

Financial Services Regulatory Highlights

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Over the past month, we have witnessed an unprecedented rate of change in the financial services industry and its regulatory environment. As we go to press with this edition of the Financial Services Regulatory Highlights, Congress has just voted against the initial \$700 billion bailout bill and has gone back to the drawing board. The full impact of all of regulatory changes that have occurred to date - and are yet to come - cannot yet be determined. In this edition of the Financial Services Regulatory Highlights, we have tried to capture many of the individual regulatory developments that have occurred over the past month. We expect the fluid nature of regulatory developments and changes to continue, and the nature of the industry and its regulatory environment will be largely dependent on the actions that Congress takes on the bailout bill.

In addition to our monthly Financial Services Regulatory Highlights, we will continue to keep our clients up to date on the rapidly changing regulatory environment through our periodic FS Regulatory Briefs. Please remember that the Regulatory Highlights and the Briefs - as well as our daily Regulatory Updates - are available at www.pwc regulatory.com.

Federal Reserve Board Approves Applications for Bank Holding Company Status by Goldman Sachs and Morgan Stanley

On Sunday September 21, 2008, the Federal Reserve Board approved the applications of Goldman Sachs and Morgan Stanley for Bank Holding Company ("BHC") status, pending a five day anti-trust waiting period, under the Bank Holding Company Act. The following day, Monday September 22, 2008, after consulting with the Department of Justice, the Federal Reserve Board announced that the applications would be consummated immediately, bypassing the anti-trust waiting period. Additionally, Morgan Stanley was approved as a financial holding company ("FHC"); Goldman Sachs is expected to request approval for financial holding company status.

The Goldman Sachs Group, Inc. and Goldman Sachs Bank USA Holdings LLC were approved to become BHCs upon the conversion of the Goldman Sachs Bank USA, a Utah chartered, industrial loan company, to a state-chartered bank. Morgan Stanley entities received approvals to become BHCs upon the conversion of Morgan Stanley's Utah-chartered, industrial loan company (MS Bank) to a national bank. The primary effect of these conversions is that both Goldman Sachs and Morgan Stanley will now be subject to oversight by

the Federal Reserve Board. Previously, both of these companies had been primarily regulated by the SEC under the CSE approach. (See related article.)

Converting to FHCs will not significantly alter the activities that are currently performed; however, as banks, both Goldman Sachs and Morgan Stanley will be permitted to accept both personal and commercial deposits and be required to maintain capital levels consistent with banking regulatory requirements.

Short Sale Regulatory Developments

The SEC and the FSA took a series of extraordinary steps this month dramatically altering the regulatory framework governing short selling. Both regulators took action that had been hinted at for weeks by introducing a series of new short sale rules, including banning all short selling in financial services firms, with limited exceptions. Additionally, the SEC approved separate Emergency Orders requiring the disclosure of new short positions and expanding the safe harbor provisions related to issuer repurchases.

New Rules

Several of the SEC's new rules go beyond the recent Emergency Orders which applied temporary bans on short sales of certain large financial services firms with access to the Federal Reserve's Primary Dealer Credit Facility. These rules, which will apply to short sales of all publicly traded companies, can be summarized as follows:

- The Commission adopted, on an interim final basis, a new rule requiring that short sellers and their broker-dealers deliver securities by T+3 and imposing penalties for failure to do so. If a short sale fails to settle, then any broker-dealer acting on any customer's behalf will be prohibited from further short sales in the same security unless the shares are located and pre-borrowed. The rule was effective immediately, but the Commission is seeking comment during a period of 30 days.

- The Commission eliminated the options-market maker exception for meeting the three-day settlement window. This amendment to Regulation SHO would take effect five days after the rulemaking appears in the Federal Register. Thus, options dealers would be treated as all other short-sale participants and naked short selling would be 100% banned in all cases.
- The Commission adopted Rule 10b-21, an anti-fraud rule focused on short sale traders. The new rule makes it explicitly illegal for short sellers to deceive broker-dealers or any other market participants by lying about their intention or ability to deliver securities in time for settlement.

New Disclosure Requirements

In addition to new short sale rules, the SEC approved an Emergency Order this month requiring the disclosure of short positions. Specifically, and with certain exceptions, the Order requires that institutional investment managers exercising investment discretion on accounts holding section 13(f) securities having an aggregate fair market value of at least \$100 million dollars must file a new form (Form SH) with the Commission. Form SH must be filed the first business day of every calendar week immediately following a week in which a manager effected a short sale. The filing will include the number and value of securities sold short for each section 13(f) security, excluding options, and the opening short position, closing short position, the largest intraday short

position, and the time of the largest intraday short position, for that security during each calendar day of the prior week.

SEC Bans Short Selling in Financial Companies

In the most significant move of the month, the SEC approved an Emergency Order on September 18, 2008, immediately banning all short selling in the stocks of 799 financial firms with certain limited exceptions. While the SEC's action terminates on October 2, 2008, the Commission is able to extend the Order for another 10 days beyond that if it deems the action to be in the public interest and necessary for the protection of investors. The following week, certain technical amendments were made to the Order to give listing exchanges the discretion to determine which financial companies should be covered by the Order. As expected, this has increased the number of financial companies covered by the Order. Current lists of companies covered by the Order can be found on the exchanges' websites.

Issuer Repurchases

The SEC also loosened restrictions this month on issuer repurchases through a separate Emergency Order. The SEC determined to alter the timing and volume conditions contained in Exchange Act Rule 10b-18 to

give issuers greater flexibility in repurchasing their own stock.

New York Attorney General Investigations

New York Attorney General Andrew Cuomo also announced that his office has initiated a "wide-ranging" investigation of short selling activities. Intending to use the state's Martin Act, Cuomo is focusing on potentially fraudulent and manipulative activity in the stocks of financial services firms.

UK Bans Short Selling in Financial Companies

On September 18, 2008, the Financial Services Authority (FSA) in the UK announced that it will introduce new rules to prohibit the establishment or increase of net short positions in publicly traded financial companies, effective at midnight on the 18th. Additionally, as of September 23rd, the FSA now requires a daily disclosure of all net short positions in excess of .25 percent of a stock. The FSA notes that it will extend this requirement to other sectors if necessary.

These provisions will remain in effect until January 2009, but the FSA will review them after 30 days. The FSA plans to publish a comprehensive review of the rules on short selling in January.

SEC Expands Sweeping Investigation of Market Manipulation

On September 19, 2008, due to recent reports of trading irregularities, allegations of false rumor mongering and abusive short selling, the Securities and Exchange Commission announced an expansion of its ongoing investigation into possible market manipulation in the securities of certain financial institutions. This expanded investigation will include obtaining statements under oath from market participants disclosing their positions in significant trading activity in credit default swaps.

In addition, the Commission approved a formal order of investigation that will allow SEC enforcement staff to

obtain additional documents and testimony by subpoena. Parallel inquiries from NYSE Regulation and FINRA examiners will also take place with on-site visits to various broker dealers in order to address the recent short selling activity.

The SEC, NYSE and FINRA are collaboratively working together in order to quickly identify, isolate and prosecute any violations of the federal securities laws during the recent market turmoil.

Treasury Announces Guaranty Program for Money Market Funds

On September 30th, the U.S. Treasury Department opened its Temporary Guarantee Program for Money Market Funds. The U.S. Treasury will guarantee the share price of any publicly offered eligible money market mutual fund – both retail and institutional – that applies for and pays a fee to participate in the program. All money market mutual funds that are regulated under Rule 2a-7 of the Investment Company Act of 1940, maintain a stable share price of \$1, and are publicly offered and registered with the Securities and Exchange Commission will be eligible to participate in the program. Treasury first announced this program on Friday, September 19.

The temporary guarantee program provides coverage to shareholders for amounts that they held in participating money market funds as of the close of business on September 19, 2008. The guarantee will be triggered if a participating fund's net asset value falls below \$0.995, commonly referred to as breaking the buck.

The program is designed to address temporary dislocations in credit markets. The program will exist for an initial three month term, after which the Secretary of the Treasury will review the need and terms for extending the program. Following the initial three month term, the Secretary has the option to renew the program up to the close of business on September 18, 2009. The program will not automatically extend for the full year without the Secretary's approval, and funds would have to renew their participation at the extension point to maintain coverage. If the Secretary chooses not to renew the program at the end of the initial three month period, the program will terminate.

To participate in the program, the Treasury Department will require money market funds with a net asset value per share greater than or equal to \$0.9975 as of the close of business on September 19, 2008, to pay an upfront fee of 0.01 percent, 1 basis point, based on the number of shares outstanding on that date. Funds with net asset value per share of greater than or equal to \$0.995 and below \$0.9975 as of the close of business on September 19, 2008, will be required to pay an upfront fee of 0.015 percent, 1.5 basis points, based on the number of shares outstanding on that date. These fees will only cover the first three months of participation in the program.

Funds with a net asset value below \$0.995 as of the close of business on September 19, 2008, may not participate in the program.

While the program protects the accounts of investors, each money market fund makes the decision to sign-up for the program. Investors cannot sign-up for the program individually. Funds should apply by October 8, 2008 for the program using the forms on the program webpage:

<http://www.treas.gov/offices/domestic-finance/key-initiatives/money-market-fund.shtml>.

Eligible funds include both taxable and tax-exempt money market funds. The Treasury and the IRS issued guidance that confirmed that participation in the temporary guarantee program will not be treated as a federal guarantee that jeopardizes the tax-exempt treatment of payments by tax-exempt money market funds.

Federal Reserve Issues a Policy Statement on Equity Investments in Banks and Bank Holding Companies

On September 22, 2008, the Federal Reserve Board (the Board) announced the approval of a policy statement on equity investments in banks and bank holding companies. The policy statement provides additional guidance on minority equity investments in banks and bank holding companies that generally do not constitute "control" for purposes of the Bank Holding Company Act. This policy statement is important because it clarifies the minority investments that can be made without triggering the "control" provisions and becoming subject to supervision and regulation as a Bank Holding Company.

The Statement indicates that a determination whether an investor has a controlling influence over a banking organization depends on the facts and circumstances surrounding the investment. The new guidance outlines four key tests for determining "control":

- **Director Representation.** A minority investor (a company that acquires between 10 and 24.9 percent of the voting stock of banking organization) should generally be able to have one representative on the board of directors without acquiring a controlling influence over the management or policies of the banking organization. Absent other indicia of control, a minority investor with two board representatives will likely not be able to exert control assuming certain tests are met. In general, a minority investor's board representative should not serve as the banking organization's board chairman or a chairman of a committee of the board.
- **Voting and total equity ceilings.** The Board continues to believe that any company which owns 25 percent of the total equity of the banking organization is in a position to exert a controlling influence. However, a minority investor would not expect a minority investor to have a controlling

influence over a banking organization if the investor owns a combination of voting shares and nonvoting shares that, when aggregated, represent less than one-third of the total equity of the organization (and less than one-third of any class of voting securities) and the investor does not own, hold, or vote 15 percent or more of any class of voting securities.

- **Consultations with management.** The Board believes that a noncontrolling minority investor may communicate with banking organization management about, and advocate for changes in, any of the banking organization's policies and operations. The Statement outlines permissible communications. In order to avoid the exercise of a controlling influence as it relates to a particular position or action, in all cases, (1) the decision must remain with the banking organization's shareholders as a group, its board of directors, or its management and (2) the role of the minority investor must be limited to voting its shares.
- **Business relationships.** The Board recognizes that not all business relationships provide the investor a controlling influence over the management or policies. Therefore, the Board believes that business relationships that are quantitatively limited and qualitatively nonmaterial generally would not influence control. Business relationships should remain limited and the Board will continue to review relationships on a case by case basis.

Federal Reserve Approves Two Interim Final Rules Providing Liquidity

On September 19, 2008, the Federal Reserve Board announced it had approved two interim final rules to increase market liquidity. The rules aim to facilitate participation by depository institutions and bank holding companies in a special lending program as intermediaries between the Federal Reserve and money market mutual funds. The Federal Reserve hopes to provide liquidity to markets by extending loans to banking organizations to finance their purchases of high-quality asset-backed commercial paper from money market mutual funds.

The first rule provides a temporary limited exception from the Board's leverage and risk-based capital rules for bank holding companies and state member banks. The second provides a temporary limited exception from sections 23A and 23B of the Federal Reserve Act, which establish certain restrictions on and requirements for transactions between a bank and its affiliates.

These exceptions will expire on Jan. 30, 2009, unless extended by the Board.

Federal Reserve Announces Several Initiatives to Support Financial Markets

The Federal Reserve Board on September 14th announced several initiatives to provide additional support to financial markets, including enhancements to its existing liquidity facilities.

"In close collaboration with the Treasury and the Securities and Exchange Commission, we have been in ongoing discussions with market participants, including through the weekend, to identify potential market vulnerabilities in the wake of an unwinding of a major financial institution and to consider appropriate official sector and private sector responses," said Federal Reserve Board Chairman Ben S. Bernanke. "The steps we are announcing today, along with significant commitments from the private sector, are intended to mitigate the potential risks and disruptions to markets."

"We have been and remain in close contact with other U.S. and international regulators, supervisory authorities, and central banks to monitor and share information on conditions in financial markets and firms around the world," Chairman Bernanke said.

The collateral eligible to be pledged at the Primary Dealer Credit Facility (PDCF) has been broadened to closely match the types of collateral that can be pledged

in the tri-party repo systems of the two major clearing banks. Previously, PDCF collateral had been limited to investment-grade debt securities.

The collateral for the Term Securities Lending Facility (TSLF) also has been expanded; eligible collateral for Schedule 2 auctions will now include all investment-grade debt securities. Previously, only Treasury securities, agency securities, and AAA-rated mortgage-backed and asset-backed securities could be pledged.

These changes represent a significant broadening in the collateral accepted under both programs and should enhance the effectiveness of these facilities in supporting the liquidity of primary dealers and financial markets more generally.

Also, Schedule 2 TSLF auctions will be conducted each week; previously, Schedule 2 auctions had been conducted every two weeks. In addition, the amounts offered under Schedule 2 auctions will be increased to a total of \$150 billion, from a total of \$125 billion. Amounts offered in Schedule 1 auctions will remain at a total of \$50 billion. Thus, the total amount offered in the TSLF program will rise to \$200 billion from \$175 billion.

The Board also adopted an interim final rule that provides a temporary exception to the limitations in section 23A of the Federal Reserve Act. It allows all insured depository institutions to provide liquidity to their

affiliates for assets typically funded in the tri-party repo market. This exception expires on January 30, 2009, unless extended by the Board, and is subject to various conditions to promote safety and soundness.

Federal Reserve Announces Initiative To Support Purchases of High-Quality Asset-Backed Commercial Paper

The Federal Reserve Board on September 19th announced an initiative to extend non-recourse loans at the primary credit rate to U.S. depository institutions and bank holding companies to finance their purchases of high-quality asset-backed commercial paper (ABCP) from money market mutual funds. This should assist money funds that hold such paper in meeting demands for redemptions by investors and foster liquidity in the ABCP markets and broader money markets.

The Fed also approved two interim final rules in connection with its initiative to extend loans to banking organizations to finance their purchases of high-quality asset-backed commercial paper (ABCP) from money market mutual funds.

The first interim final rule would provide a temporary limited exception from the Board's leverage and risk-based capital rules for bank holding companies and state member banks. The second would provide a temporary limited exception from sections 23A and 23B of the Federal Reserve Act, which establish certain restrictions on and requirements for transactions between a bank and its affiliates.

The interim final rules approved by the Board will facilitate participation by depository institutions and bank holding companies in this special lending program as intermediaries between the Federal Reserve and money market mutual funds. These exceptions expire on January 30, 2009, unless extended by the Board, and are subject to various conditions to promote safety and soundness.

In support of the ABCP program, the OCC also adopted an exemption from its risk-based capital guidelines for ABCP purchased by a national bank as a result of its participation in the facility. Specifically, this amends the OCC's risk based capital guidelines to permit national banks to assign a zero percent risk weight to ABCP purchased as a result of its participation in the facility. Because of the non-recourse nature of the Federal Reserve's credit extension to the banking organization, the bank is not exposed to the credit or market risk of the ABCP purchased by the bank and pledged to the Federal Reserve.

The ABCP Lending Facility is set to expire on January 30, 2009.

Regulators Provide "Tips" for Broker-Dealers on Avoiding Failures to Deliver Securities

SEC's Division of Trading and Markets and SEC's Office of Compliance Inspections and Examinations, along with FINRA and NYSE are providing the following information to assist broker-dealer firms in preventing failures to deliver securities. Firms conducting short sales are encouraged to consider practices to prevent delivery failures, including:

- **Borrowing:** Borrowing and obtaining control of the securities before settlement, rather than entering into an agreement to borrow such securities.
- **Arrangement to borrow:** Entering into an agreement to borrow securities, especially in transactions in hard-to-borrow securities, in order to ensure that the firm will be able to settle the transaction on T+3.
- **Earmarking:** If the firm enters into an arrangement to pre-borrow shares without obtaining control, determining that the source of shares for the pre-borrow will be available on T+3. Shares may be specifically earmarked for each arrangement to borrow.
- **Maintaining an inventory:** Maintaining adequate inventory of securities in which the firm frequently executes short sales sufficient to cover anticipated short sales and to cover any pre-borrows granted by the firm.
- **Documenting the source of shares:** In instances where a customer relies on a broker-dealer other

than the executing broker-dealer to settle a transaction, the broker-dealer that settles the customer's transaction documents the source of the customer's pre-borrow. The executing broker-dealer has adequate controls in place to ensure that locates or pre-borrow arrangements provided by the customer are valid. Additionally, executing broker-dealers are reminded that when a customer provides assurance that it has access to shares to settle their transaction, the executing broker-dealer is required to document the source of the customer's pre-borrow.

- **Monitoring locates:** Monitoring the performance of the locates provided by customers to assess future reliability.
- **Encouraging timely affirmations:** Working with institutional clients to encourage the development of efficient systems for confirmation and affirmation of trades, to assure timely delivery of DVP trades.
- **Direct market access/sponsored access:** Firms may also want to consider the practices outlined here in conjunction with their policies and procedures regarding short sales entered via direct market access or sponsored participant arrangements. Document the source of pre-borrowed shares when a short sale transaction is entered via a direct market access and/or other sponsored access arrangements.

Chairman Cox Announces the End of Consolidated Supervised Entities Program

On September 25, 2008 the Office of the Inspector General (OIG) at the Securities and Exchange Commission issued final reports on the OIG's audits of the CSE program and the SEC's oversight of Bear Sterns. The OIG initiated its reviews in response to an April 2, 2008 Congressional Request. The audits were intended to evaluate the Commission's CSE program, review the Commission's oversight of Bear Sterns, and determine if and where improvements could be made to the CSE program. The CSE report concludes, among other things, that the CSE program failed to carry out its mission in its oversight of Bear Sterns. OIG identified 26 recommendations intended to improve the Commission's Oversight of CSE firms. On September 26, 2008 however, the SEC announced that the CSE program was ending, as the remaining two CSE program institutions applied for and received permission to transform themselves into Bank Holding Companies.

Background

The CSE regime is a voluntary program that was created in 2004 by the Commission. The program allowed the Commission to supervise broker dealer holding companies on a consolidated basis. As such, for participating entities, the Commission's authority extended beyond the registered broker dealer to the unregulated affiliates and to the holding company of the broker dealer. The intention of the program was to allow the Commission to monitor for financial or operational weakness in a CSE holding company. CSE approved entities were exempt from standard net capital computations and instead used an alternative method.

Audits

The OIG conducted two separate audits related to the Commission's oversight of Bear Sterns and related entities. In an audit of the Commission's Broker Dealer Risk Assessment Program, OIG found that the Division of Trading and Markets is not fulfilling its obligations in accordance with the underlying purpose of the Broker Dealer Risk Assessment Program.

Findings and Recommendations

The audit of the adequacy of the CSE program found significant questions about a number of CSE program requirements, as Bear Sterns was compliant with several of them but still collapsed. Additionally, the audit found that the Division of Trading and Markets learned of numerous potential red flags prior to the collapse of Bear Sterns but did not take action to mitigate these risks. The audit also found that SEC procedures and processes were not strictly adhered to. The OIG issued 26 recommendations that it believes would have significantly improved the CSE program.

End of CSE Program

On September 26, 2008, Chairman Cox announced that the CSE program was ending. Chairman Cox stated that the events of the last six months made it clear that voluntary regulation does not work. He believes that the CSE program was "fundamentally flawed" because participation was voluntary. The SEC was never given the statutory authority to regulate investment bank holding companies. The Chairman noted the Commission will closely review the OIG's recommendations for applicability to other areas of the Commission's oversight.

SEC Charges LPL Financial for Failing to Protect Customer Privacy

On September 11, 2008, the SEC settled an administrative proceeding with LPL Financial Corporation, formerly known as Linsco/Private Ledger Corporation. According to the SEC, LPL failed to adopt policies and procedures to safeguard customers' personal information. Additionally, LPL failed to correct an internal audit finding that revealed deficiencies about its security controls to safeguard customer information at its branch offices. Consequently, customer information was inappropriately accessed and unauthorized persons gained access to LPL's online trading platform and placed or attempted to place more than 209

unauthorized trades worth more than \$700,000 in 68 customer accounts. Although the breach was detected and most of the trade requests were rejected, LPL compensated affected customers for any losses in their accounts due to inappropriately executed trades.

In addition to paying a \$275,000 fine, LPL agreed to establish policies and procedures for training its employees on safeguarding customer records. The firm must also retain an independent consultant to review LPL's written policies and procedures relating to the Safeguards Rule of Regulation S-P.

Federal Banking Agencies Issue Joint Release on Fannie Mae and Freddie Mac

On September 7, 2008, two days after the announcement by the Federal government that it would be taking control of the government sponsored enterprises (GSEs), Fannie Mae and Freddie Mac, the Federal Banking Agencies issued a joint statement regarding bank exposure to Fannie Mae and Freddie Mac.

The Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, and Office of Thrift Supervision expressed confidence that while some

financial institutions have preferred stock in Fannie Mae and Freddie Mac, it is small compared to their capital holdings. They continued, stating that Federal Banking Agencies will work with financial institutions, under the Federal Deposit Insurance Corporation Improvement Act, to develop corrective action plans to restore capital. Finally, the release reminded institutions that equity security holdings with readily determinable fair value must be reported as available-for-sale equity security holdings and unrealized losses should be deducted from regulatory capital.

Federal Banking Agencies Evaluating FASB's Accounting Proposals

On September 15, 2008 the Financial Accounting Standards Board (FASB) proposed amendments to certain generally accepted accounting principles (GAAP). The proposals would amend Statement of Financial Accounting Standards No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities (FAS 140) and FASB Interpretation No. 46(R), Consolidation of Variable Interest Entities (Fin 46(R)).

The amendment to FAS 140 would remove the concept of qualifying special purpose entity (QSPE) which would require that variable interest entities previously accounted for as QSPEs under FAS 140 be analyzed to

determine whether they must be consolidated in accordance with FIN 46(R). The amendment would also revise the criteria for reporting a sale versus a financing.

The amendments would also modify FIN 46(R) for determining which enterprise would consolidate a variable interest entity and require additional disclosures.

The Federal Reserve Board, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, and Office of Thrift Supervision are evaluating the potential impact that these proposals could have on financial statements, regulatory capital, and other regulatory requirements.

OCC Updates Policy Statement on Minority-Owned National Banks

The Office of the Comptroller of the Currency announced today it has reissued its Policy Statement on Minority-Owned National Banks. The updated statement replaces a 2001 policy statement.

“We reissued the statement in part to update it and take account of changes in the business environment in which minority national banks operate,” said Comptroller of the Currency John C. Dugan. “But I also wanted to reissue the statement to reaffirm my own commitment – and that of the OCC – to minority-owned institutions.

These banks provide vital services to minority communities, and the OCC is strongly committed to supporting them.”

While the OCC is not subject to Section 308 of the Financial Institutions Reform, Recovery and Enforcement Act of 1989, the policy statement represents the OCC's commitment to uphold the spirit of that law, which is intended to preserve and promote minority banks.

Request for Comment on Draft Interagency Proposed Rule to Permit a Banking Organization to Reduce the Amount of Goodwill Deduction

On September 15, 2008, the Federal Banking Agencies [OCC, OTS, FDIC and Federal Reserve Board] requested public comment on an interagency notice of proposed rulemaking that would permit a banking organization to reduce the amount of its goodwill deduction from tier 1 capital by any associated deferred tax liability.

The Agencies are proposing to amend their respective capital rules to permit a banking organization to reduce the amount of goodwill it must deduct from tier 1 capital by the amount of any deferred tax liability associated with that goodwill. However, a banking organization that reduces the amount of goodwill deducted from tier 1 capital by the amount of the associated deferred tax liability would not be permitted to net this deferred tax liability against deferred tax assets when determining regulatory capital limitations on deferred tax assets. The proposed change would permit a banking organization to effectively reduce its regulatory capital deduction for goodwill to an amount equal to the maximum regulatory capital reduction that could occur as a result of the goodwill becoming completely impaired or derecognized.

This would increase a banking organization's tier 1 capital, which is used to determine the banking organization's leverage ratio and risk-based capital ratios. The Agencies request comment on all aspects of this proposal. Specifically, the Agencies request comment on the impact that the proposed treatment could have on a banking organization's regulatory capital ratios.

The Agencies are considering for purposes of any final rule whether they should extend the treatment proposed for goodwill to other intangible assets acquired in a taxable business combination that currently are not deductible from tier 1 capital net of associated deferred tax liabilities. Accordingly, the Agencies request comment on whether they should permit any additional intangible assets to be deducted from tier 1 capital net of associated deferred tax liabilities. For such assets, the Agencies request information regarding the type of intangible asset and an estimate of the potential impact on banking organizations' capital ratios from extending this proposal to cover those assets, as well as any other relevant data or pertinent information.

FDIC Report Highlights Suggestions for Expanding Mortgage Loans to Low and Moderate Income Households

On September 4, 2008 the FDIC issued a report on the ways that mortgage lenders can responsibly and profitably expand the availability of home loans to low and moderate income borrowers and still make a profit.

The disruptions of available credit for mortgages in the lower-income borrowers are affecting those with low to moderate incomes opportunities for homeownership. The Census Bureau reports that the national homeownership rate was about 68 percent as of the

second quarter 2008. However, the homeownership rate is only about 52 percent for those households with below median incomes. Additionally, data from the Federal Reserve's 2004 Survey of Consumer Finances, show that homeownership of the bottom fifth of all earners, is the lowest rate, about 40 percent.

The report was a summary of best practices discussed by participants at the FDIC forum on July 8, 2008 on

problems in the mortgage market. The best practices include:

- Back to basics underwriting - Basic, traditionally underwritten, 30-year fixed rate mortgages are the most suitable mortgages for most low and moderate income borrowers.
- Incentives/Compensation - Ensure that all parties to a mortgage transaction have a long-term stake in the outcome of the transactions.
- Transparency and Due Diligence - Improved transparency throughout the mortgage process is critical to reviving the secondary market.

- Expanding existing products and innovations - A variety of existing and proposed products and processes may increase the availability of low and moderate income mortgage credit, including extending amortization schedules, expanding alternative underwriting processes for consumers with limited credit history, and creating innovative insurance products to address temporary income disruptions, among other things.
- Public/Private Partnerships - Partnerships with community organizations, nonprofit corporations, banks, borrowers, local government, and others facilitate credit enhancements and home ownership counseling that makes responsible low and moderate income mortgage lending possible.

Changes to FDIC Deposit Insurance Rules for Revocable Trust Accounts

The FDIC has adopted an interim regulation simplifying the rules for insuring revocable trust accounts - commonly known as payable-on-death accounts and living trust accounts. The new rules are easier to understand and apply, and provide at least as much coverage as the former rules for revocable trust accounts. The revised rules take effect on September 29th and apply to all existing and future revocable trust accounts at FDIC-insured institutions. The FDIC welcomes comments on the interim rule for 60 days after its publication in the Federal Register.

Under the interim rule:

- The concept of "qualifying" beneficiaries based on certain family relationships has been eliminated.
- For each account owner with combined revocable trust deposit balances of \$500,000 or less at a

single bank, the maximum coverage will be determined by multiplying the number of different beneficiaries by \$100,000. (This will apply to the vast majority of revocable trust accounts.)

- For each account owner with combined revocable trust deposit balances of more than \$500,000 and more than five named beneficiaries, coverage is the greater of \$500,000 or, as before, the aggregate of all beneficiaries' proportional interests in the trust deposits, limited to \$100,000 per beneficiary.
- In determining coverage for living trust accounts, a life estate interest is valued at \$100,000.
- Irrevocable trusts that spring from a revocable trust upon the death of the revocable trust owner will continue to be insured under the revocable trust rules.

FINCEN Clarifies Application of Money Transmitter Definition for Brokers or Dealers in Currency

On September 10, 2008, FinCEN issued interpretive guidance FIN-2008-G008, to clarify whether a person who conducts transactions in currency or other commodities is a money services business (MSB) for purposes of complying with the Bank Secrecy Act and its implementing regulations. This guidance addresses whether a broker or dealer in currency or other commodities is a money transmitter when, in the ordinary course of business, the broker or dealer accepts and transmits funds in order to effect transactions in currency or other commodities for or with a customer.

The guidance states that, when a broker or dealer transmits funds solely to effect the *bona fide* purchase or sale of currency or other commodities, they are not engaged in the business of transferring funds and are therefore not a money transmitter. In such circumstances, the transmission of funds is a

fundamental element of the actual transaction necessary to execute the contract for the purchase or sale of the currency or the other commodity. The transmission of funds is not a separate and discrete service provided in addition to the underlying transaction. It is a necessary and integral part of the transaction.

- FinCEN cautions that this guidance is limited to circumstances in which a broker or dealer in currency or other commodities accepts and transmits funds as an integral part of the execution and settlement of a transaction other than the funds transmission itself. The guidance indicates that a broker or dealer in currency or other commodities is not solely engaged in the execution and settlement of a purchase or sale of currency or other commodities when it transfers funds between a customer and a third party that is not party to the transaction.

Fragmented Markets: FINRA Conference Takes on the Credit Crisis, ARS, Information Barriers and a New Regulatory Environment

On September 9, the Financial Industry Regulatory Association (FINRA) hosted its annual NY Regulation and Compliance Conference at the Waldorf Astoria Hotel, an event focused on discussing regulatory requirements and compliance practices of large, multi-line broker/dealer firms and businesses.

This year's conference was a lively forum, where current topics such as the implications of the government bailout of Fannie Mae and Freddie Mac, the collapse of the Auction Rate Securities market, and the credit crisis took center stage with other areas of interest, including limitations to the existing regulatory structure, maintaining information barriers, and FINRA's efforts to

integrate the NASD and the member regulation operations of the NYSE.

Reconsidering the Regulatory Structure

Grace Vogel, Executive Vice President of FINRA, opened the conference with an address that spoke to the immediate concerns of the participants – managing risk in a volatile market and the ability of the existing regulatory structure to help prevent other crises like the current credit crunch. Ms. Vogel advised that financial firms are facing a world where they must “prepare [themselves] to fight a new war against risk, operating under new assumptions and using innovative tactics.”

In a market where risk management systems broke down colossally, Ms. Vogel stressed that market participants must recognize that the structural risks inherent in our modern financial system no longer impact one institution or sector at a time; risk now reverberates throughout the marketplace in an instant, threatening firms and exposing investors to harm. To this end, Ms. Vogel indicated that the regulatory structure that has been in place for decades needs to be placed under a microscope and reconsidered.

Referencing the US Treasury's Blueprint for a Modernized Regulatory Structure, Ms. Vogel made clear that the current, highly-fragmented regulatory structure lacks the coherence to most effectively deal with a financial crisis like the current one and needs to be revised to address the problems in a more comprehensive way.

Like the Blueprint, Ms. Vogel traced the problem of the regulatory structure to the limits of functional regulation, "When each regulator is focused on a single product line, whether it is banking, securities, or insurance, there is no one surveying the overall market. And when no single regulator has the full picture, systemic risks are left either unchecked or may even go unnoticed."

Ms. Vogel believes FINRA is doing its part in this effort, most notably through its very own formation and subsequent integration of the NASD and the member regulation operations of the NYSE. According to Ms. Vogel, some of the key advantages of combining these regulatory bodies have been (1) the creation of a consolidated examination process; (2) a combined enforcement team; (3) an integrated technology platform; and (4) a consolidated rulebook.

These thoughts were echoed during the first plenary session where panelists James Donovan, Steve Luparello, Marc Menchel, and Tom Selman, all members of FINRA's executive leadership, discussed emerging regulatory issues, trends and priorities. Each panelist also discussed what specific efforts have been

undertaken to help make FINRA a unified and integrated regulatory body.

Mr. Donovan, a new member of FINRA's management team, also stressed that the seminal topics of the day (e.g., ARS, the credit crunch) remind firms that no matter how well FINRA and other regulatory organizations try to regulate effectively, there will always be "white spaces that cannot be contemplated until they have actually happened." As such, Mr. Donovan further emphasized the need for a more collaborative environment between the regulators, member firms and market participants, where such efforts could help contribute to early identification and curtailment of problems potentially threatening investor protection and market integrity.

Mr. Donovan's observation is a critical point in the context of Ms. Vogel's call for an integrated regulatory approach which deals with issues in a more comprehensive and holistic way. But, it is easier said than done. As one conference participant remarked, for the most part, regulatory bodies here in the U. S. spend the majority of their time performing examinations, executing enforcement actions, and conducting sweeps. Though these actions are necessary to keep the industry in check, they limit the opportunities for such bodies to reflect on root causes and develop strong principles-based rules which could be implemented and applied in an effort to prevent other future, unanticipated crises and maintain market stability.

Consolidated FINRA Rulebook

In his comments regarding the consolidated rulebook, Mr. Menchel indicated that FINRA's approach to rewrite the rules is not based on a general framework (i.e., rules-based or principles-based), but rather by a more specific rule-by-rule examination of both the NASD rules and Incorporated NYSE rules, filtering out obsolete or otherwise duplicative rules, and creating combined rules driven by rules- or principles-based considerations, as appropriate.

Though such efforts build on the harmonizing work that was conducted before the consolidation of the two regulatory bodies, it is possible that FINRA is missing out on an opportunity to really step back and reconsider its overall approach to regulating the industry. An ambitious undertaking like the Treasury's plan may not be necessary, but the current approach of going rule-by-rule may inevitably lock FINRA within the old regulatory system framework, which may be too dated to address the highly-fragmented regulatory structure that Ms. Vogel expressed concerns about or possibly irrelevant to the multi-line businesses that now dominate the industry.

At the second plenary session, FINRA executives Bob Errico, Tom Gira, Susan Merrill, Dan Sibears and Grace Vogel joined Bill Brodows of the Federal Reserve Bank of New York to discuss examination and enforcement priorities.

Government Bailout of Fannie and Freddie

The session began with a briefing regarding some of the initial implications of the government's bailout of Fannie and Freddie. Some considerations included:

- The impact of not extending margin value in Fannie and Freddie's securities;
- The triggering of more than \$1 trillion in credit default swaps ("CDS") tied to Fannie/Freddie and the operational overload expected when settling these transactions; and
- The SEC's indication that Fannie and Freddie securities cannot be used to satisfy reserve deposits for reserve bank accounts.

The panel members indicated that FINRA was also concerned about the extent to which there may have been information leaked about the government's takeover and whether there was insider trading taking place in advance of the announcement. This observation made for a natural segue to the next major topic, information barriers.

Information Barriers

Heightened concerns regarding information barriers have been a high priority at FINRA over the last year, starting with a sweep of eight member firms in January. In particular, FINRA is examining how firms are enforcing procedures around the flow of material non-public information (MNPI). The sweep is looking to see whether firms:

- Have procedures concerning information barriers around MNPI;
- Are enforcing their procedures;
- Are regularly looking at trading activity;
- Have other flows of information throughout the firm that were not captured in the firm procedures; and
- Consider other information flows outside the firm to clients and affiliates and other entities.

Though the sweep is still ongoing, Ms. Merrill indicated that FINRA was pleased with what it was seeing at the selected firms and will look to publish guidance on best practices. Some of these practices will advise member firms to:

- Determine whether their procedures are geared specifically to the conduct that they are attributed to;
- Consider the language employed within their procedures, including how certain terms are defined, and whether the actions the language is committing the firm to is something the firm can conduct and perform properly; and
- Establish procedures as to when and why something should be placed on the Watch List, with an outlined approach to conducting the proper analysis and determination while providing clarity as to how those decisions are ultimately made.

Throughout the conference, panelists regularly pointed out that FINRA is seeing a substantial increase in the number of insider trading cases it is referring to the SEC for enforcement, with the number of referrals through August already surpassing last year's total for the entire year.

FINRA anticipates that prioritizing reviews of information barriers in exams as well as the recent agreement with ten U.S. exchanges to consolidate the surveillance, investigation and enforcement of insider trading, will bolster the success of trade surveillance programs, help identify and curb the potential misuse of MNPI and prevent manipulation in the securities markets.

Collapse of Auction Rate Securities Market

Also in the limelight was FINRA's review of forty mid-tier member firms suspected of potential mishandling of ARS. In its investigations, FINRA is:

- Reviewing marketing and advertising materials distributed both internally and externally;
- Examining when firm proprietary positions were exited;
- Considering when and how bids were placed on behalf of customers in auctions and whether firms put in supporting bids;
- Investigating when firms had notice of fails in auctions; and
- Researching the number of complaints received regarding firms under review.

To date, FINRA has found instances of supervisory negligence as well as marketing and advertising violations.

Observations regarding concerns around marketing and advertising practices were stressed as a general concern FINRA had with its member firms, particularly with regard to unbalanced and misleading disclosures.

In commenting on lessons learned from this crisis, the panel advised that member firms consider:

- What securities are marketed as “cash-equivalents,” particularly with regard to bank sweep products and money-market instruments;
- Whether products once identified as “cash-equivalents” should still be considered as such, given market dynamics, and implementing a program to review these securities more regularly to validate such designations; and
- Whether marketing and advertising materials sufficiently disclose the risks inherent in securities marketed as “cash-equivalents.”

Managing Conflicts Across Multi-Line Businesses

In addition to the two general plenary sessions, the conference also featured breakout sessions, including a panel discussion on managing conflicts across multi-line businesses. Susan Axelrod of FINRA introduced this session by reminding participants that the conference represented the five year anniversary of former SEC Director of Enforcement Steven Cutler's call to financial services firms to undertake a top-to-bottom review of business operations with the goal of addressing conflicts of interest of every kind.

In light of the milestone, Ms. Axelrod invited industry panelists Stuart Breslow of Morgan Stanley, Alan Cohen of Goldman Sachs, and David DeMuro of Lehman Brothers – all global compliance heads – to discuss the ways whereby their respective firms responded to Mr. Cutler's mandate to identify and mitigate conflicts.

After describing the somewhat different approaches each of their firms took to conduct and institutionalize conflicts reviews as well as the efforts they took to present their findings to the regulators, the industry panelist turned the tables on the FINRA panelists and indicated that there was a “resounding silence” from the regulators in terms of a response back with homogenized findings the member firms could use as a

best practices model, an expectation and goal, Mr. Cohen reminded, that was set by Mr. Cutler himself.

Given that these reviews were conducted at some cost to the firms, as well as enormous time and resource investments, the industry panelists challenged FINRA to come back next year and present some of the broad areas of conflicts that member firms described in their presentations as well as accepted practices to be employed in the mitigation or remediation of such conflicts.

The colorful, but friendly, banter accentuated an obvious tension many of the member firms have with their regulators as well as the challenge in creating the collaborative environment Mr. Donovan called for in the general plenary: prudential regulation can only begin with an ongoing, open and constructive dialogue between the regulator and the regulated firm. If regulated firms cannot be confident that they can discuss with the regulators specific issues and questions, and that the regulators will be willing to provide useful and timely advice as to how to comply with relevant regulations, confidence in the regulatory scheme will continue to erode.

Gifts and Business Entertainment

Also contributing to the spirited dialogue was the topic of gifts and business entertainment, particularly the \$100 limit on gifts to a single recipient per calendar year. The consensus amongst the industry panelists was clear: the amount of time, money, technology and human resources dedicated to accurately capture and

aggregate spending details to assure that no one individual receives a gift in violation of the rule completely “undermines the integrity of the compliance effort of a sophisticated organization.” As Mr. Cohen indicated, a “principle-based rule would have been a much sounder approach to this issue,” particularly when this is the method for handling business entertainment.

FINRA contended that a principle-based approach in this instance would not resolve the issue, as it would only lead to an increased number of calls requesting clarification on what the “magic number” might be, thus reverting the matter, essentially, to a rules-based issue. Though this point is arguable, it underscores the fact that many of the larger firms within the industry may be willing to shift to a principles-based regulatory structure in some instances, but it will only be effective if the regulators enforce the rules as such.

Additional Information

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