

Financial Services Regulatory Highlights

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SEC Proposes Flash Order Ban

On September 17, 2009, the Securities Exchange Commission (SEC) unanimously proposed a rule amendment that would eliminate the exception for flash orders from the quoting requirements of the Securities Exchange Act of 1934. The proposed rule addresses the SEC's concern that the use of flash orders by exchanges and other market centers could detract from the fairness and efficiency of the national market system.

Rule 602 of Regulation NMS and Rule 301(b) of Regulation ATS require exchanges and alternative trading systems to provide their best-priced quotations to

the consolidated quotation data that is widely disseminated to the public. Rule 602 exempts certain orders (flash orders) that are communicated to certain market participants and either executed immediately or withdrawn immediately after communication from the public quotation requirement.

The SEC voted unanimously to propose eliminating the flash order exception from Rule 602. If adopted, the proposed amendment would effectively prohibit all markets - including equity exchanges, options exchanges, and alternative trading systems - from displaying marketable flash orders. Flash orders with non-marketable prices would have to be included in the consolidated quotation data.

In its proposal, the SEC seeks public comment and data on a broad range of issues relating to flash orders, including the costs and benefits associated with the proposal. It also seeks comment on whether the use of flash orders in the options markets should be evaluated differently than use in the equity markets.

Comments should be received on or before November 23, 2009.

Congressman Circulates Draft of Accountability and Transparency in Credit Rating Agencies Act

On September 25, 2009, Congressman Kanjorski, Chairman of the House Financial Services Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, circulated a discussion draft of legislation to create the Enhanced

Accountability and Transparency in Credit Rating Agencies Act.

The Bill would allow the SEC to review internal processes for determining credit ratings to ascertain if

the rating organization has established and documented a system of internal controls, due diligence and implementation of methodologies for determining credit ratings. These reviews will occur no less than annually in a manner determined by the SEC.

The Bill would also require rating agencies to manage conflicts of interests. Each Nationally Recognized Statistical Rating Organization (NRSRO) or its parent entity shall have a board of directors. The board of directors shall be independent. For the Board to be considered "independent", at least one-third of the board would be required meet the standard for independence outlined below and a minimum of two members of the Board must meet the standard.

In order to be considered independent, a director of the organization may not, other than in his or her capacity as a member of the board of directors or any committee, accept any consulting, advisory or other compensatory fees from the organization or be an affiliated person of the NRSRO or any of its affiliates. The compensation of the independent directors shall not be linked to the business performance of the organization and shall be arranged to ensure the independence of their judgment. The term of the office of the independent directors shall be for a predetermined fixed period not exceeding five years and shall not be renewable. In addition to the overall responsibility of the board of directors, the board shall oversee the development, maintenance and

enforcement of policies, procedures and methodologies for determining credit ratings, as well as to address, manage, and disclose any conflicts of interest. The board of directors shall also oversee the compensation and promotion of the organization.

Additionally, the Bill would require that each organization designate an individual to serve as a compliance officer, whose duties would include:

- Report directly to the board of directors;
- Review compliance with policies and procedures to manage conflicts of interest;
- Review compliance with internal controls with respect to the procedures and methodologies for determining credit ratings;
- Consult with the board of directors and resolve any conflicts of interest that may arise;
- Ensure compliance with securities laws and the rules and regulations; and
- Establish procedures relating to complaints and remediation efforts of non-compliance issues.

Congressman Kanjorski also announced on the day the draft legislation was released, that the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises will hold a hearing on September 30, 2009, to discuss the Enhanced Accountability and Transparency in Credit Rating Agencies Act.

U.S. Treasury Releases Guidance on Stronger Capital and Liquidity Standards for Banking Firms

On September 2, 2009, the U.S. Department of the Treasury (Treasury) released a policy statement on capital and liquidity standards. The Treasury policy statement set forth the core principles that should guide reform of the international regulatory capital and liquidity framework to better protect the safety and soundness of individual banking firms and the stability of the global financial system.

Treasury acknowledges that a principle lesson from the crisis is that higher capital requirements for banking firms are essential. However, there is also recognition that standards that are more stringent will reduce the amount of financial intermediation and may limit the availability of credit. Therefore, the design of the new regulatory capital regime seeks to maximize financial stability while preventing an excessive reduction in capital availability, innovation, and economic growth. Treasury recommends that a new international capital

and liquidity standards framework should be developed by December 31, 2010 and should be implemented by December 21, 2012.

The core principles are outlined below:

- Capital and liquidity standards should seek to prevent the systemic risk caused by interconnected firms and financial holding companies, while also protecting individual firms.
- Capital and liquidity standards for all firms should be more stringent, with the standards for large, firms which pose systemic risk (i.e. Tier 1 Financial Holding Companies (FHCs)) being even higher.
- The regulatory capital framework should place a larger emphasis on higher quality forms of capital that is permanent, deeply subordinated, and does not require the issuer to make payments to investors. This higher form of capital will enable a bank to sustain losses and continue operation.
- Risk based capital rules must accurately reflect a bank's relative risk and financial position, including systemic risk. This should include a reduction in the excessive regulatory reliance on internal banking firm models and credit rating agencies risk ratings.
- Economies are procyclical in nature, with positive growth and profit trends leading to more lending and

investment, reinforcing the positive trend. However, in a downturn there is a sharp reduction in this growth and reduction. There must be a reduction in the procyclicality of regulatory capital and accounting regimes. Capital regulation that cushions the effects of adverse financial system shocks would enable banks to better sustain losses and continue operation.

- Banks must be subject to simple, non-risk based leverage requirements, which will reduce gaps, which are inevitable in any risk-based capital framework.
- The liquidity standards for Banks must be more conservative. Liquidity regulations should be aimed at enhancing short-term resiliency of banking firms by requiring them to hold a pool of unencumbered liquid assets sufficient to cover funding shortfalls, as well as reducing longer-term structural asset-liability maturity mismatches.
- With the implementation of enhanced capital liquidity standards to banking firms, there is likely to be an incentive to migrate financial transactions to the non-bank financial sector. Therefore, attention should be paid to preventing the re-emergence of an under-regulated non-bank financial sector that poses a threat to financial stability.

Changes to FINRA Rule 3310 Eliminating the Independent Testing Exception Relating to AML

On September 10, 2009, the SEC approved a proposed rule change to adopt FINRA Rule 3310 (Anti-Money Laundering (AML) Compliance Programs) and eliminate the independent testing exception. Previously, NASD IM-3011-1 permitted AML compliance program testing to be conducted by persons who report to either the AML compliance person or persons performing the function being tested if:

- The firm has no other qualified internal personnel to conduct the test;

- The firm establishes written policies and procedures to address the conflicts that may arise from allowing the test to be conducted by a person who reports to the person(s) whose activities he or she is testing;
- The person conducting the test reports the results of the test to someone who is senior to the AML compliance person or persons performing the function being tested; and
- The firm documents its rationale, which must be reasonable, for determining there is no other alternative than to comply in this manner.

The approved rule change will eliminate the independent testing exception. FinCEN has stated that the independent testing provision of the Bank Secrecy Act

(BSA) precludes AML program testing by personnel with an interest in the outcome of the testing.

SEC Grants Immediate Effectiveness to Clearing Agencies' Proposed Rule Regarding Sanction and Embargo Programs

On September 11, 2009, the SEC granted immediate effectiveness to proposed rule revisions submitted by The Depository Trust Company (DTC), the National Securities Clearing Corporation (NSCC), and the Fixed Income Clearing Corporation (FICC), collectively the Clearing Agencies. The Clearing Agencies are revising their rules to refine the obligations of their members or participants concerning the economic sanctions and embargo programs administered and enforced by the Treasury Department's Office of Foreign Assets Control. Specifically, the rule establishes a new requirement that certain members or participants subject to U.S. jurisdiction submit a "Confirmation of an OFAC Program" Letter (OFAC Letter) every two years. The OFAC Letter documents that the U.S. member or participant has implemented a program to conduct appropriate risk-

based OFAC screening and that the U.S. member or participant confirms that activity subject to OFAC sanctions regulations has been excluded from business conducted through the Clearing Agencies.

The Clearing Agencies will make the OFAC Letter available for execution by U.S. members or participants on or before October 1, 2009. U.S. members or participants that fail to provide the Clearing Agencies with the OFAC Letter by March 31, 2010, will be subject to a \$5,000 fine for failure to provide the initial OFAC Letter. The OFAC Letter must be executed every two years from the date on which the current OFAC Letter was executed.

Comments should be received on or before October 13, 2009.

Additional Information

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