The Washington Report

Americas FS Regulatory Center of Excellence

The week ended December 16, 2016

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1. Safety and soundness

1.1 Agencies finalize rules to establish an 18-month examination cycle for certain smaller institutions

On December 12, 2016, the Federal Deposit Insurance Corporation (FDIC), the Federal Reserve Board (Federal Reserve), and the Office of the Comptroller of the Currency (OCC) issued joint interagency final rules that adopt as final and without change the agencies' interim final rules issued in February 2016 that increase the asset size threshold for small banks and savings associations to qualify for an 18-month examination cycle. As finalized, well-capitalized and well-managed banks and savings associations with less than $1 billion in total assets will generally be eligible for an 18-month examination cycle. In addition, U.S. branches and agencies of foreign banks with less than $1 billion in total assets that have received a composite ROCA rating of "1" or "2" will also be eligible for the extended examination cycle. The final rules implement provisions of the Fixing America's Surface Transportation Act (FAST Act), which permits the agencies to conduct a full-scope, on-site examination of qualifying insured depository institutions with less than $1 billion in total assets once in 18-months. The final rules will become effective in 30 days after publication in the Federal Register. The interim final rules will remain in effect until that time.

[Joint Press Statement] [Interagency Final Rules]

1.2 Federal Reserve finalizes TLAC rule

On December 15, 2016, the Federal Reserve Board (Federal Reserve) adopted a final rule that requires certain large banking organizations to meet a new long-term debt and "total loss-absorbing capacity" (TLAC) requirement.

The final rule applies to U.S. top-tier bank holding companies identified under the Federal Reserve's rules as a global systemically important bank holding company (G-SIB) as well as to the top-tier U.S. intermediate holding company of a global systemically important foreign banking organization with $50 billion or more in U.S. non-branch assets.

The final rule also requires the parent holding company of a domestic G-SIB to avoid entering into certain financial arrangements that would create obstacles to an orderly resolution. These "clean holding company" requirements include measures such as bans on the issuance of short-term debt to external investors and bans on entering into derivatives and certain other types of financial contracts with external counterparties.

The final rule incorporates a number of notable changes from the proposed rule issued in October 2015. These changes include:

- Permission for long-term debt issued on or before December 31, 2016 to count toward a firm's long-term debt requirement even if the debt has certain contractual clauses not allowed by the final rule. Debt issued after December 31, 2016 will be required to fully comply with the rule to count toward the long-term debt requirements;
- Permission for the U.S. operations of certain foreign firms to issue long-term debt to external parties in addition to the requirements to issue long-term debt to their parent companies; and
- A reduction in the long-term debt requirements of foreign banks to be consistent with the treatment of domestic banks.

Compliance with the final rule will be required by January 1, 2019. [Press Statement] [Final Rule]

1.3 FSB seeks comment on guidance addressing resolution standards

On December 16, 2016, the Financial Stability Board (FSB) issued two proposals seeking input on the implementation of its resolution standards:

- *Consultation on guiding principles on the internal Total Loss-Absorbing Capacity of G-SIBs*: The TLAC standard published by the FSB in November 2015, defines a minimum requirement with respect to certain debt instruments that should be held by global systemically important banks (G-SIBs). A part of the TLAC standard also requires a certain amount of those loss-absorbing resources to be committed to subsidiaries or sub-groups that are located in host jurisdictions and deemed material for the resolution of the G-SIB as a whole, commonly referred to as the internal TLAC requirement. The consultative document proposes a set of guiding principles to support the implementation of the internal TLAC requirement by home and host authorities, covering in particular:
  - The process for identifying material sub-groups;
  - Considerations relating to the determination of the size of the internal TLAC requirement, its composition and the trigger mechanism; and
  - Cooperation and coordination between G-SIB home and key host authorities.

- *Consultation on guidance on continuity of access to Financial Market Infrastructures (FMIs) for a firm in resolution*: A key objective of resolution planning is to ensure the continuity of a firm's critical functions while in resolution. The proposed guidance seeks to address the risk of a bank in resolution being unable to access the clearing, payment, settlement and custody services provided by FMIs that are necessary for the firm to maintain its critical functions in resolution. This guidance builds on a section of the FSB's Key Attributes of Effective Resolution Regimes for Financial Institutions, which deals with the resolution of FMI participants, and sets out arrangements to support continuity of access to FMIs for a firm in resolution that apply at the level of the providers of FMI services; FMI participants; and relevant resolution and FMI authorities.

The FSB's consultation papers are expected to provide valuable guidance to authorities as they implement TLAC in their respective jurisdictions.

[Press Statement] [Guiding Principles on the Internal TLAC] [Guidance on Continuity of Access to FMIs in Resolution]

1.4 OFR publishes report on Financial Stability

On December 13, 2016, the Office of Financial Research (OFR) issued its 2016 Financial Stability Report, providing an in-depth analysis and assessment of the potential threats to financial stability in the U.S.

The OFR report is divided into two chapters. The first chapter provides an assessment of financial stability risks under five risk categories: macroeconomic, market, credit, funding and liquidity, and contagion. The second chapter provides an analysis of seven key threats facing the financial system, which were selected for analysis based on their potential impact; the probability of their occurrence; their immediacy; and the preparedness of policymakers, regulators, and market participants to mitigate them. The key threats include: i) potential spillovers from Europe; ii) credit risks in U.S. non-financial corporations; iii) cybersecurity incidents; iv) central counterparties as contagion channels; v) pressure on U.S. life insurance companies; vi) systemic footprints of the largest U.S. banks; vii) and deficiencies in data and data management.

The OFR also reports that there are four themes, or vulnerabilities, that have been central to its monitoring efforts over the past 12 months and are woven throughout the report: i) the potential for disruptions in the global economy to affect U.S. financial stability; ii) risk-taking amid low long-term interest rates; iii) risks facing U.S. financial institutions; and iv) challenges to improving financial data.

Finally, the report notes that resilience of the U.S. financial system has continued to improve over the last year though new threats from global disruptions and financial system evolution have emerged. It concludes that financial stability risks in the U.S. remain at a medium range.

[Press Statement] [2016 Financial Stability Report]

1.5 Agencies announce determination for resolution plans resubmitted by five SIFIs

In April 2016, the Federal Reserve Board (Federal Reserve) and the Federal Deposit Insurance Corporation (FDIC) jointly determined that the 2015 resolution plans submitted by five systemically important financial institutions (SIFIs) were not credible enough to facilitate an orderly resolution under the U.S. Bankruptcy Code. At that time, the agencies jointly issued notices of deficiency to each of the five banking organizations detailing the specific deficiencies in their plans and the actions to be taken to address them. Each firm was required to remedy its deficiencies by October 1, 2016, or risk being subject to more stringent prudential requirements or to restrictions on activities, growth, or operations. All of the five SIFIs resubmitted their 2015 resolution plans by the October deadline.

On December 13, 2016, the Federal Reserve and the FDIC announced that four of the five firms had adequately remediated deficiencies in their 2015 resolution plans. The agencies determined that the fifth banking organization did not adequately remedy all of its deficiencies, particularly with regard to "legal entity rationalization," "shared services," and "governance." The agencies have now jointly imposed restrictions on that firm and its subsidiaries, prohibiting them from establishing international bank entities or acquiring any non-bank subsidiary. The banking organization is expected to file a revised submission addressing the remaining deficiencies by March 31, 2017. In the event the deficiencies are not remedied then, the agencies will limit the size of the firm's non-bank and broker-dealer assets. Failure to adequately remedy the deficiencies after two years would result in required divestiture of certain assets or operations to facilitate an orderly resolution of the firm in bankruptcy. [Press Statement]

1.6 OCC releases results of third-party review to enhance large and midsize institutions

On December 13, 2016, the Office of the Comptroller of the Currency (OCC) released the results of a third-party review of its efforts to enhance the supervision of large and midsize national banks and federal savings associations. The original review was conducted in 2013 as part of an International Peer Review. It was conducted by senior regulators from Australia, Canada, and Singapore along with former staff of the International Monetary Fund. The OCC invited the same team of international regulators to assess the OCC's implementation of their recommendations, particularly with regard to the agency's approach to supervising large and midsize institutions. The overarching conclusion of the second review team was that large and midsize bank supervision at the OCC is more effective now than it was three years ago. The report noted that the agency had completed implementation of most of the recommendations and had made progress on all of them. Some of the key improvements made by the OCC as noted by the review team were:

- Strengthening the role and resources of the lead experts that expand the horizontal and system wide view of the federal banking system;
- Enhancing the National Risk Committee process by establishing new committees and processes to identify and mitigate systemic risk more effectively;
- Enhancing the staffing and human resource strategies, including providing more career development opportunities for staff;
- Developing a risk appetite statement and establishing an Enterprise Risk Management function headed by a Chief Risk Officer;
- Making improvements to the process for issuing and tracking matters requiring attention; and
- Strengthening the enterprise-wide quality assurance program

[Press Statement] [2016 Analysis of Implementation of 2013 OCC Bank Supervision Peer Review Project]

2. Enterprise and consumer compliance

2.1 FHHA finalizes "Duty to Serve" rule for Fannie Mae and Freddie Mac

On December 13, 2016, the Federal Housing Finance Agency (FHFA) issued a final rule implementing the "Duty to Serve" provisions mandated by the Federal Housing Enterprises Financial Safety and Soundness Act of 1992, as amended by the Housing and Economic Recovery Act of 2008 (the ACT). The ACT requires Fannie Mae and Freddie Mac to serve three specified underserved markets— manufactured housing, affordable housing preservation, and rural housing—by improving the availability of mortgage financing for residential properties that serve very low to moderate income families.

The final rule establishes procedures for Fannie Mae and Freddie Mac to follow in setting-up of a three-year "Underserved Markets Plan" and submitting it to the FHFA. The FHFA will then annually evaluate, rate, and report to the Congress on each entity's compliance with its Duty to Serve obligations. The final rule establishes a three-part evaluation and rating framework for the FHFA to follow: 1) a quantitative assessment; 2) a qualitative assessment; and 3) an assessment of extra-credit eligible activities, including those that promote residential economic diversity. The Plans will become effective January 2018.

The FHFA is expected to publish the following documents for public input in 2017, to support implementation of the final rule:

- FHFA's proposed evaluation guidance;
- Request for Input on what each institute should consider or include in a potential manufactured housing chattel pilot program; and
- Each institute's proposed Duty to Serve Underserved Markets Plan.

Additionally, the FHFA, in coordination with Fannie Mae and Freddie Mac, will host public hearing sessions to obtain stakeholder input on the Underserved Markets Plans. The final rule will become effective 30 days after publication in the Federal Register. [Press Statement] [Final Rule]

2.2 CFPB director of fair lending outlines areas of focus; CFPB issues semi-annual report to Congress

Patrice Ficklin, Director of the Consumer Financial Protection Bureau's (CFPB or Bureau) Office of Fair Lending, stated that the CFPB would be increasing its fair lending focus in the following areas:

- Redlining – continuing to evaluate whether lenders have intentionally avoided lending in minority neighborhoods;
- Mortgage and Student Loan Servicing – determining whether some borrowers who are behind on their mortgage or student loan payments may have more difficulty working out a new solution with the servicer because of their race or ethnicity; and
- Small Business Lending – responding to a requirement by Congress to ensure that women-owned and minority-owned businesses do not experience discrimination when they apply for credit.

Ms Fickin's remarks were included in a December 16, 2016 blog post on the CFPB's Web site. [blog post]

Also on December 16, 2016, the CFPB publicly released its Semi-Annual Report to Congress outlining its efforts to carry out its mission to protect consumers from financial harm during the six-month period between April and October 2016. The report covers, among other areas, supervisory and enforcement actions, regulations and guidance, and fair lending.

[CFPB Semi-Annual Report Fall 2016]

2.3 CFPB issues annual report to Congress on Student Banking and related Compliance Bulletin addressing credit card agreements

The Consumer Financial Protection Bureau (CFPB or Bureau) released its annual report to Congress on Student Banking on December 16, 2016. In the report, the Bureau raises concern that many students are subject to costly fees and risky account features attached to certain college-sponsored accounts. In particular, the Bureau's analysis of approximately 500 marketing agreements for prepaid and debit card accounts between colleges and financial institutions found that, despite new student protections and the availability of safer and more affordable accounts, some colleges and universities continue to maintain agreements with financial institutions that allow for the marketing of products that may not be in the best financial interests of their students and that contain costly features (such as no limits on account fees, including overdraft fees, out-of-network ATM fees, or other common charges).

The Student Banking report also examines trends in the school-sponsored credit card market. The Bureau states that this market is in decline and marked by a shift from credit card agreements to college-sponsored checking and prepaid accounts. The Bureau has issued Compliance Bulletin 2016-04 to remind colleges and universities that they are required to publicly disclose marketing agreements with credit card companies and to outline options for disclosing this information. The CFPB warns that any such marketing agreements with credit card issuers must be disclosed publicly without delay.

[Student Banking Report] [CFPB Bulletin 2016-04]

3. Capital markets and investment management

3.1 FINRA proposes rule change to align standard settlement cycle with SEC proposed rule and industry initiative

On December 14, 2016, the Financial Industry Regulatory Authority (FINRA) filed a proposed rule change with the Securities and Exchange Commission (SEC) to amend certain FINRA Rules in order to shorten the standard settlement cycle for most broker-dealer transactions from three business days after the trade date (T+3) to two business days after the trade date (T+2). This is in line with the industry-led initiative to shorten the settlement cycle from T+3 to T+2. The shorter settlement cycle is expected to reduce the risks that arise from the value and number of unsettled securities transactions prior to the completion of settlement, including credit, market, and liquidity risks faced by market participants. If the SEC approves the proposed rule change, FINRA will announce the effective date of the rule change through a Regulatory Notice. Such date will correspond with the industry-led transition to a T+2 standard settlement cycle and the effective date of the SEC's proposed amendment to SEA Rule 15c6-1(a) to require a T+2 settlement.

[Press Statement]

3.2 IOSCO issues guidance on the consistency and quality of reporting on compliance with the Principles for Financial Benchmarks

The Board of the International Organization of Securities Commissions (IOSCO) issued guidance on December 16, 2016, seeking to increase the consistency and quality of reporting by Benchmark Administrators on their compliance with the IOSCO Principles for Financial Benchmarks, which were published in July 2013. The "Guidance on Statements of Compliance with the IOSCO Principles for Financial Benchmarks" sets out expectations about the level of detail that should be included in these statements for the purpose of enabling market authorities, users of benchmarks, and other market participants and stakeholders to understand the extent to which an administrator has implemented the Principles. [Press Statement] [Guidance]

3.3 Enforcement Actions

The Securities and Exchange Commission (SEC) and the Financial Regulatory Authority (FINRA) announced the following enforcement actions in the past week:

— The SEC charged two traders with manipulating more than 2,000 NYSE and NASDAQ traded stocks and reaping more than $26 million in profits from these trades. The two traders allegedly used multiple accounts at various brokerage firms to carry out their scheme and engaged in a series of manipulative trading activities. The traders were charged with violating and abetting violations of the antifraud provisions of securities laws. The SEC investigation is ongoing, and the agency is seeking the imposition of a permanent injunction, return of ill-gotten gains with interest, and penalties to settle charges. In a parallel action, the U.S. Attorney's Office for the District of New Jersey announced criminal charges against the traders.

- The SEC barred several market participants from the penny stock industry for their roles in false initial public offerings (IPOs) of microcap stocks that defrauded investors. The defendants agreed to settle charges without admitting or denying the SEC's findings and to pay financial penalties totaling $321,000.

  Concurrent with the announcement of the enforcement action, the SEC released a Whitepaper prepared by its Division of Economic and Risk Analysis outlining some of the consequences of investing in stocks quoted in the microcap markets compared to those listed on a national securities exchange. The Whitepaper also reports on recent trends in the microcap markets and synthesizes academic research on the documented risks of investing in these stocks. After analyzing 1.8 million trades by more than 200,000 individual investors, the staff determined that individual investor returns in the microcap markets tend to be negative, with returns worsening for penny stocks of less transparent companies and those that have experienced an alleged promotional campaign. Demographic analysis revealed that older, retired, low-income, and less-educated investors experience significantly poorer outcomes in microcap stock markets. [Whitepaper]

- The SEC announced that it had entered into a consent agreement with a bank for allegedly misleading clients about the performance of its automated order router that sent client orders to dark pools. A dark pool refers to private exchanges or forums for trading securities. Unlike stock exchanges, dark pools are not accessible by the investing public. According to SEC investigation, the bank claimed to be using ongoing data analysis to rank the dark pools best suited for customer orders when its system failed to actually do this analysis. Automated strategies for routing customer orders are a critical element of the market, and customers must be informed if a routing program fails to function properly, relies on stale data, or routes orders contrary to the described methodology. In misleading customers, the bank was found to have violated Section 17(a)(2) of the Securities Act and Rule 301(b)(2) of the SEC's Regulation ATS. Along with the SEC, a parallel action was undertaken by the New York Attorney General's office. The bank agreed to admit wrongdoing in the case and to pay the SEC and NYAG each a penalty of $18.5 million.

- FINRA announced that it had entered into an agreement with a bank for failing to provide consistent information pertaining to its Alternative Trading System (ATS) and related services and features to all of its clients. The SEC's Regulation ATS requires ATS operators to disclose certain information to the SEC by filing a Form ATS. In line with Regulation ATS, the bank was required to provide all of its ATS users with identical access to all services and features offered by the ATS. A FINRA investigation revealed that the bank had failed to timely or completely disclose to all of its users the availability of certain ATS services and features. The bank neither admitted nor denied FINRA's charges but consented to the entry of FINRA's findings, and agreed to pay a fine of $3.25 million to settle charges.

Contact us

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

Amy Matsuo, Principal, National Leader, Financial Services Regulatory Risk Practice amatsuo@kpmg.com

Ken Albertazzi, Partner and National Lead, Financial Services Safety & Soundness kalbertazzi@kpmg.com

Kari Greathouse, Principal and National Lead, Enterprise and Consumer Compliance cgreathouse@kpmg.com

Tracy Whille, Principal and National Lead, Capital Markets and Investment Management twhille@kpmg.com

Deborah Bailey, Managing Director, Americas FS Regulatory Center of Excellence dpbailey@kpmg.com

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Additional Contacts

Asset Management, Trust, and Fiduciary
Bill Canellis wcanellis@kpmg.com

Bank Regulatory Reporting
Brett Wright bawright@kpmg.com

Capital Markets Regulation
Stefan Cooper stefancooper@kpmg.com

Capital/Basel II and III
Paul Cardon pcardon@kpmg.com

Commodities and Futures Regulation
Dan McIsaac dmcisaac@kpmg.com

Consumer & Enterprise Compliance
Stacey Guardino sguardino@kpmg.com

Cross-Border Regulation & Foreign Banking Organizations
Paul Cardon pcardon@kpmg.com

Financial Crimes
Terry Pesce tpesce@kpmg.com

Insurance Regulation
Matthew McCorry memccorry@kpmg.com

Investment Management
Larry Godin lgodin@kpmg.com

Safety & Soundness, Corporate Licensing & Governance, and ERM Regulation
Greg Matthews gmatthews1@kpmg.com

FS Regulatory Center of Excellence
Karen Staines kstaines@kpmg.com

kpmg.com/socialmedia

kpmg.com/app