Financial Services Regulatory Highlights

volume 10 no. 3 March 2008

In this issue:

Treasury Releases Blueprint for Reform of Financial Services Regulatory Structure 1
Federal Reserve Board Requested Comment on Proposed Changes to its Payments System Risk Policy 2
OCC Will Require Data from Large Bank Mortgage Servicers 3
FDIC Issues a Letter on the Importance of Managing Commercial Real Estate Concentrations 3
FDIC Publishes Guide to Calculating Deposit Insurance Coverage for Revocable and Irrevocable Trusts.. 4
Agencies Release Proposed Revisions to Interagency Questions and Answers Regarding Flood Insurance 4
Federal Financial Regulatory Agencies Issued Statement on Reporting of Securitized Subprime Adjustable Rate Residential Mortgages 5
FFIEC Release Updated Business Continuity Planning Booklet 5
GAO Publishes Report on Bank Fees............ 6
SEC Announces Next Steps for Implementation of Mutual Recognition Concept...................... 6
SEC Director of Office of Compliance Inspections and Examinations Discusses the Top 10 Focus Areas in SEC Examinations of Investment Advisers 7
SEC Approved Amendments to NASD Rule 2210 Regarding Principal Approval of Sales Materials 9
SEC Issues Proposed Rule on "Naked" Short Selling Anti-Fraud.. 9
FINRA Issues Notice Regarding the Rulebook Consolidation Process................................. 10
FINRA Issues Annual Examination Priorities Letter.. 10
FinCEN Issues Guidance Regarding Customer Identification Program Rule No-Action Position 11

Treasury Releases Blueprint for Reform of Financial Services Regulatory Structure

On March 31, 2008, the US Treasury released its 200-page blueprint for reforming the financial services regulatory structure. The Treasury Department has been working on the "Blueprint for a Modernized Financial Regulatory Structure" as part of Treasury Secretary Henry M. Paulson Jr.'s efforts to create a more efficient U.S. financial services regulatory structure and to improve the competitiveness of the U.S. capital markets. The Blueprint, which calls for some significant changes in the regulatory oversight of the financial services industry, will certainly initiate a dialogue among federal and state financial services regulators, Congress and industry participants that will likely extend over several years. Following are some highlights of the Blueprint's short term, intermediate term and long term recommendations.

Short term recommendations to improve regulatory coordination and oversight immediately include:

- Modernization of the President's Working Group on Financial Markets to reinforce its mission, make it an ongoing mechanism for communication and coordination, and expand its membership to include the OCC, OTS and FDIC;
- Creation of a Mortgage Origination Commission to evaluate, rate and report on the adequacy of each state's system for licensing and regulating participants in the mortgage origination process; and
- Clarification of Liquidity Provisioning by the Federal Reserve to provide it with the information that it needs about non-depository institutions that are given access to Federal Reserve liquidity, including on-site examinations or other means determined by the Federal Reserve.

The intermediate term recommendations focus on eliminating duplicative functional regulation and include:

- Transitioning the federal thrift charter to a national bank charter and merging the OTS with the OCC;
- Rationalization of the oversight and supervision of state chartered banks including a study to determine whether the Federal Reserve or FDIC should be a single federal regulator of state banks;
- Creation of an Optional Federal Charter for insurance companies to be overseen by an Office of National Insurance within Treasury, with an intermediate step of establishing a federal Office of Insurance Oversight to establish a federal presence in insurance for regulatory or international issues;
- Development of a federal charter for payment and settlement systems with oversight by the Federal Reserve;
- Merger of the SEC and CFTC and certain changes in the SEC's processes; and
- The establishment of a self-regulatory regime for investment advisors.

The long term recommendations to create the "Optimal Regulatory Structure" include taking an objectives-based approach to the oversight of the financial services industry by establishing:

- A Market Stability Regulator (i.e., Federal Reserve) to address overall conditions of financial market stability;
- A Prudential Financial Regulator focusing on the safety and soundness of firms with federal guarantees (such as deposit insurance); and
- A Business Conduct Regulator which would monitor business conduct regulation (including disclosure requirements, business practices and chartering and licensing of certain types of financial firms.

We anticipate providing a more detailed analysis of the Treasury Blueprint and its potential impact on our clients in subsequent Newsletters or PwC publications.

Federal Reserve Board Requested Comment on Proposed Changes to its Payments System Risk Policy

On February 28, 2008, the Federal Reserve Board requested public comment on proposed changes to its payments system risk (PSR) policy which are intended to loosen intraday liquidity constraints and reduce operational risks in financial markets and the payments system.

The Board proposed a new strategy that would provide intraday credit to depository institutions and would encourage these institutions to collateralize their daylight overdrafts.

The Board's proposed changes would:

- Adopt a policy of supplying intraday balances to healthy depository institutions predominantly through explicitly collateralized daylight overdrafts;
- Allow depository institutions to pledge collateral voluntarily to secure daylight overdrafts;
- Encourage the voluntary pledging of collateral to cover daylight overdrafts by providing collateralized daylight overdrafts at a zero fee and by raising the fee for uncollateralized daylight overdrafts to 50 basis points (annual rate) from the current 36 basis points;

In developing the proposal, the Board sought to minimize the effect of the proposed policy changes on institutions that use small amounts of daylight overdrafts by increasing substantially the biweekly fee waiver to $150 from $25;

The proposed changes would also include change to other policy provisions, including:

- Adjusting net debit caps;

- Streamlining procedures for the expansion of daylight overdraft capacity for certain foreign banking organizations;
- Eliminating the current deductible for daylight overdraft fees; and
- Increasing the penalty daylight overdraft fee for ineligible institutions to 150 basis points (annual rate) for the current 136 basis points.

The Board expects to have a revised PSR policy implemented approximately two years from the adoption of the final rule.

In a separate release, the Federal Reserve Board also requested comments on proposed changes to the daylight overdraft posting rules under the PSR policy to align the posting times for commercial and government ACH credit and debit transfers in the payments system.

Comments for both are requested on or before June 4, 2008.

OCC Will Require Data from Large Bank Mortgage Servicers

On February 29, 2008, the Office of the Comptroller of the Currency (OCC) issued a news release stating that they will now require that large national banks mortgage servicers provide comprehensive mortgage data on a monthly basis.

The required data will build upon the efforts of the HOPE NOW alliance, a cooperative effort between investors, lenders and counselors intended to help distressed homeowners. The HOPE NOW alliance is collecting data on subprime mortgages, while the OCC plans to include information on all mortgages, as well as home equity loans later this year.

The data is expected to give the OCC and other regulators a more complete view of the market, which will help with the prevention of unnecessary foreclosures. Metrics developed from the data on subprime lending will be available to state agencies through the HOPE NOW alliance, and should provide a robust and comprehensive overview of subprime mortgage lending.

FDIC Issues a Letter on the Importance of Managing Commercial Real Estate Concentrations

On March 17, 2008, the Federal Deposit Insurance Corporation (FDIC) issued the Financial Institution Letter, *Managing Commercial Real Estate Concentrations in a Challenging Environment.*

The letter emphasizes:

- Importance of strong capital and loan loss allowance levels;
- Robust credit risk-management practices for institutions with concentrated commercial real estate (CRE) and construction and development (C&D) exposure consistent with the interagency guidance on CRE lending and the interagency policy statement on the allowance for loan and lease losses; and

The letter recommends five key risk management practices and the FDIC's expectations in each of these areas for institutions with significant CRE and C&D loan concentrations:

- Increase or maintain strong capital levels;
- Ensure that loan loss allowances are appropriately strong;
- Manage CRE and C&D portfolios closely;
- Maintain updated financial and analytical information; and
- Bolster loan workout infrastructures.

FDIC Publishes Guide to Calculating Deposit Insurance Coverage for Revocable and Irrevocable Trusts

The FDIC Published the *FDIC Guide to Calculating Deposit Insurance Coverage for Revocable and Irrevocable Trusts* (Guide) in January 2008.

The Guide has been developed to assist in answering the most common question asked of the FDIC by bank personnel, trustees, depositors, attorneys and accountants: What is the maximum amount of deposit insurance coverage available at a single FDIC-insured institution, using a specific trust agreement?

The Guide describes coverage for both informal and formal trusts, with special emphasis on the process for calculating deposit insurance coverage for formal revocable trusts. The Guide is organized into the following chapters:

Chapter 1 -- Introduction to FDIC Deposit Insurance Coverage
Describes the fundamental concepts of FDIC deposit insurance coverage, including how FDIC deposit insurance works and the different account ownership categories that qualify for separate insurance coverage under FDIC rules. The FDIC strongly recommends reviewing this chapter before proceeding to the subsequent chapters.

Chapter 2 -- Overview of Revocable Trusts
Discusses the differences between informal and formal revocable trust accounts.

Chapter 3 – Informal Revocable Trusts
Describes the requirements for establishing a revocable trust deposit that is eligible for FDIC insurance coverage without a formal revocable trust document. Provides a definition of an informal revocable trust, a methodology for calculating the amount of deposit insurance coverage for informal revocable trusts, and specific examples applying this methodology.

Chapter 4 – Formal Revocable Trusts
Describes the requirements for FDIC deposit insurance coverage based upon a formal, written revocable trust document (usually created with the assistance of a legal professional). Describes a methodology for calculating coverage for bank deposits held by formal revocable trusts. While the requirements for FDIC coverage of informal and formal revocable trusts are similar, there are significant differences with respect to determining deposit insurance coverage.

Chapter 5 – Life Estate Beneficiaries
Describes the FDIC's rules for deposit insurance coverage of formal revocable trusts that provide life estate interests for one or more beneficiaries. Describes a methodology for determining deposit insurance coverage for formal revocable trusts with life estate beneficiaries.

Chapter 6 – Irrevocable Trusts
Describes the requirements for FDIC coverage of irrevocable trusts and explains how to calculate coverage for bank deposits held by irrevocable trusts.

Agencies Release Proposed Revisions to Interagency Questions and Answers Regarding Flood Insurance

On March 21, 2008, the federal bank, thrift, credit union, and Farm Credit System regulatory agencies requested comment on revised interagency questions and answers regarding flood insurance.

The agencies are proposing new questions and answers to help financial institutions meet their responsibilities under federal flood insurance legislation and to increase public understanding of the flood insurance regulations.

The proposed changes include:

- Substantive modifications to questions and answers pertaining to construction loans and condominiums;
- New questions and answers pertaining to second lien mortgages, the imposition of civil money penalties, and loan syndications/participations; and
- Revising and reorganizing certain existing questions and answers to clarify areas of potential misunderstanding.

Comments must be received on or before May 20, 2008.

Federal Financial Regulatory Agencies Issued Statement on Reporting of Securitized Subprime Adjustable Rate Residential Mortgages

On March 3, 2008, the federal financial regulatory agencies each issued a letter or statement encouraging the institutions that they supervise to utilize the HOPE NOW alliance's loan modification reporting standards for subprime adjustable rate residential mortgages.

The agencies believe that a standard reporting format will help investors monitor foreclosure prevention efforts and provide transparency for investors in securitization trusts.

The agencies support the HOPE NOW alliance, as well as other initiatives that address the rising home foreclosures.

FFIEC Release Updated Business Continuity Planning Booklet

On March 19, 2008, the Federal Financial Institutions Examination Council (FFIEC) issued updated guidance to identify business continuity risks and evaluate controls and risk management practices for effective business continuity planning.

The guidance updates the March 2003 "Business Continuity Planning Booklet."

This revised booklet:

- Includes enhancements to the business impact analysis and testing discussions and addresses emerging threats and lessons learned in recent years;
- Stresses the responsibilities of each institution's board and management to address business continuity planning with an enterprise-wide perspective by considering technology, business operations, communications, and testing strategies for the entire institution;
- Adds key elements of the FFIEC's December 2007 Interagency Statement on Pandemic Planning (see Financial Services Regulatory Highlights December 2007);
- Highlights the importance of business continuity planning for all financial institutions; and
- Reviews lessons learned from financial institutions that suffered damage from hurricanes Katrina and Rita.

GAO Publishes Report on Bank Fees

On March 4, 2008, the Government Accountability Office (GAO) published their report on how federal banking regulators could better ensure that consumers have required disclosure documents prior to opening checking or savings accounts.

For the study, the GAO reviewed:

- Trends in the types and amounts of checking and deposit account fees since 2000;
- How federal banking regulators address such fees in their oversight of depository institutions; and
- The extent that consumers are able to obtain account terms and conditions and disclosures of fees upon request prior to opening an account.

The GAO found that:

- Customers were unable to obtain detailed fee information and account terms and conditions at over one-fifth of the 185 branches visited; and
- Federal regulators ensure that there are written policies and procedures in place, but do not determine whether consumers actually receive them.

They recommend that the federal banking regulators assess to what extent customers receive disclosures on fees and account terms into their oversight.

SEC Announces Next Steps for Implementation of Mutual Recognition Concept

On March 24, 2008, the Securities and Exchange Commission (SEC) announced a series of actions it plans to take to further the implementation of the mutual recognition concept for high quality regulatory regimes in other countries.

The SEC is considering the following actions:

- Exploring initial agreements with one or more foreign regulatory counterparts, which would be based upon a comparability assessment by the SEC and by the foreign authority of one another's regulatory regimes.
- Considering adoption of a formal process for engaging other national regulators on the subject of mutual recognition. This process could be accomplished through rulemaking or other appropriate mechanisms, possibly informed by one or more initial agreements with other regulators.
- Developing a framework for mutual recognition discussions with jurisdictions comprising multiple securities regulators tied together by a common legal framework, including Canada (which has no national securities regulator, but rather provincial regulators) and the European Union (whose national securities regulators are subject to supranational legislation and directives).
- Proposing reforms to Rule 15a-6 in order to improve the process by which U.S. investors have access to foreign broker-dealers.

SEC Director of Office of Compliance Inspections and Examinations Discusses the Top 10 Focus Areas in SEC Examinations of Investment Advisers

On March 20, 2008, in a speech to the IA Compliance Best Practices Summit in Washington, D.C SEC Director of the Office of Compliance Inspections and Examinations, Lori Richards, discussed the top 10 focus areas in SEC examinations of investment advisers.

Controls Over Valuation
What examiners are looking for:

- Whether the firm understood the nature of the security before buying it;
- Had a plan with respect to how it would price the security;
- Whether it has adequate processes and procedures related to risk management, valuation, and accounting;
- Whether it is following those procedures;
- Whether it has disclosed the risks of investments in illiquid securities to its clients; and
- Dealer price quotes and whether valuations reflect prices at which the security can be sold.

Ms. Richards states that, "...we're looking at whether prices are calibrated to observable trade data even if the market for a security is less liquid than in the past."

Controls Over Non-Public Information/Personal Trading/Code of Ethics
Examiners will focus on:

- Whether a firm has identified the source and type of non-public information;
- Whether the firm has crafted and implemented adequate procedures to maintain the confidentiality of that information, and is implementing those procedures;
- Whether the firm has guidelines with respect to when and to whom it will provide information.

According to Ms. Richards, "Examinations will seek to understand the firm's own compliance and supervisory programs with respect to insider trading, and will probe more deeply if there are weaknesses in these programs."

Ms. Richards suggests that advisers should be:

- Asking new questions;
- Discussing procedures; and
- Employing tests.

Dealing with Senior Investors
The SEC examiners will be looking for investment advisory firms to discuss effective supervisory, compliance and the other practices they use in the following areas:

- Marketing and advertising for seniors;
- Account opening;
- Product and account review;
- Ongoing review of the relationship and appropriateness of products; and
- Discerning and meeting the changing needs of customers as they age.

Compliance and Supervision
This is a key area of the examination. Examiners will seek to understand the adviser's compliance program and whether it appears designed to capture and manage the adviser's compliance risks. Areas of interest are:

- Whether the adviser has conducted a risk assessment;
- Identified its own compliance risks and conflicts of interest; and
- Crafted and implemented procedures to effectively mitigate those risks.

Portfolio Management

Examiners are interested in whether processes and procedures related to risk management, valuation, accounting, and other back office functions are adequate given the types of investments made on behalf of the client.

The SEC is placing particular emphasis on client investments in structured products and other complex derivative instruments.

Brokerage Arrangements and Best Execution

Examiners are interested in whether brokerage arrangements are consistent with fiduciary obligations to clients. In particular they are looking for:

- Whether the adviser seeks best execution;
- Whether it uses soft dollars consistent with its disclosures; and
- Whether the adviser periodically and systematically evaluates the costs and benefits of its brokerage arrangements.

Allocations of Trades

Examiners are interested in:

- Whether the adviser has disclosed its policy with respect to how it will allocate trades;
- The adviser's policies and procedures for allocating IPO's, block trades, and investment opportunities among clients and proprietary accounts; and
- Whether actual practices are consistent with both policies and disclosures.

Performance Advertising, Marketing, and Fund Distribution Activities

Examiners are looking for:

- Whether funds and advisers have effective policies and procedures to make sure that their claims about their past investment performance, their advertisements, and other marketing materials contain accurate information;
- Whether conflicts of interest like revenue-sharing or other arrangements with third parties to increase assets have been effectively disclosed, and the use of solicitors; and
- Whether pitchbooks, RFPs and other materials provided to clients are accurate.

Safety of Clients' and Funds' Assets

Examiners are looking for:

- Whether funds and advisers have effective policies and procedures for safeguarding their clients' assets from theft, loss, and misuse;
- Review firms custodian arrangements; and
- Assess whether there is a process for reconciling client & fund balances.

Information Processing and Protection

Examiners are looking for:

- Whether the adviser has effective policies and procedures for capturing, compiling, maintaining, and reporting relevant and timely information in its books and records, and in reports to the clients and regulators; and
- Whether controls in the firm's business continuity plan that protect this information from hackers or other unauthorized persons, and from being destroyed in a disaster.

Ms. Richards concluded by stating, "I view your work as compliance professionals as so critical to the protection of investors. If you are able to work within your firms to implement effective compliance programs, you will prevent problems from occurring, and detect and promptly correct problems that do occur."

SEC Approved Amendments to NASD Rule 2210 Regarding Principal Approval of Sales Materials

Effective March 26, 2008, principal approval is no longer required for certain previously filed sales material. The amendment to NASD Rule 2210 also codifies FINRA's staff interpretation regarding recordkeeping requirements of sales materials.

Based on recommendations made by FINRA's Small Firms Rules Impact Task Force, and to eliminate a compliance redundancy, the approved amendment creates an exception to Rule 2210's registered principal approval requirements for intermediary firms that use the sales material of another firm. The exception applies only to sales material that another firm has filed with FINRA, and for which FINRA has issued a review letter finding that the material appears to be consistent with applicable standards. An intermediary firm that relies on this exception may not materially alter the sales material or use it in a manner that is inconsistent with any conditions stated in the FINRA review letter.

The rule change also revises certain advertising recordkeeping requirements. Rule 2210(b)(2)(A) states that firms must maintain a copy of all sales material for a period of three years from the date of last use. FINRA staff has interpreted this provision to mean that the recordkeeping requirement begins on the date of first use, and that these records must include dates of first use and if applicable, the date of last use. The rule change codifies this position. Firms that are relying on the principal approval exception must keep a record of the name of the firm that filed the sales material and a copy of the related FINRA letter.

SEC Issues Proposed Rule on "Naked" Short Selling Anti-Fraud

On March 20, 2008, the SEC proposed an anti-fraud rule to address fails to deliver securities that have been associated with “naked” short selling.

The proposed rule highlights the liability of persons that deceive specified persons about their intention or ability to deliver securities in time for settlement, including persons that deceive their broker-dealer about their locate source or ownership of shares and that fail to deliver securities by settlement date.

The proposed rule would:

- Target short sellers who deceive their broker-dealers about their source of borrowable shares for purposes of complying with Regulation SHO’s “locate” requirement;
- Apply to sellers who misrepresent to their broker-dealers that they own the shares being sold;
- Aid broker-dealers in complying with the locate requirement of Regulation SHO and, thereby, potentially reduce fails to deliver;
- Help reduce manipulative schemes involving “naked” short selling;
- Cover situations where a seller deceives a broker-dealer, participant of a registered clearing agency, or a purchaser about its intention to deliver securities by settlement date, its locate source, or its share ownership, and the seller fails to deliver securities by settlement date;
- Apply to the deception of persons participating in the transaction – broker-dealers, participants of registered clearing agencies, or purchasers; and
- Hold a seller liable if it deceives a broker-dealer, participant of a registered clearing agency, or purchaser about its ownership of shares or the deliverable condition of owned shares and fails to deliver securities by settlement date.

Although the proposed rule is primarily aimed at sellers that deceive specified persons about their intention or ability to deliver shares or about their locate sources and ownership of shares, broker-dealers could also be liable for aiding and abetting a customer's fraud.

While "naked" short selling as part of a manipulative scheme is already illegal under the general anti-fraud provisions of the federal securities laws, the SEC believes that the proposed anti-fraud rule would highlight the specific liability of persons that deceive specified persons about their intention or ability to deliver securities in time for settlement.

Comments should be received on or before May 20, 2008.

FINRA Issues Notice Regarding the Rulebook Consolidation Process

On March 12, 2008, FINRA issued an information notice on the process to develop the new consolidated NASD and NYSE rulebook.

The purpose of the new consolidated rulebook is to harmonize and streamline existing NASD and NYSE rules and to take into consideration the rapidly changing and broadly diverse securities firms subject to FINRA regulation.

The new rulebook will:

- Consist only of FINRA rules;
- Apply to all FINRA members; and
- Feature a new organizational framework which will group and categorize rules.

FINRA staff has been conducting a review of all the NASD and NYSE rules. They have been:

- Identifying obsolete and duplicative NASD and NYSE rules;
- Identifying significant differences between the NASD and NYSE rules that apply to Dual Members;
- Exploring whether one or a combination of approaches can be applied to the final consolidated FINRA rules covering member conduct, application and registration, and financial and operational requirements; and
- Identifying rules that will be maintained without substantive modification.

The SEC will need to approve all FINRA rules prior to them being effective.

FINRA Issues Annual Examination Priorities Letter

On March 24, 2008, FINRA issued their annual letter to firms, which highlights regulatory topics that are of particular significance to the year's examination program.

The letter discusses new developments, as well as more traditional topics, for firms to consider when reviewing their supervisory and compliance programs. The topics covered in the letter include:

- Senior Investors - FINRA has devoted considerable resources to the topic of senior investors and "baby boomers." Examinations found significant concerns relating to seniors, including sales pitches masquerading as education seminars, misleading advertising and sales materials, poor supervision, product suitability and outright fraud.
- Deferred Variable Annuities - With the approval of NASD Rule 2821 regarding broker-dealers' compliance and supervisory responsibilities for deferred variable annuities, a particular focus will be placed on the requirements of the rule.
- Anti-Money Laundering - All member firms must have an AML Program, regardless of

size or business model -- even if the firm does not hold customer funds.

- Protection of Customer Information - With the growing sophistication of technology, firms must examine how they are protecting customer information and records.
- Supervision - Supervision is a core element for FINRA examinations. NASD Rules 3010, 3012 and 3013 will continue to be a focus during examinations. Firms should take note of amendments to MSRB Rule G-27.
- Sales of New Products - Firms must consider the suitability of any securities they recommend to their customers. Security recommendations should take into account the customer's financial situation and needs, risk tolerance, investment time horizon, investment objectives, among other things.
- Fee-Based Accounts - Firms that maintain fee-based accounts can expect FINRA examiners to review what was completed with these accounts in light of the Financial Planning Association decision.
- Transaction Reporting - FINRA has found continued violations in this area. Firms are reminded that they are responsible for the accuracy of transaction information reported on their behalf.
- Information Barriers - Firms are reminded that they must have procedures in place to prevent the misuse of material, non-public information and insider trading.
- Bank Sweep Programs - SEC Rules 15c3-1 and 15c3-3 regarding the protection of client funds and net capital requirements will continue to be a major focus.
- Agency Lending Disclosure - Agency lending practices will continue an as important area of review during FINRA examinations of firms that operate an agency securities lending business. FINRA's continued emphasis is a result of 2007 examination results.
- Inventory Valuations - Firms are reminded to review controls in place to independently validate the pricing of inventory positions.
- Order Audit Trail System (OATS) - OATS reporting requirements were expanded to include OTC equity securities. In February 2008, other modifications were implemented to address Reg NMS and certain other technical changes.
- Regulation NMS - SEC Rules 610 and 611 were fully implemented for all NMS stocks as of October 8, 2007. Initial examinations have indicated that some firms mistakenly believe that Reg NMS does not apply to them. Firms should be aware that Reg NMS does not include any exception to the definition of "trading center" based on *de minimis* activity.
- Short Interest Reporting - NASD rule 3360 was amended to increase the frequency of short interest reporting from monthly to twice a month.

FinCEN Issues Guidance Regarding Customer Identification Program Rule No-Action Position

On March 4, 2008, FinCEN issued guidance regarding its no-action position on Customer Identification Program ("CIP') rule application to broker-dealers operating under fully disclosed clearing agreements. Certain broker-dealers ("introducing firms") enter into clearing agreements with other broker-dealers ("clearing firms") which permit the introducing and clearing firms to specify the respective function and responsibilities of each firm.

FinCEN is issuing this notice to clarify its position respecting the CIP rule obligations of a clearing firm. FinCEN has come to the view that it would be appropriate to require only the introducing firm to comply with the requirements of the CIP rule with respect to customers introduced to a clearing firm pursuant to a clearing agreement that allocates functions, such as extending credit, safeguarding funds and securities, and issuing confirmations and statements. Accordingly, FinCEN will take no action against a clearing firm for not complying with the CIP rule with respect to an introduced customer under these circumstances. This position promotes consistency with the application of the CIP rules to intermediated relationships in other industries.

This position also extends to piggybacking arrangements, whereby an introducing firm does not enter into a clearing agreement with a clearing firm, but rather establishes a relationship with an introducing firm that has established a clearing agreement with a clearing firm, thus piggybacking off the introducing firm's clearing agreement. In cases where a piggybacking firm retains the functions of opening and approving customer accounts and directly receiving and accepting orders from introduced customers, FinCEN will take no action against the introducing firm or the clearing firm for not complying with the CIP rule with respect to the customers introduced by the piggybacking firm.

Despite this position, a clearing firm's AML program should contain risk-based policies, procedures, and controls for assessing the money laundering risk posed by its fully disclosed clearing agreements, for monitoring and mitigating that risk, and for detecting and reporting suspicious activity. Similarly, the introducing firm's AML program should contain risk-based policies, procedures and controls respecting both its direct customers and any customers that may be introduced to it by the piggybacking firm.

Finally, nothing in the guidance published precludes any broker-dealer from contracting with another financial institution for the performance of any or all of its CIP functions. An introducing firm may continue to enter into service agreements with a clearing firm that may or may not include CIP reliance provisions.

Additional Information

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

David Albright, Principal	703-918-1364
John Campbell, Principal	646-471-7120
Roger Coffin, Principal	646-471-2545
Jeff Lavine, Partner	703-918-1379
Ric Pace, Principal	703-918-1385
Bruce Roland, Principal	410-783-7650
Ellen Walsh, Principal	646-471-7274
Gary Welsh, Managing Director	703-918-1432
Dan Weiss, Managing Director	703-918-1431
Stephen Lurie, Director	646-471-5129
David Sapin, Director	703-918-1391
Michael VanHuysen, Director	703-918-1429
Karen Severe, Manager	646-471-7234
Michael B. Tuohy, Manager	646-471-4209

www.pwc.com

© 2007 PricewaterhouseCoopers LLP. All rights reserved. "PricewaterhouseCoopers" refers to PricewaterhouseCoopers LLP (a Delaware limited liability partnership) or, as the context requires, other member firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity. *connectedthinking is a trademark of PricewaterhouseCoopers LLP (US)