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In This Issue

Safety & Soundness

Regulators Issue Supervisory Scenarios for 2015 Capital Planning and Stress Testing Program

On October 23, 2014, the Federal Reserve Board (Federal Reserve), the Office of the Comptroller of the Currency (OCC), and the Federal Deposit Insurance Corporation (FDIC) issued the supervisory economic and market scenarios they will use in the 2015 capital planning and stress testing programs. The programs include the Federal Reserve's Comprehensive Capital Analysis and Review (CCAR) and the related stress testing exercises for bank holding companies (BHCs) with $50 billion or more of total consolidated assets. The programs also include stress testing exercises required by the *Dodd-Frank Wall Street Reform and Consumer Protection Act* (Dodd-Frank Act) for BHCs, savings and loan holding companies, and institutions with more than $10 billion in total consolidated assets supervised by the Federal Reserve, OCC, or FDIC.

The three scenarios - baseline, adverse, and severely adverse - run from the fourth quarter of 2014 until the fourth quarter of 2017, and consider 28 variables, including economic activity, unemployment, exchange rates, prices, incomes, and interest rates. The adverse and severely adverse scenarios are not forecasts but rather describe hypothetical sets of events designed to assess the strength of banking organizations and their resilience to adverse economic environments. The baseline scenario follows a similar profile to the average projections from surveys of economic forecasters.

Certain BHCs with large trading operations will be required to factor in a global market shock as part of their scenarios. The Federal Reserve intends to provide the data for the global market shock scenario as soon as possible, but no later than December 1, 2014. In addition, certain BHCs with substantial trading or custodial operations will be required to incorporate a counterparty default scenario.

Six Federal Agencies Jointly Issue Final Risk Retention Rule

On October 22, 2014, six federal agencies released a joint final rule (the rule, or the final rule) to implement the credit risk retention requirements required by Section 941 of the *Dodd-Frank Wall Street Reform and Consumer Protection Act* (Dodd-Frank Act). The final rule is largely consistent with the risk retention framework proposed by the agencies in August 2013 and generally requires the securitizer of an asset-backed security (ABS) to retain not less than five percent of the credit risk of the assets collateralizing the ABS issuance. It will become effective one year after publication in the *Federal Register* for residential mortgage-backed securitizations and two years after publication for all other securitization types.

As required by the Dodd-Frank Act, the final rule defines a "qualified residential mortgage" (QRM) and aligns the QRM definition with that of a qualified mortgage (QM) as defined by the Consumer Financial Protection Bureau. Securitizations collateralized exclusively by QRMs are exempt from the final rule's risk retention requirement. In addition, the definition of a QRM must be reviewed no later than four years after the effective date of the rule with respect to

the securitization of residential mortgages and every five years thereafter. Each agency is permitted to request a review of the definition at any time that circumstances warrant.

Additional exemptions from the risk retention requirement are provided for securitizations of commercial loans, commercial mortgages, or automobile loans that meet specific standards for high-quality underwriting. The rule also sets forth prohibitions on transferring or hedging the credit risk that the sponsor is required to retain.

The six issuing agencies include the Federal Reserve Board, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Department of Housing and Urban Development, the Federal Housing Finance Agency, and the Securities and Exchange Commission.

Federal Reserve Board Governor Tarullo and New York Federal Reserve Bank President Dudley Discuss Culture in Financial Services Firms

On October 20, 2014, Federal Reserve Board (Federal Reserve) Governor Daniel K. Tarullo and William C. Dudley, President and Chief Executive Officer of the Federal Reserve Bank of New York, provided remarks before the Federal Reserve Bank of New York's Workshop on "*Reforming Culture and Behavior in the Financial Services Industry*." In particular, they discussed the impact of reward and punishment systems on employees as well as the roles of management and regulators in shaping norms of behavior within firms. They urged financial services firms to establish an internal culture that effectively shapes employee behavior and warned that failure to do so could result in heightened regulatory attention including "requirements, constraints, and punishments."

Governor Tarullo said that factors shaping employee behavior include:

- Shared expectations about which of the stated values and rules of their firm "will be supported and reinforced by management action, and which are generally regarded as window dressing."
- External influences, including shareholders and market analysts, regulators, prosecutors, elected officials, the media, the public, market conditions, and the actions of competitors.
- A narrow, or "check-the-box," mentality toward compliance by senior and mid-level management or, more positively, a mentality that internalizes the aims of the risk management processes and systems.

"Do employees understand their job to be maximizing revenues in any way possible so long as they do not do anything illegal, or do they understand their job to be maximizing revenues in a manner consistent with a broader set of considerations?" asked Governor Tarullo.

President Dudley said, "Culture relates to the implicit norms that guide behavior in the absence of regulations or compliance rules - and sometimes despite those explicit restraints. Culture relates to what 'should' I do, and not to what 'can' I do."

Governor Tarullo suggested firms develop concrete organizational systems to implement the firm's goals or values and to avoid losses from conduct and operational risks. He suggested possible approaches to this, such as developing a:

- Score for conduct risk that would rank the business or product against factors that frequently give rise to conduct issues, including the sophistication of the customer, the complexity of the product, and the level of staff training.

- Formal system to "monitor adherence to the original product approval criteria, especially where the product is growing rapidly and/or is generating extraordinary profits."

President Dudley suggested that firms develop a comprehensive culture survey that would be anonymous and conducted each year by an independent third-party and the results shared with supervisors.

Both Governor Tarullo and President Dudley said rewards and punishments are an important determinant of employee behavior, particularly incentive compensation arrangements. Governor Tarullo said risk metrics should be better targeted to specific activities, and risk adjustments should be applied more consistently. He said firms should reward employees with increased compensation or promotion for forestalling losses and that the reward system be transparent within the firm. Similarly, he said, "it is important that the consequences of violations of a firm's norms and expectations, much less regulations and laws, be well-specified and clearly communicated to employees."

President Dudley's closing remarks ended with a warning. "If those of you here today as stewards of these large financial institutions do not do your part in pushing forcefully for change across the industry, then bad behavior will undoubtedly persist. If that were to occur, the inevitable conclusion will be reached that your firms are too big and complex to manage effectively. In that case, financial stability concerns would dictate that your firms need to be dramatically downsized and simplified so they can be managed effectively. It is up to you to address this cultural and ethical challenge."

Enterprise & Consumer Compliance

CFPB Adopts Rule to Amend Privacy Disclosures Requirements Under Gramm-Leach Bliley Act and Regulation P

The Consumer Financial Protection Bureau (CFPB or Bureau) announced on October 20, 2014, that it has adopted a final rule to amend its Regulation P, which implements provisions of the *Gramm-Leach Bliley Act* (GLBA) that require, among other things, financial institutions to provide an annual disclosure of their privacy policies to their customers. Under the Bureau's new rule, financial institutions will be permitted to use an alternative delivery method - posting privacy notices online instead of distributing an annual paper copy - provided they satisfy certain conditions. The new rule becomes effective immediately after publication in the *Federal Register* and applies to banks and nonbanks that are within the CFPB's jurisdiction.

Under the new rule, which is substantially the same as proposed in May 2014, institutions may use the alternative delivery method for annual privacy notices if:

- "No opt-out rights are triggered by the financial institution's information sharing practices under GLBA or the *Fair Credit Reporting Act* (FCRA) Section 603, and opt-out notices

required by the FCRA Section 624 have previously been provided, if applicable, or the annual privacy notice is not the only notice provided to satisfy those requirements;"
- The information included in the privacy notice has not changed since the customer received the previous notice; and
- The financial institution uses the model form provided in Regulation P as its annual privacy notice.

In addition, the financial institution must:

- Continuously post the annual privacy notice in a clear and conspicuous manner on a page of its Web site, without requiring a login or similar steps or agreement to any conditions to access the notice.
- Mail annual notices to customers who request them by telephone, within ten days of the request.
- Insert a clear and conspicuous statement at least once per year on an account statement, coupon book, or a notice or disclosure the institution issues under any provision of law.
- Use one of the permissible delivery methods that predate this rule change (referred to as the standard delivery methods) if the institution, among other things, has changed its privacy practices or engages in information-sharing activities for which customers have a right to opt out.

Institutions that choose not to use the new disclosure method must continue to deliver annual privacy notices to customers using other delivery methods.

CFPB Issues Final Rule Amending Certain Mortgage Rules

On October 22, 2014, the Consumer Financial Protection Bureau (CFPB or Bureau) issued a final rule that amends certain of its mortgage-related rules. The CFPB states the amendments respond to "concerns about origination and servicing issues" and include:

- An alternative definition of a "small servicer" applicable to certain 501(c)(3) nonprofit organizations that permits them to consolidate their servicing activities while maintaining their exemption from some of the servicing rules.
- An amendment to the Ability-to-Repay exemption that permits certain nonprofit groups extend certain interest-free, forgivable loans, also known as "soft seconds," without regard to the 200-mortgage loan limit.
- An allowance that permits lenders, in limited circumstances, to refund excess points and fees to borrowers when the lender discovers after a loan has closed that the points and fees charged the borrower exceed three percent of the loan principal. The refund must be paid within 210 days after the loan is made and permits the loan to retain Qualified Mortgage (QM) status. The provision also allows secondary market participants to provide these refunds. This allowance will expire on January 10, 2021.

The final rule will become effective upon publication in the *Federal Register*. The cure mechanism will be available only to transactions consummated on or after the effective date of the final rule and on or before the sunset date. One revision to the commentary section related to the QM cure and the RESPA (*Real Estate Settlement Procedures Act*) tolerance cure becomes effective August 1, 2015.

Regulators Issue Joint Proposal for Flood Insurance Rule

On October 24, 2014, five federal regulatory agencies issued a joint notice of proposed rulemaking that would amend their regulations pertaining to loans secured by property located

in special flood hazard areas. The proposed rule was issued by the Federal Reserve Board (Federal Reserve), the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the National Credit Union Administration, and the Farm Credit Administration. Comments are requested for a period of 60 days after the rule is published in the *Federal Register*.

The proposed rule would implement provisions of the *Homeowner Flood Insurance Affordability Act of 2014* (HFIAA) relating to escrowing flood insurance payments and the exemption of certain detached structures from the mandatory flood insurance purchase requirement. The HFIAA amends the escrow provisions of *the Biggert-Waters Flood Insurance Reform Act of 2012* (the Biggert-Waters Act).

In accordance with HFIAA, the proposed rule would include new and revised sample notice forms and clauses concerning the escrow requirement and the option to escrow. It would require regulated lending institutions to:

- Escrow premiums and fees for flood insurance for loans secured by residential improved real estate or mobile homes that are made, increased, extended, or renewed on or after January 1, 2016, unless the regulated lending institution or a loan qualifies for a statutory exception.
- Provide borrowers of residential loans outstanding on January 1, 2016, the option to escrow flood insurance premiums and fees.

The proposal also would eliminate the requirement for regulated lending institutions to purchase flood insurance for a structure that is a part of a residential property located in a special flood hazard area if that structure is detached from the primary residential structure and does not also serve as a residence. However, under the HFIAA, lenders may nevertheless require flood insurance on the detached structures to protect the collateral securing the mortgage.

The agencies announced they will address other provisions of the Biggert-Waters Act that were not amended by HFIAA in a separate rulemaking.

CFPB Proposes Language Access Plan

In an October 23, 2014, blog post, the Consumer Financial Protection Bureau (CFPB or Bureau) announced that it issued a proposal for a Language Access Plan to provide persons with limited English proficiency (LEP) meaningful access to its programs and services. The Language Access Plan describes the CFPB's policy and how the Bureau's current language access activities are implemented across all of the Bureau's operations, programs, and services. The CFPB intends to review this plan every three years and revise it as necessary. Comments on the plan and related programs and activities are requested by January 6, 2015.

The Bureau has specifically requested feedback regarding how it communicates with non-English speaking consumers to:

- Explain consumer protections;
- Provide access to our complaint system;
- Communicate during supervision and enforcement actions;
- Distribute consumer guides and tools;
- Use online communities and social media; and
- Reach out through community organizations.

Insurance

IAIS Develops Basic Capital Requirements for Global Systemically Important Insurers

On October 23, 2014, the International Association of Insurance Supervisors (IAIS) announced that it has completed development of a global insurance capital standard, referred to as the Basic Capital Requirement (BCR), which will be applicable to global systemically important insurers (G-SIIs).

The IAIS states the development of the BCR is the first step of a long-term project to develop risk-based, group-wide global insurance capital standards. The second step will be the development of Higher Loss Absorption (HLA) requirements for G-SIIs, which is due to be completed by the end of 2015. The HLA will build on the BCR and address additional capital requirements for G-SIIs reflecting their systemic importance in the international financial system. The final step will be the development of a risk-based group-wide global insurance capital standard (ICS), which is due to be completed by the end of 2016 and applied to Internationally Active Insurance Groups (IAIGs) beginning 2019. The development of the ICS will be informed by the BCR and, once finalized, is expected to replace the BCR as a foundation for the HLA.

As released by the IAIS, the BCR status of a G-SII is captured by its BCR Ratio, which is calculated by dividing Total Qualifying Capital Resources by Required Capital. These measures are initially derived from a comparable market adjusted valuation approach using current estimates of insurance liabilities. BCR Total Qualifying Capital Resources are determined on a consolidated group-wide basis for all financial and material non-financial activities and are classified as either Core or Additional Capital. Qualifying Additional Capital is limited to 50 percent of Required Capital.

The BCR Required Capital is calculated on a consolidated group-wide basis for all financial and material non-financial activities. It is determined using a factor-based approach applied to defined segments and their specified exposure measures within the main categories of a G-SII's activity: traditional life insurance; traditional non-life insurance; non-traditional insurance; assets; and non-insurance. All holding companies, insurance legal entities, banking legal entities, and any other companies in the group will be included in the consolidation. Individual non-financial entities within the group may be excluded from the scope of the BCR if the risks of or from those entities are negligible. These entities, however, should be "regularly reconsidered for inclusion."

Beginning 2015, G-SIIs will be required to report the BCR on a confidential basis to group-wide supervisors and the IAIS, which will review the reported results and "suitability of the BCR factors" in order to implement refinements as needed. Beginning 2019, G-SIIs will be required to hold capital no lower than the BCR plus the HLA.

Capital Markets & Investment Management

CFTC Issues Interpretative Guidance Regarding Customer Margin Deposits Submitted Using ACH Payment Processing Systems

On October 23, 2014, the Commodity Futures Trading Commission's (CFTC) Division of Swap Dealer and Intermediary Oversight issued an interpretation of Commission Regulations 1.22, 22.2 and 30.7, which provides that a futures commission merchant (FCM) may credit a customer's futures, foreign futures, and/or cleared swaps trading account for a margin payment upon the FCM's initiation of a withdrawal from the customer's bank account using the Automated Clearing House (ACH) transaction system. This interpretation (CFTC Letter No. 14-129) is conditioned upon the FCM and customer having entered into a written agreement authorizing the FCM to initiate an ACH transaction to withdraw funds from the customer's bank account to meet a margin call, among other conditions.

The interpretation is consistent with a previous staff interpretation regarding how an FCM should account for checks deposited by customers for margin payments. It also provides that an FCM may include pending ACH payments as margin funds received in computing the FCM's under margined capital charge under Regulation 1.17.

FINRA Chief Risk Officer Discusses Culture and Ethics

In an October 20, 2014, address at the National Conference for the National Society of Compliance Professionals, Carl di Florio, Chief Risk Officer and Head of Strategy at the Financial Industry Regulatory Authority (FINRA), addressed ethics, culture, and regulatory issues in the markets. He stated that "the principles of an ethical business culture must be at the core of a firm's everyday words and deeds" and that firms need to "reinforce that message with policies, processes, and controls that reward ethical behavior and deter and punish unethical behavior."

Noting that conflicts of interest are "one of the central and most pressing challenges facing the industry," Mr. di Florio said firms need an effective conflicts management framework to:

- Establish new product review processes to:
  - Include perspectives independent from the business proposing products;
  - Identify potential conflicts raised by new products; and
  - Restrict distribution of products that may pose conflicts that cannot be effectively mitigated and that periodically re-assesses products through post-launch reviews;
- Make independent decisions in the wealth management business about the products they offer without pressure to favor proprietary products or products for which the firm has revenue-sharing agreements;
- Minimize conflicts in compensation structures between customer and broker or firm interests where possible and include heightened supervision when conflicts remain;

- Mitigate conflicts of interest through disclosures and other information that enables customers to understand the factors that may affect a product's financial outcome—such as the use of scenarios and graphics for a particular product; and
- Include "best-interest-of-the-customer" standards in codes of conduct that apply to brokers' personalized recommendations to retail customers in order to maintain and increase investor trust.

CFTC Signs Cross-Border Oversight MOU with Manitoba Securities Commission

The Commodity Futures Trading Commission (CFTC) announced on October 21, 2014, that CFTC Chairman Tim Massad and Chair of the Manitoba Securities Commission (MSC) Donald Murray have signed a Counterpart to the Memorandum of Understanding (MOU) signed by the CFTC and other Canadian authorities on March 25, 2014. That MOU addressed cooperation and the exchange of information in the supervision and oversight of regulated entities that operate on a cross-border basis in the United States and in certain Canadian provinces. It included a provision for additional Canadian authorities to become parties to the MOU. The execution of the Counterpart permits the MSC to join the MOU.

MSRB Proposes Extension of Its Gifts Rule to Municipal Advisors and Finalizes a Supervisory and Compliance Framework

On October 23, 2014, the Municipal Securities Rulemaking Board (MSRB) issued proposed amendments to MSRB Rule G-20, which addresses gifts, gratuities, and non-cash compensation given or permitted to be given by brokers, dealers, and municipal securities dealers, that would expand the applicability of the rule and the related record-keeping requirements to municipal advisors.

The proposed amendments would also:

- Codify current guidance on the application of the rule in particular situations; and
- Add a new provision to explicitly prohibit MSRB-regulated entities from expensing certain entertainment costs to municipal securities issuances.

The MSRB will host a webinar on the proposed amendments on November 13, 2014; Comments on the proposed amendments are requested by December 8, 2014.

Coincident with the proposal, the MSRB announced that it plans to submit two other proposals for Securities and Exchange Commission (SEC) approval, including one to set baseline professional qualification requirements for municipal advisors, and another to create core standards of conduct for non-solicitor municipal advisors.

On October 24, 2014, the MSRB announced that it had received SEC approval to create new MSRB Rule G-44, which establishes baseline supervisory and compliance obligations for municipal advisors. The new supervision requirements take effect April 23, 2015, though firms are provided six months to implement the required policies and procedures. By April 23, 2016, the chief executive officers (or the equivalent) of municipal advisor firms must make the first of their annual certifications in writing that the municipal advisor has in place processes to establish, maintain, review, test, and modify written compliance procedures and written supervisory procedures reasonably designed to achieve compliance with applicable rules.

FINRA Issues Regulatory Notice Regarding SEC Adoption of the Supplemental Inventory Schedule

The Financial Industry Regulatory Authority (FINRA) issued Regulatory Notice 14-43 on October 23, 2014, to advise broker dealers that the Securities and Exchange Commission (SEC) has approved the adoption of the Supplemental Inventory Schedule (SIS), a supplemental schedule that must be filed by firms required to file FOCUS Report Part II, FOCUS Report Part IIA or FOGS Report Part I, and has inventory positions as of the end of the FOCUS or FOGS reporting period, unless the firm has (1) a minimum dollar net capital or liquid capital requirement of less than $100,000 or (2) inventory positions consisting only of money market mutual funds. The initial SIS disclosing inventory positions as of December 31, 2014, must be filed with FINRA on or before January 30, 2015.

Enforcement Actions

The Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC) recently announced the following enforcement actions:

- The SEC announced that a former hedge fund manager has settled insider trading charges brought against him, another individual, and a hedge fund advisory firm. Without admitting or denying the charges, he agreed to pay more than $840,000 in disgorgement, prejudgment interest, and a civil money penalty and accept securities industry bars.
- The SEC charged an individual in New Jersey with insider trading, alleging that that he traded in the securities of two companies based on a tip from a financial analyst. The SEC seeks a permanent injunction, disgorgement with prejudgment interest, and financial penalties. The SEC's investigation is continuing. In a parallel action, the U.S. Attorney's Office also announced insider trading cases against both individuals.
- The SEC sanctioned a Florida-based auditor for violating federal laws and regulations requiring lead audit partners to periodically rotate off their audit engagements with a publicly traded companies. The audit partner settled the SEC's charges and agreed to pay a $15,000 penalty and be suspended for at least one year from practicing as an accountant on behalf of any publicly traded company or other entity regulated by the SEC.
- The CFTC announced that U.S. District Court found in favor of the CFTC in a complaint it filed against a Massachusetts-based commodity pool operator and his company for fraud and registration violations of the *Commodity Exchange Act*. The court ordered them to pay a $2.86 million civil penalty and imposed permanent trading and registration bans.
- The CFTC announced that a U.S. District Court entered a default judgment and issued a permanent injunction against a Texas-based corporation for fraudulently soliciting approximately $1.7 million from one individual to trade leveraged, off-exchange foreign currency contracts. The Order requires the corporation to pay restitution of $827,000 and a civil monetary penalty of $2,481,000. The CFTC previously settled with the individual, who controlled the corporation. The individual agreed to a permanent injunction and to pay $1.5 million in restitution and a civil monetary penalty.
- The CFTC announced that U.S. District Court entered a permanent injunction against an individual and two California-based companies he owned in connection with a commodity pool scheme. The CFTC had charged the company with fraud, misappropriation, and registration violations. The Order imposes a permanent injunction and permanent trading and registration bans. It requires the individual to pay a civil monetary penalty of $3,430,000 and the companies to pay a civil monetary penalty of $14,790,000.

Recent Supervisory Actions against Financial Institutions

Last Updated: October 24, 2014

Agency	Institution Type	Action	Date	Synopsis of Action
CFPB	State Member Bank	Consent Order	10/09	The Consumer Financial Protection Bureau assessed financial penalties on a financial services entity for engaging in unfair, deceptive, or abusive acts or practices, related to its deceptive advertising of free checking accounts for consumers.
CFPB	Title Insurance Agency	Consent Order	09/30	The Consumer Financial Protection Bureau announced that it had assessed financial penalties on an insurance agency for entering into quid pro quo agreements with companies that referred business to its mortgage closings and title insurance businesses in violation of the *Real Estate Settlements and Procedures Act*.
CFPB	Federal Savings Bank	Consent Order	09/29	The Consumer Financial Protection Bureau assessed financial penalties on a federal savings bank and loan servicer related to its default servicing practices that violated the loss mitigation provisions of the *Real Estate Settlement Procedures Act*. Mortgage Servicing Rule.
FDIC	State Nonmember Bank	Consent Order	09/29	The Federal Deposit Insurance Corporation assessed financial penalties on a financial services entity for unfair and deceptive practices related to marketing and servicing of credit card add-on products, in violation of the *Federal Trade Commission Act*.
CFPB and OCC	National Bank	Individual Consent Orders	09/25	The Consumer Financial Protection Bureau and the Office of the Comptroller of the Currency assessed financial penalties on a large financial services entity for unfair billing of identity theft protection products in violation of the *Federal Trade Commission Act*.
Federal Trade Commission	Nonbank Debt Collector	Complaint	09/23	The Federal Trade Commission charged a nonbank debt collector that used fictitious names and threatened consumers into paying debts they may not have owed in violation of the *Federal Trade Commission Act* (FTC Act) and *the Fair Debt Collection Practices Act* (FDCPA).
Federal Reserve Board	State Member Bank	Written agreement	09/19	The Federal Reserve entered into a written agreement with a Massachusetts-based state member bank to address an unauthorized cash dividend to shareholders. The Federal Reserve objected to the capital plan the bank submitted in January 2014.
CFPB	Nonbank Payday Lender	Complaint	09/17	The Consumer Financial Protection Bureau charged a Missouri-based payday lender with originating online payday loans without consumers' consent and debiting fees from their checking accounts in violation of the *Consumer Financial Protection Act*, the *Truth in Lending Act*, and the *Electronic Fund Transfer Act* (EFTA).
CFPB	Nonbank For-Profit Educational Institution	Complaint	09/16	The Consumer Financial Protection Bureau charged a California-based, publicly traded, for-profit college chain with operating an illegal predatory lending scheme in violation of the *Consumer Financial Protection Act* and the *Fair Debt Collection Practices Act*. .

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