

# Financial Services Regulatory Highlights

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## Treasury Outlines Framework for Regulatory Reform

On March 26, 2009, the U.S Department of the Treasury provided an outline for proposed regulatory reform of the Financial Services industry to address perceived regulatory failures that contributed to the financial crisis. As Secretary Geithner stated in his testimony, "to address these failures will require comprehensive reform -- not modest repairs at the margin, but new rules of the road. The new rules must be simpler and more effectively enforced and produce a more stable system, that protects consumers and investors, that rewards innovation and that is able to adapt and evolve with changes in the financial market."

The four broad components of the Administration's regulatory reform proposal include:

- Addressing Systemic Risk;
- Protecting Consumers and Investors;
- Eliminating Gaps in Our Regulatory Structure; and
- Fostering International Coordination.

Secretary Geithner's testimony focused on describing the framework of the "systemic risk" component. In the coming weeks, detailed frameworks for each of the other components are expected to be released.

### Components of Regulatory Reform: Systemic Risk

- A single independent regulator with responsibility over systemically important firms and critical payment and settlement systems:
  - Defining a systemically important firm
  - Focusing on what companies do, not the form they take
  - Clarifying regulatory authority over payment and settlement activities
- Higher Standards on Capital and Risk Management for Systemically Important Firms
  - Setting more robust capital requirements
  - Imposing stricter liquidity, counterparty and credit risk management requirements
  - Creating prompt-corrective action regime
- Requiring all hedge funds above a certain size to register
  - Requiring registration of all hedge funds
  - Mandating investor and counterparty disclosure

- Providing information necessary to assess threats to financial stability
- Sharing reports with systemic risk regulator
- A comprehensive framework of oversight, protection and disclosure for the OTC derivatives market
  - Regulating credit default swaps and over-the-counter derivatives for the first time
  - Instituting a strong regulatory and supervisory regime
  - Clearing all contracts through designated central counterparties
  - Requiring non-standardized derivatives to be subject to robust standards
- Making aggregate data on trading volumes and positions available
- Applying robust eligibility requirements to all market participants
- New requirements for money market funds to reduce the risk of rapid withdrawals
  - Strengthening the regulatory framework around money market funds
- A stronger resolution authority to protect against the failure of complex institutions
  - Covering financial institutions that may pose systemic risks
  - Requiring covered institutions to fund the resolution authority

## Chairman Bernanke Discusses Systemic Risk

On March 10, 2009, Federal Reserve Chairman Ben Bernanke discussed four key elements for financial reform and how to address systemic risk. Chairman Bernanke noted the following four key elements of such a strategy:

- Address the problem of financial institutions that are deemed to big, or too interconnected to fail;
- Strengthen the financial infrastructure that governs trading, payment, clearing and settlement to ensure that it will perform well under stress;
- Review regulatory policies and accounting rules to ensure that they do not overly magnify the ups and downs in the financial system and the economy; and
- Consider creating an authority specifically charged with monitoring and addressing systemic risks that would be tasked with protecting the system from financial crises like the one we are currently experiencing.

Chairman Bernanke noted that currently the government assistance to avoid failures at major financial institutions has been necessary to avoid a further destabilization of the financial system. However, going forward,

policymakers must address this issue by better supervising systemically critical firms to prevent excessive risk-taking and by strengthening the resilience of the financial system to minimize the consequences when a large firm must be unwound.

The aim in terms of the financial infrastructure should not only help make the financial system as a whole better able to withstand future shocks, but also to mitigate moral hazard and the problem of "too big to fail" by reducing the range of circumstances in which systemic concerns might prompt government intervention. More broadly, both the operational performance of key payment and settlement systems and their ability to manage counterparty and market risks in both normal and stressed environments are critical to the stability of the broader financial system. Given how important robust payment and settlement systems are to financial stability, a good case can be made for granting the Federal Reserve explicit oversight authority for systemically important payment and settlement systems.

Chairman Bernanke also noted that there is some evidence that capital standards, accounting rules and other regulations have made the financial sector ease

credit in booms and tighten credit in downturns more than is justified by changes in the creditworthiness of borrowers, thereby intensifying cyclical changes. Capital regulations should be reviewed to ensure they are appropriately forward looking and capital is allowed to serve its intended role as a buffer. Additionally, the ongoing move by those who set accounting standards toward requirements for improved disclosure and greater transparency is a positive development that deserves full support. As a result, further review of accounting standards governing valuation and loss provisioning would be useful and might result in modifications to the accounting rules that reduce their procyclical effects without compromising the goals of disclosure and transparency.

A macro prudential approach would complement and build on the current regulatory and supervisory structure, in which the primary focus is the safety and soundness

of individual institutions and markets. Chairman Bernanke noted certain elements that could be included in this macro prudential approach. These elements include:

- Monitoring large or rapidly increasing exposures across firms and markets, rather than only at the level of individual firms or sectors;
- Assessing the potential for deficiencies in evolving risk management practices, broad-based increases in financial leverage, or changes in financial markets or products to increase systemic risks;
- Analyzing possible spillovers between financial firms or between firms and markets; and
- Identifying possible regulatory gaps, including gaps in the protection of consumers and investors that pose risks for the system as a whole.

## Federal Reserve's Cole Addresses Risk Management in the Banking Industry

[On March 18, 2009, Roger Cole, Director of the Division of Banking Supervision and Regulation at the Federal Reserve, testified on the state of risk management in the banking industry before the U.S. Senate Subcommittee on Securities, Insurance and Investment. In addition to providing background about the Federal Reserve's supervisory mandate and activities, Director Cole focused his testimony specifically on Federal Reserve actions to improve risk management practices and supervisory lessons learned. We briefly summarize Director Cole's testimony here.](#)

### **Supervisory Actions to Improve Risk Management Practices**

A key initiative of the Federal Reserve and other supervisors since the issuance of the March 2008 Senior Supervisors Group ("SSG") report has been to assess the industry's response to the observations and recommendations on the need to enhance key risk management practices. Firms are required to conduct self-assessments that must be shared with the

organization's board of directors and serve to highlight progress in addressing gaps in risk management practices. Federal Reserve staff is currently reviewing firms' self-assessments, but enhancements to risk management practices are evident. Director Cole addressed developments in the following areas.

### **Liquidity Risk Management**

One lesson learned in this crisis is that several key sources of liquidity may not be available in a crisis. Along with other U.S. supervisory agencies, the Federal Reserve is monitoring the major firms' liquidity positions on a daily basis, and discussing key market developments and our supervisory views with the firms' senior management.

The Federal Reserve is also conducting additional analysis of firms' liquidity positions to examine the impact various scenarios may have on their liquidity and funding profiles.

### **Capital Planning and Capital Adequacy**

The Federal Reserve has been closely monitoring firms' capital levels relative to their risk exposures, in conjunction with reviewing projections for earnings and asset quality and discussing our evaluations with senior management.

The Federal Reserve has been engaged in its own analysis of loss scenarios to anticipate institutions' future capital needs, analysis that includes the potential for losses from a range of sources as well as assumption of assets currently held off balance sheet.

### **Firm-Wide Risk Identification and Compliance Risk Management**

There is a need for timely and effective communication about risks; Federal Reserve efforts pertaining to capital and liquidity are designed to ensure that management and boards of directors understand the linkages within the firm and how various events might impact the balance sheet and funding of an organization.

### **Residential Lending**

The Federal Reserve will continue to focus on the adequacy of institutions' underwriting standards, and re-emphasize the importance of a lender's assessment of a borrower's ability to repay the loan.

The Federal Reserve is requiring institutions to maintain risk management practices that more effectively identify, monitor, and control the risks associated with their mortgage lending activity and that more adequately address lessons learned from recent events.

### **Counterparty Credit Risk**

Supervisors are analyzing management reports and, in some cases, are having daily conversations with management about ongoing issues and important developments.

### **Commercial Real Estate**

The Federal Reserve is focused on commercial real estate (CRE) exposures. In 2006 guidance on CRE, the agency emphasized its concern that some institutions' strategic- and capital-planning processes did not adequately acknowledge the risks from their CRE concentrations.

### **Supervisory Lessons Learned**

Director Cole also addressed internal efforts:

- There is opportunity to improve the communication of supervisory and regulatory policies, guidance, and expectations of regulated entities;
- With respect to consumer protection matters, the Federal Reserve has a greater understanding that reviews of consumer compliance records of nonbank subsidiaries of bank holding companies can aid in confirming the level of risk that these entities assume; and
- The Federal Reserve must further enhance its ability to develop clear and timely analysis of the interconnections among both regulated and unregulated institutions, and among institutions and markets, and the potential for these linkages and interrelationships to adversely affect banking organizations and the financial system.

## **Agencies to Begin Forward-Looking Economic Assessments**

On February 25, 2009, the federal bank regulatory agencies announced that they will start conducting forward-looking economic assessments of large U.S. banking organizations, as the Capital Assistance Program (CAP) gets underway. These assessments will be completed on an interagency basis as a coordinated supervisory exercise to ensure the assessments are carried out in a timely and consistent manner.

Supervisors will work with institutions to estimate the range of possible future losses and the resources to absorb such losses over a two-year period.

Currently, the major U.S. banking institutions have capital in excess of the amounts required to be considered "well capitalized". The CAP is designed to ensure that major U.S. banking organizations have

sufficient capital to perform their critical role in the financial system on an ongoing basis and can support economic recovery, even in more severe economic environments.

The assessments will be conducted at eligible U.S. bank holding companies with assets exceeding \$100 billion

under two economic scenarios: a baseline and a more adverse scenario. The baseline scenario reflects a consensus expectation among private forecasters and the more adverse scenario reflects a deeper and longer recession than in the baseline. The agencies expect to complete the assessment process as soon as possible, but no later than the end of April 2009.

## SEC's Lori Richards' Remarks Before the IA Compliance Best Practices Summit

On March 12, 2009, Lori Richards, Director, Office of Compliance Inspections and Examinations at the SEC gave a speech to the IA Compliance Best Practices Summit regarding Adviser's compliance programs. Ms. Richards noted that it has been six years since the adoption of the Compliance Rule and that it is no longer a new obligation. SEC examiners will be reviewing the adequacy of firms' compliance programs with the expectation that firms will have fully operational and effective compliance programs.

Ms. Richards highlighted some steps that she thinks advisory firms can take now to help assure that the conduct of the firm and its employees meets fiduciary standards owed to advisory clients. These steps include:

- **Disclosure:** Advisers should ensure that a client would clearly understand said the substance of the disclosure. This area is a point of weakness as disclosure was among the top five most common deficiencies that the SEC examiners found in exams last year.
- **Custody:** Advisory client's assets must be held by a qualified custodian and the custodian must provide

each advisory client with an account statement at least quarterly. In instances where this differs, the adviser must have a surprise verification by an independent auditor that includes a verification of client holdings.

- **Performance Claims:** Advisers must ensure that performance history provided to clients or potential clients is accurate. Given the conflicts of interest in this area and the fact that advisory fees may be pegged on performance, the marketing significance of performance claims and the simple fact that there is a natural disinclination to deliver bad news to clients, makes this an area where CCOs should focus their attention.
- **Resources:** While conducting the annual review of a firms' compliance policies and procedures, a CCO may want to consider whether the program has adequate resources. If a lack of resources affects the CCOs ability to perform an effective review, the CCO should include this information in the CCO's annual report or other indication of the annual review.

# SIFMA's AML Committee Releases Hedge Fund AML Due Diligence Practices Guide

On February 26, 2009, SIFMA's AML and Financial Crimes Committee ("AML Committee") released its AML Suggested Due Diligence Practices for Hedge Funds ("Hedge Fund AML SDP"). Hedge Funds have become a significant player in the securities industry, drawing estimated investments of over one trillion dollars. Further, Hedge Funds have become more and more a part of the business of larger financial institutions, which have opened the door to investments in such funds to certain qualified private clients. In addition, Hedge Funds have been the focus of extensive reporting by the press, as well as the scrutiny of Congress and regulators. Therefore, the AML Committee believes it may be helpful for firms to set forth various considerations relevant to dealing with Hedge Fund clients and their Managers. Given that the AML rules do not currently apply to Hedge Funds and their Managers, these procedures should assist firms in addressing their AML responsibilities regarding appropriate levels of review and AML Due Diligence on their Hedge Fund clients.

The Hedge Fund AML SDP is intended to describe suggested practices for conducting AML Due Diligence on Hedge Funds that may act in the capacity of a customer or in another role with the firms. Depending on the nature of the relationship a firm has with a Hedge Fund, firms should determine whether Customer Information Program ("CIP") requirements apply, and the extent to which the Hedge Fund AML SDP might be appropriately applied. The Hedge Fund AML SDP discusses the characteristics of a Hedge Fund and potential relationships with Hedge Funds and investment manager.

The Hedge Fund AML SDP considers the level of AML Due Diligence that is reasonable to apply to a Hedge Fund or its Manager and the factors that may trigger the appropriate level of AML Due Diligence. For the purposes of the Hedge Fund AML SDP, there are two levels of AML Due Diligence - Simplified and Increased.

## **Simplified AML Due Diligence**

A firm may choose to apply Simplified AML Due Diligence when the Manager or Hedge Fund is:

- Either organized in a jurisdiction not otherwise identified by a firm as high risk.
- Subjected to or, as a result of a firm-wide or global policy, elects to apply, an equivalent comprehensive and consolidated AML regime.

Other factors that firms may wish to consider include the following:

- Information relating to the Manager introducing the Hedge Fund customer.
- Degree to which and length of time the key parties who are responsible for the management of the Hedge Fund and Manager are known to the firm.
- Whether a senior representative of the firm has met with them in person.
- Third party association with or acting on behalf of the Hedge Fund.
- Reputation of the Hedge Fund Administrator, legal counsel and/or its auditor.

The following are examples of possible measures to be considered, either in combination or separately, as part of the firm's AML program:

- Perform screening of, and internal process to review, the Hedge Fund / Manager and Principals of the Hedge Fund / Manager. Screenings types may include, but are not limited to: (1) OFAC, (2) negative news searched and (3) additional sanction lists.
- Consideration on whether or not an attestation from the Manager or Fund Administrator, regarding the applicable AML procedures is also appropriate.

## Increased AML Due Diligence

Increased AML Due Diligence may be appropriate where the information available about the Hedge Fund does not fall within the Simplified AML Due Diligence. Increased Due Diligence may be applied after evaluating the following circumstances:

- Is Hedge Fund organized or domiciled in a high risk jurisdiction?
- Has the Hedge Fund voluntarily subjected itself to an equivalent comprehensive and consolidated AML regime?
- What circumstances have arisen from performed Simplified Due Diligence?

The following are examples of possible measures to be considered, either in combination or separately, as part of the firm's AML program:

- Performing screening of, and establishing internal process to review, the Hedge Fund / Manager and

Principals of the Hedge Fund / Manger. Screenings types may include, but are not limited to: (1) OFAC, (2) negative news searched and (3) additional sanction lists.

- Obtaining references from other brokerage firms, other clients or senior management of the firm.
- Consider the use of an attestation, questionnaire or client profile.
- Request and review of internal or other private investigatory reports.

In conclusion, the AML Committee hopes that the Hedge Fund AML SDP will allow firms to better evaluate their own approach to Hedge Funds as part of their own internal risk assessment. The Hedge Fund AML SDP is not to be utilized for client identification requirements, but rather the suggestions should be utilized if firms deem it appropriate.

## FinCEN Proposes Rules to Permit Sharing of Suspicious Activity Information within an Organization

On March 3, 2009, FinCEN proposed rules and new guidance that permit certain affiliates of depository institutions, as well as broker-dealers in securities, mutual funds, futures commission merchants, and introducing brokers in commodities, to share suspicious activity reports ("SARs") within a corporate organizational structure.

The proposed amendments to FinCEN's SAR rules include key changes that would:

- Clarify the scope of the statutory prohibition against the disclosure by a financial institution of a SAR;
- Address the statutory prohibition against the disclosure by the government of a SAR;
- Clarify that the exclusive standard applicable to the disclosure of a SAR, or any information would reveal the existence of a SAR by the government is "to fulfill official duties consistent with Title II of the

BSA," in order to ensure that SAR information is protected from inappropriate disclosures unrelated to the NSA purposes for which SARs are filed;

- Modify the safe harbor provision to include changes made by the USA PATRIOT Act; and
- Harmonize minor technical differences that exist between the confidentiality, safe harbor, and compliance provisions of current rulemakings for different industries.

FinCEN believes the proposed changes offer a number of benefits to the industry. Specifically, the revised rules would:

- Help financial institutions better facilitate compliance with the applicable requirements of the BSA and more effectively implement enterprise-wide risk management;

- Help financial institutions assess risks based on information regarding suspicious transactions taking place through other affiliates or lines of business within their corporate organization structures; and
- Eliminate the present need to a financial institution that wants to provide information to such an affiliate

to create a separate summary document, which has to be crafted carefully to avoid revealing the existence of the SAR itself.

These amendments are consistent with similar proposals to be issued by some of the Federal bank regulatory agencies. Comments must be received by June 8, 2009.

## FinCEN Issues Money Services Business Rulings

On December 11, 2008, FinCEN issued ruling FIN-2008-R012 to address whether a Money Services Business ("MSB") must establish and maintain separate deposit accounts for its separate check cashing and money transmission lines of business in order to comply with the Bank Secrecy Act ("BSA"). The ruling states that BSA regulations do not require a MSB to maintain separate bank accounts for different lines of business, and there is no BSA regulatory requirement prohibiting the MSB from mixing funds derived from various legitimate business activities in a single deposit account. FinCEN notes, however, that the BSA does not prohibit a financial institution from choosing to adopt policies that address issues not addressed in BSA regulations, at the financial institution's discretion.

On January 22, 2009, FinCEN also issued ruling FIN-2009-R001 to address whether certain operations of a service provider to prepaid stored value program participants should be classified as a MSB. In the ruling, FinCEN states that regulations define the term "money services business" to include a money transmitter. A "money transmitter" is defined as "any person ... who engages as a business in accepting currency, or funds denominated in currency, and transmits the currency or

funds or the value of the currency or funds, by any means through a financial agency or institution ... or any other person engaged as a business in the transfer of funds." The money transmitter definition also provides that "the acceptance and transmission of funds as an integral part of the execution and settlement of a transaction other than the funds transmission itself ... will not cause a person to be a money transmitter."

FinCEN also states that its regulations define a money services business to include a seller or redeemer of stored value who sells or redeems stored value in an amount greater than \$1,000 per person per day in one or more transactions. Stored value is defined as "funds or monetary value represented in digital electronics format (whether or not specially encrypted) and stored or capable of storage on electronic media in such a way as to be retrievable and transferable electronically." Service providers engaged in the marketing, sale, loading and reloading of stored value cards only as an intermediary between an arranger and its selling agents, are not a seller or redeemer of stored value as that term is defined in FinCEN regulations. Rather, such service providers would be engaging in providing back-office services in connection with the provision of a stored value product.

# Term Asset-Backed Securities Loan Facility ("TALF") Task Force Established to Deter, Detect, and Investigate Fraud

On March 11, 2009, Neil M. Barofsky, the Special Inspector General for TARP in conjunction with the Inspector General for the Board of Governor's of the Federal Reserve System, announced the establishment of a task force to deter, detect and investigate fraud in the soon to be launched TALF.

In an effort to increase lending to consumers and small businesses, the Federal Reserve Bank of New York established TALF to make loans fully secured by collateral to households and small businesses. TALF will loan up to \$200 billion in asset-backed securities backed by credit-card loans, auto financing, student loans and Small Business Administration loans. TALF loans have a three-year term and the Federal Reserve has no recourse against the borrower beyond the collateral of the loan. TALF is supported by up to \$20

billion in TARP funds in the event of default and has the option of being extended to increase lending to \$1 trillion with up to \$100 billion of support from TARP funds.

The task force will be composed of the following civil and criminal law enforcement agencies; Special Inspector General for the Troubled Asset Relief Program, Inspector General for the Board of Governor's of the Federal Reserve System, the Federal Bureau of Investigation, the Financial Crimes Enforcement Network, U.S. Immigration and Customs Enforcement, the Internal Revenue Service, Criminal Investigation, the Securities and Exchange Commission, and the U.S. Postal Inspection Service. Due to the size and potential for abuse surrounding this program the agencies will participate in regular briefings, training, and identify areas of fraud vulnerability.

## FinCEN Mortgage Fraud Report

On February 25, 2009, FinCEN released their latest mortgage fraud report, titled *Filing Trends in Mortgage Loan Fraud*. The analysis indicates that SARs filed on suspected mortgage fraud increased 44% in the 12 months ending in June 2008 compared with the prior year.

FinCEN Director, James H. Freis, Jr, stated that one trend FinCEN spotted in the latest round of analysis is the increase in mortgage fraud detection in connection with mortgage purchasers sending home loans back to originators for repurchase. Filing institutions referenced repurchase demands in 8% of filings.

In addition to suspicion triggered in connection with repurchase demands, there were other trends in the growth in suspected mortgage fraud. Filing institutions referenced foreclosures in 13% of their SAR filings, insurers in 8% and early default payments in 2% of filings as indications of suspected fraud. These patterns

of filings generally involved the detection of suspected fraud after the mortgage had been granted. FinCEN also detected that there was an increase in the percentage of SARs filed prior to granting the loan (34% as compared to 31% in the prior one-year period, which, as highlighted in FinCEN's April 2008 report, was an increase from 21% over the preceding decade). The overall SAR filing trend does not necessarily reflect fraudulent activity on current mortgage originations.

Since 2006, FinCEN has issued three public mortgage fraud reports based upon an analysis of SAR filings by depository institutions where mortgage loan fraud is specifically indicated. For the second consecutive year, mortgage loan fraud was the third most reported SAR activity during the reporting period behind the general Bank Secrecy Act / structuring / Anti Money Laundering (BSA/AML) category, and check fraud. Nearly 900 filing institutions submitted SARs reporting mortgage loan fraud over the most recent 12-month period studied.

# FINRA Announces 2009 Exam Priorities

On March 9, 2009, the Financial Industry Regulatory Authority (FINRA) released its 2009 Exam Priorities in a letter to members. In the letter, FINRA first addressed some general concerns given the current market environment. Firms are focusing on reducing expenses, which has taken the form of headcount reductions throughout the organization. Moreover, in many organizations, the non-income producing areas have suffered significant reductions in staff. While firms maintain the discretion to determine the adequacy of headcount, FINRA recommends that firms carefully consider the impact of headcount reductions in areas such as compliance, finance and operations, and other control functions to determine whether they are commensurate with the business-line reductions in those areas. FINRA stressed that strong compliance, supervision and risk management are more critical than ever.

FINRA discussed the following topics, which should remain a high priority for firms to consider when reviewing their supervisory and compliance programs:

## **Consolidated FINRA Rulebook**

As firms are aware, a new FINRA Rulebook will eventually replace the current NASD and Incorporated NYSE Rules. FINRA expects firms to have a process in place to periodically review and update their Written Supervisory Procedures ("WSPs") as new rules become effective. Firms going through regular reviews and updates should make the necessary changes to reflect the new FINRA rules. As rules become effective, firms must carefully review the new rule requirements to ensure compliance with those rules; but changes to rule citations in WSPs can wait until the firms next scheduled update, if the update cycle frequency is reasonable. FINRA also expects firms to communicate the specific requirements of rule amendments to appropriate firm personnel and provide education and training to the extent deemed necessary.

## **Supervision**

Comprehensive supervisory procedures and their effective administration are the keys to compliance for all

business activities in which a firm engages. Accordingly, examiners will continue to focus on the extent to which firms establish, maintain and administer their supervisory systems. FINRA reminds firms of their ongoing obligation, pursuant to NASD Rule 3012.

Firms are also reminded of their annual CEO certification requirements pursuant to FINRA Rule 3130 and, for NYSE member firms, the additional requirements under NYSE Rule 342.30(a) through (c).

## **Anti-Money Laundering**

FINRA examiners continue to focus on AML requirements. Firms should ensure that their AML policies and procedures are appropriately tailored to the firm's business model, risk profile and volume of transactions, particularly with regard to monitoring, detecting and reporting suspicious activity. Procedures and systems that focus solely on money movements and do not address potentially suspicious activities related to securities transactions may not be appropriate.

## **Variable Annuities**

Examiners continue to focus on the sale and supervision of variable annuities and to closely review recommendations made to senior investors to purchase or redeem variable annuities. They also continue to review the rationale for instances where a variable annuity is exchanged for another annuity, including exchanges that involve equity-indexed annuities, exchanges resulting from a representative's change in employment and exchanges that may be based on the financial condition of the issuing insurance company.

## **Senior Investors**

FINRA continues to pay close attention to sales practices aimed at senior investors and baby boomers. FINRA's efforts include educating investors, firms and registered representatives on key issues surrounding investors in or approaching retirement.

## **Additional High Priorities**

Firms should consider the following when reviewing their supervisory and compliance programs: Cash

Alternatives; Foreign Corrupt Practices Act; Unregistered Resales of Restricted Securities (Including Penny Stock Liquidations); Protection of Customer Information and IT Security; Outsourcing; Information Barriers; Back to Basics: Customer Protection; Excess SIPC Protection; Inventory and Collateral Valuations; Funding and

Liquidity; Counterparty Credit Risk; Intercompany Reconciliations; Suspense Account Reconciliations; Bank Sweep Programs; Fully Paid Lending Programs; Sales of Equity Securities; Circulation of Rumors; Order-Entry Controls; Marking the Close; Trade Reporting; FTC's Red Flags Rule; and Alternative Investments.

## FINRA Proposes Pilot Program for Margining Credit Default Swaps

On March 18, 2009, FINRA announced that it has proposed a pilot program for the margining of credit default swaps ("CDS"), due to concerns about the rapid growth of the CDS, the potential inability of parties to meet their obligations as counterparties and subsequent risk to the financial system. Proposed Rule 4240 would apply to any transactions in CDS executed by a FINRA member regardless of the type of account in which the transaction is booked including those the central clearing counterparty services of the CME.

The rule proposal also would require firms to maintain a comprehensive written risk analysis methodology for assessing the potential risk to the broker/dealer's capital over a range of possible market movements over a specific period. These procedures would also need to include reviews of the firm's credit extension activities in an effort to:

- Determine whether CME margin requirements are adequate with respect to their customer, broker/dealer accounts and positions within the accounts. If the broker/dealer uses a central counterparty clearing other than the CME, then the broker/dealer must use the rule's Supplementary Materials to determine the adequacy of the margin requirement.

- Aggregate amount of margin BD collects from customers and BDs for CDS must be equal to or exceed aggregate amount of margin posted with CME.
- Develop a comprehensive risk methodology and review the broker/dealer's written supervisory procedures for:
  - Consistency with risk monitoring procedures and guidelines;
  - Determining whether data used for monitoring is accessible on a timely basis; and
  - Determining if information systems are available to capture, monitor, analyze and report relevant data.

The proposed rule also includes "Supplementary Material" that addresses the capital charges that firm's must take when the CDS exposure in a single name position exceeds certain thresholds when compared to the firm's tentative net capital.

This pilot program is scheduled to automatically expire on September 25, 2009.

## FINRA Announces Creation of "Office of the Whistleblower" and SEC Revamps Whistleblower Process

On March 5, 2009, FINRA announced that it has established a new Office of the Whistleblower to expedite the review of high-risk tips by FINRA senior staff and ensure a rapid response for those tips believed to have merit. Some of FINRA's most significant enforcement actions have resulted from investor complaints or anonymous or insider tips. Stephen Luparello, FINRA's Interim CEO, said, "One of the most important lessons learned from the recent scandals is the need for regulators to recognize and react to regulatory intelligence offered by whistleblowers."

To facilitate the submission of whistleblower information, the new Office of the Whistleblower has established a toll free number, 866-963-4672, and has posted a

dedicated webpage ([www.finra.org/whistleblower](http://www.finra.org/whistleblower)), where individuals may email their information to FINRA.

As FINRA announced the creation of the Office of Whistleblower, the SEC announced that it is also revamping its process for reviewing whistleblower complaints and enforcement tips to better protect investors. The SEC has enlisted the services of the Center for Enterprise Modernization to begin working immediately with the SEC to conduct a comprehensive review of internal procedures used to evaluate tips, complaints, and referrals. The SEC is seeking to establish a more centralized process that will more effectively identify valuable leads for potential enforcement action as well as areas of high risk for compliance examinations.

## SEC Chairman Announces Agenda for New Regulations Before Senate Banking Committee

On March 26, 2009, SEC Chairman Mary Schapiro testified before the U.S. Senate Committee on Banking, Housing and Urban Affairs, during which she outlined the SEC's plans for new regulation for investment advisers. Chairman Schapiro announced the SEC is considering seeking legislation, which would require hedge fund managers and possibly hedge funds to register with the SEC. Hedge fund managers would be subject to regulation under the Investment Advisers Act of 1940 and examination by the SEC staff. This would be the SEC's second attempt at requiring registration for hedge fund advisers. In 2005, the SEC adopted a similar rule, which was later vacated in 2006 by the U.S. Court of Appeals for the District of Columbia Circuit. During her testimony, Chairman Schapiro acknowledged the rules overseeing financial intermediaries need to be modernized.

Chairman Schapiro announced that the SEC is considering requesting legislation "to break down the statutory barriers that require a different regulatory regime for investment advisers and broker-dealers, even

though the services they provide often are virtually identical from the investor's perspective". Regarding custody and investor protection, Chairman Schapiro announced a proposal is underway which would require annual, surprise third-party audits for investment advisers with custody of client assets. Additionally, certain advisers would be subject to third-party compliance audits to review their compliance with the law. Furthermore, senior officers would be required to attest to the adequacy of the controls in place over client assets. A list of certifying firms as well as their auditor would be publically available on the SEC's website. This would allow investors to obtain information regarding the custody of their assets. Additionally, in the spring the SEC will issue proposed rules for money market mutual funds, which cover ways to improve credit quality, maturity, and liquidity standards. These new standards will aim to protect against the risk of breaking the buck. The SEC is also reviewing areas of regulatory gaps, including the oversight of credit default swaps and municipal securities.

## Additional Information

If you would like additional information about the topics discussed in this newsletter, or about PwC Financial Services Regulatory, please call:

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