Financial Services Regulatory Highlights

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In this issue:

Agencies Adopt Final Rules to Implement the Bank "Broker" Provisions of the Gramm-Leach-Bliley Act

The SEC and Board of Governors of the Federal Reserve System (Board) on Monday announced the adoption of final joint rules to implement the "broker" exceptions for banks under Section 3(a)(4) of the Securities Exchange Act of 1934. These exceptions were adopted as part of the Gramm-Leach-Bliley Act of 1999 (GLB Act). The SEC and the Board approved the final rules at separate open meetings held on September 19, 2007, and September 24, 2007, respectively.

The Board and SEC issued proposed rules for comment in December 2006. The final rules are similar to the proposed rules in overall scope and approach. In response to comments, the agencies also have modified the rules in several important respects to make the rules more workable and less burdensome.

The rules define the scope of securities activities that banks may conduct without registering with the SEC as a securities broker and implement the most important "broker" exceptions for banks adopted by the GLB Act. Specifically, the rules implement the statutory exceptions that allow a bank, subject to certain conditions, to continue to conduct securities transactions for its customers as part of the bank's trust and fiduciary, custodial and deposit "sweep" functions, and to refer customers to a securities broker-dealer pursuant to a networking arrangement with the broker-dealer.

The rules are designed to accommodate the business practices of banks and to protect investors. In developing these rules, the agencies consulted extensively with the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation and the Office of Thrift Supervision. Banks do not have to start complying with the rules until the first day of their fiscal year commencing after September 30, 2008. The final rules and accompanying explanation will be published shortly in the Federal Register.

SEC Votes to Adopt Temporary Rule on Principal Trades With Certain Advisory Clients

On September 20, 2007, the SEC voted to adopt a temporary rule that will establish an alternative means for investment advisers who are registered as broker-dealers to meet the requirements of Section 206(3) of the Advisers Act when they act in a principal capacity in transactions with certain advisory clients.

The temporary rule is being adopted in response to the decision by the U.S. Court of Appeals for the District of Columbia Circuit in *Financial Planning v. SEC*. The Court's decision, which will be effective as early as October 1, will require that fee-based brokerage customers decide whether they will convert their accounts to fee-based accounts that are subject to the Advisers Act or to commission-based brokerage accounts.

The rule, will permit an adviser, with respect to a non-discretionary advisory account, to comply with Section 206(3) of the Advisers Act by:

- Providing written prospective disclosure regarding the conflicts arising from principal trades;
- Obtaining written, revocable consent from the client prospectively authorizing the adviser to enter into principal transactions;
- Making certain disclosures either orally or in writing and obtaining the client's consent before each principal transaction;
- Sending to the client confirmation statements disclosing the capacity in which the adviser has acted and disclosing that the adviser informed the client that it may act in a principal capacity and that the client authorized the transaction; and
- Delivering to the client an annual report itemizing the principal transactions.

The temporary rule will expire and no longer be effective on December 31, 2009. Comments should be submitted to the SEC on or before November 30, 2007.

The SEC also voted to propose rule amendments that would reinstate three interpretive provisions of a rule that was vacated by the Court Appeals for the District of Columbia in *Financial Planning v. SEC*. The proposed rule amendments would re-codify guidance as to when advice is "solely incidental" to the conduct of business as a broker-dealer within the meaning of Section 202(a)(11)(C) of the Advisers Act.

When a broker-dealer charges a separate fee or separately contracts for advisory services, its advice would not be considered "solely incidental" to the business of brokerage.

When a broker-dealer exercises investment discretion it would not be considered to be providing advice that is "solely incidental" to the business of brokerage.

Under the proposal, a broker-dealer does not receive "special compensation" solely because it charges a commission for discount brokerage that is less than it charges for full-service brokerage.

The proposed amendments would re-codify an interpretation that dually-registered broker-dealers and investment advisers are considered investment advisers solely with respect to those accounts for which they provide services that subject them to the Advisers Act.

Comments on these proposed amendments should be submitted to the SEC on or before November 2, 2007.

Agencies and CSBS Issue Statement on Loss Mitigation Strategies for Servicers of Residential Mortgages

On September 4, 2007, the federal financial agencies and the Conference of State Bank Supervisors (CSBS) issued a statement to encourage federally regulated financial institutions and state-supervised entities that service securitized residential mortgages to determine the full extent of their authority under pooling and servicing agreements to identify borrowers at risk of default and pursue appropriate loss mitigation strategies designed to preserve homeownership.

Many hybrid adjustable-rate mortgages will reset throughout this year and next. Subprime and other mortgage loans have been transferred into securitization trusts that are governed by pooling and servicing agreements. These agreements may allow servicers to contact borrowers at risk of default, assess whether default is reasonably foreseeable, and, apply loss mitigation strategies designed to achieve sustainable mortgage obligations. Servicers may have the flexibility to contact borrowers in advance of loan resets.

Appropriate loss mitigation strategies may include:

- Loan modifications;
- Conversion of an adjustable rate mortgage into a fixed rate;
- Deferral of payments; or
- Extending amortization.

Institutions should also consider referring appropriate borrowers to qualified homeownership counseling services that may be able to work with all parties to avoid unnecessary foreclosures.

SEC Approves FINRA Rule Governing Sales Practices of Deferred Variable Annuities

On September 10, 2007, the SEC approved new FINRA Rule 2821 that will govern the sales practice standards of deferred variable annuities. The rule is applicable to the purchase or exchange of these products but not reallocations of sub-accounts or subsequent premium payments made after the initial purchase. The rule would also apply to certain retirement accounts when the broker recommends the purchase or exchange of a variable annuity.

Brokers must have a reasonable basis to believe that the transaction is suitable for the customer. In addition to the general suitability rules, the broker must also believe that the customer will benefit from the various product features. For variable annuity exchanges, brokers must also take into account and sign documentation regarding the benefits to the customer; any surrender charges; loss of any existing benefits; additional fees or expenses; or if the customer exchanged a variable annuity in the past three years.

In addition to these suitability requirements, the rule has the following three components:

- Principal review standards that require principals to review transactions before the customer's application is sent to the issuing insurance company for processing.
- Establishing and maintaining specific written supervisory procedures reasonably designed to achieve compliance with the standards set forth in the proposed rule.
- Training policies or programs designed to ensure compliance with the requirements of the rule and salespersons' understanding of the material features of deferred variable annuities.

FINRA Announces Major Regulatory Sweeps at Seniors Summit

On September 10, 2007, FINRA announced the initiation of two new major regulatory sweeps intended to ensure that securities firms are using appropriate sales practices in their dealings with seniors and individuals nearing retirement.

The first new sweep will examine whether brokers are using so-called "professional" designations to mislead and defraud investors. FINRA is concerned about the proliferation of professional designations, particularly those that require no meaningful training or specialized knowledge but suggest an expertise in retirement planning or financial services for seniors.

The second new sweep is looking at early retirement seminars conducted by securities firms designed to entice older workers to liquidate their retirement funds and invest them with a specific firm or representative.

FINRA is also launching a campaign aimed at informing human resource professionals about the risks of flawed and fraudulent early retirement seminars. The Seminar Scan program will review information related to a financial seminar sent to a HR department.

There are also two current sweeps focusing on:

- the sale of collateralized mortgage obligations targeted at seniors; and
- the sale of life settlements.

FinCEN Issues Guidance to Clarify Due Diligence Obligations of Executing Dealers in OTC Derivatives Markets

On September 5, 2007, the Financial Crimes Enforcement Network (FinCEN) issued interpretive guidance to clarify the due diligence obligations of executing dealers in over-the-counter foreign exchange and derivatives markets (OTC derivatives markets) pursuant to prime brokerage arrangements under the rules implementing the correspondent account provisions ofsection 312 of the USA PATRIOT Act.

The guidance addresses whether executing dealers conducting transactions pursuant to prime brokerage arrangements in the OTC derivatives markets may establish correspondent accounts with prime brokerage clients that would require executing dealers to comply with the correspondent account rule. In general, FinCEN does not view the interaction between an executing dealer and a prime brokerage client as establishing, maintaining, or managing a correspondent account for the prime brokerage client. Therefore, the enhanced due diligence requirements applicable to correspondent banking services do not apply to those activities.

FDIC, CSBS and AARMR Suggest Servicers Avoid Debt-to-Income Ratios Above 50 Percent for Modified Obligations

On September 4, 2007, the FDIC, CSBS, and American Association of Residential Mortgage Regulators (AARMR) cautioned their supervised institutions about debt-to-income (DTI) ratios above 50 percent when applying loss mitigation techniques intended to achieve long-term sustainable obligations to provide stability to borrowers, investors, and marketplace.

The agencies state that DTI ratios over 50 percent increase the chance of future repayment issues. The action is issued as a supplement to the statement issued by the federal financial agencies on loan mitigation strategies for servicers of residential mortgages.

OCC Issues Alert on Debt Elimination Fraud

On September 5, 2007, the OCC issued an Alert on fraudulent schemes to eliminate mortgage, credit card, or small business debt.

The OCC is aware of a variety of fraudulent schemes designed to "eliminate" debt. These schemes, which are being spread via the internet and in seminars, are marketed to ordinary people. This includes borrowers who are current on their payments and those approaching foreclosure.

These schemes are designed to defraud victims of an upfront fee, which can range from $400 to $7,500. As a result, victims can lose money, property, damage their credit record, face legal action, and potentially become the victim of identity theft.

Any information regarding these matters should be brought to the attention of local and/or federal law enforcement agencies.

Federal Reserve Board Issues Final Rule on Annual Dollar Trigger for Certain Home Mortgage Loans Bearing Fees Above a Certain Amount

On August 1, 2007, the Federal Reserve Board published the annual adjustment to the Regulation Z dollar amount threshold that triggers additional disclosure requirements for certain home mortgages. . The Home Ownership and Equity Protection Act of 1994 restricts credit terms such as balloon payments and requires additional disclosures when total points and fees payable by the consumer exceed the fee-based trigger (initially set at $400 and adjusted annually) or 8 percent of the total loan amount, whichever is larger.

The Board has annual adjusted the $400 amount based on the annual percentage change reflected in the Consumer Price Index that is in effect on June 1. The adjusted dollar amount for 2008 is $561.

The final rule is effective on January 1, 2008.

OCC Issues Guidance on Prohibition on Political Contributions by National Banks

On August 24, 2007, the OCC issued guidance to describe and emphasize the prohibitions on political contributions or expenditures by national banks pursuant to the Federal Election Campaign of 1971 (Act).

The Act makes its unlawful for a national bank to make any contribution or expenditure or to provide any service or anything of value in connection with any election to any political office, or in connection with any primary election or political convention or caucus held to select candidates for any political office. The prohibition applies to all federal, state, and local elections, political conventions, and caucuses.

Additionally, it is unlawful for any officer or any director of a national bank to consent on behalf of the bank to any political contribution or expenditure prohibited by the Act, and it is unlawful for any candidate, political committee, or other person to knowingly accept or receive a political contribution or expenditure prohibited by the Act.

Federal Election Commission (FEC) regulations prohibit other forms of political contributions or expenditures by national banks, including, the purchase of tickets to political dinners or other political fundraising events, advertisements in political literature, and donations of goods or services in connection with political fundraising events and activities.

Bank employees, in their personal capacity, may make contributions from their own funds. Also, a national bank is not prohibited under the Act from making a contribution to a fund whose purpose is to influence a ballot referendum, provided the referendum does not involve elections to any political office.

National banks are reminded that when a bank examiner discovers a direct or indirect political contribution or expenditure by a national bank, the OCC will require that the bank stop the practice, take measures to prevent its recurrence, and will make appropriate referrals to the FEC. If the FEC does not pursue a matter referred to it by the OCC, the OCC will consider taking appropriate action, including supervisory and enforcement actions to make the bank whole.

Agencies Request Comment on Statement of Best Practices on Garnishment Orders of Exempt Federal Benefit Funds

On September 19, 2007, the federal financial agencies requested comment on a proposed guidance encouraging federally regulated financial institutions to follow best practices to protect federal benefit payments from garnishment orders.

The Statement represents guidance on best practices for financial institutions to protect consumers' funds while remaining in compliance with state laws and court orders governing garnishment, attachment, and other legal process.

The Agencies encouraged financial institutions to have policies and procedures in place to address garnishment orders, including procedures designed to expedite notice to the consumer of the garnishment process and release funds to the consumer as quickly as possible.

The best practices include:

- Promptly notify a consumer when a financial institution receives a garnishment order and places a freeze on the consumer's account;
- Provide the consumer with information about what types of federal benefit funds are exempt, including Social Security and Veteran's benefits, in order to aid the consumer in asserting federal protections;
- Promptly determine, as feasible, if an account contains only exempt federal benefit funds such as SSA or VA benefits;
- Notify the creditor, collection agent, or relevant state court that the account contains exempt funds in cases in which the financial institution is aware that the account contains exempt funds;
- If state law or the court order will permit a freeze not to be imposed if the account is determined to contain only exempt federal benefit funds, act accordingly if that determination is made;
- Minimize the cost to a consumer when the consumer's account containing exempt federal benefit funds is frozen, such as by refraining from imposing overdraft, NSF, or similar fees while the account is frozen or refunding such fees when the freeze has been lifted;
- Allow the consumer access to a portion of the account equivalent to the documented amount of exempt federal benefit funds as

soon as the financial institution determines that none of the exceptions to the federal protections against garnishment exempt federal benefit funds are triggered by the garnishment order;

- Offer consumers segregated accounts that contain only federal benefit funds without commingling of other funds; and
- Lift the freeze on an account as soon as permissible under state law.

FINRA Proposes Amendments to NASD Rule 2711 and NYSE Rule 472

On September 12, 2007, FINRA filed with the SEC proposed rule changes to NASD Rule 2711 and NYSE Rule 472 with respect to a member's disclosure and supervisory review obligations when it distributes or makes available third-party research reports.

The proposed amendments would:

- Define "third-party research report" for the purposes of the rules as a research report that is produced by a person or entity other than a member.
- Create a subcategory of "independent third-party research" and eliminate the content review requirement when a member distributes or makes available such research.
- Define "independent third-party research" for the purposes of the rules to mean a third-party research report, in which the person or entity producing the report: (1) has no affiliation or business or contractual relationship with the distributing member or that member's affiliates that is likely to inform the content of its research reports; and (2) makes coverage and content determinations without any input from the distributing member or that member's affiliates.
- Create an exception from the disclosure review requirement for independent-third party research reports made available by a member either (1) upon request, (2) through a member-maintained web site, or (3) where such report is made available by a member to a customer in connection with a solicited order in which the registered representative has informed the customer, during the course of the solicitation, of the availability of independent research on the solicited equity security and the customer requests such independent research.
- Require that current applicable third-party disclosures accompany any third-party research report that does not meet the definition of "independent third-party research report," irrespective of whether it is distributed or made available upon request, on a member-maintained web site or in connection with a solicitation, as described above.
- Amend NASD Rule 2711 and NYSE 472 to allow a member to direct a customer to a web address where such applicable third-party disclosures could be found.

FINRA believes the proposed rule change will promote the availability of independent third-party research, as well as, maintain member supervisory review in those circumstances where the member's relationship with the research provider is such that the research is not free from the control or influence of the member. The proposed rule change also preserves the requirement that a member disclose potential conflicts with the subject company whenever it "pushes out" research to customers.

FINRA Issues Notice on Amendments to NASD Rule 3210 to Conform with Amendments to the SEC's Regulation SHO Delivery Requirements

On September 24, 2007, FINRA issued Regulatory Notice 07-45, to advise firms and other interested parties of changes to NASD Rule 3210 - Short Sale Delivery Requirements - to conform with amendments to the SEC's Regulation SHO delivery requirements.

As of October 15, 2007, firms will be required to close out within 35 consecutive settlement days any previously "grandfathered" fail-to-deliver positions in a non-reporting threshold security that is on the Rule 3210 threshold list on that date.

Any new fails in a non-reporting threshold security after October 15, 2007 will be subject to Rule 3210's 13 consecutive settlement day close-out requirements. There is one exception: as of October 15, firms will have 35, rather than 13, consecutive settlement days to close out fails to deliver resulting from sales of non-reporting threshold securities pursuant to SEC Rule 144.

United Healthcare Agrees to Pay Up to $20 Million in Regulatory Fines

On September 7, 2007 state insurance regulators announced a settlement with United Healthcare Insurance Company, in which the health insurer agreed to pay up to $20 million in fines to 36 States and the District of Columbia for violating state laws regarding claims processing. Specifically the company was cited for not applying correct fee schedules and deductibles.

The negotiation, resulting from an extensive multi-state market conduct exam, was led by the states of Arkansas, Connecticut, Florida, Iowa, and New York. The review focused on claims handling and other administrative practices including the coordination and explanation of benefits. These areas were reviewed based on complaint data and prior market conduct examinations.

In addition to monetary settlement reached, United Healthcare agreed to implement a three-year claims process improvement plan with quarterly reviews and yearly benchmarks. Failure to meet these benchmarks will result in United Healthcare facing up to $20 million in additional regulatory fines.

To date, jurisdictions that have adopted the agreement include: Alabama, Alaska, Arkansas, California, Connecticut, District of Columbia, Florida, Hawaii, Idaho, Illinois, Indiana, Iowa, Kansas, Kentucky, Louisiana, Maine, Michigan, Minnesota, Montana, Nebraska, Nevada, New Hampshire, New Mexico, New York, North Dakota, Ohio, Oklahoma, Oregon, Pennsylvania, South Carolina, South Dakota, Tennessee, Utah, Vermont, Virginia, West Virginia and Wyoming.

TRIREA Passes House; White House Threatens Veto

On September 19, 2007, the US House of Representatives passed H.R. 2761, the Terrorism Risk Insurance Revision and Extension Act of 2007 (TRIREA), by a vote of 312-110. The current reinsurance program expires on December 31, 2007, but TRIREA would extend it by 15 years and expand its terms and coverage.

Despite the overwhelming vote in the House, TRIREA's outlook is uncertain. The Bush Administration opposes extending the program beyond anything but a few years, and also opposes expanding its coverage, including the mandate that all insurers make available coverage for nuclear, biological, chemical and radiological (NBCR) attacks. Though similar legislation is being considered in the Senate, Republican opposition there might lead senators to alter the House bill to address some of the concerns raised by the White House. The White House has signaled a willingness to veto the bill, should it reach the President in its current form.

Additional Information

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

David Albright, Principal	703-918-1364
John Campbell, Principal	646-471-7120
Roger Coffin, Principal	646-471-2545
Jeff Lavine, Partner	703-918-1379
Ric Pace, Principal	703-918-1385
Bruce Roland, Principal	410-783-7650
Ellen Walsh, Principal	646-471-7274
Gary Welsh, Managing Director	703-918-1432
Stephen Koslow, Director	312-298-3829
David Sapin, Director	703-918-1391
Michael VanHuysen, Director	703-918-1429
Stephen Lurie, Director	646-471-5129
Karen Severe, Manager	646-471-7234
Michael B. Tuohy, Manager	646-471-4209

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