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Contents

1. Safety and soundness

1.1 BCBS releases final standard for regulatory capital treatment of TLAC instruments

On October 12, 2016, the Basel Committee on Banking Supervision (BCBS) published its final standard on the regulatory capital treatment of bank investments in total loss-absorbing capacity (TLAC) and pari passu instruments. The final standard applies to both global systemically important banks (G-SIBs) and non-G-SIBs. Key features of the standards include a:

- Tier 2 deduction - Banks must deduct holdings of TLAC instruments that do not otherwise qualify as regulatory capital, and instruments ranking pari passu with subordinated forms of TLAC, from their own Tier 2 capital; and
- Threshold below which no deduction is required - The Tier 2 capital deduction is subject to the thresholds that apply to existing holdings of regulatory capital and an additional 5 percent threshold for non-regulatory-capital TLAC holdings only. For G-SIBs to be eligible for the additional 5 percent threshold, the TLAC holdings must meet certain additional conditions, including being held in the trading book.

The final standard also reflects changes to Basel III specifying how G-SIBs must account for their TLAC requirement when calculating regulatory capital buffers.

The BCBS standard will take effect on January 1, 2019, along with the minimum TLAC requirements set out by the Financial Stability Board for G-SIBs.
[Press Statement] [TLAC Holding Standards]

1.2 BCBS releases consultative document and discussion paper on regulatory treatment of accounting provisions for credit losses

On October 11, 2016, the Basel Committee on Banking Supervision (BCBS) released a consultative document on the regulatory treatment of accounting provisions for credit losses under the Basel III regulatory capital framework.

The document responds to recently finalized accounting standards adopted by the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB), which require the use of expected credit loss (ECL) models rather than incurred loss models. ECL models incorporate forward-looking assessments into the estimation of credit losses. The IASB standards become effective January 1, 2018, while the FASB standard will take effect on January 1, 2020 for certain banks that are public companies and in 2021 for all other banks. Early application will be permitted for all banks in 2019.

In the consultative document, the BCBS proposes to retain, for an interim period, the current regulatory treatment of provisions under the standardized and internal ratings-based approaches. In addition, the BCBS is seeking comment on whether any transitional arrangement is warranted to allow banks time to adjust to the new ECL accounting standards. Possible transitional arrangements are outlined in the proposal.

Concurrent with the release of the consultative document, the BCBS also released a discussion paper setting out policy options for the long-term regulatory treatment of provisioning when the new ECL standards become applicable. Policy options under consideration include: i) retaining the current regulatory treatment of provisions; ii) retaining the distinction between general provisions (GP) and specific provisions (SP) for regulatory purposes based on definitions that would produce universally aligned categorizations of ECL provisions as GP or SP across jurisdictions; iii) introducing a standardized regulatory expected loss component to the standardized approach for credit risk; or iv) pursuing another alternative.

The BCBS will accept comments on the consultative document and the discussion paper through January 13, 2017.
[Press Statement] [Consultative Document] [Discussion Paper]

1.3 G-7 countries publish fundamental elements of cybersecurity for the financial sector

The finance ministers and central bank governors of the Group of Seven (G-7) countries released a publication on October 11, 2016, regarding "Fundamental Elements of Cybersecurity for the Financial Sector." The publication sets out eight elements to serve as the building blocks for designing and implementing a cybersecurity strategy and operational framework. The elements also provide steps for re-evaluating the strategy and framework as the operational and threat framework evolve.

The fundamental elements include:

- Cybersecurity Strategy and Framework;
- Governance;
- Risk and Control Assessment;
- Monitoring;
- Response;
- Recovery;
- Information Sharing; and
- Continuous Learning.

The G-7 countries state the guidance document is non-binding but anticipate that private and public entities in the financial sector will tailor the elements to their specific operational and threat landscape, role in the sector, and legal and regulatory requirements. The G-7 also expects that the elements can be used by public authorities, including finance ministries, central banks, and regulators within and across jurisdictions to guide their public policy, regulatory, and supervisory efforts.

The G-7 comprises Britain, Canada, France, Germany, Italy, Japan and the United States. [Press Statement] [G-7 Fundamental Elements of Cybersecurity for the Financial Sector]

2. Enterprise and consumer compliance

2.1 Enforcement action

The Consumer Financial Protection Bureau (CFPB or Bureau) entered into a consent order with a federal credit union to address the CFPB's allegations the credit union engaged in unfair and deceptive debt collection practices in violation of the Consumer Financial Protection Act. The CFPB alleges the credit union made false threats about debt collection to its members, which included active-duty military, retired servicemembers, and their families, and placed unfair restrictions on account access when members' loans became delinquent. Without admitting or denying the charges, the credit union agreed to pay approximately $23 million in redress to harmed consumers and a civil money penalty of $5.5 million.

2.2 Circuit Court decision requires CFPB to operate as an executive agency

The U.S. Court of Appeals for the District of Columbia Circuit (Court) issued a ruling on October 11, 2016, finding that the Consumer Financial Protection Bureau (CFPB or Bureau) is "unconstitutionally structured." The Court, however, is allowing the CFPB to continue operations but is requiring it to do so as an executive agency under the supervision and direction of the President. The President now has the power to remove the CFPB Director at will.

The ruling is made in conjunction with a case brought by a mortgage lender challenging a CFPB's enforcement action alleging the mortgage lender illegally referred consumers to mortgage insurers in exchange for kickbacks. The enforcement action resulted in a $109 million order against the company. In seeking to vacate the order, the mortgage lender challenged the constitutionality of the CFPB's status as an independent agency headed by a single Director.

The Court's ruling also vacated the CFPB's order against the mortgage lender. The Court agreed with the mortgage lender's assertion that Section 8 of the Real Estate Settlement Procedures Act (RESPA) allows captive reinsurance arrangements so long as the amount paid by the mortgage insurer for the reinsurance does not exceed the reasonable market value of the reinsurance. In addition, the Court agreed that the three-year statute of limitations that has traditionally applied to agency actions enforcing Section 8 will continue to apply.

2.3 NYDFS issues guidance on incentive compensation arrangements

The New York Department of Financial Services (NYDFS) issued new guidance on October 11, 2016, regarding incentive compensation arrangements. The guidance states that no incentive compensation may be tied to employee performance indicators, such as the number of accounts opened or the number of products sold per customer, without effective risk management, oversight, and control. In addition, incentive compensation arrangements must, at a minimum, meet the following principles:

- <u>Balance between risks and rewards</u>: Risk and financial results must be balanced in a manner that does not encourage employees to expose their organizations to imprudent risks;
- <u>Effective risk management and controls</u>: Risk management processes and internal controls must reinforce and support the development and maintenance of any incentive compensation arrangements: and
- <u>Effective corporate governance</u>: Incentive compensation arrangements must be supported by strong corporate governance, including active and effective oversight by the organization's board of directors.

The guidance applies to state-regulated institutions, including banks, savings banks, bank holding companies, credit unions, and branches and agencies of foreign banks (Banking Institutions). The NYDFS will conduct supervisory reviews of incentive compensation arrangements during its regular risk focused examination process, including the review of processes in place to identify and deter misconduct, participation of frontline business units, effective risk management and internal audit, and effective oversight of the board of directors. Banking Institutions are expected to maintain records that document the structure and approval process of their incentive compensation arrangements, as well as the related risk management and oversight of such arrangements.

Incentive compensation arrangements found to be misaligned and corporate or individual conduct that results in consumer harm or other unsafe and unsound practices may be subject to supervisory actions. [NYDFS Guidance]

3. Capital markets and investment management

3.1 CFTC issues proposed rule to apply swap provisions to cross-border transactions

On October 11, 2016, the Commodity Futures Trading Commission (CFTC) issued a proposed rule that addresses the application of certain swap provisions of the Commodity Exchange Act (CEA) and the CFTC's regulations to cross-border transactions. Specifically, the proposed rule would define key terms for the purpose of applying the CEA's swap provisions to cross-border transactions and address the application of registration thresholds and external business conduct standards for swap dealers and major swap participants, including the extent to which they would apply to swap transactions that are arranged, negotiated, or executed using personnel located in the United States (ANE transactions). The proposed rule would also provide an interpretation of the types of activities that classify as ANE transactions.

As proposed, a "U.S. person" would include those individuals or entities whose activities have a significant nexus to the U.S. market by virtue of their organization or domicile in the United States. A "Foreign Consolidated Subsidiary" (FCS) would identify a non-U.S. person that is consolidated for accounting purposes with an ultimate parent entity that is a U.S. person.

Key requirements of the proposed rule include:

- Registration thresholds: A U.S. person would be required to consider and count all swap dealing transactions, irrespective of the counterparty. A non-U.S. person that is an FCS, or whose swap transactions are guaranteed by a U.S. person, would be required to do the same. Other non-U.S. persons would be required to count swap dealing transactions with U.S. persons and with non-U.S. persons that are FCSs or whose swap transactions are guaranteed by a U.S. person, unless the swap is executed anonymously on a registered platform and cleared. A similar counting framework would apply to major swap participant registration thresholds.
- External business conduct (EBC) standards: U.S. swap dealers (except their foreign branches) would be required to comply with applicable EBC standards. Non-U.S. swap dealers and foreign branches of U.S. swap dealers would be required to comply with applicable EBC standards only for their transactions with a U.S. person counterparty (that is, not a foreign branch of a U.S. entity), except that certain EBC standards prohibiting fraud, manipulation, or other abusive conduct would apply to ANE transactions.

The CFTC is expected to address the cross-border application of other swap requirements, including their application to ANE transactions, in subsequent rulemakings. Comments on the proposed rule will be accepted for sixty days following publication in the Federal Register.
[Press Statement] [Factsheet] [Proposed Rule]

3.2 CFTC issues Order extending the phase-in termination date for the swap dealer de minimis threshold until December 31, 2018

On October 13, 2016, the Commodity Futures Trading Commission (CFTC) issued an Order establishing December 31, 2018 as the termination date for the phase-in period of the swap dealer registration de minimis threshold. With this order, the de minimis threshold will remain at $8 billion until December 18, 2018. Absent further action by the CFTC, the de minimis threshold will change to $3 billion after that date.

The CFTC's definition of a "swap dealer" provides that a person shall not be deemed to be a swap dealer unless its swap dealing activity exceeds an aggregate gross notional amount threshold of $3 billion (measured over the prior 12-month period), subject to a phase-in period during which the gross notional amount threshold is set at $8 billion. The phase-in period was set to terminate on December 31, 2017, which would have required firms to start tracking their swap activity beginning January 1, 2017.

The CFTC notes that it has not yet adopted a regulation on capital requirements for swap dealers, which is a significant component of swap dealer registration. The agency believes that it would be more prudent to finalize the capital rule before addressing the de minimis threshold. The one year delay would allow the CFTC to finalize the swap dealer capital rule and assess the implementation of margin requirements for uncleared swaps. [Press Statement] [CFTC Order]

3.3 SEC adopts rules modifying reporting by funds, requiring liquidity risk management programs, and permitting swing pricing

On October 13, 2016, the Securities and Exchange Commission (SEC) adopted new rules to: i) modernize and enhance the reporting and disclosure of information by registered investment companies; and ii) enhance liquidity risk management by open-end funds, including mutual funds and exchange-traded funds (ETFs).

The new rules form a part of the SEC's initiative to enhance the monitoring and regulation of the asset management industry. The final rules include:

- New reporting rules, which will require mutual funds, ETFs and other registered investment companies other than money market funds to provide portfolio-wide and position-level holdings data to the SEC in a new monthly portfolio reporting form (Form N-PORT). The rules also require registered funds to report certain census-type information on a new annual reporting form (Form N-CEN). In addition, funds will be required to make enhanced and standardized disclosures in financial statements and add new disclosures in fund registration statements with respect to a fund's securities lending activities. Most funds will be required to begin filing new Form N-PORT and Form N-CEN after June 1, 2018. Fund complexes with less than a $1 billion in net assets will be required to begin filing reports on Form N-PORT after June 1, 2019.
- Liquidity risk management rules, which will require mutual funds and ETFs to establish liquidity risk management programs that address multiple elements, including classification of the liquidity of fund portfolio investments and a highly liquid investment minimum. The rules also strengthen the 15 percent limit on illiquid investments and require enhanced disclosure regarding fund liquidity and redemption practices. A new form, Form N-LIQUID, would be used to notify the SEC when a fund's level of illiquid assets exceeds 15 percent of its net assets or when its highly liquid investments fall below its minimum. Most funds will be required to comply with the liquidity risk management program requirements on December 1, 2018. Fund complexes with less than a $1 billion in net assets would be required to do so on June 1, 2019.
- A swing pricing rule, which will permit mutual funds to use swing pricing – the process of adjusting a fund's net asset value to pass on to purchasing or redeeming shareholders costs associated with their trading activity. A fund that chooses to use swing pricing is expected to have swing pricing policies and procedures in place that specify the process of determining the fund's swing factor and swing threshold, and establish and disclose an upper limit on the swing factor used. The upper limit may not exceed two percent of net asset value per share. The final rule will become effective 24 months after publication in the Federal Register. [Press Statement]

3.4 SEC adopts rules modifying reporting and disclosure requirements for asset management industry

On October 11, 2016, the Securities and Exchange Commission (SEC) released a statement summarizing its enforcement efforts and results for its fiscal year (FY) ending September 30, 2016. The agency reports it filed 868 enforcement actions, including 160 cases against investment advisers or investment companies and 21 cases related to violations of the Foreign Corrupt Practices Act (FCPA). The SEC highlights the most significant enforcement actions in FY 2016 addressed insider trading, beneficial ownership, customer protection, conflicts of interest, and FCPA. First-of-their-kind actions included charges against: i) a firm for failing to file Suspicious Activity Reports when appropriate; ii) an audit firm for auditor independence failures predicated on close personal relationships with audit clients; iii) municipal advisers for violating fiduciary duty requirements; iv) a private equity adviser for acting as an unregistered broker; and v) an issuer of retail structure notes for misstatements and omissions. [Press Statement]

3.5 Enforcement actions

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

- The SEC charged an investment bank with failure to properly safeguard material nonpublic research information produced by its research analysts. While the bank encouraged its equity research analysts to communicate frequently with customers and sales and trading personnel, the SEC alleges it lacked adequate policies and procedures to ensure that analysts did not disclose non-public views and analyses, changes in estimates, and short-term trade recommendations during morning calls, trading day squawks, idea dinners, and non-deal road shows. The bank was also charged with publishing an improper research report and failing to properly preserve and provide certain electronic records sought by the SEC during its investigation. The bank agreed to settle charges without admitting or denying the SEC's allegations. Under the terms of the consent order, the bank agreed to pay a civil money penalty of $9.5 million, to be censured, and to cease and desist from violating provisions of the Securities Exchange Act of 1934 and the SEC's Rules.

- The SEC imposed a cease and desist order against a company that operated mobile phone games described as "fantasy sports for stocks." Players predicted the order in which a number of securities would perform relative to each other and won points and cash prizes based on the accuracy of their predictions. The company kept a percentage of the entry fees. The SEC determined the agreements with players constituted security-based swaps as they provided for a payment that was dependent on an event associated with a potential financial, economic, or commercial consequence and based on the value of individual securities. The SEC also determined that the company failed to register its security-based swap offering, and failed to sell the contracts through a national securities exchange as required. In doing so, it failed to ensure that information about its offering was fully transparent to retail investors and that the platforms it used to transact were subject to the necessary level of regulatory oversight. The company consented to the SEC's order without admitting or denying the findings that it violated sections of the Securities Act of 1933 and the Securities Exchange Act of 1934, and agreed to pay a civil money penalty of $50,000 to settle charges.
- The SEC charged a hedge fund advisory firm and a senior research analyst for failure to detect insider trading by one of their employees. The SEC alleges the firm failed to maintain and enforce written policies and procedures to adequately prevent the misuse of material nonpublic information, and also failed to respond appropriately to red flags that should have alerted them to the misconduct. To settle charges, the firm agreed to disgorge illicit trading profits totaling nearly $5.2 million, plus interest of $1.1 million, and to pay a civil money penalty of $2.6 million. Additionally, the supervisor agreed to pay a penalty of $130,000 and to be suspended from the securities industry for 12 months.

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