

Financial Services Regulatory Highlights

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The President Signs into Law the "Housing and Economic Recovery Act of 2008"

On July 30, 2008, the President signed into law comprehensive legislation dealing with the current housing crisis. Following are highlights of the some of the legislation's key provisions.

FHA Housing Stabilization and Homeownership Retention Act

- Expands the FHA program so many borrowers in danger of losing their home can refinance into lower-cost government-insured mortgages they can afford to repay.
- In order to participate, lenders and mortgage investors must take significant losses by reducing the loan principal. In exchange for an FHA guarantee on the mortgage, borrowers must share any profit from the resale of a refinanced home with the government.
- Only primary residences are eligible.
- Provides \$180 million for financial counseling and legal assistance to help families stay in their homes.

Strengthening Regulation of the GSEs

- Consolidates the regulation of Fannie Mae, Freddie Mac and the Federal Home Loan Banks into single new regulator, the Federal Housing Finance Agency. The new regulator will have enhanced authority to raise capital standards, set strict prudential standards, including internal controls, audits, and to enforce these new standards and promptly take corrective action.
- Raises the GSE loan limits for single family homes to create affordable mortgage loans for moderately priced homes by allowing GSE loans up to 115% of the local area median home price, and to make GSE loans effective in high cost areas by raising the permanent loan limit from \$417,000 to \$625,500,.

- Creates a new permanent affordable housing trust fund – financed by the GSEs and not by taxpayers – to fund the construction, maintenance and preservation of affordable rental housing for low and very low-income individuals and families nationwide in both rural and urban areas.

Backstopping Fannie Mae and Freddie Mac To Shore Up the Housing Market

- Gives the Secretary of the Treasury the authority to increase the already existing line of credit to Freddie and Fannie for the next 18 months, as well as giving the Treasury Department standby authority to buy stock in those companies to provide confidence in the GSEs and stabilize housing finance markets.
- Strengthens oversight by requiring the Federal Reserve and Treasury to consult with the new regulator on issues concerning the safety and soundness of the GSEs and use of the standby authority.
- The legislation requires the Treasury Secretary to make an emergency designation before using the authority -- certifying that he is acting to provide stability to financial markets, prevent disruptions in the availability of mortgage finance, protect the taxpayers, and facilitate an orderly restoration of private markets.

Stabilizing Neighborhoods Hurt by the Foreclosure Crisis

- Provides \$4 billion in emergency assistance (CDBG Funds) to communities hardest hit by the foreclosure and subprime crisis to purchase foreclosed homes, at a discount, and rehabilitate or redevelop the homes to stabilize neighborhoods and stem the significant losses in home values of neighboring homes.
- Foreclosed and rehabilitated homes would be sold or rented to moderate-income individuals and families -- whose incomes do not exceed 120 percent of the area median income. At least 25 percent of the funds would be targeted to house low-income and very low-income persons and families -- whose incomes do not exceed 50 percent of area median income.
- Any profit from the sale, rental, rehabilitation or redevelopment of these properties must be reinvested in affordable housing and neighborhood stabilization.

Preventing Future Abuses and Crises

- Establishes a nationwide loan originator licensing and registration system that will set minimum standards for loan originator licensing substantially improving the oversight of mortgage brokers and bank loan officers.

- Establishes improved mortgage disclosure requirements that will help ensure that mortgage borrowers understand their mortgage loan terms.

FHA Modernization

- Expands affordable mortgage loan opportunities for families and for seniors through expanded access to reverse mortgages through Federal Housing Administration reform.
- Raises FHA loan limits to create affordable mortgage loans for moderately priced homes by allowing FHA loans up to 115% of the local area median home price, and to make GSE loans more available in high cost areas by raising the permanent loan limit from \$362,790 to \$625,500.
- Expands opportunities for seniors to tap into equity in their home through FHA reverse mortgage loans, by increasing the loan limit for the program, reducing and capping lender fees for such loans, and strengthening consumer protections limiting the sale of other financial products in conjunction with FHA reverse mortgage loans.
- Prevents HUD from raising single family loan fees on lower- and middle-income borrowers, and from raising loan fees on FHA rental housing loans.

Preserving Home Ownership for Our Nation's Veterans

- Increases VA Home Loan limit, as was done in the stimulus package, for high-cost housing areas so that veterans have more homeownership opportunities.
- Helps returning soldiers avoid foreclosure and stay in their home by lengthening the time a lender must wait before starting foreclosure, from three months to nine months after a soldier returns from service and providing returning soldiers with one-

year relief from increases in mortgage interest rates.

- Requires the Department of Defense to establish a counseling program for veterans and active service members facing financial difficulties and provides a moving benefit to servicemen and women who are forced to move out because their rental housing was foreclosed on.

Tax Provisions to Expand Refinancing Opportunities and Spur Home Buying (H.R. 5720)

- Provides \$15 billion in tax benefits, including tax credits to first-time homebuyers, a real property tax deduction for non-itemizers, an additional \$11 billion in mortgage revenue bonds for states, and improves access to low-income housing.

FDIC Publishes Final Policy Statement on the Treatment of Covered Bonds

Despite the limited historical issuance of covered bonds in the United States, market participants are showing greater interest in underwriting these instruments. Therefore, and because there are no legal or regulatory restrictions on U.S. banks issuing these products, the FDIC published a Final Policy Statement on July 15, 2008 addressing the treatment of covered bonds in a conservatorship or receivership. The FDIC issued interim guidance on this topic in April 2008, evaluated the feedback and adopted certain revisions to the Interim Policy Statement, articulated by this Final Policy Statement. The FDIC seeks to reduce market uncertainty and clarify the application of its authority to these products. This Statement does not impose any new obligations on the FDIC as conservator or receiver. Rather, the Statement defines the circumstances and covered bonds transaction types for which the FDIC will grant consent to expedited access to pledged collateral.

Summary of Key Points

A covered bond is defined in the Statement as a non-deposit, recourse debt obligation of an insured depository institution (IDI) with a term greater than one year and no more than thirty years, that is secured directly or indirectly by a pool of eligible mortgages or, not exceeding ten percent of the collateral, by AAA-rated mortgage bonds. Additional key points of the Statement are summarized below:

- The debt obligation is either a covered bond sold directly to investors, or mortgage bonds which are sold to a trust or special purpose vehicle (SPV) as collateral for the SPV to sell covered bonds to investors.

- To address concerns about the potential for excessive increases in the proportion of secured liabilities to unsecured liabilities, the Statement applies only to covered bond issuances made with the consent of the IDI's federal regulator in which the IDI's total covered bond obligations at such issuance comprise no more than 4 percent of the IDI's total liabilities.
- The Policy Statement is restricted to covered bond issuances secured by perfected security interests under applicable state and federal law on performing eligible mortgages on one-to-four family residential properties, underwritten at the fully indexed rate and relying on documented income, a limited volume of AAA-rated mortgage securities, and certain substitution collateral.
- The mortgages must also be underwritten at the fully indexed rate relying on documented income, and comply with existing supervisory guidance governing the underwriting of residential mortgages (e.g., October 2006 Interagency Guidance on Non-Traditional Mortgage Products, July 2007 Interagency Statement on Subprime Mortgage Lending and other guidance applicable at origination).
- The FDIC believes that the limited inclusion of AAA-rated mortgage-backed securities as

collateral for covered bonds during this interim period will enhance liquidity without risks to the deposit insurance fund. Therefore, as previously noted, covered bonds that include up to 10 percent of their collateral in AAA-rated mortgage securities (backed by loans made consistent with this Statement) will meet the standards of the Statement.

- Substitution collateral for the covered bonds may include cash and Treasury and agency securities as necessary.
- The FDIC as conservator or receiver consents to a covered bond obligee's exercise of the rights and powers listed in 12 U.S.C. § 1821(e)(13)(C), and will not assert any rights to which it may be entitled pursuant to 12 U.S.C. § 1821(e)(13)(C), after the expiration of the specified amount of time (10 days), and the occurrence of certain events.
- The consents set forth in the Statement do not act to waive or relinquish any rights granted to the FDIC in any capacity, pursuant to any other applicable law or any agreement or contract. Nothing in the Statement alters the claims priority of collateralized obligations.

- The Statement does not authorize the waiver of the prohibitions in 12 U.S.C. § 1825(b)(2) against levy, attachment, garnishment, foreclosure, or sale of property of the FDIC, nor does it authorize nor shall it be construed as authorizing the attachment of any involuntary lien upon the property of the FDIC.

Conclusion

Although a Final Statement, the FDIC acknowledges that the evolution of the covered bond market in the United States may result in bond structures and structural elements not encompassed by this Final Statement. As such, the FDIC may amend this Policy as the market develops.

SEC Staff's *ComplianceAlert* Identifies Weaknesses Uncovered During Recent Examinations

On July 22, 2008, SEC staff issued a *ComplianceAlert* addressing common deficiencies and weaknesses uncovered during recent inspections and examinations of investment advisers, broker dealers and transfer agents. In this Regulatory Highlight, we summarize the staff's key findings related to investment advisers and broker dealers. To avoid examination findings or enforcement actions, we encourage firms to review their activities in these areas to ensure their compliance programs meet the staff's expectations.

Personal Trading

SEC examiners found deficiencies regarding how investment advisers manage and supervise the personal securities trading of employees. Specifically: 1) codes of ethics were often incomplete; 2) codes of ethics were not adhered to; 3) reporting requirements were not followed and/or monitoring was not performed; and 4) disclosures about the controls over personal trading were inaccurate.

Advisers should be cognizant of the regulatory and reputational risks associated with deficiencies and/or employee misconduct in this area. To assist in enhancing the oversight of personal trading,

the SEC staff sets forth useful lists of internal compliance controls and compliance review and reporting activities. Advisers are encouraged to review this list in its entirety. Generally, compliance departments should be active in implementing policies and procedures and educating employees about permitted personal trading. Requiring that employees receive training and certify that they have read the Code of Ethics can also assist in developing strong compliance around employee trading.

Proxy Voting and Funds' Use of Proxy Voting Services

Third party proxy firms provide various services to investment advisers. Often these firms manage the administrative processes around proxy voting. Examiners uncovered: 1) weak controls around ensuring that proxy service

providers' recommendations were consistent with funds' policies and procedures and identifying if the third parties had any conflicts of interests; 2) inconsistency in documenting an adviser's review of service providers, imperative for assessing the proxy firms' independence; 3) that funds did not vote consistently with their proxy voting policies; 4) that funds did not file Form N-PX as required; 5) the failure to include the necessary information in SAls, as required by Form N-1A; and 6) that improper fees were charged to the funds.

Valuation and Liquidity in High Yield Muni Bond Funds

Muni bond funds can be difficult to value because many of the securities held by the funds may trade infrequently or not at all in the secondary market. As a result, a high yield muni bond fund's board is often involved in the valuation process. Some highlights of the examiners' findings include: 1) not surprisingly, funds with higher average credit qualities, fewer unrated securities, and fewer distressed and defaulted securities were less likely to have valuation and liquidity issues; 2) high yield funds did not often disclose the increased risk with respect to liquidity and valuation; 3) third party valuation services frequently relied on fund management for certain information so funds should be careful when representing that they have an "independent" valuation; and 4) fund boards should take steps to assess the accuracy of prices provided by third parties.

Soft Dollar Practices of Investment Advisers

Examiners reviewed the soft dollar programs at a number of investment advisers. Examiners provided general feedback about the products and services received, total commissions directed, best execution analyses, and related disclosures. Additionally, examiners noted that effective soft dollar practices required the adviser to: 1) maintain reports of the arrangements and transactions; 2) periodically reconcile commissions; 3) review mixed-use product allocation; and 4) ensure that a committee or the CCO approves products and services acquired with soft dollars.

"Free Lunch" Sales Seminars

FINRA, NASAA and the SEC have conducted over 100 examinations of broker-dealers and other financial services firms that conduct sales seminars offering a free meal and other incentives to entice perspective clients to attend. Often targeting retirees, the seminars are intended to result in new accounts for the sponsor of the event. The majority of the regulators' inspections reflected that firms used advertising and sales materials that were misleading or made exaggerated claims. Many FINRA broker dealers did not submit their sales material to FINRA as required by

rule. Examiners also found evidence that firms exercised weak supervision of these seminars. Additionally, SEC examiners found indications that unsuitable products were recommended to attendees. Of great concern to regulators, 13% of the examinations uncovered possible fraudulent practices. If your firm hosts these types of events, compliance staff should closely supervise them and require the approval of all advertisements and sales material. Firms should ensure that the products they recommend are suitable for the seniors in attendance. The SEC staff notes that firms should consider requiring employees to forward all materials to the firm's home office for review prior to distributing them at a seminar.

Valuation and Collateral Management Processes

In reviewing the valuation and collateral management processes at large broker-dealers, SEC examiners reiterated the importance of the independent oversight of valuations assigned by trading personnel ("product control groups"). With decreasing liquidity in certain products, firms are using modeled prices instead of third party vendors to value inventory positions. In terms of deficiencies in this area, examiners noted that some processes used by the oversight/product control group to verify prices lacked necessary rigor. Examiners also observed that these independent validation groups were not sufficiently staffed with experienced individuals. Policies and procedures for verifying valuations were not sufficiently documented, nor was the valuation work itself. Examiners found certain firms that didn't utilize the product control group to validate prices of collateral held by the firm. The SEC staff lists six specific examples of strong control practices in this area that broker dealers are encouraged to review. In summary, effective product control groups are adequately staffed, rely on established standards and practices aligned with market conditions, and appropriately document their activities.

Broker Dealers Affiliated with Insurance Companies

Examiners reviewed the activities of broker dealer subsidiaries of insurance companies and uncovered evidence of unsuitable recommendations involving mutual funds and/or variable annuities and deficiencies related to firms' compliance with financial responsibility requirements. The *ComplianceAlert* notes that these deficiencies stem from a lack of compliance, operational and supervisory controls. Some of these exams revealed that the firms did not have adequately experienced personnel familiar with the rules and regulations of the securities industry.

Supervision of Solicitations of Advisory Services

Broker dealers can designate registered representatives as "solicitors" for an investment adviser. Examiners reviewed how these solicitors were supervised with respect to their activities as a solicitor. Certain inspections revealed that neither the broker dealer nor the investment adviser had taken responsibility for reviewing the suitability of the products and services provided. In a related finding, broker dealers did not appear to comply with their supervisory obligations because they did not establish and/or enforce adequate WSPs to oversee solicitor activity by their registered representatives. False and/or misleading sales material was also noted as area of concern.

Mortgage Financing as Credit for the Purchase of Securities

Certain broker dealers have recommended that clients obtain a second or reverse mortgage on their homes through an affiliated bank to invest in securities. Although some firms have specifically prohibited their registered representatives from recommending loans, certain firms offer inducements to representatives to refer customers to an affiliated bank. Primarily, SEC exams highlighted that supervision and record keeping around these activities was deficient. Examiners also had some concerns related to the suitability of certain statements made about the "safety" of mortgaging a home to purchase securities.

OSJ Supervisory Structure

Broker dealers' supervisory and compliance controls under an Office of Supervisory Jurisdiction structure were a focus of SEC inspections. Examiners found that broker dealers and OSJs had not adopted, implemented or consistently applied WSPs. The creation and retention of the required books and records was also noted as a weakness.

SEC's Emergency Order on Short Selling

On July 15, 2008, the SEC issued an Emergency Order mandating new short sale requirements for market participants, effective July 21, 2008. This change restricts short sales in specified securities unless a "person" or its agent has borrowed or arranged to borrow the security or otherwise has the security available to borrow in inventory. The Order impacts short selling in the stock of 19 financial services issuers through trading on August 12, 2008.

Amendment, Guidance and Extension

The SEC issued an Amendment to the Order on July 18, 2008, addressing some of the industry feedback generated by the Order. Additionally, the Staff of the SEC's Division of Trading and Markets published guidance concerning the implementation of the Order. Most recently, On July 29, 2008, the SEC extended the temporary Order pursuant to its authority under Section 12(k)(2) of the Securities Exchange Act of 1934 such that the Order now expires at

11:59pm EDT on Tuesday, August 12, 2008. Although there was some speculation that the SEC might expand the Order to apply to other issuers, the SEC instead extended only the duration. The Order cannot be extended beyond August 12th and therefore the SEC is now considering a formal rulemaking related to short selling.

We issued a FS Regulatory Brief on July 17, 2008 that summarizes the Order, the Amended Order and the SEC staff's guidance on the implementation of the Order. Our Brief also consolidates some preliminary industry feedback and identifies points of clarification and points of consideration for market participants. Please

Statement by Secretary Henry M. Paulson Jr. on Regulatory Reform before House Committee on Financial Services

[Treasury Secretary Henry Paulson spoke to the House Committee on Financial Services regarding the Blueprint for a Modernized Financial Services Regulatory Structure \("the Blueprint"\).](#)

Secretary Paulson reiterated the recommendations outlined in the Blueprint including outlining a regulatory framework consisting of three primary regulators. One focused on market stability across the entire financial sector, another focused on safety and soundness of institutions supported by a federal guarantee, and a third focused on protecting consumers and investors. He opined "a major advantage of this structure is its timelessness and its flexibility and that, because it is organized by regulatory objective rather than by financial institution category, it can more easily respond and adapt to the ever-changing marketplace."

The Secretary noted that the initial Blueprint is a long-term vision, but due to recent events in the financial markets including the collapse of Bear Stearns, several changes can be implemented in the near-term. Secretary Paulson recommends that those near term changes include:

- Formalizing the current informal coordination among U.S. financial regulators by amending and enhancing the Executive Order which created the President's Working Group on Financial Markets.
- Creating a new federal-level commission, the Mortgage Origination Commission to establish minimum standard for, among other things, personal conduct and disciplinary history, minimum educational requirements, testing criteria and procedures and appropriate licensing revocation standards.
- Focusing on payment and settlement systems and on areas, such as futures and securities, where the U.S. regulatory structure inhibits U.S. competitiveness in the Secretary's opinion.

- Creating the Optional Federal Charter for insurance companies, similar to the dual-chartering system for banking.
- Creating a federal charter for systemically important payment systems with the Federal Reserve to oversight responsibilities. .
- Giving the Federal Reserve the explicit statutory authority to step in to avert situations that pose unacceptable systemic risk and provide the FRB with access to necessary information from complex financial institutions, either a commercial bank, an investment bank, a hedge fund, or any other type of financial institution.
- Clarifying that lending from the Fed or any other government support is not readily available. Secretary Paulson notes that from first hand experience that presumed access to government funds has the potential to change behavior within the financial institutions and with their creditors.
- For market discipline to effectively constrain risk, financial institutions must be allowed to fail. To ensure that the financial system can withstand the failure of a complex financial firm, we will need to give our regulators additional emergency authority to limit temporary disruptions and the trigger from invoking such authority should be very high, such as a bankruptcy filing.

Statement on Regulatory Restructuring by Federal Reserve Chairman Ben S. Bernanke, before the Committee of Financial Services, U.S. House of Representatives

The Chairman noted that findings from the President's Working Group on Financial Markets and the Financial Stability Forum, noted a number of specific problem areas including: mortgage lending practices and their oversight; risk measurement and management at large financial institutions; the performance of credit rating agencies; accounting and valuation issues; and issues relating to the clearing and settlement of financial transactions. These reports and their findings complement the Blueprint for regulatory reform. Chairman Bernanke focused on three issues: the prudential supervision of investment banks; strengthening the financial infrastructure; and preventing or mitigating future crises.

The SEC and the Federal Reserve agreed upon a memorandum of understanding relating to the supervision of investment banks. Cooperation between the Fed and the SEC is taking place with the existing statutory framework. In the longer term, legislation may be needed to provide a more robust framework for the supervision of investment banks and other large securities dealers. Chairman Bernanke noted that currently oversight is based on a voluntary agreement between the SEC and firms and further notes that Congress should consider requiring consolidated supervision of those firms and providing the regulator the authority to set standards for capital, liquidity holdings and risk management.

The Federal Reserve, together with other regulators and the private sector are engaged in an effort to strengthen the financial

infrastructure. In the process of strengthening the financial system, the aim is to make the financial system better to withstand future shocks and also to mitigate moral hazard and the problem of "too big to fail". Chairman Bernanke, more generally notes that the broader financial system requires key payment and settlement systems to operate smoothly under stress to effectively manage counterparty risk. Chairman Bernanke noted that Congress should consider granting the Federal Reserve explicit oversight authority for systematically important payment and settlement systems.

Chairman Bernanke noted that Congress may wish to consider whether new tools are needed for ensuring an orderly liquidation of a systematically important firm that is on the verge of bankruptcy. One possible model is the process currently in place under FDICIA for dealing with insolvent commercial banks. The FDICIA procedures give the FDIC the authority to act as a receiver for an insolvent bank and to set up a bridge bank to facilitate an orderly liquidation of the firm.

Additional Information

If you would like additional information about the topics discussed in this newsletter, or about PwC Financial Services Regulatory, please visit pwcregulatory.com or call one of the following FS Regulatory professionals:

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