



# The Washington Report

ADVISORY

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## Legislative Update

### Secretary Geithner Outlines Administration's Proposal to Regulate OTC Derivatives

On July 10, the House Committee on Financial Services and the House Committee on Agriculture conducted a joint hearing to *Review the Administration's Proposal to Regulate the Over-the-Counter Derivatives Market*. Timothy Geithner, Secretary of the Department of the Treasury ("Treasury") was the sole witness.

Secretary Geithner's testimony expanded on the Obama Administration's proposal to comprehensively regulate the over-the-counter ("OTC") derivatives market that was included in its recommendations for financial regulatory reform, which were released on June 17 as a White Paper entitled, "*Financial Regulatory Reform - A New Foundation: Rebuilding Financial Supervision and Regulation*." He stated that the proposal was

designed to achieve the following broad objectives:

- Prevent activities in the OTC derivatives market from posing risk to the stability of the financial system;
- Promote efficiency and transparency of the OTC derivatives market;
- Prevent market manipulation, fraud, and other abuses; and
- Protect consumers and investors by ensuring that OTC derivatives are not marketed inappropriately.

To achieve these objectives, Secretary Geithner outlined the following steps:

- Require all standardized derivative contracts to be cleared through well-regulated central counterparties and executed either on regulated exchanges or regulated electronic trade execution systems.
- Encourage, through capital requirements and other measures,

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substantially greater use of standardized OTC derivatives and thereby facilitate substantial migration of OTC derivatives onto central clearinghouses and exchanges. Customized and non-centrally cleared derivatives would be required to meet higher capital and margin requirements.

- Require all OTC derivative dealers, and all other major OTC derivatives market participants, to be subject to substantial supervision and regulation, including capital requirements, margin requirements, and business conduct standards.
- Make the OTC derivatives market fully transparent. To bring this about, the Securities and Exchange Commission ("SEC") and Commodities Futures Trading Commission ("CFTC") would be required to impose recordkeeping and reporting requirements (including an audit trail) on all OTC derivatives. OTC derivatives that are not centrally cleared would be required to be reported to a regulated trade repository on a timely basis.
- Provide the SEC and CFTC with clear authority for civil enforcement and regulation of fraud, market manipulation, and other abuses in the OTC derivatives market.
- Work with the SEC and CFTC to tighten the standards that govern who can participate in the OTC derivatives market and ensure that inappropriate marketing practices are not employed to sell derivatives to unsophisticated individuals, companies, and other parties.
- Continue to work with international counterparts to help ensure that the strict and comprehensive regulatory

regime for OTC derivatives employed in the U.S. is matched by a similarly effective regime in other countries.

Secretary Geithner stated that he welcomed the commitment of the Congressional leadership to move forward with legislation this year.

On June 22, SEC Chairman Shapiro and CFTC Chairman Gensler testified before the Senate Committee on Banking, Housing and Urban Affairs' Subcommittee on Securities, Insurance and Investment regarding their efforts and ideas for modernizing oversight of the OTC derivatives market to increase transparency and reduce risk. Chairman Shapiro suggested the SEC take primary responsibility for securities-related OTC derivatives (because it is responsible for the markets affected by these derivatives) and that the CFTC take primary responsibility for all other OTC derivatives, including those related to interest rates, foreign exchange, commodities, energy and metals.

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### **House Committee Releases Proposed Legislation for Consumer Financial Protection Agency**

On July 8, Barney Frank, Chairman of the House Committee on Financial Services, introduced H.R. 3126 to establish the Consumer Financial Protection Agency ("CFPA") as proposed by the Obama Administration June 30. As introduced by Chairman

Frank, H.R. 3126 is essentially the same as the *Consumer Financial Protection Agency Act of 2009* (the "CFPA Act") drafted by the Administration though with some exceptions, including:

- Enforcement of the *Community Reinvestment Act* would not be transferred to the CFPA but would be retained by the regulatory agencies; and
- References to the National Banking Supervisor, which does not yet exist, have been deleted and replaced with the Office of the Comptroller of the Currency and the Office of Thrift Supervision, as appropriate.

In a press statement, Chairman Frank indicated that he intended to schedule a mark-up of the bill by the end July.

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### **House Subcommittee Considers the Independence of the Fed and its Role in Systemic Risk Regulation**

The House Committee on Financial Services Subcommittee on Domestic Monetary Policy and Technology held a hearing on July 9 to consider the potential impact that becoming a systemic risk regulator might have on the Federal Reserve Board's ("Fed") independence with respect to monetary policy. Nine witnesses provided written testimony, including several current and former Fed governors.

In general, the Fed governors all believed that the Fed's monetary policy role and a supervisory and regulatory role as a systemic risk regulator were mutually compatible. They also inferred that the Fed was already acting as the systemic risk regulator in many ways, citing its leadership in the Supervisory Capital Assessment Program ("SCAP") completed in the spring of 2009 for the 19 largest bank holding companies, as well as the relatively few firms that would fall under systemic risk regulation in addition to the relevant bank holding companies currently subject to the Fed's oversight. One governor did state, however, that the Fed did not have sufficient resources to take on this additional responsibility.

The other witnesses were mixed in their views though, on balance, believed that the role of systemic risk regulator would compromise the Fed's independence with respect to monetary policy and dilute its focus. They offered a variety of alternative reform measures including:

- Pricing for systemic risk through capital and liquidity requirements, and through fees for access to the Fed's lending facility and fees for insurance through the Federal Deposit Insurance Corporation or other similar agency.
- Implementing only the Financial Services Oversight Council (proposed by the Administration) to monitor systemic risk and adherence to principals. (One witness suggested that a systemic risk regulator may serve as an excuse for the other regulatory agencies to pass off responsibility for regulatory failures).

- Ending "too big to fail" and extending FDICIA (the *Federal Deposit Insurance Corporation Improvement Act of 1991*) to bank holding companies (e.g., prompt corrective action).
- Requiring the Fed to issue a rule on "lender of last resort."

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#### **Treasury Releases Proposed Legislation for Investor Protection**

On July 10, the Department of the Treasury released the Obama Administration's proposed legislation "to strengthen the SEC's authority to protect investors" consistent with its recommendations for regulatory reform released on June 17. Among other things, the *Investor Protection Act of 2009* would:

- Permanently establish an Investor Advisory Committee to advise and consult with the SEC on:
  - Regulatory priorities and issues regarding new products, trading strategies, fee structures and the effectiveness of disclosures;
  - Initiatives to protect investor interest; and
  - Initiatives to promote investor confidence in the integrity of the market place.
- Clarify the SEC's authority to conduct consumer testing.
- Give the SEC the authority to promulgate rules to require a fiduciary duty for any broker, dealer, or investment adviser who gives

investment advice to a retail customer.

- Give the SEC authority to regulate the quality and timing of disclosures.
- Give the SEC authority to prohibit mandatory arbitration clauses in broker-dealer, municipal securities dealer, and investment advisory agreements.
- Create consistent remedies to pursue serious misconduct under the *Securities Act of 1933*, *Securities Exchange Act of 1934*, *Investment Advisers Act of 1940* and *Investment Company Act of 1940*.
- Create an Investor Protection Fund to compensate whistleblowers for information that leads to enforcement actions resulting in significant financial awards.
- Give the SEC authority to remove regulated persons from all aspects of the securities industry rather than just a specific segment.

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#### **Congressmen Dodd and Frank Ask Agencies to Consider Second Mortgages and Credit Card Interest Rate Changes**

On July 9, Chris Dodd, Chairman of the Senate Committee on Banking, Housing and Urban Development, sent a letter to the heads of the federal bank, thrift and credit union regulatory agencies (Federal Reserve Board, Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, Office of

Thrift Supervision, and National Credit Union Administration – collectively, the “Agencies”) reminding them of a provision in the *Credit Card Accountability Responsibility Disclosure Act* (“Credit CARD Act”) enacted in May 2009 that requires credit card companies to review every six months any account where the interest rate has been raised since January 1, 2009, and reduce the rate if the review indicates that the cardholder has become less risky or the circumstances that warranted the increase are no longer present.

He asked the Agencies to immediately notify all credit card companies under their respective jurisdictions that they will be held accountable for all interest rate increases since January 1, 2009 and will be subject to the review requirement once it takes effect.

In addition, Chairman Dodd specifically stated that he expected the Federal Reserve Board to draft regulations that provide clear, robust requirements for the review of rate increases. Further, he expected the Agencies enforcing the regulations to hold the credit card companies strictly accountable for conducting thorough reviews and decreasing rates where warranted. He said that Congress would closely monitor both the development of the implementing regulations and their enforcement.

On July 10, Chairman Dodd and Barney Frank, Chairman of the House Committee on Financial Services, sent a joint letter to the Agencies asking them to look into the carrying values of second mortgages on bank balance sheets. The Congressmen expressed

concerned that many mortgage servicers are carrying subordinate liens, in the form of close-end second mortgages and home equity lines of credit, at inflated values because they do not have associated loss allowances that are insufficient to “realistically and accurately reflect their value” given the sharp declines in national home prices and the expectation of further declines.

The Congressmen stated that one of the most significant impediments to the success of the Federal Housing Administration’s Hope for Homeowners (“H4H”) program has been the unwillingness of subordinate lien holders to extinguish their liens as required for participation in the program. They suggest that carrying these loans at potentially inflated values may contribute to resistance on the part of servicers to negotiate the disposition of these liens, and may stand in the way of increasing participation in the H4H program.

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## **Bank & Thrift Regulatory Update**

### **Agencies Issue Statement Providing Update on Legacy Loan and Legacy Securities Programs**

The Department of the Treasury (“Treasury”), the Federal Reserve Board (“Fed”) and the Federal Deposit Insurance Corporation (“FDIC”) jointly released a statement on July 8 to provide updates on the implementation

of the Legacy Loan and Legacy Securities Programs.

In particular, the agencies announced that the:

- FDIC will test the funding mechanism contemplated by the Legacy Loan Program in a sale of receivership assets this summer. Bids are expected to be solicited during July.
- Treasury has pre-qualified nine firms to participate as fund managers in the initial round of the Legacy Securities Public-Private Investment Program (“Legacy Securities PPIF”). Each of the firms will receive an equal allocation of capital from Treasury. The first closing of a Public-Private Investment Fund (“PPIF”) is expected in early August.
- Certain commercial mortgage-backed legacy securities will become eligible collateral for the Fed’s Term Asset-Backed Securities Lending Facility (“TALF”) in July 2009.

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### **Basel Committee Releases Basel II Enhanced Guidance**

On July 13, the Bank for International Settlements’ Basel Committee on Banking Supervision (“Basel Committee”) released three separate measures to provide enhanced guidance relative to its Basel II Capital Framework.

The first item, “*Enhancements to the Basel II Framework*,” provides:

- Higher risk-weights for securitization exposures and a requirement that banks conduct more rigorous credit analyses of externally rated securitization exposures (Pillar 1 – minimum capital requirements).
- Supplemental guidance (Pillar 2 - supervisory review process) in areas of weaker bank risk management practices, including:
  - Firm-wide governance and risk management;
  - Capturing the risk of off-balance sheet exposures and securitization activities;
  - Managing risk concentrations;
  - Providing incentives for banks to better manage risk and returns over the long term; and
  - Sound compensation practices.
- Strengthening disclosure requirements (Pillar 3 – market discipline) in the areas of:
  - Securitization exposures in the trading book;
  - Sponsorship of off-balance sheet vehicles;
  - Resecuritization exposures; and
  - Pipeline and warehousing risks with regard to securitization exposures.

Banks and supervisors are expected to begin implementing the Pillar 2 guidance immediately. The new Pillar 1 capital requirements and Pillar 3 disclosures should be implemented no later than December 31, 2010.

The other two items, “*Guidelines for Computing Incremental Risk in the*

*Trading Book*,” and “*Revisions to the Basel II Market Risk Framework*,” introduce higher capital requirements to capture the credit risk of complex trading activities as well as a stressed value-at-risk (“VaR”) requirement that is in addition to the VaR requirement. The Guidelines and the Revisions become effective December 31, 2010.

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#### **FDIC Answers Frequently Asked Questions about Certain Sweep Account Disclosures**

On July 6, the Federal Deposit Insurance Corporation (“FDIC”) released Financial Institution Letter 39-2009 to release answers to Frequently Asked Questions (“FAQs”) regarding the agency’s final rule for disclosure requirements associated with certain sweep accounts.

The disclosure requirements became effective July 1, 2009 and were part of the FDIC’s final rule on “*Processing of Deposit Accounts in the Event of an Insured Depository Institution Failure*,” which establishes practices for determining deposit and other account balances at a failed depository institution as well as the disclosure requirements for certain sweep accounts.

To assist insured depository institutions with the disclosure requirements, the FDIC has prepared the FAQs to cover the following general categories of questions:

- The types of sweep accounts covered by the disclosure requirements, as well as those that are excluded.
- The type and nature of disclosures required by the rule.
- The frequency of required sweep account disclosures.
- The principles used by the FDIC to determine how swept funds will be treated in the event of failure.
- The requirements for a properly structured repo sweep.

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#### **Agencies Release Guidance on California State Registered Warrants**

The federal bank, thrift and credit union regulatory agencies (Federal Reserve Board, Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, Office of Thrift Supervision and National Credit Union Administration) jointly released a statement on July 8 to provide guidance to institutions that accept the registered warrants issued by the State of California on July 2 and thereafter. The agencies state that the warrants should receive a 20 percent risk-weight for risk-based capital purposes, consistent with the risk-weight applicable to general obligations of the state.

Financial institutions are instructed to exercise prudent judgment and sound risk management practices with respect to the warrants and this will be evaluated as part of the normal supervisory process. The agencies state that financial institutions are

individually responsible for understanding, managing, and controlling the risks and obligations arising from accepting and holding these warrants. Risk-management practices should include evaluating the credit quality of the warrants, establishing appropriate concentration limits, and ensuring appropriate liquidity risk management.

(Please refer to related article under the Securities and Investment Management Regulatory Update section.)

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## Securities & Investment Management Regulatory Update

### SEC Releases Staff Statement and Investor Alert on California Registered Warrants

The Securities and Exchange Commission ("SEC") released a staff statement on July 9 regarding the registered warrants, or IOUs, recently issued by the State of California. The IOUs are obligations of the State of California, are negotiable, and bear interest. The statement indicates that the registered IOUs are "securities" under federal securities law, and as such, holders of these IOUs and those who may purchase them are protected by the provisions of the federal securities laws that prohibit fraud in the purchase or sale of securities.

The SEC cautions broker-dealers and any potential secondary markets that the requirements of the securities laws and the rules of the Municipal Securities Rulemaking Board ("MSRB") are applicable to the IOUs. The MSRB rules include a requirement that the securities sold are suitable for the purchaser. The SEC further notes that although the IOUs are called "registered warrants," they are not, and do not need to be, registered with the SEC.

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### SEC Initiates Enforcement Action Against Broker-Dealer for Receiving Undisclosed Compensation Related to Sales of REITs

The Securities and Exchange Commission announced on July 10 that it had initiated an enforcement action against a broker-dealer for receiving millions of dollars in undisclosed compensation as a condition for offering and selling certain real estate investment trusts ("REITs") to its brokerage customers.

The SEC's order finds that the firm demanded and received so-called "revenue sharing" payments related to its sales of REITs and neither the firm nor the REITs disclosed to investors that additional payments were being made in connection with the sale of REIT shares, or the conflicts of interest these additional payments created. The order also finds that the firm issued a variety of mislabeled invoices to the REITs as a means of collecting the undisclosed revenue sharing payments

that appeared to be legitimate reimbursements for services.

The SEC censured the firm and ordered it to pay \$17.3 million in disgorgement and financial penalties to settle the SEC's charges. The firm consented to the order without admitting or denying the findings.

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### FINRA Makes Template Available to Facilitate Compliance with FTC Red Flags Rule

The Financial Industry Regulatory Authority ("FINRA") announced on July 1 that it has developed a new, optional template that may be used by firms as a guide to fulfilling their requirements under the Federal Trade Commission's Red Flags Rule. The Red Flags Rule, which implements obligations imposed by the *Fair and Accurate Credit Transactions Act of 2003* ("FACT Act"), requires specified firms to create a written Identity Theft Prevention Program ("ITPP") that is designed to identify, detect and respond to "red flags"—patterns, practices or specific activities—that could indicate identity theft. It becomes effective August 1, 2009.

The Red Flags Rule requires firms to prepare an ITPP if they are either a "financial institution" or a "creditor" and offer "covered accounts." FINRA anticipates that most member firms will be required to prepare an ITPP under the Red Flags Rule. Firms choosing to use the template as a guide must adapt

it to reflect their individual business situations.

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## Recent Supervisory Actions

*A Monthly Look Into Significant Federal Supervisory Actions Taken Against Financial Institutions*

Last Updated July 7, 2009

Agency	Institution Type/Size	Type of Action	Date	Synopsis of Action	Web Site
Federal Deposit Insurance Corporation	State Nonmember Bank	Cease and Desist; Civil Money Penalties	07/01	The Federal Deposit Insurance Corporation entered into an Order to Cease and Desist and an Order to Pay Civil Money Penalties with a state nonmember bank to address violations of the Federal Trade Commission Act related to unfair or deceptive acts or practices with regard to its cash back reward program and interest rate increases on certain small business accounts.	<a href="http://www.fdic.gov">www.fdic.gov</a>
Federal Reserve Board	Bank Holding Company	Written Agreement	07/02	The Federal Reserve Board entered into a Written Agreement with an Illinois-based bank holding company to ensure that it serves as a source of strength for its state nonmember bank and various nonbank subsidiaries. The agreement addressed concerns related to dividends and distributions, debt and stock redemption, and compliance with laws and regulations	<a href="http://www.federalreserve.gov">www.federalreserve.gov</a>
Federal Deposit Insurance Corporation, Office of Thrift Supervision	State Nonmember Bank; Federal Savings Bank	Cease and Desist; Civil Money Penalties	06/30	The Federal Deposit Insurance Corporation entered into an Order to Cease and Desist and an Order to Pay Civil Money Penalties with a state nonmember bank to address violations of the Federal Trade Commission Act related to unfair or deceptive acts or practices with regard to convenience checks. The Office of Thrift Supervision entered into an Order to Cease and Desist and an Assessment of Civil Money Penalties with an affiliated federal savings bank for engaging in the same violations.	<a href="http://www.fdic.gov">www.fdic.gov</a> ; <a href="http://www.ots.treas.gov">www.ots.treas.gov</a>
Federal Reserve Board	Bank Holding Company	Written Agreement	06/30	The Federal Reserve Board entered into a Written Agreement with an Illinois-based bank holding company to ensure that it serves as a source of strength for its national bank subsidiary. The agreement addressed concerns related to dividends and distributions, debt and stock redemption, capital and compliance with laws and regulations	<a href="http://www.federalreserve.gov">www.federalreserve.gov</a>
Federal Reserve Board	Bank Holding Company	Written Agreement	06/25	The Federal Reserve Board entered into a Written Agreement with an Iowa-based bank holding company and its national bank subsidiary to address concerns related to dividends and distributions, debt and stock redemption and compliance with laws and regulations.	<a href="http://www.federalreserve.gov">www.federalreserve.gov</a>
Federal Reserve Board	State member bank	Prompt Corrective Action Directive	06/24	The Federal Reserve Board entered into a Prompt Corrective Action Directive with a South Dakota state member bank to address the bank's undercapitalization.	<a href="http://www.federalreserve.gov">www.federalreserve.gov</a>

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