

# Financial Services Regulatory Highlights\*

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## NASD and NYSE Group Announced Plan to Consolidate Regulation of Securities Firms

On November 28, 2006, the NASD and New York Stock Exchange ("NYSE") Inc. announced the signing of a letter of intent to consolidate their member regulation operations into a new self-regulatory organization ("SRO") that will be the private sector regulator for all securities brokers and dealers doing business with the public in the United States.

The plan is aimed at increasing the efficiency and consistency of securities industry oversight and is expected to reduce regulatory costs to the industry by millions per year.

The new SRO is expected to begin operations in second quarter 2007 and will consist of the current 2,400-person NASD organization and approximately 470 of NYSE Regulation's member regulation, arbitration, and related enforcement team.

The NASD currently regulates more than 5,100 securities firms throughout the United States, of this, almost 200 are also members of the NYSE. With the consolidation, those dually regulated firms and their registered representatives will ultimately be subject to one set of rules created and enforced by a single SRO.

Highlights of the announcement include:

- The new SRO will be responsible for all member examination, enforcement, arbitration and mediation functions, as well as other current NASD responsibilities. NYSE Regulation will continue to oversee the NYSE market, through its market surveillance division, related enforcement functions, and listed company compliance.
- A 23-person Board of Governors will oversee the SRO's activities with 11 seats held by Public Governors. Large firms (500 or more registered persons) and small firms (150 or fewer registered persons) will each be guaranteed three seats on the new SRO Board. Medium sized firms with 151-499 registered persons, NYSE floor members, independent dealer/insurance

affiliated firms, and investment companies will each be guaranteed one seat. The Chairman and CEO will also serve on the interim board.

- Upon closing of the transaction, each NASD member firm will receive a one-time payment of \$35,000 in recognition of anticipated cost savings. Certain member fees will also be reduced for the first five years.
- This transaction is structured to be financially neutral to NYSE Group shareholders.

## NASD Fines Hedge Fund Manager for Deceptive Market Timing in Variable Annuities

On October 25, 2006, the NASD imposed a \$2.25 million fine (including the disgorgement of illicit profits) against a hedge fund manager for engaging in deceptive market timing in variable annuities. This is the largest penalty ever levied against an individual for using deceptive practices to market time through variable annuities.

The hedge fund manager executed approximately 1,000 variable annuity transactions and personally made approximately \$750,000 in illicit profits from the deceptive conduct.

The hedge fund manager used three deceptive practices to continue market timing:

- Purchased contracts in the same variable annuity for other partnerships and continued trading through those contracts;
- Obtained additional contracts in the same variable annuity, but changed the name of the annuitant. All of the annuitants were actually employees of entities the manager controlled; and

- When certain insurance companies rejected an annuity contract because it was purchased with a large initial investment, the manager purchased another contract with a much smaller initial investment. When the contract was accepted, he transferred funds from accounts of other related partnerships to the accepted contract and then began market timing in the contract's sub accounts.

The NASD stated that this enforcement action "makes clear that brokers, including those who operate as hedge fund managers, will be held accountable for this kind of misconduct and will be required to disgorge their profits and pay a substantial penalty"

## SEC Issues Final Rule on Tender Offer Best-Price Rules

The Securities Exchange Commission ("SEC") on November 2, 2006 issued a final rule on the tender offer best-price rules.

The amendments to the third-party and issuer tender offer best-price rules:

- Clarify that the provisions only apply with respect to the consideration offered and paid for securities tendered in a tender office;

- Provide that any consideration that is offered and paid according to employment compensation, severance or other employee benefit arrangements entered into with security holders of the subject company that meet certain requirements will not be prohibited by the rules; and
- Provide a safe harbor provision so that arrangements that are approved by certain independent directors of either the subject

company's or the bidder's board of directors, as applicable, will not be prohibited by the rules.

The rule is effective on December 8, 2006.

There is also a technical amendment to correct a cross-reference in the rules that govern the ability to delegate authority for purposes of granting exemptions under the best-price rule.

## SEC Approves Proposed Rule Change to NASD Rule 2860

On November 15, 2006 the SEC requested comment on Amendment No. 1 and approved the proposal, as amended by Amendment No. 1, on an accelerated basis on the NASD's proposed rule change to amend NASD Rule 2860, which relates to position and exercise limits and position reporting obligations for members that hold positions in index and equity options or that represent customers holding such positions.

Amendment No. 1 includes the following criteria for a "conventional index option":

- An index must contain nine or more equity securities;
- No equity security may comprise more than 30% of the equity security component of the index's weighting; and
- Each equity security in the index is either:
  - 1) A component security of the Russell 3000 Index or the FTSE All-World Index Series; or

- 2) Characterized by a minimum market capitalization and minimum trading volume.

The NASD is proposing to revise its Rule 2860(b)(5) to provide that a member must report a position in a "conventional index option" only when such option is based on an index that underlies, or is substantially similar to an index that underlies, an exchange-traded option.

The revised rules also clarify that the definition's requirements apply as of the date the option position is created.

Comments must be received on or before December 13, 2006.

## SEC Requests Comment on NASD Proposed Rule Change Relating to TRACE Requirements

On November 1, 2006 the SEC requested comment on a NASD proposed rule change regarding the TRACE requirements in connection with the exercise or settlement of options or similar instruments.

NASD proposed to adopt IM-6230, which would:

- Provide exemptive relief from certain provisions NASD Rule 6230 for transactions that are executed in connection with the termination or settlement of a CDS;

- Allow a member to enter the "time of execution" as the time that the member submits the transaction report; and,
- Allow a limited group of transactions in TRACE-eligible securities that are executed in connection with the termination or settlement of a CDS to be exempt from reporting and that a related group be exempt from the requirement to correct a previously transmitted erroneous trade report.

NASD proposed the following to amend its Rule 6250:

- Not to disseminate information on certain transactions in TRACE-eligible securities executed in connection with the exercise or settlement of an option or similar instrument or the

settlement or termination of CDS, any other type of swap, or similar instrument.

## NASD Issues Guidance on Securities Industry/Regulatory Council Continuing Education Issues Firm Element Advisory

The NASD issued in Notice to Members ("NtM") 06-65 guidance on the annual Firm Element Advisory issued by the Securities Industry/Regulatory Council on Continuing Education.

The Firm Element Advisory is a guide that firms can use when developing their continuing education Firm Element training plans.

This year, the Firm Element Advisory has been redesigned to identify each topic briefly and then provide links to relevant documents issued on the specified subjects. Starting in 2007, the Council plans to update the Firm Element Advisory twice a year to provide firms with updated material.

## FinCEN Advises Financial Industry on Potential Risks of Shell Companies

On November 9, 2006 the Financial Crimes Enforcement Network ("FinCEN") issued an advisory on identifying, assessing, and managing the potential risks associated with accounts maintained for shell companies.

FinCEN also released an assessment that shows how shell companies can be exploited by money launderers and other perpetrators of financial crime because of the lack of transparency in the formation process and the inability to identify beneficial owners.

In addition, FinCEN will continue its outreach effort with the states to address the issue of some states' lack of transparency in shell company formations. They will continue to collect information and

study how best to address the role of certain businesses specializing in the formation of business entities in its effort to reduce money laundering and related vulnerabilities in the financial system through the promotion of greater transparency.

FinCEN found that abuse of shell companies for illicit financial purposes is not limited to activity within the U.S. Suspicious Activity Report ("SAR") data shows suspected shell companies incorporated or organized in the U.S. have moved billions of dollars globally from bank accounts located in foreign countries.

## NCOIL Adopts Market Conduct Surveillance Model Law

On November 11, 2006, The National Conference of Insurance Legislators ("NCOIL") adopted the Market Conduct Surveillance Model Law outlining a uniform market surveillance framework.

The model provides for coordination between state regulators to improve both the efficiency and effectiveness of market conduct exams. The model's provisions include:

- Standardization of data collection methods
- Allowing domiciliary states to have responsibility to perform market conduct surveillance
- A continuum of market conduct actions to be considered prior to undertaking targeted

market conduct exams, as well as a structure for those exams

- Greater collaboration between regulators to minimize duplication in data gathering and evaluation efforts

Adoption of the model capped more than five years of NCOIL effort regarding market conduct reform, including the release of two studies on the issue.

## Interstate Insurance Product Regulation Commission Meets, Elects Chair

The Interstate Insurance Product Regulation Commission held its inaugural annual meeting November 15-16, 2006 in Lansdowne, Virginia. The meeting followed the September 28, 2006 adoption of both bylaws and a rulemaking rule by the 28 member states. The Commission established a permanent Management Committee, to be chaired by Pennsylvania Insurance Commissioner Diane Koken. Following a thorough discussion, the Commission decided to consider both the Public Access Rule and the Uniform Product Standards at the December 8th meeting in San Antonio, Texas.

The Commission is charged with developing uniform national product standards for certain insurance products, including life insurance, annuities, disability income and long-term care insurance. It also aims to create a central point of electronic filing for those products. It officially came into existence when the twenty-sixth state approved the Interstate Insurance Product Regulation Compact earlier this year.

## Kanjorski Likely to Head Insurance Subcommittee in House; 'Enamored' with Idea of Federal Charter

Rep. Paul E. Kanjorski (D-PA) is likely to assume the chairmanship of the House Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises when the 110th Congress convenes in January of 2007. While speaking at a forum on November 15, 2006, Kanjorski's legislative director, Todd Harper, stated, "My boss is very much enamored of the idea of creating an optional federal charter. I would expect we will spend a lot of time over the next two years looking at how one structures an optional federal charter, and eventually probably moving legislation."

It is possible that Kanjorski would introduce his own federal charter bill, one that would include stronger consumer protections than those found in the National Insurance Act of 2006, the federal

charter bill currently before the House and Senate. Harper stated that Kanjorski is studying whether a federal charter bill could be an effective vehicle for requiring insurers to offer "all-perils" policies.

Though Kanjorski is considered the likely candidate to head the subcommittee, that appointment is contingent upon the decision of the House Democratic Caucus, which will set committee chairs and jurisdictions when meeting in January.

## FDIC Approves New Risk-Based Premiums for Deposit Insurance

On November 2nd, the Federal Deposit Insurance Corporation ("FDIC") adopted final regulations that implement the Federal Deposit Insurance Reform Act of 2005 passed by Congress earlier this year.

Among the final regulations is a new rule on the risk-based assessment system that will enable the FDIC to more closely tie each bank's premiums to the risk it poses to the deposit insurance fund. In addition, the FDIC has new

flexibility to manage the deposit insurance fund's reserve ratio within a range, which in turn will help prevent sharp swings in assessment rates that were possible under the design of the former system.

"Throughout the FDIC's push for deposit insurance reform, our goals have been to provide for long-term stability and less procyclicality in the deposit insurance system," said FDIC Chairman Sheila C. Bair. "This new system will enable the FDIC to achieve our goals, and also will add incentives for good risk management at insured institutions."

Under the new risk-based assessment system, the FDIC will evaluate each institution's risk based on three primary sources of information -- supervisory ratings for all insured institution, financial ratios for most institutions, and long-term debt issuer ratings for large institutions that have them. The ability to differentiate on the basis of risk will improve incentives for effective risk management and will reduce the extent to which safer banks subsidize riskier ones.

As a result of the final rulemaking, the FDIC today set the assessment rates that will take effect at the beginning of 2007. The new rates for nearly all of the industry will vary between five and seven cents for every \$100 of domestic deposits.

As part of the Reform Act, Congress provided credits to institutions that paid high premiums in the past to bolster the FDIC's insurance reserves. As a result, the majority of banks will have assessment credits to initially offset all of their premiums in 2007.

"We are taking advantage of the sound banking environment to reverse the decline in the reserve ratio," said Chairman Bair. "In keeping with the intent of Congress, we are building up the fund in good times so it can be drawn down when problems arise, thus providing for long-term stability in premiums. Deposit insurance is

an important benefit, and it is appropriate for banks to pay something for that benefit."

In related actions today that complete the required rulemakings under the reform law, the FDIC Board adopted regulations that:

- Set the designated reserve ratio for the deposit insurance fund during 2007 at 1.25 percent of estimated insured deposits;
- Make operational changes intended to enable the assessment system to react more quickly and more accurately to changes in an institution's risk profile;
- Require banks and savings associations to use the same FDIC sign and follow the same advertising rules; and
- Establish penalties for institutions that fail to pay their deposit insurance premiums in a timely manner.

The rules are in addition to previous regulations implementing the reform law, including those governing the one-time assessment credit, a temporary system of dividend payments to insured institutions, and an increase in the deposit insurance coverage for certain retirement accounts.

The FDIC has now adopted all of the regulations required by the Reform Act within the 270-day deadline set by Congress.

## Federal Reserve Approved Final Rule on Electronic Fund Transfers; and Requested Comment on Proposed Rule

[On November 27, 2006 the Federal Reserve Board \("the FRB"\) announced approval of a final rule to amend Regulation E and the Official Staff Commentary.](#)

The rule has been revised to apply to any fees collected for an EFT or a check that has been returned unpaid. The revision clarifies that

the obligation to obtain a consumer's implied consent to the collection of a returned item fee applies to the person electronically collecting that returned item fee. Obtaining the consumer's implied consent to the fee in this situation consists of providing the consumer with

notice of the intent to collect the fee from the consumer's account if the item is returned, disclosure of the amount of the fee, and the consumer proceeds with the underlying transaction following the notice.

The rules also provide guidance concerning the notice requirements that must be provided to the consumer when the person initiates an electronic fund transfer, before a returned item fee may be collected. The effective date for this final rule is January 1, 2007.

The FRB also proposed to further amend Regulation E to create an exception for certain small-dollar transactions (\$15 dollars or less) from the requirement that terminal receipts be made available to consumers at the time of the transaction.

Comments should be received on or before 60 days after publication in the Federal Register.

## OCC, CSBS Agree on Consumer Complaint Information-Sharing Plan

On November 20th, the Office of the Comptroller of the Currency ("OCC") and the Conference of State Bank Supervisors ("CSBS") announced agreement on procedures for the exchange of consumer complaint information between state banking departments and the OCC.

The agreement recognizes that consumers do not always know which regulatory agency – state or federal – supervises their bank, and provides a model Memorandum of Understanding to ensure misdirected complaints are sent to the appropriate agency. The MOU, which is intended to be executed by state banking departments and the OCC on a state-by-state basis, provides a two-way street for the sharing of such complaints, including information on how complaints are resolved.

"This agreement is an excellent first step in an effort to enhance cooperation between the states and federal government in the area of consumer protection," said CSBS President and CEO Neil Milner.

"I am committed to working with state bank regulators to ensure a high level of consumer protection for all bank customers," said Comptroller John C. Dugan. "The burden should not be on consumers to know which agency regulates their financial institution, and the framework we developed offers bank customers a seamless system for ensuring that their complaints reach the right supervisory agency."

The CSBS Executive Committee, acting at the direction of the Board of Directors, approved the MOU at a meeting last week.

## Comptroller Dugan Tells Bankers that Managing Risk in Derivatives Markets Is Essential to Maintain Public Confidence in Nation's Financial Institutions

In a speech before the New York Bankers Association on November 10th, Comptroller of the Currency John C. Dugan said that ensuring effective management of the large credit risks that have accumulated in the derivatives portfolios of the major trading banks is a matter of concern for all banks, even those not active in derivatives markets.

Mr. Dugan said that "[s]ignificant mismanagement of these risks could precipitate market disruptions that affect public confidence in financial institutions generally." The OCC's most recent quarterly report on derivatives shows that nearly one in six national banks use

derivatives to control and reduce uncertainty and risk.

The Comptroller said that the OCC's approach to large bank supervision, which involves the continuous, on-site presence of large teams of examiners at each of the agency's largest banks, gives the OCC useful insights into conditions in derivatives markets.

Three focal points for the OCC's supervision of derivatives activities involve pricing, credit, and operational risk, he said. Although trading losses at banks have been low historically, "our concern is that even with prudent internal limits, a bank's risk profile can change very quickly in the event of a market disruption, with the potential for losses far exceeding such limits."

While credit exposures – currently totaling about \$199 billion – are quite large, the Comptroller said it is important to recognize that banks actively secure much, and sometimes all, of such exposures with high quality collateral, or margin, to mitigate this risk.

"Nevertheless, derivatives credit exposure remains a real and quite significant risk," Mr. Dugan added. Competitive pressure may induce banks to lower collateral requirements, and unexpected market disruptions can dramatically increase credit exposures. In addition, many derivatives counterparties are highly leveraged and their balance sheets are frequently too opaque to easily evaluate.

Operational risk – the risk that arises from trade and settlement processing – has surfaced most prominently in the rapidly expanding market for credit derivatives, the Comptroller said.

## OTS Director Reich Outlines Opportunities, Challenges in Global Retail Lending

[Office of Thrift Supervision \("OTS"\) Director John Reich addressed a Special Seminar on International Banking and Finance in Tokyo, Japan, on November 16th regarding the topic of global retail finance.](#)

Director Reich stressed that growth in retail and consumer lending is rapidly expanding beyond developed countries to emerging markets all over the world. This trend brings with it "unparalleled opportunities for individuals to access the capital they need to improve their lives," observed Mr. Reich.

"We found that the processing infrastructure for these often sophisticated risk management products was decidedly unsophisticated and 'low tech,' with significant manual trade confirmations in a high volume business," he said. "As a result, we observed an unacceptably high volume of unconfirmed transactions and undisclosed trade assignments – a practice where a hedge fund counterparty arranges for another dealer to assume its position without informing the derivatives dealer."

The Comptroller noted that five institutions, all national banks, account for 97 percent of the \$119 trillion notional amount of outstanding derivatives and said that type of concentration would ordinarily be a significant concern for the OCC.

But derivatives aren't like other products, he said. "Given the resource commitment necessary to conduct a derivatives business in a safe and sound manner, and the critical importance of credit quality to assure performance on contracts, it is understandable that derivatives activity is concentrated in those few institutions with the requisite credit strength and scale required to effectively compete," Mr. Dugan said.

It also presents opportunities for financial institutions to expand their horizons. He noted that OTS-supervised holding companies are capitalizing on the strong growth in global retail finance. This is "creating profits for the companies involved, increased opportunities for borrowers and challenges for supervisors," Mr. Reich added.

"Given the global reach of our holding company population, we have found it in our interest to grow our understanding of the retail and

consumer finance marketplace outside the United States,” noted Mr. Reich. “Because many OTS-supervised companies offer these products through regulated subsidiaries in local jurisdictions, we have worked hard in recent years to build strong relationships with our supervisory counterparts in key jurisdictions around the world.”

He indicated that OTS has also strengthened its supervisory program for financial conglomerates ensuring a better understanding of OTS-supervised conglomerates' overall financial condition, corporate strategy, and risk management structure.

In his speech, available at OTS's website at [www.ots.treas.gov](http://www.ots.treas.gov), Mr. Reich addressed challenges facing emerging markets experiencing rapid growth in retail and consumer lending, including market access to foreign firms, lack of a robust regulatory and credit-reporting infrastructure, and the need for strong underwriting standards.

Difficulties arise when the enthusiasm of consumers and lenders for loan growth gets out of sync with the economic cycle or basic underwriting standards. “This can lead to problems for all parties involved, including lenders, borrowers, and the regulators tasked with looking after the overall health of the system and protection of the consumer,” Mr. Reich said.

Mr. Reich concluded, “Close cooperation at the regulatory level – combined with responsible and thorough governance at the firms themselves – will preserve profitability, help prevent systemic imbalances and ensure that growth in consumer finance will continue to improve lives and enhance standards of living around the world.”

## 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:

Roger Coffin, Partner	646-471-2545
Gary Welsh, Managing Director	703-918-1432
Stephen Koslow, Director	312-298-3829
David Sapin, Director,	703-918-1391
Jim Steffenburg, Director	646-471-2302
Michael VanHuysen, Director	703-918-1429
Karen Severe, Manager	646-471-7234
Michael B. Tuohy, Manager	646-471-4209

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