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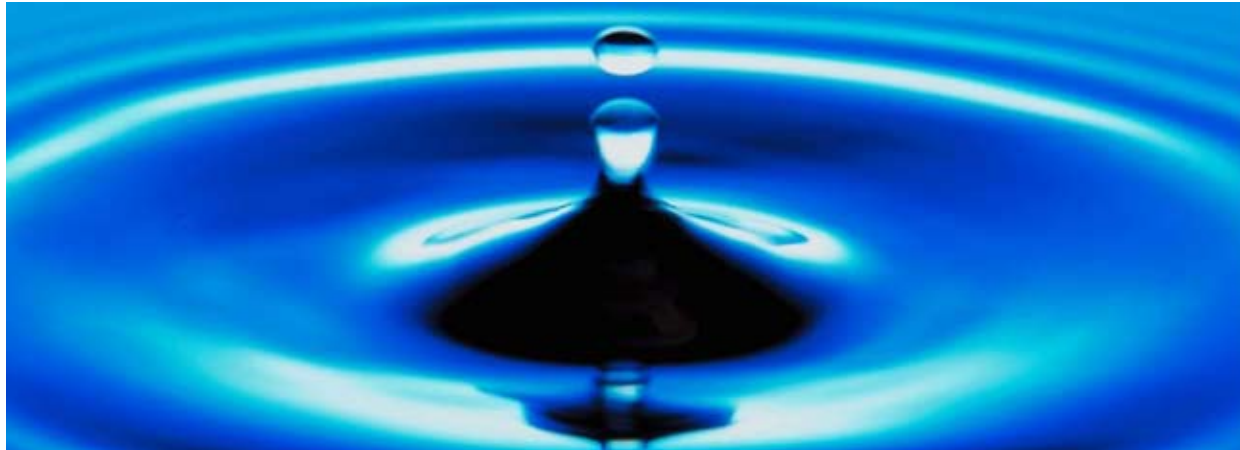
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News Bulletins: Banking

Federal Reserve Board Proposes Rules Implementing Regulation Z

On September 29, 2009, the Federal Reserve Board proposed rules to implement provisions of the Credit Card Accountability and Disclosure Act of 2009 (Credit Card Act) that are effective on February 22, 2010. The proposal would amend Regulation Z (Truth in Lending) in order to protect consumers using credit cards from certain unfair practices. Specifically, the proposed rules would, among other things:

- Prohibit creditors from applying unexpected increases in interest rates during the first year after an account is opened. After the first year, any increases on new transactions would have to comply with previously implemented notice requirements.
- Prohibit creditors from issuing a credit card to consumers who are under the age of 21 without a written application that supports the consumer's ability to make the required minimum payments unless the consumer has the signature of a parent/cosigner.
- Require institutions of higher education to publicly disclose agreements with credit card issuers regarding the marketing of credit cards.

- Require creditors to obtain a consumer's consent before charging fees for transactions that exceed the credit limit.
- Require consideration of a consumer's ability to make required minimum payments before opening a new account or increasing the credit limit.
- Limit the high fees associated with subprime credit cards.
- Prohibit a creditor from imposing more than one over-the-limit fee or charge per billing cycle.
- Prohibit creditors from allocating payments in ways that maximize interest charges, i.e., require payments made above the required minimum payment first be allocated to the balance with the highest annual percentage rate.

As background, the Credit Card Act amended provisions of the Truth in Lending Act (TILA) and established several new requirements to establish fair and transparent practices pertaining to open-end consumer credit plans. The requirements of the Credit Card Act are being implemented in three stages; initial provisions became effective on August 20, 2009. Those provisions require consumers to receive 45 days advance notice of increases in interest rates and significant changes in the terms to credit card agreements, and regarding the amount of time available to make payment. The second stage of implementation will take place February 22, 2010 and the final stage is scheduled for August 22, 2010.

The complete notice, which will be published in the *Federal Register*, can be found at: <http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20090929a1.pdf>. Comments on the proposed rule must be submitted within 30 days after publication, which is expected shortly.

Suspicious Activity Reports Regarding TARP-related Programs

The Financial Crimes Enforcement Network (FinCEN) has issued an advisory asking for assistance from financial institutions in identifying suspicious transactions that involve Troubled Asset Relief Program (TARP)-related entities. This advisory is part of the U.S. Department of Treasury's effort to ensure that the funds from the government's Financial Stability Plan are used to lay the foundation for economic recovery, rather than illicit activity.

The following are examples of suspicious activities that may be related to TARP-related transactions:

- Conflicts of interest: Some TARP-related programs, such as the Public Private Investment Program (PPIP) are structured and designed to benefit service providers which may impact how particular assets are priced in the market. An increase in the price of an asset could benefit anyone who already owns or manages the asset, including the PPIP manager making investment decisions. Indications of activities such as "flipping" (i.e., multiple transactions over a short time period), which result in a rapid increase in asset valuation in an otherwise stagnant market, should raise the suspicions of institutions involved in these transactions.
- Collusion: PPIP managers could be persuaded through kickbacks, quid pro quo transactions, or other collusive arrangements, to manage PPIPs for personal gain. Financial institutions should be aware of anomalous or out-of-market pricing of assets in seemingly arm's-length transactions among affiliated parties.
- Insider trading: There is opportunity for insiders to benefit in trading immediately prior to a public announcement of the approval, receipt, use of or repayment of TARP-related funds. A review of trading in the days prior to the announcement of activities involving Capital Purchase Program

(CPP)-funded banks may reveal suspicious activity.

- Money laundering: TARP programs present an opportunity for money-laundering organizations to launder their illicit proceeds. Transactions of this nature might closely resemble traditional money laundering transactions, but would involve funds from TARP programs.

For further information on this report, refer to FinCEN's website at http://www.fincen.gov/statutes_regs/guidance/html/fin-2009-a006.html.

FinCEN'S SAR Activity Review

FinCEN has released the sixteenth edition of its *SAR Activity Review – Trends, Tips & Issues*¹ (the "Review"), which is published semi-annually in May and October. This issue looks at Bank Secrecy Act (BSA) reporting, specifically as it relates to mortgage loan fraud for the period January 1 to June 30, 2009.

Overall filings

There was less than a one percent increase in the number of mortgage loan fraud Suspicious Activity Reports (MLF SARs) filed from the number filed for the same time period in 2008. MLF SARs filed during this period accounted for nine percent of all SARs filed.

Ten depository institutions accounted for 72% of the MLF SARs filed. The top relational subjects of the filings were borrowers (43%) and brokers (13%). The next largest category was "Other" which encompassed such varied categories as: real estate professional, borrower or family member, seller, closing agent. California, Florida and New York, along with their respective cities, i.e., Los Angeles, Miami and New York City, ranked as the top three states represented by filers of MLF SARs.

Secondary activities to mortgage loan fraud were also tracked during this same time period. False statement was the major activity indicated, accounting for 28% of the total. Other activities, but to a lesser degree were: identify theft, consumer loan fraud, and misuse of position or self-dealing.

Approximately 735 financial institutions submitted MLF SARs, and of these 61% were supervised by the Office of the Comptroller of the Currency. Thirty-three percent of the filers came under the supervision of the Office of Thrift Supervision and the Board of Governors of the Federal Reserve System.



The complete report can be found at http://www.fincen.gov/news_room/rp/files/sar_tti_16.pdf.

News Bulletins: Investment Management

Legislative Initiatives to Require Private Advisers to Register with the SEC

On July 15, 2009, the Obama Administration delivered to the U.S. Congress proposed legislation that would require private fund advisers² with assets under management of more than \$30 million to register with the U.S. Securities and Exchange Commission (SEC). The Private Fund Investment Advisers Registration Act of 2009³ (the "Registration Act") is the fourth piece of legislation⁴ introduced in 2009 aimed at amending the current registration requirements governing private fund advisers. The objective of the legislation, as outlined by the Obama Administration⁵ is to:

- Help protect investors from fraud and abuse
- Increase transparency
- Increase information disclosure requirements to better assess potential systemic risk and potential threats to overall financial stability

SEC registration and exemptions

The Registration Act would eliminate the private adviser exemption under the Investment Advisers Act of 1940 ("Advisers Act") and as stated above would require U.S. investment advisers to private investment funds with more than \$30 million in assets under management to register with the SEC. A discussion draft on the Registration Act, released October 1, 2009 by the U.S. House of Representatives Financial Services Committee, includes an exemption in the legislation for advisers to venture capital funds.⁶ The House draft would not require venture capital fund advisers to register with the SEC, but would require such advisers to file reports with the SEC and to keep records, in both cases as the SEC deems appropriate.

The Registration Act would not require foreign investment advisers to register under the Advisers Act if the foreign adviser:

- Has had less than \$25 million in assets under management attributable to U.S. clients and fewer than 15 U.S. clients during the preceding 12 months;
- Does not maintain a U.S. place of business; and
- Does not hold itself out to the U.S. public as an investment adviser or serve as an adviser to a U.S. registered investment company.

Regulatory reporting

In addition to requiring certain private funds advisers to register with the SEC, the Registration Act would amend the Advisers Act to authorize the SEC to require registered private fund advisers to maintain records and submit reports relating to the private funds they manage. These records and reports are intended to facilitate an assessment by the Board of Governors of the Federal Reserve, and the yet-to-be established Financial Services Oversight Council, of the systemic risk such advisers and their funds might pose to the financial system. Required information would include, but not be limited to:

- Amount of assets under management
- Use of leverage (including off-balance sheet leverage)
- Counterparty credit risk exposures, and
- Trading and investment positions and trading practices

The Registration Act mandates that the SEC keep confidential the information included in these reports, unless requested by Congress or other federal agencies.

Recordkeeping requirements and disclosures

Under the Registration Act, registered private fund advisers, like other registered advisers, would be subject to the Advisers Act requirements governing, among other things, client disclosures, recordkeeping, and formalized compliance policies and procedures. Registered private fund advisers, would also be required to make these records available to the SEC during inspections within a reasonable timeframe of the request.

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Feature Articles: Banking

Correspondent Concentration Risks

On September 25, 2009, the Office of the Comptroller of the Currency (OCC), the Office of Thrift Supervision (OTS), the Federal Deposit Insurance Corporation (FDIC), and the Federal Reserve Board of Governors (FRB) (collectively “the Agencies”) published in the *Federal Register*⁷ proposed guidance and a request for comment on “Correspondent Concentration Risks.” This proposed guidance does not replace, but rather supplements current regulatory guidance on concentration risks.

The proposed guidance addresses the regulators’ expectations with regard to financial institution identification, monitoring and management of risks associated with concentrations arising in correspondent relationships. The focus of the guidance is on financial institutions’ aggregate credit and funding exposures. Correspondent credit exposures are at risk in the event the borrowing institution fails, while funding risk occurs in instances where financial institutions rely heavily on a limited number of institutions providing liquidity. In the event an institution fails, the continued viability of other financial institutions can be affected if the failed institution was a major source of liquidity for, or a major recipient of credit from, an institution.

The proposed guidance also outlines regulatory expectations of financial institutions’ “appropriate due diligence” on institutional credit and funding exposures. Concentrations in correspondent relationships lack diversification, increasing the need for strong risk management programs. Concentrations are determined on direct as well as indirect exposure and the guidance instructs financial institutions to “aggregate credit and funding exposures to other institutions on a standalone basis, and take into account exposures to other institutions’ affiliates.”⁸ Institutions should be aware of their correspondent relationships,

including their own affiliates’ exposures to the same correspondents as well as exposure to affiliates of their correspondents.

The following summarizes the major guidance points.

Identifying correspondent concentration risk

Institutions should implement procedures that identify correspondent concentrations on a standalone as well as on a consolidated basis, including affiliate transactions. Concentrations should be calculated using both gross and net credit exposures, reducing exposures to a net position only when secured by readily marketable collateral.

Monitoring correspondent concentrations

The FRB requires FDIC-insured institutions to have policies and procedures that require periodic reviews of the financial condition of correspondents, noting any deterioration in such financial condition⁹ pursuant to Regulation F. The regulators expect financial institutions to specify the information needed; the ratios used to monitor; and the trends management will review for an institution’s correspondent relationships on an ongoing basis. Such monitoring should include the following:

- Timely reviews of correspondent relationships
- Documentation requirements for the reviews
- Criteria for determining when relationships that meet or exceed internal criteria are to be reported to the Board of Directors or the appropriate management committee for an assessment of risk and risk reducing strategies

Managing correspondent concentrations

Financial institutions have an obligation “to establish prudent correspondent concentration limits, as well as ranges or tolerances for each factor being monitored.”¹⁰ Prudent risk management of correspondent concentrations should include:

- Procedures that address concentrations, established limits, ranges, or tolerances and what to do when the limits, ranges or tolerances are breached;
- Contingency plans for managing risk when the limits, ranges, or tolerances are breached (individually or collectively) and “such contin-



agency plans should not rely on temporary deposit insurance programs for mitigating concentration risk.”¹¹

Appropriate due diligence

The proposed guidance reinforces the regulators’ past and present expectations that financial firms with credit or funding exposures to other financial firms have effective risk management programs in place for these credit and funding activities. Such programs should include written investment, lending, and funding policies and procedures, with appropriate limits set for these activities. Institutions should conduct independent analyses of credit and funding transactions prior to entering into them. All such credit and funding transactions are expected to be “on an arm’s length basis, conform to sound investment, lending, and funding practices, and avoid potential conflicts of interest.”¹²

The Agencies requested comments on the proposed guidance itself and specifically:

- Appropriateness of aggregating *all* credit and funding exposures and whether some types of advances or commitments should be excluded;
- Types of factors institutions should consider when assessing correspondents’ financial condition;
- Need to establish internal limits as well as ranges or tolerances for each factor being monitored;
- Types of actions that should be considered for contingency planning and the timeframes for implementing those actions; and
- Whether there are operational issues the regulators should consider when finalizing the proposed guidance.

Comments were due October 26, 2009.

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Feature Articles: Investment Management

The SEC Proposes to Restrict “Pay-to-Play” Practices

On August 3, 2009, the U.S. Securities and Exchange Commission (SEC) released for public comment IA-2910, *Political Contributions by Certain Investment Advisers*,¹³ commonly referred to as the proposed “pay-to-play” rule under the Investment Advisers Act of 1940. The proposed rule seeks to curb the influence registered investment advisers may have on their selection to manage public monies based on political contributions.

Investment advisers often manage a variety of public funds, used to finance local and state pension and retirement plans, as well as other public funding needs, e.g., infrastructure improvements. The management of these funds is frequently handled by investment advisers chosen by elected officials or by their staff.

According to the SEC, the decision to choose one adviser over another may be influenced by the level of political contributions made to a certain official or campaign.¹⁴ The proposed rule states that “elected officials who allow political contributions to play a role in the management of these assets violate the public trust by rewarding those who make political contributions.”¹⁵ This practice may result in financial loss to the end beneficiary due to poor fund management, increased management fees or other, similar negative impacts. In an effort to curb “pay-to-play” practices, the proposed rule focuses on a number of restrictions, described below.

The proposed rule would prohibit an investment adviser from receiving compensation for advisory services from a government entity¹⁶ for a two-year period if the adviser or a covered associate of the adviser has made a political contribution¹⁷ exceeding \$250 to a government official who is in a position to directly or indirectly influence the selection of an

investment adviser to manage public funds. The proposed \$250 de minimis exception applies to the adviser and its covered associates¹⁸ individually on a per election basis; consequently, the adviser and its associates could in the aggregate give more than \$250 in political contributions to an applicable government official during a campaign without running afoul of the proposed rule, i.e., individual donors may make \$250 contributions during a primary and general election. (The SEC indicated that these de minimis contributions are not likely to be made with the intent of influencing political decisions). Contributions by other persons, such as employees of the adviser who are not covered associates, would not fall within the rule's restrictions, unless the contribution was made in an effort to influence a government entity's or official's selection of the adviser.

Advisers may continue to support and serve a government client if a political contribution in excess of the de minimis \$250 exception is made within the two-year period preceding the adviser's selection to manage public funds, but must do so on an uncompensated basis. This provision is designed to avoid forcing advisers to abruptly abandon the management of public assets, which could have detrimental effects on these assets. Advisers could receive an exemption from the two-year restriction on receiving compensation for advisory services, if political contributions are made to an entity that is not in a position of investment decision-making authority or in a position to impact the investment adviser selection process. Such exemptions would be granted by the SEC, following an application process from the adviser.

The proposed rule would prohibit advisers from directly or indirectly compensating a third party who solicits investment advisory services from any government entity, i.e., so called "third party solicitors." By prohibiting the use of "third party solicitors," it becomes more difficult for advisers to circumvent the rule's prohibition on "pay-to-play" practices by utilizing outside sources to make political contributions on their behalf.

The proposed rule would prohibit advisers and/or their covered associates from coordinating through another entity or third party a contribution to a government official to which the adviser is providing, or seeking to provide, investment advisory services. This restriction would assist in curtailing so-called "gatekeeper" arrangements where political contributions or payments are arranged by an intermediary,

typically a pension consultant, who distributes or directs contributions or other payments to elected officials or candidates.¹⁹ Similarly, the proposed rule would prohibit investment advisers and their covered associates from circumventing the rule, by directly or indirectly channeling political contributions through others, such as family members, lawyers, consultants, or other companies affiliated with the investment adviser, if the contribution would violate the rule had the adviser made the contribution or payment directly.

Registered advisers would be required to maintain records regarding their political contributions and those of their covered associates. These records and the internal controls associated with their safeguarding are to be documented, and integrated as part of a robust compliance program. Associated records and documentation relating to political contributions that fall above the de minimis contribution²⁰ would be required to be made available to the SEC as part of an inspection.

The SEC leveraged the Municipal Securities Rulemaking Board Rules G-37 and G-38²¹ (which have undergone several amendments since inception) as the basis for the current proposed rule. The SEC believes these rules have been successful in curbing "pay-to-play" practices within the municipal bond industry.

The SEC introduced a similar proposal in 1999, in an attempt to restrict "pay-to-play" practices involving investment advisers. That proposal was generally met with opposition from politicians and investment advisers, and the proposal was not adopted. In issuing the proposed rule at this time, the SEC determined that allegations of unlawful "pay-to-play" practices were re-emerging in the investment management arena, as criminal cases involving "pay-to-play" in the selection of investment advisers have gone forward in New York, New Mexico, Illinois, Ohio, Connecticut and Florida,²² most notably when New York Attorney General, Andrew Cuomo, launched an extensive investigation into "pay-to-play" practices involving New York State pension funds in June of 2009.²³

The proposed rule would apply to registered advisers as well as those advisers who manage a "covered investment pool," which includes funds that are exempt from registration under the Investment Company Act of 1940 under sections 3(c)(1), 3(c)(7) or 3(c)(11). The comment period for the rule closed on October 6th, 2009.



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End Notes

- ¹ SAR Activity Review – Trends, Tips & Issues. http://www.fincen.gov/news_room/rp/files/sar_tti_16.pdf
- ² The Registration Act describes private fund advisers as “advisers to hedge funds and other private pools of capital, including private equity and venture capital investments.”
- ³ Private Fund Investment Advisers Registration Act of 2009. <http://www.treasury.gov/press/releases/reports/title%20iv%20reg%20advisers%20priv%20funds%207%2015%2009%20fnl.pdf>.
- ⁴ Additional proposed legislation includes: The Hedge Fund Adviser Registration Act of 2009; The Hedge Fund Transparency Act of 2009; and The Private Funds Transparency Act of 2009.
- ⁵ Fact Sheet: Administration’s Regulatory Reform Agenda Moves Forward: Legislation for the Registration of Hedge Funds Delivered to Capitol Hill, July 15, 2009. <http://www.treas.gov/press/releases/tg214.htm>.
- ⁶ House Financial Services Committee press release: Kanjorski releases financial reform drafts on Investor Protection, Private Advisor Registration, and Federal Insurance; October 1, 2009. http://www.house.gov/apps/list/press/financialsvcs_dem/presskanj_100109.shtml.
- ⁷ *Federal Register* 74, no. 185 (September 2009): 48955. <http://edocket.access.gpo.gov/2009/pdf/E9-23208.pdf>
- ⁸ *Ibid*, p. 48957.
- ⁹ 12 CFR Part 206. *Limitation on Interbank Liabilities*.
- ¹⁰ *Federal Register* 74, no. 185 (September 2009): 48959.
- ¹¹ *Ibid*.
- ¹² *Ibid*.
- ¹³ Political Contributions by Certain Investment Advisers; Proposed Rule; Release No. IA-2910; File No. S7-18-09; August 3, 2009. The Release may be found at: <http://sec.gov/rules/proposed/2009/ia-2910.pdf>.
- ¹⁴ *Ibid*, p. 7.
- ¹⁵ *Ibid*, p. 7.
- ¹⁶ The proposed rule defines “Government entity” as “any State or political subdivision of a State, including any agency, authority, or instrumentality of the State or political subdivision, a plan, program, or pool of assets sponsored or established by the State or political subdivision or any agency, authority or instrumentality thereof; and officers, agents, or employees of the State or political subdivision or any agency, authority or instrumentality thereof, acting in their official capacity.”
- ¹⁷ Under the proposal, a “contribution” is defined as “any gift, subscription, loan, advance, deposit of money, or anything of value made for the purpose of influencing an election for a federal, state or local office, including any payments for debts incurred for such an election.”
- ¹⁸ A “covered associate” would include the adviser’s general partners, managing members, executive officers, and other individuals with a similar status or function, as well as any employee of the of the adviser who solicits business from a state or local official for the adviser.
- ¹⁹ *Ibid*, p. 55.
- ²⁰ The SEC is seeking comment on whether or not the final rule should include language that would require the same level of record keeping on all political contributions made, not just those over the \$250 threshold.
- ²¹ The Municipal Securities Rulemaking Board Rules G-37 and G-38 are rules that were designed to address “pay-to-play” practices specifically in the municipal securities markets.
- ²² *Ibid*, p.12-13.
- ²³ *Ibid*, p. 21.

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