

Financial Services Regulatory Highlights

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PWG Asset Managers' Committee Report - "Best Practices for the Hedge Fund Industry"

On April 15, 2008, the Asset Managers' Committee (AMC) of the President's Working Group (PWG) on Financial Markets released its report titled "Best Practices for the Hedge Fund Industry." The AMC's report calls on hedge fund managers, both registered and unregistered, to establish a best practice "framework" in the critical areas of (i) disclosure, (ii) valuation, (iii) risk management, (iv) operations and (v) compliance/conflicts.¹ The report publicly acknowledges the huge growth and influence of hedge funds and the accompanying need for robust business practices and accountability.

In adopting and implementing a best practice framework, managers are advised to assess their business as a whole and tailor their controls based on activities and circumstances specific to their operations. The standards encourage Hedge Fund managers to consider the following when designing their controls:

- The desired goals and essential elements of the framework;
- The need for clear and consistent policies and procedures;
- A regular process to review and update the framework; and
- The dedication of adequate resources and knowledgeable personnel to support the framework.

While various controls discussed in the report may be standard industry practice, particularly for registered hedge fund managers, the report provides a comprehensive guide for managers to use in revisiting their control structures. In our view, while the report is based on past industry efforts, it lays-out standards that are more descriptive, specific and actionable than previous guidance. Of particular note are recommendations made in the areas of disclosure and valuation, which will require significant efforts from hedge fund managers beyond current general practices.

¹ The AMC's report is available at <http://www.ustreas.gov/press/releases/reports/amcreportapril152008.pdf>

Salient points in each of the five areas noted in the report are discussed below.

Disclosure

The goal of hedge fund disclosures should be to help investors (i) make informed investment decisions and (ii) monitor and manage the ongoing risks associated with their investments. Disclosures to counterparties and credit providers are also essential. Key investor disclosures, including conflicts of interest, key personnel changes, changes in operating or valuation procedures, and other material information, should be made in private offering memos, financial reports, performance reports, risk reports, and investor letters.

Key best practices to be considered are:

- Provision of quarterly risk reports to investors disclosing, among other things, portfolio asset types, geography, leverage employed and the basis on which it is calculated, concentration of positions, and material changes in asset allocation.
- Does the firm include a qualitative performance discussion to help investors better understand the factors behind fund's quantitative performance?
- Pursuant to FAS 157, at the end of the 2008 audit year, managers will be required to categorize assets in three levels based on valuation difficulty: Level 1 (i.e., marketable securities), Level 2 (i.e., assets with some observable market price like broker quotes), and Level 3 (i.e., illiquid, hard-to-value assets). Significantly, the report goes beyond FAS 157's annual disclosure requirement and recommends making this disclosure to hedge fund investors quarterly, including how fund performance is attributed to each category.
- How do managers guard against disclosing key information to one or a select few investors?
- Does the firm have a process in place to annually review its private placement memoranda to assess whether, in light of ongoing developments in the fund, new or additional disclosures are necessary?
- Has the manager determined and agreed on the nature and frequency of communications/reports that must occur with counterparties?

Valuation

The report highlights recent concerns with valuation and related conflicts. It emphasizes that managers should establish a

framework to ensure independent and consistent valuation of investment positions. The framework should ensure adequate segregation of the portfolio management and trading function from valuation with oversight from senior management in the form of a Valuation Committee.

Fund managers and investors should ask:

- Does the manager have a Valuation Committee, including senior management, in place, responsible for establishing valuation policies and providing ongoing oversight in the valuation process?
- Is the valuation process sufficiently independent from the portfolio management function, even when portfolio managers and traders have input or can challenge a valuation?
- Are the manager's valuation policies reviewed at least annually by the Valuation Committee to ensure the fairness of the policy and feasibility of consistent application?
- Does the manager back test a sample of its valuations against recent sale prices to help assess the effectiveness of the manager's valuation process, particularly for securities categorized in Levels 2 and 3 of the FAS 157 tiers?
- Does the manager maintain documentation to support the valuation of illiquid securities?
- Does the manager use "side pockets"? Are there established guidelines for when an investment may be transferred into/out of the side pocket other than when the investment is purchased/sold?

Risk Management

The manager's risk framework should allow the measurement and monitoring of risk in relation to the fund's pre-determined risk profile. In addition to disclosing the fund's risk profile, there

should be clear and consistent risk reporting to investors. The principal categories of risk detailed in the report include, liquidity risk, leverage, market risk, counterparty credit risk and operational risk. Key Risk Management issues to consider include:

- Has a risk profile been determined for each fund? Has senior management been involved in determining such risk profile?
- Does the manager have a Chief Risk Officer responsible for the risk framework established?
- Does the Chief Risk Officer have regular dialogue with portfolio managers and senior management to clearly understand each fund's positions and strategies?
- Does the manager have measurement and monitoring processes in place to review principal categories of risk including, liquidity risk, leverage, market risk, counterparty credit risk and operational risk?
- If risk measurement processes are outsourced to an external provider, do the Chief Risk Officer and senior management continue to hold responsibility for the outsourced processes, as recommended in the report?

Trading and Business Operations

The report's discussion of trading and business operations emphasizes developing an integrated framework suitable for the size and complexity of the manager's activities and investment strategies. As part of this, the manager should adopt policies and procedures and have checks and balances in place for various operational and accounting functions including:

- Selection and monitoring of its counterparties;
- Management of cash, margin and collateral requirements;
- Selection of key service providers;
- Adequate accounting and operational processes; and
- Disaster recovery plan.

Key issues to consider in the area of trading and business operations include:

- Does the manager have a Chief Operating Officer (or other senior manager) responsible for business operations, and are those operations sufficiently segregated between business operations and portfolio management processes?

- Does the manager have adequate systems and automation to support the size and nature of its business, and are systems and infrastructure reviewed on a regular basis to ensure they are current in light of internal and external changes?
- Does the manager have a robust disaster recovery plan, which is tested on a regular basis? Does the disaster recovery plan cover all aspects of the manager's operations (not just technology based recovery)?

Compliance, Conflicts and Business Practices

The report emphasizes a manager's compliance and conflicts framework can be effective only if the firm has a culture of compliance that emanates from senior management down to all levels through personal example, communication and training. As part of this framework, the report requires that managers adopt a written code of ethics, a written compliance manual and of particular note, a Conflicts Committee to review various conflict of interest issues.

Key Issues to consider in the area of compliance, conflicts and business practice include:

- Does the manager have a committee in place, with representation from senior management (including the Chief Compliance Officer), to review various conflict of interest issues? Conflicts could arise from many issues including proprietary trading, valuation processes, allocation of expenses, gifts and affiliate relationships.
- Once a real or potential conflict is identified, does the manager adopt policies and procedures to address the conflict and ensure its application is consistent, disclosed and controlled?

- Does the manager have a written Code of Ethics, which addresses issues such as personal trading, gifts and entertainment?
- Does the manager have a written Compliance Manual, which includes policies in the areas of trading and business practices, marketing and communications, and anti-money laundering as discussed in the report?
- Does the manager have effective surveillance systems in place to monitor compliance with its policies and procedures, including testing and review of relevant documentation?
- In the event of non-compliance, does the manager have a disciplinary action and sanctions process?
- Is the manager's compliance framework assessed at least annually to ensure effectiveness?

Conclusion

Overall, while the report is not legislation for the hedge fund industry, it certainly sets a higher standard, which if adopted by hedge fund managers, will provide greater comfort to regulators and

investors alike. It is an acknowledgement that hedge funds have grown-up as an industry, and that with growing influence and resources comes a responsibility to increase transparency and controls over the management of "other people's money." The framework is very detailed, and together with developing valuation guidance sets forth an ambitious agenda for the industry. The challenge now will be for hedge fund managers to undertake honest self-assessments in measuring their activities and disclosures against these high standards.

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SEC Reverses Course on Distributing ADV Part 2 to Private Fund Investors

When the SEC proposed amendments to Form ADV Part 2 (April 2000), the staff stated that they intended to require registered hedge fund advisers to distribute this key disclosure document to each investor in a private fund. Even after the court's [Goldstein](#) decision affirmed that a hedge fund adviser's client is the fund itself and not the individual limited partners invested in the fund, SEC examiners continued to state that registered advisers must distributed ADV 2 to hedge fund investors.

The exam staff is now backing away from this position. On February 13th, the SEC proposed amending ADV 2 to require more narrative brochures written in plain English. Gene Gohlke, Associate Director in the Office of Compliance, Inspections and Examinations, was quoted in a recent interview with [Compliance Reporter \(5/9/08\)](#) as saying that examiners in the field should be aware of the position that investors in hedge funds are not "clients" for purposes of ADV 2 distribution.

Nevertheless, if the SEC passes the currently proposed amendments to ADV 2, all registered advisers will be required to post their ADV 2 on the SEC's public disclosure website, even if they do not hand it out to private fund investors. Many hedge funds have expressed concern about publicly displaying the resumes of their key officers and portfolio managers - information that will be available to head hunters and competitors.

For more information, please contact Kent Knudson at (703) 918-1377.

FinCEN Report Warns of Money Laundering Methods and Trends in Residential Real Estate Industry

On May 1, 2008, the Financial Crimes Enforcement Network (FinCEN) released the latest in a series of reports, which are based upon analysis of suspicious activity reports (SARs) provided by the financial industry. The report, titled [*Suspected Money Laundering in the Residential Real Estate Industry: An Assessment Based Upon Suspicious Activity Report Filing Analysis*](#), identified several transactional typologies and associated illicit activities that may be perpetrated by individuals or groups seeking to launder funds via residential property transactions. The report also provides summaries of SAR narratives that were reviewed for this study, which illustrate activities that may be indicative of money laundering and associated illicit financial activity.

This study confirms an increase in the number of SARs indicating suspected money laundering in the industry, which tracks closely with the past expansion of the real estate market, especially in the

2004 - 2005 period. Laundering money through residential real estate involves turning the proceeds of crime into the use or ownership of real property assets. For example, a criminal may use illicit funds to outright purchase or to make monthly rental payments on real property.

FinCEN's report shows that U.S. financial institutions that have been able to identify some possible instances of money laundering through residential real estate. This report is intended to raise awareness of the vulnerability and assist financial institutions to better recognize risk and thus provide better information to law enforcement in order to combat criminal activity.

FINRA Issues Regulatory Notice on Misleading Communications

On May 20, 2008, FINRA issues guidance, in [Regulatory Notice 08-27](#), on misleading communications about expertise.

FINRA reminds firms of their obligation to supervise representatives' communications with the public used to establish their expertise. NASD Rule 2210 prohibits false, misleading or exaggerated communications with the public and the omission of material facts or qualifications that would cause a communication to be misleading. All communications must comply with principles of fair dealing and good faith.

Registered representatives may not suggest that they authored investment-related books, articles or similar publications if they did not write them. A publication created by a third-party vendor must disclose that it was prepared either by the third party or for the representative's use. Firms must also prominently disclose their names in all advertisements and sales literature as required by Rule 2210.

FINRA Fines Three Firms \$1.6 Million for OATS Reporting and Supervision Violations

On May 15, 2008, FINRA announced that it had fined three firms a total of \$1.6 million for multi-year violations relating to FINRA's Order Audit Trail System (OATS) rules and supervisory failures.

The OATS rules require firms to report information related to the handling and execution of customer orders, as well as proprietary orders for Nasdaq and OTC Equity securities.

The three firms were fined as follows:

- \$750,000 for failing to report approximately 23.5 million Reportable Order Events relating to orders received;
- \$500,000 for failing to report "New Order Reports" and "Route Reports;" and

- \$350,000 for failing to report to OATS over 28 million orders which were generated by an affiliate.

FINRA also found that the three firms did not have adequate systems of supervision in place to monitor their OATS reporting compliance.

FINRA Issues a Staff Interpretive Memo on NASD Rule 2510 - Discretionary Accounts

On May 15, 2008, FINRA staff issued an interpretive memo to address the application of NASD Rule 2510(d)(2)(D) to the transfer, by a firm, of customer funds from one or more designated money market sweep funds in customers' accounts to alternative money market sweep funds.

Certain member firms have informed FINRA that due to recent market conditions, designated money market sweep funds have indicated they may refuse or limit additional share purchases.

Generally, member firms must obtain written authorization from a customer prior to exercising discretionary power in the customer's account. However, FINRA staff believes that due to the significant number of customer accounts potentially affected by the closing of money market sweep funds without adequate notice that it is in the best interest of the customer to permit firms to select a new money market sweep fund for customers without having to wait for the 30-day negative consent period.

In instances where the money market sweep fund closes without giving the firm adequate time to provide the 30-day negative consent period, the firm may stop attempting to sweep customer

cash balances into the current designated money market sweep fund and must:

- Use best efforts to seek a new sweep money market mutual fund that is an appropriate money market mutual fund for customers, considering such factors as yield, fees, investment objectives, risks and current market conditions;
- Establish instructions to sweep customer cash balances into newly designated money market mutual funds;
- Promptly notify customers using negative response letters of the change in sweep funds and include in such written notifications the disclosures to customers; and
- State in the written notification that customers may give instructions to invest in available alternatives to a newly designated money market sweep fund.

FINRA Requests Comment on Proposals for Consolidated Rules Governing Financial Responsibility, Supervision, Books & Records, Investor Education

On May 14, 2008, FINRA requested comment on four proposals consolidating NASD and NYSE rules for the new FINRA rulebook.

- **Financial Responsibility** -- These consolidated rules would govern members' financial responsibility requirements; and

would also afford registered firms served with a notice under these rules an expedited review proceeding;

- **Supervision and Supervisory Controls** -- This proposal would provide firms with greater flexibility as to the manner in which they meet their supervisory and supervisory control obligations;
- **Books and Records** -- This proposal has three goals in view: to streamline the books and records rule; to group books and records requirements along similar subject matter lines to make finding them a more intuitive process and to provide firms with a better understanding of the regulatory scheme; and to eliminate obsolete and duplicative books and records requirements; and

- **Investor Education and Protection** -- This proposal would require member firms to provide customers with FINRA's web site address and information regarding FINRA's BrokerCheck program at least once every calendar year.

The deadline for submitting comments is June 13, 2008.

FINRA Issues Publication on Improving Examination Results

On May 21, 2008, FINRA issued a publication to help member firms with their compliance efforts by highlighting examination priorities and frequently found deficiencies relating to FINRA's examination period.

Senior Investors

Member firms should:

- Ensure that advertisements and sales material are fair and accurate;
- Not make exaggerated or misleading statements;
- Ensure that recommendations made to seniors are suitable, with consideration paid to current investment objectives and age; and
- Cognizant of suitability issues relevant to senior investors.

During an examination, FINRA will focus on sales to seniors and other investors approaching retirement. Member firms should ensure that their supervisory system is adequate to detect and prevent any type of abusive or inappropriate sales practices toward these investors.

Deferred Variable Annuities

Rule 2821 -- Members' Responsibility Regarding Deferred Variable Annuities -- became effective on May 5, 2008. The rule requires:

- No member or person associated with a member may recommend to any customer the purchase or exchange of a deferred variable annuity unless such member or person associated with a member has a reasonable basis to believe that the transaction is suitable; and

- Member firms that conduct business in deferred variable annuities must develop and document specific training policies or programs for associated persons and principals who effect or review deferred variable annuity transactions.

Anti-Money Laundering (AML)

AML continues to be a focus of examinations. Firms can expect FINRA staff to examine whether they are effectively monitoring suspicious activity and filing Suspicious Activity Reports (SARs) when appropriate. Examiners will also verify that member firms are appropriately testing their AML programs.

Protection of Customer Information

Firms must examine how they are protecting customer information and records, including information stored on electronic devices. Firms must ensure that their policies and procedures are designed to reasonably protect against any anticipated threats or hazards to the security and integrity of customer records and information. Firms should consider how they protect customer information stored on electronic devices when they are discarded by the firm.

Firms offering online customer access or trading should assess their internal surveillance and develop plans for handling account intrusions.

Firms should also be diligent in their review of account activity for "red flags" that may indicate suspicious activity.

Firms can expect examination staff to review their Reg S-P policies to make sure that member firms are taking the appropriate steps to ensure the privacy and security of customer information.

Supervision and Supervisory Controls

Firms must establish adequate systems, policies and procedures for all areas of their business and appropriately review and update their supervisory systems, policies and procedures.

Firms should also have procedures in place for reviewing and identifying individuals or business areas that require enhanced scrutiny due to sales practice concerns.

Sales of New or Non-Conventional Products

Firms should conduct adequate due diligence to understand the features of a product it allows its representatives to market. Firms should also perform a reasonable-basis suitability analysis for the product, as well as a customer-specific suitability analysis in connection with any recommended transactions. Firms must also provide a balanced disclosure of the risks and potential rewards associated with the particular product, implement appropriate internal controls, and train registered persons regarding the features, risks and suitability of these products.

Examiners will review suitability, but will be focused on recommendations in new and non-conventional products.

Transaction Reporting

FINRA reminds firms that they are responsible for the accuracy of the transaction information reported on their behalf, regardless of the means by which that information is reported.

Business Continuity Planning (BCP)

All member firms are required to create and maintain a business continuity plan, conduct an annual review of their plan and update the plan as needed. Each firm should periodically test their plan to ensure that all of its components work.

The FINRA examination will ensure that the member firms are maintaining current BCPs and that these BCPs are tested so that firms have assurance that they could continue business, or implement alternative plans, in the event of an emergency.

Data Integrity

FINRA examiners will conduct reviews to determine both the timeliness and the accuracy of information that member firms submit. Member firms can expect data integrity reviews regarding CRD filings, the customer complaint reporting systems and data reported pursuant to NASD Rule 3150.

Bank Sweep Programs

FINRA will continue to examine the programs of broker-dealers sweeping customer credit balances into deposits at banks. The focus of the examinations are to ensure that customer funds are protected at all times and include requirements for minimum net capital requirements, titling of bank sweep accounts, treatment of bank sweep account balances under SEC Rules 15c3-1 and 15c3-3, written agreements with the bank and other related parties, bank sweep account reconciliations, and maintenance of books and records.

Agency Lending Disclosure

Examiners will focus on:

- Pre-approval of principal counterparties,
- The adequacy of credit risk reviews performed,
- Preparation of daily reconciliations at both the agent and underlying principal counterparty level,
- Maintenance of books and records at the principal counterparty level,
- Application of securities borrow deficit charges to the net capital computation, and
- Inclusion of excess collateral received from agent lenders on securities borrow contracts as credit items in the customer reserve formula computation.

Inventory Valuations

FINRA examiners will focus on a firm's practices with respect to inventory valuation.

Outsourcing

FINRA expects and will examine for formalized oversight and monitoring policies, procedures and processes as part of its review of a firm's supervisory system. Firms should consider the risks of activities that are outsourced to entities operating in foreign jurisdictions, and determine the impact of outsourcing arrangements on the firm's business continuity plans.

Order Audit Trail System (OATS)

OATS reporting continues to be a focus of examinations. Examiners routinely conduct reviews to determine the accuracy of order information submitted to OATS.

Regulation NMS

FINRA examinations may include a combination of:

- On-site observation of member firms' operations;
- Review of member firms' written operation procedures;
- Review of member firms' written supervisory procedures;
- Review of member firms' documentation evidencing the conduct of supervisory reviews; and/or
- Review of data retained by the firm to support its compliance obligations under Regulation NMS.

FDIC Proposes Home Ownership Preservation Loans

On May 1, 2008, the Federal Deposit Insurance Corporation (FDIC) proposed that Congress authorize the Treasury Department to make loans to borrowers with unaffordable mortgages to pay down up to 20 percent of their principal.

Mortgage investors and borrowers would bear the cost for the repayment and financing costs for these Home Ownership Preservation (HOP) loans. These loans would only apply to

mortgages for owner-occupied residences. This approach will help avoid unnecessary foreclosures and help stabilize mortgage and housing prices.

FDIC Issues a Financial Institution Letter on Provision for Independent Testing for BSA/AML Compliance

On May 16, 2008, the FDIC released a Financial Institution Letter (FIL) on the importance of an effective independent review of the BSA/AML Compliance Program.

The FIL emphasizes the importance of independent testing of the BSA/AML program. An effective audit is valued by regulators in identifying and monitoring a bank's specific risks and by assessing how those risks are managed and controlled. Effective audits assist examiners in determining the BSA/AML examination scope and in identifying areas requiring less review.

The *FFIEC BSA/AML Examination Manual* provides details regarding the BSA/AML Compliance Program, states minimum areas to be covered by the independent audit, and addresses limiting transaction testing to the independent review.

Independent testing (audit) assists the bank's board of directors and senior management by identifying areas of weakness or matters requiring stronger controls. The audit should be risk-based and will vary depending on the bank's size, complexity, risk profile, quality of control functions, geographic diversity, and use of technology. By incorporating the bank's *BSA/AML Risk Assessment* into the independent testing process, the audit program can be more effectively tailored to cover all of the bank's activities.

The FDIC's AML Section will conduct a teleconference on Thursday, June 5, 2008, to

discuss the BSA requirement to provide adequate independent testing as part of the BSA/AML compliance program. Information

provided through the independent test can impact the scope of the review and improve efficiency of the examination process.

Senator Dodd Introduces Major Reform of Credit Card Practices

On May 1, 2008, Senator Chris Dodd introduced comprehensive legislation to improve credit card billing, marketing and disclosure practices.

The Credit Card Accountability, Responsibility and Disclosure Act (the C.A.R.D. Act) seeks to end credit card practices that increase consumers' debt burden.

The CARD Act will strengthen the credit card industry's regulation and oversight, and prohibit unfair and deceptive practices such as universal default and double-cycle billing.

Federal Reserve Board Proposes Rules to Prohibit Unfair Practices Regarding Credit Cards

On May 2, 2008, the Federal Reserve Board proposed rules to prohibit unfair practices regarding credit cards and overdraft services that would protect consumers from unexpected increases in the rate charged on pre-existing credit card balances.

The rules would forbid banks from imposing interest charges using the "two-cycle" billing method, would require that consumers receive a reasonable amount of time to make their credit card payments, and would prohibit the use of payment allocation methods that unfairly maximize interest charges. They also include protections for consumers that use overdraft services offered by their bank.

The provisions addressing credit card practices are part of the Board's ongoing effort to enhance protections for consumers who use credit cards, and follow the Board's 2007 proposal to improve the credit card disclosures under the Truth in Lending Act. The FTC Act proposal includes five key protections for consumers that use credit cards:

- Banks would be prohibited from increasing the rate on a pre-existing credit card balance (except under limited circumstances) and must allow the consumer to pay off that balance over a reasonable period of time.

- Banks would be prohibited from applying payments in excess of the minimum in a manner that maximizes interest charges.
- Banks would be required to give consumers the full benefit of discounted promotional rates on credit cards by applying payments in excess of the minimum to any higher-rate balances first, and by providing a grace period for purchases where the consumer otherwise eligible.
- Banks would be prohibited from imposing interest charges using the "two-cycle" method, which computes interest on balances on days in billing cycles preceding the most recent billing cycle.
- Banks would be required to provide consumers a reasonable amount of time to make payments.

Federal Reserve Chairman Bernanke Discusses Risk Management in Financial Institutions

On May 15, 2008, the Federal Reserve Chairman Ben S. Bernanke spoke at the Federal Reserve Bank of Chicago's Annual Conference on Bank Structure and Competition on the "lessons of the recent experience for risk-management practices in financial institutions as well as the supervisory oversight of those practices."

The Chairman addressed the origins of the financial turmoil. He stated that the financial stress began with the problematic implementation of the so-called originate-to-distribute approach to credit extension. This model spreads risk and reduces financing costs allowing a wider range of borrowers to have greater access to capital, while still giving investors flexibility in choosing and managing credit exposures.

The Chairman highlighted two recently published reports that address the weaknesses with this approach in greater detail -- one report was issued by the President's Working Group on Financial Markets (PWG); and the second was issued by the Financial Stability Forum (FSF). The reports show that problems occurred at every step of the credit-extension chain, from the underwriting standards to risk-management weaknesses at large global financial institutions that created and held complex credit products. "Both the PWG and the FSF reports highlighted the important role played by financial regulators in overseeing and helping to strengthen risk-management practices in the firms they supervise, and the reports recommend that the regulators review their own policies, guidance, and supervisory practices to identify areas in which improvements could be made." stated Chairman Bernanke.

The Chairman discussed the lessons in four categories of risk-management practices:

Risk Identification and Measurement

The Chairman emphasized that stress tests would be a good way to augment models and other standard quantitative techniques for risk management. He believes that they provide a valuable perspective on risks outside those typically captured by statistical models as well as those that are not captured in scenarios. This type of testing forces practitioners to step back and think through the implications of the scenarios if they come to fruition.

Valuation

Valuation practices are an area that the supervisors view as critical. Firms that paid close attention to problems relating to the valuation of financial instruments fared much better than those who did not.

Liquidity Risk Management

Chairman Bernanke identified liquidity risk management as another crucial lesson from recent events and stated that firms need to understand their liquidity needs and be prepared for the possibility that their market liquidity may erode quickly and unexpectedly.

Senior Management Oversight

"Effective oversight of an organization as a whole is one of the most fundamental requirements of prudent risk management." stated Chairman Bernanke. Firms that had solid senior management oversight and engagement were a key factor in their performance during the recent events.

The Chairman also addressed lessons learned for the supervisors. He indicated that supervisors must redouble their efforts to help organizations improve their risk-management practices and the need for more emphasis on the enterprise-wide perspective as it relates to risk.

He concluded, "With renewed attention to these principles and the restoration of strong incentives for sound risk management, institutions should be able to overcome the difficulties we have seen in the recent application of the originate-to-distribute model and begin to use it successfully again."

Governor Kroszner Addresses Risk Management and Basel II

On May 14, 2008, the Federal Reserve Board Governor Randall S. Kroszner spoke at the Federal Reserve Bank of Boston AMA Conference on the implementation of Basel II, as well as the proposal to implement the standard approach in the U.S.

Basel II has been an official regulation in the U.S. for just over a month and a key instrument in the qualification process is the implementation plan. The written implementation plan is a detailed and tangible representation of how the bank complies or plans to comply with the qualification requirements of the rule. This plan needs to be approved by the bank's board of directors.

Governor Kroszner stated, "One important part of a credible implementation plan is a thorough assessment of how the bank intends to address the gaps it has identified between its existing practices and the qualification requirements set forth in the rule for the advanced approaches that cover all consolidated subsidiaries." The implementation plan must include:

- Objective, measurable milestones;
- Delivery dates; and
- Target date for full implementation.

Large, internationally active banks must adopt an approved implementation plan by October 1, 2008.

The Governor spoke briefly on the standardized approach, which will be published for public comment soon. This approach is directed towards banks that are not subject to the advanced approaches of Basel II. This approach would:

- Enhance risk sensitivity by increasing the number of risk-weight categories to which a bank would assign credit exposures;
- Increase capital requirements for certain off-balance sheet exposures;
- Allow for broader recognition of credit risk mitigants; and
- Include a specific capital requirement for operational risk.

Federal Financial Regulators Issue Final Illustrations of Consumer Information for Hybrid Adjustable Rate Mortgage Products

On May 22, 2008, the federal financial regulatory agencies issued final illustrations for helping consumers understand certain hybrid adjustable rate mortgage (ARM) products.

The agencies' Statement on Subprime Mortgage Lending, which became effective July 10, 2007, recommended that institutions provide clear, balanced and timely information to consumers about the relative benefits and risks of hybrid ARM products. The illustrations are intended to assist institutions in providing this information.

Institutions are not required to use the illustrations. They may use them, provide information based on them, or provide consumers with information described in the guidance in an alternate format.

The illustrations will be available on each of the agencies websites for downloading and printing.

The illustrations consist of:

- An explanation of some key features of products covered by the Subprime Statement, and
- Three charts with examples of the potential payment shock accompanying these types of loans.

Agencies Announce Proposed Rules on Risk-Based Pricing Notices

On May 8, 2008, the Federal Reserve Board and the FTC announced proposed regulations that would require a creditor to provide a consumer with a risk-based pricing notice when the creditor offers or provides credit to the consumer on terms less favorable than the terms it offers or provides to other consumers.

Risk-based pricing is the practice of using a consumer's credit report, which reflects his or her risk of nonpayment, in setting or adjusting the price and other terms of credit offered or extended to a particular consumer. The proposed rules would apply, with certain exceptions, to all creditors that engage in risk-based pricing. The proposal:

- Provides a number of different approaches that creditors may use to identify the consumers to whom they must provide risk-based pricing notices;
- Includes certain exceptions to the notice requirement, such as permitting creditors, in lieu of providing a risk-based pricing notice to those consumers who receive less favorable terms, to provide all of their consumers with their credit scores and explanatory information; and
- Would implement section 311 of the Fair and Accurate Credit Transactions Act of 2003.

Additional Information

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

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