Financial institutions industry developments : including depository and lending institutions and brokers and dealers in securities, 2011-12; Audit risk alerts

American Institute of Certified Public Accountants (AICPA)

2011/12

Financial Institutions Industry Developments:

Including Depository and Lending Institutions and Brokers and Dealers in Securities

AUDIT RISK ALERT

STRENGTHENING AUDIT INTEGRITY
SAFEGUARDING FINANCIAL REPORTING

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Audit Risk Alert: 2011/12 Financial Institutions Industry Developments

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Notice to Readers

This Audit Risk Alert replaces *Financial Institutions Industry Developments: Including Depository and Lending and Brokers and Dealers in Securities—2010/11.*

This Audit Risk Alert is intended to provide auditors of financial statements of financial institutions, including depository and lending institutions and brokers and dealers in securities, with an overview of recent economic, industry, technical, regulatory, and professional developments that may affect the audits and other engagements they perform. This Audit Risk Alert also can be used by an entity's internal management to address areas of audit concern.

This publication is an *other auditing publication*, as defined in AU section 150, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*). Other auditing publications have no authoritative status; however, they may help the auditor understand and apply the Statements on Auditing Standards.

If an auditor applies the auditing guidance included in an other auditing publication, he or she should be satisfied that, in his or her judgment, it is both relevant to the circumstances of the audit and appropriate. The auditing guidance in this document has been reviewed by the AICPA Audit and Attest Standards staff and published by the AICPA and is presumed to be appropriate. This document has not been approved, disapproved, or otherwise acted on by a senior technical committee of the AICPA.

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Greg Anglum
James W. Bean, Jr.
Christine M. Bouvier
Tom Canfarotta
Ronald Carletta
Sydney K. Garmong
Terrill L. Garrison, Jr.
Larry Gee
Al Goll
Harrison E. Greene, Jr.
David W. Hinshaw
Christopher G. Johnson
Jean M. Joy
John D. Keyser
Jamie A. Mayer
Randy Oberdiek
Myrna Parker
Steven J. Triezenberg
Chis Vallez
Lisa Watson
Stephen A. Zammitti

AICPA Staff

Teresa Brenan
Technical Manager
Accounting and Auditing Publications

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The Audit Risk Alert *Financial Institutions Industry Developments: Including Depository and Lending and Brokers and Dealers in Securities* is published annually. As you encounter audit or industry issues that you believe warrant discussion in next year's Audit Risk Alert, please feel free to share them with us. Any other comments that you have about the Audit Risk Alert also would be appreciated. You may e-mail these comments to A&APublications@aicpa.org.

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How This Alert Helps You

.01 This Audit Risk Alert (alert) helps you plan and perform your audits of financial institutions, including depository and lending institutions and brokers and dealers (broker-dealers) in securities, and also can be used by an entity's management. This alert provides information to assist you in achieving a more robust understanding of the business, economic, and regulatory environments in which your clients operate. This alert is an important tool to help you identify significant risks that may result in a material misstatement of financial statements, and it delivers information about current accounting, auditing, and regulatory developments. For developing issues that may have a significant impact on the financial institutions industry in the near future, the "On the Horizon" section of this alert provides information on these topics, including guidance that either has been issued but is not yet effective or is in a development stage.

.02 This alert is intended to be used in conjunction with the Audit Risk Alert *General Accounting and Auditing Developments—2011/12* (product no. 0223311), which explains important issues that affect entities in all industries in the current economic climate. You should refer to the full text of accounting and auditing pronouncements, as well as the full text of any rules or publications, that are discussed in this alert.

.03 It is essential that the auditor understand the meaning of audit risk and the interaction of audit risk with the objective of obtaining sufficient appropriate audit evidence. In AU section 312, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*), *audit risk* is broadly defined as the risk that the auditor may unknowingly fail to appropriately modify his or her opinion on financial statements that are materially misstated. Further, paragraph .04 of AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*), explains that the auditor should use professional judgment to determine the extent of the understanding required of the entity and its environment. The auditor's primary consideration is whether the understanding that has been obtained is sufficient to assess risks of material misstatement of the financial statements and to design and perform further audit procedures.

Economic and Industry Developments

Debt Crisis

Municipal Bond Exposures

.04 In the current environment, there continues to be an elevated level of (*a*) risk that certain issuers of state and municipal bonds and certain highly leveraged European governments could default on their debt obligations and (*b*) concern over the potential impact on price and price volatility for sovereign debt securities, currency exchange rates, and securities issued by the financial institutions that lend to these governments.

.05 Although, historically, relatively few state and local municipal bond issuers have defaulted on their bonds, the recent deteriorating conditions characterized by sharp declines in tax revenues and increasing budget deficits may impede the ability of some municipalities to continue to make timely principal and interest payments. Similar issues and considerations relate to sovereign debt exposures in some euro-area countries (for example, Ireland and Greece).

Downgrade of Securities Issued or Guaranteed by the U.S. Government, U.S. Government Agencies, and Government-Sponsored Entities

.06 On August 5, 2011, Standard & Poor's (S&P), which represents one of the top three credit rating agencies in the United States,[1] lowered its long-term credit rating of the U.S. government and federal agencies from AAA to AA+. In response to this action, the Board of Governors of the Federal Reserve System (Federal Reserve), the Federal Deposit Insurance Corporation (FDIC), the National Credit Union Administration (NCUA), and the Office of the Comptroller of the Currency (OCC) (collectively, the federal financial institutions regulators) issued, on August 5, 2011, guidance through a joint press release to clarify the treatment of federal debt for regulatory purposes. The guidance provided that, for risk-based capital purposes, the risk weights for securities issued or guaranteed by the U.S. government, U.S. government agencies, and government-sponsored entities would not change and that the treatment of those securities under other federal banking agency regulations would be unaffected. Thus, it is not expected at this time that depository institutions will be required to hold more capital to offset the heightened perceived risk that may be indicated by the rating change.

.07 Subsequently, on August 8, 2011, S&P announced an equivalent downgrade on the following:

- Issuer credit ratings for 10 out of the 12 banks in the Federal Home Loan Bank[2] (FHLB) System and senior debt issued by the FHLB System
- Senior debt issued by the Farm Credit System
- Senior issue ratings on Federal National Mortgage Association (Fannie Mae) and Federal Home Loan Mortgage Corporation (Freddie Mac)
- Certain bonds guaranteed by the FDIC and the NCUA
- Long-term counterparty credit ratings on the Depository Trust Company, the National Securities Clearing Corporation, the Fixed Income Clearing Corporation (all subsidiaries of the Depository Trust & Clearing Corporation), and the Options Clearing Corporation

European Union Debt Crisis

.08 The European Union (EU) currently faces unprecedented challenges as it works to stabilize its ongoing debt crisis. To stabilize the crisis, the EU has proposed reforms to its European Financial Stability Fund, which would allow the fund to

- purchase bonds issued by distressed euro governments directly from secondary market investors and

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[1] Moody's and Fitch, which represent the remaining two of the top three credit rating agencies in the United States, did not downgrade their credit ratings of the U.S. government and federal agencies.

[2] Prior to the U.S. sovereign downgrade, the Federal Home Loan Banks of Chicago and Seattle were already rated AA+.

- provide lines of credit to European nations that require support for undercapitalized banks.

.09 In response to the debt crisis in Greece, during the October 26, 2011, Euro Summit meeting, Greek bondholders voluntarily consented to a 50 percent write-off in the value of Greek bonds, conditional on a 30 billion euro contribution by the EU member states. EU leaders also agreed to a new 100 billion euro financing program for Greece, partially funded by the International Monetary Fund. The new programs are expected to be implemented at the beginning of 2012.

.10 In addition, the debt issues could potentially affect the European banking system more broadly because European banks may face significant credit risk associated with direct or indirect exposure to obligations of the distressed governments, including loans, debt securities, and derivative instruments. For European banks vulnerable to losses on euro-area government bonds, the EU leaders agreed to raise core capital levels to 9 percent in an effort to offset the risk of potential losses. The banks would have until June 2012 to meet the new requirements.

.11 Due to the economic and financial uncertainty surrounding the European debt crisis, auditors should remain alert for evolving reforms by the EU to address financial stability within the European market. Readers can access up-to-date information regarding economic and financial affairs through the European Commission's website at http://ec.europa.eu/economy_finance/index_en.htm.

Conclusions

.12 Financial institutions should review their portfolios and evaluate whether they hold any affected financial instruments. For such interests held, they should consider the impact of the increased credit risk on the allowance for loan losses (ALL), fair value of financial instruments, and other-than-temporary impairment of debt securities. For information on the auditor's evaluation of management's conclusions regarding accounting estimates and fair value measurements, readers should refer to the Audit Risk Alert *General Accounting and Auditing Developments—2011/12* (product no. 0223311). Readers may also consider reviewing the Public Company Accounting Oversight Board's (PCAOB's) observations related to audit risk areas, which include deficiencies involved in ALL, fair value measurements, and other-than-temporary impairment valuations. The PCAOB's observations can be found in the "Audit and Accounting Developments" section of this alert.

Banks and Savings Institutions

.13 Collectively, trends within FDIC-insured depository institutions (IDIs) through the second quarter of 2011 were favorable, in comparison with recent years. Net income improved year over year for the eighth consecutive quarter as of June 30, 2011. Lower expenses for loan loss provisions were the primary source of the increase in quarterly net income because many banks continue to reduce their ALL due to reduced credit concerns and lower total loan balances. Although the number of insured commercial banks and savings institutions continued to decline through the second quarter, the FDIC reported the smallest number of failures in a quarter since the first quarter of 2009. In addition, the number of institutions on the FDIC's problem list declined for the first time since the third quarter of 2006.

.14 During the 6 months ended June 30, 2011, approximately 65 percent of the decline in IDIs reporting financial results is attributable to mergers with other IDIs, compared with 51 percent during the 6 months ended June 30, 2010. Some believe that the number of mergers and acquisitions, particularly for smaller institutions, may increase in response to compliance costs resulting from implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act).

.15 According to the summer 2011 issue of the FDIC's *Supervisory Insights*, the FDIC has noticed an increase in the number of deposit relationships between financial institutions and third-party payment processors and a corresponding increase in the risks associated with these relationships. Deposit relationships with payment processors can expose institutions to risks not present in other commercial customer relationships because the financial institution does not have a direct customer relationship with payment processors' merchant clients. The FDIC explains the types of merchant categories that may be associated with high-risk activity, high-risk payment processor relationship warning signs, risk controls, and supervisory responses. Auditors should be aware of the categories of deposit relationships held by their banking clients to determine whether additional risk assessment or control procedures are needed in regard to third-party payment processor relationships. For further information included within the supervisory insight, readers are encouraged to visit the FDIC website at www.fdic.gov/regulations/examinations/supervisory/insights/index.html.

Credit Unions

.16 Collectively, federally insured credit unions reported improved earnings and lower loan delinquencies and loan charge-offs during the first half of 2011. The annualized return on average assets for credit unions increased by 26 basis points to 77 basis points between December 31, 2010, and June 30, 2011. In addition, the loan delinquency ratio fell from 1.76 percent at December 31, 2010, to 1.58 percent at June 30, 2011. Although total loan delinquencies and net charge-offs declined, delinquencies in real estate, business, and loan participations remain elevated. Further, an increase in real estate and business loan modifications has been observed, which may increase the potential for future nonperformance. Further discussion regarding auditing troubled debt restructurings can be found in the "Audit and Accounting Developments" section of this alert.

.17 Although, collectively, credit unions have reflected favorable trends during 2011, the NCUA believes sustained caution is necessary. In a summary of trends by asset groups, the NCUA noted that smaller credit unions (that is, those under $10 million) have experienced the greatest challenges with earnings, loan growth, overall delinquency, and membership growth. As such, the NCUA has suggested that focused efforts should remain on credit unions with elevated levels of credit risk, interest rate risk (IRR), and concentration risk.

.18 IRR remains a supervisory concern because many credit unions have significant portfolios of long-term, fixed-rate loans, as well as investment securities with long-term maturities. In contrast, member shares are primarily held in short-term accounts, such as regular share, share draft, and money market accounts, which are highly liquid and sensitive to interest rate changes. The IRR resulting from the mismatch in durations could have a severe negative impact on earnings if interest rates begin to rise. A discussion addressing the

NCUA's proposed regulation on IRR policies can be found in the "On the Horizon" section of this alert.

.19 Finally, particular attention should also be given to concentration risk because this has recently become an area of greater emphasis for NCUA examiners. The high level of real estate loans as a percentage of total loans, compounded by continuing declines in real estate values across the country, highlights the need for sound concentration risk mitigation strategies and practices.

.20 Readers may find the most recent financial trends on federally insured credit unions, which are issued quarterly through the *NCUA Letter to Credit Unions*, on the NCUA website at www.ncua.gov.

Mortgage Banking

.21 According to the Mortgage Bankers Association's (MBA's) *Mortgage Delinquency Survey*, as of June 30, 2011, the delinquency rate[3] for mortgage loans on 1-to-4-unit residential properties increased to a seasonally adjusted rate of 8.44 percent of all loans outstanding as of the end of the second quarter of 2011. This represents a 12 basis point increase from March 31, 2011, and a 141 basis point decrease from June 30, 2010. Although year-over-year delinquencies have declined, which is primarily attributable to a continued decline in long-term delinquencies, the drop is slightly offset by an increase in newly delinquent loans. The MBA's chief economist, Jay Brinkmann, noted in a statement regarding second quarter results that

> Mortgage loans that are one payment, or 30 days, past due are very much driven by changes in the labor market, and the increase in these delinquencies clearly reflects the deterioration we saw in the labor market during the second quarter. Weekly first-time claims for unemployment insurance started the quarter at 385,000 but finished the quarter at 432,000. The unemployment rate started the quarter at 8.8 percent but climbed to 9.2 percent by the end of the quarter.[4]

.22 By inference, mortgage delinquencies can be expected to continue to be a concern as long as unemployment rates remain elevated.

.23 In addition, the MBA's *Mortgage Delinquency Survey* reported that the percentage of loans on which foreclosure actions were started during the second quarter of 2011 was 0.96 percent, representing a decline of 15 basis points year over year, and that the percentage of loans in the foreclosure process at the end of the second quarter was 4.43 percent, representing a decline of 14 basis points year over year.

.24 Although it may be viewed as a positive trend that the percentage of long-term delinquencies is declining, along with the foreclosure rate because a backlog of foreclosures is not being created, the declines are partially attributed to banks modifying the terms of mortgage loans, rather than immediately foreclosing on such property, and the slowdown caused by the regulatory review of their servicing and foreclosure procedures. There is still much uncertainty on the effectiveness of loan modification programs that have been implemented

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[3] According to the Mortgage Bankers Association's *Mortgage Delinquency Survey*, as of June 30, 2011, the delinquency rate includes loans that are at least one payment past due but does not include loans in the process of foreclosure.

[4] See www.mortgagebankers.org/newsandmedia/presscenter/77688.htm.

by many financial institutions. The ability for borrowers to remain current on modified loans is dependent on other external factors, such as unemployment levels.

.25 Discussions in other areas of this alert related to mortgage loans include the following:

- Mortgage and other loan activities and overauditing troubled debt restructurings in the "Audit and Accounting Developments" section of this alert
- Regulatory concerns about foreclosure processing as a result of reviews conducted by the OCC; the Federal Reserve; the FDIC; and the Office of Thrift Supervision (OTS), prior to its abolishment,[5] at 14 federally regulated mortgage servicers. See the foreclosure management discussion in the "Legislative and Regulatory Developments" section of this alert.
- The current servicing compensation structure in the "On the Horizon" section of this alert

Broker-Dealers in Securities

.26 Broker-dealers in securities continue to experience repercussions from the economic crisis and will continue to experience unprecedented changes within the industry as a result of the regulatory reform measures discussed throughout this alert.

.27 As of December 31, 2010, the Financial Industry Regulatory Authority (FINRA) oversaw nearly 4,600 brokerage firms, according to the *FINRA 2010 Year in Review and Annual Financial Report*. FINRA now oversees fewer than 4,500 brokerage firms, according to the FINRA website, as of November 2011. Failures were partially attributable to increased legal costs as a result of investor lawsuits. It is speculated that rising FINRA and Securities Investor Protection Corporation (SIPC) fees, along with the high costs of errors and omission insurance, will force many of the smaller broker-dealer firms into consolidating with larger firms.

.28 Auditors should also be aware of the macroeconomic risks for broker-dealers, including market volatility, low interest rates, the U.S. credit rating downgrade, and the European sovereign debt crisis. Brokerage firms rely heavily on trading volume, and with increased investor apprehension in the market, investors may be less likely to trade. Combining lower trading volumes as a result of market volatility with tight margins, partially attributable to the current low interest rate environment, could potentially force many broker-dealers firms out of business. For further information on U.S credit ratings and the European debt crisis, see the "Debt Crisis" section of this alert.

Commodities

.29 Global futures and options contract volume increased by 10 percent, from 11.2 billion contracts to 12.4 billion contracts, when comparing the first 6 months of 2011 with the same period in 2010. In the first 6 months of 2011, volume on U.S. futures exchanges was 4 billion contracts, a 10 percent increase

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[5] See the discussion of the Office of Thrift Supervision (OTS) abolishment in the "Abolishment of the OTS" section of this alert.

from the same period in 2010. Volume traded on foreign exchanges amounted to 8.4 billion contracts in the first 6 months of 2011, which is also a 10 percent increase over the same 2010 period. The trading volume in interest rate and equity products continued to account for well over half of the worldwide trading volume.

.30 The total amounts required under the Commodities Future Trading Commission (CFTC) regulations to be held in segregated or secured accounts (including retail foreign exchange [forex] obligations of $729 million in 2011) on behalf of futures commission merchant (FCM) customers increased by $62 billion, from approximately $167 billion as of June 30, 2010, to approximately $229 billion as of June 30, 2011.

Legislative and Regulatory Developments

Dodd-Frank Act Regulations

.31 The Dodd-Frank Act was signed into law by President Obama on July 21, 2010. It aims to promote U.S. financial stability by improving accountability and transparency in the financial system, putting an end to the notion of too big to fail, protecting American taxpayers by ending bailouts, and protecting consumers from abusive financial services practices.

.32 The impact of the Dodd-Frank Act reforms on capital markets and credit availability is difficult to predict. The reforms have a widespread effect, and it may take years to evaluate the impact. Although strengthening transparency is an appropriate response to the recent economic recession, it is yet to be seen how the substantial regulatory changes will affect the financial system and economic recovery.

.33 Auditors should be cognizant of these changes and assess the impact of noncompliance on financial reporting and, if applicable to the engagement, internal controls over financial reporting. In addition, due to the volume of new compliance reporting requirements and disclosures, compliance costs for financial institutions could significantly increase. Thus, the new regulatory environment could lead to increased mergers and consolidations as entities consider the regulatory burden associated with the Dodd-Frank Act. Auditors should also consider the impact of regulatory compliance on the internal audit functions (that is, the potential internal audit resource limitations due to the shifted focus on regulatory compliance, in comparison with financial reporting and internal control). This may be an important factor in the auditor's determination of the reliance that he or she may place on the institution's internal audit department, especially with respect to audits of internal control over financial reporting.

Off-Exchange Retail Foreign Currency Transactions

.34 The CFTC issued final regulations concerning off-exchange retail foreign currency transactions, effective October 18, 2010. The rules implement provisions of the Dodd-Frank Act and the Food, Conservation, and Energy Act of 2008, which, together, provide the CFTC with broad authority to register and regulate entities wishing to serve as counterparties to, or to intermediate, retail forex transactions.

.35 The final forex rules put in place requirements for, among other things, registration, disclosure, recordkeeping, financial reporting, minimum capital, and other business conduct and operational standards. Specifically, the regulations require the following:

- Counterparties offering retail foreign currency contracts as either FCMs or retail foreign exchange dealers (RFEDs), a new category of registrant, are to be registered.
- Persons who solicit orders, exercise discretionary trading authority, or operate pools with respect to retail forex also will be required to register either as introducing brokers, commodity trading advisers, or commodity pool operators (as appropriate) or associated persons of such entities to be registered.
- Otherwise regulated entities, such as U.S. financial institutions and Securities and Exchange Commission (SEC) registered broker-dealers, remain able to serve as counterparties in such transactions under the oversight of their primary regulators.
- FCMs engaged in retail forex activity and RFEDs are to maintain net capital of $20 million plus 5 percent of the amount, if any, by which liabilities to retail forex customers exceed $10 million.
- Leverage in retail forex customer accounts will be subject to a security deposit requirement set by the National Futures Association (NFA) within limits provided by the CFTC.
- All retail forex counterparties and intermediaries will be required to distribute forex-specific risk disclosure statements to customers and to comply with comprehensive recordkeeping and reporting requirements.

.36 The final rule can be found in the *Federal Register* at www.federalregister.gov/articles/2010/09/10/2010-21729/regulation-of-offexchange-retail-foreign-exchange-transactions-and-intermediaries#p-3.

Deposit Insurance Assessment Base, Assessment Rate Adjustments, Dividends, Assessment Rates, and Large Bank Pricing Methodology

.37 The Dodd-Frank Act requires the FDIC to set a designated reserve ratio of not less than 1.35 percent for any year and to increase the level of the Deposit Insurance Fund (DIF) to 1.35 percent of estimated insured deposits by September 30, 2020.[6] The Dodd-Frank Act also called for a revision to the definition of the deposit insurance assessment base. The intent of changing the assessment base was to shift a greater percentage of overall total assessments away from community institutions and toward the largest institutions.

.38 In response to the provisions of the Dodd-Frank Act, in February 2011, the FDIC's board of directors, through the issuance of Financial Institution Letter (FIL)-8-2011, adopted the final rule *Deposit Insurance Assessment Base, Assessment Rate Adjustments, Dividends, Assessment Rates, and Large Bank Pricing Methodology* to redefine the deposit insurance assessment base, as required by the Dodd-Frank Act; alter the assessment rates; implement the

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[6] The *Deposit Insurance Fund* (DIF) is used to (*a*) insure the deposits of, and protect the depositors of, failed Federal Deposit Insurance Corporation (FDIC)-insured institutions and (*b*) resolve failed FDIC-insured institutions upon appointment of the FDIC as receiver. The reserve ratio represents the ratio of the net worth of the DIF to aggregate estimated insured deposits of FDIC-insured institutions. The DIF is funded primarily through deposit insurance assessments.

Dodd-Frank Act's DIF dividend provisions; and revise the risk-based assessment system for all large IDIs (those with at least $10 billion in total assets). The final rule

- redefines the deposit insurance assessment base as average consolidated total assets minus average tangible equity (the assessment base had previously been defined as total domestic products).
- makes generally conforming changes to the unsecured debt and brokered deposit adjustments to assessment rates.
- creates a depository institution debt adjustment.
- eliminates the secured liability adjustment.
- adopts a new assessment rate schedule effective April 1, 2011, and, in lieu of dividends, other rate schedules when the reserve ratio reaches certain levels.

.39 In addition, the final rule establishes a new methodology for calculating deposit insurance assessment rates for highly complex and other large IDIs[7] (commonly referred to as the Large Bank Pricing Rule). The new methodology combines CAMELS ratings and financial measures to produce a score that is converted into an institution's assessment rate. The Large Bank Pricing Rule authorizes the FDIC to adjust, up or down, an institution's total score by 15 points. The final rule became effective on April 1, 2011. For further information, readers can access the final rule on the FDIC website at www.fdic.gov/news/news/financial/2011/fil11008.pdf.

.40 In September 2011, the FDIC adopted guidelines describing the process that the FDIC will follow to determine whether to make an adjustment, to determine the size of any adjustment, and to notify an institution of an adjustment made to its assessment rate score, as allowed under the Large Bank Pricing Rule. The guidelines also provide examples of circumstances that might give rise to an adjustment. Further information on the guidelines can be found in FIL-64-2011, *Assessments: Assessment Rate Adjustment Guidelines*, at www.fdic.gov/news/news/financial/2011/fil11064.html.

Noninterest-Bearing Transaction Accounts

.41 In November 2010, the FDIC issued a final rule to implement section 343 of the Dodd-Frank Act that provides temporary unlimited coverage for noninterest-bearing transaction accounts at all FDIC IDIs (commonly referred to as the Dodd-Frank Deposit Insurance Provision). It became effective on December 31, 2010, and terminates on December 31, 2012. For further information, see FIL-76-2010, *Final Rule: Temporary Unlimited Coverage for Noninterest-Bearing Transaction Accounts*, at www.fdic.gov/news/news/financial/2010/fil10076.html. Readers can also obtain further discussion on the Dodd-Frank Deposit Insurance Provision, including differences between the provision and the expired Transaction Account Guarantee Program, on the FDIC website at www.fdic.gov/deposit/deposits/unlimited/implementation.html.

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[7] A *large insured depository institution* (IDI) is defined as an IDI with at least $10 billion in total assets. In general, a highly complex IDI will be an IDI (other than a credit card bank) with more than $50 billion in total assets that is controlled by a parent or an intermediate parent company with more than $500 billion in total assets or a processing bank or trust company with at least $10 billion in total assets.

Securitizations

.42 The Dodd-Frank Act requires changes to rules and regulations for securitization transactions. The Dodd-Frank Act also requires entities that sponsor products such as mortgage-backed securities to retain at least 5 percent of the credit risk, unless the underlying loans meet standards that reduce the risk. It also requires these sponsors to disclose more information about the underlying assets, including an analysis of the quality of the underlying assets.

.43 In January 2011, the SEC adopted new rules related to representations and warranties in asset-backed securities offerings, as outlined in Release No. 33-9175, *Disclosure for Asset-Backed Securities Required by Section 943 of the Dodd-Frank Wall Street Reform and Consumer Protection Act*. These rules require securitizers of asset-backed securities to disclose fulfilled and unfulfilled repurchase requests. The rules also require nationally recognized statistical rating organizations (NRSRO) to include information regarding the representations, warranties, and enforcement mechanisms available to investors in an asset-backed securities offering in any report accompanying a credit rating issued in connection with such offering, including a preliminary credit rating. See www.sec.gov/rules/final/2011/33-9175.pdf for additional information.[8]

.44 Pursuant to section 945 of the Dodd-Frank Act, the SEC issued Release No. 33-9176, *Issuer Review of Assets in Offerings of Asset-Backed Securities*, which requires any issuer registering the offer and sale of an asset-backed security to perform a review of the assets underlying the asset-backed security. In addition, the rule amended Regulation AB by requiring an asset-backed security issuer to disclose the nature, findings, and conclusion of its review of the assets. For further information, see www.sec.gov/rules/final/2011/33-9176.pdf.

.45 Section 942(a) of the Dodd-Frank Act eliminated the automatic suspension of the duty to file under section 15(d) of the Securities Exchange Act of 1934 (the 1934 Act) for asset-backed securities issuers and granted the SEC the authority to issue rules providing for the suspension or termination of such duty. To implement section 942(a), the SEC issued Release No. 34-65148, *Suspension of the Duty to File Reports for Classes of Asset-Backed Securities Under Section 15(d) of the Securities Exchange Act of 1934*, which establishes rules to provide certain thresholds for suspension of the reporting obligations for asset-backed securities issuers. For further information, see www.sec.gov/rules/final/2011/34-65148.pdf.

.46 Rulemaking regarding credit risk retention is still in process, as discussed further in the "On the Horizon" section of this alert. However, in connection with making amendments to its safe harbor rule that were necessary due to the implementation of Financial Accounting Standards Board (FASB) Statement No. 166, *Accounting for Transfers of Financial Assets—an amendment of FASB Statement No. 140* (codified in FASB *Accounting Standards Codification* (ASC) 860, *Transfers and Servicing*), and FASB Statement No. 167, *Amendments to FASB Interpretation No. 46(R)* (codified in FASB ASC 810, *Consolidation*), the FDIC included a condition to safe harbor, among other conditions, that sponsors must retain an economic interest of no less than 5

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[8] In August 2011, the Securities and Exchange Commission (SEC) made a technical correction to the final ruling due to an incorrect paragraph reference in an instruction to Rule 15Ga-1. See www.sec.gov/rules/final/2011/33-9175a.pdf for further discussion on the correction.

percent of the credit risk of the financial assets underlying a securitization until the joint interagency regulations that are required to be adopted under the Dodd-Frank Act become effective. The sponsor is not permitted to hedge the credit risk of the retained interest but may hedge certain other risks (such as interest rate and currency).[9] Other conditions are necessary to qualify for the safe harbor. The rule grandfathers the previous safe harbor rule for transfers of financial assets on or prior to December 31, 2010. For further information on the FDIC's safe harbor rule, see www.fdic.gov/news/board/10Sept27no4.pdf.

Funds Availability

.47 Section 1086 of the Dodd-Frank Act amended the Expedited Funds Availability Act to require depository institutions to make the first $200 of funds deposited into an account by certain checks available for withdrawal on the first business day after the banking day in which the deposit is received. Previously, depository institutions were required to only make the first $100 available. In response to section 1086, the Federal Reserve proposed revisions to Regulation CC to incorporate this change in March 2011. Although the proposed revisions to Regulation CC have not been finalized, the Federal Reserve expects supervised institutions to comply with the applicable statutory requirements. For further information on the proposed revisions, see http://edocket.access.gpo.gov/2011/pdf/2011-5449.pdf.

Regulation Q Repeal

.48 Effective July 21, 2011, section 627 of the Dodd-Frank Act repealed Regulation Q, which prohibited banks from paying interest on commercial demand deposit accounts (DDAs). In response, in May 2011, the FDIC released FIL-38-2011, *Deposit Insurance Notice Requirement Regarding the Payment of Interest on Demand Deposit Accounts*, to remind IDIs that, on or after July 21, 2011, if an IDI modifies the terms of a DDA, so that the account may pay interest, the IDI must notify the affected customers that the account no longer will be eligible for unlimited deposit insurance coverage as a noninterest-bearing transaction account under section 343 of the Dodd-Frank Act. For further information, readers can access FIL-38-2011 at www.fdic.gov/news/news/financial/2011/fil11038.html.

Advanced Capital Adequacy Framework

.49 In June 2011, the OCC, the Federal Reserve, and the FDIC published a final rule, *Risk-Based Capital Standards: Advanced Capital Adequacy Framework—Basel II; Establishment of a Risk-Based Capital Floor*. The final rule was effective July 28, 2011, and it amends (*a*) the advanced risk-based capital adequacy standards (advanced approaches rules) in a manner that is consistent with certain provisions of the Dodd-Frank Act and (*b*) the general risk-based capital rules to provide limited flexibility consistent with section 171(b) of the Dodd-Frank Act for recognizing the relative risk of certain assets generally not held by depository institutions.

.50 The advanced approaches rules are applicable to depository institutions and bank holding companies with total consolidated assets of $250 billion or more or on-balance sheet foreign exposure of $10 billion or more and to banking organizations that have elected to use the advanced approaches rules.

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[9] After their effective date, the interagency regulations will govern the risk retention requirements for sponsors.

In addition, the advanced approaches rules are applicable to both subsidiary depository institutions and bank holding companies of depository institutions that apply the advanced approaches rules.

.51 Each organization implementing the advanced approaches rules will continue to calculate its risk-based capital requirements under the agencies' general risk-based capital rules, and the capital requirement that it computes under those rules will serve as a floor for its risk-based capital requirement computed under the advanced approaches rules. The effect of this rule on banking organizations is to preclude certain reductions in capital requirements that might have occurred in the future, absent the rule and any further changes to the capital rules. The rule will not have an immediate effect on banking organizations' capital requirements because all organizations subject to the advanced approaches rules are currently computing their capital requirements under the general risk-based capital rules.

.52 For bank holding companies subject to the advanced approaches rule, the final rule provides that they must calculate their floor requirement under the general risk-based capital rules for state member banks. However, in accordance with the Dodd-Frank Act, these organizations may include in regulatory capital certain debt or equity instruments issued before May 19, 2010, as described in section 171(b)(4)(B) of the Dodd-Frank Act.

.53 The final rule also includes a modification to the general risk-based capital rules to address the appropriate capital requirement for low-risk assets held by depository institution holding companies or nonbank financial companies supervised by the Federal Reserve in situations when there is no explicit capital treatment for such exposures under the general risk-based capital rules. Under limited circumstances, such exposures receive the capital treatment applicable under the capital guidelines for bank holding companies. This treatment is limited to cases in which a depository institution is not authorized to hold the asset under applicable law other than under the authority to hold an asset in connection with the satisfaction of a debt previously contracted or similar authority, and the risks associated with the asset are substantially similar to the risks of assets that otherwise are assigned a risk weight of less than 100 percent under the general risk-based capital rules.

Debit Card Interchange Fees and Routing

.54 As required under the Dodd-Frank Act, in June 2011, the Federal Reserve issued a final rule, commonly referred to as the Durbin Amendment, establishing standards for debit card interchange fees and prohibiting network exclusivity arrangements and routing restrictions.

.55 Under the final rule

- an issuer may receive, at the maximum, an interchange fee for an electronic debit transaction equal to the sum of 21 cents per transaction and 5 basis points multiplied by the value of the transaction. This provision regarding debit card interchange fees became effective October 1, 2011.
- all issuers and networks are prohibited from restricting the number of networks over which unaffiliated networks may process electronic debit transactions to less than two. The effective date for the network exclusively prohibition is April 1, 2012, with respect to issuers, and October 1, 2011, with respect to payment

card networks. Additionally, the final rule prohibits issuers and networks from preventing a merchant's ability to direct the routing of the electronic debit transactions over any network that the issuer has enabled to process them. The merchant routing provisions became effective on October 1, 2011.

.56 The Federal Reserve also approved an interim final rule that allows for an upward adjustment of no more than 1 cent to an issuer's debit card interchange fee if the issuer develops and implements policies and procedures reasonably designed to achieve the fraud-prevention standards established in the interim final rule. If an issuer meets these standards and wishes to receive the adjustment, it must certify its eligibility to receive the adjustment to the payment card networks in which it participates. The fraud-prevention adjustment also became effective on October 1, 2011.

.57 Issuers that, combined with their affiliates, have assets of less than $10 billion are exempt from the debit card interchange fee standards. The Federal Reserve also intends to issue, annually, lists of institutions that exceed and fall below the small issuer exemption to aid payment card networks in evaluating which of the issuers must adhere to the debit card interchange fee standards.

.58 Readers can access the final ruling and interim ruling at www.gpo.gov/fdsys/pkg/FR-2011-07-20/pdf/2011-16861.pdf and www.gpo.gov/fdsys/pkg/FR-2011-07-20/pdf/2011-16860.pdf, respectively.

Abolishment of the OTS

.59 The Dodd-Frank Act abolished the OTS, which had been the federal supervisor for thrifts and thrift holding companies. Its authority was transferred mainly to the OCC, which also regulates federally chartered national banks, and its authority for savings and loan holding companies (SLHCs) was transferred to the Federal Reserve. However, the thrift charter has been preserved. The transfer of authority took place on July 21, 2011, and certain regulations have been enacted in response, as discussed subsequently.

.60 The OCC published a final rule in July 2011 implementing several provisions of the Dodd-Frank Act, including the transfer of certain functions from the OTS and changes to national bank preemption and visitorial powers. This rule was effective on July 21, 2011. For further information on this final rule, readers can access the rule on the OCC website at www.occ.gov/news-issuances/news-releases/2011/nr-occ-2011-95.html.

.61 As part of the integration of the OTS functions into their respective agencies, the OCC and the Federal Reserve issued interim final rules with requests for comments. For further information, readers can access the OCC's interim final rule on the OCC website at www.occ.gov/news-issuances/bulletins/2011/bulletin-2011-33.html and can access the Federal Reserve's interim final rule on the Federal Reserve website at www.gpo.gov/fdsys/pkg/FR-2011-09-13/pdf/2011-22854.pdf.

.62 On July 25, 2011, the Federal Reserve also issued Supervision and Regulation (SR) Letter 11-13, *Guidance Regarding Prior Notices with Respect to Dividend Declarations by Savings Association Subsidiaries of Savings and Loan Holding Companies*, stating that, effective July 21, 2011, any savings association that is a subsidiary of an SLHC must provide notice to the Federal Reserve at least 30 days before declaring a dividend. For further information, readers can access SR Letter 11-13 at www.federalreserve.gov/bankinforeg/srletters/sr1113.htm.

CFTC Regulations

.63 On July 21, 2010, the CFTC released a list of 30 areas of rulemaking to implement the Dodd-Frank Act.

.64 The rule-writing areas have been divided into eight groups: Comprehensive Regulation of Swap Dealers & Major Swap Participants, Clearing, Trading, Data, Particular Products, Enforcement, Position Limits, and Other Titles.

.65 A comprehensive listing of final rules and proposed rules required by the Dodd-Frank Act can be found on the CFTC website at www.cftc.gov/LawRegulation/DoddFrankAct/index.htm.

.66 Significant regulations enacted to date in accordance with the Dodd-Frank Act include the following:

- *Retail Foreign Exchange Transactions; Conforming Changes to Existing Regulations in Response to the Dodd-Frank Wall Street Reform and Consumer Protection Act*, effective September 12, 2011
- *Swap Data Repositories: Registration Standards, Duties and Core Principles*, effective October 31, 2011
- *Final Rules for Implementing the Whistleblower Provisions of Section 23 of the Commodity Exchange Act*, effective October 24, 2011
- *Agricultural Swaps*, effective December 31, 2011
- *Provisions Common to Registered Entities; Correction*, effective September 26, 2011
- *Removing Any Reference to or Reliance on Credit Ratings in Commission Regulations; Proposing Alternatives to the Use of Credit Ratings*, effective September 23, 2011
- *Large Trader Reporting for Physical Commodity Swaps*, effective September 20, 2011, including the following additional information: *Guidelines Regarding Large Trader Reporting for Physical Commodity Swaps*
- *Privacy of Consumer Financial Information; Conforming Amendments Under Dodd-Frank Act*, effective September 20, 2011
- *Business Affiliate Marketing and Disposal of Consumer Information Rules*, effective September 20, 2011
- *Effective Date for Swap Regulation*, effective July 14, 2011
- *Prohibition on the Employment, or Attempted Employment, of Manipulative and Deceptive Devices and Prohibition on Price Manipulation*, effective August 15, 2011
- *Agricultural Commodity Definition*, effective September 12, 2011
- *Regulation of Off-Exchange Retail Foreign Exchange Transactions and Intermediaries*, effective October 18, 2010
- *Performance of Registration Functions by National Futures Association With Respect to Retail Foreign Exchange Dealers and Associated Persons*, effective September 10, 2010

.67 The following is a preliminary outline of Dodd-Frank Act regulations still to be considered by the CFTC:

Remainder of 2011	***First Quarter of 2012***
Clearinghouse rules	Capital and margin requirements
End-user exception	Governance and conflict of interest
Entity definitions and registration	Swap execution facilities
Position limits	Segregation for uncleared swaps

Federal Financial Institutions Regulators

Appraisal and Evaluation Guidelines

.68 On December 10, 2010, the current federal financial institutions regulators and the OTS, prior to its abolishment, issued *Interagency Appraisal and Evaluation Guidelines*, which replaced the guidelines issued in 1994. These guidelines describe the elements of a sound program for conducting appraisals and evaluations in compliance with the agencies' appraisal regulations. The guidelines provide additional clarification for when real estate appraisal and evaluation is required to support a real estate-related financial transaction. Further, they explain the minimum regulatory appraisal standards and the supervisory expectations for the development and content of an evaluation, which is permitted in certain situations in lieu of an appraisal. The guidelines build on the existing federal regulatory framework and reaffirm long-standing supervisory expectations. They also incorporate the agencies' recent supervisory issuances and, in response to advances in IT, clarify standards for the industry's appropriate use of analytical methods and technological tools in developing evaluations. The Dodd-Frank Act underscores the importance of sound real estate lending decisions; revisions to the guidelines may be necessary after regulations are adopted to implement the act. Financial institutions should review their appraisal and evaluation programs to ensure that they are consistent with the guidelines. Readers can access the guidance from any of the federal financial institutions regulators' websites.

.69 An auditor may consider enhancing procedures over entity-level controls to determine whether organizational structure and training is in place to carry out real estate appraisal and evaluation activities, as well as to determine whether management maintains appropriate documentation of policies and procedures for effective guidance. In addition, the auditor may consider the effectiveness of controls surrounding senior management and the board's review of such policies and procedures, as well as the effectiveness of controls surrounding appraisal valuations (that is, the selection of appraisers with market and property competency, independence of the appraisal function from the loan production staff, monitoring collateral, and the use of a third party to perform all or part of the institution's collateral valuation function), and perform procedures to verify the integrity of the underlying data. This would include a review process to determine whether a given appraisal or evaluation provides sufficient support for the institution to engage in the transaction. Auditors may also consider reviewing the institution's own self-assessments and regulatory examinations and assessing the results and remediation because the findings could have an impact on the risk assessment related to the appraisal process.

Model Risk Management

.70 Financial institutions routinely rely on quantitative analysis and models for a wide variety of activities, including underwriting; valuing financial instruments and positions; managing and safeguarding customer assets; determining capital and adequacy reserves; and measuring and managing liquidity, interest rate, and capital risk. In recent years, financial institutions have applied models to more complex products and with increased scope, such as enterprise-wide risk measurement. The markets in which these analyses are utilized have also broadened and changed. With the increase in use of data-driven, quantitative decision-making tools, there comes an associated risk with their potential misuse.

.71 In response to the increased risk for model management, the OCC and the Federal Reserve jointly developed and issued *Supervisory Guidance on Model Risk Management*, which was released as Bulletin OCC 2011-12, *Sound Practices for Model Risk Management: Supervisory Guidance on Model Risk Management*, and SR Letter 11-7, *Guidance on Model Risk Management*, in April 2011. The new guidance replaces Bulletin OCC 2000-16, *Model Validation*. Although model validation remains at the core of the new guidance, the broader scope of model risk management encompasses model development, implementation, and use, as well as governance and controls related to models. All banks should ensure that internal policies and procedures are consistent with the risk management principles and supervisory expectations contained in this guidance. For further information, readers can access the supervisory guidance from either the OCC website at www.occ.gov or the Federal Reserve website at www.federalreserve.gov.

.72 An auditor may consider enhancing procedures over entity-level controls to verify appropriate documentation of policies and procedures over model risk management. In addition, the auditor may consider the effectiveness of controls surrounding senior management and the board's review of such policies and procedures, as well as the effectiveness of controls surrounding model valuations (that is, the competency of those performing valuation, segregation of duties, and so on) and the integrity of the underlying data. Auditors may also consider the challenges around validating assumptions (that is, the fair values of other real estate, mortgage-backed securities, and ALL) utilized within models and verifying that the institution maintains appropriate support for assumptions utilized within models.

Foreclosure Management

.73 In the fourth quarter of 2010, the OCC, the Federal Reserve; the FDIC; and the OTS, prior to its abolishment, conducted reviews of foreclosure processing at 14 federally regulated mortgage servicers. The reviews were designed to evaluate the adequacy of controls and governance over servicers' foreclosure processes and to assess servicers' authority to foreclose. Examiners focused on foreclosure policies and procedures, quality control and audits, organizational structure and staffing, and oversight and monitoring of third-party law firms and other vendors. The agencies found critical weaknesses in servicers' foreclosure governance processes; foreclosure documentation preparation processes; and the oversight and monitoring of third-party vendors, including foreclosure attorneys. The weaknesses resulted in unsafe and unsound practices and violations of applicable federal and state laws.[10] The results of the review performed can be found in the April 2011 *Interagency Review of Foreclosure Policies and Practices* that was issued by the OCC, the Federal Reserve, and the OTS. Readers can access this report from the OCC website at www.occ.gov/news-issuances/news-releases/2011/nr-occ-2011-47a.pdf or the Federal Reserve website at www.federalreserve.gov/boarddocs/rptcongress/interagency_review_foreclosures_20110413.pdf.

.74 In response to the foreclosure processing reviews, the OCC issued guidance in June 2011 to communicate the OCC's expectations for the oversight and management of mortgage foreclosure activities by national banks. National banks engaged in mortgage servicing, whether for their own loans or loans owned by others, must ensure compliance with foreclosure laws, conduct foreclosure processing in a safe and sound manner, and establish responsible business practices that provide accountability and appropriate treatment of borrowers in the foreclosure process. In particular, the guidance outlined management's responsibilities in relation to foreclosure process governance, dual-track processing, single point of contact, affidavit and notarization practices, documentation practices, legal compliance, and third-party vendor management.

.75 Further, the OCC directed national banks that have not already done so to conduct self-assessments of foreclosure management practices to ensure that their practices conform to the expectations outlined in this guidance. The self-assessments should include testing and reviewing files and should be appropriate in scope, considering the level and nature of the bank's mortgage servicing and foreclosure activity. The self-assessment is required to be performed no later than September 30, 2011. Banks that identify weaknesses in their foreclosure processes through the self-assessment should take immediate corrective action. Banks should determine if the weaknesses resulted in any financial harm to borrowers and provide remediation, when appropriate. Readers can access this guidance from the OCC website at www.occ.gov/news-issuances/bulletins/2011/bulletin-2011-29.html.

.76 Auditors of institutions with an increased volume in this area should consider the entity's internal control over the foreclosure governance process, affidavit and notarization practices, and foreclosure documentation. In addition, when there is a risk of material misstatement in the financial statements, auditors should consider designing audit procedures over entity-level controls to determine whether organizational structure is in place to carry out foreclosure activities, as well as appropriate documentation of policies and procedures. In instances when the institution may utilize third-party assistance within the foreclosure process, auditors should consider the guidance addressed in AU section 324, *Service Organizations* (AICPA, *Professional Standards*). Finally,

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[10] As a result of the foreclosure processing review, the Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System, and the OTS required the mortgage servicers reviewed to engage independent firms to conduct an independent review of foreclosure actions that occurred in 2009 and 2010. On November 2, 2011, the OCC announced that the independent reviews had begun. The independent consultants are responsible for evaluating whether borrowers suffered financial injury through errors, misrepresentations, or other deficiencies in foreclosure practices and for determining appropriate remediation for those customers. When a borrower suffered financial injury as a result of such practices, the consent orders require remediation to be provided. The cost of these independent reviews and any required remediation shall be covered by the mortgage servicers.

auditors may consider reviewing the institution's own self-assessments and assessing the results and remediation because the findings could have an impact on the risk assessment related to the foreclosure process and related accounts.

Counterparty Credit Risk

.77 The financial crisis of 2007–09 revealed weaknesses in counterparty credit risk (CCR) management at many banking organizations (that is, shortcomings in the timeliness and accuracy of exposure aggregation capabilities and inadequate measurement of correlation risks). *CCR* is defined as the risk that the counterparty to a transaction could default or deteriorate in creditworthiness before the final settlement of a transaction's cash flows. The financial crisis also highlighted deficiencies in the ability of banking organizations to monitor and manage counterparty exposure limits and concentration risks ranging from poor selection of CCR metrics to inadequate system infrastructure.

.78 To address these weaknesses, in June 2011, the Federal Reserve; the OTS, prior to its abolishment; the OCC; and the FDIC issued *Interagency Supervisory Guidance on Counterparty Credit Risk Management*. The guidance clarifies supervisory expectations and sound practices for an effective counterparty credit risk management framework. The guidance emphasizes that banks should use appropriate reporting metrics and limits systems, have well-developed and comprehensive stress testing, and maintain systems that facilitate measurement and aggregation of counterparty credit risk throughout the organization.

.79 The guidance is intended for banks with significant derivatives portfolios. Banks with limited derivatives exposure, particularly noncomplex exposures that are typical for community banks, such as embedded caps and floors on assets or liabilities, forward agreements to sell mortgages, or simple interest rate swaps, should apply this guidance as appropriate. Banks using derivatives that are more complex or those with significant noncomplex derivatives exposure should refer to the guidance for applicable risk management principles and practices. Readers can access the guidance from any of the agencies' websites.

.80 Auditors should consider whether significant concentrations are held within the entity's portfolio, the competency of the board and senior management to monitor the risk, the accuracy of underlying data utilized in analyzing the portfolio, and whether timely and periodic reviews of reporting metrics are performed by both the board and senior management. In addition, auditors should consider the adequacy of controls over stress test result evaluations and the validity of underlying assumptions, including assumptions for credit valuation adjustments, which are adjustments to reflect CCR in fair value measurements of derivatives.

Credit Unions

Corporate Credit Union Rule Amendments

.81 In September 2010, the NCUA released its Corporate System Resolution strategy, which assumed control of three additional undercapitalized corporate credit unions, announced a plan to isolate the impaired assets in the corporate credit union system, and finalized a set of stronger regulations. NCUA Letter to Credit Unions No. 10-CU-19, *Corporate Credit Union System Resolution*, was also released in September 2010 to address the reform action plan. Additional details on the NCUA's Corporate System Resolution strategy can be found at www.ncua.gov/Resources/Corps/CSR/Pages/default.aspx.

.82 Additionally, in September 2010, the NCUA issued major revisions to its rule governing corporate credit unions contained in Title 12 U.S. *Code of Federal Regulations* (CFR) Part 704. The major revisions involved corporate credit union capital, investments, asset-liability management, governance, and credit union service organization (CUSO) activities. The amendments established a new capital scheme, including risk-based capital requirements; imposed new prompt corrective action requirements; placed various new limits on corporate investments; imposed new asset-liability management controls; amended some corporate governance provisions; and limited a corporate CUSO to categories of services preapproved by the NCUA. The amendments became effective January 18, 2011, with the exception of amendments to 12 CFR 702.15(a); 703.14; 704.2; 704.3; 704.4; and subpart M of 12 CFR 747, which became effective on October 20, 2011.

.83 Following the September revisions, additional revisions were released in April 2011, which became effective on May 31, 2011, that now

- require all board votes to be recorded votes and to include the votes of the individual directors in the minutes (12 CFR 704.13);
- permit corporate credit unions to charge members reasonable, one-time membership fees to facilitate retained earnings growth (12 CFR 704.22);
- require disclosure of certain compensation received from the corporate CUSO for senior corporate credit union executives of CUSOs (12 CFR 704.11 and 704.19).

Investments

.84 In regard to investments, the final amendments now involve a rigorous investment screening process prior to purchase. Some of the significant changes within the process include (*a*) NRSRO ratings screen; (*b*) an additional prohibition of certain highly complex and leveraged securities (specifically, a collateralized debt obligation, a net interest margin security, private label residential mortgage-backed securities, or a security subordinated to any other securities in the issuance); (*c*) single obligor limits tightened from 50 percent of capital to 25 percent of capital; (*d*) the portfolio weighted average life (WAL) not to exceed 2 years; and (*e*) the portfolio WAL (assuming prepayment slowdown of 50 percent) not to exceed 2.5 years. In addition, some corporations may hold investments that are in violation of 1 or more of these new prohibitions, and these investments will be subject to the investment action plan provisions.

Nonperpetual Capital Accounts

.85 Effective October 20, 2011, membership capital accounts for corporate credit unions were replaced with nonperpetual capital accounts (NCAs). *NCAs* are funds contributed by members or nonmembers that

- are term certificates with an original minimum term of five years or that have an indefinite term with a minimum withdrawal notice of five years,
- are available to cover losses that exceed retained earnings and perpetual contributed capital (PCC),

- are not insured by the National Credit Union Share Insurance Fund (NCUSIF) or other share or deposit insurers, and
- cannot be pledged against borrowings.

.86 Membership capital accounts that were not converted to NCAs or PCCs by October 21, 2011, must be put on notice by the corporate credit union and, to the extent not needed to cover operational losses, returned to the member at the end of the notice period.

Perpetual Contributed Capital

.87 Effective October 20, 2011, paid-in capital was renamed PCC. *PCC* means accounts or other interests of a corporate credit union that are perpetual, noncumulative dividend accounts; are available to cover losses that exceed retained earnings; are not insured by the NCUSIF or other share or deposit insurers; and cannot be pledged against borrowings.

Leverage Ratio

.88 Effective October 20, 2011, the 1 existing total capital ratio was replaced with a new leverage ratio—Tier 1 risk-based capital ratio—and a total risk-based capital ratio by the corporate credit union final rule. The *leverage ratio*, prior to October 21, 2013, means the ratio of total capital to moving daily average net assets. The *leverage ratio*, on or after October 21, 2013, means the ratio of adjusted core capital (as defined in the final ruling) to moving daily average net assets. The *Tier 1 risk-based capital ratio* is defined as the ratio of Tier 1 capital (that is, adjusted core capital) to the moving monthly average net risk-weighted assets. The *total risk-based capital ratio* is defined as the ratio of total capital to moving monthly average net risk-weighted assets. The *moving monthly average net risk-weighted assets* is defined as the average of the net risk-weighted assets for the month being measured and the previous 11 months.

.89 The final rule establishes a minimum of 4 percent for the leverage ratio, 4 percent for the Tier 1 risk-based capital ratio, and 8 percent for the total risk-based capital ratio. The final rule also requires that a corporate credit union attempt to build retained earnings to a level of 0.45 percent of its moving daily average net assets by October 21, 2013, and submit a retained earnings accumulation plan to the NCUA if it fails to do so.

Prompt Corrective Action

.90 Effective October 20, 2011, the corporate credit union final rule established prompt corrective action requirements. The purpose of this section is to define, for corporate credit unions that are not adequately capitalized, the capital measures and capital levels that are used for determining appropriate supervisory actions. It also establishes procedures for the submission and review of capital restoration plans and the issuance and review of capital directives, orders, and other supervisory directives.

Conclusions

.91 An auditor should be cognizant of these changes and discuss with credit unions how the changes in regulations are being addressed. In addition, the auditor should assess the impact of noncompliance on financial reporting and, if applicable to the engagement, internal controls over financial reporting.

.92 See further discussion on the corporate credit union rule amendments, which will become effective subsequent to 2011, in the "On the Horizon" section of this alert.

Broker-Dealers in Securities

Cost Basis Reporting

.93 Historically, Form 1099-B required those acting in the capacity of a broker to report the gross proceeds from sales of stock or securities to the seller. In October 2010, the IRS issued final regulations that require brokers to also report a customer's adjusted basis in sold securities and classify the resulting gain or loss as long or short term. Auditors of banking institutions should consider whether their institutions act as a broker or custodian of its own stock, and if so, the requirements discussed subsequently may apply to their institution.

.94 The adjusted basis reporting requirement only applies to the following covered securities, provided that they are held in a brokerage or similar custodial account:

- Shares of stock (other than mutual fund and dividend reinvestment plan shares) acquired for cash on or after January 1, 2011
- Mutual fund and dividend reinvestment plan shares acquired for cash on or after January 1, 2012
- Debt securities acquired for cash on or after January 1, 2013, or such later date determined by the Treasury Department
- Other securities that the Treasury Department may designate in future years

.95 Due to stakeholder comments received over stock basis reporting, the IRS issued interim guidance, in June 2011, on issues relating to the basis of stock subject to broker reporting. The interim guidance discusses changes from the broker default average basis method, the 10 percent reinvestment rule and fractional shares, and lost selection methods across accounts. For further information, the interim guidance can be accessed from the IRS website at www.irs.gov/irb/2011-29_IRB/ar07.html.

.96 Internal Revenue Code (IRC) Section 6045A was enacted, along with the newly adopted adjusted basis requirements of Form 1099-B, and requires that brokers and professional custodians who effect transfers of stock to other brokers or custodians must issue a transfer statement to the receiving broker or custodian within 15 days of the transfer. If the transfer statement is not received within the allotted time, a penalty will be assessed. The transfer statement is required to contain various identifications about the transferred securities, including a designation regarding whether the transferred securities are covered securities. If the transferred securities are covered securities, then the original acquisition date and tax basis of the securities must be included within the transfer statement. Subsequent to the enactment of IRC Section 6045A, the IRS released Notice 2010-67, *Information Reporting Requirements Relating to Transfers of Securities*, which suspended all penalties for failure to issue transfer statements related to 2011 transfers between brokers or custodians that are not incidental to a sale or purchase of the transferred securities. Auditors of banking institutions should also consider whether their institutions act as their own transfer agent, and if so, the requirements of IRC Section 6045A may apply to their institution.

.97 IRC Section 6045B, enacted by the Energy Improvement and Extension Act of 2008, mandated various new information reporting requirements for issuers of stock, stockbrokers, and mutual funds. Beginning in 2011, an issuer of stock must report to the IRS any organizational action (that is, stock split, merger or acquisition, stock dividends, nondividend distributions, and so on) that affects the stock's basis. When the organizational action occurs, the issuer generally is required to make a report available to each shareholder of record by January 15 of the subsequent calendar year and the IRS within 45 days following the action (or, if earlier, January 15 of the subsequent year). Both of these reporting requirements can be satisfied by posting the required information on the taxpayer's public website within 45 days of the organizational action and keeping it available for 10 years. Auditors of banking institutions should also consider whether their institutions have undertaken an action that affects their shareholders' stock basis, and if so, the requirements of IRC Section 6045B may apply to their institution.

.98 Subsequent to the enactment of IRC Section 6045B, in February 2011, the IRS released Notice 2011-18, *Postponing Filing Date for Section 6045B Issuer Return*, which suspended all penalties for failure to report the action to the IRS within 45 days, provided that the issuer properly reports to the IRS by January 17, 2012. The penalty protection does not apply to the reporting requirements for shareholders. The transitional relief was provided because, at the time of the notice, the IRS had not yet developed the return for issuers to use to report organizational actions or determined what information would be required on the return.

.99 To ensure compliance with the new rules and reporting requirements, broker-dealers, banks, mutual funds, and other financial entities may have made substantial changes to internal operations, such as updating front- and back-office client interfaces, securities' files, accounting systems, and reporting platforms. Auditors should consider discussing the implications that the new reporting requirements have on their clients' internal operations and should consider the need to enhance control risk assessments due to the first year of implementation. Additional challenges may also arise in the accounting treatment of short sales, wash sales when the taxpayer has multiple brokerage accounts, dividend reinvestment plans, and securities purchased in foreign currencies.

Funding and Liquidity Risk Management Practices

.100 The objective of effective funding and liquidity risk management is to ensure that the financial entity can efficiently meet customer loan requests, customer account withdrawals or deposit maturities, and other cash commitments under both normal operating conditions and unpredictable circumstances of industry or market stress. To achieve this objective, the financial entity must establish and monitor liquidity guidelines that require sufficient asset-based liquidity to cover potential funding requirements and avoid overdependence on volatile, less reliable funding markets. Unencumbered debt and equity securities in the trading and securities available-for-sale portfolios should provide asset liquidity, in addition to the immediately liquid resources of cash and due from banks and federal funds sold, securities purchased under resale agreements, and other short-term investments. Asset liquidity should be further enhanced by the ability of the financial entity to access secured borrowing facilities through the FHLB or the Federal Reserve.

.101 In November 2010, FINRA issued Regulatory Notice 10-57, *Funding and Liquidity Risk Management Practices*, in response to practices identified through FINRA examinations and a survey of 15 midsized and large broker-dealers that hold inventory positions and carry customer accounts. The purpose of the guidance was to relay the importance that broker-dealers need to develop and monitor funding and liquidity risk management programs that take into consideration a broad range of adverse circumstances, including extraordinary credit events.

.102 The notice provides a list of practices that can help broker-dealers prepare for various market scenarios that could affect their liquidity position and ability to fund operations. The notice discussed practices involving risk limits and reporting, independent risk oversight, the maturity profile of funding sources, red flags of potential funding and liquidity problems, inventory valuation, stress testing, a contingency funding plan, and the use of customer assets. See Regulatory Notice 10-57 at www.finra.org/Industry/Regulation/Notices/2010/P122389.

Regulation SHO Compliance Extension

.103 In November 2010, the SEC extended the compliance date for the amendments to Rules 201 and 200(g) of Regulation SHO under the 1934 Act from November 10, 2010, to February 28, 2011. Rule 201 adopts a short sale-related circuit breaker that, if triggered, will impose a restriction on the prices at which securities may be sold short (short sale price test restriction).

.104 The amendments to Rule 200(g) provide that a broker-dealer may mark certain qualifying short sale orders short exempt. In accordance with Rule 200(g)(2), a sale order should be marked short exempt only if the provisions of Rule 201(c) or (d) are met. Under the provisions of Rule 201(c) and (d), a broker-dealer submitting a short sale order of the covered security in question to a trading center may mark the order short exempt if the broker-dealer identifies the order as being at a price above the current national best bid at the time of submission or has a reasonable basis to believe that the short sale order of a covered security is

- by a person that is deemed to own the covered security pursuant to Rule 200, provided that the person intends to deliver the security as soon as all restrictions on delivery have been removed.
- by a market maker to offset customer odd-lot orders or liquidate an odd-lot position that changes such broker-dealer's position by no more than a unit of trading.
- for a good faith account of a person who then owns another security by virtue of which he or she is, or presently will be, entitled to acquire an equivalent number of securities of the same class as the securities sold, provided that such sale, or the purchase that such sale offsets, is effected for the bona fide purpose of profiting from a current difference between the price of the security sold and the security owned and that such right of acquisition was originally attached to, or represented by, another security or was issued to all the holders of any such securities of the issuer.

- for a good faith account and submitted to profit from a current price difference between a security on a foreign securities market and a security on a securities market subject to the jurisdiction of the United States, provided that the short seller has an offer to buy on a foreign market that allows the seller to immediately cover the short sale at the time that it was made.
- by an underwriter or a member of a syndicate or group participating in the distribution of a security in connection with an overallotment of securities or for purposes of a lay-off sale by an underwriter or a member of a syndicate or group in connection with a distribution of securities through a rights or standby underwriting commitment.
- by a broker-dealer effecting the execution of a customer purchase or a customer long sale on a riskless principal basis.
- for the sale of a covered security at the volume weighted average price (VWAP) that meets the following criteria:
  - The VWAP for the covered security is calculated by calculating the values for every regular way trade reported in the consolidated system for the security during the regular trading session by multiplying each such price by the total number of shares traded at that price, compiling an aggregate sum of all values, and dividing the aggregate sum by the total number of reported shares for that day in the security.
  - The transactions are reported using a special VWAP trade modifier.
  - The VWAP-matched security qualifies as an actively-traded security, or the proposed short sale transaction is being conducted as part of a basket transaction of 20 or more securities in which the subject security does not comprise more than 5 percent of the value of the basket traded.
  - The transaction is not effected for the purpose of creating actual or apparent active trading in, or otherwise affecting the price of, any security.
  - A broker-dealer shall be permitted to act as principal on the contraside to fill customer short sale orders only if the broker-dealer's position in the covered security, as committed by the broker-dealer during the preopening period of a trading day and aggregated across all its customers who propose to sell short the same security on a VWAP basis, does not exceed 10 percent of the covered security's relevant average daily trading volume.

.105 The SEC extended the compliance date for the amendments to Rules 201 and 200(g) to give certain exchanges additional time to modify their current procedures for conducting single-priced opening, reopening, and closing transactions for covered securities that have triggered Rule 201's circuit breaker in a manner that is consistent with the goals and requirements of Rule 201. Further, the extended compliance period was intended to give industry participants additional time for programming and testing compliance with the requirements of the rule.

Risk Management Controls for Broker-Dealers With Market Access

.106 Given the increased automation of trading on securities exchanges and alternative trading systems (ATSs) today and the growing popularity of sponsored or direct market access arrangements in which broker-dealers allow customers to trade in those markets electronically using the broker-dealers' market participant identifiers, the SEC is concerned that the various financial and regulatory risks that arise in connection with such access may not be appropriately and effectively controlled by all broker-dealers. New SEC Rule 15c3-5 is designed to ensure that broker-dealers appropriately control the risks associated with market access, so as not to jeopardize their own financial condition, that of other market participants, the integrity of trading on the securities markets, and the stability of the financial system.

.107 In November 2010, the SEC issued Release No. 34-63241, *Risk Management Controls for Brokers or Dealers with Market Access*, to announce the adoption of Rule 15c3-5 under the 1934 Act. Rule 15c3-5 requires broker-dealers with access to trading securities directly on an exchange or ATS, including those providing sponsored or direct market access to customers or other persons, and broker-dealer operators of an ATS that provide access to trading securities directly on their ATS to a person other than a broker-dealer to establish, document, and maintain a system of risk management controls and supervisory procedures that, among other things, are reasonably designed to (*a*) systematically limit the financial exposure of the broker-dealer that could arise as a result of market access and (*b*) ensure compliance with all regulatory requirements that are applicable in connection with market access. The required financial risk management controls and supervisory procedures must be reasonably designed to prevent the entry of orders that exceed appropriate preset credit or capital thresholds or that appear to be erroneous. The regulatory risk management controls and supervisory procedures must also be reasonably designed to prevent the entry of orders unless there has been compliance with all regulatory requirements that must be satisfied on a preorder entry basis, prevent the entry of orders that the broker-dealer or customer is restricted from trading, restrict market access technology and systems to authorized persons, and ensure that appropriate surveillance personnel receive immediate posttrade execution reports.

.108 The financial and regulatory risk management controls and supervisory procedures required by Rule 15c3-5 must be under the direct and exclusive control of the broker-dealer with market access, with limited exceptions specified in the rule that permit the reasonable allocation of certain controls and procedures to another registered broker-dealer that, based on its position in the transaction and relationship with the ultimate customer, can more effectively implement them. In addition, a broker-dealer with market access is required to establish, document, and maintain a system for regularly reviewing the effectiveness of the risk management controls and supervisory procedures and for promptly addressing any issues. Among other things, the broker-dealer is required to review, no less frequently than annually, the business activity of the broker-dealer in connection with market access to ensure the overall effectiveness of such risk management controls and supervisory procedures and to document that review. The review, which must also be documented, is required to be conducted in accordance with written procedures.

In addition, the CEO (or equivalent officer) of the broker-dealer is required, on an annual basis, to certify that the risk management controls and supervisory procedures comply with Rule 15c3-5 and that the regular review previously described has been conducted. The compliance date for this ruling was July 14, 2011, with the exception of certain requirements discussed subsequently. For additional information, the final ruling can be found on the SEC website at www.sec.gov/rules/final/2010/34-63241.pdf.

.109 In July 2011, the SEC released Rule No. 34-64748, *Risk Management Controls for Brokers or Dealers with Market Access*, to extend the compliance date for certain requirements of Rule 15c3-5 under the 1934 Act. Specifically, the SEC extended the compliance date until November 30, 2011, for all requirements of Rule 15c3-5 for fixed income securities and the requirements of Rule 15c3-5(c)(1)(i) for all securities. The SEC extended the compliance date in an effort to allow broker-dealers with market access additional time to develop, test, and implement the relevant risk management controls and supervisory procedures required under the rule. The final ruling can be found on the SEC website at www.sec.gov/rules/final/2011/34-64748.pdf.

.110 Auditors should be cognizant of the requirements that pertain to Rule 15c3-5 and assess the impact of noncompliance on financial reporting. Auditors might also consider the implication that these new regulations will have on the design of audit procedures because additional control work and compliance procedures may be required surrounding the client beyond those performed in prior year audits, and they should be planned for accordingly.

Large Trader Reporting

.111 In July 2011, the SEC adopted a new Rule 13h-1 and Form 13H to assist in both identifying and obtaining trading information on market participants that conduct a substantial amount of trading activity. Rule 13h-1 requires a *large trader*, defined as a person whose transactions in National Market System securities (exchange-listed securities) equal or exceed 2 million shares or $20 million during any calendar day or 20 million shares or $200 million during any calendar month, to identify itself to the SEC and make certain disclosures on Form 13H. Each large trader will receive an identification number that must then be provided to its registered broker-dealers. Those registered broker-dealers will be required to maintain certain records and, upon request, report large trader information to the SEC. In addition, certain registered broker-dealers subject to the rule will be required to perform limited monitoring of their customers' accounts for activity that may trigger the large trader identification requirements of Rule 13h-1. The compliance date for a large trader to identify itself to the SEC is December 1, 2011. The compliance date for a broker-dealer to maintain records and report on and monitor large trader activity pursuant to the rule is April 1, 2012. For more information, see Release No. 34-64976, *Large Trader Reporting*, on the SEC website at www.sec.gov/rules/final/2011/34-64976.pdf.

Electronic Submission of Broker-Dealer Annual Audit Reports

.112 In November 2011, FINRA revised the submission process of annual audited financial statements, as required under SEC Rule 17a-5(d). Firms whose designated examining authority (DEA) is FINRA and with a fiscal year-end on or after September 30, 2011, must submit their annual audit reports in electronic form. Firms must also submit the oath and affirmation electronically and maintain the oath and affirmation page with an original manual signature as part of their books and records, in accordance with Rule 17a-4(a). Further information regarding the electronic submission process, including directions for how to submit an amended annual audit report, can be found at www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p125029.pdf.

Commodities

Commodity Exchange-Traded Funds and Certain Independent Directors or Trustees of These Commodity Pools

.113 Effective June 17, 2011, the CFTC amended its part 4 regulations to provide relief from certain disclosure, reporting, and recordkeeping requirements for commodity pool operators (CPOs) of commodity pools whose units of participation are listed and traded on a national securities exchange (commodity exchange-traded funds [ETFs]). This action, now falling under CFTC Regulation 4.12(c), codifies relief that the CFTC staff previously had issued to these CPOs on a case-by-case basis. It also codifies, under CFTC Regulation 4.13(a)(5), relief from the CPO registration requirement for certain independent directors or trustees of these actively managed commodity pools that the CFTC staff similarly had issued.

.114 These amendments also require that requests for relief under CFTC Regulations 4.12(c) and 4.13(a)(5) be filed through the NFA's electronic exemption system, which is available at www.nfa.futures.org/NFA-electronic-filings/exemptions.HTML, by a person duly authorized to bind the CPO or commodity trading adviser (CTA). Any commodity ETF or independent director or trustee that was previously granted relief from these requirements by the CFTC staff need not file a request for relief.

The CFTC Annual "Dear CPO" Letter

.115 On February 2, 2011, the CFTC staff issued its annual letter to CPOs outlining key reporting issues and common reporting deficiencies found in annual financial reports for commodity pools. The CFTC anticipates issuing a similar letter in January 2012. The letter emphasizes the CFTC staff's concerns and, accordingly, may alert the auditor to high-risk issues that could affect assertions contained in the financial statements of commodity pools. The CFTC staff also suggests that CPOs share the letter with their independent auditors. Major concerns addressed in the letter include the following:

- Filing deadlines and due dates of commodity pool financial filings
- Master/feeder and fund of funds
- Requests for limited relief from U.S. generally accepted accounting principles (GAAP) compliance for certain offshore commodity pools
- Reports of liquidating pools
- Accounting resources, including the following:
  - — FASB ASC
  - — AICPA Practice Aid *Audits of Futures Commission Merchants, Introducing Brokers, and Commodity Pools*
  - — AICPA Audit Risk Alerts
  - — FASB ASC 820, *Fair Value Measurement*

— AICPA technical guidance regarding organization and offering costs contained in the Audit and Accounting Guide *Investment Companies*

.116 The CFTC has issued similar letters in prior years, which are available on the CFTC website.[11] Those letters should be consulted with respect to commodity pool annual financial statements and reporting. Readers are encouraged to view the full text of this letter at www.cftc.gov/ucm/groups/public/@iointermediaries/documents/file/cpoannualguidanceletter2010.pdf and to monitor the CFTC website for the most recent guidance.

.117 Auditors may also consider additional CFTC guidance related to auditing regulatory supplementary schedules, maintaining minimum financial requirements and notification requirements, segregation of customer funds in multiple currencies, and forex transactions. For additional details, readers may refer to the CFTC website at www.cftc.gov.

NFA

.118 For additional information on the subsequent discussions, readers should visit the NFA website at www.nfa.futures.org/news/newsNoticeList.asp.

Amendments to the NFA's Forex Requirements, Including the NFA's Jurisdiction Over Forex Dealer Members

.119 The NFA made a number of amendments, effective October 1, 2011, to its requirements that govern retail forex activities of NFA members. In brief, these amendments provide the following:

- Eliminating previous exclusions granted in certain cases
- Eligibility of members to conduct forex activities
- Imposing the know-your-customer requirements to members' forex transactions
- Imposing office location requirements on forex dealer members (FDMs)
- Making certain technical clarifying amendments to the "Code of Arbitration" section of the *NFA Manual*

Amendments to NFA Financial Requirements for FDMs

.120 Amendments to NFA financial requirements, effective February 1, 2011,

- prohibit an FDM from including assets as current for purposes of determining adjusted net capital and from using those assets to cover currency positions if the assets are held at an affiliate or unregulated person. An *unregulated person* is defined by the rule to include any entity except those specifically excluded from that definition.
- remove financial institution from the list of excluded entities and replace it with bank or trust company regulated by a U.S. banking

[11] Letters from 1998 to the present are available on the Commodities Future Trading Commission's website at www.cftc.gov/industryoversight/intermediaries/guidancecporeports.html.

regulator, as provided in CFTC Regulation 5.7, *Minimum financial requirements for retail foreign exchange dealers and futures commission merchants offering or engaging in retail forex transactions*.

- include in current assets those assets held at certain foreign banks and trust companies regulated in a money center country and that maintain regulatory capital in excess of $1 billion.
- remove insurance companies from the list of qualified entities.

.121 The NFA will, however, continue to have the authority to approve the use of certain foreign equivalent entities that are appropriately regulated and capitalized. Section (C)(3) of the related Interpretive Notice 9053, *Forex Transactions*, lists the factors that the NFA considers when determining whether to approve an otherwise unregulated entity for purposes of section 11(b)–(c) of the "Financial Requirements" section of the *NFA Manual*.

FDM Trade Reporting System

.122 Effective February 4, 2011, FDMs must submit a daily electronic report of daily trade information to the NFA prepared as of 5:00 p.m. EST and filed with the NFA by 11:59 p.m. EST that same day. During the submission process, the FDM must certify that the report is true and complete. Prior to the effective date, FDMs are required to submit at least 3 consecutive sets of files with no errors to ensure that the firm can be validated via the system. Each daily report that is filed after it is due shall be accompanied by a late fee of $200 for each business day that it is late.

New Financial Reporting Requirements for FDMs

.123 FDMs must include the following additional information on the Exchange Supplementary Schedule of CFTC Form 1-FR-FCM financial filings:

- Gross revenue from forex transactions with retail customers
- Total net aggregate notional value of all open forex transactions in retail customer and noncustomer (not proprietary) accounts
- Total aggregate retail forex assets
- Total amount of retail forex obligations
- Retail forex-related minimum dollar amount requirement

.124 After providing the preceding information on the Exchange Supplementary Schedule, FDMs should proceed to the Statement of Computation of the Minimum Capital Requirement on CFTC Form 1-FR-FCM. In line item 22.C, FDMs should enter the net capital requirement that was reported in line item 13.C on the Exchange Supplementary Schedule. This figure should be the initial requirement of $20 million plus 5 percent of the total retail forex obligation in excess of $10 million.

The NFA Offers Guidance on the CFTC's Final Forex Regulations

.125 Based on further consultation with the CFTC staff, the NFA issued a notice providing additional guidance on the following areas:

- The risk disclosure statement required by CFTC Regulation 5.5, *Distribution of "Risk Disclosure Statement" by retail foreign exchange dealers, futures commission merchants and introducing brokers regarding retail forex transactions*

- Qualifying institutions for holding assets equal to the retail forex obligation
- Introducing broker (IB), CPO, and CTA registration
- Other registration issues

Recent Changes to the NFA's Self-Examination Questionnaire and Interpretive Notice 9020

.126 The NFA requires all members to review the self-examination questionnaire on a yearly basis in order to help members identify and correct any supervisory deficiencies. As originally drafted, the questionnaire contained a general section for all members, as well as a supplemental section specifically tailored for FCMs, IBs, CPOs, and CTAs.

.127 Effective April 8, 2011, the NFA added a section to the questionnaire specifically tailored to an FDM's operations (for example, trading systems, disclosure obligations, and trading standards) and updated other questionnaire sections to assist other members engaging in forex transactions in reviewing their forex operations. In addition to these changes, the NFA modified the questionnaire as follows:

- Changed the format from a checklist to a questionnaire in order to generate a "Yes" or "No" response from the member completing the questionnaire
- Identified CFTC and NFA requirements related to the specific areas covered in the questionnaire
- Updated the content of the questionnaire by removing outdated practices

.128 In order to implement these changes, the NFA also amended the related Interpretive Notice 9020, *Compliance Rules 2-9, 2-36 and 2-39: Self-Audit Questionnaires*, to specifically require FDMs to complete the questionnaire and to require other members engaging in forex transactions to use the questionnaire to review their forex operations. The amendments to Interpretive Notice 9020 also clarify that a supervisory person in a member's branch office must review the branch office's operations. The revised questionnaire is available on the NFA's website at www.nfa.futures.org/nfamanual/NFAManual.aspx?RuleID=9020&Section=9. Members should use the revised questionnaire at the time of their next annual review.

NFA Launch of New Web-Based Anti-Money Laundering Procedures System

.129 The NFA has launched a Web-based Anti-Money Laundering (AML) Procedures System to assist NFA member FCMs and IBs and applicants in developing an AML program that meets the requirements of the Bank Secrecy Act of 1970 and NFA Compliance Rule 2-9(c). The system is designed to assist firms in developing an adequate written compliance program by identifying the minimum components of the program and providing guidance and information on the components, along with examples of suggested language.

.130 FCMs and IBs are not required to use this system to develop their AML program. In fact, FCMs and IBs should be aware that this system is intended to provide an outline for the program and that you may need to make modifications to ensure that the final program addresses the money laundering risks associated with the member's business. Using the system does not guarantee that your program will satisfy the AML program requirements nor does it provide a safe harbor from violations of the program requirements.

.131 The AML Procedures System can be accessed via the NFA's website at www.nfa.futures.org/NFA-electronic-filings/aml-procedures.HTML, employing the same user name and password that would be used to access the NFA's Online Registration System.

Audit and Accounting Developments

PCAOB Observations Related to Audit Risk Areas Affected by the Economic Crisis

.132 In September 2010, the PCAOB released *Report on Observations of PCAOB Inspectors Related to Audit Risk Areas Affected by the Economic Crisis*. This report was issued to discuss the audit risks and challenges that resulted from the economic crisis that the PCAOB identified through its inspection program. This report covers inspections from the 2007–09 inspection cycles, which generally involved reviews of audits of issuers' fiscal years ending in 2006–08. The PCAOB's inspections covered by this report focused on audits of issuers in industries affected by the economic crisis. Thus, the PCAOB paid particular attention to audits of financial institutions industry issuers, including the larger financial institution audit clients.

.133 Heightened risk factors identified by the PCAOB that are of importance to financial institutions include fair value measurements, asset impairments, ALL, and the consideration of an issuer's ability to continue as a going concern.

.134 Readers should refer to the Audit Risk Alert *General Accounting and Auditing Developments—2011/12* (product no. 0223311) for detailed guidance on auditing fair value measurements, auditing accounting estimates, and consideration of an entity's ability to continue as a going concern.

Fair Value Measurements

.135 The economic crisis increased uncertainty around fair value measurements, which significantly increased audit risk. Failing to properly test issuers' fair value measurements and disclosures may lead to the auditor not detecting a material misstatement in issuers' financial statements, which may cause investors to be misled.

.136 The PCAOB has focused on the auditor's testing of an issuer's estimates of fair value of financial instruments. Some firms performed procedures that included evaluating the reasonableness of the issuer's significant assumptions and testing the valuation model and underlying data. Deficiencies observed in audits of these tests included firms' failures to

- evaluate, or evaluate sufficiently, whether fair value measurements were determined using appropriate valuation methods.
- test, or test adequately, controls over issuers' valuation processes.
- evaluate, or evaluate sufficiently, the reasonableness of management's significant assumptions. Examples of this include not performing tests beyond inquiries of management; not appropriately

evaluating the reasonableness of assumptions such as discount rates, credit loss expectations, and prepayment assumptions; and not involving a valuation specialist, when appropriate.

- evaluate available evidence that was inconsistent with issuers' fair value estimates.

.137 Alternatively, some firms evaluated issuers' estimates of the fair value of financial instruments by developing an independent expectation of fair value. Firms often used external pricing services or external valuation specialists to make this evaluation. Deficiencies of the firms observed in this situation included failing to understand the methods or assumptions used by these external parties and failing to evaluate significant differences between the independent estimates used or developed by firms and the fair values recorded by issuers.

.138 Further, firms sometimes failed to test, or test sufficiently, significant, difficult-to-value securities (for example, limiting their testing to inquiries of issuer personnel). The PCAOB has also found that some firms failed to perform sufficient procedures in light of the volatile market conditions to provide a reasonable basis for extending to year-end the conclusions regarding the valuation of investment securities that were reached at an interim date. There were also instances in which firms failed to perform sufficient tests to determine whether issuers' fair value disclosures were in conformity with the requirements of FASB ASC 820.

Impairment of Goodwill, Indefinite-Lived Intangible Assets, and Other Long-Lived Assets

.139 Inspectors observed instances in which firms failed to challenge issuers' conclusions that goodwill did not need to be tested for impairment more frequently than annually despite the existence of impairment indicators, such as recent declines in issuers' stock prices or reduced estimates of future income in situations when such declines or reductions appeared to be potentially significant to issuers' most recent impairment analyses. In addition, inspectors observed that firms sometimes failed to test, or test appropriately, issuers' assessments that other indefinite-lived intangible assets or other long-lived assets were not impaired. In some cases, firms failed to evaluate the reasonableness of certain significant assumptions used by issuers in their impairment assessments.

ALL

.140 PCAOB inspectors identified deficiencies related to procedures performed to evaluate the reasonableness of ALL. These deficiencies included firms' failures to

- sufficiently test issuers' specific allowances on impaired loans. For example, firms sometimes failed to (*a*) sufficiently test issuers' conclusions regarding the identification and measurement of impaired loans, (*b*) perform procedures to establish a basis for relying on the work of certain issuer personnel, and (*c*) understand the methods and assumptions used by external parties engaged by issuers to perform appraisals of collateral underlying impaired loans.

- evaluate, or evaluate sufficiently, the effect on ALL of deficiencies identified in management's process and to alter the nature, timing, and extent of the firms' testing of ALL in light of the identified deficiencies.
- evaluate, or evaluate sufficiently, the reasonableness of management's significant assumptions used to develop ALL, including assumptions about the nature or size of qualitative adjustments. For example, some firms failed to evaluate the reasonableness of loss factors or other assumptions used to estimate ALL that were not directionally consistent with negative credit quality trends in loan portfolio performance or significant adverse conditions in the economic environment.
- test, or test sufficiently, the data underlying management's calculation of ALL. Specifically, firms sometimes failed to test, or test sufficiently, the completeness and accuracy of the data in system-generated or manually prepared reports used to develop ALL. These reports often formed the basis for significant inputs for the calculation of ALL, such as loan delinquency data, credit score information, the value of loan collateral, and internally developed loan ratings.

.141 In other cases, firms evaluated the reasonableness of these issuers' ALL by developing an independent expectation of ALL. When this approach was used, inspectors noted instances in which firms failed to obtain evidence to support the assumptions that they used or failed to test the completeness and accuracy of the issuer's data used by the firm in developing the independent expectation.

Off-Balance Sheet Structures

.142 Inspectors observed deficiencies in firms' audit procedures related to off-balance sheet structures. Specifically, inspectors noted instances in which firms failed to (*a*) sufficiently test issuers' transactions with external parties or special purpose entities to determine whether such transactions were appropriately accounted for as off-balance sheet arrangements and (*b*) test the ongoing compliance with accounting requirements for certain off-balance sheet arrangements, including performing tests for the occurrence of events that would affect the accounting for these arrangements.

Other-Than-Temporary Impairment of Certain Investments

.143 Inspectors observed instances in which firms failed to adequately evaluate issuers' conclusions that a decline in the fair value of securities was not other than temporary. In these instances, inspection teams observed deficiencies that included firms' failures to

- evaluate, beyond inquiries of management, certain significant assumptions underlying issuers' assessments that investments in debt and equity securities were not other-than-temporarily impaired for significant classes of securities, including securities for which fair value had been below cost for a period greater than 12 months.
- evaluate issuers' assertions regarding their intent and ability to hold securities for a period of time sufficient to allow for any anticipated recovery in fair value.

- consider contradictory evidence, such as sales of securities or contractual agreements, that would call into question whether issuers had the intent and ability to hold the investment until recovery.

Conclusions

.144 The observations from the PCAOB report will serve to inform future actions in connection with certain inspection, enforcement, and standard-setting activities, and consideration will be given to whether additional guidance is needed relating to existing standards. The report can be accessed at http://pcaobus.org/Inspections/Documents/4010_Report_Economic_Crisis.pdf.

Auditing Troubled Debt Restructurings

.145 Weakness in the housing market and elevated levels of nonperforming loans and delinquencies continue to increase the potential for higher levels of loan restructurings. An audit risk includes not identifying modifications as troubled debt restructurings (TDRs), thus leading to inaccurate disclosures and a potentially understated allowance for loan loss estimates. The *OCC Mortgage Metrics Report: Disclosure of National Bank and Federal Savings Association Mortgage Loan Data* for the second quarter of 2011 contains trends in mortgage modifications for the most recent quarter and provides performance data on first-lien residential mortgages serviced by national banks and federal thrifts. The report can found at www.occ.gov/news-issuances/news-releases/2011/nr-occ-2011-124.html.

.146 Due to the continued high level of debt modifications, auditing TDR continues to be an audit risk. Auditors should also be aware of accounting and disclosure changes resulting from the issuance of Accounting Standards Update (ASU) No. 2011-02, *Receivables (Topic 310): A Creditor's Determination of Whether a Restructuring Is a Troubled Debt Restructuring*, and assess whether their clients are effectively implementing the considerations discussed within this ASU. TDR disclosure requirements discussed in ASU No. 2010-20, *Receivables (Topic 310): Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses*, were previously deferred and became effective with the issuance of ASU No. 2011-02. Auditors should design audit procedures to determine whether management has designed and implemented effective internal controls to timely identify TDRs (including whether appropriate documentation has been developed to support management's assessment of internal control over financial reporting, if applicable) for purposes of measuring impairment. They should also consider whether the entities have appropriate tracking and reporting processes in place to address disclosure requirements applicable to TDRs. Readers should refer to the Audit Risk Alert *General Accounting and Auditing Developments—2011/12* (product no. 0223311) for further information on ASU Nos. 2010-20 and 2011-02.

.147 In addition, auditors should consider reviewing substandard or watch-listed loans that have been renewed at similar terms to the original loan. In such instances, it is likely that the loan would not qualify for the terms as offered in the renewal terms. In these instances, the institution may have granted a concession because there is likely no market interest rate for such a renewal, and therefore, the renewal under such terms is a strong indicator that the loan should be accounted for as a TDR. In such cases, auditors should consider whether the institutions have appropriately accounted for the renewal of this nature. Auditors may also want to review the assumptions of projected cash flows utilized in impairment measurements to determine the reasonableness of the estimates because this will drive the allocated allowance for such loans.

Auditing Other Real Estate Owned

.148 Another significant risk factor for depository and lending institutions has been the extensive amount of other real estate owned (OREO) by depository and lending institutions. Generally, the largest component of real estate owned by lenders includes assets taken in settlement of troubled loans through surrender or foreclosure. Becoming familiar with the current risks related to OREO, along with the applicable accounting guidance, including guidance applicable to transactions by which these assets are sold and potentially derecognized, is important for auditors of depository and lending institutions. Examples of potential audit risks related to these assets include the following:

- Outdated or stale appraisals
- Appraisals in unstable market conditions
- OREO values inflated to hide loan losses
- Ineffective processes for identifying losses
- The disposition of OREO and whether the OREO qualifies for derecognition or sale accounting

.149 FASB ASC 310-40 applies to the initial measurement of a foreclosed property. At the time of foreclosure, foreclosed property should be recorded at the lower of the net amount of the receivable or the fair value less estimated selling costs, establishing a new cost basis, in accordance with FASB ASC 310-40-40-7. For subsequent measurement, FASB ASC 360-10-35-43 states that a long-lived asset (disposal group)[12] classified as held for sale should be measured at the lower of its carrying amount or fair value less cost to sell.

.150 Further, FASB ASC 310-40-40-6 provides that a TDR that is, in substance, a repossession or foreclosure by the creditor (that is, the creditor receives physical possession of the debtor's assets, regardless of whether formal foreclosure proceedings take place, or the creditor otherwise obtains one or more of the debtor's assets in place of all or part of the receivable) should be accounted for according to the provisions of FASB ASC 310-40-35-7; paragraphs 2–4 of FASB ASC 310-40-40; and, if appropriate, FASB ASC 310-40-40-8.

.151 FASB ASC 360-20 establishes standards for the recognition of profit on all real estate sales transactions, other than retail land sales, without regard to the nature of the seller's business. FASB ASC 360-20-40 presents the real estate derecognition guidance primarily from the perspective of the profit recognition upon a sale. This guidance also pertains to sales recognition when the seller finances the purchase.

.152 The sale of foreclosed property may be financed by a loan at less than current market interest rates. In those circumstances, the auditor may consider verifying that the loan is adjusted for its below market rate terms. In addition,

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[12] Although generally accepted accounting principles allow for the grouping of assets, the federal banking agencies generally do not. According to the glossary of the *Instructions for the Preparation of Consolidated Reports of Condition and Income*, after foreclosure, each foreclosed real estate asset must be carried at the lower of (*a*) the fair value of the asset minus the estimated costs to sell the asset or (*b*) the cost of the asset (as defined in the glossary definition of *foreclosed assets*). This determination must be made on an asset-by-asset basis.

depository and lending institutions may facilitate the sale of foreclosed property by requiring little or no down payment or offering terms favorable to the buyer. In such instances, the buyer's initial and continuing investments may be considered inadequate for recognition of profit by the full-accrual method. FASB ASC 360-20-40 also provides guidance on alternative methods of accounting when the conditions for the full-accrual method are not met.

.153 Auditors may consider the following when evaluating sales of foreclosed property:

- Whether each disposition and related financing is evaluated by management to determine whether the conditions have been met for sale derecognition and to record the transaction using a full accrual method
- For each disposition and related financing, the type of property, the composition and amount of the initial investment, whether the initial investment was funded by the buyer or another source of financing, and the percentage of the receivable to the sales price
- Whether the terms of the sale represent an option to buy the property
- Possible factors affecting the collectibility of the receivable
- The length of the financing period, the interest rate, and other terms of the financing arrangement

.154 FASB ASC 360-20-55 provides additional guidance regarding the full accrual method, as well as methods of accounting when the criteria for the full accrual method are not met. FASB ASC 360-20-55-21 includes a decision tree that provides an overview of the major provisions in FASB ASC 360-20 and includes the general requirements for recognizing a sale and all the profit on a sale of real estate at the date of sale.

.155 Auditors may also consider the following related to the recording, measurement, and derecognition of OREO:

- Whether OREO is measured and reported in accordance with the applicable guidance, including FASB ASC 310, *Receivable*; 360-20; and 820
- Whether the institution has documented written policies and procedures that may include the following:
  - — The frequency of appraisals and the selection and qualifications of appraisers
  - — The disbursement of funds and the capitalization of costs
  - — Review and monitoring of marketing efforts
  - — The nature and amount of facilitating financing
  - — Estimates of costs to sell
  - — Capitalization of interest
  - — Proper authorizations for specific transactions
  - — Estimation of the fair value of real estate assets

— Accounting for dispositions, including whether derecognition (sale) and profit recognition are appropriate

.156 Estimates of the fair value of real estate assets are necessary to account for such assets. AU section 328, *Auditing Fair Value Measurements and Disclosures* (AICPA, *Professional Standards*), provides guidance on auditing fair value estimates. Many fair values will be based on valuations by independent appraisers. In applying audit procedures to real estate, the auditor often relies on representations of independent experts, particularly appraisers and construction consultants, to assist in the assessment of real estate values. AU section 336, *Using the Work of a Specialist* (AICPA, *Professional Standards*), provides guidance regarding using the work of a specialist. When an appraisal is used as audit evidence, the auditor may

- consider the following to evaluate the professional qualifications of the specialist in determining that the specialist possesses the necessary skill or knowledge in the particular field:
  — The professional certification, license, or other recognition of the competence of the appraiser
  — The reputation and standing of the appraiser in the views of peers and others familiar with the appraiser's capability or performance
  — The appraiser's experience with the particular type of real estate collateral being valued
  — The appraiser's experience with real estate in the specific geographic location of the collateral
- evaluate the objectivity of the appraiser based on any relationships that the appraiser has with the financial institution.
- obtain an understanding of the methods and assumptions used by the appraiser.
- test the data provided to the appraiser.
- evaluate whether the appraiser's findings support the fair value measurement.

.157 The auditor should also consider whether management's review process of the appraisal seems reasonable because the estimate is ultimately management's responsibility.

.158 Readers should also refer to supervisory guidance that has been issued by the banking agencies regarding appraisal and evaluation guidelines and the foreclosure management process. Both discussions can be found in the "Legislative and Regulatory Developments" section of this alert.

Revised Audited Financial Statement Reporting Requirements for Supervised Lenders in Parent-Subsidiary Structures

.159 The Department of Housing and Urban Development (HUD) Mortgagee Letter 2011-05, *Revised Audited Financial Statement Reporting Requirements for Supervised Lenders in Parent-Subsidiary Structures and New Financial Reporting Requirements for Multifamily Mortgagees*, was issued in January 2011. It amends the requirement regarding the submission of audited financial statements referenced in the Office of Inspector General's (OIG's) *Consolidated*

Audit Guide for Audits of HUD Programs (HUD Audit Guide) for supervised lenders in parent-subsidiary relationships.

.160 Mortgagee Letter 2011-05 states that Federal Housing Administration (FHA)-approved supervised lenders in parent-subsidiary structures (that is, subsidiaries) are permitted to submit the audited consolidated financial statements of a parent company, accompanied by internally prepared consolidating schedules,[13] if they meet one of the following conditions:

- The FHA-approved subsidiary accounts for at least 40 percent of the parent company's assets.
- The FHA-approved subsidiary provides the FHA with an executed corporate guarantee agreement, acceptable to the secretary of HUD, between it and the parent company in which the parent company guarantees the ongoing net worth[14] and liquidity compliance of the FHA-approved subsidiary.

.161 An FHA-approved lender electing to submit audited consolidated financial statements pursuant to one of the previously mentioned conditions must also submit its fourth quarter Consolidated Reports of Condition and Income (Call Report) as an attachment to its annual audited financial statements submission in HUD's Lender Assessment Subsystem (LASS). A Compliance Report and Internal Control Report must still be prepared and included as an attachment to the FHA-approved lender's audited financial statements submission in LASS. For further information, readers can access HUD mortgagee letters from the HUD website at www.hud.gov/offices/adm/hudclips/letters/mortgagee.

.162 Auditors should be cognizant of the revised reporting standards and assess the impact of noncompliance on financial reporting. In addition, it is important for auditors to understand that, although the consolidated financial statements may be submitted, the compliance report and internal control report must reflect compliance with the FHA's requirements at the FHA-approved subsidiary level. Thus, additional control work and compliance procedures may be required surrounding the subsidiary beyond those performed in prior year audits and should be planned for accordingly.

.163 In addition, auditors should be aware that these audits must not only be performed in accordance with generally accepted auditing standards (GAAS) (or PCAOB standards if the entity is an issuer) but also the standards for financial audits of the Government Accountability Office's *Government Auditing Standards* (GAGAS) issued by the comptroller general of the United States (and available at www.gao.gov/govaud/ybk01.htm). In conducting audits in accordance with GAGAS, auditors assume certain responsibilities beyond those of audits performed in accordance with GAAS.

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[13] The internally prepared consolidating schedule is no longer required based on provisions of Mortgagee Letter 2011-25, *Alternative Reporting Requirements for Small Supervised Lenders and Clarification of Requirements for Supervised Lenders in Parent-Subsidiary Structures*. The provisions of this mortgagee letter can also be found in the "Mortgage Banking" section of this alert.

[14] The Federal Housing Administration (FHA) implemented increases to its net worth requirements in May 2011. Each lender or mortgagee with FHA approval as of May 20, 2010, that meets or exceeds the size standards for a *small business*, as defined by the Small Business Administration, must possess a net worth of at least $500,000 or $1 million, respectively, of which not less than 20 percent must be liquid assets consisting of cash or its equivalent. Additional information regarding the increase can be found at www.hud.gov/offices/adm/hudclips/letters/mortgagee/files/10-20ml.pdf.

.164 GAGAS describes ethical principles, establishes general standards, and establishes additional fieldwork and reporting standards beyond those required by GAAS. For example, an auditor must meet the GAGAS auditor qualifications, including the qualifications relating to independence and continuing professional education (CPE), which, in some cases, are more restrictive than GAAS. Additionally, the audit organization must meet the quality-control standards of GAGAS. A number of additional requirements exist. Chapters 1–4 of the Audit Guide Government Auditing Standards *and Circular A-133 Audits* provide additional information on the GAGAS requirements that might be useful to auditors who are new to this area.

Alternative Reporting Requirements for Small Supervised Lenders and Clarification of the Requirements for Supervised Lenders in Parent-Subsidiary Relationships

.165 Mortgagee Letter 2011-25, *Alternative Reporting Requirements for Small Supervised Lenders and Clarification of Requirements for Supervised Lenders in Parent-Subsidiary Structures*, was issued in July 2011. It was issued to advise supervised lenders and mortgagees with consolidated assets below the audited financial reporting thresholds set by the FDIC, the OTS, and the NCUA (currently less than $500 million) of changes to the FHA requirements regarding the submission of audited financial statements as a condition for FHA lender approval and renewal.

.166 Effective immediately, FHA-approved supervised lenders that are regulated by the FDIC, the OTS,[15] or the NCUA whose consolidated assets do not meet the threshold required by those agencies for submitting audited financial statements are not required to submit audited financial statements to the FHA nor an audited computation of net worth. These new directions apply at the time of approval and at recertification but will expire on April 7, 2012. However, the supervised lenders must still submit a copy of their unaudited regulatory report (that is, a Call Report, a consolidated or fourth quarter Thrift Financial Report [TFR], or a consolidated or fourth quarter NCUA Call Report) that aligns with their respective fiscal year-end. These lenders are also still required to submit an independent auditor's report on (*a*) internal control as it relates to administering HUD-assisted programs and (*b*) compliance with specific requirements applicable to major and nonmajor HUD programs.

.167 In addition, FHA-approved supervised lenders that submit audited consolidated financial statements of a parent company, in accordance with Mortgagee Letter 2011-05, are no longer required to submit internally prepared consolidating schedules. Instead, these lenders must submit a copy of the subsidiary's unaudited regulatory report that aligns with the lender's fiscal year-end. However, net worth and liquidity requirements must be met by the FHA-approved lender, regardless of the lender's financial reporting documentation. For further information, readers can access HUD mortgagee letters from the HUD website at www.hud.gov/offices/adm/hudclips/letters/mortgagee.

.168 Auditors should be cognizant of the revised reporting standards and assess the impact of noncompliance on financial reporting. In addition, it is important for auditors to understand that, although audited financial statements may not be required, the compliance report and internal control report must

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[15] See footnote 5.

reflect compliance with HUD-assisted programs. Thus, additional control work and compliance procedures may be required beyond those performed in prior year audits and should be planned for accordingly.

HUD Audit Guide

.169 Currently, the OIG is updating the HUD Audit Guide for numerous revisions, including supervised lenders, and is releasing each chapter as it is completed. The HUD Audit Guide is available at www.hud.gov/offices/oig/reports/auditguide. While the revisions are being made, auditors should note that chapter 1, "General Audit Guidance"; chapter 2, "Reporting Requirement and Sample Reports"; and chapter 7, "HUD-Approved Title II Nonsupervised Mortgagees and Loan Correspondents Audit Guidance," will generally be applicable to supervised lenders. In addition, auditors should review the remaining chapters of the audit guide to assess applicability to supervised lenders.

.170 Auditors should also be aware of the following changes that are being implemented to the HUD Audit Guide:

- A transmittal letter, dated April 1, 2011, discussing revisions to chapter 1, as outlined subsequently, will be effective for audits of years ending on or after September 30, 2011 (these revisions are not yet available on the HUD website):
  - — The auditor's report on compliance should include an opinion on the auditee's compliance with specific requirements applicable to each of its major programs. Previously, major program determinations were based on a value exceeding $300,000. This value has now been increased to $2 million.
  - — The auditor will now be required to contact the HUD OIG single audit coordinator by phone if the auditor becomes aware of fraud or illegal acts.
  - — Engagement letters between the auditor and client for all audits of HUD programs must state that the client grants permission for the auditor to obtain information from the prior auditor and report fraud, as revised in the audit guide.
  - — Appendix A of chapter 1, which applies to all audits performed using the audit guide, provides the sampling methodology to be utilized and establishes minimum sample sizes.
- Chapter 2's auditor's report examples B, B-2, C, and D have been revised to reflect the reporting requirements of Statement on Auditing Standards (SAS) No. 117, *Compliance Audits* (AICPA, *Professional Standards*, AU sec. 801). The revised chapter is currently available on the HUD website.
- Chapter 7 is currently under revision to account for supervised lenders. Auditors should review Mortgagee Letters 2011-05 and 2011-25 for changes to reporting requirements for supervised lenders.

.171 Auditors should also consider the guidance in SAS No. 119, *Supplementary Information in Relation to the Financial Statements as a Whole*

(AICPA, *Professional Standards*, AU sec. 551), and determine its applicability to compliance audit components of these engagements.

SEC Rule 17a-5 Compliance Communication Letter

.172 In November 2010, the AICPA Stockbrokerage and Investment Banking Expert Panel received a communication from the SEC on the importance of complying with existing requirements, as found in SEC Rule 17a-5, related to the review of the accounting system, internal control, and procedures for safeguarding securities in connection with the annual audit of broker-dealers. The communication, which references several paragraphs in the Audit and Accounting Guide *Brokers and Dealers in Securities*, notes that the requirements found in Rule 17a-5(g)(1) clearly state that the scope of the audit and review should be sufficient to provide reasonable assurance that any material inadequacies existing at the date of the examination would be disclosed. The letter also references guide content that notes that the audit should include (*a*) a review of the broker-dealer's practices, procedures, and controls to ensure compliance with the securities possession or control and the cash reserve elements of the Customer Protection Rule and (*b*) those tests that the auditor considers necessary to provide reasonable assurance that any material inadequacies (and significant deficiencies or material weaknesses) existing at the date of the examination would be disclosed. The letter notes that, in order to obtain reasonable assurance to support the reporting of material inadequacies to the SEC, the auditor should follow the requirements contained in existing professional standards, including the AICPA's Statements on Standards for Attestation Engagements. (SEC Release No. 34-62991, *Commission Guidance Regarding Auditing, Attestation, and Related Professional Practice Standards Related to Brokers and Dealers*, states that auditors should continue to use AICPA professional standards, pending further anticipated rulemaking.) Finally, the letter notes that both the annual financial statement audit and the compliance examination procedures performed by the auditor are critical compliance elements relative to the SEC's regulatory oversight of broker-dealers and that auditors performing audits of broker-dealers should ensure that they do so in a manner that is in conformity with the requirements of the applicable rules and professional standards.

.173 Readers should refer to discussions regarding revisions to Rule 17a-5 and proposed PCAOB attestation standards in the "On the Horizon" section of this alert.

PCAOB Interim Inspection Program—Audits of Broker-Dealers

.174 As part of its oversight over the audits of broker-dealers, the PCAOB is authorized to establish an inspection program for audits of broker-dealers. As authorized, the inspection program may differentiate among broker-dealer classes and potentially exempt certain auditors.

.175 In August 2011, the PCAOB adopted a temporary rule for an interim inspection program for audits of broker-dealers. Under the interim inspection program, the PCAOB will inspect audit engagements of all types of broker-dealers.

.176 One of the objectives of the interim inspection program is to assess the degree of compliance of registered public accounting firms with the applicable regulatory rules and professional standards in connection with the performance of audits, the issuance of audit reports, and other related matters involving audits of broker-dealers.

.177 Another objective is to gather information that will assist in determining the elements needed in a permanent inspection program, including whether and how to differentiate among classes of broker-dealers, whether to exempt any category of public accounting firm, and the establishment of minimum inspection frequency schedules. In addition, the information gathered during the interim inspection program will assist the PCAOB in determining what rules and standards need to be developed as part of their standard-setting responsibility.

.178 The PCAOB does not plan on issuing firm-specific inspection reports for nonissuer broker-dealers before the scope of a permanent inspection program is set. However, any significant issues in audit work found will be addressed with the inspected firm and, when appropriate, the SEC and FINRA. In addition, absent unusual situations, the PCAOB does not plan on incorporating any evaluation of a firm's broker-dealer practice in the public portion of an issuer's firm-specific report before a permanent inspection program is in effect.

.179 The temporary rule for the interim inspection program provides that the PCAOB will publish a report on the interim inspection program no less frequently than every 12 months, beginning 12 months after the effective date of the rule, and continuing until rules for a permanent inspection program take effect. This report will describe the progress of the interim inspection program and any significant observations that may impact either the PCAOB's consideration of a permanent program or information appropriate to protect the interests of investors or further the public interest. As is consistent with the restriction imposed by the Sarbanes-Oxley Act of 2002, these reports will not identify the broker-dealer when observations related to an inspection are described in a report.

.180 The PCAOB anticipates being in a position to propose rules for a permanent inspection program by 2013. The final rule can be found on the PCAOB website at http://pcaobus.org/Rules/PCAOBRules/Pages/Section_4.aspx#rule4020t.

The PCAOB's Accounting Support Fee to Include Broker-Dealers

.181 To provide funds for the PCAOB's oversight of audits of broker-dealers, the Dodd-Frank Act amended Section 109 of the Sarbanes-Oxley Act of 2002 to require that the PCAOB assess broker-dealers an appropriate portion of the accounting support fee assessed on both issuers and broker-dealers.

.182 In August 2011, the PCAOB adopted a rule change to its funding rules to allocate a portion of the accounting support fee among broker-dealers, establish classes of broker-dealers for funding purposes, describe the methods for allocating the appropriate portion of the accounting support fee to each broker-dealer within each class, and address the collection of the assessed share of the broker-dealer accounting support fee from broker-dealers. In addition, the rule includes amendments to the PCAOB's funding rules with respect to the allocation, assessment, and collection of the accounting support fee among issuers. The amendments to its funding rules are effective for the allocation, assessment, and collection of the 2011 broker-dealer accounting support fee and the 2012 issuer accounting support fee. The amendments can be found on the PCAOB website at http://pcaobus.org/Rules/PCAOBRules/Pages/Section_7.aspx.

.183 Auditors may consider reviewing the PCAOB website at http://pcaobus.org/About/Ops/Pages/SupportFee.aspx to ensure that their clients are included on the listing of entities with no outstanding past-due share of the accounting support fee because failure to pay an allocated share constitutes a violation of the 1934 Act.

Auditing CFTC Regulatory Supplementary Schedules

.184 CFTC Regulation 1.16(d) requires that "[t]he audit must include all procedures necessary under the circumstances to enable the independent licensed or certified public accountant to express an opinion on the financial statements and schedules." Auditors should review and test an FCM's segregation and capital computations, even if the amounts are considered immaterial in relation to the financial statements as a whole. Indeed, when Regulation 1.16 was adopted, the CFTC commented that auditors must review such computations as part of a proper audit.[16]

.185 The CFTC staff is drafting amendments to CFTC Regulations 1.10, *Financial reports of futures commission merchants and introducing brokers*, and 1.16, *Qualifications and reports of accountants*, to require more robust assurances from FCMs and their independent accountants regarding, among other things, such schedules.

.186 It should be noted that the SEC proposed similar rules that may become effective for year-end 2011 audits. Those proposed rules include, among other things, the revocation of the requirement for a report on material inadequacies in internal control (MI letter). Dual-registered FCMs have to comply with both SEC and CFTC regulations. If SEC proposed rules are effective for 2011 and CFTC rules are not, auditors of those dual-registered entities will be required to issue differing reports.

On the Horizon

.187 Auditors should keep abreast of regulatory and accounting developments and upcoming guidance that may affect their engagements. The following sections present brief information about some ongoing projects that have particular significance to the financial institutions industry. Remember that exposure drafts and proposed regulatory rulemaking are nonauthoritative and cannot be used as a basis for changing existing standards.

.188 Information on, and copies of, outstanding exposure drafts may be obtained from the various standard-setters' websites. These websites contain in-depth information about proposed standards and other projects in the

[16] As published in the *Federal Register* on September 8, 1978 (43 F.R. 39956)

Accountants should be aware that in order to conduct a proper audit under these rules, they must be familiar with the Act and the rules and regulations of the Commission and in particular with the segregation requirements, the recordkeeping requirements, and the minimum financial regulations applicable to FCMs. The accountant must assure himself that the daily computations of the segregation requirements are being made in accordance with such requirements. In addition, the accountant must ascertain that the periodic computations of the minimum capital requirements are being done in accordance with §1.17 and are being computed monthly in accordance with §1.18. The Commission anticipates that it will selectively review the FCM audits conducted by independent public accountants to monitor compliance with the auditing standard set for in §1.16.

pipeline. Many more accounting and auditing projects and regulatory rulemaking projects exist, in addition to those discussed herein. Readers should refer to the Audit Risk Alert *General Accounting and Auditing Developments—2011/12* (product no. 0223311) for further information.

Legislative Reform

National Servicing Standards

.189 Currently, the U.S. Senate Committee on Banking, Housing, and Urban Affairs is considering legislation to institute national servicing standards. The key provisions of the legislation are to establish a single point of contact, eliminate dual tracking, and require an independent eligibility review for denied cases prior to notifying the borrower of denial. A copy of the full text of the bill can be accessed at www.govtrack.us/congress/bill.xpd?bill=s112-967. Readers may also monitor the status of the bill at the previously noted Web address.

Dodd-Frank Act Regulatory Reform

Resolution Plans

.190 In September 2011, the FDIC approved a final rule to be issued jointly by the FDIC and the Federal Reserve to implement Section 165(d) of the Dodd-Frank Act. This rule requires bank holding companies with assets of $50 billion or more and companies designated as systemically important by the Financial Stability Oversight Council to report periodically to the FDIC and the Federal Reserve the company's plan for its rapid and orderly resolution in the event of material financial distress or failure.

.191 The goal of this rule is to achieve a rapid and orderly resolution of an organization that would not cause a systemic risk to the financial system. The final rule also establishes specific standards for the resolution plans (commonly referred to as living wills), including requiring a strategic analysis of the plan's components; a description of the range of specific actions to be taken in the resolution; and analyses of the company's organization, material entities, interconnections and interdependencies, and management information systems, among other elements.

.192 The timing of the requirement to submit resolution plans will be staggered based on the asset size of a covered company's U.S. operations. Companies with $250 billion or more in nonbank assets must submit plans on or before July 1, 2012; companies with $100 billion or more in total nonbank assets must submit plans on or before July 1, 2013; and companies that predominately operate through one or more IDIs must submit plans on or before December 31, 2013. The rule requires companies to update their plans annually. A company that experiences a material event after a plan is submitted has 45 days to notify regulators of the event.

.193 Separately, the FDIC's board of directors approved a complementary interim final rule under the Federal Deposit Insurance Act to require IDIs with $50 billion or more in total assets to submit periodic contingency plans to the FDIC for resolution in the event of the depository institution failure. This interim ruling will have an effective date of January 1, 2012.

.194 The interim rule requires these IDIs to submit a resolution plan that will enable the FDIC, as receiver, to resolve the bank to ensure that depositors receive access to their insured deposits within one business day of the institution's failure, maximize the net present value return from the sale or disposition of its assets, and minimize the amount of any loss to be realized by the institution's creditors.

.195 Both the final rule related to certain bank holding companies and systemically important companies and the interim final rule related to certain IDIs can be found on the FDIC website at www.fdic.gov/news/news/press/2011.

TFR Conversion

.196 In February 2011, the OTS, prior to its abolishment; the OCC; the FDIC; and the Federal Reserve issued a joint proposal, *Proposed Agency Information Collection Activities*, to require savings associations that currently file TFRs to convert to filing Call Reports beginning with the reporting period ending on March 31, 2012.

.197 The proposal also indicated that a mapping of TFR line items to associated Call Report line items would be published on the OTS and the Federal Financial Institutions Examination Council (FFIEC) websites. The mapping is now available and can be found on the OCC website at www.ots.treas.gov/_files/4830092.pdf and the FFIEC website at www.ffiec.gov/ffiec_report_forms.htm. The intention of the map is to aid TFR preparers and users in understanding the relationship between TFR data and associated Call Report data.

.198 Readers should remain alert for a final regulation regarding the TFR to Call Report conversion.

SLHCs' Regulatory Reporting Requirements

.199 On February 3, 2011, the Federal Reserve released a notice of intent to require SLHCs to submit the same reports as bank holding companies, beginning with the March 31, 2012, reporting period. In August 2011, after consideration of comments received on the initial proposal, the Federal Reserve revised its reporting requirements and proposed a two-year phase-in period for most SLHCs to file Federal Reserve regulatory reports with the Federal Reserve and an exemption for some SLHCs from initially filing Federal Reserve regulatory reports. Exempt SLHCs would continue to submit Schedule HC, which is currently a part of the TFR, and the OTS H-(b)11 Annual/Current Report. For further information on the proposed reporting requirements, including the phase-in schedule, readers can access the proposed regulation at www.gpo.gov/fdsys/pkg/FR-2011-08-25/pdf/2011-21736.pdf.

Volcker Rule

.200 Section 619 of the Dodd-Frank Act (commonly referred to as the Volcker Rule) prohibits banking entities and affiliated companies from proprietary trading; acquiring or retaining any equity, partnership, or other ownership interest in a hedge fund or private equity fund; and sponsoring a hedge fund or private equity fund. Proprietary trading consists of transactions made by an entity that affect the entity's own account but not the accounts of its clients. Banks are allowed to make de minimis investments in hedge funds and private equity funds using no more than 3 percent of their Tier 1 capital in all such funds combined. Also, a bank's investment in a private fund may not exceed 3 percent of the fund's total ownership interest. Nonbank financial institutions supervised by the Federal Reserve also have restrictions on proprietary trading, hedge fund investments, and private equity investments.

.201 In February 2011, the Federal Reserve adopted a final rule, *Conformance Period for Entities Engaged in Prohibited Proprietary Trading or Private Equity Fund or Hedge Fund Activities*. This rule was adopted to implement the conformance period during which banking entities and nonbank financial companies supervised by the Federal Reserve must bring their activities and investments into compliance with the prohibitions and restrictions on proprietary trading and relationships with hedge funds and private equity funds imposed by the Volcker Rule. This rule became effective on April 1, 2011. The final rule has been incorporated into Regulation Y (12 CFR 225).

.202 Under the new ruling, in general, a banking entity should bring its activities and investments into compliance with the requirements of section 13 of the Bank Holding Company Act no later than 2 years after the earlier of July 21, 2012, or 12 months after the date on which final rules adopted under section 13(b)(2) of the Bank Holding Company Act are published in the *Federal Register*. A nonbank financial company supervised by the Federal Reserve should become compliant with all applicable requirements of section 13 of the Bank Holding Company Act, including any capital requirements or quantitative limitations adopted, no later than 2 years after the date that the company becomes a nonbank financial company supervised by the Federal Reserve. The rule also addresses conformance periods for new banking entities established subsequent to July 21, 2010, and conformance period extensions for both banking entities and nonbank financial entities. The final ruling can be accessed at http://edocket.access.gpo.gov/2011/pdf/2011-3199.pdf.

.203 In October 2011, the OCC, the Federal Reserve, the FDIC, and the SEC released a proposed ruling to implement the Volcker Rule. The proposed regulation clarifies the scope of the Volcker Rule's prohibitions and provides certain exemptions. In addition, the proposed regulation would require banking entities engaging in exempt activities to establish an internal compliance program designed to monitor compliance with the regulation. The proposal also imposes certain regulatory reporting requirements on entities with significant trading operations. The proposed regulation can be accessed at any of the respective agencies' websites.

Derivatives Trading

.204 The Dodd-Frank Act provided the SEC and the CFTC with the authority to regulate over-the-counter derivatives and required central clearing and exchange trading for derivatives. The SEC has authority over security-based swaps (including credit default swaps), and the CFTC has authority over all other swaps, including energy-rate swaps, interest-rate swaps, and broad-based security group or index swaps. Standardized swaps will be traded on an exchange or in other centralized trading facilities, which will promote transparency; standardized derivatives will also have to be handled by central clearinghouses. The Dodd-Frank Act requires all cleared swaps to be traded on a registered exchange or board of trade.

.205 The SEC has proposed numerous rulings related to the provisions of derivative trading included in the Dodd-Frank Act. Proposed rulings can be found on the SEC website at www.sec.gov/spotlight/dodd-frank/derivatives.shtml. Readers should remain alert for final regulations. A discussion of regulations proposed and enacted by the CFTC can be found in the "Legislative and Regulatory Developments" section of this alert.

.206 In addition, the SEC readopted certain beneficial ownership rules to preserve their application to persons who purchase or sell security-based swaps. Release No. 34-64628, *Beneficial Ownership Reporting Requirements and Security-Based Swaps*, can be found on the SEC website at www.sec.gov/rules/final/2011/34-64628.pdf.

Credit Risk Retention Requirements

.207 In March 2011, the OCC, the Federal Reserve, the FDIC, the SEC, the Federal Housing Finance Agency (FHFA), and HUD proposed rules to implement the credit risk retention requirements of section 15G of the 1934 Act, as added by section 941 of the Dodd-Frank Act. Section 15G generally requires the securitizer of asset-backed securities to retain not less than 5 percent of the credit risk of the assets collateralizing the asset-backed securities.

.208 Under the proposed rule, a sponsor generally would be permitted to choose from a menu of four risk retention options to satisfy a minimum 5 percent risk retention requirement. The options were designed to provide sponsors with flexibility while also ensuring that they actually retain credit risk to align the interests of sponsors with those of investors. The proposed rules also include three transaction-specific options related to securitizations involving revolving asset master trusts, asset-backed commercial paper conduits, and commercial mortgage-backed securities. Also, as required by section 941, the proposal provides a complete exemption from the risk retention requirements for asset-backed securities collateralized solely by qualified residential mortgages (QRMs) and establishes the terms and conditions under which a residential mortgage would qualify as a QRM. Readers may access the proposed regulation at http://edocket.access.gpo.gov/2011/pdf/2011-8364.pdf and should remain alert for final regulations.

Incentive Compensation

.209 In April 2011, the Federal Reserve; the FDIC; the FHFA; the NCUA; the OCC; the OTS, prior to its abolishment; and the SEC issued a joint proposed rule to ensure that certain regulated financial institutions design their incentive compensation arrangements to account for risk and to implement section 956 of the Dodd-Frank Act.

.210 The proposed rule would prohibit incentive compensation arrangements at certain financial institutions with more than $1 billion in assets that could encourage inappropriate risks. The proposal would require compensation practices at regulated financial institutions to be consistent with three key principles that incentive compensation arrangements should (*a*) appropriately balance risk and financial rewards, (*b*) be compatible with effective controls and risk management, and (*c*) be supported by strong corporate governance. The proposal further requires that these institutions have policies and procedures ensuring compliance with the requirements of the rule and that they submit an annual report to their federal regulator describing the structure of their incentive compensation arrangements.

.211 Larger financial institutions, generally those with $50 billion or more in assets, would be required to defer at least 50 percent of the incentive compensation of executive officers for at least 3 years, with the amounts ultimately paid adjusted to reflect losses or other aspects of performance over time. For purposes of credit unions, *large financial institutions* would be defined as those with $10 billion or more in assets. The FHFA proposed that the income-deferral provisions apply to all entities that it regulates, regardless of size.

.212 Readers may access the proposed regulation at http://edocket.access.gpo.gov/2011/pdf/2011-7937.pdf and should remain alert for final regulations.

Swap Margin and Capital Requirements

.213 The Dodd-Frank Act provided regulators the authority to impose capital and margin requirements on swap dealers and major swap participants. The credit exposure from derivative transactions will be considered in banks' lending limits. In May 2011, the FDIC, the OCC, the Federal Reserve, the Farm Credit Administration, and the FHFA issued Notice of Proposed Rulemaking *Margin and Capital Requirements for Covered Swap Entities* to implement sections 731 and 764 of the Dodd-Frank Act. The proposed regulations are intended to establish minimum margin and capital requirements for registered swap dealers, major swap participants, security-based swap dealers, and major security-based swap participants for which one of the agencies is the prudential regulator. Readers may access the proposed regulation at www.gpo.gov/fdsys/pkg/FR-2011-05-11/pdf/2011-10432.pdf and should remain alert for final regulations.

Risk-Based Capital Guidelines—Market Risk

.214 In December 2010, the OCC, the Federal Reserve, and the FDIC jointly issued the proposed regulation *Risk-Based Capital Guidelines: Market Risk* to revise their market risk capital rules to modify the rules' scope to better capture positions for which the market risk capital rules are appropriate; reduce procyclicality in market risk capital requirements; enhance the rules' sensitivity to risks that are not adequately captured under the current regulatory measurement methodologies; and increase transparency through enhanced disclosures. Readers can access the proposed regulation at www.gpo.gov/fdsys/pkg/FR-2011-01-11/pdf/2010-32189.pdf and should remain alert for a final regulation.

Stress Testing

.215 In June 2011, the Federal Reserve; the OTS, prior to its abolishment; the OCC; and the FDIC jointly issued proposed guidance on stress testing for banking organizations with more than $10 billion in total consolidated assets.[17] The proposed guidance highlights the importance of stress testing as an ongoing risk management practice that supports a banking organization's forward-looking assessment of its risks. In addition, the guidance highlights four principles that should be part of a banking organization's stress testing framework. The framework should (*a*) include activities and exercises that are tailored to the activities of the organization; (*b*) employ multiple conceptually sound activities and approaches; (*c*) be forward looking and flexible; and (*d*) be clear, actionable, well supported, and used in the decision-making process. Furthermore, the guidance discusses four types of stress tests scenarios,

[17] Although the supervisory guidance on stress testing only applies to banking organizations with more than $10 billion in consolidated assets, some smaller national banks may benefit from considering the principles and techniques addressed within this guidance.

which include scenario analysis, sensitivity analysis, enterprise-wide stress testing, and reverse stress testing. Readers can access the proposed regulation at www.gpo.gov/fdsys/pkg/FR-2011-06-15/pdf/2011-14777.pdf and should remain alert for a final regulation.

Basel III

.216 The Basel Committee on Banking Supervision (Basel Committee) approved for consultation a package of proposed measures to strengthen global capital and liquidity regulations and to strengthen the Basel II Framework. These proposed measures, commonly referred to as Basel III, aim to (*a*) improve the banking sector's ability to absorb shocks arising from financial and economic stress, whatever the source; (*b*) improve risk management and governance; and (*c*) strengthen banks' transparency and disclosures. The reforms target (*a*) bank-level, or microprudential, regulation, which will help raise the resilience of individual banking institutions to periods of stress; (*b*) macroprudential, systemwide risks that can build up across the banking sector; as well as (*c*) the procyclical amplification of these risks over time. The Basel Committee's oversight body—the Group of Governors and Heads of Supervision (GHOS)—agreed on the broad framework of Basel III in September 2009, and the Basel Committee set out concrete proposals in December 2009. These consultative documents formed the basis of the Basel Committee's response to the financial crisis and are part of the global initiatives to strengthen the financial regulatory system that have been endorsed by the G-20 leaders. The GHOS subsequently agreed on key design elements of the reform package at its July 2010 meeting and on the calibration and transition to implement the measures at its September 2010 meeting, including the definition of capital, the treatment of counterparty credit risk, the leverage ratio, and the global liquidity standard. In December 2010, the Basel Committee issued the finalized version of the Basel III rules, which were later revised in June 2011.

.217 Basel III regulations include (*a*) a tighter definition of Tier 1 capital—banks must hold 4.5 percent by January 2015 then a further 2.5 percent capital conservation buffer, totaling 7 percent; (*b*) the introduction of a leverage ratio; (*c*) a framework for countercyclical capital buffers; (*d*) measures to limit counterparty credit risk; and (*e*) short- and medium-term quantitative liquidity ratios.

.218 In July 2011, the Basel Committee issued for comment a proposal on the methodology for assessing global systemic importance and the amount of additional loss absorbency that global systemically important financial institutions should maintain. The proposed methodology for determining global systemic importance is based on assessing a bank's (*a*) size, (*b*) interconnectedness, (*c*) lack of substitutability, (*d*) global activity, and (*e*) complexity. The proposal's additional loss absorbency will be met with common equity Tier 1 capital ranging from 1 percent to 2.5 percent, depending on the bank's systemic importance. The higher loss absorbency requirements would be introduced between January 1, 2016, and December 31, 2018, and would become fully effective on January 1, 2019. The Basel Committee continues to refine its methodology.

.219 A compilation of documents that form the global regulatory framework for capital and liquidity can be found at www.bis.org/bcbs/basel3/compilation.htm.

Corporate Credit Union Rule Amendments

.220 In April 2011, the NCUA released the following additional amendments, which will become effective subsequent to December 31, 2011, requiring corporate credit unions to

- establish internal control and reporting requirements similar to those required for banks under the Federal Deposit Insurance Corporation Improvement Act of 1991 and the Sarbanes Oxley Act of 2002 (12 CFR 704.15), effective January 1, 2012.
- establish an enterprise risk management committee staffed with at least one risk management expert (12 CFR 704.21), effective April 29, 2013.

.221 See further discussion on the corporate credit union rule amendments, which became effective in 2011, in the "Legislative and Regulatory Developments" section of this alert.

Credit Union IRR Management

.222 In March 2011, the NCUA proposed to amend its regulations to require federally insured credit unions to have a written policy addressing IRR management and an effective IRR program as part of their asset liability management. The NCUA believes that a written IRR policy and an effective IRR program are crucial to maintaining safe and sound operations. Readers are encouraged to follow the progress of such regulations by visiting the NCUA website at www.ncua.gov/Legal/Regs/Pages/default.aspx.

Mortgage Servicing Compensation Reform

.223 Under the typical current servicer compensation structure, the loan servicer is paid a servicing fee that is normally expressed as a percentage of the principal balance of the outstanding loan, which is collected over the life of the loan as payments are received.

.224 The servicer is ultimately responsible for performing its duties, regardless of whether the loan is performing or nonperforming. Servicing a performing loan is generally significantly less complex and expensive then servicing a nonperforming loan because servicing for performing loans can be performed almost entirely from centralized processing operations that have been automated. In contrast, the servicing of nonperforming loans tends to be more labor intensive because it requires the servicer to directly interact with borrowers.

.225 As a result of the housing crisis and rise in mortgage delinquencies, the current servicing compensation structure has come under much debate. Enhanced automation of loan servicing increased the spread between servicing fees and the costs of servicing for performing loans. Some believe that servicers were too focused on increasing the spread for performing loans, resulting in them failing to invest appropriately in the technology, systems, and infrastructure needed for managing nonperforming loans when the volume of loan delinquencies and foreclosures increased.

.226 In January 2011, the FHFA requested Fannie Mae and Freddie Mac to work on a joint initiative with the FHFA and HUD to consider alternatives for future mortgage servicing structures and servicing compensation for their single-family mortgage loans. The joint initiative was developed with the goal to improve service for borrowers, reduce financial risk to servicers, and provide flexibility to guarantors to better manage nonperforming loans.

.227 In September 2011, the FHFA released for public comment the discussion paper *Alternative Mortgage Servicing Compensation Discussion Paper*. The discussion paper proposes two alternatives to the current servicing compensation structure. The first proposal provides for a reduced minimum servicing fee, along with a reserve account that would offset unexpectedly high servicing costs resulting from extraordinary deteriorations in industry conditions. The second proposal introduces the concept of a fee-for-service structure, which would allow for a base servicing fee for performing loans. For further information, the discussion paper can be found on the FHFA website at www.fhfa.gov/webfiles/22663/ServicingCompDiscussionPaperFinal092711.pdf.

.228 The OCC and other federal bank regulatory and housing agencies are developing guidance to address the full range of mortgage servicing issues that have surfaced during the current housing crisis. Guidance on broader mortgage servicing issues resulting from this effort will be released at a later date. Readers can follow the progress of such guidance by visiting the OCC website at www.occ.gov.

Broker-Dealer—Revisions to Rule 17a-5

.229 In Release No. 34-64676, *Broker-Dealer Reports*, issued in June 2011, the SEC proposed amendments to its broker-dealer financial reporting rule. The proposed amendments are intended to update the broker-dealer audit requirements to provide greater assurance about a broker-dealer's compliance with SEC requirements. The amendments will have the most significant effect on broker-dealers that maintain custody of customers' assets; however, they will affect all broker-dealers to some extent.

.230 The proposed amendments are grouped into three main sets of amendments. The first set of amendments, collectively termed the Annual Reporting Amendments, would, among other things

- update the existing requirements of Rule 17a-5;
- facilitate the ability of the PCAOB to implement oversight of independent accountants of broker-dealers, as required by the Dodd-Frank Act;
- eliminate redundant requirements for certain broker-dealers affiliated with, or dual-registered as, investments advisers.

.231 The second set of amendments, collectively termed the Access to Audit Documentation Amendments, would require broker-dealers that either clear transactions or carry customer accounts to consent to allow the SEC and designed examining authorities (DEAs) to have access to independent accountants to discuss their findings with respect to annual audits of broker-dealers and to review related audit documentation. The third set of amendments, collectively termed Form Custody Amendments, would enhance the SEC's and the DEAs' ability to oversee broker-dealer's custody practices by requiring broker-dealers to file a new Form Custody. The following paragraphs discuss significant changes to Rule 17a-5, as found in the proposed amendments.

Annual Reporting Amendments[18]

.232 Although the current reporting and filing requirements regarding the audited financial statements and certain supporting schedules (collectively, the financial report) would remain unchanged for all broker-dealers, carrying broker-dealers would be required to file a new report asserting compliance with specified rules and related internal controls (Compliance Report). The broker-dealer would also be required to file a report from its independent public accountant (Examination Report) that addresses the assertions in the Compliance Report. The Compliance Report would include a statement about whether the broker-dealer has established and maintained a system of internal control to provide the broker-dealer with reasonable assurance that any instances of material noncompliance[19] with Rules 15c3-1, 15c3-3, or 17a-13 or the Account Statement Rule (collectively, the Financial Responsibility Rules) will be prevented or detected on a timely basis. In addition, management of a carrying broker-dealer would be required to make certain assertions in the Compliance Report. The Compliance Report would be required to contain a description of each identified instance of material noncompliance and each identified material weakness in internal control over compliance with the specified rules.

.233 The reporting required under the proposed revision to Rule 17a-5 significantly changes the current requirement that an auditor issue a report describing a study of certain practices and procedures followed by the broker-dealer. It should be noted that the proposed rule does not include an assertion related to the effectiveness of internal control over financial reporting, as is required for issuers.

.234 Under the proposed amendments, a noncarrying broker-dealer claiming an exemption from Rule 15c3-3 would be required to file an Exemption Report. This Exemption Report is based on a review by an independent accountant of the assertion by the broker-dealer that it is exempt from the provisions of Rule 15c3-3 because it meets one or more of the conditions set forth in paragraph (k) of Rule 15c3-3 with respect to all its business activities. This report would replace the current requirement that a broker-dealer claiming exemption from Rule 15c3-3 have an independent accountant ascertain that the conditions of the exemption were being complied with as of the examination date.

Compliance With the Financial Responsibility Rules

.235 As proposed, the amendments to Rule 17a-5 provide that a broker-dealer could not assert compliance with the financial responsibility rules as of its most recent fiscal year-end if it identifies one or more instances of material noncompliance. *Material noncompliance* is defined in the proposed rule as a failure by the broker-dealer to comply with any of the requirements of the financial responsibility rules in all material respects. The proposed rule notes that the SEC believes that any failure by the broker-dealer to perform any of the procedures enumerated in the financial responsibility rules would be an instance of noncompliance, and any noncompliance identified would need to

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[18] In Public Company Accounting Oversight Board (PCAOB) Release No. 2011-04, *Proposed Standards for Attestation Engagements Related to Broker and Dealer Compliance or Exemption Reports Required by the U.S. Securities and Exchange Commission*, the PCAOB has proposed an attestation standard, *Examination Engagements Regarding Compliance Reports of Brokers and Dealers*, to be used for this type of engagement.

[19] The SEC is proposing to remove all references to material inadequacies in Rule 17a-5.

be evaluated to determine if it is material. See Release No. 34-64676 for more information about the evaluation of noncompliance and material weaknesses under the proposed rule.

.236 As noted previously, as it applies to internal control over compliance, the Examination Report would cover the full fiscal year instead of relating to the effectiveness of internal controls only at year-end. These changes are intended to encourage, in connection with broker-dealer audits, greater focus by the auditor on internal control over compliance as it pertains to key regulatory requirements, including a greater focus on broker-dealer custody practices under the Financial Responsibility Rules.

.237 If, during the course of the examination, the independent accountant determines that an instance of material noncompliance exists with respect to any of the financial responsibility rules, notification must be given to the SEC within one business day. Specific requirements related to the notification can be found in the proposed rule.

.238 The proposed rule notes that the SEC has preliminarily determined that the Examination Report regarding compliance required under the rule would satisfy the internal control report requirements under the investment advisers' custody rule for those broker-dealers that come under its scope.

Form Custody Amendments

.239 Another significant change is that the SEC is proposing that broker-dealers file a new form, Form Custody, with their quarterly Financial and Operational Combined Uniform Single Report. This form is designed to elicit information concerning whether a broker-dealer maintains custody of customer and noncustomer assets and, if so, how such assets are maintained.

.240 The Form Custody requests information in nine line items, some of which have multiple questions. In addition, a few items require completion of charts and disclosure of customer-related information specific to the broker-dealer completing the form. The proposed rule contains details on the information being requested at each line item.

Professional Standards Used in Engagements

.241 The proposed rule amends paragraph (g) of Rule 17a-5 to require that audits of broker-dealers be performed in accordance with standards of the PCAOB. Accordingly, for both issuer and nonissuer broker-dealers, the audit of the financial report, the examination of the Compliance Report, and the review of the Exemption Report would be performed under standards established by the PCAOB.[20]

SIPC Reporting

.242 The proposed rule amends Rule 17a-5 to require that broker-dealers continue to file a supplemental report related to the SIPC assessment to the

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[20] The SEC has issued transitional guidance in Release No. 34-62991, *Commission Guidance Regarding Auditing, Attestation and Related Professional Practice Standards Related to Brokers and Dealers*, that clarifies that audits of nonissuer broker-dealers will continue to be performed under generally accepted auditing standards, as issued by the Auditing Standards Board of the AICPA, and any applicable rules of the SEC. This interpretation will be revisited in connection with current standard-setting projects.

SEC until such time that the SIPC changes its rules related to procedures around, and reporting on, the SIPC assessment.[21] In addition, the proposed rule updates the reporting related to the SIPC assessment to conform to professional standards and industry practice. Rule 17a-5(e)(4) would be amended to require a report pursuant to an agreed-upon procedures engagement based upon the procedures outlined in Rule 17a-5 for SIPC assessments.

Access to Audit Documentation Amendments

.243 To facilitate regulatory examinations, the SEC proposes amendments requiring that each broker-dealer that clears transactions or carries customer accounts (a clearing broker-dealer) consent to permitting its independent accountant to make available to the SEC and the DEA examination staff the audit documentation associated with its annual audit reports required under Rule 17a-5 and to discuss findings relating to the audit reports with the SEC and the DEA examination staff. As proposed, such requests would be made exclusively in connection with conducting a regulatory examination of a clearing broker-dealer, and any information obtained from audit documentation and discussions with the independent public accountants would be used to establish the scope and focus of such examination.

.244 Further details on the amendments and scope of Release No. 34-64676 can be found on the SEC website at www.sec.gov/rules/proposed/2011/34-64676.pdf.

Investment of Funds Deposited With Clearing Organizations and FCMs

.245 In 2009, the CFTC issued an advance notice of proposed rulemaking seeking public comment on possible changes to its regulations regarding the investment of customer funds segregated pursuant to Section 4(d) of the Commodity Exchange Act and funds held in an account subject to CFTC Regulation 30.7, *Treatment of foreign futures or foreign options secured amount*. Comment letters received have been analyzed, and a formal proposal is being circulated for CFTC approval.

Depository Acknowledgement Letters

.246 In August 2010, the CFTC proposed amending CFTC Regulation 1.20, *Customer funds to be segregated and separately accounted for*; Regulation 1.26, *Deposit of instruments purchased with customer funds*; and Regulation 30.7 concerning the acknowledgment letters that an FCM or derivatives clearing organization must obtain from any depository holding its segregated customer funds or funds of foreign futures or foreign options customers. The proposal sets out standard template acknowledgment letters that reaffirm and clarify the obligations that depositories incur when accepting segregated customer funds.

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[21] As of this writing, an illustration of an independent accountants' report required under Rule 17a-5(e)(4) that covers an entity's exclusion from Securities Investor Protection Corporation membership was being developed. When the illustrative report is available, it will be posted on the AICPA website in the Stockbrokerage and Investment Banking Expert Panel section at www.aicpa.org/InterestAreas/FRC/IndustryInsights/Pages/Expert_Panel_Stockbrokerage_and_Investment_Banking.aspx.

Auditing and Attestation Pipeline—Issuers

Confirmations

.247 The PCAOB has proposed a draft auditing standard on confirmations. A concept release was originally issued in April 2009 and received 24 comment letters. This proposed auditing standard, issued in July 2010, would strengthen the requirements under the current auditing standard—AU section 330, *The Confirmation Process* (AICPA, *PCAOB Standards and Related Rules*, Interim Standards)—and replace it, upon final issuance of a standard and approval from the SEC. The proposed new standard

- requires confirmation procedures for specific accounts, such as receivables that arise from credit sales, loans, or other transactions, and also in response to significant risks that relate to the relevant assertions that can be adequately addressed by confirmation procedures.
- incorporates procedures in response to the risk of material misstatement, such as in the areas of investigating exceptions reflected on confirmation responses and evaluating nonresponses to confirmation requests.
- updates the confirmation guidance to reflect significant advances in technology and explains that confirmation responses received electronically (for example, by fax, by e-mail, through an intermediary, or by direct access) might involve additional risks relating to reliability. Therefore, the auditor must perform additional requirements.
- defines a confirmation response to include electronic or other media.
- enhances requirements when confirmation responses include disclaimers and restrictive language by requiring the auditor to evaluate the effect on the reliability of a confirmation response. Further, if the disclaimer or restrictive language causes doubts about the reliability of a confirmation response, the auditor should obtain additional appropriate audit evidence.

.248 In drafting this proposed standard, the PCAOB considered the guidance contained in International Standard on Auditing 505, *External Confirmations*, and the AICPA's proposed guidance on confirmations.

.249 The comment period for the PCAOB's proposed standard ended on September 13, 2010. A summary about the comments received was then discussed at the October 14, 2010, Standing Advisory Group (SAG) meeting. Respondents recommended that the proposed standard be modified to be more principles and risk based; include that the presumption to confirm receivables may be overcome if the use of confirmations would be ineffective; and discuss limitations on the use of internal audit or refer to AU section 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements* (AICPA, *Professional Standards*). SAG noted that they would take the comments received into account as they deliberated their next steps with regard to the proposed standard. As of September 2011, the PCAOB anticipates to adopt a final standard or repropose the standard for public comment during the second quarter of 2012.

PCAOB Pricing Sources Task Force

.250 The PCAOB, as announced at the SAG meeting on March 24, 2011, has formed a task force known as the Pricing Sources Task Force. The group focuses on the auditing of fair value of financial instruments that are not actively traded and the use of third-party pricing sources. The task force assists the PCAOB's Office of the Chief Auditor to gain insight into current issues related to auditing the fair value of financial instruments, which may result in the development of new standards or guidance. The task force comprises several members of the SAG, as well as other investors, preparers, and auditors, and representatives from pricing services and brokers. Readers should be alert to developments and are encouraged to visit the Pricing Sources Task Force website at www.pcaobus.org/Standards/SAG/Pages/PricingSourcesTaskForce.aspx.

Auditing and Attestation Pipeline—Broker-Dealers

.251 The PCAOB has proposed two new attestation standards—*Examination Engagements Regarding Compliance Reports of Brokers and Dealers*, and *Review Engagements Regarding Exemption Reports of Brokers and Dealers*—and related amendments to certain PCAOB standards. These attestation standards would apply to compliance examination engagements or review engagements, respectively, of broker-dealers, whichever is required, pursuant to proposed Rule 17a-5 of the 1934 Act.

.252 These proposed attestation standards are intended to establish requirements for examining the assertions in a broker-dealer's compliance report and reviewing a broker-dealer's assertion in an exemption report. In addition, the proposed standard for compliance examinations of broker-dealers would revise the existing reporting to report on whether the broker-dealer's assertions are fairly stated in all material respects.

.253 Both of the proposed attestation standards include requirements related to the auditor's consideration of fraud risks, including the risk of misappropriation of customer assets. In addition, both emphasize coordination between the examination engagement or review engagement and the audit of the broker-dealer's financial statements and supporting schedules. The PCAOB expects that the proposed standards would be effective for fiscal years ending on or after September 15, 2012. For further information on the proposed standards, see PCAOB Release No. 2011-04, *Proposed Standards for Attestation Engagements Related to Broker and Dealer Compliance or Exemption Reports Required By The U.S. Securities and Exchange Commission and Related Amendments to PCAOB Standards*, at http://pcaobus.org/Rules/Rulemaking/Docket035/PCAOB_Release_2011-004.pdf.[22]

Resource Central

.254 The following are various resources that practitioners engaged in the financial institutions industry may find beneficial.

[22] The effective date of these proposed standards conflicts with that of the SEC Rule 17a-5 proposed revision. However, neither has been issued as of the writing of this alert. Readers should be alert to further developments.

Publications

.255 Practitioners may find the following publications useful. Choose the format best for you—online or print:

- Audit and Accounting Guide *Depository and Lending Institutions: Banks and Savings Institutions, Credit Unions, Finance Companies, and Mortgage Companies* (2011) (product no. 0127311 [paperback] or WDL-XX [online with the associated Audit Risk Alert])
- Audit and Accounting Guide *Brokers and Dealers in Securities* (2010) (product no. 0127010 [paperback] or WBR-XX [online with the associated Audit Risk Alert and Practice Aid *Audits of Futures Commission Merchants, Introducing Brokers, and Commodity Pools*])

CPE

.256 The AICPA offers a number of CPE courses that are valuable to CPAs working in public practice and industry, including the following specifically related to the financial institutions industry:

- *Audits of Banks, Savings Institutions, Credit Unions and Other Financial Institutions* (product no. 733443 [text]). This course features practical worksheets and insights, such as the applicable metrics that create value for financial institutions.

.257 Visit www.cpa2biz.com for a complete list of CPE courses.

Webcasts

.258 Stay plugged in to what is happening and earn CPE credit right from your desktop. AICPA webcasts are high quality, two-hour CPE programs that bring you the latest topics from the profession's leading experts. Broadcast live, they allow you to interact with the presenters and join in the discussion. If you cannot make the live event, each webcast is archived and available on CD-ROM. An annual webcast of highlights from the AICPA National Conference on Banks and Savings Institutions is available. For additional details on available webcasts, please visit www.cpa2biz.com/AST/AICPA_CPA2BIZ_Browse/Store/Webcasts.jsp.

Member Service Center

.259 To order AICPA products, receive information about AICPA activities, and get help with your membership questions, call the AICPA Service Operations Center at 888.777.7077.

Hotlines

Accounting and Auditing Technical Hotline

.260 Do you have a complex technical question about GAAP, other comprehensive bases of accounting, or other technical matters? If so, use the AICPA's Accounting and Auditing Technical Hotline. AICPA staff will research your question and call you back with the answer. The hotline is available from 9 a.m. to 8 p.m. EST on weekdays. You can reach the Technical Hotline at 877.242.7212 or online at www.aicpa.org/Research/TechnicalHotline/Pages/TechnicalHotline.aspx. Members can also e-mail questions to aahotline

@aicpa.org. Additionally, members can submit questions by completing a Technical Inquiry form found on the same website.

Ethics Hotline

.261 In addition to the Technical Hotline, the AICPA also offers an Ethics Hotline. Members of the AICPA's Professional Ethics Team answer inquiries concerning independence and other behavioral issues related to the application of the AICPA Code of Professional Conduct. You can reach the Ethics Hotline at 888.777.7077 or by e-mail at ethics@aicpa.org.

Industry Conference

.262 The AICPA offers an annual National Conference on Banks and Savings Institutions in the fall of each year. The conference is a three-day conference designed to update attendees on recent developments related to audit, accounting, regulatory, legislative, and tax issues affecting the industry. For further information about the conference, call 888.777.7077 or visit www.cpa2biz.com.

.263 The AICPA offers an annual National Conference on Credit Unions in the fall of each year. The conference is a three-day conference designed to update attendees on recent developments related to the credit union industry. For further information about the conference, call 888.777.7077 or visit www.cpa2biz.com.

.264 The National Conference on the Securities Industry is cosponsored by the AICPA and the Financial Management Society of the Securities Industry and Financial Markets Association and is geared toward practitioners in public practice and industry. This conference offers a two-day comprehensive update in industry, accounting, and regulatory matters, with speakers from the SEC, the PCAOB, and other regulatory agencies and organizations.

AICPA Industry Expert Panels—Financial Institutions

.265 For information about the activities of the AICPA Depository and Lending Institutions Expert Panel, visit the panel's Web page at www.aicpa.org/InterestAreas/FRC/IndustryInsights/Pages/Expert_Panel_Depository_and_Lending_Institutions.aspx.

.266 For information about the activities of the AICPA Stockbrokerage and Investment Banking Expert Panel, visit the panel's Web page at www.aicpa.org/InterestAreas/FRC/IndustryInsights/Pages/Expert_Panel_Stockbrokerage_and_Investment_Banking.aspx.

Industry Websites

.267 The Internet covers a vast amount of information that may be valuable to auditors of financial institutions, including current industry trends and developments. Some of the more relevant sites for auditors with financial institutions clients include those shown in the following table.

Organization	*Website*
Board of Governors of the Federal Reserve System	www.federalreserve.gov
Commodity Futures and Trading Commission	www.cftc.gov
Federal Deposit Insurance Corporation	www.fdic.gov
Federal Financial Institutions Examination Council	www.ffiec.gov
Federal Housing Finance Agency	www.fhfa.gov
Financial Industry Regulatory Authority	www.finra.org
Futures Industry Association	www.futuresindustry.org
Mortgage Bankers Association	www.mbaa.org
National Credit Union Administration	www.ncua.gov
National Futures Association	www.nfa.futures.org
Office of the Comptroller of the Currency	www.occ.treas.gov
Securities and Exchange Commission	www.sec.gov
Securities Industry and Financial Markets Association	www.sifma.org
U.S. Department of Housing and Urban Development	www.hud.gov

.268 The financial institutions industry practices of some of the larger CPA firms also may contain industry-specific auditing and accounting information that is helpful to auditors.