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# Safety & Soundness

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## FDIC Proposes to Remove References to Credit Ratings for International Banks

The Federal Deposit Insurance Corporation (FDIC) issued a Notice of Proposed Rulemaking (NPR) on June 21, 2016, seeking comments on proposed amendments to the FDIC's international banking regulations related to permissible investment activities and the pledging of assets. The proposal would apply to insured state nonmember banks that operate foreign branches and insured U.S. branches of foreign banks. In particular, it would:

- Conform the FDIC's international banking regulations with the requirements of Section 939A of the *Dodd-Frank Wall Street Reform and Consumer Protection Act* by removing references to external credit ratings.
- Make amendments to replace references to credit ratings in the definition of "investment grade" with a standard of creditworthiness that has been adopted in other federal regulations to conform with Section 939A.
- Define "investment grade" as a security issued by an entity that has adequate capacity to meet financial commitments for the projected life of the security or exposure. An entity would have adequate capacity to meet financial commitments if its default risk is low, and the full and timely repayment of principal and interest is expected.
- Make amendments requiring assets pledged to the FDIC by insured branches of foreign banks satisfy a liquidity standard and are subject to a fair value discount.
- Add two asset categories to the list of assets eligible for pledging: i) cash, and ii) obligations issued by government-sponsored enterprises. [\[FIL-40-2016\]](#) [\[Notice of Proposed Rulemaking\]](#)

## Financial Stability Oversight Council Releases 2016 Annual Report and Recommendations

On June 21, 2016, the Financial Stability Oversight Council (FSOC) released its 2016 Annual Report to Congress outlining significant financial market and regulatory developments as well as potential emerging threats to the financial stability of the United States. The report also makes recommendations to promote market discipline; maintain investor confidence; and enhance the integrity, efficiency, competitiveness, and stability of U.S. financial markets. The report is organized around the following key themes that the FSOC highlights as warranting continued attention and/or further action from the FSOC members. Highlights of the FSOC recommendations are included as well.

- Cybersecurity: Government agencies and the private sector should continue to work to improve and enhance information sharing, baseline protections such as security controls and network monitoring, and response and recovery planning.
- Risks Associated with Asset Management Products and Activities: The FSOC continues to give consideration to the products and activities in the asset management industry, especially the activities of hedge funds, given the increasing significance of the sector to the stability of the U.S. financial markets and the broader economy.
- Capital, Liquidity, and Resolution: Regulators should continue to work to ensure that financial institutions have sufficient capital and liquidity to reduce systemic risk, including finalizing rules setting standards for the minimum levels of total loss-absorbing capacity and long-term debt maintained by certain large banking organizations operating in the U.S.
- Central Counterparties (CCPs): Member agencies are encouraged to continue to evaluate whether existing rules and standards for CCPs and their clearing members are sufficiently robust to mitigate potential threats to financial stability, and to work with international standard-setting bodies to provide detailed guidance on international risk management standards in order to enhance the safety and soundness of CCPs.
- Wholesale Funding Markets' Reform: Regulators are encouraged to capture better data to assist policymakers in understanding how the aggregate tri-party repurchase agreement (i.e., repo) market operates, as well as to continue to evaluate the effectiveness of structural reforms of money market mutual funds.

- Reforms Relating to Reference Rates: Regulators and market participants should continue their efforts to develop alternative benchmark interest rates and implement plans to achieve a smooth transition to these new rates.
- Data Quality, Collection, and Sharing: Regulators and market participants should continue to work together to improve the scope, quality, and accessibility of financial data.
- Housing Finance Reform: Housing finance reform legislation is needed to create a more sustainable system that enhances financial stability as federal and state regulators are approaching the limits of their ability to enact wholesale reforms likely to “foster a vibrant, resilient housing finance system.”
- Risk Management in an Environment of Low Interest Rates and Rising Asset Price Volatility: Depressed energy and metals commodities prices, large swings in equity valuations, and upward movement in high-yield debt spreads, underscore the need for supervisors to ensure that firms and funds maintain robust risk management standards.
- Changes in Financial Market Structure and Implications for Financial Stability: New vulnerabilities may be introduced by the growing importance in certain markets of propriety trading firms and automated trading systems, including operational risks associated with the very high speed and volume of trading activity. Increased coordination among regulators is needed to evaluate and address these risks.
- FinTech - Financial Innovation and Migration of Activities: Financial regulators are encouraged to be vigilant in monitoring new and rapidly growing financial products as well as “new and untested underwriting models”, even in the nascent stages of those products and practices when they may not constitute a current risk to financial stability. Risks embedded in new products and practices maybe difficult to foresee at the outset.
- Operational Risk/Third Party Service Providers: The FSOC continues to analyze potential financial stability risks associated with “the use of service providers and reliance on technology within the asset management industry.” They identify as a particular focus “the potential for operational disruptions or problems to cause significant losses and disrupt market functioning.”
- Global Economic and Financial Developments: Regulators and market participants are encouraged to be vigilant to potential foreign shocks that could disrupt financial stability in the U.S. [\[Press Release\]](#) [\[2016 FSOC Annual Report\]](#)

## Enterprise & Consumer Compliance

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### CFPB Highlights Technology Failings in Special Edition Report on Mortgage Servicing, and Issues New Mortgage Servicing Examination Procedures

On June 22, 2016, the Consumer Financial Protection Bureau (CFPB or Bureau) released a special edition supervision report focused specifically on mortgage servicers. The report summarizes CFPB supervision work completed between January 2014 and April 2016 and addresses examiner findings that the investments in compliance made by across the servicing marketplace have not been sufficient to ensure compliance. In particular, CFPB examiners found that outdated and deficient technology poses current risks to consumers across a number of mortgage servicers. In addition, several mortgage servicers lack proper training, testing, and auditing of their computer systems and software platforms and those of their service providers. The CFPB states this insufficient investment has resulted in ongoing mortgage servicing problems, especially with regard to loan modification data and loan transfers.

The CFPB also released new mortgage servicing examination procedures featuring greater exam emphasis on:

- Consumer complaints handling, especially with regard to expedited and escalation processes associated with troubled borrowers; and
  - Fair lending compliance, especially with regard to mortgage loan modification approvals.
- [\[Press Release\]](#) [\[Supervisory Mortgage Servicing Report\]](#) [\[Exam Procedures\]](#)

# Insurance

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## IAIS Concludes 9<sup>th</sup> Annual Global Seminar

The International Association of Insurance Supervisors (IAIS) recently concluded its 9<sup>th</sup> Annual IAIS Global Seminar. Discussion topics included global capital standards and the development of an Insurance Capital Standard; the assessment and designation process for global systemically important insurers; selected issues in emerging economies and developing insurance markets; conduct of business supervision; assessment as a first step in implementing Insurance Core Principles; and cyber risk and cyber insurance. [\[Press Statement\]](#)

# Capital Markets and Investment Management

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## FINRA Seeks Rule Change to Include Debt Research Reports in Rule 2210

The Financial Industry Regulatory Authority (FINRA) issued a proposed rule change on June 24, 2016, to clarify the application of FINRA Rule 2210 (*Communications with the Public*) to debt research reports in addition to equity research reports as the result of its new FINRA debt research conflict of interest rule, Rule 2242 (*Debt Research Analysts and Debt Research Reports*). FINRA has requested approval for the proposed rule change to become effective on July 16, 2016, coincident with the effective date for Rule 2242. [\[SR-FINRA-2016-021\]](#)

## FSB Proposes Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities

On June 22, 2016 the Financial Stability Board (FSB) published for public consultation *Proposed Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities*. The document sets out 14 proposed policy recommendations to address the following structural vulnerabilities from asset management activities that could potentially present financial stability risks:

- Liquidity mismatch between fund investments and redemption terms and conditions for fund units;
- Leverage within investment funds;
- Operational risk and challenges in transferring investment mandates in stressed conditions; and
- Securities lending activities of asset managers and funds.

The policy recommendations for liquidity mismatch focus on open-ended funds (public and private, including exchange-traded funds but excluding money market funds), while those for leverage would apply to all types of funds that may use leverage. The FSB is coordinating its efforts with the International Organization of Securities Commissions (IOSCO) and is seeking to finalize the recommendations by year-end 2016. [\[Press Release\]](#) [\[Policy Recommendations\]](#)

## IOSCO Outlines Priorities Regarding Data Gaps in the Asset Management Industry

The International Organization of Securities Commissions (IOSCO) issued a public statement on June 22, 2016, outlining its priorities regarding data gaps in the asset management industry. Based on a review of data currently available to securities regulators, IOSCO recommends that data in the following three areas should be obtained on a priority basis in order to improve the ability of securities regulators to monitor risks across the industry and gain a better understanding of specific industry issues:

- Open-ended regulated Collective Investment Schemes;
- Separately managed accounts; and
- Alternative funds.

IOSCO seeks to encourage members to collect data with a view to deliver improved systemic risk identification. IOSCO will seek to coordinate the enhanced data collection for greater consistency in data collection and better cross-border comparability. IOSCO also encourages use of internationally agreed standards of entity and transaction identifiers.

[\[Press Release\]](#) [\[Statement on Data Gaps\]](#)

## CFTC Seeks Comment on DCO Submissions for Determination of a Clearing Requirement

On June 23, 2016, the Commodity Futures Trading Commission (CFTC) requested public comment on submissions that the agency has received over the last several years from seven registered derivatives clearing organizations (DCOs) regarding swaps that they plan to accept for clearing, pursuant to section 2(h)(2)(B) of the *Commodity Exchange Act* (CEA) and CFTC regulation 39.5(b). In total, the seven DCOs have made 34 submissions, all of which can be viewed on the CFTC Web site. They cover certain interest rate swaps, credit default swaps, foreign exchange non-deliverable forwards, energy swaps, agricultural swaps, and inflation swaps. Comments submitted in response to this request, will inform the CFTC as it considers whether to propose swap clearing requirements pursuant to section 2(h)(2)(D) of the CEA. The comment period will be open until July 25, 2016. [\[Press Release\]](#)

## SEC Announces Initiative Targeting the Customer Protection Rule

The Securities and Exchange Commission (SEC) announced on June 23, 2016 that it would be undertaking a two-part initiative designed to investigate and identify violations of its Customer Protection Rule. The first initiative seeks to encourage broker-dealers to proactively report potential violations of the rule to the SEC and provides for cooperation credit and favorable settlement terms in any enforcement recommendations arising from self-reporting. Under the second initiative, the Enforcement Division, in coordination with the Division of Trading and Markets and the Office of Compliance Inspections and Examinations, will conduct risk-based examinations of certain broker-dealers to assess their compliance with the Customer Protection Rule. The SEC's announcement was made in conjunction with an enforcement action.

## Enforcement Actions

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

- The SEC reached an agreement with a manufacturer and its wholly-owned foreign subsidiary that requires them to pay nearly \$15 million to settle civil and criminal charges related to violations of the *Foreign Corrupt Practices Act* (FCPA). The SEC alleged that the company's foreign subsidiary engaged in hundreds of sham transactions with distributors that funneled approximately \$20 million to third parties, including individuals and shell companies. The manufacturer agreed to pay \$7.67 million in disgorgement and \$3.8 million in prejudgment interest to settle the SEC's charges that it failed to keep accurate books and records and maintain adequate internal accounting controls. The subsidiary agreed to pay a \$3.4 million criminal fine in a non-prosecution agreement with the U.S. Department of Justice.

- The SEC obtained an emergency court order to freeze the assets of a foreign country resident charged with intruding into the online brokerage accounts of U.S. investors to make unauthorized stock trades that allowed him to profit on trades in his own account. The SEC complaint alleges that the individual hacked into numerous accounts of U.S. customers of broker-dealers inside and outside of the U.S. He placed stock trades without the customers' knowledge and then traded in the same stocks through his own brokerage account. According to the complaint, the accused's scheme made profits of at least \$68,000 for himself and caused the victims' accounts to lose at least \$289,000. The individual violated antifraud provisions of federal securities laws and a related SEC antifraud rule. In addition to freezing the individual's assets and prohibiting him from destroying evidence, the SEC is also seeking permanent injunctions, return of allegedly ill-gotten gains with interest, and financial penalties.
- The SEC charged four companies and eight individuals in an \$80 million fraud. The fraud was orchestrated by the CEO of a company, who was charged with disseminating false and misleading offering materials, misappropriating millions of dollars of investor funds, and attempting to manipulate his company's stock. The SEC also charged the company and suspended trading in its securities for 10 business days. The SEC investigation is ongoing, and no financial penalties have been levied so far.
- The SEC charged a financial services firm with making misleading statements in offering materials provided by its parent company to retail investors for structured notes linked to a proprietary volatility index. According to the SEC's order, the offering materials emphasized that the notes were subject to a sales commission and an annual fee, but failed to adequately disclose a fixed and recurring third cost. The SEC's order finds that the firm did not have effective policies and procedures in place to ensure its personnel drafted and approved disclosures that adequately disclosed the impact of this third cost. The SEC found the firm to be in violation of the *Securities Act of 1933*, which prohibits obtaining money or property by means of material misstatements and omissions in the offer or sale of securities. Without admitting or denying the findings, the bank agreed to cease and desist from committing or causing any similar future violations and to pay a penalty of \$10 million. This is the agency's second case involving misleading statements by a seller of structured notes.
- The CFTC announced that a U.S. District Court had granted the CFTC's motion for entry of a final default judgment Order against an individual and three of his companies (the defendants) for engaging in illegal, leveraged, off-exchange precious metals transactions with retail customers and failing to register with the CFTC as Futures Commission Merchants (FCMs). The Order requires the defendants to pay disgorgement and a civil monetary penalty totaling more than \$2.4million and also imposes permanent trading, solicitation, and registration bans against the defendants and prohibits them from violating provisions of the CEA.
- The CFTC obtained a Default Judgment Order and Permanent Injunction against three related foreign individuals in connection with a commodity pool fraud. The individuals were charged with fraudulently soliciting funds from investors in the U.S. and Canada to trade in commodity futures and other products on their behalf; the funds were either misappropriated or lost in trading. The Order requires the defendants to pay more than \$3.2 Million in restitution, disgorgement, and civil monetary penalties and also permanently bans the individuals from trading or registering with the CFTC.
- The CFTC obtained a Default Final Judgment Order against an individual and two of his companies (the defendants) for defrauding clients in connection with the operation of a commodity trading pool. The Court Order requires the defendants to more than \$2.7 million in restitution and monetary penalties for their involvement in the commodity pool fraud and other violations of the *Commodity Exchange Act* (CEA). The Order required the defendants to disgorge ill-gotten funds and permanently enjoined them from engaging in any commodity-related activity and from registering with the CFTC.
- The SEC announced an agreement with a financial services firm to address the SEC's findings the firm misused customer cash to generate profits for its own account and failed to safeguard customers' securities from the claims of its creditors. In particular, an SEC investigation found that the firm violated the SEC's Customer Protection Rule by engaging in complex options trades "that lacked economic substance and artificially reduced the required deposit of customer cash in the reserve account." The firm used the customer cash that should have been deposited into a reserve account to finance its own trading activities. In addition, the SEC found the firm further violated the Customer Protection Rule by failing to adhere to requirements that fully-paid for customer securities be held in lien-free accounts and shielded from claims by third parties should a firm collapse. The firm agreed to pay \$415 million to settle charges. The SEC also announced a litigated administrative proceeding against the firm's Head of Regulatory

Reporting, whom the SEC alleges is ultimately responsible for determining how much money the firm would reserve in its special account, and failed to adequately monitor the trades and provide specific information to the firm's regulators about the substance and mechanics of the trades.

In conjunction with this case, the SEC announced a two-part initiative designed to investigate further and identify additional violations of the Customer Protection Rule. The first initiative seeks to encourage broker-dealers to proactively report potential violations of the rule to the SEC and provides for cooperation credit and favorable settlement terms in any enforcement recommendations arising from self-reporting. Under the second initiative, the Enforcement Division, in coordination with the Division of Trading and Markets and the Office of Compliance Inspections and Examinations, will conduct risk-based examinations of certain broker-dealers to assess their compliance with the Customer Protection Rule.

## Alternative Finance

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### Financial Stability Oversight Council Identifies Financial Innovation and the Migration of Activities Among the Potential Emerging Threats and Vulnerabilities

In its 2016 Annual Report to Congress, the Financial Stability Oversight Council (FSOC) identified financial innovation and the migration of activities as a potential emerging threat to the financial stability of the United States. The FSOC acknowledged that innovation is critical to the long-term health of the U.S. financial system, but added that “precisely because innovations are new and potentially disruptive, they merit special attention from financial regulators who must be vigilant to ensure that new products and practices do not blunt the effectiveness of existing regulations or pose unanticipated risks to markets or institutions.” It suggests that risks embedded in new products and practices may be difficult to foresee and encourages financial regulators to monitor and evaluate the implications of whether or how new products and practices could pose risks to financial stability. In addition, the FSOC recommends that policies to protect consumers should be reviewed on an ongoing basis to assess the appropriate treatment of new products. Marketplace lending, facilitated by online platforms which automate underwriting processes, and distributed ledger systems, facilitated by advances in cryptology and data processing logorithms, were highlighted as innovations poised for substantial near-term growth. [\[FSOC Annual Report\]](#)

## Brexit

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### FSOC Responds to UK Referendum to Exit European Union

On June 24, 2016, the Financial Stability Oversight Council (FSOC) met to discuss the United Kingdom referendum on membership in the European Union. FSOC members provided updates on financial market developments and concluded that the U.S. financial system is functioning in an orderly manner, and that the FSOC would continue to monitor the ongoing developments. [\[Press Release\]](#)

## G7 Ministers and Central Bank Governors Issue Statement on UK Referendum

The G7 Ministers and Central Bank Governors issued a statement on June 24, 2016, with respect to the United Kingdom referendum to exit from the European Union. The group stated that it respects the referendum outcome and is monitoring market developments following the outcome of the referendum. It affirmed its confidence in the resilience of the UK economy and financial sector as well as the ability of the UK authorities to address market consequences resulting from the referendum. The group recognized that excessive volatility and disorderly movements in exchange rates can have adverse implications for economic and financial stability and noted that, accordingly, the G7 central banks have taken steps to ensure adequate liquidity to support the functioning of markets. [\[Press Release\]](#)



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This is a publication of KPMG's Financial Services Regulatory Risk Practice and KPMG's Americas FS Regulatory Center of Excellence

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