

Financial Services Regulatory Highlights*

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DOJ Issues Statement on Proposed Acquisition of CBOT Holdings, Inc. by Chicago Mercantile Exchange Holdings, Inc.

On June 11, 2007, the Department of Justice Antitrust Division issued a statement on its decision to close its investigation of the proposed acquisition of CBOT Holdings, Inc. by Chicago Mercantile Exchange Holdings, Inc. (CME).

The Antitrust Division determined that evidence does not indicate that either the transaction or the clearing agreement is likely to reduce competition substantially. It was determined that although the two exchanges account for most financial futures traded on exchanges in the U.S.:

- Their products are not close substitutes and seldom compete head to head, but rather provide market participants with the means to mitigate different risks; and
- They are, absent the merger, unlikely to introduce new products that compete directly with the other's entrenched products, in part due to the difficulty of overcoming an incumbent exchange's liquidity advantage in an established futures contract.

The Division also looked at whether the combination would lead to less innovation and fewer new products. The evidence suggests that the competition between CME and CBOT has provided them incentive to develop new products; but it is not concluded that the competition is needed to continue to innovate. The two principal impetuses for innovation have been:

- The prospect of winning business from the over-the-counter market; and
- The potential to offer products that the OTC community can use to hedge the risk associated with its activities.

The evidence also suggests that neither the clearing agreement nor the transaction will foreclose entry by other exchanges.

OCC Issues Alert on Fraudulent Correspondence

On June 6, 2007, the Office of the Comptroller of the Currency (OCC) issued an alert on fraudulent correspondence regarding the supposed release of funds under the control of the OCC.

The OCC advises that correspondence in the form of e-mails, faxes, and postal mail allegedly issued by the OCC regarding restricted funds supposedly under its control continue to circulate. Any of these documents that claim the OCC is holding any funds for the benefit of any individual or entity are fraudulent. The OCC does not participate in the transfer of funds for, or on behalf of individuals, business enterprises, or governmental entities. The OCC also does not establish, maintain, or control any deposit accounts for, or in the name of, any individuals, businesses or governments.

These emails are originating from many sources around the world. At a minimum, the OCC recommends that one should:

- Contact the OCC directly to verify the legitimacy of the proposal;
- Not rely on the contact information contained in the correspondence to determine whether or not a proposal is legitimate;
- Review the OCC alerts and related information, which can be accessed on the OCC's website; and
- If the proposal appears to be fraudulent, and it was received by either e-mail or the Internet, please report the incident to the Internet Crime Complaint Center.

OTS Publishes Interim Rule on Personal Transactions in Securities

On June 1, 2007, the Office of Thrift Supervision (OTS) issued an interim rule with a request for comment on Personal Transactions in Securities.

The rule currently requires that certain officers and employees of savings associations file their personal securities transactions within ten business days after the end of each calendar quarter.

The interim final rule changes this period to be consistent with the SEC -- which requires that the personal securities transactions be

filed no later than 30 calendar days after the end of each calendar quarter.

The interim final rule was effective on June 1, 2007. Comments must be received on or before July 31, 2007.

FDIC Publishes *Supervisory Insights* Summer 2007

On June 21, 2007, the FDIC published the summer 2007 edition of *Supervisory Insights*.

This issue covers:

- How banks can manage risks associated with third-party arrangements;

- Need for vigilance toward mortgage fraud;
- Challenges in maintaining wind insurance;
- Electronic exchange of documentation in bank examinations; and
- Recent decisions affecting the accounting for split-dollar life insurance.

FTC Releases Report on Consumer Mortgage Disclosures

On June 13, 2007, the Federal Trade Commission (FTC) issued a report on how to improve consumer mortgage disclosures.

The report from the Bureau of Economics was based on 36 in-depth interviews with recent mortgage customers and the testing of disclosure forms with 819 mortgage customers. The study examined how consumers search for mortgages, how well consumers understand mortgage costs disclosures and the terms of their own recently obtained loans, and whether better disclosures can help consumers understand mortgage costs, shop for mortgage loans, and avoid deceptive lending practices.

The results found that mortgage disclosure forms fail to convey key mortgage costs and terms to many customers. The key findings include:

- Current disclosures failed to convey key mortgage costs to many customers, and better disclosures significantly improved this deficiency;
- With the current disclosures, both prime and subprime borrowers misunderstood key loan terms, and both groups benefited from better disclosures; and
- For complex loans, where prime and subprime borrowers had the most difficulty understanding loan terms, better disclosures provided the greatest benefit.

The study concluded that better disclosures can be created to help consumers understand the costs and terms of mortgages to enable them to make informed decisions about mortgage products.

Comptroller Dugan Discusses OCC Supervision

On June 13, 2007, the Comptroller of the Currency John C. Dugan testified before the House Financial Services Committee that OCC supervision plays an important role to ensure compliance with federal consumer protection standards.

The Comptroller describes OCC supervision as, "supervision first, enforcement if necessary."

The Comptroller also announced a new cooperative initiative with state agencies that aims to curb abuses by mortgage brokers. The initiative involves parallel examinations of OCC regulated national banks and state regulated mortgage brokers. The OCC and state regulators will share information of practices inconsistent with nontraditional mortgage guidance or the pending subprime mortgage guidance.

"The intersection of our regulatory jurisdictions provides a real and useful opportunity to coordinate our efforts -- especially given the recent criticism of mortgage broker practices," stated Mr. Dugan.

Mr. Dugan also discussed the Supreme Court decision of *Watters v. Wachovia*, which deals with national bank preemption. He said that the case does not mark a shift in law, but clarifies accountability.

The Comptroller said that consumers benefit most when state and federal regulators focus on their respected areas of jurisdiction and find productive ways to cooperate.

Mr. Dugan suggested a number of improvements to federal consumer protection regulation:

- Joint agency authority;
- Before issuing regulations, an agency charged with writing consumer protection regulations

- should consult the regulators charged with implementing them;
- Consumer protection laws be updated more regularly to keep up with change; and

- Centralized web site for complaints by consumers of any banking institution.

FTC Releases Staff Comments on Protecting the Military from Predatory Lending Practices

On June 14, 2007, the FTC released staff comments to the Department of Defense (DOD) on its proposed regulation, which would limit terms of credit extended to service members and dependents.

The proposed regulation would amend the existing DOD regulations in order to implement the military lending protections of the John Warner National Defense Authorization Act of Fiscal Year 2007. The proposed regulation would require:

- Oral and written disclosures;
- 36 percent rate cap;
- Prohibitions or restrictions on refinances and renewals by the same creditor;

- Mandatory arbitration;
- Creditor demands for certain notices from borrowers;
- Creditor use of vehicle titles as security; and
- Prepayment penalties or fees.

Violators of these rules would be subject to criminal prosecution and contracts in violation would be void.

The FTC staff supports the proposed regulation because it is tailored to prevent practices that Congress has concluded were causing harm to military consumers.

FinCEN Issues Guidance on Requests from Law Enforcement for Financial Institutions to Maintain Accounts

On June 13, 2007, the Financial Crimes Enforcement Network (FinCEN) issued guidance for financial institutions with an account relationship that law enforcement may have an interest in.

If a law enforcement agency requests that a financial institution maintain a particular account; the financial institution should ask for a written request. A supervisory agent, an attorney within the United States Attorney's Office, or another office within the Department of Justice, should issue the request.

If a state or local law enforcement agency requests that an account be maintained, the written request should come from a supervisor of the state or local law enforcement agency, or from an attorney within a state or local prosecutor's office.

The written request should also:

- Indicate that the agency has requested the financial institution to maintain the account;

- The purpose of the request; and
- The duration for the request (not to exceed six months).

Law enforcement agencies may make subsequent requests after the expiration of the initial request.

FinCEN recommends that financial institutions maintain documentation for at least five years after the request has expired. FinCEN also recommends that if a financial institution is aware -- through subpoena, 314(a) request, National Security Letter, or similar communication -- that an account is under investigation, the financial institution should notify law enforcement before making any decision regarding the status of the account.

Financial Institutions are reminded that they are required to have written policies and procedures to address the identification and

reporting of suspicious activity as part of their Bank Secrecy Act/Anti-Money Laundering compliance program.

FinCEN Issues Guidance on Suspicious Activity Report Supporting Documentation

On June 13, 2007, the FinCEN issued guidance on suspicious activity reporting (SAR) supporting documentation.

The guidance clarifies:

Disclosure of Supporting Documentation to FinCEN and Appropriate Law Enforcement or Supervisory Agencies

A financial institution is required to maintain a copy of the SAR and the original or business record equivalent of any supporting documentation for a period of five years from the date of filing the SAR. The financial institution must provide all documentation supporting the filing of a SAR upon request by FinCEN or appropriate law enforcement or supervisory agency.

The financial institution should verify that a requestor is in fact a representative of FinCEN or an appropriate law enforcement agency. A procedure for such verification should be incorporated into its BSA compliance or anti-money laundering program.

What Constitutes Supporting Documentation

"Supporting documentation" refers to all documents or records that assisted a financial institution in making the determination that certain activity required a SAR filing. The documentation must be identified at the time the SAR is filed.

The financial institution's method for maintaining supporting documentation should be laid out in their anti-money laundering program written procedures.

No Legal Process is Required for Disclosure of Supporting Documentation

There is no requirement for disclosing a customer's financial record when the financial institution provides the financial records or information to FinCEN or a supervisory agency in the exercise of its "supervisory, regulatory, or monetary functions." There is also not a requirement when FinCEN, an appropriate law enforcement agency or supervisory agency requests either a copy of a SAR or supporting documentation underlying the SAR.

The rules under BSA state that financial institutions must retain copies of supporting documentation and those financial institutions must provide supporting documentation upon request. FinCEN has interpreted these regulations under BSA requiring a financial institution to provide supporting documentation even in the absence of legal process.

OTS Publishes BSA Effectiveness and Efficiency Fact Sheet

On June 22, 2007, the Office of Thrift Supervision (OTS) published a fact sheet on BSA effectiveness and efficiency.

The fact sheet discusses:

Matching Risk-Based Examination to Risk-Based Obligations

An institution with minimal to no international business that serves only a handful of communities does not share the same risk profile as a bank that does business around the world in many currencies. For this reason,

FinCEN will initiate a joint effort with federal banking regulators to ensure that financial institutions and regulators treat compliance obligations in a manner that helps to avoid expenditures that are not commensurate with actual risk.

MSBs

FinCEN has been working with the IRS, state regulators and federal functional regulators to address issues related to MSB oversight and access to banking services. These efforts will result in:

- Production of MSB examination materials; and
- A more narrowly defined definition of MSBs.

Making Regulations More Intuitive

FinCEN will start working on a new chapter of the Code of Federal Regulation, which will include one general, as well as, separate and specific parts for each covered industry. An institution will then only need to look in two places to identify its regulatory responsibilities.

SEC Proposes to Shorten Holding Period for Affiliates and Non-Affiliates

[On June 22, 2007, the SEC proposed changes to Rule 144 and 145 to shorten the holding period for affiliates and non-affiliates.](#)

The SEC proposes a six-month holding period requirement under Rule 144 for “restricted securities” of companies that are subject to the reporting requirements of the Securities Exchange Act of 1934. The proposed six-month holding period for restricted securities of reporting companies would be extended, for up to an additional six months, by the amount of time during which the security holder has engaged in hedging transactions. Restricted securities of companies that are not subject to the Exchange Act reporting requirements would continue to be subject to a one-year holding period prior to any public resale.

The SEC also proposes to:

- Substantially reduce the restrictions on the resale of securities by non-affiliates;

Feedback

FinCEN issues many reports and studies, but seeks to provide additional quality information to industry and law enforcement. FinCEN will provide written feedback to the affected industry within 18 months of the effective date of a new regulation or change to an existing regulation and will focus on providing additional trend analyses. When issues of non-compliance do arise, FinCEN will strive to better communicate how any penalties are correlated to the underlying violations, to avoid misimpressions about the nature of such conduct and provide a clear message to the industry about these actions.

- Simplify the Preliminary Note to Rule 144;
- Eliminate the manner of sale restrictions with respect to debt securities;
- Increase the Form 144 filing thresholds; and
- Codify several staff interpretive positions that relate to Rule 144.

Finally, the SEC proposes amendments to Rule 145, which establishes resale limitations on certain persons who acquire securities in business combination transactions, to eliminate the presumptive underwriter position in Rule 145(c), except for transactions involving a shell company, and to revise the resale requirements in Rule 145(d).

SEC Votes to Adopt Final Amendments to Rule 105 of Regulation M

On June 21, 2007, the SEC voted to adopt amendments to Rule 105 of Regulation M. Rule 105 helps prevent abusive short selling and market manipulation to ensure that offering prices are set by natural forces of supply and demand for the securities being offered rather than by manipulative activity.

The amendments:

- Change the prohibited activity from "covering" to purchasing the offered security;

- Include a provision to allow a restricted period short seller to participate in an offering if the seller makes a bona fide purchase prior to pricing an offering; and
- Includes exceptions concerning investment companies and certain other entities that make separate trading and investment decisions.

The amendments to Rule 105 will be effective 60 days after publication in the *Federal Register*.

NASD Chairman and CEO Announces the Name of the New SRO

On June 20, 2007, the NASD Chairman and CEO, Mary L. Schapiro, announced the name of the new consolidated SRO in a speech at The Exchequer Club in Washington, DC.

The new SRO will be called the Securities Industry Regulatory Authority or SIRA.

In a separate announcement, Ms. Schapiro detailed some of the organizational moves, including:

Member Regulation

The Member Regulation department will be split in two. Grace Vogel, who currently head Member Firm Regulation at NYSE Regulation, will head the new Department of Risk Oversight and Operational Regulation. Robert Errico, current head of Member Regulation at NASD, will lead the Department of Sales Practice Regulation.

Emerging Issues

Susan Merrill, current head of Enforcement at NYSE Regulation, will be Chief of the combined operation based in New York. James Shorris, NASD's current Enforcement Chief, will be Executive Director based in Washington.

Dispute Resolution

The head of the Office of Dispute Resolution will be, Linda Fienberg, current head of NASD's Dispute Resolution.

Technology

The Technology office will be led by Marty Colburn, NASD's current Chief Technology Officer; supported by NYSE's Angela Posillico.

NASD and NYSE Requests Comment on the Supervision of Electronic Communications

The NASD and NYSE request comment on the proposed joint guidance on the review and supervision of electronic communications.

The NASD and NYSE are issuing the proposed guidance to address the compliance challenges brought on by the technological innovations that have altered how people deliver, receive and

store communications. The proposed Joint Guidance sets forth principles for members to consider when developing supervisory systems and procedures for electronic communications that are reasonably designed to achieve compliance with applicable federal securities laws and SRO rules.

The growth of electronic communications has raised the need for further interpretative guidance around firm obligations to review and supervise electronic communications. The following summarize the key principles addressed in the proposed guidance.

Risk-Based Review Procedures

In adopting such supervisory review procedures firm should:

- Identify the types of correspondence that will be pre- or post-reviewed;
- Identify the organizational position(s) responsible for conducting reviews of the different types of correspondence;
- Monitor the implementation of, and compliance with, the member's procedures for reviewing public correspondence;
- Periodically re-evaluate the effectiveness of the member's procedures for reviewing public correspondence and consider any necessary revisions;
- Provide that all customer complaints, whether received via e-mail or in other written form, are reported to the SROs in compliance with the SRO reporting requirements;
- Prohibit employees from the use of electronic communications unless such communications are subject to supervisory and review procedures developed by the member; and
- Conduct necessary and appropriate training and education.

Written Policies and Procedures

An effective supervisory system starts with clear policies and procedures for the general use and supervision of electronic communications, both internal and external, which are updated to address new technologies. For example, a general electronic communications policy written five years ago may well not include policies to regulate employees' use of technologies such as weblogs and podcasting to communicate with the public.

A firm's written policies and procedures addressing written communications should include:

- Quick and easy access to electronic communication policies and procedures;
- Clear list of permissible electronic communication mechanisms;
- Specific language explaining to employees the potential consequences of non-compliance; and
- Training on a regular and as-needed basis.

Electronic Communications Requiring Review

Firm policies and procedures for electronic communications should address the wide range of communications that can occur both externally (e.g. non-member e-mail platforms, message boards, and e-faxes) and internally (related to conflict management efforts and internal communications related to branch exams, regulatory inquiries, disciplinary reviews etc.).

Identification of the Person(s) Responsible for the Review of Electronic Communications

Firm procedures should clearly identify the person(s) responsible for performing the reviews of electronic communications. A supervisor/principal may delegate certain functions but all reviewers must have sufficient knowledge, experience, and training to adequately perform the reviews.

Method of Review for Correspondence

Firms should develop review procedures that are both reasonably designed to achieve compliance with applicable securities laws, regulations and SRO rules and that are appropriate for their business structure. Members may consider the following methods of review:

- Lexicon-based review of electronic correspondence;
- Random review of electronic correspondence;
- Combination of lexicon and random review of electronic correspondence; and
- Standards applicable to all review systems.

Frequency of the Review of Correspondence

The frequency of correspondence review should be determined based on the type of business conducted, the type of customers involved; the scope of activities; geographical location of activities;

disciplinary record of covered persons; and the volume of communications subject to review.

Documentation of the Review of Correspondence

Firms must evidence their reviews, whether electronically or on paper.

Comments on the proposed guidance must be received on or before July 13, 2007.

NASD Requests Comment on Proposed Rule 2721

The NASD, in NtM 07-27, requests comment on proposed Rule 2721 to regulate member private securities offerings.

The proposed Rule, pertaining to private placements of unregistered securities issued by a member, would require that:

- A private placement memorandum (PPM) be provided to each MPO investor with information regarding risk factors, intended use of proceeds, offering expenses and any other information necessary to ensure that required information is not misleading;
- The PPM be filed with NASD's Corporate Financing Department at or prior to the time it is provided to any investor; and
- At least 85% of the offering proceeds be used for the business purposes identified under the "use of proceeds" disclosure in the PPM.

Rule 2721 is proposed in response to problems NASD has identified in connection with the private offerings of members' securities or those of a control entity. The proposed Rule contains several types of institutional investors, offerings under various provisions of the federal securities laws for which NASD believes the protections of the proposed rule are not necessary, and offerings in which investors otherwise would be expected to have access to sufficient information about the issuer.

Comment period expires July 20, 2007.

NAIC Adopts Viatical Settlements Model Act Revision

On June 4, 2007, The National Association of Insurance Commissioners (NAIC) adopted amendments to the Viatical Settlements Model Act.

The Model, which has been widely discussed among state regulators, addresses several issues in the life settlement marketplace, including an emerging type of life insurance practice known as Stranger-Originated Life Insurance (STOLI). It also strengthens several consumer protections and imposes a five-year ban settling a life insurance policy with specified elements indicative

of a STOLI transaction. The Model also requires brokers to receive at least 15 hours of continuing education on the topic every 2 years.

A life settlement is the transfer of life insurance benefits available under a policy. STOLI transactions are traditionally defined as life insurance policies manufactured for the purpose of settling in the secondary market.

According to the NAIC, the life settlement industry has changed significantly since the last

revisions to the Viatical Settlements Model, which 35 states have adopted.

House Bill Would Extend TRIA for 10 Years, Expand Definition of Terrorism

On June 19, 2007, U.S. Rep. Mike Capuano (D-MA) and the Chairman of the House Financial Services Committee Barney Frank (D-MA) introduced H.R. 2761, the "Terrorism Risk Insurance Revision and Extension Act of 2007 (TRIREA)."

The bill extends the Terrorism Risk Insurance Act (TRIA) for 10 years and aims to spur the development of a private market for terrorism risk insurance. TRIREA includes provisions to:

- Extend TRIA for 10 years with current co-payments and deductibles for conventional terrorism acts;
- Expand TRIA's "make available" requirement to include nuclear, biological, chemical, and radioactive (NBCR) attack coverage;
- Change TRIA's definition of terrorism to include acts of domestic terrorism;
- Set the program trigger at \$50 million;
- Add group life insurance to the lines of insurance for which terrorism coverage must be made available;
- Decrease deductibles and triggers for areas previously impacted by a significant terrorist attack; and,

- Continue to require studies of the development of a private market for terrorism risk insurance.

On June 21, Paul Kanjorski (D-PA) chairman of the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, held a hearing to discuss the bill. David Nason, Deputy Assistant Secretary for Financial Institutions Policy at the Treasury Department, stated, "The program should not be expanded to introduce new lines or types of coverage willingly provided by the private market." Nason said the Bush administration believes TRIA should remain temporary and short-term. He did not state whether or not President Bush would veto TRIREA, should it make it through Congress.

Sununu, Johnson Reintroduce Optional Federal Charter Legislation

On May 24, 2007, United States Senators John Sununu (R-NH), and Tim Johnson (D-SD) introduced S.B. 40, "The National Insurance Act of 2007." The legislation provides for an optional federal charter (OFC) for insurers.

The new bill is extremely similar to the OFC bill the senators introduced last year. Aside from technical and clarifying changes, the primary difference is the inclusion of provisions that would add surplus lines of insurance as a type of insurance that a person with a federal producer's license would be authorized to sell under the federal charter program. The Senate is expected to hold a hearing on the bill in the coming months.

The following groups have expressed support for the National Insurance Act: the American Insurance Association, the Agents for Change, the American Bankers Association, the American Bankers Insurance Association, the American Council of Life Insurers, the Financial Services Forum, the Financial Services Roundtable, the Life Insurers Council, the National Association of Independent Life Brokerage Agencies, and the Risk and Insurance Management Society.

The National Association of Mutual Insurance Companies and the Independent Insurance

Secretary Paulson Announces Next Steps on U.S. Markets' Global Competitiveness

On June 27, 2007, Treasury Secretary Henry M. Paulson announced the next steps of his capital markets competitiveness action plan. The plan will include:

- **Pursuing a Modernized Regulatory Structure** - The Treasury Department is examining the structure of the regulatory system for all financial services providers and will release its blueprint for reforms by early next year.
- **Encourage Development and Adoption of Industry Best Practices for Asset Managers and Investors in Hedge Funds** - The President's Working Group on Financial Markets will work with asset managers and investors to help these two groups define separate sets of best practices that address investor protection, enhance market discipline and mitigate systemic risk. This effort, based on the PWG principles and guidelines released earlier this year, will complement the ongoing reviews of counterparties' and creditors' practices by supervisors globally.
- **Modernize Treasury's Cash Management and Debt Management** - The Department will strengthen the U.S. Government's cash and debt management systems through a broad series of public initiatives in the coming year, further improving the efficiency, integrity, transparency and competitiveness of the U.S. Treasury market.
- **Complete Basel II Rulemaking** - Treasury will work with U.S. regulators to move the Basel II capital requirements forward. These new rules will reduce uncertainty, relieve burdens for both

domestic and foreign banks, and enhance the United States' competitive position.

- **Empower All Investors through Financial Education** - Any effort to improve the oversight of the financial services industry to protect investors must be coupled with empowering investors to better understand their options and decisions. Treasury will lead the President's inter-agency public initiative to help all Americans better understand money and personal finance. By encouraging saving and better access to financial services, Treasury can help broaden America's investor class.
- **Encourage International Investment Opportunities with Recognition of Comparable Regulatory Regimes** - Mutual recognition between countries with regulatory schemes comparable to the United States could increase international investment opportunities and enhance risk diversification while preserving investor protection. Treasury supports SEC consideration of mutual recognition for foreign broker-dealers and foreign stock exchanges offering services to U.S. investors.

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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