

Financial Services Regulatory Highlights

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Obama Administration Releases Regulatory Reform Proposal

On June 17, 2009, the Obama Administration released "Financial Regulatory Reform, A New Foundation: Rebuilding Financial Supervision and Regulation". This document was prepared in response to what is described as the "most severe financial crisis since the Great Depression". The Administration stated that, while the crisis had many causes, the government could have done more to prevent many of these problems from threatening the stability of our financial system. As a result, this reform proposal seeks to meet five key objectives:

- Promote robust supervision and regulation of financial firms;
- Establish comprehensive supervision of financial markets;
- Protect consumers and investors from financial abuse;

- Provide the government with the tools it needs to manage financial crises; and
- Raise international regulatory standards and improve international cooperation.

The following sections further describe these objectives and explain the Administration's proposed methods for achieving these goals.

Promote Robust Supervision and Regulation of Financial Firms

Financial institutions that are critical to market functioning should be subject to strong oversight. No financial firm that poses a significant risk to the financial system should be unregulated or weakly regulated. There is a need for accountability in financial oversight and supervision. This objective may be achieved by the following:

- Creating a new Financial Services Oversight Council of financial regulators to identify emerging systemic risks and improve interagency cooperation;
- Providing the Federal Reserve with new authority to supervise any firm that poses a threat to financial stability, irrespective of whether the institution is or owns a bank;
- Creating stronger capital and other prudential standards for all financial firms and even higher standards for large, interconnected firms;
- Creating a new National Bank Supervisor to supervise all federally chartered banks;
- Eliminating the federal thrift charter and other provisions that allowed some depository institutions to avoid bank holding company regulation by the Federal Reserve; and

- Registering advisers of hedge funds and other private pools of capital with the SEC.

Establish Comprehensive Supervision of Financial Markets

Major financial markets must be strong enough to withstand both system-wide stress and the failure of one or more large institutions. The proposed method to achieve this objective includes:

- Enhancing regulation of securitized markets, including new requirements for market transparency, stronger regulation of credit rating agencies, and a requirement that issuers and originators retain a financial interest in securitized loans;
- Creating comprehensive regulation of all over-the-counter derivatives; and
- Providing new authority to Federal Reserve to oversee payment, clearing, and settlement systems.

Protect Consumers and Investors from Financial Abuse

To rebuild trust in the markets, the financial system needs strong and consistent regulation and supervision of consumer financial services and investment markets. This oversight should not be based on speculation or abstract models, but on actual data about how people make financial decisions. This should also include transparency, simplicity, fairness, accountability, and access. The proposed method to achieve this objective includes:

- Creating a new Consumer Financial Protection Agency to protect consumers across the financial sector from unfair, deceptive, and abusive practices;

- Strengthening regulations to improve the transparency, fairness, and appropriateness of consumer and investor products and services; and
- Creating a level playing field and higher standards for providers of consumer financial products and services, whether, or not, those institutions are part of a bank.

Provide the Government with the Tools it Needs to Manage Financial Crises

The government must have the tools it needs to manage crises, if and when they arise, so that the government is not left with untenable choices between bailouts and financial collapse. The proposed method to achieve this objective includes:

- A new regime to resolve nonbank financial institutions whose failure could have serious systemic effects; and
- Revisions to the Federal Reserve's emergency lending authority to improve accountability.

Raise International Regulatory Standards and Improve International Cooperation

These challenges are not unique to the United States. As regulatory standards are enhanced in the United States, the rest of the world will be asked to do the same. The proposed approach to achieve this objective includes:

- Creating international reforms to support efforts in the United States, including strengthening the capital framework; improving oversight of global financial markets; coordinating supervision of internationally active firms; and enhancing crisis management tools.

Treasury Adopts Rules on TARP Standards for Compensation and Corporate Governance

Effective June 15, 2009, the Department of the Treasury adopted an Interim Final Rule establishing standards for compensation and corporate governance for TARP recipients. The Rule implements amendments to the

Emergency Economic Security Act (EESA) by the American Recovery and Reinvestment Act of 2009 (ARRA). The rule also includes certain new Treasury requirements and the establishment of the Office of the

[Special Master for TARP Executive Compensation \(Special Master\)](#).. Among the issues addressed by the Rule are the following:

Limitations on Executive Compensation for Companies Receiving TARP Assistance

The Rule establishes certain standards for executive compensation practices at firms receiving TARP assistance. Specifically, the new regulations limit bonuses paid to senior executive officers and to a specified number of the most highly compensated employees of TARP recipients; however, a TARP recipient is permitted to award long-term restricted stock that does not exceed one-third of total compensation of the covered Executive. Additionally, the Rule also expands the definition of "golden parachutes" to include payments made in connection with a change in control of the company and requires that TARP recipients exercise their clawback rights for any bonuses paid based on materially inaccurate performance criteria.

Appointment of a Special Master and Other Provisions Not In ARRA

As part of the Rule, Treasury announced the appointment of the Special Master who will be responsible for reviewing payments and compensation plans for executives of TARP recipients and for the 100 most highly compensated employees of TARP recipients that have received "exceptional assistance." Companies receiving exceptional financial assistance currently include AIG, Citigroup, Bank of America, Chrysler, GM, GMAC and Chrysler Financial. The Special Master has

the authority to disapprove any compensation arrangement and require the company to resubmit the plan if the Special Master finds that any plans are excessive, inappropriate or designed to encourage unsound risk-taking. The Special Master will automatically approve proposed compensation to employees of TARP recipients receiving exceptional assistance so long as the employee's total annual compensation is not more than \$500,000, with any additional compensation paid in the form of long-term restricted stock.

Additionally, the Special Master will use a set of general principles set forth by the Rule to evaluate the appropriateness of the plans. Specifically, the Special Master will consider risk, taxpayer return, performance based compensation and comparable payments, among other principles.

The Rule also requires a TARP recipient to annually disclose any "perks" whose total value for the fiscal year exceeds \$25,000 for each of the Senior Executive Officers (SEOs) and highly-compensated employees covered under the bonus provisions. The Compensation Committee is also required to make certain annual disclosures regarding any services provided by a compensation consultant. In addition, the Rule generally prohibits "gross-ups" (for taxes) by a TARP recipient to any of the SEOs and next most highly compensated employees during the TARP period. Although the rule is principally concerned with implementing the provisions of ARRA .

SEC Approves New FINRA Rule 5122

[In response to concerns regarding conflicts of interest in the offering of securities by a member firm, or control entity of the firm in a private placement, the SEC has approved FINRA Rule 5122, which became effective on June 17, 2009. Private placements are non-public offerings of securities conducted through an exemption from registration under the Securities Act. Rule 5122 will require firms that conduct private placements of the firm's securities, or those of a control entity, to comply](#)

[with disclosure and filing requirements and limitations on the use of proceeds. The rule will require such firms to:](#)

- Disclose the intended use of offering proceeds and expenses to investors in a private placement memorandum, termsheet or other offering document;
- File the placement memorandum, termsheet or other offering document with FINRA's Corporate

Financing Department prior to distributing the document to investors; and

- Commit that at least 85% of the offering proceeds will be used for business purposes (will not include offering costs, discounts, commissions and any cash/ non-cash sales incentives).

Rule 5122 will not apply retroactively to any offerings that have already commenced selling efforts as of the effective date.

SEC Takes Steps to Strengthen Existing Rules Governing Securities Trading by Personnel

On May 22, 2009, the SEC announced a series of measures the agency is taking to strengthen its internal compliance program to guard against inappropriate employee securities trading. The measures aim to address potential weaknesses in the internal programs that monitor compliance with these rules.

These measures include:

- New internal rules governing securities transactions for all SEC employees that will require preclearance of all trades. It will also prohibit, for the first time, staff trading in the securities of companies under SEC investigation regardless of whether the employee has personal knowledge of the investigation. The rules have been submitted to the federal government's Office of Government Ethics, which approves agency ethics rules.
- Contracting with an outside firm to develop a computer compliance system to track, audit, and oversee employee securities transactions and financial disclosure in real time.
- Consolidation of responsibility for oversight of employee securities transactions and financial disclosure reporting within the Ethics Office, as well as the hiring of a new chief compliance officer.

Revising the SEC Rule Governing Securities Trading by SEC Personnel

Current agency rules prohibit, among other things, short selling, carrying securities on margin, engaging in options or futures transactions in instruments whose value is derived from an underlying security, and holding

a security interest in broker-dealers and registered investment advisers. The current rules also mandate that employees hold stock that they purchase for at least six months to limit speculative activity. Further, SEC employees are required to report all trades within five days of receiving confirmations.

In addition to the existing rules, the newly approved rules will:

- Require employees to pre-clear all their securities transactions to ensure, among other things, the company whose stock they are trading is neither being investigated by the SEC nor is involved in an IPO. In addition, any employee with access to non-public information about a company's registration statement may not trade in that security;
- Prohibit ownership of securities in publicly-traded exchanges and transfer agents, in addition to existing prohibitions against owning securities in broker-dealers, registered investment advisers and others directly regulated by the Commission;
- Require that all employees authorize their brokers to provide the agency with duplicate trade confirmation statements. Those statements would then be integrated into a new computerized system so that employees can more easily comply with reporting obligations and the ethics office can more effectively monitor compliance; and
- Require employees to certify before any trade that they do not possess any non-public information about the company being traded. Under the current rules, preclearance is recommended but not

mandated. If an employee were to voluntarily seek such preclearance, the only stocks that would be

prohibited would be stocks of companies that have pending registration statements before the SEC.

Agencies Issue Frequently Asked Questions on Identity Theft Rules

On June 1, 2009, Federal Trade Commission, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, National Credit Union Administration, Office of the Comptroller of the Currency, and Office of Thrift Supervision, collectively (the Agencies), issued a set of frequently asked questions (FAQs) to help financial institutions, creditors, users of consumer reports, and issuers of credit cards and debit cards comply with federal regulations on identity theft and discrepancies in changes of address.

The "Red Flags and Address Discrepancy Rules," which implement sections of the Fair and Accurate Credit Transactions Act of 2003 (FACT Act), were issued jointly on November 9, 2007. The rules require financial institutions and creditors to develop and implement written Identity Theft Prevention Programs and require issuers of credit cards and debit cards to assess the validity of notifications of changes of address. The rules also provide guidance for users of consumer reports regarding reasonable policies and procedures to employ

when consumer reporting agencies send them notices of address discrepancy.

The agencies' staff have jointly developed answers to these FAQs to provide guidance on numerous aspects of the rules, including which types of entities and accounts are covered; establishment and administration of an Identity Theft Prevention Program; address validation requirements applicable to card issuers; and the obligations of users of consumer reports upon receiving a notice of address discrepancy. Topics addressed in the FAQ include, but are not limited to, the following:

- Record retention requirements;
- Applicability to foreign branches of US banks;
- Definition of "covered account"; and
- Address validation requirements.

FinCEN Guidance Clarifies 314(b) Information Sharing

On June 16, 2009, FinCEN issued interpretative guidance to clarify the application of the rule implementing section 314(b) of the USA PATRIOT Act. Section 314(b) permits two or more financial institutions and any association of financial institutions to "share information with one another regarding individuals, entities, organizations, and countries suspected of possible terrorist or money laundering activities."

The guidance issued clarifies that a financial institution participating in the section 314(b) program may share information relating to transactions that the institutions suspect may involve the proceeds of one or more

specified unlawful activities and such an institution will still remain within the protection of the section 314(b) safe harbor liability.

The privacy and security of any shared data is of paramount concern and financial institutions that participate in the section 314(b) information-sharing program must maintain adequate procedures to protect the security and confidentiality of such information. Participation in the section 314(b) information sharing is voluntary and utilized at the discretion of the participating financial institution.

FinCEN Moves to Streamline Mutual Fund BSA Requirements

On June 5, 2009, FinCEN issued a Notice of Proposed Rulemaking (NPRM) that would replace a mutual fund requirement to file IRS/FinCEN Form 8300 with a requirement to file FinCEN Form 104, which is standard for financial institutions. Both forms document a transaction in currency above \$10,000, but differ in some technical aspects.

FinCEN is proposing to include mutual funds within the general definition of "financial institution" in rules implementing the Bank Secrecy Act (BSA). This update

will subject mutual funds to the scope of the rules that require the filing of currency transaction reports (CTRs) and the creation, retention, and transmittal records or information on transmittals of funds and other specified transactions. This change will streamline their reporting requirements and make the information they provide more readily available, and formatted more consistently, for use by law enforcement investigators.

Comments are due to FinCEN by September 3, 2009.

SEC Announces Creation of Investor Advisory Committee

On June 3, 2009, the SEC announced the formation of an Investor Advisory Committee to give investors a greater voice in the SEC's work. The Investor Advisory Committee's charter provides for a broad scope of interest, including:

- Advising the SEC on matters of concern to investors in the securities markets;
- Providing the SEC with investors' perspectives on current, non-enforcement, regulatory issues; and

- Serving as a source of information and recommendations to the SEC regarding the SEC's regulatory programs from the point of view of investors.

The Committee will begin its work in the next weeks, after the SEC staff files the Committee's charter with Congress.

Securities Industry/Regulatory Council on Continuing Education Issues Firm Element Advisory Update

On May 27, 2009, FINRA issued NTM 09-26 to notify firms of the second-quarter 2009 Firm Element Advisory (FEA), which identifies regulatory and sales practice topics that firms should consider in their Firm Element training plans. The FEA is issued semi-annually and topics are not exhaustive and are intended as a guide for firms to use when developing and updating their Firm Element needs analysis and training plan. Firms should continue to consider the specific nature of their business, clients, products and services when creating their training plans. The FEA addresses many different topics. These topics include:

- Anti-Money Laundering;
- Communications;
- Customer Accounts;
- Ethics and Business Conduct;
- Finance and Operations;
- Markups/Markdowns; and
- Insurance and Annuities.

Some of the new items in the FEA are as follows:

- Supervision of “market letters” as correspondence rather than sales literature if requirements are met.
- Amended provisions of NASD Rule 2220 to achieve greater consistency with FINRA’s general communications rule (NASD Rule 2210) and the options communications rules of other self-regulatory organizations (SROs)
- The SEC approved new FINRA Rule 5280 (Trading Ahead of Research Reports) as part of the Consolidated FINRA Rulebook.
- Reminder to firms and their associated persons of the obligation to understand and present balanced information about the risks and returns of high yield securities such as bonds, bond funds, structured products and non-conventional investments, in a high-yield environment.

Additional information pertaining to the new and updated FEA can be found at <http://www.cecouncil.com>.

SEC Charges Madoff Solicitors and Feeder with Fraud

On June 22, 2009, the SEC charged Cohmad Securities Corporation and four individuals with securities fraud, alleging that they collectively raised billions of dollars from investors for Bernard L. Madoff’s alleged Ponzi scheme. In a separate complaint, the SEC also charged Stanley Chaise, investment adviser, who oversaw three funds that invested all of their assets with Madoff. When the alleged Ponzi scheme collapsed, Chais investors’ accounts were valued at nearly \$1 billion.

The Cohmad Complaint

The SEC’s complaint against Cohmad defendants alleges that while bringing investors to Madoff, they ignored, and even participated in, many suspicious practices that clearly indicated Madoff was engaged in fraud. For example, the SEC’s complaint alleges that the chairman and chief operating officer filed false Forms BD and FOCUS reports that concealed Cohmad’s primary business of bringing in investors to Bernard L. Madoff Investment Securities LLC (BMIS). The complaint also alleges that the compensation arrangement between BMIS and Cohmad indicated fraudulent conduct at BMIS.

The Chais Complaint

The SEC’s complaint alleges that Chais committed fraud by misrepresenting his role in managing the funds’ assets and for distributing account statements that he should have known were false. According to the SEC’s

complaint, for the last 40 years, Chais has held himself out as an investing wizard who managed hundreds of millions of dollars of investor funds in three partnerships, the Lambeth, Popham and Brighton Companies (the Funds). Chais made a number of misrepresentations over the years to the Funds’ investors indicating that he formulated and executed the Funds’ trading strategy. In reality, Chais was an unsophisticated investor who did nothing more than turn all of the Funds’ assets over to Madoff, while charging the Funds more than \$250 million in fees for his purported “services.”

The SEC also alleges that Chais ignored red flags indicating that Madoff’s reported returns were false. For example, Chais told Madoff that Chais did not want there to be any losses on any of the Funds’ trades. Madoff complied with Chais’s request, and from 1999 to 2008, despite reportedly executing thousands of trades on behalf of the Funds, Madoff did not report a loss on a single equities trade. Chais however, with the assistance of his accountant, prepared account statements for the Funds’ investors based upon the Madoff statements, and continued to distribute them to the Funds’ investors even though he should have known they were false.

According to the SEC’s complaint, Chais also opened and exercised control over approximately 60 other accounts at Madoff’s firm on behalf of his family members and related entities. Taking all of these

accounts collectively, between 1995 and 2008, Chais and his family members and related entities withdrew more than \$500 million more than they actually invested with Madoff.

Both SEC's complaints seek injunctions, financial penalties and court orders requiring all parties to disgorge their ill-gotten gains.

Additional Information

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

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