cutting through complexity

The Washington Report

for the week ended June 3, 2016

In This Issue

Safety & Soundness

BIS Publishes Working Papers On Liquidity-Related Issues

The Bank for International Settlements (BIS) released the following working papers related to liquidity issues during the week ended June 3, 2016:

- *Working paper 561: Mobile collateral versus immobile collateral*
  The authors summarize that this working paper seeks to evaluate new policies aimed to make collateral immobile, notably through the BIS Liquidity Coverage Ratio (LCR) for banks. They state that prior to the 2007/2008 financial crisis, U.S. bank loans were securitized into bonds, which made them mobile as the bonds could be traded, posted as collateral, and re-hypothecated. Since the financial crisis, regulatory changes have the effect of making collateral immobile. The authors pose two main arguments: 1) There is a cost to making collateral immobile because it ties up safe debt; and 2) Making collateral immobile actually increases other forms of bank debt making the overall system riskier. [Working Paper]

- *Working paper 563: Who supplies liquidity, how and when?*
  The authors state that the working paper highlights that proprietary traders provide liquidity with contrarian marketable orders, thus helping the market absorb shocks and earning profits in the process. They state that while fast traders provide liquidity by leaving limit orders in the book, only proprietary traders can do so without making losses. They suggest this implies that technology alone is not sufficient to overcome adverse selection and that monitoring incentives are also needed. [Working Paper]

- *Working paper 565: The Collateral Trap*
  This working paper looks into the role of collateral in an active wholesale financial market. The authors make a distinction between "outside collateral" and "inside collateral." They suggest the use of inside assets, such as loans, creates a "collateral pyramid," in that cash flows from one loan can be pledged to secure another. Through collateral pyramids the financial sector creates safe assets but at the cost of exposing the economy to systemic risks. "Outside collateral," such as treasuries, stabilize this pyramid. There is a threshold for the volume of treasuries used in transactions, below which investors panic, the pyramid collapses, and there are not enough safe assets to support wholesale market activity. This situation is referred to as the "collateral trap." This working paper explores how banks' holdings of outside collateral affect the creation of inside collateral, and how this collateral creation process affects the efficiency and stability of wholesale financial markets. It also highlights that sudden swings in collateral creation and value is a source of fragility in interbank markets, leading to a collateral trap. [Working Paper]

Enterprise & Consumer Compliance

CFPB Issues Proposed Rule on Payday, Vehicle Title, and High-Cost Installment Loans

On June 2, 2016, the Consumer Financial Protection Bureau (CFPB or Bureau) issued a proposed rule that would create a new regulation, 12 CFR part 1041, to contain regulations creating consumer protections for certain consumer credit products, including payday loans, vehicle title loans, and certain high-cost installment loans. As summarized by the CFPB, the proposed rule would cover two categories of loans: 1) loans with a term of 45 days or less; and 2) loans with a term greater than 45 days, provided they i) had an all-in annual percentage rate greater than 36 percent, and ii) are repaid either directly from the consumer's account or income or are secured by the consumer's vehicle. For both categories, the proposal would require a lender, before making a loan, to reasonably determine that the consumer has the ability to repay the loan. Failure to do so would be identified as an abusive and unfair practice. A safe harbor from the ability-to-repay requirement would be provided for loans meeting certain conditions. The proposed rule would also identify as an abusive and unfair practice, attempts to withdraw payments from a consumer's account for a covered loan after two consecutive payments have failed unless the lender obtains the consumer's new and specific authorization to make further withdrawals from the account. Comments are requested by September 14, 2016. [Press Statement] [Proposed Rule]

In addition to the proposed rule, the CFPB issued a Request for Information on practices and products that are related to but may not be addressed in the Bureau's proposed rule. In particular, the CFPB seeks input on 1) potential consumer protection concerns with loans that fall outside of the scope of the proposed rule but are designed to serve similar populations and needs as loans covered by the proposed rule, and 2) business practices concerning loans falling within the proposed rule that raise potential consumer protection concerns that are not addressed by the proposed rule, such as methods used to seize borrowers' wages, funds, vehicles, or other personal property, or sales and marketing practices for credit insurance, debt suspension, or debt cancellation agreements, and other add-on products. Comments are requested by October 14. 2016. [Request for Information]

Speaking at a field hearing, CFPB Director Richard Cordray stated, "Based on our review of the available evidence, we believe the vast majority of borrowers would still be able to get the credit they need in an emergency…but now they would be shielded by an umbrella of stronger protections that would keep them from getting trapped in debt they cannot afford." He said the CFPB did not intend to "disrupt the basic underwriting approaches taken by many banks, credit unions, and traditional finance companies, as well as some newer entrants, which offer installment loans in ways designed to assure that consumers can afford to repay them." [Speech]

The same day, the Honorable Jeb Hensarling, Chairman of the House of Representatives' Committee on Financial Services issued a statement suggesting the CFPB's proposed rule would set out requirements that would make it harder for people to access small dollar loans. [Press Statement]

Enforcement Actions

The Consumer Financial Protection Bureau (CFPB or Bureau) and the Federal Trade Commission (FTC) announced the following enforcement actions in the past week:

- The CFPB filed suit against a third-party payment processer and its president and chief executive officer for allegedly enabling unauthorized and other illegal withdrawals from consumer accounts by their clients. In the suit filed in federal district court, the CFPB alleges that the company violated the *Consumer Financial Protection Act*'s prohibition against unfair acts and practices by processing payments for clients without adequately investigating, monitoring, or responding to red flags that indicated some clients were breaking the law or deceiving customers.
- The FTC charged a company with violating the unfair and deceptive acts or practices provisions of the *Federal Trade Commission Act* as well as the FTC's *Mail, Internet or Telephone Order Merchandise Rule* in conjunction with the advertising and sales of gold and silver. According to the complaint, the defendants marketed gold and silver as retirement savings investments, but often failed to deliver on orders following receipt of payment. The FTC seeks to recover money from the defendants to return to their customers.

Insurance

Federal Reserve Invites Comment on Capital Standards Frameworks for Institutions Engaged in Insurance and Approves Proposed Rule for Enhanced Prudential Standards

The Federal Reserve Board (Federal Reserve) approved an advance notice of proposed rulemaking (ANPR) on June 3. 2016, inviting comment on two conceptual frameworks for capital standards that would apply to systemically important insurance companies (nonbank financial companies that the Financial Stability Oversight Council has designated for supervision by the Federal Reserve and that have significant insurance activities) and to insurance companies that own a bank or thrift (depository institution holding companies significantly engaged in insurance activities). One approach, the consolidated approach, would apply to systemically important insurance companies. It would categorize an entire insurance firm's assets and insurance liabilities into risk segments, apply appropriate risk factors to each segment at the consolidated level, and set a minimum ratio of required capital. The second approach, the building block approach, would apply to insurance companies that also own a bank or thrift. This approach would aggregate existing capital requirements across a firm's different legal entities to arrive at a combined, group-level capital requirement, subject to adjustments to reflect the supervisory objectives of the Federal Reserve. The Federal Reserve notes that it currently supervises 2 systemically important insurance companies and 12 insurance companies that own a bank or thrift. Comments on the ANPR are requested by August 2, 2016. [Press Statement] [ANPR]

Separately, the Federal Reserve approved a proposed rule that would apply enhanced prudential standards (pursuant to Section 165 of the *Dodd-Frank Wall Street Reform and Consumer Protection Ac*t (Dodd-Frank Act)) to systemically important insurance companies. As required under the Dodd-Frank Act, these standards would apply consistent liquidity, corporate governance, and risk-management standards to the firms. The firms would also be required to employ both a chief risk officer and a chief actuary to help ensure that firm-wide risks are properly managed. Comments on the proposed rule are requested by August 2, 2016. [EPS Proposed Rule for Insurance Companies]

Capital Markets and Investment Management

Enforcement Actions

The Securities and Exchange Commission (SEC), the Commodity Futures Trading Commission (CFTC), and the Financial Industry Regulatory Authority (FINRA) announced the following enforcement actions in the past week:

- The SEC announced insider trading charges against an investment banker and his associate. The Analysis and Detection Center of the SEC Enforcement Division’s Market Abuse Unit detected an illicit pattern of trading by the associate, who was being tipped with nonpublic information on 10 different occasions ahead of public merger announcements. The banker and his friend were charged with violating sections of the *Securities Exchange Act of 1934*, Rule 10b-5 and Rule 14e-3. They were ordered to disgorge their ill-gotten gains along with interest and penalties, and permanently enjoined from future violations of federal securities laws.
- The SEC charged a mortgage company and six of its senior executives with defrauding investors with respect to the sale of Residential Mortgage-Backed Securities (RMBS) guaranteed by the Government National Mortgage

Association (Ginnie Mae). The SEC alleged that the company pulled out current and performing loans from the Ginnie Mae RMBS by falsely claiming they were delinquent, in order to sell them at a profit in a newly-issued RMBS. The executives were charged with violating sections of the *Securities Act of 1933*, the *Securities Exchange Act of 1934*, and SEC's Rule 10b-5(a), (b) and (c). In settling charges, the company and the executives together agreed to pay a penalty of $12.7 million. They also agreed to be barred from serving as officers or directors of a public company for five years.

- The SEC charged an investment advisory firm and its owner with scheming to collect extra monthly fees from a pair of hedge funds they managed. The SEC alleged the firm and its owner arranged trades to enable the funds to realize a large gain near the end of a month and to make large losses early in the following month in order to circumvent the funds' fee structure and earn large incentive fees. The firm and its owner were charged with violating sections of the *Securities Act of 1933*, *Securities Exchange Act of 1934*, SEC's Rule 10b-5, sections of the *Investment Advisers Act of 1940*, and Rule 206(4)-8 of the U.S. Code. An interim court order restricted them from accessing $7 million of their own investments in the funds, prohibited them from collecting any further fees unless they satisfied the high water mark in the funds' fee structure, and restricted them from making additional investments in the fund. The SEC also preliminarily enjoined them from violating antifraud statutes of the federal securities laws, and sought a disgorgement of ill-gotten gains with interest and penalties, and permanent injunctions.
- The SEC charged two men and their investment firm with defrauding investors in a Ponzi scheme that purported to specialize in serving middle-class investors and promised exorbitant returns by investing in hot pre-IPO stocks. Rather than using the firm's proprietary trading models and investing in pre-IPO shares of well-known tech companies as promised to investors, the owners of the firm are charged with personally pocketing at least $2.8 million in investor funds and using funds to pay back earlier investors. The funds were never actually invested in any pre-IPO shares. The SEC obtained a court-ordered asset freeze against the firm and the executives. It also sought permanent injunctions, disgorgement and monetary penalties from them, and preliminarily enjoined them from violating the antifraud provisions of the federal securities laws and raising money from investors. In a parallel action, the U.S. Attorney's Office also announced criminal charges against the two owners.
- The SEC charged a trader with defrauding investors out of millions of dollars by misrepresenting the trader's investment track record. The trader made false claims about her supposedly profitable futures and foreign currency trading strategy and solicited funds from investors. Despite incurring heavy trading losses in the futures and forex markets, she maintained with the investors that their investments were profitable and sent them monthly account statements showing fictitious profits. New investor funds were also used to make Ponzi-like payments to earlier investors. Since 2012, she allegedly raised approximately $14 million from more than 30 investors, and has suffered more than $16 million in trading losses during that period. The SEC charged her with violating sections of the *Securities Act of 1933*, the *Securities Exchange Act of 1934* and SEC's Rule 10b-5. In settling charges the SEC sought a permanent injunction, the return of alleged ill-gotten gains plus interest and penalties. In a parallel action, the U.S. Attorney's Office also announced criminal charges against the trader.
- The SEC charged an investment adviser with breaching his fiduciary duty and defrauding investors by secretly steering portions of their real estate-related investments into deals with companies owned or operated by him. He also allegedly made false or misleading statements to investors, failed to inform them of their losses, and improperly received at least $1.5 million from bank accounts, commingling investor funds. He was charged with violating sections of the *Securities Exchange Act of 1934*, the *Securities Act of 1933*, and *the Investment Advisers Act of 1940*, the SEC's Rule 10b-5 and Rule 206(4)-8 of the U.S. Code. Without admitting or denying the allegations he agreed to pay a disgorgement plus interest and penalties yet to be determined by court, to settle charges. The settlement also bars him from any further sale of securities in a pooled investment vehicle as well as from future violations of antifraud and securities registration provisions of the federal securities laws.
- The SEC charged a private equity fund advisory firm and its owner with engaging in brokerage activity and charging fees without being registered as a broker-dealer, and for committing other securities law violations. The SEC's investigation further revealed that firm and its owner did not make full disclosures with respect to fees and expenses. They were charged with violating sections of the *Securities Exchange Act of 1934*, the *Investment Advisers Act of 1940* and Rules 206(4)-7 and 206(4)-8 of the U.S. Code. They agreed to be censured, to cease and desist from further violations, and to pay more than $3.1 million to settle charges without admitting or denying the findings.

- The CFTC issued an Order charging a bitcoin exchange with offering illegal off-exchange financed retail commodity transactions in bitcoin and other crypto currencies. The exchange was also charged with failing to register as a Futures Commission Merchant (FCM) as required by the *Commodity Exchange Act* (CEA). The CFTC ordered the exchange to pay a $75,000 civil monetary penalty and to cease and desist from future such violations of the CEA.
- FINRA censured and fined a securities trading and brokerage firm for supervisory violations. The firm provides online securities investing and trading services to retail customers, and routes customers' orders to various exchanges and non-exchange market centers. The firm allegedly failed to conduct adequate review of the quality of execution of its customers' orders. The firm's Best Execution Committee that periodically conducts reviews of the quality of customer order executions lacked sufficiently accurate information to reasonably assess the execution quality it provided its customers. FINRA also found that the firm did not have adequate systems and controls in place to ensure that there was no misuse of confidential customer order information while executing the trades. The firm neither admitted nor denied the charges, but consented to the entry of FINRA's findings and agreed to pay $900,000 to settle charges.

Financial Crimes

SEC Charges Broker-Dealer for Failure to File Suspicious Activity Reports Despite Reg Flags

The Securities and Exchange Commission (SEC) charged a registered broker-dealer with failing to sufficiently evaluate or monitor customers' trading for suspicious activity as required under federal securities laws. An SEC investigation revealed that the firm had failed to file Suspicious Activity Reports (SARs) with bank regulators for more than five years when it knew, suspected, or had reason to suspect that certain transactions involved the use of the broker-dealer to facilitate fraudulent activity or had no business or apparent lawful purpose. The firm's anti-money laundering (AML) policies and procedures listed a number of specific examples of suspicious activities that should have triggered internal review and, in a number of instances, SAR filings. The policies highlighted a number of red flags, including widely regarded indicia of potential securities fraud, such as "trading that constitutes a substantial portion of all trading for the day in a particular security," "heavy trading in low-priced securities," and "unusually large deposits of funds or securities." Despite the suspiciousness of its customers' transactions, the related red flags, and the requirements of its written policies, the broker-dealer never filed an SAR during the relevant period. The firm was charged with violating section 17(a) of the *Securities Exchange Act of 1934*. The firm agreed to be censured and pay a penalty of $300,000 without admitting or denying the findings in the order, to settle charges. While the SEC has charged other firms with anti-money laundering failures under the securities laws, the SEC notes that this is the first case against a firm solely for failing to file SARs when appropriate.

Alternative Finance

CFTC Reopens Comment Period for Certain Elements of Regulation AT

The Commodity Futures Trading Commission's (CFTC) Regulation Automated Trading (Regulation AT) comprises of a set of rules that regulate automated trading on U.S. Designated Contract Markets (DCMs). The rules include a series of risk controls, transparency measures, and other safeguards to enhance the U.S. regulatory regime for automated trading. On June 2, 2016, the CFTC announced that it will reopen the comment period for the CFTC's proposed rulemaking affecting Regulation AT (published in the *Federal Register* on December 17, 2015) to obtain input from the public on specific topics to be considered at a CFTC staff roundtable discussion on June 10, 2016. These topics include:

- Potential amendments to the proposed definition of "Direct Electronic Access;"
- Potential quantitative measures to establish the population of AT Persons;
- A potential alternative to Regulation AT's requirements for AT Persons in proposed §§ 1.80, 1.81, and 1.83(a), which could require Futures Commission Merchants to impose specific requirements on their customers and perform due diligence regarding customers' compliance;
- AT Persons' compliance with Regulation AT's proposed requirements for Algorithmic Trading and Algorithmic Trading systems when using third-party algorithms or systems; and
- Source code access and retention.

The comment period will be open between June 10, 2016, and June 24, 2016. [Press Statement] [Notice]

SEC Divisions of Corporation Finance and Trading and Markets Release Guidance on Regulation Crowdfunding

The Securities and Exchange Commission's (SEC) Division of Corporation Finance issued a Compliance and Disclosure Interpretations (C&Dis) document last month consisting of eight questions and answers on topics related to Regulation Crowdfunding. The release was intended to coordinate with the May 16, 2016, effective date of the crowdfunding regulations. The C&DIs, which cover crowdfunding exemption and requirements, disclosure requirements, advertising, and promoter compensation, are interpretations provided by Division of Corporation Finance staff and are not to be construed as rules, regulations or statements of the Commission. [Crowdfunding C&DIs]

Separately, the SEC's Division of Corporation Finance issued a Small Entity Compliance Guide for Issuers, which outlines the basic requirements of the crowdfunding regulation in plain English. In addition, the SEC's Division of Trading and Markets issued a Small Entity Compliance Guide for Crowdfunding Intermediaries.
[Small Entity Issuer Guide] [Small Entity Intermediaries Guide]

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