

Financial Services Regulatory Highlights*

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Agencies Reach Agreement on Basel II Implementation

On July 20, 2007, the Agencies announced that they have reached an agreement regarding the implementation of Basel II in the United States.

The Agencies have agreed that rules implementing the advanced approach of Basel II should be finalized expeditiously, and should be technically consistent in most respects with international approaches.

The agreement retains the NPR's transitional floor periods. Following the parallel run in 2008, those transitional floors provide for maximum cumulative reductions of 5 percent during the first year of implementation, 10 percent in the second year, and 15 percent in the third year. However, the agreement eliminates a provision in the NPR that would have capped maximum cumulative reductions at 10 percent.

After the end of the second transition year period, the Agencies will publish a study that will evaluate the new framework to determine if there are any material deficiencies. If the study finds there are material deficiencies that cannot be addressed by existing tools, banks will not be permitted to exit the third transitional period unless the deficiencies are first addressed by changes to the regulation. However, if a primary supervisor disagrees with a finding of material deficiency, it may authorize banks it supervises to exit the third transitional period, but only if it first provides a public report explaining its reasoning.

The Agencies believe the review process by which they will assess the performance of the new rules is consistent with recommendations of the U.S. Government Accountability Office and provides a structured and prudent framework for managing the implementation of Basel II in the U.S.

The Agencies also agreed to proceed promptly to issue a proposed rule that would provide all non-core banks with the option to adopt a standardized approach under the Basel II Accord. This option would replace the earlier proposed rule to adopt the Basel 1A

option. The Agencies intend that the proposed standardized option would be finalized before the core banks begin the first transition period year under the advanced approaches of Basel II.

SEC Votes to Adopt Antifraud Rule under Investment Advisers Act

On July 11, 2007, the SEC voted unanimously to adopt the new antifraud rule under the Investment Advisers Act. This clarifies the SEC's ability to bring enforcement actions under the Advisers Act.

The new rule will make it a fraudulent, deceptive, or manipulative act, practice, or course of business for an investment adviser to a pooled investment vehicle to make false or misleading statements to, or otherwise to defraud, investors or prospective investors in that pool. The rule will apply to all investment advisers to pooled

investment vehicles, regardless of whether the adviser is registered under the Advisers Act.

Under the new rule, a pooled investment vehicle will include any investment company and any company that would be an investment company but for the exclusions in Section 3(c)(1) of the Investment Company Act.

The effective date is 30 days after publication in the Federal Register.

NASD and NYSE Member Regulation Combine to Form the Financial Industry Regulatory Authority - FINRA

On July 30, 2007, the Financial Industry Regulatory Authority (FINRA) announced that it has started its operation as the largest non-governmental regulatory organization for securities brokers and dealers in the United States.

FINRA was created through the consolidation of NASD and the member regulation, enforcement and arbitration operations of the NYSE. The organization will conduct the regulatory oversight for more than 5,000 securities firms and 666,000 registered representatives. It will be responsible for rule writing, firm

examination, enforcement, and arbitration and mediation functions, as well as all functions previously overseen solely by NASD, including market regulation under contract for NASDAQ, the American Stock Exchange, the International Securities Exchange, and the Chicago Climate Exchange.

The new website is www.finra.org.

Agencies Issue Statement on Subprime Mortgage Lending

On July 10, 2007, the Agencies, issued a final interagency Statement on Subprime Mortgage Lending.

The Statement addresses the agencies' supervisory expectations concerning risk management and consumer protection practices and principles that institutions should follow to engage in responsible lending to subprime borrowers.

The Statement seeks to ensure that both lenders and subprime borrowers fully comprehend and manage the risks of certain adjustable rate mortgage (ARM) products, particularly products that have low initial payments for a short, fixed period and high or no payment caps that can result in substantial payment shock when the loan resets.

The Statement establishes prudent qualifying standards that institutions should follow to ensure that borrowers obtain loans they can afford to repay. This includes the expectation that stated income and reduced documentation loans to subprime borrowers should be offered only if there are mitigating factors that clearly minimize the need for verification of a borrower's repayment capacity.

Prudent workout arrangements that are consistent with safe and sound lending practices are generally in the long-term best interest of both the financial institution and the borrower.

The Statement is effective on July 10, 2007.

Federal Financial Agencies Issue Statement on Enforcement of Bank Secrecy Act/Anti-Money Laundering Requirements

On July 19, 2007, the OCC, Federal Reserve Board, Federal Deposit Insurance Corporation, Office of Thrift Supervision, and the National Credit Union Administration (collectively the, Agencies) issued a policy statement concerning the enforcement of certain anti-money laundering requirements of the Bank Secrecy Act (BSA).

The statement provides greater consistency among the agencies in enforcement decisions on BSA matters and provides insight into the considerations that form the basis of those decisions.

The statement also describes the circumstances under which the agencies will issue a cease and desist order, such as repeat

examination findings. The applicable statutes provide that if a regulated institution fails to establish and maintain a BSA compliance program or fails to correct a previously identified problem with its BSA compliance program, then the appropriate agency shall issue a formal cease and desist order.

The statement makes clear that the agencies may take formal or informal enforcement actions to address other concerns related to BSA or anti-money laundering.

NASD Issues Guidance on Short Sale Requirements

On July 5, 2007, the NASD issued in Notice to Members (NtM) 07-31, guidance on changes to conform with Amendments to SEC Rule 10a-1 and Regulation SHO.

The NASD filed for immediate effectiveness a proposed rule change to:

- Repeal NASD Rule 5100 and IM-5100;
- Eliminate references to NASD Rule 5100 and SEC Rule 10a-1 from NASD rules; and

- Remove any "short exempt" marking requirements in NASD rules.

NASD is also advising firms of temporary no-action relief from Rule 200(g) of Regulation SHO granted by the SEC for "short exempt" transactions in certain circumstances.

The effective date for the amendments is July 6, 2007.

Agencies Release for Comment Proposed Revisions to Interagency Questions and Answers Regarding CRA

On July 11, 2007, the Agencies requested comment on a series of new and revised interagency questions and answers pertaining to the Community Reinvestment Act (CRA).

The Agencies are proposing new questions and answers in addition to substantial and technical changes to the existing material. The revisions:

- Encourage institutions to work with homeowners who are unable to make mortgage payments by highlighting that they can receive CRA consideration for foreclosure prevention programs for low- and moderate-income families.
- Clarify that institutions of all sizes should receive favorable consideration for providing credit in a manner that is responsive to the needs of their communities.

- Clarify existing questions and answers.
- Improve readability.
- Adopt current terminology.
- Update existing guidance to reflect terminology changes made by the U.S. Office of Management and Budget and the U.S. Census Bureau or to reflect recent changes in the agencies' CRA regulations.

Comments must be received on or before September 10, 2007.

NASD Issues Fine for Improper Directed Brokerage Commissions, Other Payments

On July 11, 2007, in the first case of its kind, the NASD announced that it had fined a Registered Firm \$375,000 for improperly sharing directed brokerage commissions from a mutual fund company with an individual broker.

The NASD found that the Firm failed to adequately supervise the broker's communications with his union-sponsored retirement plan clients to ensure that the broker disclosed his additional compensation to those clients.

The NASD charged the broker with improperly receiving directed brokerage commissions and other compensation of more than \$280,000. He was also charged with misrepresenting and failing to disclose this compensation to his union retirement plan clients - at the same time he was advising those clients to maintain or include the fund company's mutual funds in the retirement plans they offered to working and retired union members.

These actions differ from previous ones involving directed brokerage. Previous actions involved firms receiving directed brokerage in exchange for providing "shelf space" for specific

mutual funds --- promoting those funds to the investing public and among their own brokers in exchange for directed brokerage from those funds. In this case, the fund company directed brokerage specifically for the benefit of an individual broker. NASD rules prohibit registered firms from granting a participation in directed brokerage to sales personnel. The conflict of interest for the broker is heightened in the type of arrangement.

In its settlement with the Firm and its complaint against the broker, the NASD found that the broker negotiated an arrangement with a mutual fund company to have thousands of dollars of brokerage commissions directed to him every month for his benefit. He used the additional compensation to hire a sales assistant, formerly employed by the fund company, to help him find new retirement plan clients. The Firm approved

the arrangement and for almost two years, from 2002 through 2003, the Firm received \$420,000 in directed commissions from the fund company for the broker's benefit. The Firm paid the broker \$262,500 and retained \$157,500.

NASD further found and alleged that while the broker was sharing in commissions generated by the fund company, all but one of his 15 union retirement plan clients included at least one mutual fund from the fund company in their plans. The broker periodically met with his clients and advised them to select or maintain fund company securities in their "investment menus" - the platform of investment choices available to the individual plan participants, union members. However, he failed to disclose that he was receiving substantial

additional compensation from the fund company and misled clients regarding his remuneration and the directed commissions.

NASD found in its settlement with the Firm that it failed to take steps to ensure that the broker describe and disclose to his customers the receipt of this additional compensation from the fund company. The firm approved one of the broker's misleading communications, despite its involvement in the directed commission arrangement that resulted in his conflict of interest.

OCC Releases Report on Best Practices of Loan Servicers to Prevent Foreclosures

[On June 26, 2007, the Office of the Comptroller of the Currency \(OCC\) released "Foreclosure Prevention: Improving Contact with Borrowers" in *Insights* report on the best practices of loan servicers to prevent foreclosures.](#)

The report found three main strategies in use around the nation for reaching borrowers who are late on mortgage payments. The first two involve direct customer contact by the loan servicer or a nonprofit counseling agency. The third depends on the delinquent borrower using a toll-free telephone number to call either the loan servicer or a housing counseling agency.

The OCC and the federal banking agencies are encouraging financial institutions to work with homeowners who are unable to make their mortgage payments. They have stated that institutions will not face regulatory penalties if they pursue reasonable workout arrangements with borrowers.

Federal and State Agencies Announce Pilot Project to Improve Supervision of Subprime Mortgage Lenders

[The three federal banking agencies and the Conference of State Bank Supervisors and the American Association of Residential Mortgage Regulators stated on July 17th that they will cooperate in an innovative pilot project to conduct targeted consumer-protection compliance reviews of selected non-depository lenders with significant subprime mortgage operations.](#)

The collaborative state/federal pilot is scheduled to begin in the fourth quarter of 2007 and will focus on non-depository subsidiaries of bank and thrift holding companies, as well as mortgage brokers doing business with, or working for, these entities. Additionally, the states will conduct coordinated examinations of independent state-

licensed subprime lenders and their associated mortgage brokers. The agencies will select a sample of entities under their respective supervisory or other authorities for review or investigation. The agencies will also share information about the reviews and investigations, take action as appropriate, collaborate on the lessons learned, and seek ways to better cooperate in ensuring effective and consistent reviews of these institutions.

The agencies will evaluate the companies' underwriting standards, as well as senior management oversight of the risk-management practices used for ensuring compliance with state and federal consumer protection regulations and laws, including the Home Mortgage Disclosure Act, the Equal Credit Opportunity Act, the Truth in Lending Act, the Real Estate Settlement Procedures Act,

the Federal Trade Commission Act, and the Home Ownership and Equity Protection Act. The agencies will initiate appropriate corrective or enforcement action as warranted by the findings of the reviews or investigations.

NASD Issues Guidance on Annual Certification of Compliance and Supervisory Processes

On July 16, 2007, the NASD issued in NtM 07-32, guidance that amends Rule 3013 and Interpretive Material 3013 to permit members to designate co-chief executive officers and multiple chief compliance officers.

The amendment will permit a member to designate multiple CCOs on Schedule A of Form BD, provided that:

- Each designated CCO is a principal;
- The member precisely defines and documents the areas of primary compliance responsibility assigned to each designated CCO and makes specific provisions for which of the designated CCOs has primary compliance responsibility in areas that can reasonably be expected to overlap;
- Each designated CCO satisfies all of the requirements of Rule 3013 and IM-3013 with respect to his or her defined area of primary responsibility as if that individual was the firm's only CCO; and
- Collectively, the designated CCOs have the responsibilities and expertise that enable them to consult with the CEO on the totality

of the subject matters required to be addressed in the certification by the CEO under Rule 3013.

The amendment also permits the designation of a single co-CEO solely for the purposes of compliance with Rule 3013 and IM-3013. However, co-CEOs may not divide up the requirements of the Rule and the IM; rather, each of the two CEOs are required to individually discharge all of the obligations set forth in Rule 3013 and IM-3013, each is responsible for the representations in the certification as if they were the member's only CEO, and the signature of each co-CEO is expected to appear on the same single annual certification.

The amendment is effective on July 16, 2007.

FDIC Chairman Applauds Federal Reserve Chairman Bernanke's Announcement to Propose Rules under HOEPA Addressing Unfair and Deceptive Lending Practices

FDIC Chairman Sheila C. Bair applauded Federal Reserve Chairman Ben Bernanke's statement on July 18th that the Federal Reserve will exercise its authority under the Home Ownership and Equity Protection Act (HOEPA) to propose additional rules this year addressing unfair and abusive lending practices. Chairman Bernanke's announcement was made in testimony before the

House Financial Services Committee in a hearing on "Monetary Policy and the State of the Economy."

Chairman Bair said: "Today's announcement by Chairman Bernanke that the Federal Reserve will exercise its authority under HOEPA to

address unfair and deceptive lending practices is a welcome development. The FDIC, the Federal Reserve, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision have acted quickly and cooperatively to issue regulatory guidance to financial institutions to establish strong standards to protect subprime borrowers. Unfortunately, a significant regulatory gap has remained due to the substantial portion of subprime lending that originates with non-bank lenders. The Federal Reserve's decision to propose additional rules under HOEPA will help to close this gap – and aid significantly to relieve negative competitive pressure on banks.

"I want to thank Chairman Bernanke for his personal interest and commitment on this issue. Under his leadership, the considerable influence, independence and integrity of the Federal Reserve Board will be mustered for the benefit of consumers, including the more vulnerable segments that have disproportionately felt the brunt of unfair and abusive lending practices. He has shown sensitivity and openness, which all should applaud."

OCC and Federal Reserve Note Possible Impact of the Fair Value Option on Application of Basel Market Risk Requirements to Banking Organizations

On July 24, 2007, the staff of the OCC and Federal Reserve reminded banking organizations that reporting an amount of gross trading assets and liabilities that equals 10 percent or more of total assets, or \$1 billion or more, may subject a banking organization to the market risk capital rule. The market risk capital rule requires banking organizations subject to the rule to have in place adequate risk management processes (including but not limited to Value-at-Risk model(s) approved by the Federal Reserve) and capital sufficient to support the market risk of their covered positions.

A banking organization that has adopted Financial Accounting Standards Board Statement No.159, *The Fair Value Option for*

Financial Assets and Financial Liabilities (FAS 159) and applied this option to securities should determine whether any resulting designation of securities as trading subjects the organization to the market risk capital rule. Banking organizations that have exceeded or expect to exceed in the near future the minimum thresholds for the market risk capital rule should contact their Reserve Bank or OCC Supervisory Office to discuss their plans to address the rule's requirements..

Additional Information

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