

Financial Services Regulatory Highlights

volume 11 no. 5 May 2009

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Credit Card Responsibility and Disclosure Act Signed into Law

On May 22, 2009, President Obama signed into law the Credit Card Accountability Responsibility and Disclosure ACT of 2009 (the Credit CARD Act). The Act includes substantial changes to the regulation of credit cards and stored value products and limits the ability of card issuers to factor in risk in underwriting and servicing of these accounts. It is notable that the ACT includes changes that reach beyond the scope of UDAP and Regulation Z rules addressing credit card accounts that were issued by the Federal Reserve in December 2008.

Some key provisions of the Act are as follows. Most will become effective within nine months, with all others becoming effective within 15 months:

- **Rates and Terms:** Prevents unfair increases in interest rates and changes in terms through prohibiting arbitrary rate increases and universal default, requiring periodic review of accounts where the interest rate has been increased to determine if conditions are such that the rate can be decreased, requiring promotional rates to last at least six months and prohibiting rate increases in the first year for new accounts.
- **Fees and Charges:** Limits certain credit card fees and charges, such as over-the-limit and late payments fees, to be proportional to the cardholders omission or violation of account agreement. Disallows issuers from charging a fee to pay credit card debt (e.g. by phone, internet, mail) unless expedited payment services are procured from a service representative of the issuer.
- **Payments:** Requires payments in excess of the minimum to be applied to the portion of the balance with the highest interest rate and requires that periodic statements be mailed 21 days prior to the payment due date.
- **Credit for Young Adults:** Prohibits issuance of credit to individuals under 21 years old without a co-signor age 21-years or older or proof of an independent means of income to repay the credit. Limits pre-screened offers, as well as increases in credit limits, to young adults.
- **Stored Value Cards:** Requires that all gift cards have an expiration date of at least five years and prohibits dormancy fees unless such fees have been disclosed on the card and there has been no activity on the card for the previous 12 months.

- Customer Ability to Repay: Prohibits issuance of cards or increase of credit limit unless the issuer considers the actual ability of the customer to repay.
- Double Cycle Billing and On-Time Payments: Bans the use of double-cycle billing and prohibits charging interest on any portion of a balance subject to a grace period if it was repaid in a timely manner.

SEC Proposes Rule Amendments to Strengthen Safeguards of Investor Funds Controlled by Investment Advisers

On May 20, 2009, the SEC issued a proposal to amend Investment Advisers Act Rule 206(4)-2, which regulates the custody practices of advisers registered under the Act. A series of recent fraud cases/ponzi schemes has caused the SEC to undertake a comprehensive review of client-asset safekeeping in order to determine if rule changes could decrease the likelihood of misappropriation or increase chances for earlier detection of fraudulent activity.

The release is characterized by over 92 questions and requests for comments. Many open-ended questions, coupled with the contemporaneous examination sweep of adviser and broker custody practices, could indicate that the SEC is still grappling with a basic approach. The main thrust of the proposal seems to be to supplement the SEC's own efforts by getting more information into client's hands and by deputizing accounting firms to help look for possible fraudulent activity.

Summary of Rule Proposal

- All advisers with custody (the ability to obtain client assets through, e.g., fee deductions, trustee responsibilities, omnibus custodial accounts, position as general partner, etc.) would have to engage an independent public accountant to conduct an annual surprise-count of client funds and securities. This requirement would be regardless of whether a qualified custodian directly provides statements to clients or, in the case of a pooled investment vehicle, the pool distributed annual audited financials to its limited partners.
- The proposed rule would continue to except advisers from the requirement to have a qualified custodian send account statements with respect to a pooled investment vehicle that is audited at least annually and distributes its audited financial statements to its limited partners.
- Accountants conducting the surprise exam would be required to notify the SEC within one business day of finding material discrepancies, and to submit Form ADV-E to the Commission accompanied by a certificate within 120 days of the time chosen by the accountant for the surprise examination describing the nature and extent of the review. Accountants would also have to submit ADV-E within four business days of their termination, resignation or removal from consideration for reappointment.
- Form ADV-E would be filed electronically on the IARD system, becoming instantly available to the SEC and to the public on the internet. This could lead to greater comparison of information provided to the SEC and would likely harmonize the standards for conducting these reviews.
- Privately offered securities (e.g. limited partnership interests and private stock offerings) would be subject to the surprise count. Currently they are excluded from all aspects of the rule.
- The definition of "custody" would be updated in the rule, to include all situations in which a related person holds customer funds or securities in connection with advisory services provided to the client.
- If the adviser or an affiliate maintains direct custody by serving as a "qualified custodian" for client funds or securities under the rule, the adviser must obtain, or receive from the related person, no less frequently than once each calendar year a written report ("internal control report"), which includes an

opinion from an independent public accountant registered with, and subject to regular inspection by, the Public Company Accounting Oversight Board (“PCAOB”), with respect to the adviser’s or related person’s controls relating to custody of client assets.

- For self- and affiliated-custody situations, the rule would also require that the surprise-count auditor be registered with and inspected by the PCAOB.
- The adviser would be required to maintain the internal control report in its records. The report would not be filed with the SEC but must be available to the Commission or its staff upon request (likely during a compliance exam).
- The rule changes would require advisers to have a basis for believing, after appropriate inquiry, that client custodians are independently sending account statements directly to the advisory clients or clients’

independent representative at least quarterly. The amendments would eliminate the current ability for an adviser to send statements in lieu of the custodian sending statements if the adviser undergoes an annual surprise exam.

- Advisers would have to give written encouragement to clients, upon notifying them of custodial accounts opened on their behalf, to compare account statements received from advisers and custodians.
- Finally, the proposed amendment would allow pooled-investment vehicles (e.g. hedge funds) to rely on the exemption from the account-statement delivery requirements only if the pool is audited upon liquidation, regardless of the liquidation date.

Comments on the proposed rule must be received by the SEC on or before July 28, 2009.

House Passes Historic Mortgage Reform Legislation

On May 7, 2009, the House of Representatives approved legislation to curb abusive and predatory lending. H.R. 1728, the Mortgage Reform and Anti-Predatory Lending Act of 2009, will outlaw many of the industry practices that marked the subprime lending boom.

The legislation requires that lenders ensure that borrowers have the ability to repay the home loans they are sold. The bill also requires that all mortgage-refinancing loans benefit the consumer, and it bans predatory schemes that “steer” borrowers into higher cost loans.

In addition, H.R. 1728 encourages a return to sound underwriting practices by prohibiting mortgage lenders from relinquishing responsibility for the loans they make and sell to Wall Street. Under the measure, lenders will now be required to retain an economic interest in a material portion (at least 5 percent) of any home loan they make and sell. In addition, for the first time ever, the large secondary mortgage market will bear responsibility for loans they purchase and securitize, bringing accountability back to every level of the mortgage lending chain.

The Federal Reserve Board Approved Final Rules that Revise the Disclosure Requirements for Mortgage Loans Under Regulation Z

On May 8, 2009, the Federal Reserve Board approved final rules that revise the disclosure requirements for mortgage loans under Regulation Z. The revisions implement the Mortgage Disclosure Improvement Act (MDIA), which was enacted in July 2008 as an amendment to the Truth in Lending Act (TILA).

The MDIA seeks to ensure that consumers receive cost disclosures earlier in the mortgage process. It requires creditors to give good faith estimates of mortgage loan costs within three business days after receiving a consumer’s application for a mortgage loan and before any fees are collected (other than a reasonable fee for

checking a consumer's credit history). The MDIA also requires early disclosures for loans secured by dwellings other than the consumer's principal dwelling.

The rules also require that creditors wait seven business days after they provide the early disclosures before

closing the loan. Creditors are also required to provide new disclosures with a revised annual percentage rate and wait an additional three business days before closing the loan if a change occurs that makes the APR in the early disclosure inaccurate beyond a specified tolerance.

Federal Reserve Announces that Certain High-Quality CMBS Will Become Collateral Under TALF

On May 19, 2009, the Federal Reserve Board announced that, starting in July, certain high-quality commercial mortgage-backed securities issued before January 1, 2009 (legacy CMBS) will become eligible collateral under the Term Asset-Backed Securities Loan Facility (TALF).

The TALF is designed to increase credit availability and support economic activity in part by facilitating renewed issuance of consumer and business asset-backed securities (ABS) and CMBS. The TALF was authorized by the Board on November 24, 2008. Under the TALF, the Federal Reserve Bank of New York (FRBNY) has extended loans secured by triple-A-rated newly issued ABS backed by certain consumer and business loans and leases. On May 1, 2009, the Board announced it would expand the range of acceptable TALF collateral to include newly issued CMBS starting with the June subscription.

On March 23, 2009, the Federal Reserve announced that it would evaluate extending the list of eligible collateral for TALF loans to include certain legacy securities. The expansion seeks to restart the market for legacy securities and, by doing so, stimulate the extension of new credit by helping to ease balance sheet pressures on banks and other financial institutions. The most recent announcement marks the first addition of a legacy asset class to the list of eligible TALF collateral.

The CMBS market, which has financed approximately 20% of outstanding commercial mortgages, including

mortgages on offices and multi-family residential, retail and industrial properties, came to a standstill in mid-

2008. The extension of eligible TALF collateral to include legacy CMBS is intended to promote price discovery and liquidity for legacy CMBS. The resulting improvement in legacy CMBS markets should facilitate the issuance of newly issued CMBS, thereby helping borrowers finance new purchases of commercial properties or refinance existing commercial mortgages on better terms.

To be eligible as collateral for TALF loans, legacy CMBS must be senior in payment priority to all other interests in the underlying pool of commercial mortgages and, as detailed in the attached term sheet, meet certain other criteria designed to protect the Federal Reserve and the Treasury from credit risk. The FRBNY will review and reject as collateral any CMBS that does not meet the published terms or otherwise poses unacceptable risk.

Eligible newly issued and legacy CMBS must have at least two triple-A ratings from Fitch Ratings, Moody's Investors Service, Realpoint, DBRS, or Standard Poor's and must not have a rating below triple-A from any of these rating agencies. More broadly, the Federal Reserve is formalizing procedures for determining the set of rating agencies whose ratings will be accepted for various types of eligible collateral in the Federal Reserve's credit programs.

The initial subscription date for TALF loans collateralized by newly issued CMBS will be June 16, 2009. The subsequent subscription dates for TALF loans collateralized by newly issued and legacy CMBS will be announced in advance. The subscription date for loans collateralized by all other ABS will remain toward the beginning of the month.

FinCEN Releases the 15th Issue of The SAR Activity Review

On May 13, 2009, FinCEN released the 15th issue of The SAR Activity Review - Trends, Tips and Issues (The Review). The Review focuses on the roles and responsibilities of the Securities and Futures Industries.

FinCEN analysts examined SAR-SFs to identify trends and patterns relating to filing volume, type of reporting institution, characterization of suspected activities, and filing by instrument type. The Review also discusses the most frequently cited alleged suspicious activities and includes examples of specific activities included in the SAR narratives.

The most frequently cited suspicious activities included the following:

- Structured Deposits and Withdrawals;
- Identify Theft;
- Possible Terrorist Financing;
- Suspected Money Laundering or Tax Evasion; and
- Suspicious Wire Transfers.

The Review provides information from the SEC staff on how to file SARs, the SEC's use of SARs and the consequences to regulated institutions for failure to file. It addresses law enforcement cases related to the securities industry, Ponzi schemes and mortgage fraud cases. Furthermore, the Review provides guidance on identifying and reporting suspicious transactions for introducing and clearing firms and completing the SAR form when reporting identity theft.

FinCEN Releases CTR Exemption Supporting Information Guidance

On April 27, 2009, FinCEN announced the publication of guidance designed to enable depository institutions to more easily determine and document certain business customers' eligibility for exemption from currency transaction reporting (CTR).

The guidance was recommended to FinCEN in a report issued last year by the Government Accountability Office (GAO). It was developed in consultation with the staffs of the federal banking agencies and is expected to both ease compliance with applicable regulatory requirements and enhance supervisory consistency. This step complements other changes made by FinCEN in 2008 to the CTR regulations designed to increase the efficiency of the reporting process, including promoting exemptions for reporting that is less valuable to law enforcement. The January 2008 GAO report underscored the value of CTRs for law enforcement investigations, while suggesting certain changes that would facilitate increased utilization by banks of eligible exemptions from reporting.

FinCEN's guidance seeks to clarify for depository institutions and examiners the variety of supporting information that is suitable for substantiating that certain business customers that engage in multiple business activities are eligible for exemption from currency transaction reporting.

This guidance further clarifies that there is no expectation that a depository institution will be able to establish the exact percentage of an eligible business customer's annual gross revenues that is derived from ineligible business activities. A depository institution must consider and maintain materials and other supporting information that allow it to substantiate that the decision to exempt the customer from currency transaction reporting was based upon a reasonable determination that the customer derives no more than 50% of its annual gross revenues from ineligible business activities. Such a reasonable determination should be based upon its understanding of the nature of the customer's business, the purpose of the customer's accounts, and the actual or anticipated activity in those accounts.

FinCEN Proposes Amendments to MSB Definition

On May 12, 2009, FinCEN issued a Notice of Proposed Rulemaking (NPRM) designed to make the determination of which businesses qualify as Money Services Businesses (MSBs) more straightforward and predictable.

FinCEN is proposing to revise the MSB definition by describing with more clarity the types of financial activities that will subject a business to the BSA implementing rules. This proposal will incorporate past FinCEN rulings and policy determinations into the regulatory text and will make it easier for MSBs to determine their responsibilities.

Currently, to meet one threshold test for an MSB, a person must conduct \$1,000 of transactions per person per day. This applies to all categories of MSBs except for "money transmission." This NPRM solicits comment on adjusting this definitional threshold. If a person meets the definition for an MSB, they are subject to the applicable recordkeeping and reporting requirements of

the BSA rules. An entity that engages in money transmission in any amount is subject to the BSA rules and the solicitation for comment on revising the threshold is directed to the other categories of MSB. FinCEN will address regulation changes concerning stored value providers in a future rulemaking. Within this rulemaking, FinCEN solicits comments on stored value issues in an effort to have a better-informed subsequent rulemaking confined to providers of stored value.

In addition, this NPRM proposes to ensure that a foreign-located entity engaging in MSB activities within the United States is regulated as an MSB. Accordingly, the proposed rule clarifies that certain foreign-located entities engaging in MSB activities within the United States, such as having U.S. customers or transmitting money to, or from, U.S. recipients, are subject to the BSA rules.

Comments concerning the NPRM from the industry and the public are welcome through September 9, 2009.

FTC Will Grant Three-Month Delay of Enforcement of 'Red Flags' Rule Requiring Creditors and Financial Institutions to Adopt Identity Theft Prevention Programs

On April 30, 2009, the Federal Trade Commission (FTC) announced the delay of enforcement of the new "Red Flags Rule" until August 1, 2009, to give creditors and financial institutions more time to develop and implement written identity theft prevention programs. This announcement does not affect other federal agencies' enforcement of the original November 1, 2008 compliance deadline for institutions subject to their oversight.

The Fair and Accurate Credit Transactions Act of 2003 (FACTA) directed financial regulatory agencies, including the FTC, to promulgate rules requiring "creditors" and "financial institutions" with covered accounts to implement programs to identify, detect, and respond to patterns, practices, or specific activities that could indicate identity theft.

During outreach efforts last year, the FTC staff learned that some industries and entities within the agency's jurisdiction were uncertain about their coverage under the Red Flags Rule. During this time, FTC staff developed and published materials to help explain what types of entities are covered, and how they might develop their identity theft prevention programs.

In addition, on May 13, 2009, to help entities that have a low risk of identity theft, such as businesses that know their customers personally, the FTC created a template that guides such businesses and organizations in developing written identity theft prevention programs to comply with the Red Flags Rule. "Create Your Own Identity Theft Prevention Program: A Guided 4-Step Process". The template has guidance and instructions that enable companies to complete and print the fill-in-

the-blank form online. Under FACTA, the Rule requires many businesses and organizations to implement a written Identity Theft Prevention Program to detect the warning signs ("red flags") of identity theft. By identifying

red flags, these entities will be in a better position to spot an imposter trying to defraud them by using someone else's identity to get products and services.

FINRA to Propose Expanding BrokerCheck to Permanently Disclose Disciplinary Histories of Former Brokers

On April 27, 2009, the Financial Industry Regulatory Authority (FINRA) proposed a major expansion of its BrokerCheck service in order to make records of final regulatory actions against brokers permanently available to the public, regardless of whether they continue to be employed in the securities industry. Under current rules, a broker's record generally becomes unavailable to the public two years after he or she leaves the securities industry and is therefore no longer under FINRA's jurisdiction. FINRA estimates there are more than 15,000 individuals who have left the securities industry after being the subject of a final regulatory action and whose disciplinary history is not currently available on BrokerCheck.

"It has never been more critical for investors to research the backgrounds of the people who approach them with investment proposals," said Richard Ketchum, FINRA Chairman and CEO. "Individuals previously barred by FINRA and other securities regulators have surfaced in a

number of recent frauds responsible for millions lost by unsuspecting investors. Investors should be able to check if the financial professional they're dealing with has been the subject of a disciplinary action by regulators."

In many cases, final regulatory actions, such as bars, suspensions and fines, against a particular individual can be found in various places on the internet, including on FINRA's own Web site, by searching individual monthly disciplinary reports. FINRA's proposal would make that information easily and centrally accessible through BrokerCheck.

FINRA filed its rule proposal to expand BrokerCheck with the Securities and Exchange Commission (SEC) in late April. The SEC will publish the proposal in the Federal Register and solicit public comment in the near future. SEC Charges Hedge Fund Manager and Bond Salesman in First Insider Trading Case Involving Credit Default Swaps

SEC Charges Hedge Fund Manager and Bond Salesman in First Insider Trading Case Involving Credit Default Swaps

On May 5, 2009, the SEC charged Renato Negrin, a former portfolio manager at hedge fund investment adviser Millennium Partners L.P., and Jon-Paul Rorech, a salesman at Deutsche Bank Securities Inc., with insider trading in credit default swaps of VNU N.V., an international holding company that owns Nielsen Media and other media businesses.

The SEC's complaint alleges that Rorech learned information from Deutsche Bank investment bankers about a change to the proposed VNU bond offering that

was expected to increase the price of the CDS on VNU bonds. Deutsche Bank was the lead underwriter for a proposed bond offering by VNU. According to the SEC's complaint, Rorech illegally tipped Negrin about the contemplated change to the bond structure, and Negrin then purchased CDS on VNU for a Millennium hedge fund. When news of the restructured bond offering became public in late July 2006, the price of VNU CDS substantially increased, and Negrin closed Millennium's VNU CDS position at a profit of approximately \$1.2 million.

The SEC's complaint charges Negrin and Rorech with violations of the antifraud provisions of the Securities Exchange Act of 1934 and seeks a final judgment ordering them to pay financial penalties and

disgorgement of ill-gotten gains plus prejudgment interest. Millennium has agreed to escrow the amount that the SEC is seeking as ill-gotten gains pending a final judgment in this case.

FINRA Fines Centaurus Financial \$175,000 for Failure to Protect Confidential Customer Information

On April 28, 2009, FINRA has announced that it has fined Centaurus Financial, Inc. (CFI), of Orange County, CA, \$175,000 for its failure to protect certain confidential customer information. Centaurus was ordered to provide notifications to affected customers and their brokers and to offer these customers one year of credit monitoring at no cost.

FINRA found that from April 2006 to July 2007, CFI failed to ensure that it safeguarded confidential customer information. Its improperly configured computer firewall, along with an ineffective username and password on its computer facsimile server, permitted unauthorized persons to access stored images of faxes that included confidential customer information, such as social security numbers, account numbers, dates of birth and other sensitive, personal and confidential data. The firm's failures also permitted an unknown individual to conduct a "phishing" scam. Phishing scams are designed to trick computer users into divulging personal information such as usernames, passwords and bank and credit card information. A file simulating a popular Internet auction site was uploaded to CFI's fax server and over a three-day period there were 894

unauthorized logins by 459 unique IP addresses, most of them from recipients of a mass email sent by the perpetrators of the scam.

Following the discovery of the phishing scam, CFI sent a misleading letter to approximately 1,400 customers and their brokers, inaccurately stating that the unauthorized access was limited to one person and that information on the server was not openly available.

The letter failed to state that other unauthorized logins had occurred and did not inform the customers that the unauthorized access was made possible by the inadequate firewall and weak username and password on its computer fax server.

CFI's conduct violated federal Regulation S-P and FINRA rules. Under the terms of the settlement, Centaurus has agreed to provide corrected notifications of the unauthorized accesses to all previously notified customers and brokers and to offer these customers one year of free credit monitoring. In addition, CFI will certify to FINRA that its procedures and systems are in compliance with privacy requirements.

Additional Information

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