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Safety & Soundness

Foreign Banking Organizations with Limited U.S. Operations Permitted to Submit Resolution Plans with Reduced Content; Submission Deadline Extended for Four Large Foreign Banking Organizations

On June 10, 2016, the Federal Reserve Board (Federal Reserve) and the Federal Deposit Insurance Corporation (FDIC) announced that 84 foreign banking organizations with limited U.S. operations will be permitted to file reduced content resolution plans for their next three submissions, beginning with the December 31, 2016 submissions. The agencies note that all of the firms have previously submitted plans and the reduced content plans are expected to focus on:

- Changes made to prior resolution plans;
- Actions taken to improve the effectiveness of those plans; and,
- Where applicable, actions to ensure that their subsidiary insured depository institutions are adequately protected from the risks arising from the activities of nonbank subsidiaries of the firm.

The *Dodd-Frank Wall Street Reform and Consumer Protection Act* (Dodd-Frank Act) requires foreign banking organizations with $50 billion or more in global consolidated assets and operating in the United States to periodically submit "resolution plans" to the Federal Reserve and the FDIC, outlining the firm's strategy for a rapid and orderly resolution under the U.S. Bankruptcy Code or other applicable insolvency regime in the event of material financial distress or failure of the firm. Firms permitted to file the reduced content plans must (i) continue to maintain less than $50 billion in U.S. assets and (ii) not experience any material events in order to continue to file the reduced content plans. [Press Statement]

Earlier in the week, on June 8, 2016, the Federal Reserve and the FDIC jointly announced they were permitting four large foreign banking organizations to delay submission of their resolution plans by one year, to July 1, 2017. The agencies indicate the decision was made in light of the significant restructuring these companies are undertaking to come into compliance with the Federal Reserve's Intermediate Holding Company (IHC) requirement, which is due July 1, 2016. The IHC requirement was established by the Federal Reserve in 2014 as part of its implementation of the enhanced prudential standards required by the Dodd-Frank Act for bank holding companies and foreign banking organizations with total consolidated assets of $50 billion or more. [Press Statement]

Federal Reserve Updates Supervisory Guidance for Risk Management at Institutions with Less Than $50 Billion in Total Consolidated Assets

The Federal Reserve Board (Federal Reserve) issued Supervision and Regulation Letter (SR) 16-11 on June 8, 2016, to update the agency's supervisory guidance for assessing risk management practices at financial institutions with total consolidated assets of less than $50 billion. The guidance re-affirms the Federal Reserve's emphasis on the importance of prudential risk management as well as reflects updates to, and partially supersedes, earlier guidance in SR 95-51, *Rating the Adequacy of Risk Management and Internal Controls at State Member Banks and Bank Holding Companies*. The new guidance also:

- Outlines core risk categories and risk management principles;
- Provides clarification on and distinguishes supervisory expectations for the roles and responsibilities of the board of directors and senior management for an institution's risk management; and
- Extends applicability to savings and loan holding companies with less than $50 billion in total consolidated assets and U.S. operations of foreign banking organizations with less than $50 billion in total consolidated U.S. assets, both of which were not previously subject to SR 95- 51.

With respect to the assignment of supervisory ratings, the updated guidance does not change the risk management rating requirements and ratings definitions from SR letter 95‑51. [SR Letter 16-11]

International Monetary Fund Working Papers

The International Monetary Fund (IMF) recently released the following two working papers:

- *Working Paper 16/109, Foreign Bank Subsidiaries' Default Risk During the Global Crisis: What Factors Help Insulate Affilates From Their Parents?* The research assesses the default risk of foreign bank subsidiaries in developing countries and their parents during the global financial crisis, with the purpose of determining the size and sign of this correlation. The purpose is to understand what factors can help insulate affiliates from parents. They find evidence of a significant and robust positive correlation between parent banks' and foreign subsidiaries' default risk. However, this correlation drops for subsidiaries with a higher share of retail deposit funding and that are more independently managed from their parents. Host country bank regulations also influence the extent to which shocks to the parents affect the subsidiaries' default risk. In particular, the correlation between the default risk of subsidiaries and their parents is lower for subsidiaries operating in countries that impose higher capital, reserve, provisioning, and disclosure requirements, and tougher restrictions on bank activities. [Working Paper]

- *Working Paper 16/110, Changes in Prudential Policy Instruments – A New Cross-Country Database.* The research documents a new prudential regulation database that incorporates both macroprudential and microprudential policies. The database spans quarterly data between 2000 and 2014 for 64 countries. Five types of prudential instruments are included: capital buffers, interbank exposure limits, concentration limits, loan to value (LTV) ratio limits, and reserve requirements. In analyzing the data, the authors find that general capital requirements experience the most changes from the cross-country perspective, but LTV ratio limits and reserve requirements (when they are used) experience the largest number of tightening and loosening episodes. Further, the use of LTV ratio limits and currency reserve requirements appear more consistent with counter-cyclical policy objectives, in most cases. The authors also analyzed the usage of prudential instruments in relation to the evolution of key variables such as credit, policy rates, and house prices, finding substantial differences in the patterns of loosening or tightening of instruments in relation to business and financial cycles. [Working Paper]

Enterprise & Consumer Compliance

FFIEC Members Propose Revisions to the Consumer Compliance Rating System

The Federal Financial Institutions Examination Council (FFIEC) is seeking public comment on proposed revisions to the existing Uniform Interagency Consumer Compliance Rating System (CC Rating System), which is a supervisory policy for evaluating financial institutions' adherence to consumer compliance requirements. The proposed revisions seek to reflect regulatory, supervisory, technological, and market changes since the CC Rating System was first adopted in 1980, as well as to reflect better FFIEC member agencies' current risk-based and tailored examination approach to consumer compliance supervision. As proposed, the revisions emphasize the importance of institutions' compliance management systems (CMS) and, in particular, the risk control processes designed to manage consumer compliance risk and prevent consumer harm. The agencies' expectations would vary by each institution's size, complexity, and risk profile, and the framework would include incentives for institutions to promote consumer protection by preventing, self-identifying, and addressing compliance issues in a proactive manner. Comments are requested by July 5, 2016.
[Proposed CC Rating System]

The FFIEC membership is comprised of the Federal Reserve Board, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the National Credit Union Administration, the Consumer Financial Protection Bureau, and the State Liaison Committee.

OCC Guidance Reminds Institutions of Extended Period for Certain SCRA Protections

The Office of the Comptroller of the Currency (OCC) released Bulletin 2016-20 on June 10, 2016, to remind financial institutions of the *Foreclosure Relief and Extension for Servicemembers Act of 2015*, which was signed into law on March 31, 2016. It amends the *Servicemembers Civil Relief Act* (SCRA) to extend temporarily certain protections available to servicemembers. In particular, the amendments continue a temporary provision that extends for one year following a servicemember's period of military service the protections related to the sale, foreclosure, or seizure of the servicemember's mortgaged property, or the filing of a legal action to enforce a mortgage obligation or other similarly secured obligation. The extension will end December 31, 2017. Beginning January 1, 2018, there will be a period of 90 days after the end of the servicemember's military service during which a foreclosure, sale, or seizure of the servicemember's property based on a breach of a mortgage, trust deed, or other security, without a court order or waiver, will not be valid. During this period, a court may also stay proceedings enforcing such obligations. The SCRA applies only to obligations that originated before the servicemember's military service and for which the servicemember is still obligated. [OCC Bulletin 2016-20]

Insurance

FSB Releases Resolution Planning Guidance for Systemically Important Insurers

On June 6, 2016, the Financial Stability Board (FSB) released final guidance on developing effective resolution strategies and plans for systemically important insurers. The guidance seeks to assist authorities in meeting the resolution planning requirement under the FSB's *Key Attributes of Effective Resolution Regimes for Financial Institutions.* It has been developed with the International Association of Insurance Supervisors (IAIS). It sets out considerations for determining a preferred resolution strategy based on a strategic analysis of insurers' business models, the criticality of insurers' functions, and policy holder protection arrangements. It also identifies a range of elements needed for credible resolution strategy implementation, including effective cross-border cooperation, information systems, and resources to absorb loss. [Press Statement] [Guidance]

NAIC Adopts Recommendation to Activate Principle-Based Reserving

On June 10, 2016, the National Association of Insurance Commissioners (NAIC) announced adoption of a recommendation to activate, beginning January 1, 2017, a Principle-Based Reserving (PBR) approach for ascertaining reserves for life insurance products. Currently, insurers use a formula-based static approach to calculate reserves and the NAIC acknowledges that insurance products have grown increasingly more complex leading to the need for a new reserving method. NAIC indicates the PBR approach more closely reflects the risks of highly complex products. The new calculation method is expected to "right-size reserves," reducing reserves that are too high for certain products and increasing reserves that are too low for other products, ensuring the maintenance of strong solvency oversight by regulators while also ensuring that companies fulfill obligations to policyholders. [Press Statement]

NAIC Releases First of Two Volumes of the 2015 Insurance Department Resources Report

The National Association of Insurance Commissioners (NAIC) has released the first volume of the 29th edition of the Insurance Department Resources Report (IDRR), which allows state insurance departments to assess their resources in comparison to other states. The 2015 report details how state insurance departments manage available resources to regulate the insurance industry. The first volume contains information for each state on the number of departmental staff and their functions, annual budgets, revenue flows, the number of insurers and insurance producers, and the number of consumer complaints and inquires. The second volume, which will be released in August 2016, will primarily include information on premium volume by type and by state. [Press Statement]

NAIC Launches Microsite for Retirement Security Initiatives

On June 7, 2016, the National Association of Insurance Commissioners (NAIC) launched a microsite as part of its consumer-oriented Insure U web pages to underscore the importance of retirement security. The NAIC Retirement Security Initiative has a three-pronged strategy: education, consumer protection, and innovation. The approach seeks to facilitate regulatory identification of practical regulatory or policy issues that need review, as well as highlight barriers to innovation, product delivery and compliance. Consumer outreach is expected to focus on the need for improved understanding and access to insurance products. The NAIC will continue to monitor for best practices regarding suitability, fair treatment, and compliance for those regulatory functions that it coordinates. [Press Statement]

Capital Markets and Investment Management

SEC Adopts Trade Acknowledgement and Verification Requirements for Security-Based Swap Transactions

The Securities and Exchange Commission (SEC) announced on July 8, 2016, adoption of final rules to establish timely and accurate trade acknowledgment and verification requirements for security-based swap dealers and major security-based swap participants (collectively, SBS entities) that enter into security-based swap (SBS) transactions. Under the new rules, SBS entities are required to:

- Promptly provide a trade acknowledgment electronically to a transaction counterparty no later than the end of the first business day following the day of execution;
- Promptly verify or dispute with a counterparty the terms of a trade acknowledgment it receives; and
- Have in place written policies and procedures designed to obtain verification of the terms outlined in any trade acknowledgment that it provides.

The final rules exempt certain transactions processed through a registered clearing agency or executed on a SBS execution facility or national securities exchange. In addition, the final rules exempt from the requirements of *Securities Exchange Act* Rule 10b-10 any broker-dealers who are both SBS entities and who satisfy the trade acknowledgment and verification requirements in the final rules.

The final rules also make available substituted compliance for foreign firms subject to SEC jurisdiction regarding these requirements. Specifically, Rule 3a71-6 is amended to provide that when the SEC has made a substituted compliance determination, non-U.S. SBS Entities may satisfy the trade acknowledgment and verification requirements applicable to SBS Entities by complying with comparable requirements of a foreign regime.

The final rules will become effective 60 days after publication in the *Federal Register* and compliance will be based on the compliance date of the registration rules for SBS entities previously adopted by the SEC. [Press Statement]

European Central Banker Offers Perspectives on Macroprudential Margins and Haircuts

Vitor Constancio, Vice President of the European Central Bank provided comments before the *European Systemic Risk Board Conference on Macoprudential Margins and Haircuts* in Frankfurt Germany on June 6, 2016. In his remarks, Mr. Constancio outlined his view that macroprudential margins and haircuts have the potential to become tools for controlling the build-up of excessive leverage in the financial system, and, in particular, beyond the banking system where nonbank and market-based financing have expanded rapidly.

To enhance the resilience of the financial system, he suggests that minimum margins and haircut floors should be required for both centrally cleared and non-cleared derivatives and securities financing transactions (SFTs) as an essential reform. He further suggests that macroprudential authorities should be given the power to intervene in margin and haircut requirements. The following three issues were identified for further consideration:

- The macroprudential framework, including standardized margin and haircut schedules, should be built on the current regulatory frameworks and policy recommendations, as applicable, for derivatives and SFTs, at the EU and global level.
- Nonbank entities should be appropriately affected by margins and haircut requirements, and macroprudential tools should be designed and applied at the transaction and participant level to ensure they can be fully "passed through" to nonbanks.
- The macroprudential tools should be applied directly to transactions, regardless of the market, jurisdiction or infrastructure where the transactions were booked to avoid arbitrage across products and across jurisdictions. [Speech]

Second Largest SEC Whistleblower Award Announced

The Securities and Exchange Commission (SEC) announced a whistleblower award of more than $17 million to a former company employee whose detailed tip substantially advanced the agency's investigation and ultimate enforcement action. The award is the second-largest issued by the SEC since its whistleblower program began nearly five years ago. The SEC issued a $30 million award in September 2014 and a $14 million award in October 2013. [Press Statement]

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 non-prosecution agreements (NPAs) with two unrelated companies that will forfeit ill-gotten gains connected to bribes paid to government officials by their foreign subsidiaries. Both companies self-reported the misconduct promptly, and cooperated extensively with the ensuing SEC investigations. The non-prosecution agreements stipulate that the companies are not charged with violations of the *Foreign Corrupt Practices Act* and do not have to pay additional monetary penalties.
- The SEC announced that a foreign company violated U.S. securities laws by selling unregistered bonds to U.S. residents. The company admitted the registration violations and has agreed to pay nearly $6 million in disgorgement and approximately $600,000 in prejudgment interest. The distribution of funds back to investors is subject to the SEC's review and approval.)
- The SEC announced that a financial services company agreed to pay a $1 million penalty to settle the SEC's charges it failed to adopt written policies and procedures reasonably designed to protect customer data. As a result of these failures, from 2011 to 2014, a then-employee impermissibly accessed and transferred the data regarding approximately 730,000 accounts to his personal server, which was ultimately hacked by third parties. The SEC's

order further found that the company violated Rule 30(a) of Regulation S-P, also known as the "Safeguards Rule." The company agree to settle the charges without admitting or denying the findings.

- The SEC announced that a former consultant to two foreign-based private equity firms has agreed to pay more than $700,000 to settle charges relating to insider trading. Without admitting or denying the allegations in the SEC's complaint, the consultant agreed to pay disgorgement of more than $367,000 plus interest as well as a penalty equal to the amount of the disgorged gains. The settlement is subject to court approval.
- The CFTC announced that it has filed a civil enforcement action against three individuals and their companies charging them with fraud, engaging in illegal, off-exchange transactions in precious metals, and acting as futures commission merchants without registering as such with the CFTC, as required. The CFTC's Complaint alleges the defendants fraudulently solicited and received more than $2.7 million from at least 60 customers for the purchase of precious metals on a leveraged, margined, or financed basis, which are illegal off-exchange transactions under the *Dodd-Frank Wall Street Reform and Consumer Protection Act*. In addition, the defendants are charged with employing a deceptive "bait-and-switch" scheme to further defraud their customers. The CFTC seeks disgorgement of ill-gotten gains, civil monetary penalties, restitution for the benefit of customers, permanent registration and trading bans, and a permanent injunction from future violations of the *Commodity Exchange Act*.
- FINRA announced that it has fined a financial services company $2.25 million and ordered the firm to pay restitution of more than $716,000 to affected customers for selling leveraged, inverse and inverse-leveraged exchange-traded funds (non-traditional ETFs) to retail customers without reasonable supervision, and for recommending non-traditional ETFs that were not suitable for certain customers. FINRA also found that the company failed to conduct adequate due diligence regarding the risks and features of non-traditional ETFs and, as a result, did not have a reasonable basis to recommend these ETFs to retail customers. The company neither admitted nor denied the charges, but consented to the entry of FINRA's findings.

Alternative Finance

SEC Approves Expanded Scope of Persons Required to Register as Securities Traders

The Securities and Exchange Commission (SEC) has approved an amendment to NASD Rule 1032(f) that expands the scope of persons required to register with the SEC as a Securities Trader. Beginning January 30, 2017, each associated person who is primarily responsible for the design, development or significant modification of an algorithmic trading strategy relating to equity, preferred or convertible debt securities, or who is responsible for the day-to-day supervision or direction of such activities, must pass the Series 57 exam and register as a Securities Trader. The amendment was announced on June 6, 2016, through Financial Industry Regulatory Authority (FINRA) Regulatory Notice 16-21.
[Press Statement] [Regulatory Notice 16-21]

FFIEC Members Alert Financial Institutions to Risks Related to Interbank Messaging and Wholesale Payment Networks

The members of the Federal Financial Institutions Examination Council (FFIEC) issued a joint statement on June 7, 2016, to remind financial institutions they supervise of the need to actively manage risks associated with interbank messaging and wholesale payment networks. The statement responds to recent cyber attacks on interbank messaging and wholesale payment networks that resulted in large-dollar fraud at several foreign institutions. The agencies note that these attacks have demonstrated a capability to:

- Compromise the financial institution's wholesale payment origination environment and bypass information security controls;

- Obtain and use valid operator credentials to create, approve, and submit messages;
- Employ a sophisticated understanding of funds transfer operations and operational controls;
- Use highly customized malware to disable security logging and reporting, as well as other operational controls, to conceal and delay the detection of fraudulent transactions; and
- Quickly transfer stolen funds across multiple jurisdictions to avoid recovery.

Through the joint statement, the member agencies direct supervised financial institutions to review risk management practices and controls over information technology (IT) and wholesale payment systems networks, including authentication, authorization, fraud detection, and response management systems and processes. They are further directed to take risk mitigation steps, as appropriate, including:

- Conducting ongoing information security risk assessments;
- Performing security monitoring, prevention, and risk mitigation;
- Protecting against unauthorized access;
- Implementing and testing controls around critical systems regularly;
- Managing business continuity risk;
- Enhancing information security awareness and training programs; and
- Participating in industry information-sharing forums. [Joint Statement]

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Central Counterparties

Macroprudential Framework for Central Counterparties Being Developed

Mr. Benoit Coeure, Member of the Executive Board of the European Central Bank highlighted the growing macroprudential policy attention central counterparties (CCPs) are receiving at a speech to the *European Systemic Risk Board Conference on Macoprudential Margins and Haircuts* in Frankfurt Germany on June 6, 2016. He attributes the increased policy attention to the drive toward central clearing, which has made CCPs "key nodes" for propagating risk in the system.

He also outlined the following five elements of the macroprudential approach to CCPs currently being developed and implemented by the Committee on Payments and Market Infrastructures (CPMI) and the International Organization of Securities Commission (IOSCO):

- Establishing a set of criteria to identify CCPs that are systemically relevant in more than one jurisdiction.
- Ensuring that CCPs rigorously apply the Principles for Financial Market Infrastructures (PFMI), published by the CPMI-IOSCO in 2012, and have adopted appropriate arrangements for recovery planning in line with CPMI-IOSCO guidance released in 2014.
- Identifying and mitigating potential procyclical behavior by requiring CCPs to address procyclicality within their risk management frameworks.
- Complementing CCPs' in-house stress testing with a supervisory CCP stress testing framework that can be conducted across jurisdictions.
- Mapping, understanding, and assessing the interdependencies between CCPs and their participants. In particular, he noted that the FSB is currently conducting an exercise to map the interlinked exposures of participating jurisdictions.

The methodology developed through this effort is expected to inform proposals in other areas, such as supervisory stress testing.

Finally, he indicated international policymakers expect to issue additional guidance regarding stress testing, CCP resolution, and quantitative metrics for use in model validation processes to assess potential procyclicality at CCPs. [Speech]

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