DEPARTMENT OF EDUCATION

34 CFR Part 682

RIN 1840–AC33

Federal Family Education Loan (FFEL) Program; Guaranty Agencies—Conflicts of Interest

AGENCY: Department of Education.

ACTION: Final regulations.

SUMMARY: The Secretary amends the Federal Family Education Loan (FFEL) Program regulations. These final regulations are needed to implement changes to the Higher Education Act of 1965, as amended (HEA) giving the Secretary additional powers to assure the safety of Federal reserve funds and assets maintained by guaranty agencies insuring educational loans under the FFEL Program. The regulations establish conflicts of interest restrictions for guaranty agency staff and affiliated individuals and prohibit agencies from using Federal reserve funds for certain purposes.

DATES: Effective date: These regulations take effect on July 1, 1997. However, affected parties do not have to comply with the information collection requirement in § 682.418(c) until the Department of Education publishes in the Federal Register the control number assigned by the Office of Management and Budget (OMB) to this information collection requirement. Publication of the control number notifies the public that OMB has approved this information collection requirement under the Paperwork Reduction Act of 1995.

FOR FURTHER INFORMATION CONTACT: Mr. George Harris, Senior Policy Specialist, U.S. Department of Education, 600 Independence Avenue, S.W., Room 3045, Regional Office Building 3, Washington, DC 20202–5449. Telephone: (202) 708–8242. Individuals who use a telecommunications device for the deaf (TDD) may call the Federal Information Relay Service (FIRS) at 1–800–877–8339 between 8 a.m. and 8 p.m., Eastern time, Monday through Friday.

SUPPLEMENTARY INFORMATION:

Background

On September 19, 1996 the Secretary published a notice of proposed rulemaking (NPRM) for this part in the Federal Register (61 FR 49382). The NPRM included a discussion of the major issues surrounding the proposed changes, which will not be repeated here. The following list summarizes those issues and identifies the pages of the preamble of the NPRM on which a discussion of those issues may be found:

- The use of FFEL reserve funds to pay a lender's claim if a guaranty agency fails to comply with Federal reinsurance requirements. (page 49383)
- The addition of a requirement that guaranty agencies prohibit conflicts of interest by guaranty agency staff and affiliated individuals. (page 49383)
- Prohibition of certain uses of a guaranty agency's reserve fund. (page 49384)

Executive Order 12866

These final regulations have been reviewed in accordance with Executive Order 12866. Under the terms of the order the Secretary has assessed the potential costs and benefits of this regulatory action.

The potential costs associated with the final regulations are those resulting from statutory requirements and those determined by the Secretary to be necessary for administering this program effectively and efficiently.

In assessing the potential costs and benefits—both quantitative and qualitative—of these final regulations, the Secretary has determined that the benefits of the final regulations justify the costs.

Summary of Potential Costs and Benefits

The potential costs and benefits of these final regulations are discussed elsewhere in this preamble under the following heading: Analysis of Comments and Changes.

Analysis of Comments and Changes

In response to the Secretary's invitation in the NPRM, 53 parties submitted comments on the proposed regulations. An analysis of the comments and of the changes in the regulations since publication of the NPRM follows.

Major issues are grouped according to subject, with appropriate sections of the regulations referenced in parentheses. Other substantive issues are discussed under the section of the regulations to which they pertain. Technical and other minor changes—and suggested changes the Secretary is not legally authorized to make under the applicable statutory authority—generally are not addressed.

Paperwork Reduction Act of 1995

Section 682.418(c) contains information collection requirements. As required by the Paperwork Reduction Act of 1995, the U.S. Department of Education has submitted a copy of this section to the Office of Management and Budget (OMB) for its review. (44 U.S.C. 3504(h)). In response to the Secretary's invitation in the NPRM to comment on any potential paperwork burden associated with this regulation, the following comments were received.

Role of a Guaranty Agency as a Trustee or Fiduciary

Comment: A number of guaranty agencies questioned the Secretary's discussion of the role of guaranty agencies in the preamble to the NPRM. In particular, the commenters argued that the Secretary was overstating the holdings of the court decisions cited in the preamble. The commenters suggested that these decisions did not hold them to be trustees or fiduciaries for the Federal Government. In addition, they noted that neither the HEA nor the agreements between the Department and the agencies use the term ''fiduciary'' or ''trustee'' and argued that the Secretary's description of their role was not supported by legal authority.

Discussion: The Secretary's position that ''the guaranty agencies' role is best characterized as that of a trustee holding money for the benefit of another'' is firmly rooted in the HEA. Under section 422(e) of the HEA, the reserve funds of the guaranty agencies and any assets purchased with those funds are the property of the United States. This statute is consistent with court decisions that describe the guaranty agency as ''akin to that of a trustee,'' *Ohio Student Loan Com'n v. Cavazos,* 900 F.2d 894, 899 (6th Cir. 1990), *cert. denied* 111 S.Ct. 245 (1990) or ''analogous to that of a trustee holding money for the benefit of another,'' *Education Assistance Corp. v. Cavazos,* 902 F.2d 617, 627 (8th Cir. 1990), *cert. denied* 111 S.Ct. 246 (1990). Other courts have specifically concluded that the guaranty agency does not have an ownership interest or property right in its reserve fund and that the reserve funds are ultimately under the control of the United States. *Puerto Rico Higher Education Assistance Corp. v. Riley,* 10 F.3d 847, 851 (D.C. Cir. 1993); *State of Colorado v. Cavazos,* 962 F.2d 968, 971 (10th Cir. 1992); *Rhode Island Higher Education Assistance Auth. v. Secretary, U.S. Dep't of Education,* 929 F.2d 844 (1st Cir. 1991); *Great Lakes Higher Education Corp. v. Cavazos,* 911 F.2d 10 (7th Cir. 1990); *South Carolina State Education Assistance Auth Corp. v. Cavazos,* 897, F.2d 1272 (4th Cir. 1990), *cert. denied* 111 S.Ct 243; *Delaware v. Cavazos,* 723 F.Supp. 234 (D.Del. 1989), *aff'd without opinion,* 919 F.2d 137 (3d Cir. 1990); *Student Loan Fund of Idaho v. Riley,* Case No. CV 94–0413–S–LMB (D.Ida., Memo. Decision, Sept. 14, 1995), *appeal pending,* No. 95–36179

(9th. Cir.); *Connecticut Student Loan Foundation v. Riley,* Case No. 3:93CV02570 (JBA) (D.Conn., Oct. 31, 1996). The guaranty agency commenters who challenged the Secretary's reading of the law in this area failed to cite any statutes or court decisions that counter this authority. A party who holds property for the benefit of another and who must carry out specific duties with regard to that property falls clearly within the legal definition of a trustee. *Black's Law Dictionary* 1514 (6th ed. 1990). A trustee owes a fiduciary duty to the beneficiary. *Id.* at 1508 (''trust'') and 1514. In the case of guaranty agencies, the Secretary (who provides the funds used to maintain the reserve funds and reserve funds assets) is the beneficiary and is entitled to issue appropriate rules to protect the Federal Government's interests in those funds and assets by prohibiting inappropriate uses and protecting against conflicts of interest.

Guaranty agencies are State or private non-private organizations, that are required to serve the public good. Thus, even outside the legal obligations governing the agencies' relationship to the reserve fund and assets, the agencies should have been held to a high standard in protecting the public trust. While these regulations provide further protection for the Secretary in regard to the agencies' role in the FFEL Program and maintenance of Federal property and assets, they are consistent with the agencies' long-standing obligations under State and common law.

Changes: None.

Separate Non-FFEL Funds

Comment: Some guaranty agencies questioned the discussion in the preamble to the NPRM that distinguished between funds that are subject to these regulations and funds that were consistently funded and maintained separate from their reserve funds and that are not covered by these regulations. These commenters argued that the requirement that non-FFEL program activities must be funded exclusively from sources unrelated to the FFEL guaranty agency activities exceeded the Secretary's authority. These commenters also contended that the prohibition on the use of FFEL funds for non-FFEL purposes was only established in regulations issued by the Secretary in 1986 and should not be applied prior to the effective date of those rules.

Discussion: The court decisions cited above reaffirmed that a guaranty agency had no legitimate expectation or right at the time it joined the FFEL Program that it could use Federal reserve funds for other than FFEL purposes. *Delaware* v. *Cavazos,* 723 F.Supp. at 240. Thus, an agency that wanted to engage in non-FFEL program activities has always been required to maintain separate funds. The discussion in the preamble to the NPRM is consistent with this requirement. Moreover, a guaranty agency has a fiduciary responsibility to protect the reserve funds and assets held by it for the Federal Government from uses inconsistent with the purposes for which they were provided.

Changes: None.

Classification of Guaranty Agencies Under the Regulatory Flexibility Act

Comment: Several commenters stated that the basis for determining that guaranty agencies are not small entities for the purposes of Regulatory Flexibility Analysis has not been provided. The commenters asserted that there are a substantial number of guaranty agencies with assets below $100 million. The commenters further recommended that the regulations be reviewed by the Small Business Administration.

Discussion: The Secretary analyzed the assets of the 12 private non-profit guaranty agencies that will be covered under these regulations. This analysis follows the letter and the spirit of the Regulatory Flexibility Act, which dictates the terms of the analysis. The analysis of asset levels of the 12 agencies is based on the latest audited financial statements that the agencies have provided to the Secretary. The analysis used generally accepted accounting principles and found that all 12 had asset levels above $100 million. Thus, for the purposes of Regulatory Flexibility Analysis, the certification that these regulations will not have a substantial impact on a significant number of small entities is affirmed.

On September 16, 1996, a copy of the proposed regulations was provided to the Small Business Administration (SBA). The SBA did not comment on the proposed regulations.

Changes: None.

Analysis of Burden Under the Paperwork Reduction Act of 1995

Comment: Several commenters representing guaranty agencies disputed the estimate of one hour recordkeeping burden required by the development of a cost allocation plan and maintenance of documentation for audit. The commenters believed this analysis of the burden grossly understated the amount of time necessary to analyze and comply with OMB Circular A–87. One commenter estimated that it would require three or four people years of work for an agency to develop and maintain a cost allocation system. Another commenter estimated that it would take at least 1,000 hours for an agency to develop a cost allocation plan and an additional two employees annually to manage it properly. The commenters acknowledged that the recordkeeping burden is already established in § 682.410(a) of the current regulations and guaranty agencies already have established cost allocation plans. However, they argued that the scope of the cost allocation provisions in OMB Circular A–87 is different in many respects from what is required in the regulations and what guaranty agencies have developed to comply with applicable Federal and State laws and would involve in most instances the development or update, or both, of a different method of cost allocation. The commenters stated that this provision would also require guaranty agencies in many instances to maintain an additional set of financial accounting records.

Discussion: Since publishing the NPRM, the Secretary has received information that indicates that the one-hour estimate given in the NPRM was not an accurate estimate of the recordkeeping burden associated with the modified requirements. The Secretary continues to believe that the scope of the cost allocation provisions in OMB Circular A–87 is not radically different, at least not to the extent suggested by some of the commenters, from what is already required in existing regulations.

The Secretary has sought to minimize burden to the extent possible. However, in light of the comments received, the Secretary now believes that a more appropriate estimate would be 100 hours. The Secretary will continue to look at this issue and welcomes additional input from guaranty agencies concerning the burden associated with the cost allocation plan requirement.

Changes: See discussion above.

Section 682.401 Basic Program Agreement

Comment: Several commenters representing guaranty agencies objected to § 682.401(b)(28) on the grounds that it was an unnecessary attempt to micromanage the operations of a guaranty agency and would serve to hamper the effective operations of the guaranty agency. The commenters stated that existing regulations mandating a specified level of reserves, coupled with the regulations proposed in the NPRM mandating reasonable costs, would provide adequate protection of the Federal fiscal interest. The commenters

recommended that, at the very least, the transfer of default records by a guaranty agency to third party contractors should be exempted from this requirement. One commenter stated that guaranty agencies should be encouraged to reduce costs where possible and that the main area in which a guarantor could reduce costs was in computer software, hardware, and development. One commenter agreed that the Secretary should be notified of a conversion to another information or computer system, but recommended that the 30-day notification period be increased to 45 days so that a guaranty agency could more properly prepare its notification to the Secretary and the Secretary would have more time to respond. The same commenter opposed the requirement that notice must be given in the case of a proposed conversion.

Discussion: The Secretary does not agree that a notification requirement is an attempt to micromanage the operations of a guaranty agency. A guarantor's decision to place new guarantees or to convert records relating to its existing guarantees to an information or computer system that is owned by or otherwise under the control of an entity that is different than the party that owns or controls the agency's existing system is a major decision that could have significant impact on program participants, especially borrowers. The Secretary needs advance notification of such proposed conversions because the Secretary's statutory duty to administer the FFEL Program properly would be hindered if information relating to major changes planned by a guaranty agency is not known by the Secretary until after the fact. If an agency experiences an emergency situation that would make it impossible for the agency to provide that notification to the Secretary at least 30 days before a planned conversion, the agency should notify the Secretary as soon as practicable before the date of the planned conversion.

As for the comment about reducing costs, the notification requirement contained in § 682.401(b)(28) has no effect on an agency's attempt to reduce costs. The Secretary encourages guarantors to find ways to reduce costs while preserving high quality services, and that goal can be achieved simultaneously with the notification requirement.

When developing these regulations, the Secretary did not want to require a guaranty agency to provide the notification more than 30 days before a planned conversion from one system to another, or before solicitation of bids begins. However, if an agency wishes to provide that notification more than 30 days before a planned conversion or before solicitation of bids begins, it may do so.

Changes: Section 682.401(b)(28) has been revised to clarify that the notification must be provided to the Secretary at least 30 days prior to the conversion or before solicitation of bids begins.

Comment: One commenter representing a collection contractor asked the Secretary to clarify that the notification requirement contained in § 682.401(b)(28) did not apply to the transfer of copies of records from a guaranty agency to a collection contractor.

Discussion: The commenter's understanding is correct.

Changes: None.

Section 682.410 Fiscal, Administrative, and Enforcement Requirements

Comment: Many commenters expressed concern that the provision in § 682.410(a)(2) would cause lenders to end their participation with any guaranty agency that did not have non-FFEL reserve fund assets available to pay lender claims in cases in which the claims did not qualify for Federal reinsurance because the agency did not meet its Federal requirements. The commenters believed that a lender that performs all of the required regulatory and statutory activities should be entitled to an insurance payment from the guaranty agency for a properly filed claim, even if the agency would not be eligible to receive or retain a reinsurance payment from the Secretary because the agency failed to meet a reinsurance requirement prescribed under § 682.406. The majority of the commenters recommended that the Secretary require a guaranty agency to pay all insurance claims that qualify for insurance under the terms of the guaranty agency's program, even if it meant that the reserve fund would be used to pay claims for which the agency could not receive or retain Federal reinsurance payments. One guaranty agency went further by stating that all claims paid by an agency should be considered proper uses of the reserve fund.

Most of the commenters recommended the addition of language that would permit the payment of a claim if the agency made a good faith determination that the claim met the requirements of § 682.406 at the time the claim was paid or if the only violation was the guaranty agency's inability to meet the claim payment deadlines. Otherwise, the commenters believe, the guarantor would be penalized for paying a claim that appeared in good faith to be reinsurable but only to discover at a later date that it was not (*e.g.,* due to nonpayment of origination fees). The suggested language would prevent the penalizing of lenders or servicers in the instances where they have done nothing wrong. The addition of the language ''in good faith'' would allow for a level of tolerance that would be consistent with the provisions of section 432(g) of the HEA, and would reflect the practicalities of high volume claims processing and the situations where critical data not in the hands of the guarantor is unavailable or unreliable. The commenters stated that section 432(g) only imposes a fine or penalty after a hearing upon a showing that a violation was material and knowing and would not penalize a guaranty agency for multiple infractions involving systemic errors.

The commenters asked the Secretary to consider that other sources of funds are often not available to guaranty agencies or may be earmarked for other expenditures by the provisions of State law. One commenter noted that the Secretary has repeatedly viewed funds received by a guaranty agency for its FFEL Program to be part of the reserve fund. The commenter wondered how the Secretary could recommend that an agency obtain non-FFEL funding to honor its insurance agreements with lenders, while at the same time considering those funds to be part of the reserve fund. The commenter believed that by definition, those outside funds would become part of the reserve fund and thus would be unusable by the guaranty agency for paying claims that did not meet the requirements of § 682.406. One commenter objected to the restriction in § 682.410(a)(2)(i) and stated that the outcome of such a restriction would mean that the fund into which insurance premiums have been paid cannot be used to pay a valid insurance claim submitted by the holder. One commenter from a State guaranty agency was concerned that if a State agency was required to obtain non-FFEL funds to pay lender claims that did not meet the requirements of § 682.406, the agency would expose the State to a financial liability that had previously not existed. The commenter speculated that some State guarantors would be forced to look towards privatization as a means of maintaining the State's fiscal interests. One commenter from a guaranty agency recommended that a guarantor be permitted to use the reserve fund to pay

lender claims that did not meet the requirements of § 682.406, unless this category of claims exceeds a specified percentage of the agency's total claim payments in the fiscal year in question. One commenter believed that section 432(o) of the HEA would entitle the lender to a claim payment from the Secretary if the guaranty agency failed to pay a claim. In addition, one commenter representing a State guaranty agency said that under State law, the State was prohibited from using State funds to cover the expenses incurred by the State guaranty agency. In effect, the commenter argued, the Secretary's restriction in § 682.410(a)(2)(i) would prohibit the agency from honoring its contractual obligations.

Discussion: The Secretary agrees that a lender that performs all of the regulatory and statutory activities required of the lender should be entitled to an insurance payment from the guaranty agency for a properly filed claim. Therefore, the Secretary is withdrawing this provision of the regulations, and will permit guaranty agencies to use reserve funds to pay such claims. However, the Secretary will take appropriate action against a guaranty agency that violates regulatory requirements.

Changes: The Secretary is returning this provision of the regulations to its current published form.

Comment: One commenter recommended that the list of costs in § 682.410(a)(2)(ii) deemed to be ordinary and necessary for the agency to fulfill its responsibilities under the HEA be expanded to include costs of customer assistance and education and training on laws, regulations, and guarantor policies, procedures, and services. The commenter stated that these are basic services provided by guaranty agencies.

Discussion: The use of examples following the word ''including'' in § 682.410(a)(2)(ii) does not mean that other examples are not applicable. While the Secretary does not disagree that the type of costs suggested by the commenter may be ordinary and necessary for the agency to fulfill its responsibilities under the HEA, the Secretary sees no need to add them to the brief list of examples given in the regulations.

Changes: None.

Section 682.410(a)(11)(iii) Reasonable Cost

Comment: Some commenters, while not significantly opposed to the definition of ''reasonable cost'' contained in § 682.410(a)(11)(iii), nevertheless thought the provisions in § 682.410(a)(2)(ii)(B), (C), and (D) were overly broad, vague, and duplicative of the definition of ''reasonable cost.'' The commenters believed that the reasonable cost definition, together with the existing audit requirements for guaranty agencies was sufficient, and recommended the deletion of § 682.410(a)(2)(ii)(B), (C), and (D).

Discussion: The Secretary believes the requirements in § 682.410(a)(2)(ii)(B), (C), and (D) are clear, but agrees that the provisions in (B) and (C) are addressed in paragraph § 682.410(a)(11)(iii)(B) of the ''reasonable cost'' definition. However, § 682.410(a)(2)(ii)(D) is intended to apply a specific test to determine if a cost, though reasonable for other purposes, can be considered an expenditure that is ordinary and necessary for the agency to fulfill its responsibilities under the HEA.

Changes: The provisions in § 682.410(a)(2)(ii)(B) and (C) have been removed, and § 682.410(a)(2)(ii)(A)–(G) has been renumbered § 682.410(a)(2)(ii)(A)–(E).

Comment: One commenter stated that in some cases (*e.g.*, collections activities) the Secretary's specific requirements may increase costs beyond those that would otherwise be required. Therefore, the commenter recommended that additional language be added to § 682.410(a)(2)(ii)(D) to provide an exception for costs to the extent that applicable Federal requirements increase the costs of the activities beyond those of equivalent non-Federal activities.

Discussion: The requirement that costs must not be higher than the agency would incur under established policies, regulations, and procedures that apply to any non-Federal activities of the guaranty agency is intended to apply to expenditures for activities or items that are roughly equivalent in both the agency's FFEL and non-FFEL activities. This requirement has no effect on the comparison of disparate activities or items. For example, if an agency operates a non-FFEL loan program which has less stringent due diligence standards than found in the FFEL Program, the agency's servicing costs for its non-FFEL loan program could be lower than its servicing costs relating to the FFEL Program. In this example (and for other similar cost areas) the Secretary did not intend for § 682.410(a)(2)(ii)(D) to be interpreted to limit the agency's FFEL servicing costs to no more than that paid for the agency's non-FFEL loan program, if the services provided are not comparable.

Changes: The Secretary has added the word ''comparable'' before ''non-Federal activities'' in § 682.410(a)(2)(ii)(D).

Comment: Some commenters vigorously objected to the provision in § 682.410(a)(11)(iii) that requires a guaranty agency to prove that costs are reasonable, although one guaranty agency commenter agreed with the regulatory language in the NPRM. The objecting commenters argued that this provision would stifle the activities of the guaranty agency. The commenters feared that every single agency expenditure will be subject to retroactive challenge at the Secretary's discretion and that the burden of reasonableness will be on the guaranty agency without any ''safe harbor'' or ''de minimis'' rule. The commenters believed that this requirement would make it difficult, if not impossible, to know the standard of duty involved in planning and making expenditures and would disrupt the delivery of services to students and schools. The commenters recommended a deletion of the language placing the burden of proof on the guaranty agency and proposed placing the burden of proof on the Secretary to challenge the reasonableness of the cost. In addition, the commenters suggested that the Secretary's authority to challenge the expenditure should be limited to one year from the date of the expenditure, absent a showing of fraud and abuse by the agency, and wanted the regulations to be prospective in their effect.

Discussion: These regulations establish clear principles for determining if a cost is reasonable. The guaranty agency commenters want the Secretary to presume that expenditures made by a guaranty agency from the reserve fund reflect costs that the guaranty agency believes are reasonable. The Secretary notes that it is the guarantor, not the Secretary, that has the information and documentation to show that it has complied with the reasonable cost principles prescribed in these regulations. In the event the Secretary questions the reasonableness of a particular expenditure, the Secretary believes the guarantor's unique role as the front-line steward responsible for the use of the reserve fund carries with it the obligation to document that its use of Federal funds has been appropriate. It is not the Secretary's role either to prove or disprove; rather, it is the Secretary's role to consider the agency's documentation and rationale for a questioned cost and, on behalf of the taxpayers, decide if the agency has complied with the Federal requirements.

Changes: None.

Comment: A few commenters recommended that § 682.410(a)(11)(iii)(A) be modified to

recognize differences in costs as affected by the differences in guaranty agencies. The commenters suggested that what may be reasonable, ordinary, and necessary for the operation of a large guaranty agency in a low cost geographic area may not be reasonable for a smaller guaranty agency in an area with a labor shortage and high cost of living. The commenters believed that the regulatory provision, as written, would interfere with the intent of § 421(a)(1)(A) of the HEA, which recognizes and encourages guaranty agencies to operate within different States pursuant to State charters. The commenters recommended the regulations take into account the geographic area, demographics, higher education community, size, and nature of the guaranty agency. Several commenters suggested that § 682.410(a)(11)(iii)(B) be expanded to include a balancing of the risks and benefits of a particular action as well as an evaluation of price, quality, and service. One guaranty agency commenter agreed with the regulatory language that was presented in the NPRM.

Discussion: The regulations do not prohibit a guaranty agency from considering reasonable factors, including those presented by the commenters, when deciding if a particular expenditure would meet the reasonable cost definition in § 682.410(a)(11)(iii). The Secretary reminds the commenters that the burden of proof is upon the guaranty agency, as a fiduciary, to establish that costs are reasonable.

Changes: None.

Comment: Several commenters were concerned about the extent to which an agency would be required to go to prove an expenditure was reasonable if it was required to document the market prices of comparable goods or services under § 682.410(a)(11)(iii)(C). The commenters noted that guaranty agencies are involved in numerous purchases of goods and services for which the price is not always the most important consideration. The commenters recommended that the regulations permit an agency to exercise its judgment concerning other factors, including the quality of the goods or services or their timely delivery. One guaranty agency commenter agreed with the regulatory language that was presented in the NPRM.

Discussion: As discussed above, the regulations do not prohibit a guaranty agency from considering reasonable factors, including those presented by the commenters, when deciding if a particular expenditure would meet the reasonable cost definition in § 682.410(a)(11)(iii). However, it is inconceivable that a reasonable cost determination could be made without considering the market prices for comparable goods or services.

Changes: None.

Section 682.410(b)(11) Conflicts of Interest

Comment: One commenter rejected what the commenter perceived to be the underlying premise of § 682.410(b)(11), that the sharing by a guaranty agency of a corporate management structure with affiliates would necessarily raise issues of self-dealing and conflicts of interest. The commenter stated that guaranty agencies, through the provisions of the Internal Revenue Code governing section 501(c)(3) organizations, State ethics codes, and State non-stock corporation provisions, as well as other provisions of State law, are already prevented from engaging in the type of conduct being regulated in the NPRM. The commenter stated that the Internal Revenue Code explicitly forbids a section 501(c)(3) organization from having any part of its net earnings inure to the benefit of those who control it or who financially support it. The commenter stated that although section 432(p) of the HEA empowers the Secretary to act when there is a conflict of interest, the commenter was unaware of any instance when the Secretary exercised that power. Thus, the commenter concluded, the regulations proposed by the Secretary are too broad and unnecessary. In the commenter's view, the Secretary should instead draft ''firewall'' regulations focusing on conflicts of interest between guarantor staff and lender/secondary market staff. Another commenter disagreed with the scope of the proposed conflicts of interest regulations and recommended they be limited, if imposed at all, to decision-making employees.

Discussion: The Secretary has taken steps in the past to address specific instances of actual or potential conflicts of interests involving guaranty agencies. However, those steps generally have not been completely successful in eliminating or preventing conflicts of interests at those specific agencies, nor do those specific steps have general applicability to all guaranty agencies. Therefore, the Secretary has decided that stronger measures, in the form of these comprehensive regulations, are needed to protect the Federal reserve funds and assets. The Secretary believes that these FFEL-specific regulations should impose no significant additional burdens on any guaranty agency covered under the more generic rules of the Internal Revenue Code and other requirements that restrict entities and individuals from engaging in the type of conduct addressed in the Secretary's regulations.

Furthermore, there is a unique role for the Secretary. The existence of a Federal reserve fund in agencies with activities outside of the guaranty agency role creates a dangerous incentive for managers to find ways to move funds from the restricted-use reserve fund into a less regulated operation or affiliate. For example, agencies have been found to be enriching their affiliates by moving operations to the affiliate, on paper, and then charging the reserve fund a mark-up for the services performed. The Inspector General found evidence of agencies protecting their affiliates from fines and losses related to due diligence violations. The Secretary has responsibility to protect the Federal reserve funds entrusted to guaranty agencies. That is the Secretary's role, a role that has been clearly defined by Congress when it directed the Secretary, in section 422(g)(1)(C) of the HEA, to prevent the ''misapplication, misuse, or improper expenditure of reserve funds and assets.'' Finally, in response to the comment about decision-making employees, the Secretary notes the NPRM proposed to apply the conflicts of interest rules only to guaranty agency employees who had decision-making authority as to the administration of a contract or agreement supported by the reserve fund.

Changes: None.

Comment: One commenter opposed the restrictions in § 682.410(b)(11)(i) on the grounds that they were too sweeping. The commenter recommended that, instead of applying the disclosure requirement to financial or other interests in any entity, the regulations should limit it to entities ''related to student financial aid.''

Discussion: The regulations are meant to be sweeping, because the types of organizations with which a guaranty agency could have actual or potential conflicts of interest are not limited to those organizations involved in student financial aid.

Changes: None.

Comment: A few commenters were concerned that the conflict of interest restrictions in § 682.410(b)(11) would force some guaranty agencies to modify or abandon affiliation relationships that had been in place for years and that they believed were beneficial to the FFEL Program. Some commenters suggested that the Secretary's underlying motive was to interfere with the ability of guaranty agencies to compete with the Federal Direct Loan Program. Several

guaranty agency commenters agreed with the regulatory language that was presented in the NPRM. One commenter representing schools recommended that the Secretary prohibit a guaranty agency from having any affiliated business activities.

Discussion: The Secretary recognizes that some affiliate relationships may result in improved services and economies of scale that benefit the affiliated parties, including the guaranty agency. Thus, the regulations do not require a strict separation of those entities. Instead, the regulations require that appropriate safeguards be established to ensure that the Federal fiscal interest is not jeopardized as a result of those affiliate relationships. The Secretary will continue to monitor these relationships closely to ensure that the programmatic and other costs of these relationships do not exceed the benefits.

Changes: None.

Comment: One commenter noted that Congress has continually given guaranty agencies authority to expand their participation in the FFEL Program. The commenter stated that guarantors have been asked to be lenders, lenders of last resort, and escrow agents. The commenter believed the Secretary had no authority to regulate a guaranty agency's affiliations.

Discussion: The Secretary has not said that all affiliations are prohibited. Only those that result in a real or potential conflict of interest are the subject of these regulations. Moreover, the various obligations placed on the guaranty agencies are the responsibilities of those agencies. Nothing in the HEA authorizes or suggests that the agency may shift its responsibilities to an affiliate.

Changes: None.

Comment: One commenter suggested that § 682.410(b)(11)(i)(A) should be applied to all guaranty agencies, without a special exemption for employees of a State agency covered by State codes of conduct. The commenter believed that most State codes of conduct are generic and focus on preventing individual transgressions that might be committed by employees with limited decision-making authority operating within well established procurement, contracting, or other decision-making parameters. The commenter doubted that many State codes of conduct address the broad, more subtle policy issues that the Secretary intended to address in the regulations. Several guaranty agency commenters agreed with the regulatory language that was presented in the NPRM.

Discussion: The Secretary believes that State codes of conduct provide sufficient safeguards to protect the interests of the FFEL Program. If that assumption turns out to be invalid, the Secretary will consider additional action.

Changes: None.

Comment: Several commenters representing guaranty agencies recommended the word ''trustee'' be replaced with ''director'' and that the word ''agents'' be deleted. The commenters recommended this change wherever the words ''trustee'' and ''agents'' are used. Some guaranty agency commenters agreed with the regulatory language that was presented in the NPRM.

Discussion: The Secretary acknowledges that the title ''director'' appears to be commonly used by guaranty agencies.

Changes: The Secretary has added the title ''director'' to the list of individuals designated in the regulations.

Comment: One commenter argued that the prohibitions in § 682.410(b)(11)(i)(A) should apply only to guarantor employees who have financial interests in non-affiliated organizations, not in affiliated State agencies or not-for-profit corporations. The commenter recommended that the exemption in § 682.410(b)(11)(i)(A) be revised to include employees of multiple State agencies within the State covered by codes of conduct established under State law or to employees, officers, trustees, or agents employed by a not-for-profit guarantor and its not-for-profit affiliates covered by a published code of conduct that, among other standards, requires disclosures of the interests specified in § 682.410(b)(11)(i)(A). One commenter stated that some private, not-for-profit guarantors are not State agencies, but are nevertheless subject to State statutory codes of conduct. The commenter recommended that the exemption in § 682.410(b)(11)(i)(A) be expanded to cover those agencies.

Discussion: The Secretary has seen no evidence showing that private, not-for-profit guarantors and their employees, officers, directors, trustees, and agents, are covered under State ethics codes to the extent that State guaranty agencies are covered. The Secretary believes that State guaranty agencies have sufficient authorities and responsibilities that allow the Secretary to provide greater deference to them than to private, not-for-profit guarantors.

Changes: None.

Comment: Several guaranty agency commenters agreed with the regulatory language that was presented in § 682.410(b)(11)(i)(A) of the NPRM. Another commenter also agreed, but asked that the Secretary define the term ''nominal'' with respect to unsolicited favors, gratuities, or other items that may be accepted.

Discussion: Minor and low cost unsolicited favors, gratuities, or other items generally may be accepted. The Secretary is reluctant to place an absolute dollar value on the unsolicited favors, gratuities, or other items that may be accepted, but it would be highly unlikely that the agency could justify any case where the value exceeded $25.

Changes: None.

Comment: Several commenters objected to the provisions of proposed § 682.410(b)(11)(ii). That section proposed that if a guaranty agency fails to meet the conflict of interest requirements in the regulations, the Secretary may require the agency to comply with additional appropriate measures to protect the Federal fiscal interest, including the divestiture of the agency's non-FFEL functions and its interests in any affiliated organization. The commenters argued that this provision exceeded the Secretary's statutory authority. In addition, they argued that any divestiture authority that arguably exists could only be exercised after providing the affected guaranty agency with appropriate due process. In contrast, one commenter agreed with the proposed rule and another commenter suggested only that divestiture not be required in situations in which the agency failed to enforce the prohibition on gifts and gratuities in proposed § 682.410(b)(11)(i)(C).

Discussion: The Secretary notes that divestiture of the agency's non-FFEL functions is only one possible measure that may be required to protect the Federal fiscal interest. The Secretary acknowledges that divestiture might have a significant impact on the guaranty agency's operations. However, divestiture would clearly be appropriate if the guaranty agency organization had otherwise failed to protect the Federal fiscal interest against the impact of conflicts of interest among its various activities and among its employees. Before requiring this step, the Secretary will provide the agency with an appropriate opportunity, consistent with applicable due process requirements, to show why the action should not be required. The Secretary further notes that the requirement for divestiture to protect the Federal fiscal interest is an appropriate limitation of the guaranty agency's participation in the FFEL program as authorized by 34 CFR 682.413(c)(1).

Changes: None.

Section 682.418 Prohibited Uses of Reserve Fund Assets

Comment: Several commenters representing guaranty agencies objected to the provisions of § 682.418(a)(1). The commenters stated that pre-approval for costs such as professional services is impractical and suggested that the pre-approval process will seriously interrupt the delivery of services to students and financial aid officials. The commenters wanted State agencies to be exempt from this requirement because they believed it was redundant for State agencies with State contractual regulations. One commenter from a guaranty agency objected to the absence of any reference in § 682.418(a)(1) to the Secretary taking into consideration the differences in guaranty agencies, or the standards by which the Secretary's approval will be granted. Some commenters recommended that § 682.418(a)(1) be deleted, or that an exception be carved out for contracts awarded by way of a competitive bidding process. Otherwise, they suggest, a guaranty agency could end up paying more for services provided by a non-affiliate than by its affiliate.

Discussion: The Secretary's pre-approval is only required in those rare instances where the agency demonstrates that an unusual circumstance exists that warrants paying an affiliate more than cost for services rendered. The commenters can be assured that the Secretary will take all relevant information into account when deciding if the Federal interests would be served if a guaranty agency paid more than cost for goods, property, or services provided by its affiliate. The Secretary believes that under an affiliation relationship, a guaranty agency should be able to obtain goods, property, or services from its affiliate at cost.

The Secretary does not agree that State rules will fully protect Federal reserve funds maintained by a State guaranty agency which has an affiliated organization.

Changes: None.

Comment: One commenter suggested that the Secretary define the term ''affiliated organization,'' as used in § 682.418(a)(1).

Discussion: The Secretary believes that a regulatory definition of ''affiliated organization'' would limit the ability to apply the regulations to new forms of affiliations devised in the future. The Secretary will determine whether a guaranty agency has a relationship with an ''affiliated organization'' based on all the facts and circumstances in the particular case. In making this determination, the Secretary intends to utilize a working definition of ''affiliated organization'' as any organization controlling, controlled by, or under common control with, the guaranty agency. A guaranty agency and its affiliate may be under common control if they share common board members or officers, or if their activities are otherwise directed by the same individuals. This definition is based on the definition of ''affiliate'' generally used by the Securities and Exchange Commission. *See,* for example, 17 CFR 240.12b–2 and 260.0–2(a).

Changes: None.

Comment: Some commenters objected that the blanket use of the term ''assets'' in § 682.418(a)(2) exceeds the statutory language found in section 422(g) of the HEA because it is not limited to assets purchased with the reserve funds but refers simply to ''assets.'' The commenters recommended that this provision specify that it applies only to assets purchased with the reserve fund. Other commenters believed that the HEA gave the Secretary limited authority in this area, and believed the regulations should exempt insurance agreements with lenders, agreements with schools, and third party contracts with private collection agencies. One commenter was concerned that this provision would infringe on the rights of parties to enter into legally binding contracts with a guaranty agency.

Discussion: The Secretary is not regulating how a guarantor handles its non-FFEL assets or funds. On the other hand, the Secretary fully intends to take steps to protect the Federal reserve fund. Accordingly, guarantor contracts with other parties that require the use of Federal reserve funds or assets are subject to the 30-day notification requirement.

Changes: None.

Comment: One commenter from a guaranty agency agreed that the Secretary should actively seek to prevent improper depletion of the reserve fund, but considered the Secretary's proposed regulations to be inadequate for that purpose. In the commenter's judgment, the protection of reserve funds cannot be achieved merely by prohibiting a limited number of specific types of expenditures which, in the aggregate, represent an insignificant share of overall guaranty agency costs. Instead, the commenter recommended that the Secretary focus on the relative cost effectiveness of individual guarantors in carrying out their primary responsibilities under the HEA. The commenter suggested an alternative approach that would enable the Secretary to focus on whether proper value is being received for reserve funds expended. The commenter additionally stated that the alternative approach would avoid what the commenter viewed to be ''inevitable, tedious, and diversionary arguments'' that the measures proposed by the Secretary to restrict specific types of expenditures are punitive in nature, represent micromanagement, and are designed to hamper the ability of guarantors to compete effectively with the Direct Lending Program. The commenter recommended that the regulations be revised to require: (1) the expansion of the Secretary's current guarantor evaluation model to provide a ''fully loaded'' (all overhead costs allocated) analysis of each guarantor's unit costs of delivering its services; (2) on-going monitoring of each guarantor's performance relative to the model by requiring Part E 1130 data to be submitted quarterly rather than annually; (3) establishment of maximum acceptable unit cost standards for each primary guarantor service (*e.g.,* 125 percent of national mean cost); (4) the identification and correction of specific factors that result in a guaranty agency exceeding the acceptable unit costs in one or more areas; (5) the taking of corrective action by a guaranty agency where overall costs exceed current revenues (exclusive of investment income); and (6) a targeted program review effort designed to ensure that acceptable unit costs are not being achieved at the expense of program integrity. The commenter believed that under the alternative approach, guaranty agencies that manage their operations in a cost-effective manner would be able to exercise management discretion and flexibility, and that the alternative approach would be consistent with the Secretary's recent initiatives to provide incentives for work well done and to encourage common sense and good business practices by guarantors.

Discussion: Although the commenter has presented an interesting proposal, the Secretary must decline to pursue it as an alternative to fiduciary standards. As long as a guaranty agency holds Federal funds, the Secretary believes it is appropriate to hold the agency accountable under those standards.

Changes: None.

Comment: One commenter thought that all of the prohibitions and limitations in § 682.418(b) were unnecessary because the Secretary could simply rely on the definition of ''reasonable cost'' found in § 682.410(a)(11)(iii). Thus, for example, contributions and donations would only

be prohibited to the extent that they were not reasonable.

Discussion: The commenter's proposal ignores the limited purpose of the Federal reserve funds and assets. Those funds and assets are provided solely to serve FFEL Program purposes. The Secretary has determined that certain uses of those funds and assets are simply unreasonable, in light of their intended purpose.

Changes: None.

Section 682.418(b)(1) Advertising

Comment: Some commenters objected to the restrictions on advertising in § 682.418(b)(1) and recommended that a guaranty agency should be permitted to use reserve funds to advertise the types of services that the agency provides. The commenters mentioned many types of services, including default prevention software, training programs, and Internet sites. A few commenters questioned how an agency could perform its customer service functions under § 682.418(b)(9), ''public relations,'' if the agency was prohibited from advertising about those customer service functions.

The commenters also generally stated that provisions on reasonable costs contained in § 682.410(a)(11) and existing provisions on guaranty agency reserve levels adequately protect the Federal fiscal interest. The commenters noted that OMB Circulars A–87 and A–122 allow for advertising costs ''necessary to meet the requirements of the Federal award.'' The commenters recommended that guarantors not be prohibited from using advertising that was related to the guaranty agency's purposes under the HEA. Other commenters believed the restrictions on advertising ran counter to the Secretary's, the President's, and the Congress' stated support of competition for better education loan services and school choice between the FFEL and the Direct Loan programs.

Discussion: A guaranty agency may use the reserve fund to pay for activities that are ordinary and necessary for the fulfillment of its FFEL guaranty responsibilities under the HEA. In § 682.418(b)(9), several examples of these activities are given, such as training of program participants and secondary school personnel, dissemination of FFEL-related information and materials to schools, loan holders, prospective loan applicants, and their parents, and training at workshops, conferences, or other forums. When developing the NPRM, the Secretary did not intend to bar the use of reserve funds to provide notices about those activities and meetings. However, a number of commenters believed that this type of notification would be prohibited because it was not specifically listed in either § 682.418 (b)(1) or (b)(9). To clarify this rule, the Secretary has decided to include such notices as an allowable activity related to ''public relations,'' under § 682.418(b)(9). The Secretary believes that this clarification, together with the overall requirement that advertising costs must be ordinary and necessary for the fulfillment of the agency's FFEL guaranty responsibilities under the HEA, eliminates the need to have a separate regulatory provision devoted solely to advertising.

Changes: Section 682.418(b)(1) is deleted and sections 682.418 (b)(2) through (b)(11) will be renumbered (b)(1) through (b)(10). The definition of the term ''public relations'' under renumbered § 682.418(b)(8) will permit the use of reserve funds to pay advertising costs related to providing notice about training of program participants and secondary school personnel, customer service functions that disseminate FFEL-related information and materials to schools, loan holders, prospective loan applicants, and their parents, and training at workshops, conferences, or other forums.

Section 682.418(b)(2) Compensation for Personnel Services

Comment: Many commenters asked for an explanation of how the Secretary's total compensation in § 682.418(b)(2) was calculated to be 118.05 percent of the Secretary's salary. The commenters generally believed that the calculation did not include all of the Secretary's compensation. Several commenters believed the Secretary has no authority to put a limit on compensation that is contained in § 682.418(b)(2). However, one guaranty agency commenter agreed with the regulatory language that was presented in the NPRM.

The commenters also argued that 18.05 percent would not cover the average percentage of a salary attributable to benefits in the non-profit sector. Some commenters argued that in order to attract and retain qualified individuals, particularly those for information systems type positions, it is critical for the guaranty agency to be able to provide competitive compensation packages to its employees. One commenter stated that many other organizations, such as universities and hospitals, receive or administer Federal funds, including funds issued by the Secretary, yet neither the Secretary or any other Federal agency has claimed authority for establishing maximum compensation for employees of those entities. Most of the commenters recommended that § 682.418(b)(2) be deleted, or if not entirely deleted, the reference to compensation and benefits should be deleted and the regulations should refer only to salary when discussing the cap.

Discussion: The Federal reserve funds are provided to guaranty agencies to be used for specific program purposes. The Secretary is not convinced that paying compensation in excess of the reasonable amounts proposed in the NPRM is a necessary or appropriate use of those funds. A guaranty agency that chooses to pay compensation that exceeds the amounts allowable under § 682.418(b)(1) (as renumbered) may use non-FFEL resources to fund those excess amounts of compensation.

Overall responsibility for the FFEL Program is one of the Secretary's many duties, whereas the administration of a guaranty agency is, by comparison, the logical equivalent of a subset of the Secretary's overall duties. The Secretary, as the overall administrator of the entire FFEL Program, in addition to many other duties, has a wider area of responsibility than any individual associated with any guaranty agency. Therefore, the most appropriate salary amount to base the compensation restrictions upon is the Secretary's total salary paid (as calculated on an hourly basis) under section 5312 of title 5, United States Code (relating to Level I of the Executive Schedule). Further, the sum of all of the components making up the annual compensation received by the Secretary resulted in the calculation that all of the benefits received by the Secretary represented a dollar value equal to 18.05 percent of the Secretary's annual salary.

Changes: None.

Section 682.418(b)(3) Contributions and Donations

Comment: Some commenters believed that § 682.418(b)(3) would prohibit charitable activities by guaranty agency employees and the training programs that guaranty agencies provide for the State financial aid organizations. The commenters stated that this training is an essential element of a guaranty agency function and should not be prohibited. They also noted that the OMB Circulars allow expenditures for the morale, health, and welfare of employees. The commenters recommended that the regulations be revised to comply with the OMB Circulars, and that the regulations allow a guaranty agency to make contributions

and donations from the reserve fund if they are for the purpose of meeting the agency's functions under the HEA. One commenter recommended that the regulations establish a maximum allowable amount to allow a reasonable level of guarantor external involvement and support for such activities, without prior approval from the Secretary. Another commenter recommended that the regulations permit minor contributions, especially in the context of matching donations of money by employees and allowing employees to volunteer small amounts of time during work hours. The commenter stated that these are reasonable and ordinary activities engaged in by reasonable organizations, and that guaranty agencies should not be prohibited from contributing to their communities.

Discussion: The prohibition against contributions and donations does not prohibit guaranty agencies from continuing to provide education and information dissemination services to schools, nor does it interfere with the ability of a guaranty agency to perform activities that are ordinary and necessary for the fulfillment of its FFEL guaranty responsibilities under the HEA. However, contributions or donations, including the volunteer services of employees during working hours, are prohibited, unless the Secretary decides that the Federal interests would benefit. In that event, the Secretary will provide specific written authorization to the agency. The Secretary also notes that, except for the reference to ''guaranty agency'' instead of ''government unit,'' the prohibition in § 682.418(b)(3) contains the exact language found in OMB Circular A–87.

Changes: None.

Section 682.418(b)(4) Entertainment

Comment: Commenters representing guaranty agencies objected to the prohibition in § 682.418(b)(4) against the use of the reserve fund for entertainment, although one guaranty agency commenter agreed with the regulatory language that was presented in the NPRM. The commenters argued that guaranty agencies should be allowed to use the reserve fund for entertainment that would improve the morale, health, and welfare of their employees. Other commenters also wanted agencies to be allowed to use the reserve fund for entertainment costs at meetings, conferences, and workshops related to the guaranty agency's responsibilities under the HEA.

Discussion: The FFEL reserve fund is intended to be used only for the purpose of ensuring that all eligible students and their parents have access to FFEL loans. In carrying out its responsibilities under the HEA, a guaranty agency, like any other organization, would need to provide for the adequate morale, health, and welfare of its employees. Such expenditures may include the reasonable costs of health or first-aid clinics, recreational facilities, employee counseling services, child care services, employee information publications, or similar activities or services. Those costs are not prohibited, and would fall under the ''ordinary and necessary'' rule with respect to reasonable costs in § 682.410(a)(11)(iii)(A). However, the Secretary does not view the types of activities specified under ''entertainment'' in § 682.418(b)(4) of the NPRM to be ordinary and necessary for the adequate morale, health, and welfare of a guaranty agency's employees.

The Secretary does not believe that the entertainment activities prohibited by these regulations are necessary to an agency's ability to conduct meetings, conferences, and workshops related to the guaranty agency's responsibilities under the HEA. The Secretary believes that such entertainment costs would divert FFEL resources from the goal of ensuring that all eligible students and their parents have access to FFEL loans.

Changes: None.

Section 682.418(b)(5) Fines, Penalties, Damages, and Other Settlements

Comment: Several commenters opposed the restrictions in § 682.418(b)(5) on the use of reserve funds to pay fines, penalties, damages, or settlements against the agency because of the agency's violation or alleged violation of a Federal, State, or local law or regulation unrelated to the FFEL Program. The commenters believed those restrictions would be unfair to the agencies that had no access to funds other than the FFEL reserves, and would effectively cut off their ability to defend themselves against lawsuits. The commenters argued that this provision is unnecessary, especially where a guaranty agency makes good faith efforts to comply with Federal and State laws unrelated to the FFEL Program.

The commenters also believed that the provisions in § 682.418(b)(5) are more restrictive than the OMB Circulars. They recommended that costs needed to defend a guaranty agency for non-FFEL related claims where the guaranty agency acted in good faith should be allowed, and that the language contained in the OMB Circulars allowing legal expenses required in the administration of a Federal program should be adopted here. A number of commenters suggested that this restriction would actually be contrary to the Federal fiscal interest since they believed it would encourage agencies to avoid litigation at all costs.

Discussion: The Secretary has decided to modify this restriction so that the interests of the taxpayer will be protected while, at the same time, guaranty agency operations will not be jeopardized because the agency is unable to use reserve funds or obtain non-FFEL funding to pay fines, penalties, damages, and settlements. The Secretary believes that a guaranty agency should be permitted to use the reserve fund to pay fines for such violations or alleged violations as long as they have been assessed against the guaranty agency, do not involve the reimbursement of agency employees, do not exceed $1,000, and result from non-criminal charges. This approach is in accord with the Secretary's understanding of normal business practices. If the penalty exceeds $1,000 or involves an actual or alleged criminal violation, the agency must receive specific prior approval from the Secretary before using the reserve fund.

Changes: The regulations have been revised accordingly, as discussed above.

Section 682.418(b)(6) Legal Expenses

Comment: Some commenters believed the prohibition in § 682.418(b)(6) of the use of the reserve fund to prosecute claims against the Federal Government would violate a guaranty agency's right to due process in the case of an agency that had no access to funds other than the FFEL reserves. The commenters recommended that, at a minimum, actions based on good faith challenges, or where a reasonable chance of success can be demonstrated based on precedent, or where there is no known precedent to the contrary, should be allowed. The commenters recommended the deletion of the Secretary's approval prior to reimbursement for legal expenses when the guaranty agency has substantially prevailed.

One commenter stated that if the Secretary was concerned with the use of Federal funds for the prosecution of frivolous matters, or initiation of legal action purely to avoid compliance, then that concern is addressed by existing ethical and court standards that prohibit the assertion of a claim by an attorney, that is unwarranted under existing law, or which cannot be supported by a good faith argument for a revision or change in existing law.

Discussion: The regulations allow a guaranty agency to use reserve funds to appeal findings and determinations of

the Department by presenting its position in administrative hearings. However, the Secretary does not believe that it is an appropriate use of taxpayer funds to pay for the agencies' unsuccessful court challenges. The Secretary notes that the right to sue the Federal Government does not include the right to use Federal property to do so.

Changes: None.

Comment: Some commenters questioned the provision in § 682.418(b)(6) that, even if the guarantor prevails in its litigation, the Secretary will determine the amount of funds to be used to reimburse the guarantor. The commenters argued that this provision would make it practically impossible for an agency to hire counsel.

Discussion: The Secretary will reimburse a guaranty agency for all documented and reasonable legal expenses incurred by the agency if the agency substantially prevails in its claim against the Secretary.

Changes: None.

Section 682.418(b)(7) Lobbying Activities

Comment: Some commenters recommended a revision so that the restrictions in § 682.418(b)(7) would not prohibit dues paid to membership organizations that do not have lobbying as their principal purpose and activity. One guaranty agency commenter agreed with the regulatory language that was presented in the NPRM. Another commenter asked if the Secretary would consider a guaranty agency's response to an inquiry from a legislator to be lobbying. Some commenters misinterpreted the restriction in § 682.418(b)(7) to mean that a guaranty agency could not be a member of an organization that engages in lobbying, even if only to a minor extent.

Discussion: The regulations do not prohibit guaranty agencies from being members of organizations that engage in lobbying. The regulations simply prohibit Federal reserve funds from being used to pay that portion of the membership dues that would be used for lobbying. This restriction is similar to existing restrictions on the activities of charitable organizations under the Internal Revenue Code.

Changes: None.

Section 682.418(b)(8) Major Expenditures

Comment: Several commenters representing guaranty agencies objected to requirements in § 682.418(b)(8) restricting the use of reserve funds to pay for major expenditures on the grounds that it was an unnecessary attempt to micromanage the operations of a guaranty agency and would serve to hamper the effective operations of the guaranty agency. However, one guaranty agency commenter agreed with the regulatory language that was presented in the NPRM. One commenter acknowledged the Secretary's obligation to regulate and review a guaranty agency's investment of Federal reserve funds in major assets such as systems or facilities, but did not believe the regulations proposed by the Secretary provided enough guidance for how such proposed investments should be justified by the guaranty agencies. Another commenter recommended a more precise definition of the term ''major expenditure.'' The commenter stated that such costs as claim payments and personnel compensation are surely ''major'' expenditures, but doubted that the Secretary intended those expenditures to be included in the notification requirement under § 682.418(b)(8).

Discussion: The use of the term ''such as'' followed by some examples of costs to be considered does not mean that costs similar to those suggested by the commenters could not be evaluated. The Secretary will not require notification of an agency's intended lender claim payment. However, the Secretary would want to know about, and would be concerned if a guaranty agency intended to pay personnel compensation (presumably, a biweekly or monthly payroll) that exceeds 5 percent of the agency's reserve fund balance at the time the compensation is paid.

Changes: None.

Comment: One commenter representing a collection agency stated that it would not be easy to determine if payments made to a collection contractor would exceed the 5 percent criterion specified in the regulations. The commenter noted that a collection contractor works on a contingency basis, therefore, potential expenditures would be difficult to predict. The commenter also observed that a collection contractor is paid only if it successfully collects a debt, so the payment to the contractor may not be a true ''expenditure'' of funds, but is simply a fee paid for increasing the balance of the agency's Federal reserve fund.

Discussion: The commenter's point is well taken, but the Secretary sees no need to revise the regulations. If a guaranty agency believes that its payment to a collection contractor would exceed the 5 percent threshold, the Secretary expects to be notified.

Changes: None.

Section 682.418(b)(9) Public Relations.

Comment: One commenter from a school was opposed to the restrictions on public relations costs in § 682.418(b)(9). The commenter believed that it was appropriate for guaranty agencies to sponsor school training sessions, workshops, and conferences on all aspects of the title IV programs. The commenter stated that schools generally had insufficient resources available for funding such training, and without the financial assistance of guaranty agencies, it would be severely curtailed or eliminated.

Discussion: A guaranty agency is permitted to use the reserve fund to pay for activities that are ordinary and necessary for the fulfillment of the agency's FFEL guaranty responsibilities under the HEA, such as training of program participants and secondary school personnel, customer service functions that disseminate FFEL-related information and materials to schools, loan holders, prospective loan applicants, and their parents, and training at workshops and conferences. The Secretary does not believe it is appropriate for a guaranty agency to use Federal reserve funds to pay for an activity that is not necessary for the agency's fulfillment of its FFEL guaranty responsibilities.

Changes: None.

Comment: Commenters representing guaranty agencies recommended that the list of permissible public relations expenditures needs to include the furnishing of lodging, transportation, and honorarium to participants in FFEL related functions. Otherwise, according to the commenters, the performance of a guaranty agency's functions under the HEA will be hindered. They also recommended the addition of language prohibiting such expenditures where the sole purpose of the expenditure is to promote a favorable image of the guaranty agency. One guaranty agency commenter agreed with the regulatory language that was presented in the NPRM.

Discussion: Allowable public relations costs may include associated costs that are reasonable, including costs of the nature discussed by the commenters. The Secretary declines to list specific costs items in the regulations because of the number of different items that can be associated with allowable public relations costs. The Secretary also believes it would be superfluous to add language prohibiting such expenditures if the sole purpose of the expenditure is to promote a favorable image of the guaranty agency, because such expenditures already

would fail to meet the regulatory requirements pertaining to allowable public relations costs.

Changes: None.

Comment: One commenter asked if the restrictions on the use of reserve funds for public relations costs would mean that a guaranty agency could not publish an annual report.

Discussion: The Secretary does not consider a guaranty agency's annual report to be a public relations activity. In the Secretary's view, an annual report is a normal and customary business document. The key test concerning such a report would be for the agency to be able to document that the cost of the report was reasonable.

Changes: None.

Section 682.418(b)(10) Relocation of Employees

Comment: One commenter believed that § 682.418(b)(10) should be deleted because, in the commenter's opinion, the IRS rules regarding relocation expenses are sufficient.

Discussion: The issue of whether relocation expenses are income to a taxpayer for IRS purposes is irrelevant to the issue of whether the Federal reserve funds should pay for those costs.

Changes: None.

Section 682.410(b)(11) Travel Expenses

Comment: Commenters representing guaranty agencies stated that travel rates available to Federal employees are not available to guaranty agency employees and, therefore, § 682.418(b)(11) is not workable, but one guaranty agency commenter agreed with the regulatory language that was presented in the NPRM. The commenters also stated there are no standards provided by which a guaranty agency can develop a travel policy that will be approved by the Secretary. The commenters recommended a deletion of § 682.418(b)(11), and suggested that a guaranty agency should submit its travel plan and be able to use it unless expressly disallowed by the Secretary. Several commenters believed the restrictions on travel costs in § 682.418(b)(11) were unnecessary because the general rules governing reasonable costs would be sufficient.

Discussion: The Secretary has an obligation to protect diligently the Federal reserve funds and assets administered by guaranty agencies. Although there may be a number of alternative approaches that could be taken to protect those reserve funds and assets, the Secretary has not been persuaded by the commenters that the approach proposed in the NPRM was unreasonable, burdensome, or failed to protect the Federal interests.

Changes: None.

Section 682.418(c) Cost Allocation

Comment: One commenter supported the requirement that guarantors be required to develop cost allocation plans subject to audit, and also supported the requirement that the plans be reasonable, as that term is used in § 682.410, specifically that the plan pass the ''prudent person'' test. However, the commenter disagreed with the requirement that the plan must be consistent with OMB Circular A–87. In the commenter's view, OMB Circular A–87 is designed for a different class of entities than guaranty agencies, thus, the required application of it to guarantors would create ambiguities and contradictions that will be difficult to resolve. The commenter stated that the guarantor agreements with the Secretary are neither grants nor cost-reimbursement contracts; they are fee-for-service contracts, with the Secretary paying the guarantor a fee for each loan guaranteed, for each loan successfully prevented from default, and for each defaulted loan collected. The commenter believed the only element of the guarantor's agreement with the Secretary that resembles cost reimbursement is the partial reimbursement of claims paid by the guarantor to lenders.

Discussion: The Secretary has stated that OMB Circular A–87 applies to guaranty agencies. The Secretary does not agree that the fee-for-service rules apply to guaranty agencies. The guaranty agencies are not paid for services provided, but instead receive Federal funds to use in performing certain roles in the FFEL Program.

Changes: None.

Assessment of Educational Impact

In the notice of proposed rulemaking, the Secretary requested comments on whether the proposed regulations would require transmission of information that is being gathered by or is available from any other agency or authority of the United States.

Based on the response to the proposed rules and on its own review, the Department has determined that the regulations in this document do not require transmission of information that is being gathered by or is available from any other agency or authority of the United States.

List of Subjects in 34 CFR Part 682

Administrative practice and procedure, Colleges and universities, Education, Loan Programs, Reporting and recordkeeping requirements, Student aid, Vocational education.

(Catalog of Federal Domestic Assistance Number 84.032 Federal Family Education Loan Program)

Dated: November 21, 1996.

Richard W. Riley,

Secretary of Education.

The Secretary amends title 34 of the Code of Federal Regulations by revising Part 682 as follows:

PART 682—FEDERAL FAMILY EDUCATION LOAN (FFEL) PROGRAM

1. The authority citation for Part 682 continues to read as follows:

Authority: 20 U.S.C. 1071 to 1087–2, unless otherwise noted.

2. Section 682.401 is amended by adding a new paragraph (b)(28) to read as follows:

§ 682.401 Basic program agreement.

* * * * *

(b) * * *

(28) *Change in agency's records system.* The agency shall provide written notification to the Secretary at least 30 days prior to placing its new guarantees or converting the records relating to its existing guaranty portfolio to an information or computer system that is owned by, or otherwise under the control of, an entity that is different than the party that owns or controls the agency's existing information or computer system. If the agency is soliciting bids from third parties with respect to a proposed conversion, the agency shall provide written notice to the Secretary as soon as the solicitation begins. The notifications described in this paragraph must include a concise description of the agency's conversion project and the actual or estimated cost of the project.

* * * * *

3. Section 682.410 is amended by revising the introductory text in paragraph (a)(2), revising paragraphs (a)(2)(ii) and (x), and adding new paragraphs (a)(11)(iii) and (b)(11) to read as follows:

§ 682.410 Fiscal, administrative, and enforcement requirements.

(a) * * *

(2) *Uses of reserve fund assets.* A guaranty agency may not use the assets of the reserve fund established under paragraph (a)(1) of this section to pay costs prohibited under § 682.418, but shall use the assets of the reserve fund to pay only—

* * * * *

(ii) Costs that are reasonable, as defined under § 682.410(a)(11)(iii), and

that are ordinary and necessary for the agency to fulfill its responsibilities under the HEA, including costs of collecting loans, providing preclaims assistance, monitoring enrollment and repayment status, and carrying out any other guaranty activities. Those costs must be—

(A) Allocable to the FFEL Program;

(B) Not higher than the agency would incur under established policies, regulations, and procedures that apply to any comparable non-Federal activities of the guaranty agency;

(C) Not included as a cost or used to meet cost sharing or matching requirements of any other federally supported activity, except as specifically provided by Federal law;

(D) Net of all applicable credits; and

(E) Documented in accordance with applicable legal and accounting standards;

* * * * *

(x) Any other costs or payments ordinary and necessary to perform functions directly related to the agency's responsibilities under the HEA and for their proper and efficient administration;

* * * * *

(11) * * *

(iii) *Reasonable cost* means a cost that, in its nature and amount, does not exceed that which would be incurred by a prudent person under the circumstances prevailing at the time the decision was made to incur the cost. The burden of proof is upon the guaranty agency, as a fiduciary under its agreements with the Secretary, to establish that costs are reasonable. In determining reasonableness of a given cost, consideration must be given to—

(A) Whether the cost is of a type generally recognized as ordinary and necessary for the proper and efficient performance and administration of the guaranty agency's responsibilities under the HEA;

(B) The restraints or requirements imposed by factors such as sound business practices, arms-length bargaining, Federal, State, and other laws and regulations, and the terms and conditions of the guaranty agency's agreements with the Secretary; and

(C) Market prices of comparable goods or services.

* * * * *

(b) * * *

(11) *Conflicts of interest.* (i) A guaranty agency shall maintain and enforce written standards of conduct governing the performance of its employees, officers, directors, trustees, and agents engaged in the selection, award, and administration of contracts or agreements. The standards of conduct must, at a minimum, require disclosure of financial or other interests and must mandate disinterested decision-making. The standards must provide for appropriate disciplinary actions to be applied for violations of the standards by employees, officers, directors, trustees, or agents of the guaranty agency, and must include provisions to—

(A) Prohibit any employee, officer, director, trustee, or agent from participating in the selection, award, or decision-making related to the administration of a contract or agreement supported by the reserve fund described in paragraph (a) of this section, if that participation would create a conflict of interest. Such a conflict would arise if the employee, officer, director, trustee, or agent, or any member of his or her immediate family, his or her partner, or an organization that employs or is about to employ any of those parties has a financial or ownership interest in the organization selected for an award or would benefit from the decision made in the administration of the contract or agreement. The prohibitions described in this paragraph do not apply to employees of a State agency covered by codes of conduct established under State law;

(B) Ensure sufficient separation of responsibility and authority between its lender claims processing as a guaranty agency and its lending or loan servicing activities, or both, within the guaranty agency or between that agency and one or more affiliates, including independence in direct reporting requirements and such management and systems controls as may be necessary to demonstrate, in the independent audit required under § 682.410(b)(1), that claims filed by another arm of the guaranty agency or by an affiliate of that agency receive no more favorable treatment than that accorded the claims filed by a lender or servicer that is not an affiliate or part of the guaranty agency; and

(C) Prohibit the employees, officers, directors, trustees, and agents of the guaranty agency, his or her partner, or any member of his or her immediate family, from soliciting or accepting gratuities, favors, or anything of monetary value from contractors or parties to agreements, except that nominal and unsolicited gratuities, favors, or items may be accepted.

(ii) *Guaranty agency restructuring.* If the Secretary determines that action is necessary to protect the Federal fiscal interest because of an agency's failure to meet the requirements of § 682.410(b)(11)(i), the Secretary may require the agency to comply with any additional measures that the Secretary believes are appropriate, including the total divestiture of the agency's non-FFEL functions and the agency's interests in any affiliated organization.

* * * * *

4. A new § 682.418 is added to subpart D to read as follows:

§ 682.418 Prohibited uses of reserve fund assets.

(a) *General.* (1) A guaranty agency may not use the assets of the reserve fund established under § 682.410(a)(1) to pay costs prohibited under paragraph (b) of this section and may not use the assets of the reserve fund to pay for goods, property, or services provided by an affiliated organization that would exceed the affiliated organization's actual and reasonable cost of providing those goods, property, or services, unless the agency demonstrates to the Secretary, and receives the Secretary's concurrence, that such a payment would be in the Federal fiscal interest.

(2) All guaranty agency contracts with respect to its reserve fund or assets must include a provision stating that the contract is terminable by the Secretary upon 30 days notice to the contracting parties if the Secretary determines that the contract includes an impermissible transfer of the reserve fund or assets or is otherwise inconsistent with the terms and purposes of section 422 of the HEA.

(b) *Prohibited uses of reserve fund assets.* A guaranty agency may use the assets of the reserve fund established under § 682.410(a)(1) only as prescribed in § 682.410(a)(2). Uses of the reserve fund that are not allowable under § 682.410(a)(2) include, but are not limited to—

(1) *Compensation for personnel services,* including wages, salaries, pension plan costs, post-retirement health benefits, employee life insurance, unemployment benefit plans, severance pay, costs of leave, and other benefits, to the extent that total compensation to an employee, officer, director, trustee, or agent of the guaranty agency is not reasonable for the services rendered. Compensation is considered reasonable to the extent that it is comparable to that paid in the labor market in which the guaranty agency competes for the kind of employees involved. Costs that are otherwise unallowable may not be considered allowable solely on the basis that they constitute personnel compensation. In no case may the reserve fund be used to pay any compensation, whether calculated on an hourly basis or otherwise, that would be proportionately greater than 118.05

percent of the total salary paid (as calculated on an hourly basis) under section 5312 of title 5, United States Code (relating to Level I of the Executive Schedule).

(2) *Contributions and donations,* including cash, property, and services, by the guaranty agency to others, regardless of the recipient or purpose, unless pursuant to written authorization from the Secretary;

(3) *Entertainment,* including amusement, diversion, hospitality suites, and social activities, and any costs associated with those activities, such as tickets to shows or sports events, meals, alcoholic beverages, lodging, rentals, transportation, and gratuities;

(4) *Fines, penalties, damages, and other settlements* resulting from violations or alleged violations of the guaranty agency's failure to comply with Federal, State, or local laws and regulations that are unrelated to the FFEL Program, unless specifically approved by the Secretary. This prohibition does not apply if a non-criminal violation or alleged violation has been assessed against the guaranty agency, the payment does not reimburse an agency employee, and the payment does not exceed $1,000, or if it occurred as a result of compliance with specific requirements of the FFEL Program or in accordance with written instructions from the Secretary. The use of the reserve fund in any other case must be requested by the agency and specifically approved in advance by the Secretary;

(5) *Legal expenses* for prosecution of claims against the Federal Government, unless the guaranty agency substantially prevails on those claims. In that event, the Secretary approves the reimbursement of reasonable legal expenses incurred by the guaranty agency;

(6) *Lobbying activities,* as defined in section 501(h) of the Internal Revenue Code, including dues to membership organizations to the extent that those dues are used for lobbying;

(7) *Major expenditures,* including those for land, buildings, equipment, or information systems, whether singly or as a related group of expenditures, that exceed 5 percent of the guaranty agency's reserve fund balance at the time the expenditures are made, unless the agency has provided written notice of the intended expenditure to the Secretary 30 days before the agency makes or commits itself to the expenditure. For those expenditures involving the purchase of an asset, the term ''major expenditure'' applies to costs such as the cost of purchasing the asset and making improvements to it, the cost to put it in place, the net invoice price of the asset, ancillary charges, such as taxes, duty, protective in-transit insurance, freight, and installation costs, and the costs of any modifications, attachments, accessories, or auxiliary apparatus necessary to make the asset usable for the purpose for which it was acquired, whether the expenditures are classified as capital or operating expenses;

(8) *Public relations,* and all associated costs, paid directly or through a third party, to the extent that those costs are used to promote or maintain a favorable image of the guaranty agency. The term ''public relations'' does not include any activity that is ordinary and necessary for the fulfillment of the agency's FFEL guaranty responsibilities under the HEA, including appropriate and reasonable advertising designed specifically to communicate with the public and program participants for the purpose of facilitating the agency's ability to fulfill its FFEL guaranty responsibilities under the HEA. Ordinary and necessary public relations activities include training of program participants and secondary school personnel and customer service functions that disseminate FFEL-related information and materials to schools, loan holders, prospective loan applicants, and their parents. In providing that training at workshops, conferences, or other ordinary and necessary forums customarily used by the agency to fulfill its responsibilities under the HEA, the agency may provide light meals and refreshments of a reasonable nature and amount to the participants;

(9) *Relocation of employees* in excess of an employee's actual or reasonably estimated expenses or for purposes that do not benefit the administration of the guaranty agency's FFEL program. Except as approved by the Secretary, reimbursement must be in accordance with an established written policy; and

(10) *Travel expenses* that are not in accordance with a written policy approved by the Secretary or a State policy. If the guaranty agency does not have such a policy, it may not use the assets of the reserve fund to pay for travel expenses that exceed those allowed for lodging and subsistence under subchapter I of Chapter 57 of title 5, United States Code, or in excess of commercial airfare costs for standard coach airfare, unless those accommodations would require circuitous routing, travel during unreasonable hours, excessively prolonged travel, would result in increased cost that would offset transportation savings, or would offer accommodations not reasonably adequate for the medical needs of the traveler.

(c) *Cost allocation.* Each guaranty agency that shares costs with any other program, agency, or organization shall develop a cost allocation plan consistent with the requirements described in OMB Circular A–87 and maintain the plan and related supporting documentation for audit. A guaranty agency is required to submit its cost allocation plans for the Secretary's approval if it is specifically requested to do so by the Secretary.

(Authority: 20 U.S.C. 1078)

[FR Doc. 96–30360 Filed 11–26–96; 8:45 am]

BILLING CODE 4000–01–P