

REGULATORY HOT TOPICS FOR FINANCIAL SERVICES INTERNAL AUDITORS

SHAUN CREEGAN – DIRECTOR, PROTIVITI

STEVEN STACHOWICZ – ASSOCIATE DIRECTOR, PROTIVITI

December 6, 2012

Today's Presenters

Shaun Creegan, *Director, Protiviti*



Shaun Creegan is a Director with Protiviti and a member of the firm's Regulatory Group. Shaun has over 12 years of experience in the financial services industry. At Protiviti, Shaun has conducted a variety of regulatory compliance, risk and internal audit assignments. These assignments have included banking and broker-dealer compliance, risk and operational reviews, Investment Company Compliance reviews, Sarbanes-Oxley documentation and testing. Shaun is a subject matter expert in Anti-Money Laundering and has worked on a variety of different AML assignments including, AML audits for several types of financial institutions, KYC re-documentation projects, money laundering investigations, OFAC sanction screening projects, enforcement remediation projects and AML program and risk assessment gap analyses. Prior to joining Protiviti, Shaun worked at two major investment banks where he worked on both internal audits and compliance reviews. Shaun holds an AML certification, is a member of ACAMS and held the Series 7 and 66 registrations.

shaun.creegan@protiviti.com

Steven Stachowicz, *Associate Director, Protiviti*



Steven Stachowicz is an Associate Director with Protiviti. Steven is a member of Protiviti's Regulatory Risk Consulting practice in Chicago. Steven has extensive experience advising financial services companies on risk management, with particular emphasis on compliance management systems and consumer protection legal and regulatory requirements, such as privacy, fair lending, and lending and deposits requirements. His clients include major U.S. banks and specialty financial services companies. Prior to joining Protiviti, Steven worked at a top-10 U.S. bank holding company, where he worked as a project manager responsible for implementing systemic controls, policies and training related to high cost lending and FCRA/FACTA compliance, as well as a compliance manager responsible for creating and maintaining a compliance risk assessment. Steven also managed individual compliance reviews of various operations, including sales, marketing and underwriting. Steven has written extensively, and has been a frequent speaker, on regulatory issues.

steven.stachowicz@protiviti.com

Agenda



2013 Regulatory Environment and Outlook

AML Expectations & Trends

Broker-Dealer Trends

CFPB Rulemaking and Enforcement Activity

Internal Compliance Audit

Question and Answers

2013 REGULATORY ENVIRONMENT AND OUTLOOK

Polling Question #1

What legal and regulatory activities do you believe will impact your organization the most in 2013?

- Regulatory Rulemaking
- Legislative Activity (New Congress)
- Regulatory Enforcement Actions
- Obama Administration Changes



2013 Regulatory Environment and Outlook

Regulatory Environment

- 113th Congress: Meet the New Boss, Same as the Old Boss?
 - Changes at the fringes
 - Consumer protection/advocacy
- Administration Changes
- Enforcement
 - Joint actions
 - Anti-money laundering

Wall Street CEOs – the same ones who wrecked our economy and destroyed millions of jobs – still strut around Congress, no shame, demanding favors and acting like we should thank them.
 - *Senator-elect Elizabeth Warren (D-MA)*

Reform driven by regulators largely pushing complex regulation is not something the administration is going to put a lot of political capital behind at this point.
 - *Neil Barofsky, former special inspector for the U.S. Treasury's Troubled Assets Relief Program*

If the [SEC] is attempting to be effective and to demonstrate it is pursuing issues with appropriate alacrity and diligence, enforcement enables it to move most quickly.
 - *Harvey Pitt, former SEC Chair*

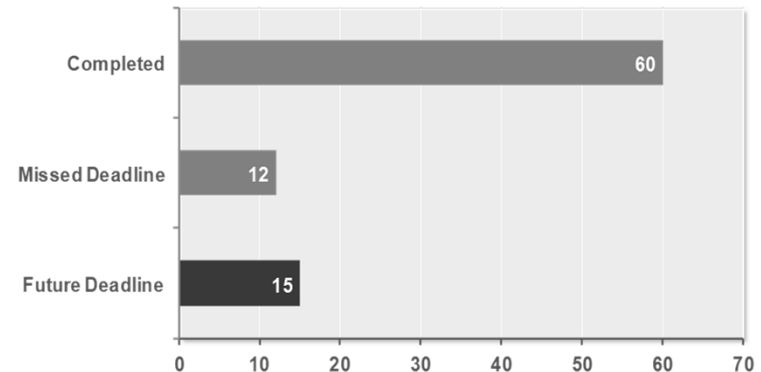
Dodd-Frank Act

Dodd-Frank Act

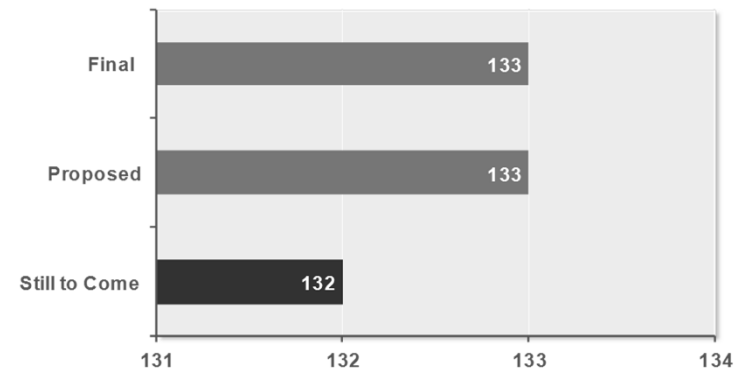
- Two years in, about 1/3rd rules finalized, 1/3rd proposed, and 1/3rd yet to come
- Pending Rulemaking
 - Designation of Nonbank SIFs
 - Derivatives Reform
 - Volcker Rule
 - Compensation Committee and Advisor Independence
 - Capital Requirements
 - Mortgage Origination and Servicing (including QM/QRM)
 - Enhanced Prudential Supervision

Source: David Polk Dodd-Frank Progress Report, November 2012

As of November 1, 2012
87 Studies Required

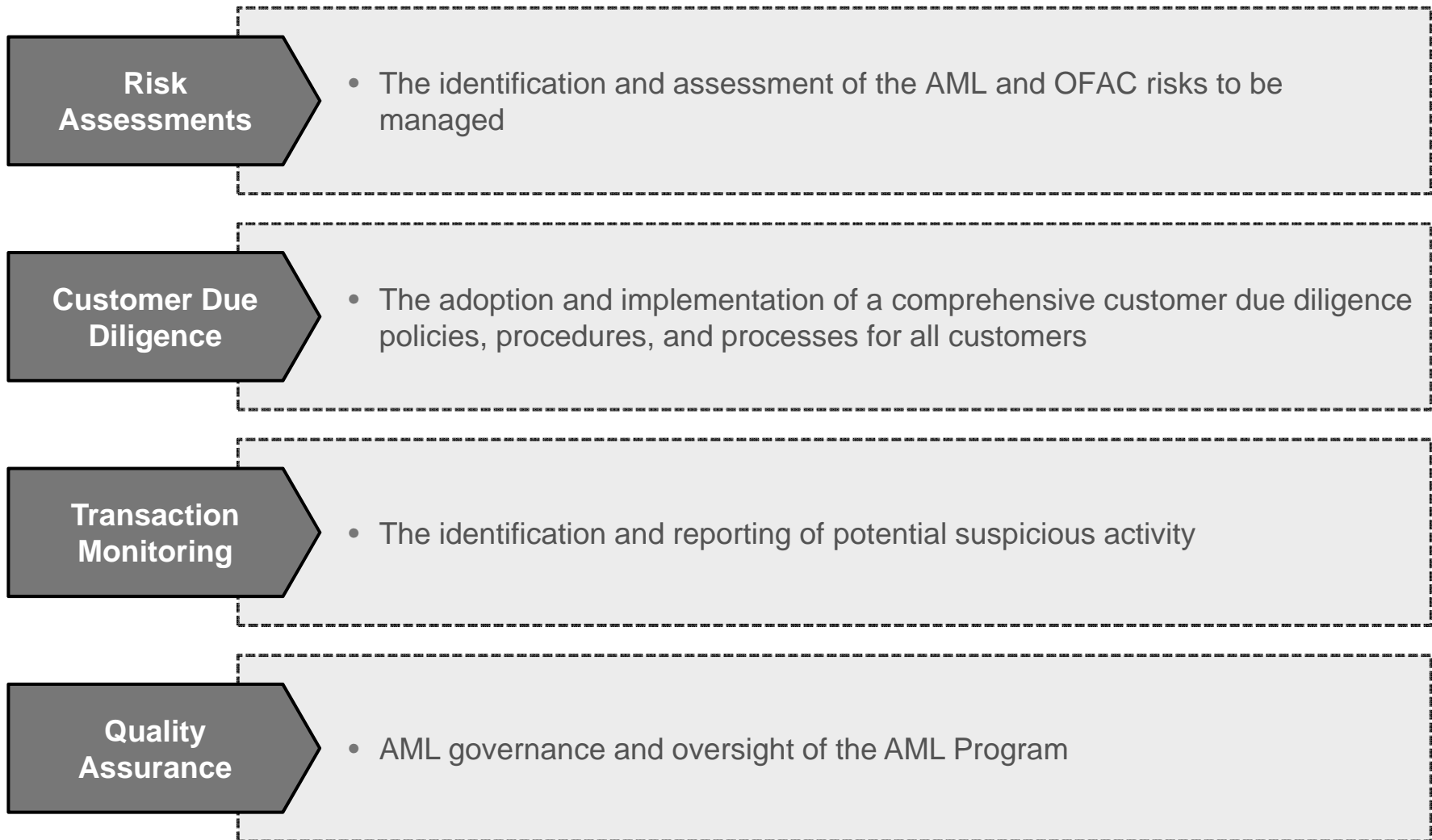


As of November 1, 2012
398 Agency Rulemakings and Other Actions



AML EXPECTATIONS & TRENDS

AML Expectations



AML Expectations

Risk Assessments

Financial institutions can more accurately and efficiently assess their AML/OFAC risks by keeping the following principals and guidelines:

- Develop and use a standard methodology and format to promote consistency across the organization
- Take an enterprise wide view of AML/OFAC risks, covering all business lines, functional units and geographies, and incorporate this view into the overall risk assessment
- Assess the inherent quantity of risk for various categories, such as customers, products and geographies, then adjust this inherent risk by the quality of risk management for that category to arrive at a residual risk rating
- Assign a direction of risk rating to rated areas to incorporate a forward-looking elements to the risk assessment
- Support and substantiate the risk assessment as much as possible with hard data, facts, and references
- Establish a regular schedule for updating the risk assessment, and amend it immediately upon triggering events, such as acquisitions, mergers, new products/services, new technology, etc.
- Document the methodology and results so that others, e.g., regulators and auditors, can understand how conclusions were reached

AML Expectations

Customer Due Diligence

Recent FinCEN Guidance includes:

- Conducting initial risk based due diligence on new customers at account opening, including identifying the customer and verifying that customer's identity as appropriate
- Understanding the purpose and intended nature of the account and expected activity associated with the account for the purpose of assessing AML risk
- Identifying beneficial owners(s) of all customers and verifying the beneficial owner(s)' identity
 - 25% ownership or the individual with the most equity interest
- Conducting ongoing monitoring of the customer relationship and conducting additional CDD as appropriate
- The additional requirements would cover banks, broker-dealers, mutual funds, Future Commission Merchants, and Introducing Brokers in Commodities
- May extended to MSBs, pre-paid access, insurance companies, casinos, precious metal dealers, and non-bank mortgage companies

AML Expectations

Transaction Monitoring

Increased expectations from the regulators on AML transaction monitoring systems including, but not limited to:

Systems Expectations:

- Inclusion of transactions for all products and services
- Automated initial and on-going customer risk ratings/profiles to factor in to the monitoring logic
- Comprehensive investigations and case management functionality
- Customized and sophisticated systems to incorporate the institution's transaction types/volumes
- Robust documented Change Management process
- Periodic data integrity review (*e.g.*, information flow from core processing system(s) to the AML transaction monitoring system)
- Periodic validation of systems to help ensure alert criteria is working as intended (internal vs. third-party)
- Robust documented Change Management process
- Electronic filing of Suspicious Activity Reports

Documentation Expectations:

- Comprehensive rationale/explanations for clearing alerts
- Maintenance of adequate audit trail
- Adequate quality assurance and documentation for review of cleared alerts

AML Expectations

Quality Assurance

- Quality Assurance Monitoring
 - KYC/CDD/EDD
 - Alert Clearance
 - Reporting (SARs, CTRs, etc.)
- System Maintenance
 - Data Validation
 - Tuning
- AML Analysis and Reporting
 - KPI, Metrics, Committees
- Staffing Analysis
- Training
- Internal Audit

AML Expectations

Additional Areas of Focus

- Third Party Payment Processors - Increase focus on due diligence and reporting
 - External investigations or pending legal actions
 - Appropriate state licenses, registrations, and approvals
 - Check the appropriate box on SAR forms
- Development of business continuity procedures for client and transaction monitoring processes in event of disruption to normal operating procedures and systems
- Increase focus on OFAC compliance
 - The Comprehensive Iran Sanctions, Accountability, and Divestment Act
- Identification , risk rating and approval of domestic PEPs
- Creative new payment mechanisms are being developed

AML Expectations

Recent AML/OFAC Enforcement Action

- First Bank of Delaware, stripped of state charter, \$15 million fine
- Moneygram International Inc., deferred prosecution agreement, \$100 million forfeiture
- JPMorgan Chase, multiple sanctions violations, \$88,300,000 settlement
- SMH Capital, suspensions, civil fines and \$150,000 firm fine
- Forex Club LLC. \$300,000 fine

Lessons Learned from Recent AML Enforcement Actions

- Inadequate customer due diligence and enhanced due diligence procedures
- Inadequate BSA/AML Risk Assessments and Comprehensive AML Programs
- Inadequate identification and monitoring of high risk customers
- Inadequate automated transaction monitoring systems
- Lack of or weaknesses in the scope and documentation of automated transaction monitoring systems validations
- Failures by the internal audit function to identify systemic BSA/AML compliance program deficiencies
- Lack of comprehensive training programs

Polling Question #2

When performing due diligence on a potential customer opening a deposit account, which information is not essential to obtain?

- Purpose of the account
- Occupation
- Expected transaction activity
- Marital status



BROKER-DEALER TRENDS

Broker-Dealer

PCAOB Interim Inspection Results

The Public Company of Accounting Oversight Board (PCAOB) issued a report on August 20, 2012 on the progress of the Interim Inspection Program related to audits of registered broker-dealers.

- 23 audits conducted by 10 different firms
- The Inspections Staff revealed deficiencies in all audits conducted
 - Customer Protection Rule – firms failed to verify the special reserve bank accounts were designated for the exclusive benefit of customers and that the account agreements contained the required restrictive provisions
 - Related Party Transactions – lack of sufficient procedures to identify the existence of related parties and material related party transactions
 - Revenue Recognition - lack of sufficient procedures to test the occurrence, accuracy, and completeness of revenue
 - Net Capital Rule – all requirements of the minimum net capital computation were not sufficiently tested
 - Consideration of Risks of Material Misstatement Due to Fraud – lack of sufficient procedures to identify, assess, and respond to the risks of material misstatement of the financial statements due to fraud
 - Fair Value Measurements - lack of sufficient procedures to test the valuation of securities

Broker-Dealer

PCAOB Interim Inspection Results

- The Inspections Staff revealed deficiencies in all audits conducted (*continued*)
 - Financial Statement Disclosures - lack of sufficient procedures to test the accuracy and completeness of certain financial statement disclosures
 - Establishing a Basis for Reliance on Records and Reports - lack of sufficient procedures for including reliance on records and reports used during audits
 - Evaluation of Control Deficiencies – identified control deficiencies were not sufficiently evaluated to assess the risk of material misstatement
 - Independence – same firm audited and prepared or assisted in the preparation of the financial statements
 - Accountant’s Supplemental Report on Material Inadequacies - lack of sufficient procedures to determine that any material inadequacies found were disclosed in the accountant’s supplement report.
 - Exemption from Provisions of the Customer Protection Rule - lack of sufficient procedures to determine if the broker-dealer complied with any exemptions under the Customer Protection Rule

CFPB RULEMAKING AND ENFORCEMENT ACTIVITY

CFPB Priorities

Consumer Disclosures

- Consolidate duplicative and overlapping early disclosures
- Simplify credit card agreements (e.g., fees, finance charges)

Consumer Complaint Intake and Resolution

- Development of centralized consumer financial products and services intake, monitoring and response process

Unfair, Deceptive or Abusive Acts or Practices

- A new “triple” standard for assessing compliance

Specific Activities, Businesses and Practice

- Mortgage lending, payday lending, student lending, credit cards, prepaid cards, overdrafts, debt suspension/cancellation and credit monitoring products, vendor management, elder abuse, collection companies, credit reporting companies

Rulemaking: Mortgage Originations

Integrated Disclosures

- DFA requires CFPB to consolidate existing TILA/Regulation Z and RESPA/Regulation X early and mortgage loan closing disclosures
- CFPB proposed rule on 7/9/2012 (published 7/18/2012); comment period now closed and final rules expected in Q1 2013 with implementation in late 2013/early 2014
- At 1,099 pages, the proposed rule provides for extensive background, summary of the CFPB's *Know Before You Owe* testing efforts, the text of the proposed regulation, model forms and official staff commentary
- CFPB proposed rule modeled after 2008 RESPA framework (e.g., tolerances, re-disclosures, etc.)
- Requires significant changes operationally, technologically, etc
- Significant changes include:
 - Three-page Loan Estimate disclosure (replaces GFE and early TIL disclosures) at application
 - “All-in” APR calculation
 - Five-page Closing Disclosure (replaces HUD-1/1A and final TIL disclosures), to be provided three days in advance of loan closing
 - Additional limitations on fee estimate changes
 - Enhanced, unified record retention requirements
 - Lender liability for settlement agent activities

Rulemaking: Mortgage Originations (Cont'd)

High Cost Lending

- DFA-required rule consolidates existing TILA/Regulation Z requirements for “high cost” lending
- CFPB proposed rule on 7/9/2012 (published 7/18/2012); comment period now closed and final rules expected in Q1 2013 with implementation in late 2013/early 2014
- Expanded coverage (lower/changed thresholds, inclusion of purchase-money loans and HELOCs)
- New restrictions on loan terms/condition, underwriting of HELOCs and homeownership counseling

Appraisals

- CFPB proposed rule 8/21/2012; comment period now closed and final rules expected in Q1 2013 with implementation in late 2013/early 2014. Rules require creditors to:
 - Provide free copies of all written appraisals/valuations for 1st lien mortgage loan applications
 - Notify applicants in writing of the right to receive a copy of each written appraisal or valuation at no cost to consumer
- CFPB and OCC/FRB/FDIC/NCUA/FHFA proposed rule 9/5/2012; comment period now closed and final rules expected in Q1 2013 with implementation in late 2013/early 2014. For higher-rate mortgages, creditors are required to
 - Obtain an appraisal(s) meeting certain specified standards
 - Provide applicants with a notification regarding the use of the appraisals
 - Give applicants a copy of the written appraisals used

Rulemaking: Mortgage Servicing

Overview of Proposed Rule

- CFPB proposed rule on 8/10/2012 (published 9/17/2012); comment period now closed and final rules expected in Q1 2013 with implementation in late 2013/early 2014
- Certain proposed changes are required by Dodd-Frank; however, others address perceived failures of mortgage loan servicers during the recent financial crisis
- Proposed standards are prescriptive, affect all mortgage servicers (large or small, bank or non-bank) and contain regulatory penalties for non-compliance

New Requirements

- | | |
|--|---|
| <ul style="list-style-type: none">• DFA-Required Changes<ul style="list-style-type: none">– Forced-Placed Hazard Insurance– Variable Rate Notifications– Periodic Mortgage Billing Statements– Prompt Payment Crediting and Payoff Statements | <ul style="list-style-type: none">• Non-DFA Required Changes<ul style="list-style-type: none">– Error Resolution and Information Requests– Information Management Policies & Procedures– Early Intervention for Delinquent Borrowers– Continuity of Contact with Delinquent Borrowers– Loss Mitigation Procedures |
|--|---|

Rulemaking: Remittance Transfers

Overview of Final Rule

- Effective in Spring 2013, EFTA/Regulation E is to be amended to create a comprehensive new system of consumer protections for remittance transfers sent by consumers in the US to individuals and businesses in foreign countries
- Institutions that do not offer remittance transfers in the normal course of business (less than 100 remittance transfers per year) are exempt from rules
- Estimates are permissible in limited circumstances, generally for the “safe harbor countries list” published by CFPB (currently includes Brazil, Aruba, Libya, China, Ethiopia)
- *A remittance transfer* is an electronic transfer of funds sent by a remittance transfer provider at a consumer’s request to another consumer or company in a foreign country (*subject to exclusions*)

New Disclosures

- Prepayment Disclosure
 - Provide pricing information before consumer makes payment to send a remittance transfer
 - Include transfer amount (in US and foreign currency), transfer fees and taxes (imposed by provider or anyone else), exchange rate
- Receipt Disclosure
 - Must be provided when payment is made (NOT when transfer occurs)
 - Includes: 1) contact information for the recipient, provider, state regulator and CFPB, 2) the date the funds will be available to the recipient, and 3) summary of sender’s error resolution rights

Rulemaking: Remittance Transfers (Cont'd)

Error Resolution

- A sender must provide notice orally or in writing to the provider within 180 days after the availability of the remittance stated in the receipt
- Provider must begin investigation and make determination within 90 days of notice
- Notice must be furnished to the sender within 3 business days after investigation is completed (if the error occurred as claimed, notice may be orally or in writing)
- When an error is confirmed, the provider must correct the error within one business day or as soon as reasonably practical
- Remedy: refund of the entire amount tendered or an amount appropriate to resolve the error OR re-send the appropriate amount to the recipient at no additional cost to the sender or the recipient

Cancellation

- Consumer may cancel within 30 minutes of placing order
 - Verbal request permissible
 - May be cancelled at any location
- Refund due to customer within 3 business days

Polling Question #3

Which of the following transactions might constitute a “remittance transfer” and require new disclosures under Regulation E?



Consumer credit card purchase of goods from a merchant in a foreign country



A preauthorized EFT made by a consumer directly with a merchant located in a foreign country



A consumer’s online bill payment request fulfilled by the Bank by sending a check to a foreign recipient



A prepaid card purchased by the consumer and sent by the Bank to a foreign recipient



CFPB Enforcement Summary



Deceptive Marketing & Billing Practices

- Deceptive marketing tactics used by Capital One's vendors to pressure or mislead consumers into paying for "add-on products" on credit cards
- \$140 million in customer restitution, \$25 in CMPs to CFPB, \$35 million in CMPs to OCC in July 2012



Deceptive Marketing Practices

- Deceptive marketing tactics used by Discover and its vendors to mislead consumers into purchasing "add-on products" on credit cards or enroll without consent
- \$200 million in customer restitution, \$14 million in CMPs to CFPB and FDIC in September 2012



Non-Compliant Credit Card Practices

- Joint CFPB-FDIC actions, as well as OCC and FRB
- Deceptive marketing of card benefits, misleading representations regarding reporting and technical non-compliance with TILA/Reg Z (late fees), FCRA/Reg V (credit reporting) and ECOA/Reg B (credit scoring systems)
- Collective CMPs \$27.5 million, estimated \$85 million in customer restitution



Chance Edward Gordon (Foreclosure Prevention)

- The L.A. law firms promised distressed owners they would help them secure loan modifications
- CFPB's first civil enforcement, putting the law firm into temporary receivership after assets were frozen

The first of what many believe is an established pipeline of enforcement cases?



INTERNAL COMPLIANCE AUDIT

Regulatory Expectations

Federal Banking Agencies

- Internal Audit is considered to be a component of an effective compliance management system
- Scope of audit activities should be appropriate for nature/size of institution and products offerings
- Audits should address new requirements

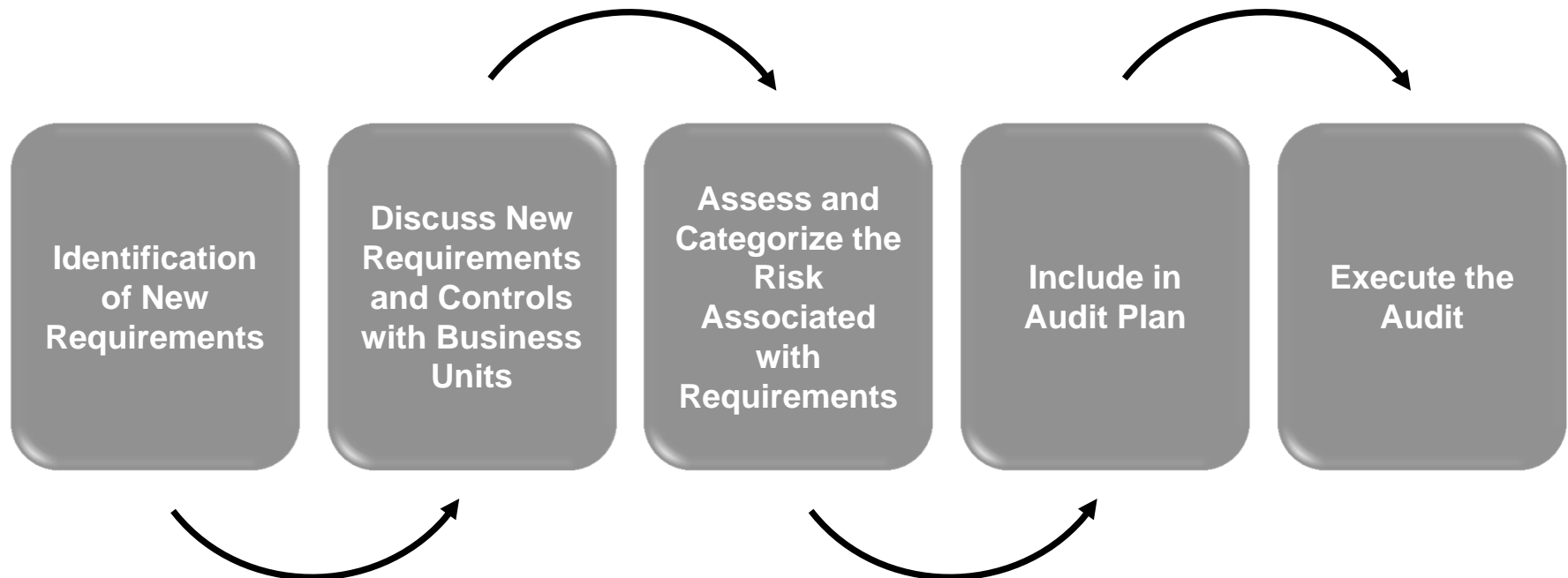
Basel Committee

- Internal Audit should have appropriate capability to undertake regular reviews of regulatory matters
- Regular audits of the institution's compliance function are expected
- As 3rd line of defense, audit's review should be risk-based, assessing efficiency and effectiveness of compliance program design and controls

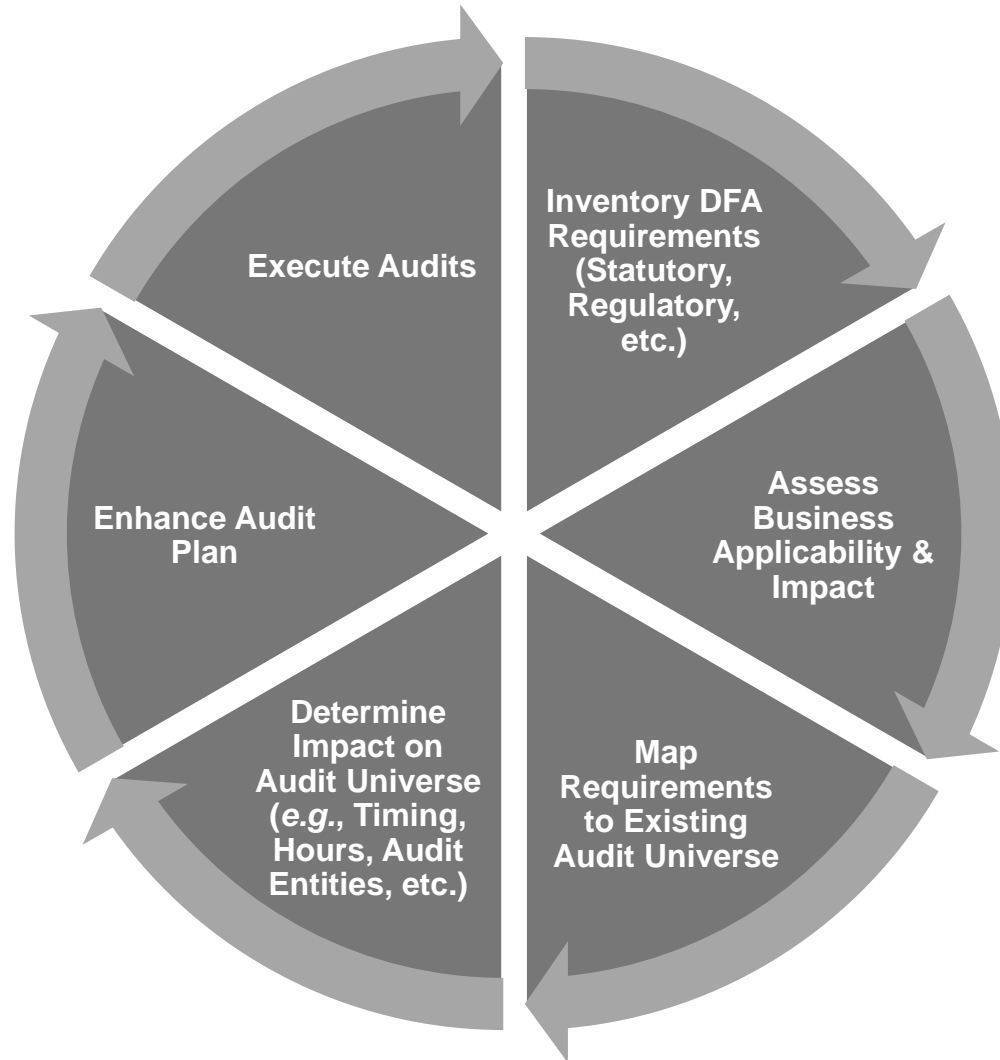
Audit Considerations

| Issue | Audit Considerations |
|------------------------------|--|
| Third Party Risk | <ul style="list-style-type: none"> • How do the institution's systems and document vendors handle these changes? • Are mortgage loan brokers, correspondents and sub-servicers keeping pace with changes, and does the institution monitor compliance closely? |
| IT/MIS Risk | <ul style="list-style-type: none"> • Can all platforms support necessary changes? • Does the institution have the required data to comply with new requirements, particularly new/enhanced disclosures? |
| Change Management/Governance | <ul style="list-style-type: none"> • Has the institution established a robust regulatory issuance and impact assessment process? • Do Compliance and/or Legal personnel have adequate involvement in systems and process changes? • Are there processes to update policies, procedures and training to incorporate regulatory changes timely? |
| Staffing and Expertise | <ul style="list-style-type: none"> • Has Audit evaluated the impact on its Plan of the new requirements in terms of timing, audit entities, resource needs? • Does Audit have the requisite expertise (or access to external SMEs) to evaluate compliance with new requirements? |

Integration of New Requirements into Audit Plan



Dodd-Frank Audit Planning



Q & A



THANK YOU!

Resources

Refer to Protiviti's website for more resources related to Dodd-Frank and other regulatory reforms:

| Protiviti (www.protiviti.com/regulatoryreform) | |
|--|----------------------------------|
| Protiviti's Guide to U.S. Anti-Money Laundering Requirements: Frequently Asked Questions, Fifth Edition | Resource Guide |
| Deriving Value from Mandated Stress Testing | FS Insights (Volume 4, Issue 1) |
| The Solvency Modernization Initiative | White paper |
| Three Notices of Proposed Rulemaking: 1. Proposal on Regulatory Capital and Implementation of Basel III 2. Proposal on Advanced Approaches on Market Risk and Risk-Based Capital Rule 3. Proposal on the Standardized Approach for Risk-Weighted Assets | Points of View |
| Basel Committee Issues Revised Supervisory Guidance on Assessing the Effectiveness of Internal Audit Functions | Flash Report |
| The Dodd-Frank Act: Here and Now | FS Insights (Special Edition) |
| The CFPB Is Coming – Are You Ready? | Point of View |
| Compliance Management in a Global World | FS Insights (Volume 3, Issue 11) |
| Final Stress Testing Guidance for Large Financial Institutions | Flash Report |
| Extraterritorial Laws and Regulations: The New Normal | Survey Results |
| Top Priorities for Internal Audit in Financial Services | Survey Results |
| Dodd-Frank Act's Potential Implications on Technology at Financial Institutions | FS Insights (Volume 3, Issue 10) |

Also look for our quarterly Compliance Corner on the IIA's FSA Times site (www.theiia.org/fsa)!