

# Financial Services Regulatory Highlights\*

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## Supreme Court Upholds Federal Preemption of State Law For Mortgage Banking Activities Conducted Through Operating Subsidiary

On April 17, 2007, the United States Supreme Court, in a 5 to 3 decision, held that a national bank's mortgage business, whether conducted by the bank itself or through the bank's operating subsidiary, is subject to regulation and supervision by the Office of the Comptroller of the Currency ("OCC") and not to the licensing, reporting, or visitorial regimes of the several States in which it operates. The case -- *Watters v. Wachovia Bank, N.A.* -- arose when Michigan's Office of Insurance and Financial Services ("OIFS") had determined that Wachovia Mortgage Corporation ("WMC") would no longer be authorized to engage in business in Michigan after it surrendered its Michigan registration once it became a wholly-owned operating subsidiary of Wachovia Bank, N.A. ("Wachovia"), a national bank. Wachovia sued the OIFS for declaratory and injunctive relief against the prohibition and won at both the District and Appellate Court levels. The OIFS petitioned the Supreme Court for review.

In support of its holding, the Supreme Court majority noted that, in a long line of cases, the Court has "focused on the exercise of a national bank's powers, not on its corporate structure." The States are not permitted to regulate the activities of national banks, whether conducted directly or indirectly through an operating subsidiary, when doing so significantly impairs the exercise of authority, whether enumerated or incidental under the National Banking Act. The Court concluded that the exercise of registration, inspection and enforcement regimes by the States would indeed impair the real estate lending authority of national banks by subjecting them to diverse and duplicative regulation and oversight. The fact that these activities were conducted through operating subsidiaries did not change the Court's conclusion, noting that for supervisory purposes the OCC treats national banks and their operating subsidiaries as a "single economic enterprise."

The Court's Majority made clear that its decision was based on the language and history of the National Bank Act itself and not on regulations issued by the OCC for purposes of preempting state laws in this area. In doing so, the Majority sidestepped the view of the Dissenting Minority who saw the case primarily as one about the power of an administrative agency -- the OCC -- to issue regulations preempting State laws.

Comptroller Dugan expressed pleasure "that the Court's decision supports the ability of national banks to continue to conduct business activities in their operating subsidiaries as they are now doing. The agency will continue to supervise national banks and their subsidiaries to assure that their customers are treated fairly and receive the strong protections available under federal laws and regulations."

The Conference of State Bank Supervisors said it was "deeply disappointed" in the high court ruling. "We see it as a setback for financial consumers and state efforts to battle predatory lending, abusive mortgage lending practices and mortgage fraud," said CSBS President and CEO Neil Milner. Milner said CSBS will continue to pursue a more seamless and coordinated state regulatory system.

House Financial Services Committee Chairman Barney Frank said he would hold a hearing in June to ensure OCC and OTS have the enforcement authority to carry out the consumer protection function that they need. Senate Banking Committee Chairman Christopher Dodd said, "I plan to carefully examine today's Court's decision and

to consider with equal care its impact on the future of bank regulation. In doing so, I intend to look closely at the commitment displayed by federal banking regulators to upholding their safety and soundness duties and their equally important consumer protection and enforcement responsibilities."

Beyond concluding that the benefits of federal preemption extend to operating subsidiaries of national banks, the Court's explicit reliance on the National Bank Act and its decision not to enter the thicket of whether and to what extent an agency, like the OCC, can adopt regulations preempting State law, emphasizes that preemption is ultimately the responsibility of the Congress. As new legislation is considered, it is reasonable to expect that the debates on what should and should not be preempted will only increase, especially in areas of consumer protection. The Federal/State dialogue is thus likely to remain lively and contentious in the Congress as financial institutions seek greater national uniformity and the States seek greater control over protections for their local citizens.

If you any questions about this article, please contact Gary Welsh.

## A Risk-Based Approach to NASD Rule 3012 Testing

The cost of compliance is at an all time high in the securities industry and securities firms are continually looking for opportunities to execute their compliance responsibilities more efficiently. While industry regulators are not opposed to "more efficient" compliance, they believe those efficiencies must be achieved without impairing the effectiveness of compliance. Implementing a risk-based approach to the supervisory control testing required by NASD Rule 3012 is one way many firms can improve both the efficiency and effectiveness of an existing compliance process.

Rule 3012 requires securities firms to implement a process to test that their system of supervisory controls is adequately designed to ensure compliance with applicable securities laws, rules and regulations. The firm's CEO must annually certify that this process

is in place. In 2005, the first year after the NASD implemented Rule 3012, many firms scrambled to implement a 3012 testing process and most firms covered the entire spectrum of applicable laws and rules and the related supervisory processes in their testing. In 2006, many firms followed the same approach and tested the entire supervisory control environment. As with the first year of testing, many firms found themselves rushing to complete their 2006 testing in time to issue the NASD 3012 report prior to the CEO certification deadline of April 1, 2007.

As firms begin their third year of supervisory controls testing and reporting under NASD Rule 3012, many are evaluating how they can improve the effectiveness of their existing program. Instead of completing testing of every area, many firms are considering, or have implemented, a risk-based approach to their supervisory controls testing. A risk-based approach permits firms to focus limited testing resources on those higher risk compliance issues, improving both the efficiency and the effectiveness of the testing program.

Implementing a risk-based NASD 3012 testing approach that will meet regulatory expectations, however, requires careful planning and a formalized methodology and process. Some of the key elements of an effective risk-based 3012 testing program include:

- A clearly defined and consistently applied risk assessment methodology;
- An initial, comprehensive compliance risk-assessment of the firm and periodic (but regular) compliance risk re-assessments;
- A risk-based testing plan that focuses on those higher risk compliance requirements, but ensures that all compliance and supervisory controls are regularly tested; and
- Detailed documentation of the risk assessment methodology, the risk assessment process and the risk-based testing plan.

### **Risk Assessment Methodology**

Failing to comply with an applicable law, rule or regulation can create financial, legal, reputational, strategic and other risks for a securities firm. The objective of a risk-based approach to compliance and supervisory control testing is to focus testing resources on those compliance issues that generate the highest level of risk to the firm. Categorizing and defining the risks is the initial step in establishing a risk-based approach to 3012 testing. One method to stratify the levels of risk created by various compliance requirements is to identify the level of "residual" risk. "Residual risk" is the level of risk remaining after considering the effect of any "mitigating controls" on the "inherent risk" of a compliance requirement.

When determining the "inherent" risk of a compliance requirement, firms should consider both issue specific risks and those risks that are unique to the business. For example, issues that are a current focus of the NASD or SEC or of law enforcement agencies may be higher risk issues. Other considerations may be how recently the rule or regulation was issued, the level of media attention on the

issue or whether the issue creates potential private litigation risk. Business-specific factors to consider in rating the "inherent" risk of a requirement include whether the firm has been criticized on that issue in the past (by auditors or regulators) or whether the issue poses a particular risk to the firm's business or customers.

### **The Compliance Risk Assessment**

A firm implementing a risk-based approach should begin by conducting a firm-wide compliance risk assessment. All of the laws, rules and regulations identified and tested under the 3012 process should be included in this assessment and their level of "inherent" risk to the firm determined and rated utilizing methodology defined specifically for that firm.

The next step in the risk assessment is to evaluate the existing "mitigating controls." During the first two years of 3012 testing, firms should have been evaluating the effectiveness of existing compliance and supervisory controls. Firms should ask themselves how effective these controls are and how much of the "inherent" risk created by a compliance requirement is mitigated by those controls. The "residual risk" rating essentially identifies the level of risk that has not been addressed by existing controls.

The level of sophistication in rating or scoring the levels of risk varies significantly by firm. Some firms have implemented sophisticated scoring models while other firms utilize a more simplistic and subjective approach (such as high, medium, low). Either approach can be effective and the appropriate approach will depend on the nature of the firm, its business profile and its approach to risk management. Some firms with existing risk and control assessment or risk-based audit processes may use or leverage those processes as part of their compliance risk assessment.

## **Risk-Based Testing Plan for 3012 Testing**

Once the level of residual risk has been determined for each compliance issue and a risk rating assigned, a firm must weigh the impact of the various ratings. How will the level of risk determined for each compliance issue impact the frequency and rigor of testing? While the compliance and supervisory controls for all of the applicable compliance requirements should be covered by the testing plan, some just may not be tested every year.

The supervisory controls addressing the highest risk compliance areas should be subject to the most rigorous and most frequent supervisory control testing under the NASD 3012 testing program. Even where the mitigating controls have reduced the overall "residual risk" of an issue, it is still important to review the controls related to those high risk issues annually to confirm that the controls are operating effectively. Firms should ensure that those higher risk areas are tested by groups with the appropriate level of experience and expertise.

Firms may determine that the compliance and supervisory controls over the compliance issues determined to be the lowest risk issues do not need to be tested every year. Firms should document in their NASD 3012 testing plans their rationale for testing lower risk issues on a more infrequent basis. As noted above, while the compliance and supervisory controls for the lower risk issues may not need to be tested every year, they must still be subject to regular testing.

### **Documentation of the Risk-Based 3012 Testing Program**

A risk-based testing approach permits firms to reduce their 3012 testing scope each year based on their determination of compliance risk to the firm. A risk-based approach is not, however, a tool that can be used at the end of the testing year to arbitrarily determine that an issue is low risk and does not need to be tested during that 3012 review year. Firms must be able to demonstrate to regulators that the risk assessment process is a formal process that is consistently applied each year. It is therefore very important that

firms clearly document their risk-based methodology, their approach to conducting their risk assessment and their risk-based testing plan. They should also clearly document the results of their initial and ongoing risk assessments.

### **Conclusion**

The securities industry is subject to an all-time high level of compliance testing and compliance costs. Just the testing required under NASD Rule 3012/NYSE Rule 342, SEC Rule 38a-1 (Mutual Funds) and SEC Rule 206(4)-7 (Advisers) are stretching firms testing resources. SOX 404 and internal audit testing are other significant drags on testing resources and on the business units being tested.

Implementing a risk-based approach ensures that testing resources are appropriately focused on the compliance issues that pose the most risk for the firm. By better allocating testing resources, firms can begin to improve the efficiency of the NASD 3012 testing process and potentially reduce compliance costs. At the same time, by using a risk-based approach firms are also able to ensure that the most experienced resources can focus their attention on higher risk issues improving the overall effectiveness of the testing program. A formally implemented risk-based 3012 testing program can therefore meet the objectives of both industry participants and industry regulators.

If you have any questions about this article, please contact David Sapin.

## **AML Issues in Trade Finance**

Although many financial institutions have anti-money laundering ("AML") programs in place, trade finance operations are becoming an increasingly important issue for both the government as well as regulators due to the lack of transparency in these types of financial transactions.

The Department of the Treasury's OFAC is charged with enforcing & administering the US government's economic and trade sanctions. OFAC is concerned with AML issues and trade-based money laundering issues in so far as they relate to sanctions targets or may be designed

to evade sanctions. Additionally, member regulatory agencies of the Federal Financial Institutions Examination Council ("FFIEC"), as well as government officials, expect banks to have a robust OFAC compliance program. For example, certain trade finance transactions involve multiple parties, some of whom may be sanctioned by OFAC. Currently, all transactions (including trade finance transactions), are prohibited with Cuba, Iran, and Sudan. Additionally, there is a comprehensive ban on the export of financial services to Burma (or Myanmar).

Bankers and other trade finance professionals should also be familiar with the OFAC Specially Designated Nationals List (SDN List), which contains approximately 3000 unique entities sanctioned by the Department of the Treasury. Any trade finance transaction with these entities is prohibited without a license or other authorization from OFAC. It is important that all trade finance transactions and documentation be carefully screened for these sanctioned references. Because letters of credit are documentation driven, screening is usually performed manually for bills of lading, invoices, shipping documents, and similar. If the details are contained in a SWIFT message, then most banks rely on "key word" searches in the free text areas.

Trade finance operations such as open accounts, cash-in-advance, letters of credit, and documentary collections typically require a funds transfer for actual settlement. Screening all parties in the reference fields in the payment instructions has become a recognized practice within the industry. Fields such as originator-to-beneficiary, or information in the bank-to-bank fields should also be screened for any sanctions references.

Messaging documents, such as the MT-202s (cover payments), may pose a higher money laundering risk due to the lack of transparency in the underlying transaction. Similarly, information regarding the originator and beneficiary addressed in the MT-103s can also be easily manipulated in an effort to evade screening. These forms are in the process of being updated.

Letters of credit also pose a unique problem in that they are less transparent than typical trade finance transactions due to the fact that they usually involve multiple parties and use of documents (e.g., bills of lading, shipping manifests, invoices, and similar), they may be more susceptible to fraud. Regulators are expecting financial institutions and trade finance professionals to perform additional due diligence on "all" relevant parties to a letter of credit

transaction. This may require requesting more documentation than has been required in the past.

The Bank Secrecy Act (BSA) compliance and risk management concepts found within the BSA/FFIEC Examination Manual are the same concepts that should be applied to the trade finance area. The focus for financial institutions should thus be on the design and implementation of an appropriate suspicious activity monitoring process. Typical risk factors associated with a trade finance department include:

- Multiple parties to each transaction (e.g., correspondent banks located in countries that do not have comparable transaction disclosure requirements);
- Document-based transactions, which typically require manual review and do not adhere to any specific format (e.g., import/export documents, bills of lading, shipping manifests, invoices, etc.);
- High-risk goods subject to manipulation (e.g., jewelry or precious metals, etc.); and
- Circumventing OFAC sanctions and other prohibitions.

There are also *red flags* that trade finance personnel should be aware of, for example:

- Over-and-under invoicing of goods and services;
- Over-and-under shipment of goods and services;
- Multiple invoicing of goods and services; and
- Falsely described goods and services.

In the end, the most important thing a financial institution can do to mitigate its risk is to implement and maintain strong *Know Your Customer* and Customer Due Diligence programs. Keep in mind that the key internal controls within trade finance are still the

suspicious activity monitoring and reporting processes.

Trade finance-related BSA compliance and money laundering risk management processes need to be an extension of the bank's BSA overall compliance program. BSA program elements should be incorporated within trade finance policies and operational procedures. Strong relationships between the BSA officer and an institution's trade finance experts will also help banks achieve a

balance in meeting the expectations of the regulators while maintaining an effective and efficient process.

If you have any questions about this article, please contact Jeff Lavine or Andy Stines.

## The President's Identity Task Force Releases Comprehensive Strategic Plan to Combat Identity Theft

On April 23, 2007, The President's Identity Task Force released a comprehensive strategic plan to combat identity theft.

The plan focuses on the following:

- Improving the effectiveness of criminal prosecutions for identity theft;
- Enhancing data protection for sensitive consumer information maintained by the public sector, private sector, and consumers;
- Providing more comprehensive and effective guidance for consumers and the business community; and
- Improving recovery and assistance for consumers.

The recommendations include the following:

- Reduce the unnecessary use of Social Security numbers by federal agencies, the most valuable commodity for an identity thief;
- Establish national standards that require private sector entities to safeguard the personal data they compile and maintain and notify consumers when a breach occurs that poses a significant risk of identity theft;
- Implement a broad, sustained awareness campaign by federal agencies to educate consumers, the private sector and the public sector on methods to deter, detect and defend against identity theft; and
- Create a National Identity Theft Law Enforcement Center to allow law enforcement agencies to coordinate their efforts and

information more efficiently, and investigate and prosecute identity thieves more effectively.

The plan also includes several legislative proposals, including:

- Amending the identity theft and aggravated identity theft statutes to ensure that identity thieves who misappropriate information belonging to corporations and organizations can be prosecuted;
- Adding new crimes to the list of offenses which, if committed by identity thieves in connection with the identity theft itself, will subject those criminals to a two-year mandatory sentence available under the "aggravated identity theft" statute;
- Broadening the statute that criminalizes the theft of electronic data by eliminating the current requirement that the information must have been stolen through interstate communications;
- Amending existing statutes to assure the ability of federal prosecutors to charge those who use malicious spyware and keyloggers; and
- Amending the cyber-extortion statute to cover additional, alternate types of cyber-extortion.

# Federal Regulators Issue Statement to Encourage Institutions to Work with Mortgage Borrowers to Make Their Payments

On April 17, 2007, the Federal Regulators issued a Statement encouraging financial institutions to work with homeowners who are unable to make their mortgage payments.

Many residential borrowers will face payment increases when the initial fixed rate of their adjustable-rate mortgage ("ARM") is reset according to the adjustable terms of the loan..

The agencies encourage financial institutions to consider prudent workout arrangements with borrowers. Arrangements that are consistent with safe and sound lending practices are generally in the long-term best interest of both the institution and the borrower. Institutions who workout reasonable arrangements with borrowers will not face regulatory penalties.

Constructive workout arrangements include modifying loan terms and/or moving borrowers from variable-rate to fixed-rate loans.

## Comptroller Dugan Discusses the Evolution of Community Reinvestment Act

On April 20, 2007, Comptroller Dugan discussed the evolution of the Community Reinvestment Act ("CRA") and the effectiveness of OCC regulation in a speech to the Greenlining Coalition's Annual Economic Summit.

The Comptroller expressed concern about the growing number of loan defaults and foreclosures and said that the OCC has been taking steps to address those issues for some time.

Some critics have argued that preemption has created a safe haven for abusive lenders, since, according to the critics, the OCC does not engage in consumer protection regulation. They also argue that preemption has prevented these states from taking effective action of their own.

In challenging this criticism, Comptroller Dugan said that "... the mortgage lending activities of national banks are in fact subject to

Bank and thrift programs that transition low-or moderate-income homeowners from higher-cost loans to lower-cost loans may receive favorable consideration under the Community Reinvestment Act ("CRA").

Institutions must inform delinquent borrowers about the availability of homeownership counseling under the Homeownership Counseling Act. Institutions should also consider working with a reputable consumer-based organization to help financially stressed borrowers avoid predatory lending.

extensive regulation, a significant part of which is expressly designed to prevent predatory lending."

The OCC was the first federal banking agency to issue comprehensive anti-predatory lending guidance and regulations specifically applicable to the institutions it supervises; and it was the first to undertake an enforcement action against unfair and deceptive practices under Section 5 of the Federal Trade Commission Act.

National banks have originated less than 10 percent of all subprime mortgages last year, and the delinquency rates for those loans have been less than half of the industry average. "We believe there is a reason for these results, Comptroller Dugan stated. "Our regulation and

supervision of subprime mortgage lending of national banks and their operating subsidiaries, while not perfect, has been effective."

"Whatever one says about national bank preemption, it certainly has no effect on the ability of states to enforce state laws against state chartered entities over which they have exclusive jurisdiction, and it certainly doesn't handcuff state efforts to prevent those state-regulated lenders from making loans that borrowers have no reasonable prospect of repaying," he said.

"Sound underwriting that realistically evaluates a prospective borrower's ability to repay an obligation, and timely information that enables borrowers to understand the terms, costs, and risks associated with a loan are not just matters of fairness -- they're good business," he said. "I believe that all lenders and regulators should share these common goals: that borrowers be treated fairly

and responsibly, and that credit remain available to the creditworthy."

Mr. Dugan concluded that "[s]ome national banks, at least in part due to CRA, are ponying up real money to address a problem not really of their making, while a number of very large financial firms that have been much more heavily involved in adjustable rate subprime lending have made no similar commitments. I know that Greenlining has urged a number of nonbanks to make voluntary CRA-like commitments, with some success. Maybe that's a thought worth thinking on a much larger scale."

## CFTC and FinCEN Issue Guidance on the Application of CIP Rules to Give-Up Arrangements

On April 20, 2007, the Commodity Futures Trading Commission ("CFTC") and the Financial Crimes Enforcement Network ("FinCEN") issued guidance on the application of customer identification program ("CIP") rules to give-up arrangements in the futures industry.

The guidance, which clarifies the 2003 CIP regulation for futures commission merchants ("FCM"), is being issued in response to a request from the Futures Industry Association.

The request asks whether FCMs acting solely as executing brokers in give-up arrangements are required to comply with CIP requirements.

The guidance explains that a clearing broker in give-up arrangements is required to comply with CIP requirements because

they establish a formal relationship with a futures and options customer when they open an account. Executing brokers, under a limited exception, do not establish a formal relationship that would require them to apply their CIPs to such futures and options customers.

The guidance also reminds FCMs that they must have an anti-money laundering program, which should contain risk-based policies, procedures and controls for assessing the money laundering risk posed by its operations, including its execution brokerage activities; for monitoring and mitigating that risk; and for detecting and reporting suspicious activity.

## SEC Approves NASD Interpretation of Mark-Up Policy for Transactions in Debt Securities

On April 16, 2007, the SEC approved the NASD proposed rule change to adopt an additional mark-up policy for transactions in debt securities other than municipal securities. The Proposed Interpretation, IM-2440-2 ("proposed interpretation") will provide

guidance to dealers for calculating fair prices and mark-ups in compliance with NASD Rule 2440.

The proposed interpretation provides that when a dealer calculates a mark-up or mark-down, the best measure of the prevailing market price of the security presumptively is the dealer's contemporaneous cost or proceeds.

A dealer may seek to overcome the presumption, and show that contemporaneous cost is not indicative of the prevailing market price, in the following instances:

- if interest rates changed enough following the dealer's contemporaneous transaction to reasonably cause a change in the debt security's pricing;
- if the credit quality of the debt security changed significantly after the dealer's contemporaneous transaction; or
- if the news was issued or otherwise distributed, and known to the marketplace, that had an effect on the perceived value of the debt security after the dealer's contemporaneous transaction.

The proposed interpretation sets forth a process that the dealer must follow to determine the prevailing market price, when the dealer has established that its cost is no longer contemporaneous, or when the dealer has presented evidence that is sufficient to overcome the presumption that its contemporaneous cost provides the best measure of the prevailing market price. The dealer must consider a three-factor hierarchy.

1. The pricing of any contemporaneous inter-dealer transactions in the same security
2. In the absence of contemporaneous inter-dealer trades, the dealer must consider the prices of contemporaneous dealer purchases in the same security from institutional accounts with which any dealer regularly effects transactions in that security
3. If contemporaneous inter-dealer trades and dealer-institutional trades in the same security are not available, a dealer must look to contemporaneous bid quotations for the security made through an inter-dealer mechanism through which transactions generally occur at the displayed quotations.

If none of the above factors are available, the dealer may consider a non-exclusive list of four factors:

- Prices of contemporaneous inter-dealer transactions in a "similar" security or prices of contemporaneous dealer transactions in a "similar" security with institutional accounts with which any dealer regularly effects transactions in the "similar" security;
- Yields calculated from prices of contemporaneous inter-dealer transactions in "similar" securities;
- Yields calculated from prices of contemporaneous transactions with institutional accounts with which any dealer regularly effects transactions in "similar" securities; and
- Yields calculated from validated contemporaneous inter-dealer bid quotations in "similar" securities.

At a minimum, a dealer must be able to fairly estimate the market yield for the subject security from the yields of similar securities.

The proposed interpretation would except a qualified institutional buyer ("QIB") that is purchasing or selling a non-investment grade debt security from the definition of customer, when the dealer has determined that the QIB has the capacity to evaluate independently the investment risk and in fact is exercising independent judgment in deciding to enter into the transaction. This exception from the customer definition would also apply to NASD Rule 2440 and IM-2440-1.41. NASD explained that there is less need to protect large institutional customers because they often have sufficient knowledge of the market. NASD also stated that applying the proposed interpretation to generally illiquid market sectors often may yield little or no pricing information useful for calculating mark-ups.

## Washington State Legislature Passes Market Analysis Program

On April 18, 2007, Washington Governor Christine Gregoire signed into law Senate Bill 5717 (2007), establishing a Market Analysis Program for the state's insurance industry. The bill was heavily supported by Washington Insurance Commissioner Mike Kriedler, who is also Chairman of the National Association of Insurance Commissioners (NAIC) Market Analysis Working Group. The bill is based upon model legislation drafted by the NAIC.

According to Kriedler, (as quoted in an NAIC press release) "under a market analysis program, states' market conduct oversight processes are streamlined. By utilizing market analysis, states can monitor companies' current performance instead of past performance, therefore protecting consumers and directing resources toward problem companies."

As outlined in a fact sheet produced by Kriedler's office, a market analysis program consists of several layers of review. The first level provides a cursory review of how insurers are performing and helps identify which insurers warrant a closer review. The next two levels are more in depth and will be useful in determining which companies, if any, require the highest levels of review.

Under the requirements of the bill, insurers must file a market conduct annual statement for each line of business written in the state of Washington. This annual statement is what Kriedler refers to as the first level of review. It is actually a Microsoft Access database, different versions of which exist for the different lines of business. The database was developed by the NAIC's Market Conduct Annual Statement subgroup and can be downloaded at [http://www.naic.org/committees\\_d\\_mcas.htm](http://www.naic.org/committees_d_mcas.htm). It contains numerous data points, including policy counts, replacement counts, claims data, complaint data and more.

The Commissioner may also grant filing extensions and request further information from insurers when additional information is deemed necessary to complete the market analysis. Additionally, the Commissioner is granted the power to adopt rules providing for

access to records and requiring compliance with the data requests. Thus, much power is left in the hands of the Commissioner in determining how to pursue the data gathering needed for the market analysis.

The bill also gives the Commissioner extensive authority in determining which "market conduct actions" to take as a result of the analysis, as long as these actions focus on the general business practices and compliance activities of insurers. This is the second level of review to which Kriedler refers. Within this level of review, the following spectrum of actions may be considered by the Department:

- Correspondence with the insurer;
- Insurer interviews;
- Information gathering;
- Policy and procedure reviews;
- Interrogatories;
- Review of insurer self-evaluations and compliance programs (including membership in a best practices organization);
- Desk examinations; and
- Investigations.

When these market conduct actions are deemed insufficient to address issues identified by the Commissioner, the final level of review, a market conduct examination, may be undertaken. The market conduct exam is to be performed according to NAIC market conduct uniform examination procedures.

## Court Ruling on Fee Based Brokerage Accounts

On March 30, 2007, the U.S. Court of Appeals for the D.C. Circuit issued its opinion in *Financial Planning Association vs. SEC*.

The court ruled in favor of the Financial Planning Association, finding that the SEC exceeded its

statutory authority under Section 202(a)(11)(F) of the Investment Advisers Act of 1940 when it adopted Rule 202(a)(11)-1, which exempted broker-dealers offering fee-based brokerage accounts from registering advisers.

The rule remains in effect until the court issues its mandate, which is expected on or shortly after May 14, 2007.

## 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:

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