

TRAWL RATIONALIZATION TRAILING ACTIONS

ISSUE: LENDERS

Draft Council Decision Analysis Document

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CHAPTER 1 PURPOSE AND NEED FOR THE PROPOSED ACTION

1.1 Introduction

This document provides background information about, and analyses for, modifications affecting the ability of the groundfish industry to acquire loans from lenders. The proposed action would require an amendment to the regulations implementing the Pacific Coast Groundfish Fishery Management Plan (FMP). If the regulatory amendment is implemented, the description of the trawl rationalization program contained in Appendix E to the groundfish FMP would automatically be revised to reflect the regulatory modification. The proposed action must conform to the Magnuson-Stevens Fishery Conservation and Management Act (MSA), the principal legal basis for fishery management within the Exclusive Economic Zone (EEZ), which extends from the outer boundary of the territorial sea to a distance of 200 nautical miles from shore. NMFS has determined that this action would be classified as a Categorical Exclusion under NEPA.

1.2 Description of the Proposed Action

1.2.1 Issue: QS Control Limit Safe Harbor for Lenders

The action considered under this issue would amend the shorebased trawl rationalization regulations as they apply to lenders with respect to QS control limits.

1.2.2 Issue: Public Record Of Lender Interest in QS ***(CONSIDERTAION POSTPONED TO FURTHER VET PROBLEM AND POTENTIAL SOLUTIONS)***

The action considered under this issue is to amend the shorebased trawl rationalization regulations to provide a means by which lender collateral interest in QS could be included in the information kept on QS accounts, with the concurrence of the QS account holder and the lender.

1.3 Purpose and Need for the Proposed Action

1.3.1 Issue: QS Control Limit Safe Harbor for Lenders

When the control limits policy was established there was substantial concern about opportunity for circumvention of the limits. When it approved the initial issuance rule implementing the IFQ program, NMFS inserted into the QS control rule an exception for banks and financial institutions. There is concern about both whether the entities qualifying for this exemption are sufficiently defined and the scope of the activities for which the exemption was provided. An overly broad class of entities receiving the exception or an overly broad scope of exempted activities could undermine effectiveness of the control limits.

The following is the regulatory text into which NMFS inserted an exception for banks and financial institutions (the insertions are underlined).

<p>660.140(d)(4) <i>Accumulation limits</i>—(i) <i>QS and IBQ control limits.</i> QS and IBQ control limits are accumulation limits and are the amount of QS and IBQ that a person, individually or collectively, may own or control. QS and IBQ control limits are expressed as a percentage of the Shorebased IFQ Program’s allocation.</p> <p>(A) <i>Control limits for individual species.</i> No person may own or control, or have a controlling influence over, by any means whatsoever an amount of QS or IBQ for any individual species that exceeds the Shorebased IFQ Program accumulation limits.</p> <p>(B) <i>Control limit for aggregate . . .</i></p> <p>(C) The Shorebased IFQ Program accumulation limits are as follows: [see Table of QS Control Limits]</p> <p>(ii) <i>Ownership—individual and collective rule.</i> The QS or IBQ that counts toward a person’s accumulation limit will include:</p> <p>(A) The QS or IBQ owned by that person, and</p> <p>(B) That portion of the QS or IBQ owned by an entity in which that person has an economic or financial interest, where the person’s share of interest in that entity will determine the portion of that entity’s QS or IBQ that counts toward the person’s limit.</p>	<p>(iii) <i>Control.</i> Control means, but is not limited to, the following:</p> <p>(A) The person has the right to direct, or does direct, in whole or in part, the business of the entity to which the QS or IBQ are registered;</p> <p>(B) The person has the right to limit the actions of or replace, or does limit the actions of or replace, the chief executive officer, a majority of the board of directors, any general partner, or any person serving in a management capacity of the entity to which the QS or IBQ are registered;</p> <p>(C) The person has the right to direct, or does direct, and/or the right to prevent or delay, or does prevent or delay, the transfer of QS or IBQ, or the resulting QP or IBQ pounds;</p> <p>(D) The person, through loan covenants or any other means, has the right to restrict, or does restrict, and/or has a controlling influence over the day to day business activities or management policies of the entity to which the QS or IBQ are registered;</p>	<p>(E) The person, <u>excluding banks and other financial institutions that rely on QS or IBQ as collateral for loans</u>, through loan covenants or any other means, has the right to restrict, or does restrict, any activity related to QS or IBQ or QP or IBQ pounds, including, but not limited to, use of QS or IBQ, or the resulting QP or IBQ pounds, or disposition of fish harvested under the resulting QP or IBQ pounds;</p> <p>(F) The person, <u>excluding banks and other financial institutions that rely on QS or IBQ as collateral for loans</u>, has the right to control, or does control, the management of, or to be a controlling factor in, the entity to which the QS or IBQ, or the resulting QP or IBQ pounds, are registered;</p> <p>(G) The person, <u>excluding banks and other financial institutions that rely on QS or IBQ as collateral for loans</u>, has the right to cause or prevent, or does cause or prevent, the sale, lease or other disposition of QS or IBQ, or the resulting QP or IBQ pounds; and</p> <p>(H) The person has the ability through any means whatsoever to control or have a controlling influence over the entity to which QS or IBQ is registered.</p>
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In the preamble to the final rule, NMFS explained that this change was adopted in response to public comment:

[Comment:] Proposed § 660.140(d)(4)(iii)(D) and (E) “could eliminate the ability of a quota share/quota pound owner to obtain necessary financing for fishing operations. Under these sub-clauses, a bank or other financial institution would be unable to provide loans using quota shares/pounds as collateral, a common practice in limited access fisheries. A quota share

brokerage would be unable to take title or otherwise encumber quota shares/pounds beyond the accumulation limits, even if a fisherman requested the broker do so.’’

[Response:] NMFS does not intend that these sections apply to banks or financial institutions, unless the financial documents specify control beyond normal business agreements. NMFS has modified the regulations accordingly. As for quota share brokerages, each transaction must comply with the accumulation or control limits; however, compliance does not prevent brokerage transactions. Compliance would be based on the facts of the transactions.

[. . .]

NMFS acknowledges that participants in the fishery may be concerned about whether potential actions would comply with the accumulation limits. It is the responsibility of the participants to comply with the regulations; if participants have questions about potential actions, NMFS encourages those participants to provide the agency with specific facts and questions prior to entering into agreements or taking action in order to understand NMFS’s interpretation of the potential facts in relation to the regulation.

Subsequent to the modifications described above, the public has expressed uncertainty about the types of institutions to which the exception is expected to apply. What types of entities might qualify as a “bank or other financial institution?” For example, it is traditional in the fishery for processors to lend harvesters money for capital acquisitions. Do the exceptions for lenders apply to such activities? Adopting language in the control limit regulations with more specificity could provide more clarity as to whether the exclusions applicable to “banks and other financial institutions” should be construed more broadly or more narrowly.

Other concerns with exempting certain activities of lending institutions from the control rule have to do with the scope of the activity for which an exception is provided and with overlaps and conflicts in the various paragraphs of the current regulatory language. The public has requested clarification regarding how the paragraphs might be applied. For example, banks and financial institutions are provided an exception with respect to the use of loan covenants to “restrict, any activity related to QS or IBQ or QP or IBQ pounds” (paragraph E) but are not provided an exception with respect to directing, delaying or preventing the transfer of QS or individual bycatch quota (IBQ) or having the right to do so (paragraph C) (see page 4 for the regulations and Table 2-1 for a summary). This concern could be addressed in a number of ways. One would be by adding the lender exemption to paragraph (C). However, there are also other conflicting overlaps between the paragraphs, for example between paragraphs (E) and (D). Again, paragraph (E) provides an exception for certain lenders pertaining to the direction of “any activity related to QS or IBQ or QP or IBQ pounds” while paragraph (D) does not provide those lenders an exception for “day to day business activities or management policies of the entities to which the QS of QP are registered.” Paragraphs (G) and (C) also overlap and conflict in a similar fashion. There is also concern as to whether the paragraphs provide a greater exception than banks require in order to achieve the interests necessary to secure their loans. For example, paragraph (E) appears to go beyond what is needed to establish security interest, covering “any activity related to QS or IBQ or QP or IBQ pounds.”

Thus, there are two sub-issues to address with respect to the safe harbor provided to lenders. The first is determination of the entities eligible for the safe harbor and the second is the scope of the exception provided to such entities (i.e. the activities allowed under the safe harbor).

1.3.2 Issue: Public Record of Lender Interest in QS

Lenders have expressed concern about their ability to ascertain whether or not QS they have accepted as collateral for a loan have been used as security for other obligations and about their ability to know about and/or prevent the transfer of any QS that has been pledged to them as security for a loan. Ability to secure interest in QS is important to both the lenders and members of the industry seeking loans. Limited ability to provide this security for QS pledged as collateral may make it more difficult and expensive to acquire loans (result in higher risk and hence higher interest rates). While the Section 305(h)(1) of the MSA requires the creation of a central lien registry, this section has never been implemented due to legal, cost, and workload issues.

CHAPTER 2 DESCRIPTION OF THE ALTERNATIVES

2.1 Issue: QS Control Limit Safe Harbor for Lenders

2.1.1 Lending Entities Qualifying for an Exception

This section deals with specification of the entities which would qualify for an exception for lending activities. Alternatives are as follows.

Status Quo: Retain existing language CFR 660.140(d)(4) which provides exceptions for “*banks and other financial institutions that rely on QS or IBQ as collateral for loans,*” (no action). Certain exceptions to the control limits are provided for “banks and other financial institutions that rely on QS or IBQ as collateral for loans” (see page 4).

Alternative 1 (Preliminary Preferred Alternative): Retain existing language CFR 660.140(d)(4) which provides exceptions for “*banks and other financial institutions that rely on QS or IBQ as collateral for loans,*” but add an amplification indicating that to qualify as a bank or financial institution for purposes of this paragraph the entity must be regularly or primarily engaged in the business of lending and not engaged in or controlled by entities whose primary business is the harvest processing or distribution of fish or fish products. Additionally, require that any lender that wishes to qualify for the exception and is not state or federally chartered banks or other financial institution disclose the identity and share of interest of any entity with a 2% or more ownership interest in the lender, in a manner similar to what is required for the trawl identification of ownership interest form CFR 660.140(d)(4)(iv).

Alternative 2: In the description of control (CFR 660.140(d)(4)), replace “*banks and other financial institutions that rely on QS or IBQ as collateral for loans*” with “*a state or federally chartered bank or other state or federally chartered financial institution that relies on QS or IBQ as collateral for loans.*”

Alternative 3: In the description of control (CFR 660.140(d)(4)), replace “*banks and other financial institutions that rely on QS or IBQ as collateral for loans*” with “*any person that relies on QS or IBQ as collateral for loans.*”

Alternative 1 would clarify that the entities qualifying for this exception include more than traditional banks and financial institutions, i.e. include other types of lenders, so long as those lenders are not otherwise engaged in the fishery. The intent is to ensure that the exception applies for those legitimately engaged in providing lending services to the industry but at the same time does not provide entities with other financial interests in the industry to gain an advantage through an exception to the control limit. To reduce the chance that this exception might be exploited by participants in the fishing industry, a requirement is included for the disclosure of ownership interest in any financial institution for which such disclosures are not already required, i.e. for banks or financial institutions that are not state or federally chartered. As compared to status quo, Alternative 2 would result in a narrower application of control rule safe harbor for lending institutions. While Alternative 2 alternative provides a clear test for whether the lending institution qualifies (i.e., whether it is state or federally chartered), it would also result in some lending institutions not being able to avail themselves of the exemptions from the control rule. For instance, private equity funds may not be state or federally chartered. Alternative 3 would result in a broader application of exemptions for lending institutions from the control rule, because “person” includes not only banks and other financial institutions, but other entities as well (such as processors or harvesting companies) and individuals.

2.1.2 Scope of the Exception Provided

This section deals with the scope of activities for which a lender receives an exception from the control limits. Alternatives are as follows.

Status Quo: No change. (see page 4 for current language and Table 2-1 for a summary).

Alternative 1: Add the appropriate language providing an exception for lenders to paragraph (C).

Alternative 2: Same as Alternative 1 but also remove the exceptions provided to lenders in all other paragraphs and add at the end of each of the other paragraphs language to the following effect: “*with the exception of those activities allowed under paragraph (C)*”

Alternative 3 (Preliminary Preferred Alternative): Same as Alternative 2 but further limit the exception under paragraphs C and G so that the lenders exception pertains only to control over the transfer of QS and IBQ and not the affiliated QP or IBQ-pounds. All associated QP will be distributed to the borrower unless the bank or financial institution provides evidence that the borrower is in default on the loan, in which case the related QP will be distributed to the adaptive management program until such time as any the QS/IBQ held by the bank or financial institution is sold, or the QS/IBQ holdings of the bank or financial institution are below the QS control limits.

Alternative 4: Add exceptions for lenders to all paragraphs.

Table 2-1 provides a summary of the paragraphs for which lender exceptions are and are not provided. The full regulatory text is provided on page 4.

Table 2-1. Summary of 660.140(d)(4): activities for which lender exceptions are provided and not provided.

No Lender Exception Provided	Lender Exception Provided
(A) & (B) directs the business of an entity or authority over director, board, partners etc.	(E) Any activity related to quota
(C) Prevents or delays quota transfer (shares or pounds)	(F) Controlling management of the entity or being a controlling factor
(D) Through loan covenants affects day to day business activities	(G) Cause or prevent sale, lease, or other disposition of quota
(H) Any other means of control over shares	

There appear to be possible conflicts in the exceptions granted between the following paragraphs:

- (C) and (E)
- (C) and (G)
- (D) and (E)/(F)
- (A/B) and (F).

Alternative 1 would make it clear that lenders could control the transfer of QS, IBQ, QP, and IBQ but leave other possible inconsistencies in place. Alternatives 2, 3, and 4 would eliminate any inconsistencies due to overlap among the paragraphs. Alternative 2 would achieve this end by restricting the exception for lenders to lender influence over the transfer of quota, as specified in paragraphs C (exceptions provided in other paragraphs would be eliminated). Alternative 3 would further restrict the paragraph C and G exception by limiting the exception just to QS and IBQ, not to the QP and IBQ-pounds. Alternative 4 would achieve consistency among all the paragraphs by providing lenders exceptions under all paragraphs.

2.2 Issue: Public Record of Lender Interest in QS **(CONSIDERTAION POSTPONED TO FURTHER VET PROBLEM AND POTENTIAL SOLUTIONS)**

During public comment, lenders have requested (1) third party verification of QS ownership, (2) a lien registry, and (3) individually serialized QS, in order to provide the means by which they could secure QS as collateral for loans. In the fall of 2011, NMFS made a determination that QS ownership information would be made publicly available, eliminating the need for third party verification of QS ownership. Creating unique identifiers for QS would either be very costly or require a modification to the program to reduce the degree of QS divisibility. An alternative to unique identifiers might be to add lender information to QS ownership records. Transfer of QS from the account would then require authorization from both the owner and the lender. The lender would have no other authority with respect to the disposition of the QP from the account. The position of the lender with respect to the QS in the account would be similar to the position of a lender on the title for a car loan. If only some of the QS held by a particular individual were to be pledged as collateral, then the individual would be allowed to establish a separate account for the QS obligated to a lender. The need for a lien registry and serialized identification might be largely met by the

combination of providing a place on QS accounts for lien holders to be listed in the NMFS data system and the state-by-state system of Uniform Commercial Code central lien registries for secured transactions. The alternatives under consideration are as follows

Status Quo: No change.

Alternative (recommendation by the GAP endorsed by the Council, November 2011): Add a place to list lender on the QS ownership records. A lender name would only be included on the record if the QS owner agrees but removal would require agreement of both the QS owner and the lender. While a lender is listed, transfer of QS from the account would require authorization from both the owner and the lender. To facilitate commitment of only part of an owners QS to a particular lender, a single QS owner would be able to establish additional QS accounts.

There are a variety of ways this alternative might be implemented. The following is one example.

1. A QS holder wishing to pledge QS as collateral and the lender desiring to use the QS as collateral would sign a form provided by NMFS. If the QS holder was only pledging part of his/her QS as collateral a separate account would be created for those QS subject to the agreement with the lender.
2. The form would state that a separate account would be opened with one field designating the owner and a separate field designating the binding party (lender). The form would also specify the amounts of QS held by the QS owner that would be placed into this account.
3. The only difference between this account and any other account would be that QS in the account could be transferred out of the account only through the filing of a QS transfer form signed by both the QS owner and the lender. The lender's only authority with respect to the account would be the ability to prevent QS transfers from the account.
4. With respect to any disputes that might arise between the QS owner and the lender regarding the terms and conditions on which the QS owner or lender is required to authorize QS transfers, these issues would be settled privately, through the courts if necessary, but not be a matter of concern for NMFS.

While this provision might begin to address the lien registry issue it would not be a complete response in that regard.

CHAPTER 3 IMPACTS

3.1 Direct and Indirect Impacts to the Physical Environment, Including Habitat and Ecosystem, and Biological Environment

Modifications to the rules affecting a lenders ability to secure QS as collateral for loans will have no direct or indirect impacts on the physical or biological environment. The effects of this proposal would be to modify the socio-economic impacts of fishery management measures implemented under the West Coast Groundfish FMP to mitigate the physical and biological impacts arising from the activities of west coast groundfish fisheries.

3.2 Direct and Indirect Impacts to the Socioeconomic Environment

3.2.1 Fishery and Business Impacts

The control rule is designed to prevent an entity from accumulating excessive shares and exerting undue influence in the market place for shares and fish. Prevention of such accumulations related to a number of fishery management objectives (MSA National Standard 4(c), 303A(c)(5)(B)(ii) and (c)(5)(D); and FMP Amendment 20 Goals and Objectives, Constraint 6). It is to the benefit of both lenders and businesses that QS be usable as collateral to secure loans. Lenders providing financing to a number of industry participants could find themselves in violation of control limits, if the control they exert to secure collateral is limited by control limits. Therefore an exception to the control limits has been provided to allow for lenders to service the industry. The exception provided is not clear both in terms of who it applies to and the nature of the activities to which the exception applies. Uncertainty has a dampening effect on lending which in turn adversely affect the industry.

The alternatives considered would increase certainty about lender position under the control limits and thereby have a number of positive effects on the industry. Increased certainty would decrease risk, reduce the costs of borrowing, and increase net benefits to the nation. Borrowing costs would be reduced because lenders require lower compensation for placing their money at risk when the lending environment is more certain.

Reducing the costs of borrowing and increasing the acceptance of QS as collateral for loans would decrease the importance wealth for individuals acquiring assets to enter the fishery, decreasing barriers to entry (a consideration of MSA 303A(c)(5)(B)). Often the collateral used for a loan is the purchases made with the loan funds. The ability to use the purchased QS as collateral decreases the amount of wealth (alternative collateral or fiscal assets to use in the purchase of QS) an individual would have to accumulate in order to enter the fishery as a QS owner.

While all of the alternatives increase certainty about the rules that apply to lenders, the alternatives for the control rule safe harbor (Section 2.1) vary in terms of who would qualify as a lender and the scope of the activities for which an exception is provided. Through these variations the alternatives perform differently with respect to objectives related to the prevention of excess control. With respect to the issue of determining which entities qualify as lenders (Section 2.1.1) Alternative 3 would allow the broadest class of entities to qualify as a lender for purposes of the lender safe harbor. It would open the door for an exception for any lender, regardless of the lender's primary business. This would provide

greater opportunities for members of the fishing industry to abuse the lender exception and gain excessive control by financing the QS purchases of others. Alternative 2 provides the most restrictive class of entities eligible for the exception: state or federally chartered financial institutions. This could rule out nonprofit and other organizations (e.g. communities) which may desire to make loans to the industry in order to pursue social policies but have no intent to control the markets and industry. Alternative 1 would leave the present language but add an amplification that banks and financial institutions include entities that are regularly or primarily engaged in lending and not engaged in the fishing industry. Additionally, to help ensure that the provisions are not used by members of the industry to circumvent limits on excessive accumulation, Alternative 1 includes a provision requiring the divulgence of ownership information by entities that are not Federal or state chartered financial institutions.

All of the alternatives on the scope of the exception (Section 2.1.2) clarify conflicts between paragraphs on the nature of the exception provided, thus contributing to a clearer and less risky regulatory environment, except Alternative 1 (Table 3-1). Alternative 1 eliminates the most important conflict, making it clear that control limits will not interfere with the lender’s right to interfere with the transfer of an asset which has been pledged as collateral, but leaves other conflicts in place. Alternative 2 is the same as Alternative 1 but eliminates all other exceptions for lenders. Elimination of these exceptions could interfere with a lenders ability to take management control of a company in the event of bankruptcy or other actions that go beyond limiting the transfer of quota but are necessary to secure their interest. Alternative 3, narrows the exception for lenders even further by restricting their ability to limit transfers to the QS (the long term asset) and not the QP that are issued annually to QS holders. Alternative 4 would provide a lender exception in every paragraph of the control rule. Because of the broader scope of the activities for which an exception is provided, Alternative 4 would provide the most opportunity for abuse of the exception by an entity desiring to exert excessive control, while Alternative 3 by providing the narrowest scope of exceptions provides the least such opportunity. At the same time, Alternatives 2 and 3 could limit the ability of lenders to secure their assets in a manner similar to the way they could for other types of collateral (e.g. taking control of a bankrupt company during reorganization), thus somewhat increasing the risk to lenders as compared to Alternative 4 and potentially resulting in somewhat higher lending costs than Alternative 4.

Table 3-1. Summary of “scope of exception” options.

	Alternative 1	Alternative 2	Alternative 3	Alternative 4
Potential Conflicts ^{a/} (C) and (E) (C) and (G)	Eliminated	Eliminated	Eliminated	Eliminated
Potential Conflicts ^{a/} (C) and (E) (C) and (G)	Remain	Eliminated	Eliminated	Eliminated
Activities exception applies to	Lender exception applies to any activity related to quota; controlling management of the entity or being a controlling factor; causing, preventing or delaying quota transfers, sales, leases or other dispositions.	Lender exception applies to QP and QS transfers	Lender exception applies only to QP transfers	Broadest scope of lender exception

a/ Potential conflicts between the paragraphs of 660.140(d)(4) – see page 4.

Action on the alternative to provide a public record of lender interest in QS (Section 2.2) has been postponed to provide more time to explore whether or not existing mechanisms can meet the identified needs. If existing mechanisms are not adequate, the types of changes considered here would be expected to decrease lender risk with the attendant positive affects of risk reduction, as discussed in the

first paragraphs of this section. The security provided by the ability to register an interest and prevent a transfer may reduce transaction costs, also enhancing net benefits and increasing access to capital.

3.2.2 Impacts on Communities

Overall, the alternatives are expected to improve access to financing and better access to financing is expected to increase the health of the industry and hence the health of the local fishing communities. Increased access to financing could also increase the probability that local control will be maintained over the QS, particularly given that there are a number of nonprofit organizations interested in funding QS purchases for the purpose of maintaining control in local communities. Additionally, the control limit exceptions of Section 2.1 might also facilitate a lending by a community that desires to directly finance QS purchases by members of the community.

3.3 Impacts on Agencies

Clarifying the lender exceptions to the control rule may decrease agency costs by decreasing regulatory confusion and enforcement.

Consideration of a recommendation that NMFS provide a place in which lender interest can be registered has been postponed. Agency costs would be associated with the implementation and administration of the registration of lender interest in QS (Section 2.2). This registration might occur initially only with joint agreement between the QS owner and the lender, but once established would also require joint agreement prior to QS transfers and in order to end the listing of the lender on the QS account. A need to create separate accounts for those QS a holder had pledged as collateral and those which had not been pledged as collateral would add to administrative costs. Additionally, if a QS holder is to be allowed to pledge QS as collateral to more than one lender, a separate joint account might be needed for each QS/Lender combination.