and include professional development expenses.

Section 105. Extension of parity for exclusion from income for employer-provided mass transit and parking benefits. The provision permanently extends the maximum monthly exclusion amount for transit passes and van pool benefits so that these transportation benefits match the exclusion for qualified parking benefits. These fringe benefits are excluded from an employee's wages for payroll tax purposes and from gross income for income tax purposes.

Section 106. Extension of deduction of State and local general sales taxes. The provision permanently extends the option to claim an itemized deduction for State and local general sales taxes in lieu of an itemized deduction for State and local income taxes. The taxpayer may either deduct the actual amount of sales tax paid in the tax year, or alternatively, deduct an amount prescribed by the Internal Revenue Service (IRS).

PART 2 – Incentives for Charitable Giving

Section 111. Extension and modification of special rule for contributions of capital gain real property made for conservation purposes. The provision permanently extends the charitable deduction for contributions of real property for conservation purposes. The provision also permanently extends the enhanced deduction for certain individual and corporate farmers and ranchers. The provision modifies the deduction beginning in 2016 to permit Alaska Native Corporations to deduct donations of conservation easements up to 100 percent of taxable income.

Section 112. Extension of tax-free distributions from individual retirement plans for charitable purposes. The provision permanently extends the ability of individuals at least 70½ years of age to exclude from gross income qualified charitable distributions from Individual Retirement Accounts (IRAs). The exclusion may not exceed $100,000 per taxpayer in any tax year.

Section 113. Extension and modification of charitable deduction for contributions of food inventory. The provision permanently extends the enhanced deduction for charitable contributions of inventory of apparently wholesome food for non-corporate business taxpayers. The provision modifies the deduction beginning in 2016 by increasing the limitation on deductible contributions of food inventory from 10 percent to 15 percent of the taxpayer's AGI (15 percent of taxable income (as modified by the provision) in the case of a C corporation) per year. The provision also modifies the deduction to provide special rules for valuing food inventory.

Section 114. Extension of modification of tax treatment of certain payments to controlling exempt organizations. The provision permanently extends the modification of the tax treatment of certain payments by a controlled entity to an exempt organization.

Section 115. Extension of basis adjustment to stock of S corporations making charitable contributions of property. The provision permanently extends the rule providing that a shareholder's basis in the stock of an S corporation is reduced by the shareholder's pro rata share of the adjusted basis of property contributed by the S corporation for charitable purposes.

PART 3 – Incentives for Growth, Jobs, Investment, and Innovation

Section 121. Extension and modification of research credit. The provision permanently extends the research and development (R&D) tax credit. Additionally, beginning in 2016 eligible small businesses ($50 million or less in gross receipts) may claim the credit against alternative minimum tax (AMT) liability, and the credit can be utilized by certain small businesses against the employer's payroll tax (i.e., FICA) liability.

Section 122. Extension and modification of employer wage credit for employees who are active duty members of the uniformed services. The provision permanently extends the 20-percent employer wage credit for employees called to active military duty. Beginning in 2016, the provision modifies the credit to apply to employers of any size, rather than employers with 50 or fewer employees, as under current law.

Section 123. Extension of 15-year straight-line cost recovery for qualified leasehold improvements, qualified restaurant buildings and improvements, and qualified retail improvements. The provision permanently extends the 15-year recovery period for qualified leasehold improvements, qualified restaurant property, and qualified retail improvement property.

Section 124. Extension and modification of increased expensing limitations and treatment of certain real property as section 179 property. The provision permanently extends the small business expensing limitation and phase-out amounts in effect from 2010 to 2014 ($500,000 and $2 million, respectively). These amounts currently are $25,000 and $200,000, respectively. The special rules that allow expensing for computer software and qualified real property (qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property) also are permanently extended. The provision modifies the expensing limitation by indexing both the $500,000 and $2 million limits for inflation beginning in 2016 and by treating air conditioning and heating units placed in service in tax years beginning after 2015 as eligible for expensing. The provision further modifies the expensing limitation with respect to qualified real property by eliminating the $250,000 cap beginning in 2016.

Section 125. Extension of treatment of certain dividends of regulated investment companies. The provision permanently extends provisions allowing for the pass-through character of interest-related dividends and short-term capital gains dividends from regulated investment companies (RICs) to foreign investors.

Section 126. Extension of exclusion of 100 percent of gain on certain small business stock. The provision extends the temporary exclusion of 100 percent of the gain on certain small business stock for non-corporate taxpayers to stock acquired and held for more than five years. This provision also permanently extends the rule that eliminates such gain as an AMT preference item.

Section 127. Extension of reduction in S-corporation recognition period for built-in gains tax. The provision permanently extends the rule reducing to five years (rather than ten years) the period for which an S corporation must hold its assets following conversion from a C corporation to avoid the tax on built-in gains.

Section 128. Extension of subpart F exception for active financing income. The provision permanently extends the exception from subpart F income for active financing income.

PART 4 – Incentives for Real Estate Investment

Section 131. Extension of temporary minimum low-income housing tax credit rates for non-Federally subsidized buildings. The provision permanently extends application of the 9-percent minimum credit rate for the low-income housing tax credit for non-Federally subsidized new buildings.

Section 132. Extension of military housing allowance exclusion for determining whether a tenant in certain counties is low-income. The provision permanently extends the exclusion of military basic housing allowances from the calculation of income for determining eligibility as a low-income tenant for purposes of low-income housing tax credit buildings.

Section 133. Extension of RIC qualified investment entity treatment under FIRPTA. The provision permanently extends the treatment of RICs as qualified investment entities and, therefore, not subject to withholding under the Foreign Investment in Real Property Tax Act (FIRPTA).

Subtitle B – Extensions through 2019

Section 141. Extension of new markets tax credit. The provision authorizes the allocation of $3.5 billion of new markets tax credits for each year from 2015 through 2019.

Section 142. Extension and modification of work opportunity tax credit. The provision extends through 2019 the work opportunity tax credit. The provision also modifies the credit beginning in 2016 to apply to employers who hire qualified long-term unemployed individuals (i.e., those who have been unemployed for 27 weeks or more) and increases the credit with respect to such long-term unemployed individuals to 40 percent of the first $6,000 of wages.

Section 143. Extension and modification of bonus depreciation. The provision extends bonus depreciation for property acquired and placed in service during 2015 through 2019 (with an additional year for certain property with a longer production period). The bonus depreciation percentage is 50 percent for property placed in service during 2015, 2016 and 2017 and phases down, with 40 percent in 2018, and 30 percent in 2019. The provision continues to allow taxpayers to elect to accelerate the use of AMT credits in lieu of bonus depreciation under special rules for property placed in service during 2015. The provision modifies the AMT rules beginning in 2016 by increasing the amount of unused AMT credits that may be claimed in lieu of bonus depreciation. The provision also modifies bonus depreciation to include qualified improvement property and to permit certain trees, vines, and plants bearing fruit or nuts to be eligible for bonus depreciation when planted or grafted, rather than when placed in service.

Section 144. Extension of look-thru treatment of payments between related controlled foreign corporations under foreign personal holding company rules. The provision extends through 2019 the look-through treatment for payments of dividends, interest, rents, and royalties between related controlled foreign corporations.

Subtitle C – Extensions through 2016

PART 1 – Tax Relief for Families and Individuals

Section 151. Extension and modification of exclusion from gross income of discharge of qualified principal residence indebtedness. The provision extends through 2016 the exclusion from gross income of a discharge of qualified principal residence indebtedness. The provision also modifies the exclusion to apply to qualified principal residence indebtedness that is discharged in 2017, if the discharge is pursuant to a written agreement entered into in 2016.

Section 152. Extension of mortgage insurance premiums treated as qualified residence interest. The provision extends through 2016 the treatment of qualified mortgage insurance premiums as interest for purposes of the mortgage interest deduction. This deduction phases out ratably for a taxpayer with AGI of $100,000 to $110,000.

Section 153. Extension of above-the-line deduction for qualified tuition and related expenses. The provision extends through 2016 the above-the-line deduction for qualified tuition and related expenses for higher education. The deduction is capped at $4,000 for an individual whose AGI does not exceed $65,000 ($130,000 for joint filers) or $2,000 for an individual whose AGI does not exceed $80,000 ($160,000 for joint filers).

PART 2 – Incentives for Growth, Jobs, Investment, and Innovation

Section 161. Extension of Indian employment tax credit. The provision extends through 2016 the Indian employment tax credit. The Indian employment credit provides a credit on the first $20,000 of qualified wages paid to each qualified employee who works on an Indian reservation.

Section 162. Extension and modification of railroad track maintenance credit. The provision extends through 2016 the railroad track maintenance tax credit. The provision modifies the credit to apply to expenditures for maintaining railroad track owned or leased as of January 1, 2015 (rather than January 1, 2005, as under current law).

Section 163. Extension of mine rescue team training credit. The provision extends through 2016 the mine rescue team training tax credit. Employers may take a credit equal to the lesser of 20 percent of the training program costs incurred, or $10,000.

Section 164. Extension of qualified zone academy bonds. The provision authorizes the issuance of $400 million of qualified zone academy bonds during 2016. The bond proceeds are used for school renovations, equipment, teacher training, and course materials at a qualified zone academy, provided that private entities have promised to donate certain property and services to the academy with a value equal to at least 10 percent of the bond proceeds.

Section 165. Extension of classification of certain race horses as 3-year property. The provision extends the 3-year recovery period for race horses to property placed in service during 2015 or 2016.

Section 166. Extension of 7-year recovery period for motorsports entertainment complexes. The provision extends the 7-year recovery period for motorsport entertainment complexes to property placed in service during 2015 or 2016.

Section 167. Extension and modification of accelerated depreciation for business property on an Indian reservation. The provision extends accelerated depreciation for qualified Indian reservation property to property placed in service during 2015 or 2016. The provision also modifies the deduction to permit taxpayers to elect out of the accelerated depreciation rules.

Section 168. Extension of election to expense mine safety equipment. The provision extends the election to expense mine safety equipment to property placed in service during 2015 or 2016.

Section 169. Extension of special expensing rules for certain film and television productions. The provision extends through 2016 the special expensing provision for qualified film, television, and live theater productions. In general, only the first $15 million of costs may be expensed.

Section 170. Extension of deduction allowable with respect to income attributable to domestic production activities in Puerto Rico. The provision extends through 2016 the eligibility of domestic gross receipts from Puerto Rico for the domestic production deduction.

Section 171. Extension and modification of empowerment zone tax incentives. The provision extends through 2016 the tax benefits for certain businesses and employers operating in empowerment zones. Empowerment zones are economically distressed areas, and the tax benefits available include tax-exempt bonds, employment credits, increased expensing, and gain exclusion from the sale of certain small-business stock. The provision modifies the incentive beginning in 2016 by allowing employees to meet the enterprise zone facility bond employment requirement if they are residents of the empowerment zone, an enterprise community, or a qualified low-income community within an applicable nominating jurisdiction.

Section 172. Extension of temporary increase in limit on cover over of rum excise taxes to Puerto Rico and the Virgin Islands. The provision extends the $13.25 per proof gallon excise tax cover-over amount paid to the treasuries of Puerto Rico and the U.S. Virgin Islands to rum imported into the United States during 2015 or 2016. Absent the extension, the cover-over amount would be $10.50 per proof gallon.

Section 173. Extension of American Samoa economic development credit. The provision extends through 2016 the existing credit for taxpayers currently operating in American Samoa.

Section 174. Moratorium on medical device excise tax. The provision provides for a two-year moratorium on the 2.3-percent excise tax imposed on the sale of medical devices. The tax will not apply to sales during calendar years 2016 and 2017.

PART 3 – Incentives for Energy Production and Conservation

Section 181. Extension and modification of credit for nonbusiness energy property. The provision extends through 2016 the credit for purchases of nonbusiness energy property. The provision allows a credit of 10 percent of the amount paid or incurred by the taxpayer for qualified energy improvements, up to $500.

Section 182. Extension of credit for alternative fuel vehicle refueling property. The provision extends through 2016 the credit for the installation of non-hydrogen alternative fuel vehicle refueling property. (Under current law, hydrogen-related property is eligible for the credit through 2016.) Taxpayers are allowed a credit of up to 30 percent of the cost of the installation of the qualified alternative fuel vehicle refueling property.

Section 183. Extension of credit for 2-wheeled plug-in electric vehicles. The provision extends through 2016 the 10-percent credit for plug-in electric motorcycles and 2-wheeled vehicles (capped at $2,500).

Section 184. Extension of second generation biofuel producer credit. The provision extends through 2016 the credit for cellulosic biofuels producers.

Section 185. Extension of biodiesel and renewable diesel incentives. The provision extends through 2016 the existing $1.00 per gallon tax credit for biodiesel and biodiesel mixtures, and the small agri-biodiesel producer credit of 10 cents per gallon. The provision also extends through 2016 the $1.00 per gallon production tax credit for diesel fuel created from biomass. The provision extends through 2016 the fuel excise tax credit for biodiesel mixtures.

Section 186. Extension and modification of production credit for Indian coal facilities. The provision extends through 2016 the $2 per ton production tax credit for coal produced on land owned by an Indian tribe, if the facility was placed in service before 2009. A coal facility is allowed only nine years of credit. The provision modifies the credit beginning in 2016 by removing the placed-in-service-date limitation, removing the nine-year limitation, and allowing the credit to be claimed against the AMT.

Section 187. Extension and modification of credits with respect to facilities producing energy from certain renewable resources. The provision extends the production tax credit for certain renewable sources of electricity to facilities for which construction has commenced by the end of 2016.

Section 188. Extension of credit for energy-efficient new homes. The provision extends through 2016 the tax credit for manufacturers of energy-efficient residential homes. An eligible contractor may claim a tax credit of $1,000 or $2,000 for the construction or manufacture of a new energy efficient home that meets qualifying criteria.

Section 189. Extension of special allowance for second generation biofuel plant property. The provision extends through 2016 the 50-percent bonus depreciation for cellulosic biofuel facilities.

Section 190. Extension of energy efficient commercial buildings deduction. The provision extends through 2016 the above-the-line deduction for energy efficiency improvements to lighting, heating, cooling, ventilation, and hot water systems of commercial buildings.

Section 191. Extension of special rule for sales or dispositions to implement FERC or State electric restructuring policy for qualified electric utilities. The provision extends through 2016 a rule that permits taxpayers to elect to recognize gain from qualifying electric transmission transactions ratably over an eight-year period beginning in the year of sale (rather than entirely in the year of sale) if the amount realized from such sale is used to purchase exempt utility property within the applicable period.

Section 192. Extension of excise tax credits relating to alternative fuels. The provision extends through 2016 the 50 cents per gallon alternative fuel tax credit and alternative fuel mixture tax credit.

Section 193. Extension of credit for new qualified fuel cell motor vehicles. The provision extends through 2016 the credit for purchases of new qualified fuel cell motor vehicles. The provision allows a credit of between $4,000 and $40,000 depending on the weight of the vehicle for the purchase of such vehicles.

TITLE II – PROGRAM INTEGRITY

Section 201. Modification of filing dates of returns and statements relating to employee wage information and nonemployee compensation to improve compliance. The provision requires forms W-2, W-3, and returns or statements to report non-employee compensation (e.g., Form 1099-MISC), to be filed on or before January 31 of the year following the calendar year to which such returns relate. The provision also provides additional time for the IRS to review refund claims based on the earned income tax credit and the refundable portion of the child tax credit in order to reduce fraud and improper payments. The provision is effective for returns and statements relating to calendar years after the date of enactment (e.g., filed in 2017).

Section 202. Safe harbor for de minimis errors on information returns and payee statements. The provision establishes a safe harbor from penalties for the failure to file correct information returns and for failure to furnish correct payee statements by providing that if the error is $100 or less ($25 or less in the case of errors involving tax withholding), the issuer of the information return is not required to file a corrected return and no penalty is imposed. A recipient of such a return (e.g., an employee who receives a Form W-2) can elect to have a corrected return issued to them and filed with the IRS. The provision is effective for returns and statements required to be filed after December 31, 2016.

Section 203. Requirements for the issuance of ITINs. The provision provides that the IRS may issue taxpayer identification numbers (ITIN) if the applicant provides the documentation required by the IRS either (a) in person to an IRS employee or to a community-based certified acceptance agent (as authorized by the IRS), or (b) by mail. The provision requires that individuals who were issued ITINs before 2013 are required to renew their ITINs on a staggered schedule between 2017 and 2020. The provision also provides that an ITIN will expire if an individual fails to file a tax return for three consecutive years. The provision also directs the Treasury Department and IRS to study the current procedures for issuing ITINs with a goal of adopting a system by 2020 that would require all applications to be filed in person. The provision is effective for requests for ITINs made after the date of enactment.

Section 204. Prevention of retroactive claims of earned income credit after issuance of social security number. The provision prohibits an individual from retroactively claiming the earned income tax credit by amending a return (or filing an original return if he failed to file) for any prior year in which he did not have a valid social security number. The provision applies to returns, and any amendment or supplement to a return, filed after the date of enactment.

Section 205. Prevention of retroactive claims of child tax credit. The provision prohibits an individual from retroactively claiming the child tax credit by amending a return (or filing an original return if he failed to file) for any prior year in which the individual or a qualifying child for whom the credit is claimed did not have an ITIN. The provision applies to returns, and any amendment or supplement to a return, filed after the date of enactment.

Section 206. Prevention of retroactive claims of American opportunity tax credit. The provision prohibits an individual from retroactively claiming the American Opportunity Tax Credit by amending a return (or filing an original return if he failed to file) for any prior year in which the individual or a student for whom the credit is claimed did not have an ITIN. The provision applies to returns, and any amendment or supplement to a return, filed after the date of enactment.

Section 207. Procedures to reduce improper claims. The provision expands the paid-preparer due diligence requirements with respect to the earned income tax credit, and the associated $500 penalty for failures to comply, to cover returns claiming the child tax credit and American Opportunity Tax Credit. The provision also requires the IRS to study the effectiveness of the due diligence requirements and whether such requirements should apply to taxpayer who file online or by filing a paper form. The provision applies to tax years beginning after December 31, 2015.

Section 208. Restrictions on taxpayers who improperly claimed credits in prior year. The provision expands the rules under current law, which bar individuals from claiming the earned income tax credit for ten year if they are convicted of fraud and for two years if they are found to have recklessly or intentionally disregarded the rules, to apply to the child tax credit and American Opportunity Tax Credit. The provision adds math error authority, which permits the

IRS to disallow improper credits without a formal audit if the taxpayer claims the credit in a period during which he is barred from doing so due to fraud or reckless or intentional disregard. The provision applies to tax years beginning after December 31, 2015.

Section 209. Treatment of credits for purposes of certain penalties. The provision applies the 20-percent penalty for erroneous claims under current law to the refundable portion of credits (reversing the Tax Court decision in *Rand v. Commissioner*). The provision also eliminates the exception from the penalty for erroneous refunds and credits that currently applies to the earned income tax credit, and the provision provides reasonable-cause relief from the penalty. The provision generally applies to returns filed after December 31, 2015.

Section 210. Increase the penalty applicable to paid tax preparers who engage in willful or reckless conduct. The provision expands the penalty for tax preparers who engage in willful or reckless conduct, which is currently the greater of $5,000 or 50 percent of the preparer's income with respect to the return, by increasing the 50 percent amount to 75 percent. The provision applies to returns prepared for tax years ending after the date of enactment.

Section 211. Employer identification number required for American opportunity tax credit. The provision requires a taxpayer claiming the American opportunity tax credit to report the employer identification number (EIN) of the educational institution to which the taxpayer makes qualified payments under the credit. The provision applies to tax years beginning after December 31, 2015, and expenses paid after such date for education furnished in academic periods beginning after such date.

Section 212. Higher education information reporting only to include qualified tuition and related expenses actually paid. The provision reforms the reporting requirements for Form 1098-T so that educational institutions are required to report only qualified tuition and related expenses actually paid, rather than choosing between amounts paid and amounts billed, as under current law. The provision applies to expenses paid after December 31, 2015 for education furnished in academic periods beginning after such date.

TITLE III – MISCELLANEOUS PROVISIONS

Subtitle A – Family Tax Relief

Section 301. Exclusion for amounts received under the Work Colleges Program. The provision exempts from gross income any payments from certain work-learning-service programs that are operated by a work college as defined in section 448(e) of the Higher Education Act of 1965. The provision is effective for amounts received in tax years beginning after date of enactment.

Section 302. Improvements to section 529 accounts. The provision expands the definition of qualified higher education expenses for which tax-preferred distributions from 529 accounts are eligible to include computer equipment and technology. The provision modifies 529-account rules to treat any distribution from a 529 account as coming only from that account, even if the individual making the distribution operates more than one account. The provision treats a refund of tuition paid with amounts distributed from a 529 account as a qualified expense if such amounts are re-contributed to a 529 account within 60 days. The provision is effective for distributions made or refunds after 2014, or in the case of refunds after 2014 and before the date of enactment, for refunds re-contributed not later than 60 days after date of enactment.

Section 303. Elimination of residency requirement for qualified ABLE programs. The provision allows ABLE accounts (tax-preferred savings accounts for disabled individuals), which currently may be located only in the State of residence of the beneficiary, to be established in any State. This will allow individuals setting up ABLE accounts to choose the State program that best fits their needs, such as with regard to investment options, fees, and account limits. The provision is effective for tax years beginning after December 31, 2014

Section 304. Exclusion for wrongfully incarcerated individuals. The provision allows an individual to exclude from gross income civil damages, restitution, or other monetary awards that the taxpayer received as compensation for a wrongful incarceration. A "wrongfully incarcerated individual" is either: (1) an individual who was convicted of a criminal offense under Federal or state law, who served all or part of a sentence of imprisonment relating to such offense, and who was pardoned, granted clemency, or granted amnesty because of actual innocence of the offense; or (2) an individual for whom the conviction for such offense was reversed or vacated and for whom the indictment, information, or other accusatory instrument for such offense was dismissed or who was found not guilty at a new trial after the conviction was reversed or vacated. The provision applies to tax years beginning before, on, or after the date of enactment.

Section 305. Clarification of special rule for certain governmental plans. The provision extends the special rule under current law for certain benefits paid by accident or health plans of a public retirement system to such benefits paid by plans established by or on behalf of a State or political subdivision. To qualify, such plans must have been authorized by a State legislature or received a favorable ruling from the IRS that the trust's income is not includible in gross income under either section 115 or section 501(c)(9) of the tax code, and on or before January 1, 2008, have provided for payment of medical benefits to a deceased participant's beneficiary. The provision is effective for payments after the date of enactment.

Section 306. Rollovers permitted from other retirement plans into simple retirement accounts. The provision allows a taxpayer to roll over amounts from an employer-sponsored retirement plan (e.g., 401(k) plan) to a SIMPLE IRA, provided the plan has existed for at least two years. The provision applies to contributions made after the date of enactment.

Section 307. Technical amendment relating to rollover of certain airline payment amounts. The provision clarifies the effective dates of Public Law 113-243 to allow certain airline employees to contribute amounts received in certain bankruptcies to an IRA without being subject to the annual contribution limit. The provision is effective as if included in Public Law 113-243.

Section 308. Treatment of early retirement distributions for nuclear materials couriers, United States Capitol Police, Supreme Court Police, and diplomatic security special agents. The provision extends the relief under current law, which provides an exception to the 10-percent penalty on withdrawals from retirement accounts before age 50 for public safety officer, to include nuclear materials couriers, United States Capitol Police, Supreme Court Police, and diplomatic security special agents. The provision is effective for distributions after December 31, 2015.

Section 309. Prevention of extension of tax collection period for members of the Armed Forces who are hospitalized as a result of combat zone injuries. The provision requires that the collection period for members of the Armed Forces hospitalized for combat zone injuries may not be extended by reason of any period of continuous hospitalization or the 180 days after hospitalization. Accordingly, the collection period expires 10 years after assessment, plus the actual time spent in a combat zone. The provision applies to taxes assessed before, on, or after the date of the enactment.

Subtitle B– Real Estate Investment Trusts

Section 311. Restriction on tax-free spinoffs involving REITs. The provision provides that a spin-off involving a REIT will qualify as tax-free only if immediately after the distribution both the distributing and controlled corporation are REITs. In addition, neither a distributing nor a controlled corporation would be permitted to elect to be treated as a REIT for ten years following a tax-free spin-off transaction. The provision applies to distributions on or after December 7, 2015, but shall not apply to any distribution pursuant to a transaction described in a ruling request initially submitted to the IRS on or before such date, which request has not been withdrawn and with respect to which a ruling has not been issued or denied in its entirety as of such date.

Section 312. Reduction in percentage limitation on assets of REIT which may be taxable REIT subsidiaries. The provision modifies the rules with respect to a REIT's ownership of a taxable REIT subsidiary (TRS), which is taxed as a corporation. Under the provision, the securities of one or more TRSs held by a REIT may not represent more than 20 percent (rather than 25 percent under current law) of the value of the REIT's assets. The provision is effective for tax years beginning after 2017.

Section 313. Prohibited transaction safe harbors. The provision provides for an alternative three-year averaging safe harbor for determining the percentage of assets that a REIT may sell annually. In addition, the provision clarifies that the safe harbor is applied independent of whether the real estate asset is inventory property. The provision generally is effective for tax years beginning after the date of enactment. However, the clarification of the safe harbor takes effect as if included in the Housing Assistance Tax Act of 2008.

Section 314. Repeal of preferential dividend rule for publicly offered REITs. The provision repeals the preferential dividend rule for publicly offered REITs. The provision is effective for distributions in tax years beginning after 2014.

Section 315. Authority for alternative remedies to address certain REIT distribution failures. The provision provides the IRS with authority to provide an appropriate remedy for a preferential dividend distribution by non-publicly offered REITs in lieu of treating the dividend as not qualifying for the REIT dividend deduction and not counting toward satisfying the requirement that REITs distribute 90 percent of their income every year. Such authority applies if the preferential distribution is inadvertent or due to reasonable cause and not due to willful neglect. The provision applies to distributions in tax years beginning after 2015.

Section 316. Limitations on designation of dividends by REITs. The provision provides that the aggregate amount of dividends that could be designated by a REIT as qualified dividends or capital gain dividends will not exceed the dividends actually paid by the REIT. The provision is effective for distributions in tax years beginning after 2014.

Section 317. Debt instruments of publicly offered REITs and mortgages treated as real estate assets. The provision provides that debt instruments issued by publicly offered REITs, as well as interests in mortgages on interests in real property, are treated as real estate assets for purposes of the 75-percent asset test. Income from debt instruments issued by publicly offered REITs are treated as qualified income for purposes of the 95-percent income test, but not the 75-percent income test (unless they already are treated as qualified income under current law). In addition, not more than 25 percent of the value of a REIT's assets is permitted to consist of such debt instruments. The provision is effective for tax years beginning after 2015.

Section 318. Asset and income test clarification regarding ancillary personal property. The provision provides that certain ancillary personal property that is leased with real property is treated as real property for purposes of the 75-percent asset test. In addition, an obligation secured by a mortgage on such property is treated as real property for purposes of the 75-percent income and asset tests, provided the fair market value of the personal property does not exceed 15 percent of the total fair market value of the combined real and personal property. The provision is effective for tax years beginning after 2015.

Section 319. Hedging provisions. The provision expands the treatment of REIT hedges to include income from hedges of previously acquired hedges that a REIT entered to manage risk associated with liabilities or property that have been extinguished or disposed. The provision is effective for tax years beginning after 2015.

Section 320. Modification of REIT earnings and profits calculation to avoid duplicate taxation. The provision provides that current (but not accumulated) REIT earnings and profits for any tax year are not reduced by any amount that is not allowable in computing taxable income for the tax year and was not allowable in computing its taxable income for any prior tax year (e.g., certain amounts resulting from differences in the applicable depreciation rules). The provision applies only for purposes of determining whether REIT shareholders are taxed as receiving a REIT dividend or as receiving a return of capital (or capital gain if a distribution exceeds a shareholder's stock basis). The provision is effective for tax years beginning after 2015.

Section 321. Treatment of certain services provided by taxable REIT subsidiaries. The provision provides that a taxable REIT subsidiary (TRS) is permitted to provide certain services to the REIT, such as marketing, that typically are done by a third party. In addition, a TRS is permitted to develop and market REIT real property without subjecting the REIT to the 100-percent prohibited transactions tax. The provision also expands the 100-percent excise tax on non-arm's length transactions to include services provided by the TRS to its parent REIT. The provision is effective for tax years beginning after 2015.

Section 322. Exception from FIRPTA for certain stock of REITs. The provision increases from 5 percent to 10 percent the maximum stock ownership a shareholder may have held in a publicly traded corporation to avoid having that stock treated as a U.S. real property interest on disposition. In addition, the provision allows certain publicly traded entities to own and dispose of any amount of stock treated as a U.S. real property interest, including stock in a REIT, without triggering FIRPTA withholding. However, an investor in such an entity that holds more than 10 percent of such stock is still subject to withholding. The provision applies to dispositions and distributions on or after the date of enactment.

Section 323. Exception for interests held by foreign retirement or pension funds. The provision exempts any U.S. real property interest held by a foreign pension fund from FIRPTA withholding. The provision applies to dispositions and distributions after the date of enactment.

Section 324. Increase in rate of withholding of tax on dispositions of United States real property interests. The provision provides that the rate of withholding on dispositions of United States real property interests is increased from 10 percent to 15 percent. The increased rate of withholding, however, does not apply to the sale of a personal residence where the amount realized is $1 million or less. The provision is effective for dispositions occurring 60 days after the date of enactment.

Section 325. Interests in RICs and REITs not excluded from definition of United States real property interests. The provision provides that the "cleansing rule" (which applies to corporations that either have no real estate or have paid tax on their real-estate transactions) applies only to interests in a corporation that is not a qualified investment entity. In addition, the proposal provides that the cleansing rule applies to stock of a corporation only if neither the corporation nor any predecessor of such corporation was a regulated investment company (RIC) or REIT at any time during the shorter of (a) the period after June 18, 1980 during which the taxpayer held such stock, or (b) the five-year period ending on the date of the disposition of the stock. The provision applies to dispositions on or after the date of enactment.

Section 326. Dividends derived from RICs and REITs ineligible for deduction for United States source portion of dividends from certain foreign corporations. The provision provides that for purposes of determining whether dividends from a foreign corporation (attributable to dividends from an 80-percent owned domestic corporation) are eligible for a dividend received deduction, dividends from RICs and REITs are not treated as dividends from domestic corporations, even if the RIC or REIT owns shares in a foreign corporation. The provision applies to dividends received from RIC and REITs on or after the date of enactment of this Act.

Subtitle C – Additional Provisions

Section 331. Deductibility of charitable contributions to agricultural research organizations. The provision provides that charitable contributions to an agricultural research organization are subject to the higher individual limits (generally up to 50 percent of the taxpayer's contribution base) if the organization commits to use the contribution for agricultural research before January 1 of the fifth calendar year that begins after the date of the contribution. In addition, agricultural research organizations are treated as public charities *per se*, without regard to their sources of financial support. The provision is effective for contributions made on or after the date of enactment.

Section 332. Removal of bond requirements and extending filing periods for certain taxpayers with limited excise tax liability. The provision allows producers of alcohol that reasonably expect to be liable for not more than $50,000 per year in alcohol excise taxes to pay such taxes on a quarterly basis rather than twice per month (and those reasonably expecting to be liable for not more than $1,000 per year to pay such taxes annually, rather than on a quarterly basis). The provision also exempts such producers from bonding requirements with the IRS. The provision is effective 90 days after the date of enactment.

Section 333. Modifications to alternative tax for certain small insurance companies. The provision increases the maximum amount of annual premiums that certain small property and casualty insurance companies can receive and still elect to be exempt from tax on their underwriting income, and instead be taxed only on taxable investment income. The provision increases the maximum amount from $1.2 million to $2.2 million for calendar years beginning after 2015, and indexes it to inflation thereafter. To ensure that this special rule is not abused, the provision also requires that no more than 20 percent of net written premiums (or if greater, direct written premiums) for a tax year is attributable to any one policyholder. Alternatively, a company would be eligible for the exception if each owner of the insured business or assets has no greater an interest in the insurer than he or she has in the business or assets, and each owner holds no smaller an interest in the business than his or her interest in the insurer. The provision is effective for tax years beginning after 2016.

Section 334. Treatment of timber gains. The provision provides that C corporation timber gains are subject to a tax rate of 23.8 percent. The provision is effective for tax year 2016.

Section 335. Modification of definition of hard cider. The provision defines hard cider for purposes of alcohol excise taxes as a wine with an alcohol content of between 0.5 percent and 8.5 percent alcohol by volume, with a carbonation level that does not exceed 6.4 grams per liter, which is derived primarily from apples, apple juice concentrate, pears, or pear juice concentrate, in combination with water. The provision is effective for articles removed from the distillery or bonding facility during calendar years beginning after 2015.

Section 336. Church Plan Clarification. The provision prevents the IRS from aggregating certain church plans together for purposes of the non-discrimination rules, which prevent highly compensated participants from receiving disproportionate benefits under the plan, and it provides flexibility for church plans to decide which other church plans with which they associate. The provision also prevents certain grandfathered church defined-benefit plans from having to meet certain requirements relating to maximum benefit accruals, and it allows church plans to offer auto-enroll accounts similar to 401(k)s. Additionally, the provision make it easier for church plans to engage in certain reorganizations and allows church plans to invest in collective trusts. The provision generally is effective on or after the date of enactment.

Subtitle D – Revenue Provisions

Section 341. Updated ASHRAE standards for energy efficient commercial buildings deduction. The provision modifies the deduction for energy efficient commercial buildings by updating the energy efficiency standards to reflect new standards of the American Society of Heating, Refrigerating, and Air Conditioning Engineers beginning in 2016.

Section 342. Excise tax credit equivalency for liquefied petroleum gas and liquefied natural gas. The provision converts the measurement of the alternative fuel excise tax credit for liquefied natural gas and liquefied petroleum gas from 50 cents per gallon to 50 cents per energy equivalent of a gallon of diesel fuel, which is approximately 29 cents per gallon for liquefied natural gas and approximately 36 cents per gallon for liquefied petroleum gas. The provision is effective for fuel sold or used after 2015.

Section 343. Exclusion from gross income of certain clean coal power grants to non-corporate taxpayers. The provision excludes from gross income certain clean power grants received under the Energy Policy Act of 2005 by an eligible taxpayer that is not a corporation. The provision requires an eligible taxpayer to reduce the basis of tangible depreciable property related to such grants by the amount excluded. The provision requires eligible taxpayers to make payments to the Treasury equal to 1.18 percent of amounts excluded under the provision. The provision is effective for grants received in tax years after 2011.

Section 344. Clarification of valuation rule for early termination of certain charitable remainder unitrusts. The provision clarifies the valuation method for the early termination of certain charitable remainder unitrusts. The provision is effective for the termination of trusts after the date of enactment.

Section 345. Prevention of transfer of certain losses from tax indifferent parties. The provision modifies the related-party loss rules, which generally disallow a deduction for a loss on the sale or exchange of property to certain related parties or controlled partnerships, to prevent losses from being shifted from a tax-indifferent party (e.g., a foreign person not subject to U.S. tax) to another party in whose hands any gain or loss with respect to the property would be subject to U.S. tax. The provision generally is effective for sales and exchanges of property acquired after 2015.

Section 346. Treatment of certain persons as employers with respect to motion picture projects. The provision allows motion picture payroll services companies to be treated as the employer of their film and television production workers for Federal employment tax purposes. The provision is effective for remuneration paid after 2015.

TITLE IV – TAX ADMINISTRATION

Subtitle A – Internal Revenue Service Reforms

Section 401. Duty to ensure that IRS employees are familiar with and act in accord with certain taxpayer rights. The provision amends the tax code to require the IRS Commissioner to ensure that IRS employees are familiar with and act in accordance with the taxpayer bill of rights, which includes the right to:

1. be informed;
2. quality service;
3. pay no more than the correct amount of tax;
4. challenge the position of the IRS and be heard;
5. appeal a decision of the IRS in an independent forum;
6. finality;
7. privacy;
8. confidentiality;
9. retain representation;
10. a fair and just tax system.

The provision is effective on the date of enactment.

Section 402. IRS employees prohibited from using personal email accounts for official business. The provision prohibits employees of the IRS from using a personal email account to conduct any official business, codifying an already established agency policy barring use of personal email accounts by IRS employees for official governmental business. The provision is effective on the date of enactment.

Section 403. Release of information regarding the status of certain investigations. The provision allows taxpayers who have been victimized by the IRS, for example, through the unauthorized disclosure of private tax information, to find out basic facts, such as whether the case is being investigated or whether the case has been referred to the Justice Department for prosecution. The provision applies to disclosures made on or after the date of enactment.

Section 404. Administrative appeal relating to adverse determinations of tax-exempt status of certain organizations. The provision requires the IRS to create procedures under which a 501(c) organization facing an adverse determination may request administrative appeal to the IRS Office of Appeals. This includes determinations relating to the initial or continuing classification of (1) an organization as tax-exempt under section 501(a); (2) an organization under section 170(c)(2); (3) a private foundation under section 509(a); or (4) a private operating foundation under section 4942(j)(3). The provision applies to determinations made after May 19, 2014.

Section 405. Organizations required to notify Secretary of intent to operate under 501(c)(4). The provision provides for a streamlined recognition process for organizations seeking tax exemption under section 501(c)(4). The process requires 501(c)(4) organizations to file is a simple one-page notice of registration with the IRS within 60 days of the organization's formation. The current, voluntary 501(c)(4) application process will be eliminated. Within 60 days after an application is submitted, the IRS is required to provide a letter of acknowledgement of the registration, which the organization can use to demonstrate its exempt status, typically with state and local tax authorities.

Section 406. Declaratory judgments for 501(c)(4) and other exempt organizations. The provision permits 501(c)(4) organizations and other exempt organizations to seek review in Federal court of any revocation of exempt status by the IRS. The provision applies to pleadings filed after the date of enactment.

Section 407. Termination of employment of Internal Revenue Service employees for taking official actions for political purposes. The provision makes clear that taking official action for political purposes is an offense for which the employee should be terminated. The bill amends the Internal Revenue Service Restructuring and Reform Act of 1998 to expand the grounds for termination of employment of an IRS employee to include performing, delaying, or failing to perform any official action (including an audit) by an IRS employee for the purpose of extracting personal gain or benefit for a political purpose. The provision takes effect on the date of enactment.

Section 408. Gift tax not to apply to contributions to certain exempt organizations. The provision treats transfers to organizations exempt from tax under section 501(c)(4), (c)(5), and (c)(6) of the tax code as exempt from the gift tax. The provision applies to transfers made after the date of enactment.

Section 409. Extend Internal Revenue Service authority to require truncated Social Security numbers on Form W-2. The provision requires employers to include an "identifying number" for each employee, rather than an employee's SSN, on Form W-2. This change will permit the Department of the Treasury to promulgate regulations requiring or permitting a truncated SSN on Form W-2. The provision is effective on the date of enactment.

Section 410. Clarification of enrolled agent credentials. The provision permits enrolled agents approved by the IRS to use the designation "enrolled agent," "EA," or "E.A." The provision is effective on the date of enactment.

Section 411. Partnership audit rules. The provision corrects and clarifies certain technical issues in the partnership audit rules enacted in the Bipartisan Budget Act of 2015.

Subtitle B – United States Tax Court

PART 1 – Taxpayer Access to United States Tax Court

Section 421. Filing period for interest abatement cases. The provision permits a taxpayer to seek review by the Tax Court of a claim for interest abatement when the IRS has failed to issue a final determination. The provision applies to claims for interest abatement filed after the date of enactment.

Section 422. Small tax case election for interest abatement cases. The provision expands the current-law procedures for the Tax Court to consider small tax cases (i.e., cases with amount in dispute that are under $50,000) to include the review of IRS decisions not to abate interest, provided the amount of interest for which abatement is sought does not exceed $50,000. The provision applies to cases pending and cases commenced after the date of enactment.

Section 423. Venue for appeal of spousal relief and collection cases. The provision clarifies that Tax Court decisions in cases involving spousal relief and collection cases are appealable to the U.S. Court of Appeals for the circuit in which an individual's legal residence is located or in which a business' principal place of business or principal office of agency is located. The provision applies to Tax Court petitions filed after the date of enactment.

Section 424. Suspension of running of period for filing petition of spousal relief and collection cases. The provision suspends the statute of limitations in cases involving spousal relief or collections when a bankruptcy petition has been filed and a taxpayer is prohibited from filing a petition for review by the Tax Court. Under the provision, the suspension is for the period during which the taxpayer is prohibited from filing such a petition, plus 60 days. The provision applies to Tax Court petitions filed after the date of enactment.

Section 425. Application of Federal rules of evidence. The provision requires the Tax Court to conduct its proceedings in accordance with the Federal Rules of Evidence (rather than the rules of evidentiary rules applied by the United States District Court of the District of Columbia, as under current law). The provision applies to proceedings commenced after the date of enactment.

PART 2 – United States Tax Court Administration

Section 431. Judicial conduct and disability procedures. The provision authorizes the Tax Court to establish procedures for the filing of complaints with respect to the conduct of any judge or special trial judge of the Tax Court and for the investigation and resolution of such complaints. The provision applies to proceedings commenced 180 days after the date of enactment.

Section 432. Administration, judicial conference, and fees. The provision extends to the Tax Court the same general management, administrative, and expenditure authorities that are available to Article III courts and the Court of Appeals for Veterans Claims. The provision also permits the Tax Court to conduct an annual judicial conference and charge reasonable registration fees. Additionally, the provision authorizes the Tax Court to deposit certain fees into a special fund held by the Treasury Department, with such funds available for the operation and maintenance of the Tax Court. The provision is effective on the date of enactment.

PART 3 – Clarification Relating to United States Tax Court

Section 441. Clarification relating to United States Tax Court. The provision clarifies that the Tax Court is not an agency of, and shall be independent of, the Executive Branch. The provision is effective upon the date of enactment.

TITLE V – TRADE-RELATED PROVISIONS

Section 501. Modification of effective date of provisions relating to tariff classification of recreational performance outer wear. The provision delays implementation of changes in the classification of certain recreation performance outerwear products that would inadvertently increase tariffs on some of those products.

Section 502. Agreement by Asia-Pacific Economic Co-operation members to reduce rates of duty on certain environmental goods. The provision ensures that the reduction of tariffs on certain environmental goods to fulfill an agreement by members of the Asia-Pacific Economic Cooperation (APEC) forum is implemented in accordance with the Trade Priorities and Accountability Act of 2015.

TITLE VI –BUDGETARY EFFECTS

Section 601. Budgetary effects. The provision provides for the bill's treatment for PAYGO purposes.