

# Financial Services Regulatory Highlights

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## New SEC Investment Advisor Examination Request List

In the past few weeks, the SEC's New York regional office (NYRO) has started to use a revised request letter in its inspections of investment advisers. This new request letter, issued by Office of Compliance Inspections and Examinations (OCIE) with a goal to standardize request letters across its regional offices, is significantly shorter than the 27 page request letter previously used by NYRO. Advisers may heave a sigh of relief in seeing this new 11 page request letter, which omits much of the detailed information requested in the past. However, based on our understanding, although advisers may be required to produce less information upfront, they should expect to see an increase in supplemental requests made by the examination staff as risks are identified during the course of the inspection. As such, it is hard to say whether the new request letter would reduce the overall hardship of document production for advisers during the inspection process.

Some specific observations we made in reviewing the new request letter are:

- In the previous request letter, while specific documents were requested for topics such as soft dollars, best execution, brokerage arrangements, solicitation arrangements, the new request letter broadly asks for any pertinent documentation relating to such topics. This increases the burden for advisers to determine relevant information that should be produced for the SEC staff. In past, if a document or report was not specifically listed in the request letter, advisers did not necessarily volunteer the information to the SEC.

- For private fund managers, in addition to the adviser's policies and procedures to safeguard non-public information when supervised persons make investment decisions for clients, proprietary or personal accounts, the SEC is requesting policies and procedures intended to prevent the inappropriate communication by investors in the private funds managed by the adviser. Advisers, particularly those who have investor committees or who allow investors to interact with fund managers, should carefully review whether they have policies and procedures in place to address this issue. The SEC has previously expressed concerns about hedge fund investors who are also officers of public companies and as a result may be privy to material non-public information which potentially could be communicated to the adviser.
- While the new request letter has mostly reduced the amount of information asked upfront, it adds a section on Financial Records (including, balance sheet, income statement, trial balance, general ledger, cash receipts and disbursement journal) that the adviser would need to produce for the entire examination period. Typically, examiners request such financial records only on a sample basis once the examination commences to review for issues, among others, such as trade errors, appropriate advisory fees and payment to solicitors or

other parties which may reveal potential conflicts of interest. Given the amount of information that would need to be generated, particularly for larger investment advisers, it may be prudent for advisers to check with the assigned examiners whether they would like the requested information for the entire examination period or for a sample period picked by them.

- One may notice how certain topics included in the previous request letter are entirely removed from the new letter. Issues such as gifts and entertainment, cross trades, email and instant messages, list of seminars and conferences attended, are some of the topics omitted, however, as previously mentioned, advisers should be prepared to produce this information for the examiners since it may be part of a supplemental request made during the course of the inspection.

## FinCEN Issues Ruling on BSA Obligations of a U.S. Clearing Broker-Dealer Establishing a Fully Disclosed Clearing Relationship with a Foreign Institution

[On June 3, 2008, the Financial Crimes Enforcement Network \(FinCEN\) issued a ruling on Bank Secrecy Act \(BSA\) obligations of a U.S. clearing broker-dealer establishing a fully disclosed clearing relationship with a foreign financial institution.](#)

FinCEN clarifies the following in the ruling:

- Whether a fully disclosed clearing agreement between a U.S. clearing firm and a foreign introducing firm is a correspondent account for the purposes of regulations implementing Section 312 of the USA PATRIOT Act;
- Whether a clearing firm is obligated to regard the fully disclosed accounts of a foreign introducing firm as its own accounts for the purposes of complying with the customer identification program regulations;

- Whether a clearing firm is expected to obligate the foreign introducing firm to comply with the obligations of the CIP rule, the correspondent account rule, and other U.S. anti-money laundering regulations respecting any accounts it may introduce to the clearing firm on a fully disclosed basis; and
- Whether a clearing firm has established or maintained a correspondent account with a foreign financial institution, thus obligating the clearing firm to comply with the provisions of the correspondent account rule, will depend on whether the clearing

firm has established a "formal relationship" with the foreign financial institution.

FinCEN views the relationship between a clearing firm and a foreign introducing firm to be a formal relationship, and therefore a correspondent account, for purposes of complying with the correspondent account rule, thus obligating the clearing firm to conduct due diligence on the foreign introducing firm. They also view the relationship between a clearing firm and a foreign introducing firm as an "account" for the purposes of complying with the CIP rule, thus obligating the clearing firm to verify the identity of the foreign introducing firm in order to form a reasonable belief that it knows the true identity of the foreign introducing firm.

A clearing firm typically is not required to look through the fully disclosed clearing relationship to perform due diligence directly on the customers that may be introduced to it by a foreign introducing firm. Rather, the clearing firm is obligated to assess the money laundering risk presented by its fully disclosed clearing arrangement with the foreign introducing firm including, but not limited to, the risk factors enumerated in the correspondent account rule.

The clearing firm also is not required to obligate a foreign introducing firm to comply with the provisions of the CIP rule, the correspondent account rule, or any other U.S. anti-money laundering regulations respecting any accounts it may introduce to the clearing firm on a fully disclosed basis. Instead, the clearing firm is obligated to apply risk-based policies, procedures, and controls to each correspondent account that are reasonably designed to detect and report known or suspected money laundering activity. The clearing firm is expected to monitor transactions conducted for introduced customers through the fully disclosed clearing agreement with the foreign introducing broker incorporating, among other information, any information the clearing firm acquires about the customers that are introduced by the foreign introducing firm in the ordinary course of its business.

## Proposed Rule Change Relating to the Adoption of FINRA Rule 3220 (Influencing or Rewarding Employees of Others) and FINRA Rule 2070 (Transactions Involving FINRA Employees) in the Consolidated FINRA Rulebook

As part of the process of developing a new rulebook, FINRA has proposed to adopt changes to NASD Rules 3060 (Influencing or Rewarding Employees of and Others) as part of the consolidated FINRA rulebook without material changes. The proposal also calls for renumbering the Rule as 3220. Currently, Rule 3060 prevents gifts in excess of \$100 and this provision remains unchanged. However, FINRA proposed eliminating the following provisions from the NYSE Rules:

- The provision in NYSE Rule 350 permitting member firms to obtain prior written consent of the recipient's employer for any gift over \$100. FINRA believes that the gift rule should establish a fixed amount and does not see any business need to justify giving gifts in amounts greater than the limits specified in the rule;

- FINRA also would eliminate the provisions in NYSE Rule 350 and NYSE Rule Interpretation 350/02 addressing compensation to operations/floor employees of NYSE as they are not relevant for FINRA;
- The provisions in NYSE Rule 350.10 pertaining to employment of, or gratuities to, personnel working the floor of other exchanges would be deleted; and
- FINRA would eliminate NYSE Rule Interpretation 350/01, and the provisions of NYSE Rule 350.10 pertaining to gifts among close relatives.

FINRA also proposed adopting NASD Rule 3090 (Transactions Involving Association and

American Stock Exchange Employees) and to renumber it as Rule 2070. While FINRA did not propose any material changes to this

rule, FINRA did propose eliminating the corresponding provision of the NYSE Rules.

## Federal Reserve Board Proposes Rule Implementing Certain Less-Complex Approaches for Calculating Risk-Based Capital Requirements

The proposal, issued on June 26, 2008 and known as the standardized framework, would be available for banks, bank holding companies, and savings associations not subject to the advanced approaches of Basel II. Under the advanced approaches rule, which took effect April 1 and is mandatory only for large, internationally active banking organizations, banking organizations are required to develop rigorous risk-measurement and risk-management techniques as part of a new risk-sensitive capital framework. The standardized framework also seeks to more closely align regulatory capital requirements with institutions' risk and should further encourage improvements in its risk-management practices.

"The increased risk sensitivity of the standardized framework is aimed at both enhancing safety and soundness for the wide range of institutions that will not be adopting the advanced approaches of Basel II and fostering competitive equity for these institutions," said Federal Reserve Board Governor Randall S. Kroszner. "Recognizing the diversity of banking organizations in the United States, we want to provide these banks the option of using a more updated capital framework without unduly increasing regulatory burden."

The proposed standardized framework addresses a number of areas including:

- Expanding the number of risk-weight categories to which credit exposures may be assigned.

- Using loan-to-value ratios to risk weight most residential mortgages to enhance the risk sensitivity of the capital requirement.
- Providing a capital charge for operational risk using the Basic Indicator Approach under the international Basel II capital accord.
- Emphasizing the importance of a bank's assessment of its overall risk profile and capital adequacy.
- Providing for comprehensive disclosure requirements to complement the minimum capital requirements and supervisory process through market discipline.

The Federal Deposit Insurance Corporation has voted to issue the interagency notice of proposed rulemaking (NPR) on the Basel II standardized framework for public comment. The Office of the Comptroller of the Currency (OCC) and the Office of Thrift Supervision (OTS) also are considering the NPR. The Board authorized the staff to publish the NPR in the *Federal Register* for public comment after the other agencies complete their approval processes.

## FDIC and United Kingdom Financial Services Authority Sign Memorandum of Understanding

On June 25, 2008, FDIC Chairman Sheila C. Bair and Sir Callum McCarthy, Chairman of the United Kingdom Financial Services Authority (FSA), signed a memorandum of understanding (MOU) that will provide formal information-sharing and contingency planning arrangements in connection with cross-border banking activities in the United States and the United Kingdom. The MOU is designed to enhance the ongoing working relationship between the two authorities.

The MOU expresses the FDIC's and FSA's intent to enhance and strengthen their consultation and cooperation in mutually understanding the complexities inherent in cross-border banking operations by firms in the United States and United Kingdom, in conducting cooperative analyses of the challenges in the resolution of the firms, and in contingency planning and simulation exercises to prepare for future challenges.

Chairman Bair said: "With the increasing globalization of banking and the concomitant expansion of major banks' cross-border operations, this MOU is important for building on the already strong

working relationship that exists between the FSA and the FDIC. The MOU will provide tremendous assistance to both countries in promoting opportunities to learn from each other's experience and expertise – and could serve as a template for future agreements with other countries. I'm very pleased by our agreement with the FSA to work together on the common goal of promoting confidence and stability in our financial markets."

The MOU will strengthen the FDIC's and FSA's continued cooperation with each other in the interest of fulfilling their respective regulatory mandates. The FDIC and the FSA intend to periodically review the functioning and effectiveness of these arrangements, with a view toward expanding or altering the MOU's scope or operation should that become necessary.

## FDIC Celebrates 75 Years as Pillar of American Banking System

In remarks commemorating the FDIC's 75th anniversary, FDIC Chairman Sheila C. Bair announced an education campaign designed to raise awareness about deposit insurance limits. The campaign includes national advertising, a multi-city outreach effort, and an award program for outstanding work in financial education. Advertising will appear in major daily newspapers, news magazines, and lifestyle publications to increase awareness about deposit insurance limits.

The basic insurance amount for funds in FDIC-insured banks is \$100,000 – per depositor, per bank. Certain retirement accounts are insured up to \$250,000 per depositor, per bank. It is possible to obtain coverage above the limits based on how accounts are structured. The FDIC encourages consumers to learn more about deposit insurance limits by visiting [www.fdic.gov](http://www.fdic.gov), calling toll-free 1-877-ASK-FDIC or asking their FDIC-insured bank.

Chairman Bair will be embarking on a road tour, stopping in four FDIC regional office cities in July and September, where she will engage guests in discussions about deposit insurance, what it means to be an FDIC-insured institution, the costs and benefits of banking services, and the consumer protections resulting from federal regulation of the banking industry.

Panel discussions will also address bank services as they relate to building assets and accessing mainstream credit services, including mortgage lending. Moving beyond the topic of financial education to joining the financial mainstream, Chairman Bair wants to stimulate discussion between financial educators and bankers about how banks can expand access to

their services among low- and moderate-income communities and other traditionally underserved populations. Finally, the Chairman will be announcing a new award to highlight innovation in financial

education. Later this year, Chairman Bair will present awards to six people or organizations (one from each region) for their efforts.

## Comptroller Dugan Unveils New OCC Mortgage Metrics Report

In a speech to the American Securitization Forum in New York, Comptroller of the Currency John C. Dugan on June 11, 2008, unveiled a new Mortgage Metrics Report compiled by the Office of the Comptroller of the Currency (OCC) and focused on delinquencies, loss mitigation actions, and foreclosures in mortgages serviced by national banks.

Recognizing the need for more granular data to assess the state of troubled mortgage markets, the OCC began in February to require the nine largest national bank mortgage servicers to submit comprehensive mortgage data on a monthly basis. The report analyzes data submitted on each of the more than 23 million loans held or serviced by these nine banks from October 2007 through March 2008. The \$3.8 trillion portfolio represents 90 percent of mortgages held by national banks and about 40 percent of mortgages overall. The participating national banks are Bank of America, Citibank, First Horizon, HSBC, JPMorgan Chase, National City, USBank, Wachovia, and Wells Fargo.

Findings highlighted by Comptroller Dugan included:

- The overall mortgage servicing portfolio of the nine banks reflects credit quality that is relatively satisfactory and relatively stable. The number of current and performing loans remained at about 94 percent over the entire six-month period.
- While subprime mortgages constituted less than 9 percent of the total portfolio, they sustained twice as many delinquencies as either prime or Alt-A mortgages.
- Among loss mitigation actions, payment plans predominated, outnumbering loan modifications in March 2008 by more than four to one, but loan modifications increased at a much faster rate during the period.
- Subprime mortgages accounted for 43 percent of all loss mitigation actions at the end of March, while making up less

than 9 percent of the portfolio. Loss mitigation actions exceeded newly initiated foreclosures among subprime borrowers by nearly 2 to 1.

- As in other studies, foreclosures in process are clearly on the rise climbing from 0.9 percent of the portfolio to 1.23 percent but the number of new foreclosures varied considerably month to month and was down substantially in March from a high in January.
- Seriously delinquent subprime loans had fewer new foreclosure starts than similarly delinquent prime or Alt-A mortgages, perhaps reflecting the national emphasis on developing alternatives and assistance programs for this class of borrowers.

Although this initial data set was provided on a best-efforts basis and includes some "noise" in the data, the OCC is working with the banks to validate the accuracy and fill gaps in the data gathered. The Comptroller also noted that some of the conclusions in the report may seem different from conclusions reported elsewhere, but with good reason. "The data in this report is more precise since it is on an individual loan basis; the population of mortgages held and serviced by these banks has some characteristics different than the overall population of mortgages; and the standard data elements and definitions in the report will also lead to differences in reported results."

## FINRA Issues Regulatory Notice on Illiquid Investments

On June 13, 2008, FINRA issued guidance on member firm obligations relating to customer requests to sell illiquid securities.

There is no FINRA rule that would require a firm to refuse to follow the customer's unsolicited instruction to liquidate a position in an illiquid security when the customer is aware of specific buying interest in that security, even if the firm believes the market or price for the security is not favorable at that time.

FINRA recognizes that there may be valid reasons for a firm to delay or obtain more information before following a customer's instructions, but gives the following conditions when firm's should not delay or decline executing a transaction.

- The customers on both sides of the transaction have indicated their understanding that the firm is not recommending the transaction or making a suitability determination;

- The customers understand that the firm cannot reach a view as to the sufficiency or competitiveness of pricing; and
- There are no legitimate concerns as to the ability of both sides to settle the proposed transaction.

Firms should also discuss buy interest to the customers, and when doing so should consider appropriate disclosure, including:

- Information regarding the firm's inability to make a representation as to the nature, fairness or sufficiency of the pricing; and
- Any pecuniary interest the firm may have in the transaction.

## FINRA to Adopt Rule 4560 (Short Interest Reporting)

On June 23, 2008, FINRA adopted the proposed rule change to the short interest reporting requirements.

Currently, firms report short interest positions in NYSE-listed securities through the NYSE's Electronic Filing Platform (EFP) and all other securities through FINRA's Regulation Filing Applications (RFA) system or the Securities Industry Automation Corporation (SIAC). As of June 30, 2008, FINRA will consolidate the collection of short interest data, and firms will be required to report short interest positions in all securities to FINRA using the RFA system; consequently, firms will no longer be able to report any of their short

interest positions using EFP or SIAC. FINRA is not retaining the text in NASD Rule 3360 that limits short interest reportable to FINRA to those positions in exchange listed securities "not otherwise reported to another self-regulatory organization." Non-self-clearing broker-dealers generally are considered to have satisfied their reporting requirement by making appropriate arrangements with their respective clearing organizations.

## Chairman Cox Discusses a Proposal to Increase Investor Protection by Reducing Reliance on Credit Ratings

On June 25, 2008, SEC Chairman Christopher Cox spoke at the open meeting of the U.S. Securities and Exchange Commission on both a proposal on credit ratings and equity indexed annuities.

The Chairman discussed the consideration of several rules that would reform the regulation of credit rating agencies. The rules were broken down into three portions. The first and second

parts were proposed on June 11. These two portions:

- Contained provisions which addressed the conflicts of interest in the credit rating industry;
- Included requirements for new disclosures designed to increase the transparency and accountability of credit rating agencies;
- Require credit rating agencies to differentiate the ratings they issue on structured products from those they issue on bonds; and
- Ensure that investors appreciate the different risk characteristics of structured products and the fact that structured product ratings rely on qualitatively different kinds of information and ratings methodologies than do ratings for bonds.

The third part of this rulemaking will focus on the way the SEC's rules refer to and rely upon credit ratings.

The SEC's recommendations are designed to ensure that the role the SEC assigns to ratings in their rules is consistent with the objective of having investors make an independent judgment of the risks associated with a particular security.

## Statement at Open Meeting on Equity-Indexed Annuities

[On June 25, 2008, Chairman Cox discussed the SEC's Division of Investment Management recommendation on "senior issues".](#)

Several years ago, the North American Securities Administrators Association (NASAA) made public its survey results which showed the scope of senior investment fraud. The survey found that:

- 45% of all investor complaints received by state securities regulators are made by seniors; and
- Equity-indexed annuities are among a handful of products most often involved in senior investment fraud.

The SEC has made cracking down on seniors fraud top priority, and this proposed rulemaking is a big part of that effort.

The new rule under consideration would establish — on a prospective basis — the standards for determining when equity indexed annuities are not considered annuity contracts under the Securities Act of 1933 and therefore are securities and thus are subject to the investor protections afforded by the securities laws.

There are references to credit ratings sprinkled throughout the SEC's rules that fall within the domains of several of the SEC's Divisions. The Division of Trading and Markets, the Division of Corporation Finance, and the Division of Investment Management have conducted evaluations of the way credit ratings are used in the rules and forms within their areas of expertise. Their recommendations are as follows:

- The complete elimination of any reference to credit ratings in 11 rules and forms;
- The substitution of a standard based on a more clearly stated regulatory purpose of concept in 27 rules and forms; and
- Leaving the reference unchanged in 6 rules and forms.

These investor protections include:

- The requirement of registration under the Securities Act, and SEC requirements related to truthful and complete disclosure of the investment to potential purchasers; and
- Protections against fraud and misrepresentation, and additional safeguards against abusive sales practices by unscrupulous marketers.

The Chairman is hopeful that in the future, these protections will help reduce the problem of investors being harmed by inappropriate sales of equity indexed annuities.

## FDIC Releases Summer 2008 Edition of *Supervisory Insights*

On June 10, 2008, the FDIC released the summer 2008 edition of *Supervisory Insights*.

This edition highlights the following topics:

- The need for greater transparency in the structured finance market;
- The risks and fallout associated with growth in nontraditional mortgage products; and
- The inappropriate use of interest reserves.

The article "Enhancing Transparency in the Structured Finance Market" explores the information available on certain securitization products and concludes that concern about transparency is necessary. The article provides several recommendations for policymakers to consider that would improve the transparency of these products and also offers a reminder about existing

supervisory guidance regarding banks' investments in rated securities.

The article "Hybrid ARMs: Addressing the Risks, Managing the Fallout" provides an overview of the risks and describes key aspects of the supervisory guidance applicable to these products.

Finally, the article "A Primer on the Use of Interest Reserves" examines the risks associated with interest reserves in Acquisition, Development and Construction (ADC) lending, underwriting practice, reviews regulatory guidance, and highlights the importance of evaluating the appropriateness of interest reserves when an ADC project falters or becomes troubled.

## Additional Information

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