SCOR	Statistical CAMELS Off-site Rating
SEC	Securities and Exchange Commission
SLHCs	Savings and Loan Holding Companies
SNC	Shared National Credit Program
SOI	Summary of Investigations
TARP	Troubled Asset Relief Program
TFR	Thrift Financial Report
TSP	Technology Service Provider
UBPR	Uniform Bank Performance Reports
UFIRS	Uniform Financial Institutions Ratings System
URSIT	Uniform Rating Systems
UTPR	Uniform Thrift Performance Reports
U.S. GAAP	U.S. Generally Accepted Accounting Standards

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I. Summary, Key Findings, and Recommendations

1. **This assessment of the United States against the Basel Core Principles (BCPs) is being undertaken in the immediate aftermath of a period of extreme market stress and continued general economic downturn.** The resilience of the U.S. banking system, as well as the complex regulatory and supervisory arrangements that oversee it, has been severely tested. Serious weaknesses that contributed to the stress have been revealed and need to be dealt with effectively. The causes of the financial crisis were many and cannot be identified simply through the lens of the BCPs, but they do identify shortcomings that were material in the run-up to the crisis, many of which were not unique to the U.S. In this assessment, three key weaknesses in the U.S. have been identified: (i) a complicated regulatory structure that necessitates a heavy burden of cooperation and coordination between agencies; (ii) legislative provisions that have hindered and discouraged strong consolidated supervision; and (iii) certain material weaknesses in the oversight of banks' risk monitoring and risk management practices.

2. **At the time of the assessment, a wide-ranging set of legislative reform proposals had already been developed by the U.S. Treasury Department to address the weaknesses identified by the financial crisis; these reforms are designed to have a broader reach than the issues noted above.** Given that the legislative reforms are continuing to be evaluated, it is not possible in this assessment to judge, or give credit for, their effectiveness. Equally, regulatory reform legislation will not be effective by itself and will require on-going vigilance and 'the will to act' on the part of those tasked with supervising the U.S. banking system.

A. Introduction

3. **This assessment of the current state of the U.S. implementation of the Basel Core Principles for Effective Banking Supervision has been completed as part of a Financial Sector Assessment Program undertaken by the International Monetary Fund during October–November** 2009, and reflects the regulatory and supervisory framework in place as of the date of the completion of the assessment. Importantly, it is not intended to assess the merits of the wide-ranging program of reforms currently being proposed and adopted within the U.S. An assessment of the effectiveness of banking supervision requires a review of the legal framework, both generally and as specifically related to the financial sector, and a detailed examination of the policies and practices of the institutions responsible for banking supervision. In line with the BCP methodology, the assessment focused on the major banks and holding companies, and their regulation and supervision, given their importance to the system.

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B. Information and Methodology Used for Assessment

4. **The assessment team[1] reviewed the legal framework for banking supervision, held extensive discussions with the staff of the Federal Reserve System,** the Office of the Comptroller of Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), the Office of Thrift Supervision (OTS), the U.S. Treasury, the Government Accountability Office, the Office of Inspector Generals, the Federal Financial Institutions Examination Council, the New York Department of State Banks, the Conference of State Bank Supervisors, industry associations representing domestic and foreign banks, think-tanks and private sector participants in the banking and financial markets. The team examined the current practice of on-site and off-site supervision of the Federal supervisory agencies. The assessment team had the benefit of working with a comprehensive self-assessment completed by the U.S. agencies, enjoyed excellent cooperation with its counterparts, and received the information it required. The team extends its thanks to the staff of the various agencies and the Treasury for their participation in the process and their comprehensive self-assessment.

5. **For context, it is important to note that the United States is the first complex economy to have a full review under the BCPs that were revised in 2006.** This is significant for two reasons: (i) the revised BCPs have a heightened focus on risk management and its practice by supervisory authorities and the supervised institutions; and (ii) the standards are evaluated in the context of a financial system's sophistication and complexity. Therefore, the expectations applied in evaluating U.S. compliance with the BCPs were high. These factors should be taken into account in any comparisons between the U.S. assessment and previous FSAPs for other countries.

6. **Reaching conclusions required judgments by the assessment team.** Banking systems differ from one country to another, as do their domestic circumstances. Furthermore, banking activities are changing rapidly around the world after the crisis, and theories, policies, and best practices for supervision are swiftly evolving. Nevertheless, by adhering to a common, agreed methodology, the assessment should provide the U.S. authorities with an internationally consistent measure of the quality of its banking supervision in relation to the revised Core Principles, which are internationally acknowledged as minimum standards

7. **The assessment of compliance with each principle is made on a qualitative basis.** A four-part assessment system is used: compliant; largely compliant; materially non-compliant; and non-compliant. To achieve a "compliant" assessment with a principle, all essential criteria generally must be met without any significant deficiencies. A "largely compliant" assessment is given if only minor shortcomings are observed, and these are not seen as sufficient to raise serious doubts about the authority's ability to achieve the objective

[1] The BCP assessment was conducted by Wayne Byres (Executive General Manager, Australian Prudential Regulation Authority), Nicholas Le Pan (IMF Consultant; ex-Head of the Office of the Superintendent of Financial Institutions, Canada and ex-Vice Chairman of the Basel Committee for Banking Supervision), and Goran Lind (Adviser to the Swedish Riksbank and longtime member of the Basel Committee).

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of that principle. Under the BCP methodology a "materially non-compliant" assessment is given whenever there are severe shortcomings, despite the existence of formal rules, regulations and procedures, and there is evidence that supervision has clearly not been effective, that practical implementation is weak, or that the shortcomings are sufficient to raise doubts about the authority's ability to achieve compliance. Assessors have rated one CP materially non-compliant, but believe, based on evidence during the assessment that the FBAs are strongly willing and able to achieve compliance. A "non-compliant" assessment is given when no substantive progress toward compliance has been achieved. In interpreting ratings, it is also important to note that for some CPs the assessment takes into account both compliance at banks and compliance of the supervisors.

8. **The U.S. financial structure is fundamentally different from some countries, in that it has advanced and well-developed capital markets, and diverse sources of credit; this means that the banking system in a traditional sense is a smaller part of the broader financial system.** The assessment of the banking supervisory system against the BCPs therefore did not cover the entire regulatory system, which would be the case in some other countries. The scope of the BCP assessment did not extend, for example, to the supervisory arrangements for the government-sponsored enterprises (GSEs) and other government-sponsored credit providers, non-bank mortgage originators and brokers, nor to the oversight of smaller community-based, bank-like organizations such as credit unions. The recent financial crisis, however, showed how developments in these non-bank parts of the system can materially affect the banking system, and the assessment must be viewed in light of these restrictions. The diversity of the U.S. banking and non-banking system needs to be borne in mind in any assessment of the banking regulatory structure.

9. **The approach taken by the assessors in assessing BCP compliance has been to examine whether the four Federal banking agencies (FBAs)—the Federal Reserve, the OCC, the OTS, and the FDIC—by themselves provide sufficiently effective supervision to meet the requirements of the BCPs.** Since almost all banks[2] in the U.S. have a primary FBA to oversee them, the assessors did not seek, nor have the capacity, to test the strength and capability of each and every state banking supervisor. Where the assessors have concluded there may be gaps or shortcomings in the operations of the FBAs relative to the BCPs, the assessors have considered whether the work of the state banking agencies would be sufficient to compensate.

10. **The use of holding company structures[3] to own and operate banks is a fundamental component of the U.S. banking system, and this is recognized within the**

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[2] "Banks" includes Federal Reserve members—all FDIC-insured national banks (supervised by the OCC) and FDIC-insured state-chartered banks (supervised by the Federal Reserve)—and nonmembers (supervised by the FDIC); and FDIC-insured savings associations (supervised by the OTS) unless the context indicates otherwise.

[3] "Holding companies" includes both bank holding companies and savings and loan holding companies except in cases where there is a material difference between them (in terms of legal authority, operations, or structure). Where an aspect of the U.S. system refers only to

(continued)

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banking supervisory arrangements that have been established. Although the BCPs refer generically to "banks" in many places, the assessors have adopted a wider interpretation to incorporate the supervision of bank and thrift holding companies. This follows the approach adopted by the U.S. in its own self-assessment, which treated the supervision of holding companies as an integral component of the system for bank supervision.

C. Institutional and Macroeconomic Setting and Market Structure—Overview

11. **The U.S. financial system is large and highly diversified. At end-2007, total U.S. financial assets amounted to almost four and a half times the size of GDP.** Of this, however, less than a quarter of total financial assets were accounted for by traditional depository institutions. Other important sectors include pension and other investment funds (each representing about 18 percent of total financial assets) and insurance companies (11 percent of total assets). The depth and diversification of the U.S. financial sector is reflected in the relatively low reliance of the corporate sector on bank credit (around 10 percent). GSEs play a significant role in the U.S. financial sector. At end-2007, they accounted for 20 percent of total financial assets, mostly concentrated in the mortgage markets.

12. **The crisis has radically changed the shape of the U.S. financial system in a short timeframe.** The top investment banks recently have been reconfigured as bank holding companies, nonbanks severely weakened, the housing GSEs are now in government conservatorship, and private securitization remains dormant. There are signs that securitization is picking up, thanks to the supervisory policy responses and the prompt development and implementation of various government support programs. How the securitization structure and markets change going forward is yet unclear, but they may be more bank-centered and (at least initially) more concentrated. The capital adequacy of the large BHCs has been bolstered by the U.S. Capital Purchase Program (CPP). Although none of the top financial institutions breached minimum regulatory requirements during the financial turmoil, the perceived quality of their assets and lack of general market confidence inflicted a severe blow to their perceived resilience to shocks. After the publication of the authorities' stress test results in early-May 2009, the 19 top BHCs were able to raise nearly US$200 billion capital (of which 63 percent was in the form of common equity), and to repay US$74.4 billion of CPP preferred shares. The 10 BHCs needing an additional Supervisory Capital Assessment Program (SCAP) buffer increased their Tier 1 common equity by more than US$77 billion in Tier 1 common equity by their deadline of November 2009. In addition, as of early February 2010, 13 of the participating BHCs have fully redeemed their US$156.7 billion of preferred shares under the Treasury's CPP and another five have either announced or taken steps to do so in the near future.

13. **After the crisis, asset quality has continued to deteriorate, despite an aggressive policy of loan loss provisioning.** In the third quarter of 2009, banks' nonperforming loans

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bank holding companies (BHCs) or savings and loan holding companies (SLHCs), it is so indicated in the text.

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rose to 4.9 percent of total loans and net charge-offs rose to 2.7 percent, the highest levels for both in the 26-year history of such recorded data. Authorities expect further write-downs and charge-offs to emerge for some time. Furthermore, although there are signs of improvements in some subsectors, these indicators are likely to further deteriorate if jobless rates continue to rise.

14. **After a sharp contraction, the U.S. economy appears to have hit bottom in the second quarter of 2009 and is showing signs of recovery, although underlying economic activity remains weak. GDP declined by 6.4 percent in 2009 Q1 and 0.1 percent in Q2 at an annual rate.** A concerted policy response—comprising aggressive monetary policies, a sizable fiscal stimulus, and efforts to stabilize financial systems—has bolstered confidence, supported demand, and reduced systemic risks. In particular, after lowering the policy rate to the 0–25 basis points range in December 2008, the Federal Reserve expanded its range of "credit easing" measures and in January 2009 indicated that conditions were likely to warrant an exceptionally low rate for an extended period. A fiscal stimulus of some 5 percent of GDP over fiscal years 2009–11 is lending increasing support to demand and U.S. financial supervisors' significant efforts to stabilize the financial system have contributed to a substantial improvement in financial conditions, largely easing the post-Lehman credit crunch. An issue is whether the present buoyancy in some financial markets is sustainable.

15. **Looking ahead, the near-term outlook is for the gradual recovery to continue, albeit slower than the typical recovery in previous cycles, with growth returning to a lower trend only in mid-2010.** The process of rebuilding household and financial intermediaries' balance sheets and relatively feeble labor market conditions will pose headwinds to demand for some time. Unemployment is expected to continue rising, cresting slightly below 10 percent in 2010; households' net worth fell by some US$11 trillion during 2008; banks face continued pressure from a challenging credit cycle; and financial conditions, while significantly improved from severely stressed levels, remain strained as key markets continue to depend heavily on policy support. On the positive side, the recent rapid pace of destocking portends some upside to production, although the strength of both domestic and foreign demand remains in question. Overall, IMF staff forecasts an annual contraction of 2.5 percent in 2009 followed by growth of 2.7 percent in 2010.

16. **Looking to the medium term, the post-crisis trend rate of U.S. growth is expected to be lower than the pre-crisis trend.** The protracted recession and tighter financial conditions will crimp capital accumulation, and high and persistent unemployment will boost equilibrium unemployment; both these factors will lower potential growth.

D. Preconditions for Effective Banking Supervision

17. **Overall, the public infrastructure supporting effective banking supervision in the U.S. is well-developed.** That said, the complexities inherent within it,[4] and the lessons

[4] Under the Federal system of the United States, the Federal Government has considerable authority, while individual states retain significant authority and responsibility. This structure has resulted in a complex and, at times, fragmented system of laws and regulations.

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learned from the recent financial crisis, demonstrate scope for enhancements to further improve its resilience.

18. **Business laws in the United States, including contract, bankruptcy, and property law, are well-developed and reliable.** Contract law is established by the combination of common law and state statute. The enforceability of contracts is well-established and enforced by the courts. Laws establishing the enforceability of security interests (i.e., interests in property conveyed to collateralize loans) are governed, primarily, under Article 9 of the Uniform Commercial Code. The enforcement of mortgages of real property is upheld under (non-uniform) state laws. Federal bankruptcy laws incorporate protections for both creditors and debtors. Property rights are protected under the Bill of Rights of the United States Constitution and under state laws.

19. **Business law disputes are typically resolved in state trial courts of general jurisdiction.** Federal courts are available when the claim involves federal law or when a state law claim involves parties from different states. A right of appeal exists in both the federal and state systems. Contracts, both commercial and consumer, may also provide for mandatory arbitration rather than dispute resolution through the courts.

20. **The U.S. possesses an independent judiciary and well-regulated accounting, auditing, and legal professions.** The judicial system is comprised of both federal and state systems. Judges in both federal and state courts must be members of the bar and generally have significant experience as practicing lawyers before becoming judges. Federal judges are appointed by the President with the advice and consent of the Senate and receive lifetime appointments. States vary in their methods of judicial appointment. Some follow a system similar to the federal system, i.e., the state governor appoints judges with some input from the legislature. Some states, however, appoint judges through a general election.

21. **Lawyers must receive a license to practice law from a state or states.** All states but one (Wisconsin) require applicants who are not already members of another state's bar to pass a bar examination prior to receiving a license. In addition to controlling admission into the profession, the states also regulate the profession. Regulation is often delegated to a self-regulatory organization, i.e., a state bar association. Lawyers are also subject to ethical standards set by the states.

22. **U.S. accounting standards (U.S. GAAP) are established by the Financial Accounting Standards Board (FASB).** U.S. GAAP has been the most widely accepted accounting framework internationally for many decades, although the International Financial Reporting Standards (IFRS) that have been produced under the auspices of the International Accounting Standards Board (IASB) in recent years have taken over this mantle. Both the FASB and IASB are currently working on a convergence program, designed to bring U.S. and international accounting standards into a single framework. However, recent statements by the IASB and the FASB have raised issues of possible divergence in the approach to accounting for financial investments; this is an issue that is important to banks and bank supervisors, but the outcome remains to be seen. Both standard setters are also examining the lessons learned from the financial crisis, as accounting standards (particularly the use of fair value accounting, and the methodology for loan loss provisioning in banks) have been

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criticized in some quarters as contributing to financial instability (see paragraph 29 for a more in-depth discussion).

23. **Financial statement audit requirements are robust, having been considerably strengthened in 2002 with the passage of the** Public Company Accounting Reform and Investor Protection Act **(also known as the Sarbanes-Oxley Act).** The Sarbanes-Oxley Act enhanced audit scrutiny, toughened auditor independence requirements, required various management attestations about the reliability of financial accounts, and expanded disclosure requirements with the objective of providing the users of financial statements with greater security as to their accuracy and reliability.

24. **The recent U.S. Treasury White Paper on Financial Regulatory Reform found gaps within the broader regulation of financial markets.** Proposals are currently being considered by Congress to include a program of measures to establish a framework for the comprehensive regulation of financial markets, including (i) systemic risk oversight, (ii) a resolution regime for complex financial firms, (iii) strengthened regulation and supervision of securitization markets, (iv) comprehensive regulation of all over-the-counter (OTC) derivatives (including credit default swaps), (v) harmonization of futures and securities regulation, and (vi) strengthening of the oversight, settlement capabilities, and liquidity of systemically important payment, clearing, and settlement systems. An additional suite of reforms is being proposed to improve consumer and investor protection.

25. **One cause of the financial crisis is that the credit culture had eroded materially over time, as lenders increasingly required less equity and/or collateral from borrowers; this applied to both mortgage and corporate/leveraged borrowers.** A number of factors appeared to play a role in this: (i) a stable macroeconomic environment with low interest rates, (ii) a public policy that provided incentives for lending to home owners by banks and non-banks alike, and (iii) competition from the non-bank/unregulated sector. The reliance on the originate-to-distribute business model (which made underwriters complacent about lending standards), a corresponding lack of scrutiny by capital markets, and end investors who provided finance (which allowed funding to continue to flow to poor quality credits), also played a significant role. Many off-balance sheet exposures proved to be opaque and insufficiently distant; under stress they had to be brought back onto bank balance sheets in order to maintain investor relations and banks' reputations.

E. Market Discipline and Corporate Governance

26. **There is a considerable infrastructure in the U.S. that promotes and supports market discipline.** This includes a well-developed system of continuous disclosure obligations by public companies, extensive disclosure obligations for certain other investments, active rating agencies and an analyst community which disseminates its views through multiple media. As a result, major banks disclose considerable quantitative and qualitative information quarterly and annually. This will be enhanced as a result of adoption of Basel II for advanced banks. U.S. Banking Laws provide additional opportunities for the operation of market discipline through a requirement that banks and their holding companies provide detailed financial information regarding their operations to shareholders, depositors, and the general public.

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27. T**hrough an inter-agency coordinating group, the FBAs regularly publish bank performance reports,** which show in detail how individual institutions compare with their peers. Formal enforcement actions brought by the FBAs are routinely made public.

28. **Following the recent crisis, weaknesses have been revealed in this infrastructure.** Credit rating agencies have been criticized for inappropriate ratings approaches and methodologies related to structured products and certain mortgage backed securities, and inadequate transparency about their methodology and the risks they are and are not rating. This has led to questioning of the suitability of the use of such ratings in regulatory policies. In addition, the opaqueness of complex structured products has been mentioned as a contributor to market disruption when the quality of underlying sub-prime assets was called into question and it was difficult for holders of these investments to assess their true value. Inadequate information on the exposures of the so-called "shadow banking system"─structured investment vehicles and hedge funds─has led to proposals for them to register and furnish basic information to securities regulators and the markets.

29. **While market discipline and transparency are based on the robust accounting standards set by U.S. GAAP, the recent crisis has led policymakers and accounting standard setters to consider areas for improvement.** Two key matters relevant for banks are the standards for accounting for financial instruments and those for loan loss provisioning. For financial instruments required to be 'fair valued,' it is now recognized that there were problems with the reliability of valuation of such assets that were not widely traded. For loan loss provisioning, the issue is the degree to which the accounting model now in effect for loans and certain other assets can be modified to permit more forward-looking provisioning. Bank regulators would naturally prefer more forward-looking provisioning while accounting standard setters want to ensure that opportunities for income smoothing are minimized. A number of observers believe that the U.S. application of this standard in practice allows for less forward-looking provisioning than does the equivalent IASB standard. Some would like to alter the current standard, while others would prefer to replace it with a comprehensive fair value requirement for all financial instruments including loans. Given the experience of fair values in the recent crisis (including volatility induced by the standards), some banks, and banking regulators generally, have expressed doubts about the latter possibility.

30. **Comprehensive corporate governance rules primarily arise from state corporations laws, as well as federal law requirements for publicly held companies, relating to financial disclosure and the auditing process, and internal controls over financial disclosure.** The same is generally true for banks, whether licensed under state or federal law. They must also have an audit committee that meets certain criteria for independence. Governance arrangements have been criticized for such matters as flawed board member selection, failing to separate the CEO from the board Chair position, complex proxy and proposal procedures that make it difficult for shareholders to replace directors, and poorly designed compensation schemes that exacerbate the tendency to focus on short-term results. Notwithstanding the legal framework for shareholder rights already in place, the Securities and Exchange Commission (SEC) and the U.S. administration have made proposals to strengthen shareholder rights to nominate board members and to have a voice in matters relating to executive compensation.

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31. **Developments in the areas of corporate governance, accounting standards, and regulation of non-bank entities could have a material impact on improving the environment for banking regulation and supervision by reinforcing sound regulatory practices.** Other possible changes, such as extending fair value accounting to banks' entire loan portfolios, could weaken the safety and soundness infrastructure. In addition, failure to act in certain areas such as introducing more forward-looking loan provisioning could make bank regulation more difficult going forward. Bank regulators, both domestically and internationally, are rightly actively involved in deliberations on these issues. To the extent that policy developments make regulation for safety and soundness materially more difficult, regulators will need to be ready to take compensating action.

F. Payment and Settlement Systems

32. **The wholesale payment infrastructure in the United States comprises two systems, which are of systemic importance and settle in central bank money.** The Federal Reserve Banks' Fedwire Funds Services (Fedwire) is a real time gross settlement system (RTGS) operated by the central bank, and the Clearing House Interbank Payments System (CHIPS) is a private sector system combining net and gross real time settlement. The retail payment infrastructure employs a number of public and private sector Automated Clearing Houses, regional and interregional check exchanges and card payment schemes. None of these is considered to be systemically important. The payment and settlement systems performed well throughout the recent period of market stress despite the significant challenges arising from unprecedented financial market stresses, higher than normal and more-variable payment and settlement volumes and values, the financial difficulties of a number of individual financial institutions, including the systems' implementation of failure management procedures, as well as a higher degree of uncertainty regarding counterparty risk. The IMF FSAP mission attributes the stability and smooth functioning of U.S. payment systems during the crisis to various factors, including primarily the robustness of their settlement and operational risk management frameworks and the massive liquidity support provided to the private sector participants by the authorities. At the same time, payments occurring late in the day in the RTGS system and the concentration of payment and clearing activities on a few players have been identified as a source of potential vulnerability in the wholesale payment systems.

G. Crisis Management and Safety Nets

Dealing with crisis situations

33. **U.S. banking laws provide the FBAs with a broad range of remedial powers; these range from requiring an institution to adopt a resolution of its board of directors formally committing the bank to implement specified corrective actions through issuance by the supervisor of a formal cease and desist order that is enforceable through injunctions entered by a Federal Court.** Civil money penalties may be levied by the FBAs against banks, holding companies, and parties affiliated with these institutions, including officers, directors, controlling shareholders, and independent contractors, such as attorneys, accountants, and appraisers. Furthermore, a Prompt Corrective Action (PCA) regime has been provided that requires the FBAs to institute receivership proceedings within

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90 days when tangible equity falls below 2 percent of a bank's assets or to take other appropriate action with the concurrence of the FDIC. PCA triggers action by banks and FBAs earlier, as soon as capital falls below "well-capitalized" threshold of 6/10 percent (Tier 1/Total capital). However, banks normally hold capital well above this well-capitalized level to minimize the chance of breaching the threshold and triggering the PCA regime. Authority to institute conservatorship proceedings, though infrequently invoked, enables the FDIC to control a troubled institution without closing it while a permanent resolution of the bank is sought.

34. **A deposit insurance scheme, sponsored by the FDIC, insures all deposits at insured banks up to US$250,000 per depositor.**[5] Deposit insurance assessments are risk-based; hence a bank will pay a higher premium if assessed as having potentially higher risks, less capital, or other weaknesses. The FDIC uses ex-ante funding and includes provisions for replenishing the Deposit Insurance Fund (DIF) through emergency assessments and, when necessary, borrowings from Treasury. Due to the current and expected demands on the DIF, insured institutions paid, in 2009, an advance premium for the coming three-year period. The DIF may be used, on a least-cost basis, either to compensate depositors or to facilitate the resolution of the failed bank, typically through a purchase-and-assumption transaction.

35. **The Federal Deposit Insurance (FDI) Act includes a systemic risk exception.** This requires the Federal Reserve Board of Governors and the FDIC Board of Directors to recommend (by a 2/3 vote of the respective Boards) to the Secretary of the Treasury that a systemic risk determination be made. The Secretary of the Treasury (in consultation with the President), then makes the systemic risk determination and finds that the systemic risk exception should be invoked, which determination concludes that compliance with the least cost requirements of the FDI Act would have a serious adverse effect on economic conditions or financial stability, and that any action or assistance would avoid or mitigate such adverse effects on the banking industry. Subject to these conditions, the exception permits the FDIC to take a wide range of actions.

36. **The President's Working Group on Financial Markets (PWG), created in 1988 by Executive Order, consists of the Secretary of the Treasury, Chairman of the Fed, and Chairs of the SEC and Commodity Futures Trading Commission (CFTC).** The PWG, working with the Federal supervisors that are not members, has been a means through which the U.S. Government has coordinated its response to the current financial crisis.

37. The **Federal Reserve Bank's emergency lending assistance capability includes authority to provide liquidity assistance to** (i) solvent but illiquid banks, (ii) undercapitalized banks certified by their primary supervisor to be viable, and (iii) any individual, partnership, or corporation "in unusual and exigent circumstances" when the borrower is unable to obtain financing from banks. The Fed has used this authority in the

[5] The amount of insurance was temporarily increased from US$100,000 to US$250,000 until year-end 2013.

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current financial crisis to provide support to financial institutions and even to non-financial entities through its support of the commercial paper market and through other means.

Resolution of an insolvent bank

38. **The FDI Act provides a comprehensive scheme for the resolution of an insolvent bank.** All state and federally chartered banks that conduct retail deposit taking operations in the United States have their deposits insured by the FDIC. The FDI Act provides a comprehensive definition of insolvency that includes a balance sheet test, a liquidity test, and various tests of viability. This authority, and the "prompt corrective action" provisions, authorizes a bank to be placed in receivership or be otherwise resolved before its capital has been exhausted.

39. **As Receiver, the FDIC has available to it a broad array of tools to facilitate the process of resolving the insolvent bank.** These include authority to engage in purchase and assumption transactions, insured deposit transfers, loss-sharing arrangements, puts for troubled assets, and the utilization of bridge banks. Whenever feasible, the FDIC prepares for closing the bank well in advance of the event and, with minimal publicity and disruption, seeks to sell the viable portions of the bank's business to healthy banks. An exemption from limits and delays ordinarily imposed on acquisitions by the anti-trust laws permits transactions involving failed banks to proceed immediately. Through the use of these tools, the FDIC is able in most cases to provide depositors at a failed bank with virtually uninterrupted access to the insured portion of their funds. Judicial review of the decision of the Federal Supervisor to place a bank in receivership is available; however, under U.S. law a litigant seeking to halt such a decision in advance of the Court's final decision bears a heavy burden.

H. Main Findings

Objectives, independence, powers, transparency, and cooperation (CP 1)

40. **The multiplicity of agencies is a striking feature of the U.S. supervisory system.** The assessors appreciate the benefits of constructive challenge and the checks and balances that a system with multiple parties can bring. While the assessors have not taken a view on the desirable number of regulators or the optimal regulatory structure for the U.S., it is clear that the system carries with it a heavy burden of ensuring cooperation and coordination between the agencies to avoid overlap and gaps. Sharing and confidentiality arrangements have been established to facilitate and improve information sharing between relevant agencies, but this remains somewhat of a patchwork. The assessment team saw many examples of opportunities for better inter-agency coordination and there remain gaps in consolidated oversight.

41. **Another striking feature of the U.S. system is the general absence of detailed, clearly stated objectives and mandates for each agency in the agency's original governing statutes, which are common features of laws in some other countries.** The assessment team observed redundancies in supervisory efforts, and a lack of clarity in the roles of each agency, which may be attributable, in part, to this absence of clear objectives

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and mandates. For example, FBAs are each separately ramping up their assessment of all entities in major banking groups, which typically include entities supervised by more than one FBA. The assessment team believes it is important for the authorities (defined to include the FBAs, departments responsible for policy, and legislators) to ensure clarity in the roles and expectations of each FBA. While coordination efforts exist, continued efforts are particularly important as mandates related to systemic stability are expanded and consumer protection mandates potentially altered. The core safety and soundness mandates and missions of the individual agencies need to be preserved. Otherwise, accountability will suffer.

42. **In addition, the fundamental issue of interaction between the supervisory focus on the bank/thrift versus the holding company/group also needs to be addressed.** The crisis showed one cannot be separated from the other. Collectively, the FBAs possess extensive powers of access, information gathering and examination, and their use is clearly evident. However, the Gramm-Leach-Bliley Act of 1999 (GLB Act) limits information gathering powers for individual agencies, which has an impact on the capacity of the FBAs to conduct full and effective consolidated supervision. The assessors noted that the U.S. Treasury proposes to remove some of these limitations as part of the financial regulation reform proposals.

43. **The FBAs have a strong tradition of authority and accountability for supervisory matters being vested in those in charge of the supervision of individual banks and holding companies.** This system has considerable strengths, but the crisis has revealed the need for agencies to better integrate institution-specific information and judgments about emerging risks with experience from broader (system-wide) perspectives. Improvement plans need to be inter-agency not just within each agency, which will require strong governance. In some FBAs, it is also desirable to ensure that risks and supervisory matters for major institutions get on-going regular attention at the highest levels. Modifications in the internal governance and accountability structures and processes could also be improved to allow for better integration of field and headquarters views of risks, and strengthen the appropriateness and timeliness of supervisory responses.

Licensing and structure (CPs 2–5)

44. **Somewhat unusually, banks have some degree of choice over their regulator. This is largely due to the existence of a dual banking structure—involving state and Federal charters—and multiple federal regulators.** As noted in the U.S. Treasury White Paper on Financial Regulatory Reform (p.5), "fragmentation of supervisory responsibilities…allowed owners of banks…to shop for the regulator of their choice." The authorities have recently taken partial steps to reduce the possibility of improper charter conversion. Since inappropriate charter conversions undermine the credibility of the regulatory agencies, the implementation of the new rules, and—if needed—supplementary rules, should be closely monitored by the authorities to see whether they should be further strengthened. The assessors are aware that the actual number of conversions in each year is small, but there remains an "implicit threat" of conversion from banks to their supervisors. The stated minimum capital of US$2 million for new banks is also relatively low, compared

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to many other countries; however, in practice much higher capital levels can be required for de-novo banks.

Prudential regulation and requirements (CPs 6–18)

45. **The U.S. system is still on the Basel I risk-based capital framework, though the advanced approaches of Basel II have been enacted and will apply to the major banks over the next 2–3 years.** Some additional features have been incorporated in the U.S. Basel I framework, e.g., an approach to securitization that is not present in Basel I. In addition, the U.S. capital regulations include minimum leverage ratio requirements. The BCPs require supervisors to set prudent and appropriate minimum capital adequacy requirements for banks. This is generally true in the United States and the U.S. system contains features such as the leverage requirements and Prompt Corrective Action requirements that lead banks to hold capital well above the minimum. However, some important shortcomings relative to CP 6 exist in the definition of Tier 1 capital for holding companies with regard to innovative instruments, in the absence of capital rules for SLHCs, and in allowing intangibles to count for a very high portion of a bank or thrift's Tier 1 capital. As the FBAs have pointed out, the "definition of capital" issues may also be present in other major jurisdictions, and this raises issues of competitive equity. Matters related to international consistency in the definition of capital and harmonization of deductions are currently being discussed internationally by the Basel Committee on Banking Supervision (BCBS).

46. **Severe shortcomings in bank risk management have been revealed in the recent crisis and supervisory oversight was not effective in identifying those weaknesses and having them remedied.** These shortcomings have been sufficiently large to create serious problems for both individual banks and for the financial system. While it would be unrealistic to expect a financial crisis of this magnitude not to have revealed weaknesses, the extent and seriousness of those weaknesses has been remarkable. As has been noted in reports issued by global senior supervisors, many of these were not unique to the U.S. However, given the systemic importance and complexity of the U.S. market, bank risk monitoring and management systems in the United States, and the U.S. authorities' ability to assess them, must be held to a very high standard.

47. **These weaknesses resulted partly from the confluence of credit (including counterparty credit), market, and liquidity risk under extreme conditions.** Multiple mergers in some institutions contributed to inconsistencies and weaknesses in enterprise-wide risk architecture. There is general agreement that the banking system needed to be able to better identify, manage, and mitigate build-ups in risk. There is broad, shared understanding of the improvements needed and the strategy to achieve them, and the processes to monitor progress are already in place. While improvements in risk governance are needed, major risk monitoring improvements at banking organizations that involve complex Information Technology (IT) systems take time. Better relating compensation to risk is at an early stage of implementation. How robust the balance is between risk and reward has to be tested in more growth-oriented times. Challenges in addressing the shortcomings for banks and supervisors mean that necessary improvements may take some time to implement and will not be in place in the immediate term. Given this state of affairs, supervisors will need to consider what compensating measures, beyond those already in

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place, they may expect firms to maintain until risk management improvements are more fully embedded.

48. **The FBAs have well-developed policies and processes to regulate and supervise traditional credit risk.** However, there is clear evidence that in the recent turmoil and the events leading up to it, these processes were not fully effective for certain markets and products. Supervisors were ineffective in preventing a widespread and material decline in underwriting standards of residential mortgage loans. Material credit concentrations emerged (including in Commercial Real Estate (CRE) concentrations at smaller and mid-size banks) and were monitored, but action was not sufficient. Weaknesses also existed in the analysis (by banks and supervisors) of complex credit products, and stress testing at large and smaller banks (appropriate to their size and complexity) was insufficiently developed. Surveillance and monitoring of credit risk needs to be enhanced (not just in banks but also in their affiliates and others they deal with). This monitoring needs to be better linked to effective action, in advance, to reduce the breadth and severity of credit risk problems in a future credit cycle.

49. **Linking monitoring to effective action will require a more comprehensive, shared, coordinated, and strategic approach to supervisory and regulatory enhancements than that presented to the assessors.** The additional monitoring, supervisory focus, and credit risk measurement tools being developed by certain FBAs are all desirable enhancements, and would fit into such a strategy. However, a comprehensive approach for the future would be built on an understanding of why FBA processes did not consistently perform as desired in the recent past. A comprehensive approach would address issues such as the forcefulness of interventions, timeliness of guidance, revisiting whether guidance needs to occasionally contain specific limits to be effective, consistency of follow-up on new guidance, and the ability of the FBAs to intervene to make their views known in future about systemic weaknesses in credit risk management practices, but that may need to be addressed by the authorities more broadly.

50. **The crisis has also revealed material weaknesses in market risk monitoring and management by financial institutions.** The major issues are in the areas of suitability of certain market risk measurement and monitoring processes and models at certain major firms, lack of reliable and prudent valuation of mark-to-market (MTM) positions, and completeness and use of market stress testing. Despite the existence of rules, supervisory implementation has not been as effective as necessary. Substantive improvements are required and improvements are in progress. But in some cases, these will take considerable time (including supervisory time to verify robustness) particularly where material improvements in IT or risk architecture or risk culture are involved. Better relating compensation to risk adjusted return is particularly important, but hard to achieve. It will be important for banks and supervisors to confirm that the new processes operate effectively as planned, as more robust market conditions return.

51. **FBA guidance on liquidity risk management and supervision is consistent with existing international standards and is likely to evolve in the near term due to pending interagency liquidity guidance and Basel liquidity standards.** Market events during the crisis moved the FBAs to assess the overall effectiveness of the implementation of the

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supervisory processes used in enforcing such guidance. Liquidity monitoring was greatly expanded and contingency plans tested. Improvements are required to make sure these crisis-driven measures used in banks and by supervisors are incorporated into more structured and sustainable improved liquidity risk management practices by banks and enhanced ongoing liquidity risk assessment by supervisors. Further progress to achieve high-quality ongoing liquidity risk management is required at certain major complex banks. Again, the needed direction is well understood by FBAs. This includes the capability for timely stress testing closely linked to management decisions regarding P&L and balance sheet positions. These improvements are linked to progress being made on better aggregation on an enterprise-wide basis of data and position information, on- and off-balance sheet, linked consistently in a timely manner to the banks' P&L, financial, and balance sheet systems.

52. **Supervision of operational risk appears to be effective overall, although some greater focus and specialization might be beneficial, perhaps learning from Basel II experience.** Furthermore, operational risk is typically a group-wide risk which is not confined to individual legal entities or balance sheets (e.g., IT and accounting systems, physical security, disaster recovery, and business continuity planning). To gain a truly group-wide perspective on operational risk will take considerable coordination amongst the agencies. Examples of good work that is currently undertaken in this regard are the Federal Financial Institutions Examination Council (FFIEC)'s IT Subcommittee (ITS) (which has produced common examination and guidance material), and the MDPS, Regional Technology Service Provider (TSP) and Basel II operational risk supervisory processes (which involve interagency supervision activities).

53. **Supervision of interest rate risk—an issue which is of increasing importance in the current environment—is broadly consistent across the FBAs in most material respects.** Additional benefits could be obtained from improved consistency in examination approaches and measurement techniques. Ideally, there would be a common framework for Interest Rate Risk (IRR) measurement across all FBAs (notwithstanding that this common framework could still have variations to take account of the differences and complexities in measuring IRR in a large internationally-active bank versus a small community bank with a simple balance sheet). Such a framework could be used as a basis for better assessing and comparing individual banks and identifying outliers, and to improve the consistency of assessment and CAMELS ratings.

54. **Banks maintain comprehensive programs, policies and procedures to reduce the risk of endangering the safety and soundness of the bank through abuse of its operations and services, including physical safety.** Supervisors monitor effectively, in their full-scope or targeted examinations, which banks comply with their undertakings. Internal audit and internal controls also contribute to overall oversight. The requirements for reporting on suspicious transactions, for example, within the bank, to the supervisors, and to the relevant judicial authorities, appear adequate. However, the FATF assessment conducted in 2006 identified a number of deficiencies relevant to banks that need to be remedied.

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Methods of ongoing banking supervision (CPs 19–21)

55. **The FBAs collectively have broad, but not unlimited, legal authority to regulate and supervise banks and holding companies subject to their jurisdiction.** The FBAs use their authority to conduct on-site reviews and off-site analyses to develop a thorough understanding of the risk profile of banks and holding companies. The primary tool of supervision is the on-site examination, and the FBAs conduct full-scope on-site examinations of banks at least once every year or 18 months. For the largest banking organizations, supervisory activities are continuous, supported by on-site examination teams. Bank holding company inspection cycles are mandated depending upon size, complexity, and rating. SLHC examinations are conducted concurrently with the OTS examination of its subsidiary savings associations. During the period of time in between full-scope, on-site examinations, the FBAs use off-site surveillance to maintain their understanding of the bank's and holding company's risk profiles. All of these mechanisms are constrained to some extent when the individual agency is not the supervisor of the entire group, or part of the group is subject to the primary oversight of another functional regulator. There is a substantial continuous supervision program at major banks.

56. **Individually, each of the FBAs employs standard supervisory techniques in a broadly consistent manner.** Each agency supplies its supervisory staff with extensive manuals, guidance, and other assessment mechanisms which supervisors can use to develop their assessments and judgments. These appear well embedded in each agency's practices. There are, however, areas where the agencies could improve consistency between their operating processes, and seek to develop a "best of breed" model for supervision. There appear to be unnecessary differences in examination manuals, with each agency using supplementary assessments and rating systems designed to support the CAMELS framework, and different off-site surveillance models. The CAMELS-based rating system used by U.S. supervisors is somewhat outdated compared to those now used by overseas peers, and relies on high-level and fairly broad descriptions. The system also does not distinguish very well between inherent risk and risk controls, and guidance on assigning the component ratings also tends to overlap. Ratings also appear to be slow to adjust to developments (reflecting the annual cycle of review) and are "sticky" over time. The lack of risk differentiation provided by the ratings might possibly reflect adverse incentives created by the multiple uses to which ratings are put (e.g., ratings influence deposit insurance premiums, deposit-gathering capacity, and branching/acquisition approval requirements).

57. **The FBAs consider that the uniform CAMELS framework and their own separate supplementary risk rating systems serve two distinct purposes, and when combined, provide more complete information than either would provide individually about the condition and evolution of the industry.** However, it is not clear why this information cannot be captured in a single measure and, in any event, the supplementary risk rating systems differ by agency and are not readily comparable. The assessors recommend that either (i) the Uniform Financial Institutions Ratings System (UFIRS) be overhauled, building on the good work that has been done by individual agencies in developing their own more granular and risk-based rating systems, or (ii) if the FBAs consider the CAMELS system is too embedded in the broader regulatory system to be easily changed, greater effort

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be directed to developing a consistent, more granular, forward-looking risk rating system that at least provides a "common language" across the FBAs.

58. **The recent market turmoil has highlighted important areas where regulatory oversight and coordination need to be strengthened.** The general approach and structure of supervision has not assisted in developing and maintaining a thorough understanding of the operations of individual banking groups, and also of the banking system as a whole. The U.S. Treasury Department's financial reform package proposes to strengthen the capacity for consolidated oversight of financial groups, but the supervisory intensity of the non-banking parts of banking groups will also need to increase.

Accounting and disclosure (CP 22)

59. **The U.S. agencies provide for extensive disclosure of financial information by regulated banks and holding companies.** This disclosure is founded on U.S. GAAP. Both the FASB and the IASB are currently reviewing accounting standards with a view to (i) converging to a single set of standards, and (ii) considering the lessons learned from the recent financial crisis. Key developments will be the decisions taken on revised international standards for fair value accounting and loan loss provisions.

60. **In discussions with supervisory staff, the decision to align regulatory reporting with U.S. GAAP, particularly with respect to the allowance for loan losses, was repeatedly criticized.** Because U.S. GAAP applies an incurred loss model for loan loss allowances, which does not permit consideration of future events when estimating loan losses, examination staff of all agencies expressed frustration at the limitations on their ability to require banks to report what they considered to be appropriate loan loss reserves from a safety-and-soundness perspective. The assessors noted that the same outcome—larger buffers against loan losses—could be achieved by imposing higher minimum capital requirements if loan loss allowances measured in accordance with U.S. GAAP were not adequate to address supervisory concerns, but supervisory staff felt this was more difficult to implement and was better addressed by an 'above the line' charge to explicitly recognize the potential for future loan losses. The current framework also undermines the efficacy of the PCA regime, as the thresholds for regulatory intervention are aligned to U.S. GAAP reporting (the assessors noted numerous instances of 'well capitalized' banks being subject to regulatory sanctions for being insufficiently capitalized).

Corrective and remedial powers of supervisors (CP 23)

61. **Generally, the FBAs identify problems during on-site and off-site examinations.** Most issues are resolved informally during the examination (or in the ongoing discussions between the bank and the EIC/Central Point of Contact (CPC) where relevant), when the bank or holding company takes steps to address any regulatory concerns. Some problems, especially if serious, pervasive or repeated, may need to be addressed through formal supervisory action, which always is expressed in a written document from the supervisors. All formal supervisory actions are, at a minimum, published on a monthly basis (with limited exceptions). Detailed policies and action plans with specific target dates may be requested from a bank or holding company, and supervisors will review the institution's board's plan

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for sufficiency and examine written progress reports by the bank against key milestone dates. Progress is also assessed through ad hoc or normal on-site examinations.

62. **The FBAs have a range of supervisory options when a bank or holding company is not complying with laws, regulations or supervisory decisions, or is engaging in unsafe and unsound practices.** The agencies may take prompt remedial action and impose penalties. Remedial penalties and sanctions may be applied to banks and holding companies and, when appropriate, to management, board members, employees, controlling shareholders, other persons who participate in a bank's or holding company's affairs, and independent contractors, such as attorneys, appraisers, and accountants. The range of tools is applied in accordance with the gravity of the situation. If there are serious or repeated deficiencies, or when management has not acted sufficiently on an informal request, the agencies may take formal enforcement action. In cases where there is an immediate threat to the bank or holding company or to the depositors' interests, an agency may take immediate action by issuing a temporary order to cease and desist.

63. **A PCA regime applies to those instances in which a bank's capital falls below the prescribed minimum ratios/levels.** The regime provides a backstop against regulatory forbearance. The agencies also have powers to intervene even before the minimum capital ratio is breached. As an indicator of timely actions by the authorities, the rapid resolution of some major banks (and non-banks) during the present crisis can be noted. However, in many cases, while adhering to regulations and supervisory guidelines, supervisors will assess banks as being capital deficient and will require an infusion of capital, while at the same time the bank could be defined as "well capitalized" under the definitions of the PCA. This dichotomy arising from the relative inconsistency between the U.S. GAAP-based PCA regime and supervisory risk assessment systems could weaken the credibility of enforcement actions.

Consolidated and cross-border banking supervision (CPs 24–25)

64. **The existing legislation for consolidated supervision needs to be strengthened.** The Federal Reserve is responsible for consolidated supervision for U.S. BHCs, including FHCs. OTS is responsible for the consolidated supervision of savings and loan holding companies (SLHCs). All BHCs and SLHCs are subject to supervision on a consolidated basis. The Federal Reserve and the OTS are expected to rely, to the extent possible, on relevant primary supervisors and functional regulators for information about financial institutions within holding companies. As noted in the U.S. Treasury White Paper on Financial Regulatory Reform, "the GLB Act impedes the Federal Reserve's ability, as a consolidated supervisor, to obtain information from or impose prudential restrictions on subsidiaries of a BHC that already have a primary supervisor" (page 26). This is also true for the OTS with respect to SLHCs. Restrictions, both statutory and practical, on access to information on various parts of a group make it difficult to assess risks from a group-wide perspective. Some steps have been taken to overcome this drawback as a result of the crisis; specifically FBAs have ramped up their consolidated supervision efforts including for the former investment banks that are now BHCs. However, clear, ready, and direct access, legally supported, for whichever agency is responsible for consolidated supervision is desirable. The ability in the existing legislation for supervisors to get around these restrictions when there is "a material risk to the bank" is not workable. The legislative

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restrictions need to be repealed. The consolidated supervision regime would be improved if the currently de facto risk-based application and monitoring of large exposure and related party limits were to be explicitly mandated by regulation for holding companies. The supervisor monitors such holding company exposures using a risk-based approach, but that will not necessarily ensure sufficient robustness. Nor does the OTS apply formal consolidated capital requirements for SLHCs.

65. **The FBAs have clear authority to share confidential supervisory information with foreign banking and other sector supervisors.** This facilitates global consolidated supervision and implementation of the underlying home-host relationship framework, but it is subject to the limitation of not impinging on "U.S. interests". The information must be used for lawful supervisory purposes, and the recipients must keep the information confidential. FBAs provide adequate data and information to host country supervisors about U.S. banks and holding companies, to enable the host country to supervise the overseas operations of the U.S. banks. The FBAs have ongoing contact with supervisors in other countries in which U.S. banks or holding companies have material operations, including periodic visits to discuss supervisory issues.

Table 1. Summary Compliance with the Basel Core Principles—Detailed Assessments

Core Principle	Grading	Comments
1. Objectives, independence, powers, transparency, and cooperation	C	
1.1 Responsibilities and objectives	C	The authorities comply with this subcomponent of CP 1. Agency mandates are derived from, but are not always expressly stated in, legislation as in some other countries. Greater clarity is needed on the expectations of the bank supervisor and the holding company supervisor where these are different agencies to ensure strong coordination and clear accountability for the supervision of banking groups. Further clarity in mandates and expectations would be desirable as FBAs are expected in future to enhance their contribution to financial stability more broadly.
1.2 Independence, accountability and transparency	C	The authorities comply with this subcomponent of CP 1. Opportunities exist to better link strategic resource planning to more-forward-looking measures of risk and future resource demands. Improved collaboration will be needed for FBAs to make improvements such as better linking on-site, surveillance and macro staff, within and across agencies. Federal Reserve District Bank governance may not fully protect from the potential of influence from industry (or the perception thereof); it should be clearly noted that, there was no evidence of this in practice.

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Core Principle	Grading	Comments
1.3 Legal framework	C	The authorities comply with this subcomponent of CP 1.
1.4 Legal powers	C	The authorities comply with this subcomponent of CP 1.
1.5 Legal protection	C	The authorities comply with this subcomponent of CP 1.
1.6 Cooperation	C	The authorities comply with this subcomponent of CP 1. There are channels for cooperation, coordination, and leveraging off best practices─within and between FBAs and functional supervisors that could be further enhanced as assessors saw many examples of opportunities for better inter-agency coordination.
2. Permissible activities	C	The authorities comply with this CP.
3. Licensing criteria	C	The authorities comply with this CP. The scope of the interagency agreement to prevent inappropriate charter conversions should be strengthened. The (absolute) minimum capital requirement for new banks is relatively low, although practice has required higher levels of capital.
4. Transfer of significant ownership	C	The authorities comply with this CP.
5. Major acquisitions	C	The authorities comply with this CP.
6. Capital adequacy	LC	CP 6 requires supervisors to set prudent and appropriate minimum capital adequacy requirements for banks. This is generally true and features such as Prompt Corrective Action and leverage requirements lead banks to hold capital well above the minimums. However, important shortcomings exist in the definition of Tier 1 capital for holding companies with regard to innovative instruments, in the absence of capital rules for SLHCs, and in allowing intangibles (especially mortgage servicing rights) to count for a very high portion of a bank or thrift's Tier 1 capital.

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Core Principle	Grading	Comments
7. Risk management process	MNC	Despite the existence of formal rules, severe shortcomings in enterprise-wide risk monitoring and management at banks, were revealed in the recent crisis. Supervisory oversight was not effective in identifying those weaknesses and having them remediated. They created serious problems for banks and for the financial system. Although many of these weaknesses were present in other firms in other jurisdictions, because the U.S. system will likely remain at the forefront of financial innovation, it is imperative that risk monitoring and management systems be compliant with the requirements of this principle, which are high for the U.S., considering (as the CP mandates) the size and complexity of the financial sector. Although weaknesses have been partially remedied the robustness of needed improvements—in both banks and supervisors—will take some time to implement and test.
8. Credit risk	LC	There are well-developed rules and guidance, but processes have not been fully effective for some markets, particularly residential mortgages and CRE exposures at smaller and mid-size banks. Weaknesses in understanding risks of complex credit products were not adequately remediated by the supervisory process. Additional monitoring, supervisory focus and credit risk measurement tools being developed by certain FBAs are all desirable enhancements, but need to be placed in a more comprehensive, coordinated strategy designed to deal with identified weaknesses (including timliness of guidance, intervention and will to act) and position the U.S. to better deal with future credit cycle issues well in advance of them becoming serious problems.
9. Problem assets, provisions, and reserves	C	The authorities comply with this CP. The FBAs process is well developed and effective. Its effectiveness would be increased if accounting rules were changed to allow more-forward-looking provisioning.
10. Large exposure limits	C	The authorities comply with this CP. although the aggregate regulatory limits for total large exposures (loans plus other exposures) are high, in comparison with international practices. Reporting requirements on large exposures lack some detail (e.g., not showing total indebtedness) .

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Core Principle	Grading	Comments
11. Exposure to related parties	C	The authorities comply with this CP. However, there is inadequate specificity in the supervisory regulations on board oversight and involvement, and the reporting requirements to boards and to the supervisors lack in scope and detail. These weaknesses are compensated for to a high degree by supervisory policies and reviews, which expect active board oversight and monitoring of related lending, and require remedial action in case deficiencies are observed. The limit for aggregate lending to a single related party or to a conntected group of related parties is set at 15 percent of the bank's own fund plus surplus funds (i.e., excess provisions for loan losses) which is in accordance with international best practices. The overall limit for lending to all related parties in aggregate is set at 100 percent of own funds plus surplus funds, which is higher than international practice, although the supervisory policy includes the possibility to comment on exposures even within the limit, if deemed unsafe or unsound
12. Country and transfer risks	C	The authorities comply with this CP.
13. Market risks	LC	Material weaknesses have been revealed at banks in market risk monitoring, use of models, valuation and risk management. Substantial improvements are in progress, but will take time to put in place and assess, because they entail complex IT and risk architecture changes as well as changes in governance, oversight and compensation incentives.
14. Liquidity risk	LC	Guidance on liquidity risk management and supervision is consistent with existing international standards (although likely will evolve in the near term in accord with international efforts). Needed improvements to effectiveness are in progress at banks and supervisors, but cannot be fully assessed currently. Crisis-induced focus on liquidity at banks and supervisors is being formalized into an enhanced, regular, in-depth supervisory program.
15. Operational risk	C	The authorities comply with this CP. The agencies should continue to build more holistic and structured approaches to operational risk assessment, utilizing enhanced cross-agency mechanisms.
16. Interest rate risk in the banking book	C	The authorities comply with this CP. Supervisors could consider introducing a consistent measurement approach to improve risk assessment across FBAs.

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Core Principle	Grading	Comments
17. Internal control and audit	C	The authorities comply with this CP.
18. Abuse of financial services	C	The authorities comply with this CP. It is noted that a number of CP 18-relevant issues as identified by the FATF remain to be addressed.
19. Supervisory approach	LC	Authorities need to improve their approach to the group-wide oversight of financial groups, including unregulated entities. Introducing domestic "supervisory colleges" involving all material U.S. regulators for a group may assist, although broader reform is necessary. A review of risk rating systems, with a view to improving their capacity to distinguish between banks, is needed.
20. Supervisory techniques	C	The authorities comply with this CP. It is suggested that the authorities could review, perhaps under the auspices of the FFIEC, existing supervisory manuals and processes to remove unnecessary differences and develop a "best of breed" approach.
21. Supervisory reporting	C	The authorities comply with this CP. It is suggested that the authorities review solo reporting requirements and consider the implications of U.S. GAAP for the effectiveness of supervision and the PCA regime.
22. Accounting and disclosure	C	The authorities comply with this CP, but could consider the introduction of statutory reporting ("whistleblower") obligations for external auditors reporting to bank supervisors, along with associated protections.
23. Corrective and remedial powers of supervisors	C	The authorities comply with this CP.
24. Consolidated supervision	LC	Present legislation and practices hinder effective conduct of consolidated supervision of financial groups although supervisors work around this by changing their interpretation of the GLB Act. There are gaps in regulatory limits and reporting of large exposures, related lending, and capital on a consolidated basis at the holding company level. De facto practices of applying and monitoring large exposure and related lending limits should be expressly mandated. Lacking a fixed rule, SLHC capital is supervised on a case-by-case basis.
25. Home-host relationships	C	The authorities comply with this CP.
Aggregate: Compliant (C) – #, Largely compliant (LC) – #, Materially noncompliant (MNC) – #, Noncompliant (NC) – #, Not applicable (N/A) – #		

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Table 2. Detailed Assessment of Compliance with the Basel Core Principles

Principle 1.	**Objectives, autonomy, powers, and resources.** An effective system of banking supervision will have clear responsibilities and objectives for each authority involved in the supervision of banks. Each such authority should possess operational independence, transparent processes, sound governance and adequate resources, and be accountable for the discharge of its duties. A suitable legal framework for banking supervision is also necessary, including provisions relating to authorization of banking establishments and their ongoing supervision; powers to address compliance with laws as well as safety and soundness concerns; and legal protection for supervisors. Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.
Description	The current framework for the regulation and supervision of financial institutions in the United States has developed over many decades primarily in response to a series of financial crises and other important social, economic, and political events. The structure of the financial system necessitates a high degree of coordination among all relevant supervisors (both federal and, where applicable, state), both in formulating regulatory and supervisory standards and supervising individual banks and holding companies. The United States operates under a "dual banking system." A bank may choose to be chartered by the federal government or by a state. Federal bank charters for "national banks" are issued by the OCC. The OTS issues charters for "federal savings associations." Each of the 50 states has a banking authority that charters banks under its own laws and regulations. These banks are generally referred to as "state banks" or "state savings associations" (in this BCP, assessment the words "thrift" and "savings association" are used interchangeably). There can be differences in powers and corporate governance requirements, business powers and other rules applying to state-chartered banks and federally chartered banks depending on the chartering authority. Each U.S. bank, whether chartered under state or federal law, is subject to regulation, supervision, and examination by a primary FBA, irrespective of whether the bank is part of a broader organization: ● for national banks, this is the OCC; ● for state banks that choose to be members of the Federal Reserve System (state member banks), this is the Federal Reserve; ● for state banks that choose not to become members of the Federal Reserve System (nonmember banks) this is the FDIC; and ● for federal or state savings associations, this is the OTS. The FBAs generally have responsibility for regulating and supervising banks under their jurisdiction. In addition, the Federal Reserve and the OTS have the responsibility for regulating and supervising bank and thrift holding companies (BHCs, SLHCs,) respectively.
Assessment	Compliant
Comments	
Principle 1(1).	**Responsibilities and objectives.** An effective system of banking supervision will have clear responsibilities and objectives for each authority involved in the supervision of banks.
Description	**EC 1:** Each FBA operates pursuant to an express statutory grant of authority. In addition, agencies are mandated to administer various specific statutes which contain implicit or explicit goals (e.g., related to fair lending, community reinvestment, bank secrecy, and anti-money laundering/counter terrorist financing,). The FBAs also exercise competition authority powers with respect to bank mergers, using Justice Department criteria. Legislation creating the agencies does not contain explicit and clear statements of mission or mandate. However, the substantive requirements imposed on agencies by statute provide the basis for the agencies' publicly reported and

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	longstanding, defined objectives and responsibilities. These typically include promoting safety and soundness, maintaining financial stability, effective competition, and providing fair access to financial services and fair treatment of customers. The FDIC also has an additional objective of minimizing the disruptive effects that can occur within the banking system when banks or savings associations fail. The OTS has the additional objective of encouraging savings associations to provide credit for housing safely and soundly. Discussions with various agency heads indicated that they appreciate the potential conflicts in these objectives but have been able to balance these objectives in their planning and resource allocation to ensure that safety and soundness objectives are not compromised. Several others the assessors talked to noted the swings in agencies' focus on their various mandates which occur in response to events and to public reaction and congressional oversight. Legislation proposed by the U.S. administration and Congress includes alteration in agency responsibilities for consumer protection. The administration's legislative proposal also includes the agency heads in the financial services oversight council (chaired by Treasury), related to financial stability more broadly. It is designed to facilitate coordination of policy development, rulemaking, examinations, reporting requirements, and enforcement actions. It is also to provide a forum for discussion of emerging market developments and financial regulatory issues, and for resolution of jurisdictional disputes. **EC 2:** Under the existing legislation, agencies have delegated authority for rulemaking and also issue guidance and manuals that describe supervisory expectations. Taken together, the banking statutes, regulations, guidelines, policy statements, interpretations, and supervisory guidance and manuals establish a framework of minimum prudential standards and best practices that banks and holding companies must meet. They address such matters as capital adequacy, loan underwriting, single borrower and related party exposure limits, asset quality, loan losses and provisioning, risk management (including requirements for addressing specific types of risks), internal controls and audits, accounting standards, liquidity, Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT)/anti-fraud measures, among others. In addition, various laws deal with the relationship among regulators in meeting their mandates. For example, the Gramm Leach Bliley Act (GLB) covers the requirement for umbrella holding company supervisors to rely as much as possible on the bank examinations conducted by the primary functional supervisor. Within a banking group, the Federal Reserve, for instance, as holding company supervisor relies on the functional regulators of any securities and insurance subsidiaries for supervisory information. The primary federal banking or holding company supervisor can only conduct an examination of a functionally regulated subsidiary, such as a securities firm, if the subsidiary is engaging in activities that pose a material risk to the bank, or for other prudential reasons and the information cannot be obtained from the functional regulator. As described in CP 24, during the crisis the practice has evolved, at least temporarily, to attempt to get around these restrictions. In addition, separate legislation created the FFIEC, with the four FBAs on the board, together with voting representatives of State banking regulators, and the National Credit Union Association. The mandate from Congress to the FFIEC is to provide uniform principles, standards and report forms for the federal examination of financial institutions. Further discussion on the role of the FFIEC is contained in CP 20. The FDI Act gives the FDIC back-up supervisory power for national banks and state members banks that are members of the Federal Reserve system, as well as for savings institutions regulated by the Office of Thrift Supervision. Legislation also establishes certain coordination mechanisms such as that for the FFIEC which are part of the overall framework. Unlike banks, certain insured depositary institutions such as industrial loan companies (ILCs),

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	special purpose credit card banks, or grandfathered depositary institutions are permitted to be part of groups where their holding company is exempt from being regulated and supervised as bank holding companies. These groups thus have access to the safety net without consolidated supervision. Several of the major corporate groups that failed or experienced severe difficulties in the recent crisis had adopted this structure. The Administration proposes that all these entities be required within five years to come under consolidated regulation and supervision as a BHC. **EC 3:** A number of statutes require the FBAs to review their regulations at regular intervals to ensure that they remain relevant and effective and to reduce the burden on regulated entities. These reviews are conducted through a process that allows for widespread public (including industry) participation. Congressional oversight bodies can also play an important role in the rule development process, though the ultimate decision belongs to the agencies. From time to time, changes in statutory provisions are adopted by Congress in response to specific crises or market failures, industry concerns or recommendations, or to update the nation's banking laws to address changes in the marketplace. **EC 4:** The FBAs regularly publish or make available to the public upon request a wide variety of information on the structure, financial strength, and performance of banks subject to their jurisdiction. The information is derived from periodic and event generated regulatory reports and is updated regularly. Largely, this information is made available through the agencies' public websites and on the website for the FFIEC. The FFIEC's website allows for peer group performance assessments of banks and banking groups. **AC 1:** The FBAs utilize a risk-based supervisory approach, and this is extensively detailed in supervisory guidance and examination manuals *(see, e.g., Federal Reserve SR letter 9724, "Risk-Focused Framework for Supervision of Large Complex Institutions," OCC Comptroller's Handbook on Bank Supervision Process, FDIC Risk Management Manual of Examination Practices; OTS Examination Handbook)*. The assessors reviewed and discussed with authorities their approach to resource allocation, including reviewing supervision resources allocated to safety and soundness relative to consumer protection. Agencies use a combination of top-down and bottom up processes to allocate resources. As in other countries there can be challenges in reallocating resources, though assessors saw many examples of such effective reallocation during the crisis period. The degree of linkages between risk assessment and resource allocation depends on the drivers of risk used in the planning process. Assessors saw evidence that CAMELS ratings, for example, are used to drive resource decisions, (in part because they drive examination frequency). That means that there are limits to risk-based resource allocation, because CAMELS ratings are an imprecise and not-very-forward-looking measures of risk, and didn't change much until recently despite the build-up of risk in the system and at individual banks. (see CP 19 for further details)
Assessment	Compliant
Comments	The assessors were struck by the multiplicity of mandates of the agencies. Their safety and soundness mandate is clear. Though the CP does not require it, best practice internationally would have all mandates set out in legislations, and more clarity on FBAs' expectations of what those mandates mean in practice. In response to the crisis, all agencies are ramping up their roles in supervision of both banks and holding companies that they are involved in. There is a risk that the agencies will find less clarity of roles, and more potential for conflict and overlap, as they each enhance their supervision of complex groups in the name of institutional safety and soundness and financial stability. Experience elsewhere suggests that true accountability requires clarity of mandate. The fundamental issue of focus on the bank/thrift versus on the holding company/ group also needs to be addressed. The crisis revealed that, for major groups, it proved impossible to wall off the banks from risks posed by holding companies and/or other affiliates (which is inherent in the safety

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	and soundness mandates of the Fed, the OCC and the FDIC, and in approaches of the OTS to holding companies versus savings associations). Particularly in groups where the insured depository is a material part of the overall group (and given the fact that risks and risk management in these groups does not line up with legal structure), the depository and the group are crucially interdependent. Serious weaknesses in either one can be fatal for the other. If they are supervised by different agencies, the supervisor of the group and of the bank both must focus on the stability of the individual depository and of the group, relying on each other. Some agencies and banks indicated to the assessment team that more statutory clarity in mandates would be desirable, but would be hard to achieve as it requires legislative action. Going forward, as authorities alter responsibilities for consumer protection and enhance responsibilities of all agencies for financial stability, it will be important to ensure that mandates and accountabilities are clear in practice. Without clarity of mandate and expectations there is a risk that focus and accountability for individual agencies' safety and soundness assessments could become blurred. Authorities should ensure that the core safety and soundness mandates and missions of the individual agencies are preserved. Many times assessors were told by FBA staff, banks, and other outside commentators, that the framework was not at all what one would design if one started from scratch. But they also mentioned its positive features and the considerable effort that goes into coordination. Assessors understand the benefits of constructive challenge and the checks and balances that a system with multiple parties can bring. However, a system with multiple supervisory/regulatory agencies (particularly if mandates are unclear or very broad in scope) can lead to overlap that dilutes accountability, unproductive rivalry and risks of lessened focus on important safety and soundness matters, material coordination costs in setting regulatory policy and supervision, and undue compliance costs for banks. The assessors have no view on the desirable number of regulators or the optimal regulatory structure for the US. Every structure has advantages and disadvantages. What is important is that authorities in any country understand the disadvantages and put in place effective processes and oversight to address them. As noted in various CPs, assessors saw evidence of material room for improvement in this regard. There also appear to be opportunities to better link strategic resource planning to forward looking risk assessment and to the various measures of risks that the agencies use internally. For example agencies have a variety of internal processes, including rating systems and monitoring tools that assess broad direction of risk in the financial system and in the banks, and identify areas of possible focus. There was little evidence that this was used in any systematic manner to drive multi-year detailed resource decisions.
Principle 1(2).	**Independence, accountability and transparency.** Each such authority should possess operational independence, transparent processes, sound governance and adequate resources, and be accountable for the discharge of its duties.
Description	**EC 1:** Laws set out the governance structure for the agencies. The OCC and OTS are separate bureaus or offices reporting to the Secretary of the Treasury with provisions to protect their independence from Treasury (e.g., by law the Secretary may not intervene in matters before the agencies and may not delay or prevent issuance of any regulation.) The FDIC is an independent agency with a board composed of three internal directors, appointed by the president with the advice and consent of the Senate, and the heads of the OCC and OTS. The Federal Reserve is the independent central bank with the Federal Reserve Board (FRB) and Reserve Banks. Reserve banks are separate entities within the system with boards of directors, presidents and delegated authority from the FRB for supervision. Laws setting up the agencies specify the appointment process for the heads of the agencies, (including Senate confirmation), which is for a fixed term. Heads may only be removed for cause, and that the reasons for such removal must be laid before the Senate. Each of the agencies is funded outside of the congressional appropriation process. The OCC and OTS are funded by fees levied on banks determined by the agency without involvement of Treasury. The FDIC supervision

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	and regulation program is funded from interest earnings on the deposit insurance fund and the FRB supervision and regulation program is funded from income on the FRB's other operations as a central bank. Agencies reported that they have operational independence in reaching safety and soundness decisions and the assessors saw or heard no evidence to the contrary. Each of the agencies has a unique internal accountability structure for supervision and regulation involving authority and review at various regional or central levels. Within each agency there are processes for delegation of various supervision and regulation functions. For example, within the Fed system, Reserve Bank Presidents have delegated authority for supervisory matters from the board. In each organization, considerable day-to-day authority for supervision decisions (such as ratings of institutions) is vested in the examiner-in-charge (EIC) for each bank. Each agency has review processes that can result in changes in these assessments in exceptional cases. The structure of the various agencies leads to their own internal review and coordination processes which differ somewhat from agency to agency. There are also processes to allow banks to appeal formal decisions of the FBAs including ratings and proposed enforcement actions. The differences in internal structure between FBAs can add to inter-agency coordination challenges. Assessors were not able to conclude that these structural differences result in material differences in supervisory processes or outcomes, though the potential undoubtedly exists (see also CP 20). Several agencies have made improvements in these internal accountability and governance arrangements in response to the crisis and to lessons learned. In some cases agencies have determined that improvements are needed in internal governance processes but the nature of these is being determined or has not been fully implemented. Often the changes being contemplated involve more centralized direction, coordination and oversight. **EC 2:** Each of the FBAs complies with the Government Performance and Results Act of 1993, which requires federal agencies, in consultation with Congress and outside stakeholders, to prepare a strategic plan covering a multiyear period and submit an annual performance plan and performance report. The performance plans and assessments are incorporated into the agencies' annual reports, which are required to be made public. The agencies also are required, by separate statute, to report annually on regulatory and supervisory actions taken during the year. There is considerable variation in the agencies' approach to public performance reporting for their regulation and supervision responsibilities, with differences in how goals are specified, measured and reported on, and considerable differences in the degree of focus on measures of activity versus outcomes. The agencies' performance reports related to regulation and supervision tend to specify a few performance measures, with a number of these related to completion of examinations within mandated cycles. There are also differences between agencies in the degree to which safety and soundness goals are reported separately from consumer protection goals. As part of its governance, each agency has internal quality control processes for supervision—and conducts 'lessons learned' exercises. Each FBA also has an independent Inspector General that performs audits and evaluations of their operations. Having such functions is a best practice. As part of their mandate they are required by legislation to perform material loss reviews (which are published) of any bank failure that costs the FDIC insurance fund more than US$25 million—a threshold that was set some time ago. These agencies are increasing their resources devoted to these mandated reviews, sometimes at the expense of other useful audit activities. IGs the assessors met indicated that they have plans to step back from the individual reviews to see if there were themes such as insufficient forcefulness or timeliness of action that needed to be addressed by FBAs. As well, IGs indicated that they wished to enhance their reviews of the supervision processes but in some cases had not done many of such reviews over the past few years because of other priorities or resource constraints. The assessors reviewed a selection of these quality control reviews, lessons learned findings and IG

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	reports. Oversight and accountability to Congress occur through various statutory reporting and frequent extensive hearings on various financial regulatory issues. Agencies' independence in expressing their views to Congress in testimony is specified by law. On behalf of Congress, the Government Accounting Office (GAO) conducts and publishes audits of the agencies performance. In 2009, the GAO placed the financial regulatory structure on its 'high risk' list of matters warranting attention by Congress and the Executive branch of government. This was because of the GAO's view that significant market developments that, in recent decades, have outpaced a fragmented and outdated regulatory structure and significant reforms to the U.S. regulatory system are critically and urgently needed. The current regulatory approach was reviewed by the GAO as having significant weaknesses that if not addressed will continue to expose the U.S. financial system to serious risks. **EC 3:** The FBAs specify that agency heads and all staff maintain high professional standards and exhibit high integrity. There are Federal laws and regulations, as well as individual conflict-of-interest rules and codes of conduct applying to each of the federal banking agencies. For all of the agencies, there are specific statutes governing ethical conduct. For example, the Comptroller of the Currency, the OTS Director, and the Federal Reserve staff are subject to statutory restrictions on activities and affiliations that might raise conflicts of interests. *See, e.g., 12 U.S.C. §§ 27 (unlawful for the Comptroller to hold an interest in a national bank), 242, 1462a(d) (unlawful for Director to hold an interest in an insured depository institution), 244 (respectively prohibiting Federal Reserve members from holding office in or stock of a member bank or related entities).* Similarly, FDIC employees and examiners and certain other employees of OCC and OTS are prohibited from owning stock in any entity regulated by their agency. 5 CFR 3101.109 (OTS). In addition, members of the FDIC Board of Directors are prohibited from holding any office, position, or employment in any bank or holding company during their time in office and for two years after they leave office, subject to certain exceptions. Senior examination staff of the FBAs generally are subject to a one year post-employment "cooling off" period with respect to entities they supervised. Violators are subject to civil monetary penalties, can be removed from office, and can be prohibited from participating in the affairs of the bank, the holding company, or any other company for up to five years. Examiners also are prohibited from accepting loans or gratuities from banks that they examine. *See 18 USC § 213.* These standards are reinforced by a number of criminal statutes, including those prohibiting corruption, bribery, theft, and fraud by agency employees. These laws are actively enforced. Each agency has administrative policies to ensure that appropriate codes of conduct are being followed. Banks and banking organizations assessors met indicated that, as a general matter, agency personnel operate with integrity and professionalism. **EC 4:** Agencies have large numbers of examination staff. The FDIC is beefing up its staff at major banks. For larger banks and holding companies, each agency has on-site teams that are housed full-time in the institution. These can range from 10–20 at a holding company to 50–70 at a major bank (the total can go as high as 80–90 once the teams from the various agencies are added together). This is because of the emphasis they put on continuous supervision. These teams are supplemented with risk specialists who participate with the teams in various on-site reviews and themselves conduct and lead horizontal reviews. Headquarters or regional staff are involved in monitoring and surveillance, as well as policy and approvals work. For mid-size institutions the examination team would be smaller but still have a dedicated EIC. For smaller banks, savings associations or community banks a portfolio approach is used. One EIC might be responsible for several smaller banks, with part-time support from other resources for specific examinations. Assessors met with staff of the FBAs involved in budgeting and resource allocation and reviewed

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	high level documents on these matters. Resource plans are done for the current year and one year forward (though published strategic plans cover a longer time period). The assessors focused on high-level understanding of the drivers of supervision resources allocated to large and small/medium-size banks. They also had the opportunity to discuss training plans (including with the FFIEC who runs training programs). In each of the agencies, overall resource levels related to supervision and regulation were essentially static in the 2–3 years prior to this assessment. In part, this appears to have been related to the fact that the number of 'problem banks' (CAMELS rated 4/5) was also very low and static. Ongoing consolidation in the industry was also a factor. Starting in 2007/2008 there were modest FTE increases in agencies, which have accelerated more recently. Agencies also noted they were able to free up resources in their large bank groups because of mergers. The FTE increases are largest at the FDIC as resources are added for resolution for problem banks. During the crisis some examinations and horizontal reviews were deferred. Some FBAs did not yet have a forward-looking resource plan related to new initiatives or improvements in supervision and monitoring processes and new priorities (e.g., more in-depth horizontal reviews, new priorities such as compensation reviews) that came from lessons learned from the crisis. Each agency is also adding specialist resources. Agencies have some flexibility in pay structures and are benefiting from the current market environment to attract specialists with considerable industry experience. The FBAs reported to the assessors that they have adequate resources to attract and retain sufficient numbers of qualified staff, with skills commensurate with the size and complexity of the institutions supervised. The mission reviewed material agencies use to monitor indicators of their human resources. The mission also discussed the state of market competition for resources, which has reduced because of the crisis. The major risk for some of the agencies is that around one-third of supervisory staff is eligible for retirement already or in the next five years. Each of the agencies undertakes an internal evaluation process to ensure its staff meets its supervisory needs. Examples include annual skills gaps analysis to determine if staffs available are meeting critical supervisory needs. Hiring and retention programs are in place to attract and retain staffs that have critical and highly marketable skills. Existing efforts that the agencies have in place are variable-pay and retention programs, benchmarking, and bonus programs. The assessors discussed the strategies the agencies have to address the risks of loss of staff through retirements. The salary scales, benefits, and work-life programs of the FBAs are not based on the U.S. Federal Government standards and provide more generous compensation. This provides greater flexibility to attract and retain qualified staff at each respective agency. Each FBA has a slightly different salary structure, and these salary scales or compensation packages are made available to the public. The agencies have the ability to commission outside experts or consultants when and where needed to fulfill any supervisory gaps, particularly during periods of financial stress. Often these are former commissioned examiners who have retired that have familiarity with the agencies' procedures, processes, and objectives. The agencies insist that staff undergo adequate and relevant training and ensure that sufficient resources are available for this purpose**.** Broadly, the FBAs have two developmental objectives: to train field examination staff to become commissioned examiners and to accomplish continuing professional development for existing commissioned examiners and other staff. The agencies use a combination of internal, external, and shared training programs to achieve these objectives; examples of shared training programs include collaboration through the FFIEC to provide continuing professional development courses on specialized topics. The agencies approve annual training budgets that provide employees with training opportunities each year. The FBAs participate in training offered by the FFIEC and by certain other regulatory agencies. All agencies are involved in developing and implementing basic and advanced training in relation to various

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	emerging issues as well as in specialized areas such as international banking, information technology, anti–money laundering, capital markets, payment systems risk, and consumer compliance. The FBAs require a staff member seeking an examiner's commission to take proficiency exams or commissioning tests. The agencies' supervisory staff have sophisticated technological equipment and support tools to review the banking industry and assess individual banks and banking groups**.** The agencies are heavily invested in electronic processes and each have an Information Technology office. FBAs include travel as part of the cost of supervisory work and approve travel budgets annually. Travel abroad is allowed and used to supervise the foreign operations of material U.S. banks and holding companies and to participate in other international activities. **AC1:** The heads of the FBAs are appointed by the President with the advice and consent of the Senate to a set term in office. The heads of the OCC and the OTS are appointed to a five-year term. During their tenure they also serve as directors of the FDIC. The FDIC's three remaining directors are appointed to six-year terms, although one of the appointed members is designated as Chairman for a five-year term. Members of the Federal Reserve Board of Governors are appointed to a full or to an unexpired portion of a 14-year term. On appointment by the President and with the advice and consent of the Senate, one of the members is designated to serve as Federal Reserve Chairman, and another of the members is designed to serve as Vice Chairman, for a four-year term. All of these agency positions are non-partisan, and there is no expectation that agency heads will resign at the conclusion of the term of the President who appointed them.
Assessment	Compliant
Comments	Assessments and comments for improvement in other CPs such as better integrating field and headquarters views of risks, and ensuring appropriateness and timeliness of supervisory responses, may necessitate alterations in agencies internal governance and accountability processes. As well, FBAs have a strong tradition of authority and accountability for supervisory matters being vested in those in charge of the supervision of individual banks and holding companies. This system has considerable strengths, but as detailed in comments on CP 7, 19, and 21, the crisis has revealed the need for agencies in many countries to better blend institution-specific information and judgments about emerging risks with experience from broader perspectives, including that of the supervisors of other banks, and those with more system-wide accountability and monitoring perspective within each agency. This balance is hard to achieve in any system. Thoughtful comments by leaders of various agencies indicate they understand the need to revamp processes to address these shortcomings. But this balance is difficult to achieve and maintain in practice. The structure of the U.S. system, both within agencies and the existence of multiple agencies, can make this a particular challenge. The authorities need to give due care and attention to these challenges in enhancing their system and need to have effective processes in place to allow senior leaders to have a way of assessing regularly and collectively how improvements are working in practice. In some FBAs it is also desirable to ensure that risks and supervisory matters for major institutions get ongoing regular attention at the highest levels. That may require changes in their internal governance, especially for organizations with multiple mandates. Some who the assessors met suggested that the Federal Reserve formalize a Fed governor—perhaps as vice chair—with ongoing oversight for supervisory matters. Assessors believe such ideas deserve to be carefully considered. Certain recommendations in this assessment will require more resources. FBAs could further enhance forward-looking resource plans, and relate them better to measures of risk. That could take account in a more systematic way of new initiatives or improvements in supervision and monitoring processes and new priorities (e.g., more in-depth horizontal reviews, new priorities such as compensation reviews) that came from lessons learned from the crisis. In addition the need to continue to deepen and broaden the analysis of the risks and quality of risk

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	monitoring and risk management at major firms means a continued need for specialist skills at various levels in the FBAs. There will also continue to be a challenge in exercising judgment about these matters at major banks. The FBAs have increased their resources but they should assess their likely ongoing needs in light of experience. There is a risk that agencies can underestimate the continuing increase in complexity of the organizations they regulate and supervise (of all sizes) and underestimate the complexity in the markets in which they operate. Achieving their mission requires a mix of appropriate skills of all staff. In light of this they should ensure their assessment of adequacy of resources, availability of expertise, and training programs, appropriately takes this into account. FBAs should also review performance reporting to enhance its relation to outcomes and improve its consistency and comparability and thus enhance accountability. There is an opportunity to use the Inspector Generals' more effectively in assisting senior management in improving performance 'including in drawing together lessons learned from their individual reports'. All FBAs should be receptive to IGs' reports, in future, that address the common lessons learned from the material loss reviews and other reviews of the regulatory process. The threshold for required material loss reviews should be raised by legislators, thereby giving IGs more discretion in how to use their resources. The governance rules (legislation and/or by-laws) for the Federal Reserve banks also need to be reviewed and altered. The need for board oversight at each Reserve Bank of the financial management and non-supervisory operations of these banks is understandable. However, the boards of these banks, two thirds of which are appointed by the regulated commercial banks, has the right to appoint the officers of the Reserve Banks (including those in charge of supervision) has the right to a say in their compensation and is involved in approving the budget. Quite properly in practice, the boards are not involved in any way in operational supervisory matters, and defer to senior bank staff on appointment and compensation decisions. There is no evidence that assessors saw of the board interfering in budget decision for supervision resources or in staffing decisions. The assessors are not aware of any independence problems in practice. Nonetheless, independence would be further assured if the governance rules for Federal Reserve banks were made consistent with current practice.
Principle 1(3).	**Legal framework.** A suitable legal framework for banking supervision is also necessary, including provisions relating to authorization of banking establishments and their ongoing supervision.
Description	**EC 1:** Federal and state laws provide for the creation and establishment of authorities with the authority to issue and revoke bank licenses. The OCC and OTS have licensing and revocation authority with respect to national banks and federal savings associations respectively, while each state has its own bank or financial institution supervisor with authority to issue and revoke state bank and savings association licenses [*see 12 U.S.C. § 27, 1464(a), 1844*]. In addition, the Federal Reserve may provide separate authorisation to become a member bank, and the FDIC has sole authority to grant, deny or revoke Federal deposit insurance. **EC 2:** The FBAs have authority to set, implement, and modify prudential measures without the need for statutory changes in most areas [*see, e.g., 12 U.S.C. §§ 1831p–1 (broad power to set safety and soundness standards for insured depository institutions) and 1464(t), 1831o(c) and 3907, 3909 (capital standards)*], although in a small number of minor cases specific prudential limits are prescribed in law, which limits the capacity for the FBAs to modify them [*see, e.g., 12 U.S.C. §§ 84, 1464(u) (single borrower lending limits); 371c, 1468(a), 1828(j)(1) (affiliate transactions); 375b (related party transactions)*]. Generally, the statutes empower the FBAs to prescribe the scope and substance of prudential measures by rules, regulations, guidelines, or orders. The agencies issue and amend regulations in accordance with the Administrative Procedure Act, which requires extensive open and public participation in the process. This mechanism provides for extensive Congressional, industry and community input into in prudential rule-making.

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	The FBAs have also published detailed compliance expectations and best practices, primarily in the form of publicly available supervisory guidance and examination manuals, covering areas such as internal controls, audit, information systems, risk management, and asset classifications and valuations. The FBAs endeavour to update these materials as needed to reflect supervisory findings and feedback, market developments and industry practices. These documents are not legally binding or strictly enforceable, but are used by the FBAs to state their expectations with respect to safe and sound banking practices. Issuance of guidance, interagency statements and examination manuals does not need to go through a public consultation process as do legally-binding regulations, although (with the exception of their examination manuals) the agencies often elect to seek public comment in developing their guidance material. **EC 3:** Collectively, the FBAs have broad authority under governing statutes and regulations to obtain financial, structural, and any other information from banks and any of their affiliates (including holding companies) in the form and with such frequency as the agencies deem necessary (see CP 21 for further details). Broadly speaking, banks and holding companies are required to file consolidated reports of condition with their primary FBA on a quarterly basis. The FBAs also require the periodic submission of a host of additional information on banks and their affiliates. The GLB Act, however, does impose some limits on the capacity of individual agencies to access information, requiring instead that they rely to the extent possible on the activities of other functional supervisors where these exist.
Assessment	Compliant
Comments	Appropriate licensing authority exists although the fragmented U.S. system means that, somewhat unusually, banks are able to choose their licensing authority, and hence have some degree of choice as to which FBA(s) will have supervisory responsibility over them. Further details on licensing are provided under CP 3. The GLB Act does limit information gathering powers to some extent, which (as discussed in CP 19 and CP 24) has an impact on the capacity of the authorities to conduct full and effective consolidated supervision. The assessors noted that the U.S. Treasury proposes to remove some of these limitations as part of the financial regulation reform proposals.
Principle 1(4)	**Legal Framework.** A suitable legal framework for banking supervision is also necessary, including powers to address compliance with laws as well as safety and soundness concerns.
Description	**EC 1:** Statutes and regulation provide authority to supervisors to address compliance with laws and the safety and soundness of institutions under their jurisdiction. In general, these authorities provide supervisors with discretion in determining when supervisory action is warranted and a range of proactive and remedial measures to address matters of concern. A statutory corrective action mechanism has been implemented via the Prompt Corrective Action regime, designed to act as a backstop by preventing forbearance involving banks with weakening capital positions [*see 12 U.S.C. 1831o*]. However, even under this mandated process which requires a minimum set of regulatory responses as a bank's capital position deteriorates, there is adequate scope for supervisory judgement as to the most effective additional measures to use to achieve the correction of capital weaknesses. **EC 2:** Collectively, the FBAs have broad statutory authority to obtain a wide range of information from supervised entities and their affiliates necessary to determine and enforce compliance with applicable laws and ensure the safety and soundness of banks [*see, e.g., 12 U.S.C. §§ 324–26, 481, 483, 602, 625, 1467, 1817, 1820, 1844, 1867*]. Under the FBAs authority to conduct examinations, banks and their affiliates must provide supervisors with full and complete access to their books, records, and employees (including directors) or risk the imposition of administrative sanctions. These obligations extend to the foreign operations of banks and their affiliates (subject to confidentiality provisions in relevant foreign legislation). Where external audits are undertaken, the FBAs also have full and complete access to the work papers, reports, and other relevant materials of external auditors. Given the predominance of the holding company structure in the U.S. banking system, agencies

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	can face the challenge of accessing information about the broader corporate group in which an individual bank is owned if they are to be able to comprehensively assess the risk profile of that entity. As noted under CP 1(3), the GLB Act does impose some limitations on the capacity of an individual agency to access information about an affiliate where another agency is the primary functional supervisor of that affiliate. The FBAs have established a range of ad-hoc information-sharing arrangements to endeavour to reduce the extent to which this impedes their ability to complete their supervisory assessments. **EC 3:** The FBAs have broad authority to impose remedial measures or sanctions when, in their judgment, a bank or holding company is not complying with laws or regulations or is likely to be engaged or is engaged in an unsafe or unsound practice. In these cases, the FBAs may require the bank to take prompt remedial action or immediately cease and desist existing practice and may impose a varying degree of sanctions depending on the gravity of the bank's violations, including, where appropriate, revocation of the banking license. Evidence exists that compliance powers/sanctions are routinely used. Further details are provided under CP 23.
Assessment	Compliant
Comments	Collectively, the FBAs possess the necessary powers of access, information gathering and examination, and their use is clearly evident. Under the GLB Act, however, individual supervisors can be dependent on their capacity to obtain information and supervisory assessments from functional supervisory agencies if they are to be broadly informed. This problem has been identified in the Treasury White Paper on Reforming Financial Regulation, and is discussed further in CP 24.
Principle 1(5)	**Legal powers.** A suitable legal framework for banking supervision is also necessary, including powers to address compliance with laws as well as safety and soundness concerns.
Description	**EC 1:** The FBAs and their staff are well protected against lawsuits for actions and omissions while discharging their duties in good faith. Sovereign immunity bars lawsuits without specific statutory authorization to pursue such litigation. Common law qualified immunity protects FBAs' heads and staff from liability for the violation of an individual's federal Constitutional rights in connection with employees' performance of discretionary functions, as long as the employees' conduct does not clearly violate established statutory or Constitutional rights. Lawsuits are permitted against FBAs' employees for acts and omissions that cause injuries while acting within the scope of their employment. In such a case, the United States would substitute itself as the defendant upon the Attorney General's certification that an employee was acting within the scope of his office or employment. Moreover, an exception to the relevant Act protects employees from lawsuits involving the execution of a statute or regulation or the exercise/failure to exercise a discretionary function, whether or not the employee abused the discretion involved. **EC 2:** In practice (the number of actual cases are few), the FBAs protect their executives and staffs against the cost of defending their actions and omissions made while discharging their duties in good faith.
Assessment	Compliant
Comments	
Principle 1(6).	**Cooperation.** Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.
Description	**EC 1:** The FBAs have broad statutory powers to share confidential business information collected in the course of official duties. *See 12 U.S.C.§§1817(a)(2)(A) and (C) on sharing with FDIC, a state or federal agency with supervisory or regulatory authority over the bank or other entity or any appropriate person, and 3412(e) on sharing of financial records, examination reports or other reports between the five FFIEC agencies, as well as the SEC, CFTC and FTC.* The necessity of maintaining the confidentiality of the information is highlighted in several statutory and regulatory provisions, as is the requirement that the information be used for lawful supervisory purposes. The FBAs have a number of formal and informal mechanisms for information sharing. By statute the agencies are required to coordinate on certain matters through the FFIEC. These matters include

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	examination procedures and shared access to electronic databases on supervisory information. The Federal Reserve and the OTS make available relevant information to other banking agencies and functional supervisors regarding operations of holding companies that may have a material impact on an individual regulated subsidiary. Vice versa, functional regulators are expected to inform the FBAs about developments which may have an adverse impact on banks within a financial group (although, in practice this does not seem to occur more than exceptionally). **EC 2:** The FBAs have concluded cooperation agreements with a number of foreign banking supervisors. Additionally, FBAs have exchanged letters outlining the conditions under which information could be shared on a best effort, case-by-case basis with several other countries. The FBAs also routinely share information with financial supervisors from other countries on an informal basis. In the experience of the FBAs both the formal and the informal arrangements work in practice. **EC 3:** The FBAs are authorized by statute and regulation to share information with domestic and foreign financial supervisors. Prior to engaging in information sharing, assurances are required that the information will be used only for lawful supervisory purposes and will be kept confidential. Under the International Banking Act, the agencies must determine that disclosure is appropriate and would not prejudice the interest of the United States. The agencies must also obtain the recipient's agreement to keep the information confidential to the "extent possible under applicable law." See *12 U.S.C. § 3109 (b).* **EC 4:** The FBAs are able to deny demands for confidential information in their possession except in limited situations. Such information may be subpoenaed by a court, a grand jury, or a committee of the U.S. Congress. When feasible, an agency that is being compelled to provide confidential information received from another supervisor will notify such supervisor and make reasonable efforts to resist disclosure. The FBAs also must notify U.S. law enforcement authorities if they receive indications of a possible violation of criminal law.
Assessment	Compliant
Comments	An ad-hoc structure of -information—sharing and confidentiality arrangements have been established to facilitate and improve information-sharing between relevant agencies, as required by this CP. However, as noted in a number of CPs (particularly CP 24), there remain deficiencies in consolidated oversight. While rightly focusing on information sharing (which is compliant) as the basis of cooperation and coordination, this CP also deals with evidence that cooperative arrangements work in practice. The assessors evidenced many examples of high quality cooperation between the FBAs in practice. In many ways the FBAs have been very innovative in finding cooperative ways to deal with some of the structural weaknesses and challenges in their system that come from the legal framework which does not match the way banks do business and organize themselves. There are many examples of extraordinary efforts by dedicated staff to cooperate to get the job done, particularly in the recent crisis. It was interesting that several senior people assessors met noted two initiatives at least partly driven by outside events—the recent SCAP process and Basel II implementation—as recent examples of cooperative processes that they wish to build on. The assessors saw examples where opportunities for cooperation and coordination and learning from best practice in other FBAs were missed. There were also examples where opportunities seemed to be missed for constructive challenge using judgment based on a shared fact base. Taken individually, none of these is crucial. But given the likely continued challenges facing the authorities, taken together they suggest a need for the FBAs to redouble their efforts at all levels of the organization to cooperate and coordinate and design processes to maximize coordination and the benefits from constructive challenge.
Principle 2.	**Permissible activities.** The permissible activities of institutions that are licensed and subject to supervision as banks must be clearly defined and the use of the word "bank" in names should be controlled as far as possible.

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Description	**EC 1:** State and federal laws expressly provide for the establishment, operation, permissible activities and transactions, and supervision of entities referred to as "banks." In general, a "bank" is an institution (a) incorporated or chartered either under state or federal law; (b) authorized to engage in activities as specified under applicable law, typically including accepting demand deposits and engaging in the business of making loans; and (c) subject to supervision by state or federal authorities. Hence, the term "bank" is defined by its range of permitted activities. Laws also provide for the establishment of specialized institutions that engage in some activities also permitted to banks, but that generally are not called "banks." These include "savings associations." They provide many of the services that banks provide and are supervised similarly. It should be noted that there is a small number of institutions, which are not subject to the full gamut of banking regulations (e.g., ILCs, trust companies, credit card banks, and "non-bank banks"). These institutions, through so called "grandfathering clauses," are still able to provide typical banking services and may remain in the deposit insurance scheme. **EC 2:** Federal and state banking laws and regulations provide clear parameters on permissible activities and transactions for banks. The National Bank Act, the Home Owners' Loan Act and implementing regulations specify the permissible activities of national banks and federal savings associations, respectively. The state laws under which state banks and state savings associations are chartered specify the permissible activities of such institutions. **EC 3:** No entity may operate as a "bank" and engage in banking operations in the United States without a charter from a federal or state banking agency. *12 U.S.C. §378* makes it a crime for any person or entity to purport to be a bank that accepts deposits if the entity is not licensed as such. In addition, states generally prohibit a corporation from using the word "bank" in its name unless it has a bank charter. Federal law also makes it a crime to make unauthorized use of terms, such as "national," "Federal," "United States," "reserve" or "Deposit Insurance" that indicate a federal banking charter, membership in the Federal Reserve or federal deposit insurance. **EC 4:** *12 U.S.C. §378* stipulates that all persons or entities engaged in demand deposit taking are required to be subject to some degree of regulation, supervision or oversight by state or federal authorities. All entities engaged in the combination of taking retail deposits and providing credits are licensed and subject to supervision as banks or savings associations. **EC 5:** Collectively through the FFIEC, and separately, the FBAs publish and regularly update information on banks and holding companies (domestic and foreign, and including branches of foreign groups) subject to their jurisdiction. Data accessible through the FFIEC's National Information Center includes detailed financial information and also other information such as on the structural organization of bank groups.
Assessment	Compliant
Comments	
Principle 3.	**Licensing criteria.** The licensing authority must have the power to set criteria and reject applications for establishments that do not meet the standards set. The licensing process, at a minimum, should consist of an assessment of the ownership structure and governance of the bank and its wider group, including the fitness and propriety of board members and senior management, its strategic and operating plan, internal controls and risk management, and its projected financial condition, including its capital base. Where the proposed owner or parent organization is a foreign bank, the prior consent of its home country supervisor should be obtained.
Description	**EC 1:** Banks are regulated and supervised by their licensing authority They are also subject to concurrent regulation and supervision by one or more additional banking agencies. Establishing a de novo bank always involves obtaining related federal deposit insurance, and often involves additional authorizations, such as membership in the Federal Reserve System, from more than one agency. The relevant authorities have well-established practices and procedures to communicate and coordinate investigations on related licensing and deposit insurance applications.

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	EC 2: The authority to license banks and the criteria to be considered are set forth in statutes and regulations. The authority for licensing national banks is conferred on the OCC, see *12 U.S.C. §21 et seq*. Similarly, the OTS is authorized to license federal savings associations, see 12 U.S.C. § 1464(a). In addition, each of the states has the authority to license banks operating within its jurisdiction. The FDIC alone is authorized to make determinations regarding deposit insurance under the FDI Act **EC 3:** Although not expressly required by the statute, the criteria for issuing licenses are generally consistent with those applied in ongoing supervision. For instance, the OCC considers whether the applicant bank: (a) has organizers who are familiar with national banking laws and provisions; (b) has competent management with ability and experience relevant to the services to be provided and the volume and type of risks to be assumed; (c) has capitalization, access to liquidity, and risk-management systems sufficient for the projected volume and type of business; (d) can reasonably be expected to achieve and maintain profitability; and (e) will operate in a safe and sound manner. See *12 CFR 5.20(f)(2).* When evaluating applications for deposit insurance, the FDIC considers seven statutory factors enumerated in Section 6 of the FDI Act. These factors assess the financial history and condition of the proposed depository institution and its parent organization, capital structure, proposed ownership and management, earnings prospects, activities to be conducted, convenience and needs of the community to be served, and potential risks to the Deposit Insurance Fund. Also important to the assessment of deposit insurance applications is the complexity and unique nature of the underlying proposal and business plan, including the conditions under which the proposed institution will operate. **EC 4:** Each licensing agency has the authority to deny an application if it determines that the applicant has not met the established criteria or if the information is inadequate. Before granting the license the agencies must evaluate the evidence and conduct investigations and exercise independent judgment in determining whether the qualifying criteria are met. **EC 5:** An essential element of the licensing process is to develop thorough understanding of the proposed legal, managerial, operational and ownership structure of a bank, both on a solo and consolidated basis. If impediments for effective supervision on a solo and consolidated basis exist, the agencies may take remedial measures, including denying a license, deposit insurance coverage, or Federal Reserve membership. **EC 6:** Applicants are required to identify prospective shareholders and key policymakers, including beneficial owners. Principal prospective shareholders, generally those owning 10 percent or more of a class of a bank's shares, and key policymakers who are not previously known to the licensing authorities must provide detailed information on their current and past work experience and financial holdings. The agencies will investigate information on integrity, criminal convictions, financial capacity and expertise in the industry. The assessment will also consider whether principal shareholders have the ability to provide financial support to the proposed bank. This includes identifying the sources of initial capital and ensuring transparency of ownership structures. The agencies will verify the information provided about beneficial owners. **EC 7:** Although the OCC does not stipulate a minimum capital amount for national banks, but sufficient net initial capital to support the "projected volume and type of business," they are de facto subject to a minimum of US$2 million since that is the required amount by the FDIC for inclusion in the deposit insurance scheme. Before granting the license the agency will verify that the required capital funds are fully available and on deposit with the institution's correspondent bank. The initial required capital of a federal savings association is also US$2 million, although OTS, like the OCC, requires sufficient net capital to support the bank's proposed business plan.This often implies a higher capital requirement than the minimum. A US$10 million capital requirement would be typical for a bank planning to grow to US$100 million assets in the start-up phase.

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	EC 8: The licensing agencies evaluate proposed directors and senior management with respect to expertise, integrity, and any potential for conflicts of interest. The agencies generally consider each individual's (a) financial institution and other business experience; (b) duties and responsibilities with respect to the proposed bank, holding companies and affiliates; (c) personal and professional financial responsibility, e.g., indicated by earlier professional experiences; (d) reputation for honesty and integrity, i.e., verified by (lack of) criminal or other records; and (e) familiarity with the economy, financial needs, and general character of the community in which the bank will operate. Applicants must demonstrate that each director has sufficient competence, experience and ability to direct the policies of the bank in a safe and sounds manner. Also key bank officers must show their ability to perform their duties successfully, e.g., in interviews with the licensing staff. **EC 9:** Applicants must show that the proposed strategic and operational plans are viable and that the proposed management team has the ability to implement the plans successfully. Typically, the plan must contain a documented analysis of the market environment and financial projections based on reasonable assumptions. To evaluate corporate governance structures, the agencies seek to understand the board's involvement in setting and enforcing clear lines of responsibility and accountability by reviewing organizational charts, business plans, and proposed policies and procedures. The agencies specifically determine how a bank's board of directors will approve, oversee, and communicate the bank's strategic objectives and otherwise exercise its fiduciary responsibilities. The agencies will also consider the relationship between the proposed bank and any related parties. This includes evaluating potential conflicts of interest, terms and conditions of any transactions or business relationships, and the terms of compensation plans. With respect to risk-management systems and policies, applicants are expected to develop appropriate written investment, loan, funds management, and liquidity policies. They also must establish an internal control structure and audit program, including exercising appropriate oversight over outsourced functions. The operational structure and risk-management framework are expected to be consistent with the complexity, risk, and scope of proposed operations. **EC 10:** Since a proposed de novo bank has no financial history, an evaluation of the reasonableness of the financial projections is paramount in the licensing process. Also critical is an assessment of the adequacy of financial strength to support the strategic plan. Estimates must be fully documented and supported by established growth patterns in the applicant's specific market area. Agencies will also evaluate concentration of funding sources for safety and soundness concerns and determine whether contingency funding plans are adequate for the bank's complexity and risk profile. The applicant must demonstrate that the proposed bank can achieve stabilized operations and be operated profitably within a reasonable period, typically, three years. **EC 11:** Foreign banks establishing a branch, agency, or a subsidiary bank in the U.S. must obtain approval both from the licensing authority and the Federal Reserve. The licensing authority may, and the Federal Reserve must, determine that the foreign bank and any parent foreign bank are subject to consolidated supervision by its home country supervisor. They also routinely contact the home country supervisor in order to take into account whether it has approved, or expressed no objection, to the proposal. Similar procedures apply before establishing or acquiring a subsidiary savings association in the US. In these cases the OTS will make the corresponding determinations. **EC 12:** Providing false or misleading information can form a basis for civil, administrative and criminal liability, and the penalties can include license revocation. *See 12 U.S.C. §93(a).* Similar representations are made on applications for federal deposit coverage and for membership in the Federal Reserve. *See 12 U.S.C. §327 (forfeiture of Federal Reserve membership).* **EC 13:** The licensing agencies require applicants to show that members of a bank's board of directors have the ability to establish and operate a bank in a safe and sound manner. At a minimum, this presumes that the board, collectively, has a sound knowledge of each of the types of activities the bank intends to pursue and the associated risks.

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	AC 1: Assessments regarding principal shareholders consider whether they have the ability to provide financial support. When applicable, a holding company is expected to serve as a source of financial strength to its subsidiary banks. It is expected to provide capital funds in times of stress. It is also expected to maintain capital-raising capacity to obtain additional resources to assist subsidiary banks. **AC2:** The FBAs monitor the progress of de novo banks in meeting business plans and strategic plans for a period after licensing, usually two to three years, during annual on-site reviews. There is also an early examination of the banks after its start, to ensure that required polices, processes and systems are in place. The banks must also give the agencies prior notice of any change in the bank's business plan during the first three years.
Assessment	Compliant
Comments	The dual banking structure, including State and Federal charters, and the multiplicity of federal regulators, mean that the banks have some degree of choice over their regulator. The U.S. Treasury White Paper on Financial Regulatory reform noted that the current structure allows banks to choose their regulators. (p.5), "fragmentation of supervisory responsibilities…allowed owners of banks…to shop for the regulator of their choice." The authorities have recently taken steps to reduce the banks' incentives for improper charter conversion," For instance, a recent interagency agreement states that conversion may not occur while supervisory measures are being implemented, or only if the same measures will be in effect also under the "new" authority. However, this interagency agreement specifically deals only with banks having a CAMELS rating of 3, 4 or 5. This leaves three quarters of all banks and savings associations outside this agreement although according to interagency policy—not manifested in the agreement—conversions are prohibited whenever there are serious or material enforcement actions pending also for firms rated 1 or 2. An additional incentive for charter conversion is that OCC and OTS charge banks for their supervision, while there are no supervisory fees levied by the Federal Reserve Bank or the FDIC. Since undue charter conversions undermine the credibility of the regulatory authorities, the implementation of the new rules, and—if needed—supplementary rules, should be closely monitored by the authorities to see whether they should be further strengthened. The assessors are aware that the actual number of conversions in each year is small, but in addition there is also the issue of "implicit threats" of conversion from banks to their supervisors. *On EC 9.* The licensing requirements clearly prescribe that applicants must present operational and business plans, which must include issues such as board oversight, internal audit and controls, risk management policies and processes, and the MIS. Furthermore, the licensing agencies are expected to gain thorough understanding of the institution by assessing a wide range of those facets of the bank as described in EC 9. The samples of licensing applications/supervisory assessments provided to the BCP assessors clearly showed that such descriptions are provided by the applicants. In addition, supervisors routinely will reaffirm these issues on an early visit after the newly licensed bank has started to operate. Significant analysis is developed during a field investigation, which is generally conducted jointly by the chartering authority, holding company authority, and the FDIC. The findings of the field investigation are reported in an in-depth review of the proposal (Report of Investigation or ROI), which is supported by examiner workpapers. The workpapers are compiled and the ROI is prepared in a fashion similar to a full-scope examination. The ROI is submitted for review prior to action being taken on the application. However, reading the sample of applications shown to the assessors, they found that the depth and comprehensiveness of the summary presentation (SOI) of the supervisory assessments of these critical issues were not sufficient, as required by this EC. In the assessors' view, the decision-maker needs more, and more deeply assessed, information on these topics in order to make an informed decision on the licensing issue. The required minimum capital is US$2 million for new banks. As explained by the FBAs, this minimum level is intended to allow for the wide variety of communities and economic markets within which institutions may be established. This variety includes the small, rural communities

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	that support locally-owned institutions, which generally require comparatively less capital than full-service institutions organized in large metropolitan areas. That said, the US$2 million level is lower than the corresponding level in many other countries, which also have small local banks. It should be noted, though, that in practice, capital contributions are significantly above the minimum of US$2 million.
Principle 4.	**Transfer of significant ownership.** The supervisor has the power to review and reject any proposals to transfer significant ownership or controlling interests held directly or indirectly in existing banks to other parties.
Description	**EC 1:** Federal statutes define controlling interest (see below). In addition, "significant ownership" is defined indirectly through the reporting requirement when a 10 percent ownership level has been reached. Statutes also address proposed changes in ownership, control or structure of banks. The FBAs have statutory authority under the Change in Bank Control Act (CIBC) [*CIBC Act, 12 U.S.C. § 1817 (j)]* to review and reject proposals involving significant changes in ownership or control of banks. In general, prior authorization is required for any person to acquire control of a bank. Control is defined as "the power…to direct the management or policies of an insured depository institution or to vote 25 per centum or more of any class of voting securities of an insured depository institution." Under limited circumstances a refutable presumption of control arises when a person would own or control 10 percent or more of any class of voting securities. Similar provisions apply for BHCs under the BHC Act *12 U.S.C. §1842(a)* and for SLHCs under the Home Owners' Loan Act (HOLA) Act, *12 U.S.C. §1467a(e*). In addition, banks are expected to inform regulators of any significant developments affecting the bank, such as a significant change in ownership within the 10 to 25 percent interval. A "person" includes an individual, a group of individuals acting in concert, or certain entities (corporations, partnerships, and trusts) that own shares of banks but do not qualify as holding companies. Beneficial shareholders are also captured under the regulations. **EC 2:** The implementing regulations for the CIBC Act, the BHC Act, and the HOLA set forth procedures that must be followed to effect a change in ownership (including beneficial ownership), the exercise of voting rights over a certain threshold, or control over a bank or holding company. Submission of a prior notice under the CIBC Act is required, but the Act exempts various categories of less significant transactions from this requirement, e.g., if temporary changes in stock prices leads to a minor breach of the 10 or 25 percent threshold, or requires a 90-days-after-the-fact notice for other kinds of transactions. Similar requirements are provided for in the Federal Reserve's and OTS's regulations. **EC 3:** Common criteria for the evaluation of an application for change in ownership include: (a) the financial condition and integrity of the ownership group; (b) the competence, experience and integrity of management; (c) the future prospects of the bank; (d) business plans for the bank;(e) the impact of the proposal on the safety and soundness of the bank; and (f) the convenience and needs of the community to be served, and (g) the impact of the transaction on depositors and the Deposit Insurance Fund. A request for authorization under any of the applicable statutes may be denied on any of the grounds considered, or an agency may impose conditions limiting an acquirer's exercise of voting rights. **EC 4:** The agencies obtain from banks and holding companies through annual reporting and/or on-site examinations, the names of all significant shareholders, including those that may exert a controlling influence and the identities of beneficial owners. The Federal Reserve requires an annual submission of identities of shareholders, including beneficial shareholders, who own or control 5 percent or more. OTS on-site examinations will likewise report the identities of shareholders owning more than 5 percent. In order to identify the true owners, the agencies will identify "company-owners" on subsequent "higher" levels as long as an owning company has at least a 25 percent stake in the next underlying company. **EC 5:** The agencies require after-the-fact notices of changes in control made without necessary notice to, or approval of, the agencies; In evaluating such requests, the agencies consider whether

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	the failure to request authorization in the first instance was a knowing violation of law (which could lead to monetary or other penalties). The agencies also consider whether appropriate procedures have been put in place to ensure that further violations do not occur. The agencies have the authority to deny or condition an after-the-fact request for authorization. They may also call for the unwinding of a change in ownership transaction. **AC1:** The agencies expect controlling shareholders, or the bank(s) with which they are affiliated, to provide the agencies with timely notice of any material information that would impact the shareholders' continued suitability. A failure to disclose such information would trigger legal provisions which could lead to sanctions. *See, 12 U.S.C. § 164(a)(1)(B).* At times, FBA supervisors meet with, and assess, principal shareholders.
Assessment	Compliant
Comments	
Principle 5.	**Major acquisitions.** The supervisor has the power to review major acquisitions or investments by a bank, against prescribed criteria, including the establishment of cross-border operations, and confirming that corporate affiliations or structures do not expose the bank to undue risks or hinder effective supervision.
Description	**EC 1:** Federal and state laws limit and define the types of acquisitions or investments banks may make. The agencies have established criteria for prior review of major acquisitions or investments. Not every investment or acquisition must be reviewed in advance by the regulatory authorities, e.g., FHCs need no prior approval due to their higher capital requirement, and Edge corporations need no prior approval for investments in foreign banking organizations (FBOs)not exceeding US$25 million. Procedural criteria have been designed to allow the supervisors to review those investments and acquisitions that could have a significant effect on a bank's condition, such as mergers and acquisitions of subsidiaries. **EC 2:** Major acquisitions and business combinations are subject to approval by federal authority. Implementing regulations specify the criteria by which individual proposals are to be judged. In some instances, the criteria are also defined by statute. Factors considered in reviewing such proposals include competitive concerns, financial and managerial resources, convenience and needs concerns (i.e., the needs of the community to be served) and future prospects of the affected bank. See *12 CFR 5.33(e).* There are additional requirements for activities and investments abroad. The risk to the Deposit Insurance Fund is addressed indirectly under the factors concerned with the financial and managerial resources as well as future prospects. **EC 3:** In all instances in which a notice or application is required the agencies assess whether the acquisition or investment would expose a bank to undue risk or would hinder effective supervision. When evaluating establishment of operations abroad, the FBAs determine that the laws or regulations of the foreign jurisdiction would not prohibit the FBAs from obtaining information needed to determine and enforce compliance with U.S. banking laws. The FBAs have the authority to deny a request if they would not be able to obtain adequate information for the exercise of consolidated supervision. **EC 4:** The assessment of a bank's financial and organizational resources includes, but is not limited to, the amount and source of initial funding, the capital condition and examination ratings of the investor, the policies and procedures that would be implemented at the target, and the measures the investor would use to oversee the operations of the target. **EC 5:** Regulations define the circumstances under which acquisitions or investments may be made without prior approval or notice to an FBA. Such procedures are generally tied to the capital levels and quality of management of the investor and its parents, or are otherwise restricted by the amount of the proposed investment. For example, the acquisition of a small portfolio within an activity already familiar to the bank would not require advance approval or notification. Also, U.S. banks must have an approval for opening a first foreign branch, but a second branch in the same country does not need approval.

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	EC 6: Significant nonbanking activities must be approved in advance by the FBAs and they have the authority to supervise and examine all of the bank's affiliates and subsidiaries, as well as contract providers (although, in practice, they are expected to rely on the functional supervisors as a first step). There are statutory provisions designed to protect against a bank suffering losses in transactions with affiliates. If certain transactions pose safety and soundness concerns federal supervisors can take actions to ensure that corrective action is taken and that the bank is protected. **AC 1:** In practice, when a bank seeks to acquire a significant holding in a foreign financial institution, the FBAs consider the quality of host country supervision and its own ability to exercise supervision on a consolidated basis. The FBAs confirm that the bank or holding company is aware of the host country laws and any restrictions that may be imposed on its operations. The FBAs also inquire into the need for host country authorization, the policies and procedures to be applied at the foreign financial institution, and the measures the parent will put in place to monitor the operations of the foreign institution.
Assessment	Compliant
Comments	
Principle 6.	**Capital adequacy.** Supervisors must set prudent and appropriate minimum capital adequacy requirements for banks that reflect the risks that the bank undertakes, and must define the components of capital, bearing in mind its ability to absorb losses. At least for internationally active banks, these requirements must not be less than those established in the applicable Basel requirement.
Description	**EC 1:** Laws and regulations require banks and BHCs to calculate and maintain minimum capital ratios. Federal statutes (1) authorize the FBAs to establish minimum capital requirements for banks, and (2) require the FBAs to impose two types of capital adequacy standards on banks. Under those authorities, the FBAs have adopted capital adequacy rules for banks and BHCs, which include both risk-based capital and leverage capital requirements (Tier 1 capital to total balance sheet assets). *See 12 CFR 3.6, 12 CFR Part 3, appendixes A, B, and C (national banks); 12 CFR 325.3, 12 CFR Part 325, appendices A, C, and D (state nonmember banks); 12 CFR Part 208, appendixes A, B, E, and F (state member banks); 12 CFR Part 225, appendixes A, B, D, E, and G (bank holding companies); 12 CFR Part 567 (savings associations).* Currently all U.S. banks and BHCs are subject to the general risk-based capital framework based on Basel I. In recognition of the diverse nature of SLHC groups, there are, however, no risk based capital rules applying to these entities. Some SLHCs are primarily financial in nature and similar to BHC groups. Others contain a wide variety of financial and non-financial affiliates of the thrift (which may be a small part of the overall assets of the group). Under general authorities for safety and soundness, the OTS assesses the adequacy of capital for these entities on a case-by-case basis considering the entire risk profile of the group. SLHCs account for approximately 10 per cent of total bank and thrift assets. Some SLHCs report a calculation of Tier 1 and Tier 2 capital publicly to deal with rating agency and counterparty interest in their capital strength. These SLHCs calculate their published proxy ratio using BHC rules, but this is neither mandated nor verified by the supervisor. The risk-based capital rule for trading book activities is based on the market risk amendment to Basel I, adopted by the FBAs in 1996 for banks and BHCs with material market risks (market risk rule). The OTS did not join the other FBAs in adopting the market risk rule in 1996, but will do so by year-end 2010 when they and the other agencies implement the new BCBS capital charges for market risk. OTS anticipates that only a few savings associations and SLHCs will have sufficient market risks to be subject to the rule. Currently, therefore, trading assets of banks not subject to the MRA are covered under the risk weights for banking book assets. The resulting capital charge may be higher or lower than the trading book treatment under the MRA depending on the asset and nature of the market risk. The market risk rule applies to any commercial bank or BHC with trading activity (on a worldwide consolidated basis) equal to 10 percent or more of its total assets, or US$1 billion or more. On a

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	case-by-case basis, the FBAs may require a bank or BHC that does not meet the applicability criteria to comply with the market risk rule if deemed necessary for safety-and-soundness reasons (*see* AC 5), or may exclude a bank or BHC that meets the applicability criteria if its recent or current exposure is not reflective of the level of its ongoing trading activity. A bank or BHC that does not meet the applicability criteria may, subject to supervisory approval, comply voluntarily with the market risk rule. FBAs report this happens rarely. Approximately 30 banking groups were subject to the market risk rule at the time of the assessment. For foreign banks with a branch or agency, to qualify for FHC status, the foreign bank has to meet the well capitalized standard consistent with the domestic PCA regime (6 percent Tier 1, 10 percent Total capital—usually based on home country calculations—with no explicit leverage requirement). Foreign branches also have to meet an asset maintenance requirement in the United States with a margin of assets over liabilities. Former investment banks that are now BHCs must compute consolidated capital under the Basel I risk-based capital rules. They were previously subject to the Basel-II-based SEC capital rules. These institutions are transitioning to Basel II rules. The leverage capital requirement supplements the risk-based capital requirement and establishes a minimum ratio of a bank's or BHC's Tier 1 capital to average total consolidated balance-sheet assets. The leverage ratio limits the extent to which a bank or BHC is able to fund itself with debt. Banks and BHCs are subject to Tier 1 and total risk-based capital ratio requirements on a consolidated basis. The minimum capital requirements for individual banks and BHCs are 4 percent Tier 1 risk-based capital, 8 percent total risk-based capital, and 4 percent Tier 1 leverage capital (3 percent Tier 1 leverage capital is the minimum requirement for banks and BHCs rated composite 1 under their respective rating systems and for BHCs that have implemented the market risk rule). Most banks and BHCs operate with capital levels well above these minimum requirements. Laws, regulations and guidelines for banks and BHCs define the components of capital. While in general emphasis is given to those elements of capital available to absorb losses, as noted in EC 2 there are also material elements in the definition of capital that the assessment team questioned from that perspective. To qualify as Tier 1 or Tier 2 capital, the capital instruments must be unsecured, and may not contain or be covered by any covenants, terms, or restrictions that are inconsistent with safe and sound banking practices. *See section 3020 of the Federal Reserve's Commercial Bank Examination Manual (CBEM), the Comptroller's Corporate Manual on Capital and Dividends (November 2007), the FDIC's Risk Management Manual of Examination Policies (Section 2.1 – Capital) and Section 0100 of the OTS Examination Handbook for a full definition and description of Tier 1 and Tier 2 capital*. Tier 3 capital is permitted to protect against market risks. Tier 3 capital is unsecured subordinated debt that has several other characteristics that are described in the market risk rule. Use of Tier 3 capital is rare. The FBAs have implemented what they describe as 'bifurcated' capital requirements for banks and BHCs. A new risk-based capital framework (based on the advanced approaches in the Basel II framework), is mandatory for "core banking organizations" and available on a voluntary basis to other banks and BHCs. This rule is enacted and implementation is in progress. Banks and BHCs are only eligible to calculate their regulatory capital based on this rule starting no earlier than 2011, once they have met a range of qualifying criteria including successfully completing a parallel run over a minimum of four quarters. FBAs must approve a banking organisation moving out of the

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	parallel run. Core banking organizations include banks and BHCs that have US$250 billion or more of total consolidated assets or US$10 billion or more of on-balance-sheet foreign exposure. At the time of assessment, implementation plans have been received from 14 core banking organizations. As this rule is not yet the basis for banks' capital calculations, it was not assessed in detail in this FSAP. However given the imminent implementation the assessors performed a high level review of the state of implementation and provided separate comments to the FBAs. The FBAs have also issued a proposed rule that would implement the Basel II standardized approach (standardized approach rule) with certain modifications to address U.S. markets, most notably residential mortgages. The proposal would permit banks and BHCs (other than core banking organizations subject to the advanced approaches final rule) to choose to remain under the current risk-based capital rule or opt into the standardized approach rule as described in the proposal. *See 73 Fed. Reg. 43982 (July 29, 2008).* Comments were received on this proposal but the implementing rule has not been finalized, and there is no publicly-announced date for its introduction. Accordingly, it was not included in this assessment. **EC 2:** The FBAs reported that the definition of capital, the method of calculation, and the minimum ratios required for U.S. banks and BHCs (as discussed in EC 1 above) are based on the Basel I Capital Accord (including the market risk amendment for commercial banks). While the Basel I Accord does not formally apply to holding companies, BHCs and banks in the U.S. are intimately related, and U.S. authorities have long held out that their capital rules for those entities are based on Basel rules. The Basel II rules, including the definition of capital, do apply formally to holding companies. The assessors reviewed these rules and discussed certain matters with the authorities. The risk weights and other aspects of the calculation of capital requirements for the general risk based capital rule including national discretion choices are essentially consistent with Basel I. An exception is the capital requirement for market risk, which only applies to certain large, complex, commercial banks and BHCs, which the authorities consider internationally active. The FBAs report that the market risk component in smaller banks is not large. As well, for smaller banks' exposures, banking book treatment could often result in higher capital than trading book treatment. The assessors discussed aspects of the definition of capital applying to banks, BHCs and SLHCs. The definition of Tier 1 capital applying to BHC's may, in the case of innovative instruments, depart from the Basel requirements. The limit of innovative instruments included in Tier 1 capital for the largest BHCs is 15 percent (the mandatory, "core" Basel II banks), which is the limit in the BCBS rules on innovative instruments. However, for other BHCs, including those that opt in to the advanced approaches rule, the limit on innovative instruments is set at 25 percent. In addition, cumulative preferred shares and cumulative trust preferred securities are included in the 15/25 percent limit, which would not normally be the case under either the BCBS rules or the published 1998 BCBS standards on innovative instruments. To qualify in Tier 1 capital under these rules, such instruments would have to be non-cumulative (as non-cumulative instruments are more loss absorbing). As with innovative instruments in other countries, these instruments count as Tier 1 capital, but returns paid on certain of them (i.e., trust preferred securities) are tax deductible. Authorities indicated that other features of these instruments meant their loss-absorption ability was appropriate for inclusion in Tier 1. They also noted that this flexibility in instruments allowed in Tier 1 capital was important to ensure a level playing field between the U.S. and practice in other jurisdictions.

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	These instruments make up 10–15 percent on average of consolidated Tier 1 capital of the 14 "core" BHC's (those under the advanced approaches rule). More recently, cumulative preferred shares beyond the 15/25 percent limit issued by BHCs and SLHCs as part of the Troubled Asset Relief Program (TARP) plan are included in Tier 1 capital through specific changes to the risk-based and advanced approaches capital rules. Again, to be eligible under Basel rules these instruments would be required to be non-cumulative. These are important sources of reported Tier 1 capital for some entities at the time of the assessment Risk-based capital rules at the bank level in a corporate group do not permit these instruments. The rules for these instruments at the holdco level are carried forward into the advanced approaches capital rule in the United States, now enacted, that will apply shortly, and that is not compliant with the Basel II requirements in this regard. The capital rules also allow certain intangibles to count as capital. The assessors discussed the issue of mortgage servicing rights (MSRs) with the authorities. Mortgage servicing rights are the valuation assigned to the payment stream a bank can earn for managing (i.e., "servicing") a mortgage portfolio that is held by another investor. The U.S. authorities do not require the automatic deduction of MSRs from capital for banks and BHCs. The U.S. provides for a category of "qualifying intangibles" which do not need to be deducted. These include MSRs, as well as non-mortgage servicing rights (NMSRs) and purchased credit card receivables (PCCRs). The latter are typically of lesser materiality for the larger banks. The FBAs consider that qualifying intangibles deserve special consideration on the basis that (i) they can be separated from and sold by the bank, (ii) the market value can be established by verifiable means, and (iii) a market exists for these assets. Qualifying intangibles may be included in capital up to 100 percent of Tier 1 capital, of which no more than 25 percent can consist of NMSRs and PCCRs. The Basel definitions of capital only require deduction of 'goodwill,' and these intangibles are not considered goodwill in the U.S. The issue is not the failure to deduct these amounts. Rather the issue is that because of the absence of lower limits, intangibles can be a very material part of Tier 1 capital Capital derived from MSRs can be material. MSRs typically amounted to 10–20 percent of Tier 1 capital for a number of the largest banks, were in the range of 40 percent of Tier 1 capital for some banks, and were 75 percent to over 100 percent of Tier 1 at a small number of institutions (including some that failed). For SLHCs, as noted earlier, there are no specific capital rules. Instead, the authorities consider a variety of factors in determining the adequacy of an entity's capital. For financial SLHC groups that are similar to BHCs, one factor is a proxy capital calculation according to the BHC risk-based capital (Basel I) rules. However, other factors (such as experience in comparable non-financial peers) may be taken into account, particularly in the case of SLHCs with material non-financial affiliates as part of the group. In the recent SCAP exercise FBAs considered capital needs of banks based on a range of indicators of capital adequacy including Tier 1, pro-forma equity capital, and considered the composition of capital. FBAs reported in the SCAP their longstanding desire that common equity, without the elements reported above, should be the predominant form of capital. As noted above, the issue is the extent to which this is applied on an on-going basis in practice. **EC 3:** The risk-based capital rules require banks and BHCs to hold capital commensurate with the level and nature of all risks to which they are exposed. The agencies have broad statutory authority to establish minimum capital levels for a bank or BHC *(reference 12 USC § 3907(a)(2)).* They also have authority under risk-based capital rules to impose capital charges on specific exposures if the charge under the rule is not appropriate for the exposures. The capital rules do not give FBAs the

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power to directly limit material risk exposures as mentioned in this EC. However, they can achieve the same result through their discretionary authority to alter capital requirements on a bank and through their general formal or informal enforcement actions in the case of threats to safety and soundness.

The assessors discussed with authorities how they used their authority to impose a specific capital charge, and saw clear evidence that this authority is used in practice.

Under the UFIRS, supervisors assess a bank's capital adequacy during every full-scope examination. This assessment is reflected in the Capital component of the CAMELS rating and is an important component of the overall CAMELS composite rating, which also factors into the PCA requirements for banks that are not adequately capitalized (*see* EC 6).

The RFI/C rating system measures the overall performance and condition of BHCs. The "F" component rates the financial condition of the BHC, which includes an assessment of the adequacy of the BHC's capital. Similarly, the OTS CORE rating system which includes capital, measures the overall performance and condition of SLHCs.

In assessing capital adequacy, the FBAs take into account, among other things, the level and severity of problem and classified assets; exposure to economic declines in capital as a result of interest rate, liquidity, funding, and market risks; the quality and level of earnings; investment, loan portfolio, and other concentrations of credit; certain risks arising from nontraditional activities; the quality of loans and investments; the effectiveness of loan and investment policies; and management's overall ability to monitor and control financial and operating risks, including the risks presented by concentrations of credit and nontraditional activities.

EC 4: The general risk-based capital rule reflects the risk profile of individual banks and BHCs and addresses the on-balance-sheet and off-balance-sheet risks of banks and BHCs. This is done by weighting assets and off-balance-sheet exposures according to their broad inherent risk levels.

Once implemented (for some banks potentially starting in 2011), the advanced approaches final rule for core banks (Basel II) will produce risk-based capital requirements for on- and off-balance-sheet items that are more risk sensitive than those produced under the general risk-based capital rule.

The leverage ratio is computed as Tier 1 capital divided by average total consolidated assets, and must exceed a specified level. These leverage ratio requirements do not include off-balance sheet risks.

EC 5: FBAs generally expect and require banks and BHCs to operate at capital levels well above the required minimums *(12 CFR Part 3, appendix A (OCC); 12 CFR Parts 208 and 225, appendix A (Federal Reserve) 12 CFR part 325, appendix A (FDIC)).* In addition to the risk-based capital requirements, the FBAs regard the leverage ratio requirement as an important element in the capital adequacy regime. It places a constraint on the maximum degree to which a bank or BHC can leverage its equity capital base.

The FBAs understand that the capital rules do not explicitly address all material risks that banks and holding companies may face, particularly in the most sophisticated and competitive financial markets. The general risk-based capital rule has built in "buffers" against these additional risks. The FBAs expect banks and holding companies to have forward-looking capital plans. Assessors saw evidence of supervisors considering capital plans but this work is evolving and being enhanced as a result of recent developments, lessons from the SCAP process, and the move to implement Basel II.

In recognition of the longstanding importance of securitization markets in the U.S., the authorities supplemented Basel I rules with an explicit capital treatment of these exposures, which is similar to

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	the Basel II treatment. Finally, the United States has established PCA requirements, based on trigger levels of capital or leverage ratios. PCA requires the FBAs to place increasingly stringent restrictions on banks as their regulatory capital levels decline. Because of these restrictions, most U.S. banks seek to maintain capital levels at or above the "well capitalized" thresholds, which exceed the capital thresholds specified by the Basel Capital Frameworks. Specifically, to be "well capitalized," a bank must have a total risk-based capital ratio of 10 percent or greater; a Tier 1 risk-based capital ratio of 6 percent or greater; and a leverage ratio of 5 percent or greater. In addition, as a result of the GLB Act, *Pub. L. 106–102,* BHCs that have elected to be financial holding companies (FHCs, which have broader investment powers) have the incentive to ensure their bank subsidiaries or affiliates remain well-capitalized (same definitions as PCA) so they can retain their FHC status in order to establish and retain certain non-banking financial subsidiaries and merchant banking investments, not otherwise permitted. BHC's, FHCs, and SLHCs themselves do not have a PCA requirement. **EC 6:** Under the PCA statute, *12 USC § 1831o*, the primary FBA for a bank may take a range of mandatory and discretionary actions if that institution's capital falls below the required minimum level for any relevant capital measure. The severity of the supervisory action depends on the severity of the capital shortfall. Well-capitalized banks are not subject to any specific regulatory restrictions. An adequately capitalized bank may not pay a rate of interest on deposits that is more than 75 basis points over the average rate for that type of deposit in the market in which the deposit is offered. An adequately capitalized bank must also apply for and receive a waiver from the FDIC before it can accept, renew, or rollover brokered deposits. In addition, for adequately capitalized banks, supervisors may take discretionary actions enumerated for undercapitalized banks. If a bank is undercapitalized, it must, by a certain deadline, submit a capital restoration plan for the primary FBA's approval. Other FBAs, such as the holding company supervisor and the FDIC may be involved in the review. A holding company that controls the bank must guarantee that the bank will comply with the plan in an amount up to 5 percent of the bank's total assets at the time the institution became undercapitalized. Until such time as the primary FBA approves the plan, the bank's asset growth and new lines of business generally are restricted. The FBA may also take other discretionary actions (e.g., formally require recapitalization; direct improvements in management; and restrict transactions with affiliates, interest rates offered, asset growth, and activities). If a bank is significantly undercapitalized, or is undercapitalized but fails to submit or implement an acceptable capital restoration plan, some of the discretionary actions discussed above become mandatory. In addition, the FBA may require the bank to dismiss officers or directors, divest itself of a risky subsidiary, or be divested by a holding company under certain circumstances. Also, the FBA must approve certain compensation before it can be paid to senior executive officers of the bank. If a bank is critically undercapitalized, the FDIC generally will restrict the activities of the bank and, at a minimum, the bank must receive the FDIC's approval to engage in certain material transactions. The primary FBA may be required to appoint a receiver or conservator. A comprehensive list of provisions for adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized banks is available in section 4133.1 of the CBEM and OCC Banking Circular 268. See also 12 CFR Part 565 (OTS). In addition to being subject to PCA requirements, a bank that fails to meet required capital minimums may become subject to a capital directive under *12 USC § 3907(b)(2)*. Directives are enforceable. Possible remedial measures include an enforcement action, assessment of civil monetary penalties, and/or denial, conditioning, or revocation of corporate applications. A failure to achieve or maintain minimum capital levels also can be the basis for termination of FDIC

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	insurance. While not subject to PCA requirements, holding companies that do not meet the minimum risk-based requirement, or that are otherwise considered to be inadequately capitalized, are expected to develop and implement plans acceptable to the Federal Reserve or OTS for achieving adequate levels of capital within a reasonable period of time. In addition, the Federal Reserve's and OTS's authority to issue capital directives for failing to maintain sufficient capital also extends to holding companies. *12 USC §§ 3907(b)(2),3909(BHCs); 12 CFR 565.7 (SLHCs).* The assessors discussed with authorities the frequency of use of these instruments and saw evidence of their application in practice. **EC 7:** Currently, certain banks can use internal assessments of risk as inputs to the calculation of regulatory capital for market risk and for certain positions in ABCP programs (this results in a 100-200 percent risk weight). To be eligible, rigorous qualifying standards must be met and models must be approved. While supervisors could revoke authorizations they are more likely to use alternatives if models do not continue to meet the standards. Use of internal assessment of risk as inputs to capital calculations will become more prevalent with the implementation of the advanced approaches final rule (Basel II). **AC 1:** All non-internationally active banks are subject to the Basel I risk-based capital requirements described above. Non-internationally active banks may not be subject to the market risk rule, depending on the size of their trading book exposures (see EC 1). However, as noted above, the definition of Tier 1 capital applying to non-internationally active bank holding companies and SLHCs may include elements that would not be permitted under Basel I rules applying to banks. (see EC 3). As well, as noted in EC 3, the capital requirements for SLHCs are determined on a case-by-case basis. That may or may not be consistent with the applicable Basel requirement in individual circumstances **AC 2:** For all banks and BHCs, risk based capital adequacy ratios are calculated and applied in a manner generally consistent with the Basel I requirements as described in EC 1. SLHC capital provisions are as described in EC 2 and are determined on a case-by-case basis. That may or may not be consistent with the applicable Basel requirement in individual circumstances. **AC 3:** The FBAs have the power to require corrective action if, in their judgment, a bank's current or prospective capital plan is inadequate and causes it to be in an unsafe or unsound condition. *See, for example, 12 CFR 3.10* and the provisions for capital plans under PCA, *12 CFR 6.5*. The FBAs expect banks and holding companies to assess their current capital adequacy and future capital needs in a systematic and comprehensive manner in light of their risk profiles and business plans. This requires a forward-looking approach to capital management in which capital levels are set in anticipation of possible changes in events or changes in market conditions that could have an adverse effect. FBAs evaluate the adequacy of bank and holding company strategic and capital plans. FBAs evaluate internal capital management processes to assess whether they meaningfully tie the identification, monitoring, and evaluation of risk to the determination of the bank or holding company's capital needs (independent of the bank or BHC's risk-based regulatory capital requirements). Banks and holding companies must consider and incorporate internal processes to address risk factors that affect the capital condition, such as overall credit risk exposure; interest-rate exposure; liquidity, funding, and market risks; earnings; investment or loan portfolio concentrations; the effectiveness of loan and investment policies; the quality of assets; and management's ability to monitor and control financial and operational risks. *See 72 Fed. Reg. 1372 (January 11, 2007) (Interagency Statement on Sound Practices Concerning Elevated Risk Complex Structured Finance Activities) (OCC); SR letter 99–18, Assessing Capital Adequacy in Relation to Risk at Large Banking Organizations and Others with Complex Risk Profile*, for example.

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	AC 4: The capital adequacy of holding companies is assessed on a top-tier, fully consolidated basis. Capital ratios also are assessed on a consolidated basis at the subsidiary bank level. However, there is no calculation of the solo bank capital position, excluding its subsidiaries. The FBAs expect the distribution of capital among entities within a banking group to reflect the risks presented by those entities. In addition, each functionally regulated subsidiary of the holding company is subject to its functional regulator's capital requirements, and those requirements take into account sector-specific risks. (For example, insurance liability risk is incorporated into the insurance risk-based capital regime.) Other subsidiaries also are expected to maintain appropriate levels of capital that are, if applicable, consistent with the expectations of supervisors with oversight responsibilities. For holding companies in which there is a significant nonbank presence, capital adequacy is analyzed with particular emphasis on the threat that current or potential issues present to any affiliated bank or overall financial condition of the enterprise. Supervisors report the need to go beyond the regular reporting on consolidated capital position of such holding companies to understand the drivers of their capital position. SLHC capital is reviewed on a case-by-case basis as described above and savings associations within the group are required to meet the risk based capital requirements. **AC 5:** The FBAs have the statutory authority to establish and enforce minimum capital levels for individual banks, BHCs, and SLHCs as determined, at the FBAs' discretion, to be necessary or appropriate for those banks, BHCs, or SLHCs in light of their particular circumstances. These levels generally exceed minimum regulatory capital requirements.
Assessment	Largely Compliant
Comments	This CP requires supervisors to set prudent and appropriate minimum capital adequacy requirements. This is generally true in the U.S., and the U.S. system includes features such as Prompt Corrective Action requirements that lead banks to hold capital well above the minimums. However, some important shortcomings exist in the definition of Tier 1 capital for holding companies with regard to innovative instruments, in the absence of capital rules for SLHCs and in allowing certain intangibles to count for a very high portion of bank or thrift Tier 1 capital. The exceptions are significant parts of what some banks and BHCs are counting as part of their Tier 1 capital. The assessment team recognizes the authorities' view that the definition of capital issues may also be present in other major jurisdictions and that there are issues of competitive equity. The assessment team also recognizes that some of these matters are being discussed internationally by the BCBS. In addition, the failure to put in place formal capital rules for SLHCs, at least for those that are primarily financial and similar to BHCs, is a significant departure from international core principles and can allow them in practice to be less well capitalized than international norms or domestic peers. Allowing SLHC holding companies to publish a calculation described as "Tier 1 capital" may also mislead investors as to what the regulatory rules and capital position is or suggest it is a Basel-based measure. Lastly, while assessors understand the need to not impose undue complexity on smaller or mid-size banks, the size threshold for applying the market risk rule appears to be at a considerably higher level than in a range of other countries though FBAs have authority to require banks below the threshold to apply the market risk rule (and the market risk rule does not currently apply to thrifts). Authorities should proceed with existing plans to apply the rule for thrifts by the end of 2010 and could and should periodically review market risk exposure of selected banks below the threshold to reconfirm their assessment that the thresholds remain appropriate.
Principle 7.	**Risk management process.** Supervisors must be satisfied that banks and banking groups have in place a comprehensive risk management process (including board and senior management oversight) to identify, evaluate, monitor and control or mitigate all material risks and to assess their overall capital adequacy in relation to their risk profile. These processes should be commensurate with the size and complexity of the institution.
Description	**EC 1:** This criterion applies to requirements on banks and banking groups and responsibilities of

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the supervisor. They are considered separately in what follows.

Banks and Holding Companies

Banks and holding companies are required to have in place comprehensive risk management policies and processes to identify, evaluate, monitor and control or mitigate material risks. Interagency safety and soundness guidelines require institutions to establish internal controls and information systems that are appropriate to the size of the institution and the nature, scope and risk of its activities. High level requirements are specified in those portions of the interagency safety and soundness guidelines addressing operational and managerial standards. There is detailed guidance and supervisory manuals on various specific risk areas and on consolidated approaches to risk management.

While Basel II is not yet formally the capital calculation, the agencies' Supervisory Guidance on the Supervisory Review Process of Capital Adequacy (Pillar 2) lays out further requirements related to risk management for core banks mandated to use the advanced capital approaches under Basel II, which they have been putting in place for some time. During the implementation process FBAs having been using Basel II implementation (and supervisors have been assessing implementation), among other measures to promote enhanced risk management practices. There are also supervisory letters which lay out additional risk management guidance. Taken together, the amount of guidance on risk management is voluminous.

In assessing the effectiveness of these rules and guidance, assessors met with the FBAs at senior levels, those in charge of supervisory policy and centralized risk assessment, groups of risk specialists, those responsible for on-site and off-site examination and on-site supervisory teams. Assessors also met with a range of major banks and discussed these matters with senior risk, finance, control, infrastructure and compliance executives. Assessors also reviewed recent reports such as those of the Senior Supervisors Group (including the update published in October as the on-site portion of the assessment was in progress), and discussed the conclusions with the authorities and with banks. This included long-time commercial banks, and former investment banks who have recently converted to BHCs.

Risk management cannot be effective if risk monitoring is not adequate. Given the size, complexity and national and global importance of the major banks it is reasonable to expect a high standard of risk monitoring and risk management, including ability for rapid analysis of enterprise-wide risk metrics across products, geographies and counterparties.

Authorities have noted that, in many cases, weaknesses in major firm's risk management systems left them unaware of the aggregate risk exposures on and off their balance sheets. Over the 2007–2009 period, a number of firms, including a number inside and outside the U.S., experienced very material difficulties in integrating credit, market and liquidity risks at the enterprise level and evaluating them jointly in a consistent manner. The assessors took note of observations from senior supervisors that lack of effective firm-wide identification of risk and robust senior management dialogue to evaluate and adjust risk exposures was a contributing factor to those firms that experienced greater difficulties. Banks and FBAs the assessors met with confirmed this observation.

The FBAs have noted that some off-balance-sheet structures were not fully considered due to legal separateness from the bank or holding company itself. Banks chose to support those structures in many cases to maintain investor relationships.

Supervisors and industry groups have highlighted the inadequacy of many firms IT and risk infrastructure in supporting the broad monitoring and management of financial risks. This affected the firms' ability, for example, to consistently value complex products throughout the organizations, estimate counterparty credit risk levels, aggregate exposures quickly to assess concentrations, and perform forward looking stress testing. Some firms report that they had

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material difficulty in identifying the links between various risks (credit risk, counterparty risk, market risk) in stress conditions and did not fully understand the direct as well as indirect exposures to the same underlying risk (e.g., through off balance sheet vehicles and exposures to hedge counterparties such as monoline insurers). For some major firms, the history of mergers made effective, consistent enterprise-wide risk monitoring difficult or impossible for some products. Certain major banks relied on AAA ratings of complex products such as Collateralized Debt Obligations (CDOs) without doing their own risk assessment.

These deficiencies were at the root of major losses and failures or near failures of some major firms. Counterparties and market participants becoming aware of the impact of these deficiencies (e.g., through reporting of material unexpected losses) was a major contributor to loss of market confidence in counterparties and retrenching of effective market operations.

Reports and discussion with FBAs emphasize the need to not underestimate the importance and impact of these weaknesses in amplifying and propagating the crisis.

The assessors discussed with the authorities and with private sector participants that progress has been made in enhancing major banks ability to take an enterprise-wide view of risk. Public reports from supervisors have assessed progress in various areas. These discussions suggest that major banks broadly understand and are committed to the needed improvements. High-level supervisory work by the FBAs, including continuous monitoring, has occurred to assess progress.

However, updates of progress understandably suggest that full remediation will take several years to achieve. Observers, banks and supervisors who assessors talked to confirm the required changes are complex, involve material data-gathering and IT improvements, can involve complex improvements to modeling capabilities and in some cases involve organizational and cultural changes to ensure that risks are not only evaluated based on modeling results but also based on sound judgment.

The result has been material losses on these portfolios and a number of bank failures. As the losses on CRE and other credit exposures continue to be recognized, problems at some smaller and medium size banks will likely continue for some quarters.

Many the assessors met with confirmed that the challenge of complexity for risk management is not limited to larger firms. Smaller and mid-size banks also need a comprehensive view of risk—some of them were involved in complex products they did not fully understand. While guidance has been released in several of these areas by the agencies within the past year or so, and further guidance is likely forthcoming in some areas according to the authorities, it is unlikely that all of these risk management deficiencies have been corrected at this stage of the downturn.

Data reviewed by the mission on recent supervisory assessments of these risk areas suggest that issues were not isolated to just a few institutions. However, there are many smaller and mid-size institutions where these risk management weaknesses are not present. There are also some larger institutions which, while needing various improvements, fared materially better than others.

Supervisors

As part of the examination process, supervisors review and rate risk management to determine the adequacy of bank processes relative to the size and nature of the bank, and identify weaknesses requiring attention from management. If FBAs determine that risk management processes are inadequate, they have the power through various means to require a banking group to strengthen them. However events revealed weaknesses in these processes as well.

Supervisors assess risk management as part of the formal rating systems and various other ratings and assessment processes they use (risk management is a part of Management assessment in the CAMELS rating for banks or part of “R” (risk and risk management) in the RFI/C rating system for BHCs, and the “O” Organizational Structure (inherent risk) and “R” Risk Management for

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	SLHCs. There are continuous supervision activities, specific on-site reviews, and horizontal supervision reviews. Of-site monitoring looks for indications of metrics that may indicate risk management issues. Risk-focused supervision places specific emphasis on the quality of risk management. Examiners consider findings relating to the following elements of a sound risk management system: active board and senior management oversight; adequate policies, procedures, and limits; adequate risk measurement, monitoring, and management information systems; and comprehensive internal controls. Examiners utilize a risk-focused approach to supervision, and apply flexibility when assessing the appropriateness of a banking organization's risk management processes to address the organization's circumstances and the nature, scope, and complexity of its operations. Large complex banks and holding companies are expected to have far more sophisticated and formal risk management systems in order to address their broader and typically more complex range of financial activities and to provide the board and senior management with the information needed to monitor and direct day-to-day activities. These risk management systems require frequent monitoring and testing by independent control areas and internal, as well as external, auditors to ensure the integrity of the information used in overseeing compliance with policies and limits. Supervisors will review the adequacy of internal audit work and their capacity to rely on it. Large complex banks and holding companies should have risk management systems or units that are credible, authoritative, and sufficiently independent of the business lines in order to ensure an adequate separation of duties and the avoidance of conflicts of interest. Supervisors review the work of these units, and Basel II supervisory work has also been used in this regard. For smaller banks engaged predominantly in traditional banking activities and whose senior managers and directors are actively involved in the details of day-to-day operations, risk management systems may be less sophisticated. Even smaller and mid-size banks can have complex parts of their operation needing sophisticated risk monitoring and risk management capabilities. Risk specialists can join supervisory activities for these banks. Assessors reviewed extensively with FBAs their approach to making these assessments of banks risk management systems and assigning ratings. A banking organization's failure to establish a management structure that adequately identifies, measures, monitors, and controls the risks involved in its various products and lines of business is considered unsafe and unsound conduct. If an agency determines that a bank fails to meet any standard established by the agency or by interagency guidelines, the agency may require the institution to submit an acceptable plan to achieve compliance. *See 12 U.S.C. § 1831p-1(e).* The agency also has the flexibility to pursue other courses of action, including enforcement actions or less formal actions, given the specific circumstances and severity of an institution's non-compliance with one or more standards. In the event that an institution fails to submit an acceptable plan within the time allowed by the agency or fails in any material respect to implement an accepted plan, the agency must, by order, require the institution to correct the deficiency. The agency may, and in some cases must, take other supervisory and/or enforcement actions, until the deficiency has been corrected. Assessors discussed with FBAs their approach to using supervisory tools, challenges and lessons learned. Reports from the authorities, discussion with the authorities and material that the mission reviewed, suggest that there were a number of cases in which banks' weaknesses in aggregating and managing risks on an enterprise-wide basis were not adequately appreciated by supervisors, as they were not by banks. Some other reviews have suggested that deficiencies were identified but in hindsight action was not forceful enough in requiring improvements. FBAs reported, and assessors viewed, examples of supervisory programs in larger, more-complex

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	banks where material complex activities were rated high inherent risk, risk management was rated only satisfactory or weak rather than "strong." Supervisors suggested that their focus was getting "less-than-satisfactory" up to 'satisfactory' (they pointed out that the bar for "strong" is intentionally high). FBAs discussed with assessors their challenges in integrating their assessments of banks and holding companies' market, credit, and liquidity risk management. They also discussed with assessors their challenges in bringing together a holistic, more-forward-looking view of major banks and holding companies that builds on the bedrock of examination findings, adds offsite analytical and macro perspectives from a wider range of sources in the FBAs and factors in views on systemic vulnerabilities that could influence assessments of risk management at individual banks and holding companies. While there are a variety of concepts under consideration, concrete plans are not in place at the time of the assessment. The SCAP process was an example of a success in this regard. FBAs are looking to how elements of that process to enhance supervision can be continued. The FBAs most involved in Basel II implementation work currently also reported that Basel II work had promoted the kind of supervisory analysis and inter-agency coordination they wished to emulate in other areas. Plans for improvements differ among the agencies and the inter-agency component of them is sometimes lacking. FBAs have started to make improvements but acknowledge more work remains. International cooperation in risk assessment of major banking groups is also important. In some cases this work involves systems enhancements at the FBAs that understandably take time to implement. Banking agencies have instituted specialty skills programs designed to identify and strengthen resources in specialized examination areas. **EC 2:** In assessing the adequacy of risk management processes, agencies' processes are designed to ensure that banks and holding companies have appropriate risk management strategies that have been approved by the relevant board of directors. Examiners also verify that the board develops policies and processes for risk-taking, establishes appropriate limits, and that senior management takes the steps necessary to monitor and control all material risks consistent with the approved strategies. The agencies assess, and ratings reflect, the board's fulfillment of its responsibilities primarily in accordance with the guidance outlined in EC 1 above. Agencies note that directors are expected to provide clear guidance regarding the level of exposures acceptable to their organizations and that they have the responsibility to ensure that senior management implements the procedures and controls necessary to comply with adopted policies. FBAs review material going to boards and are able to discuss matters with individual board members such as the chair of the audit and risk committee. Published supervisory reviews of weaknesses at major firms note that inability or unwillingness of some boards of directors and senior managers to articulate, measure, manage and adhere to a level of risk acceptable to the firm amounted to a breakdown in risk governance. They also note that some major firms assumed a level of risk well beyond that which the boards understood them to be taking. The FBAs have noted that weaknesses in executive compensation programs and corporate governance resulted in distorted incentives. At the end of October 2009, during the assessment, guidance from the Federal Reserve was issued regarding banks and BHCs better relating compensation to risk. A horizontal review of practices against this guidance was also announced. Banks the assessors met confirmed that enhancements in risk governance were underway and assessors discussed the challenges faced by the boards of these institutions.

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	EC 3: In assessing the adequacy of risk management processes, agencies ensure that risk management strategies, policies, processes, and limits are properly documented, reviewed and updated, and communicated within the bank and banking group. In addition, examiners determine that exceptions to established policies, processes and limits receive the prompt attention of and authorization by the appropriate level of management and the board where necessary. The agencies generally conduct examinations of the documentation supporting the risk management process and adherence to internal policies, processes, and limits in conjunction with targeted examinations of specific business activities. FBAs' policies and examiner guidance provides that exceptions to policies/limits must be authorized by the appropriate level of management or board. **EC 4:** FBAs review whether senior management and the board understand the nature and level of risk being taken by the institution and how this risk relates to adequate capital levels. Examiners also determine that senior management ensures that the risk management policies and processes are appropriate in the light of the institution's risk profile and business plan and that they are implemented effectively. Senior management is expected to regularly review and understand the implications (and limitations) of the risk management information that it receives. The same requirement applies to the board in relation to risk management information presented to it in a format suitable for board oversight. The agencies assess, and ratings reflect, whether senior management and the board of directors understand the nature and level of risk being taken by the organization primarily in accordance with guidance outlined in EC 1. *See Federal Reserve SR Letter 99–18, Assessing Capital Adequacy in Relation to Risk at Large Banking Organizations and Others with Complex Risk Profiles; and OCC's Community Bank Supervision and Large Bank Supervision Handbooks, for example.* FBAs report that recent events have revealed weaknesses in some banks' and holding companies' ability to identify and aggregate risks across the firm and to conduct effective stress testing. For example, some firms relied too heavily on historical correlations or focused too heavily on specific lines of businesses when conducting stress scenarios and thus failed to capture the breadth of their interconnected risk exposures fully. As noted in the overview, the agencies are actively involved in efforts to strengthen enterprise-wide risk management and stress testing practices for large financial organizations. Several firms the mission met and published supervisory reports suggest at some major firms there was a disparity between the risk firms took and those that the board of directors perceived the firm to be taking. Reports from senior supervisors, and observations the mission made in its meetings with major firms note that firms are undertaking adjustments to increase board and senior executive engagement and to strengthen the resources, stature, and authority of risk management. However it is not yet clear the extent to which these have contributed to stronger risk governance. Boards are also grappling with how they can be effective in setting robust risk appetite statements and monitoring risk, and supervisors are grappling with how to assess this aspect of board performance. While supervisors review material going to boards, and can meet board members collectively and individually, supervisors the mission met report that it is difficult to judge adequacy of board oversight. They also acknowledged their limited capacity in assessing board effectiveness, and indicated that was an area for enhanced focus going forward. **EC 5:** FBAs expect banks and bank holding companies to develop internal capital and strategic plans that exceed minimum regulatory capital requirements to ensure that the capital they are holding and forecast to need is adequate given their risk profile. Regulatory capital requirements have limitations in their ability to reflect an organization's full risk profile. (For further information on regulatory capital standards, refer to CP 6) Accordingly, all organizations are expected to understand their underlying risks and hold capital commensurate with those risks─at levels above regulatory minimums─to ensure capital adequacy. *See FRB SR Letter 99–18 and AD Letter 08–11, which provides examiner guidance for conducting reviews of compliance with these standards; OCC's Large Bank Supervision and Community Bank Supervision booklets of the Comptroller's Handbook.*

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	Recent events have highlighted weaknesses in capital standards and firms' own capital planning processes. The agencies are actively involved in the Basel Committee's recent proposals to enhance the Basel II framework for re-securitizations, certain liquidity facilities, and improved value-at-risk models and stress testing. In addition, the agencies recently completed a comprehensive, forward-looking assessment of the financial condition of the nation's 19 largest BHCs to determine what capital buffers would be sufficient for these BHCs to withstand losses and sustain lending even if the economic downturn is more severe than is currently anticipated. The agencies are actively working with those BHCs to ensure that they take appropriate steps to obtain any additional capital needed. As part of this process, holding companies are required to submit capital plans that, among other things, identify steps to address weaknesses, where appropriate, in their internal processes for assessing capital needs and engaging in effective capital planning. The FBAs have high-level guidance on determining capital adequacy in relation to risk profiles for smaller and mid-sized banks. Examiner guidance and manuals provide high-level guidance to supervisory staff as to how to evaluate capital adequacy based on the institution's risk profile. **EC 6:** Banks and holding companies generally are expected to ensure that risk management models and systems are independently validated and tested with an appropriate frequency. The FBAs' supervisory guidance directs that key assumptions, data sources, and procedures utilized in measuring and monitoring risk be appropriate and adequately documented and tested for reliability on an ongoing basis. Models should be independently validated and tested by risk management staff or by internal or outside auditors. Guidance which more specifically addresses model requirements for various types of models is found in the related sections of the agencies' manuals. *(See for example OCC Bulletin 2000–16, Risk Modeling, Model Validation and FRB SR letter 95–51)*. To address supervisory expectations more comprehensively and explicitly, the Federal Reserve plans to issue enhanced guidance covering supervisory expectations for the validation and testing of risk management models and systems in the near future. The mission discussed validation issues with the inter-agency team assessing implementation of Basel II and with other supervisors and banks. As in other countries, the robustness of validation procedures is one of the most important issues where continued improvements in banks are required. **EC 7:** The FBAs safety and soundness guidelines require banks and holding companies to have information systems that are appropriate to the size of the institutions and the nature, scope and risks of their activities and that provide access to timely and accurate financial, operational, and regulatory reports. The FBAs assess, and their supervisory ratings reflect, the adequacy of risk management information at both the holding company and institution level. Risk monitoring activities must be supported by information systems that provide senior managers and directors with timely reports clearly indicating positions and risk exposures, as well as with regular and sufficiently detailed reports for line managers engaged in the day-to-day management of the organization's activities. Examiners analyze reports flowing to executive management, board committees, and the board of directors for clarity, consistency, timeliness, quality, and coverage of crucial areas of the organization. Examiners ascertain that reporting is sufficiently comprehensive for sound decision making, and that reports relate risks relative to the bank's earnings and capital. While the mission saw evidence of these assessments and their effectiveness, as noted previously, for some major firms material inadequacies in IT systems prevented timely aggregation of risk information across portfolios to enable banks to understand their exposures on an enterprise-wide level. While assessors understand that major efforts in banks to rectify these weaknesses are underway, these necessarily take time to design and implement properly. As a consequence, for a

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	range of major firms it is not possible for supervisors to confirm their effectiveness at this point.
Assessment	Materially Non-Compliant
Comments	Severe shortcomings in bank risk management have been revealed in the recent past, and supervisory oversight was not effective in identifying these weaknesses and having them remediated. Some of the serious deficiencies arose in banks supervised by the FBAs and some occurred in entities that have recently transferred to FBA supervision. These shortcomings have been sufficiently large to create serious problems for both individual banks and for the financial system. Despite the existence of formal rules, regulations and other guidance, weaknesses have included such matters as risk aggregation, having an enterprise-wide view of risk, ensuring that the board approved risk appetite was well articulated, understood and implemented and the ability of supervisors to assess of the capacity of bank management to understand and control complex risk interactions. Risk management cannot be effective if risk monitoring is not adequate. Given the size, complexity, and national and global importance of the major banks, it is reasonable to expect a high standard of risk monitoring and risk management, including ability for rapid analysis of enterprise-wide risk metrics across products, geographies and counterparties. That was not in place at a number of major banks. Supervisors recognize and have reported that banks have made progress towards but have further to go to reach this high standard. It would be unrealistic to expect a financial crisis of this magnitude not to have revealed weaknesses in risk management processes. The extent and seriousness of those weaknesses, and the impact they had on the extent and severity of problems is remarkable. Assessors recognize that there were multiple contributors to the crisis including macro-economic factors. As the U.S market place will for the foreseeable future be at the forefront of innovative developments in the financial sector, and will likely continue to foster the most complex instruments, it is imperative that risk management systems and the supervisors' ability to assess them be commensurate. Although the most severe problems were found in the largest banks, supervisors should also keep in mind that even smaller and mid-size banks can have complex parts of their operation needing sophisticated risk monitoring and risk management capabilities. Partly, the weaknesses identified resulted from the confluence of credit (including counterparty credit), market, and liquidity risk under extreme conditions. FBAs, and banks the assessors talked to generally agreed that the system needed to be able to better identify, manage, and mitigate build-ups in risk. While improvements in risk management cannot be certain to eliminate all future problems, they should reduce their severity and scope and increase the likelihood that serious problems can be better contained. Weaknesses in enterprise-wide risk monitoring and risk management involving interactions between credit market and liquidity risk were evident (as covered in this CP). But there were also weaknesses in risk monitoring and management in credit, market and liquidity risk considered separately. A greater focus on stress testing is needed by banks and supervisors. Important new policies and guidelines such as those for better relating compensation to risk have just been promulgated. It is not possible to assess implementation by banks or supervisors at this stage. FBAs reacted strongly to the weaknesses in risk management, once identified. They have a comprehensive approach to pushing for remediation and strong oversight of banks' efforts. Publications like the periodic Senior Supervisors Group report (which are lead by U.S. FBAs and also cover banks in other jurisdictions) are effective means of reporting on progress. Assessors have no doubts about the FBAs' or banks' ability and willingness to achieve compliance with this CP.

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	However, these weaknesses have not yet been fully remedied. Challenges in addressing the shortcomings for banks and supervisors mean that necessary improvements will not be fully in place for several years. Continued implementation of Basel II for 'core' banks will help reinforce this process. The improvements will need to be tested by firms in more buoyant conditions which may challenge the balance between risk and return. Nor have the effectiveness of banks' improvements been fully tested by supervisors. Given this state of affairs, supervisors will need to consider what compensating measures, beyond those already in place they may expect firms to maintain until risk management improvements are more fully embedded. Supervisors should repeat at regular intervals a horizontal review at major banks assessing progress, including detailed testing of the robustness of risk monitoring and risk management improvements. They need to make sure this is broad enough to cover all the large complex banking organizations. Supervisors face a challenge in confirming the effectiveness of governance and operation of these systems at major banks. They need to continue efforts to ensure that they have the quantity and quality of resources at all levels of their organizations, and the cooperation across agencies and between parts of their agencies that allows them to meet these challenges.
Principle 8.	**Credit risk.** Supervisors must be satisfied that banks have a credit risk management process that takes into account the risk profile of the institution, with prudent policies and processes to identify, measure, monitor and control credit risk (including counterparty risk). This would include the granting of loans and making of investments, the evaluation of the quality of such loans and investments, and the ongoing management of the loan and investment portfolios.
Description	**EC 1:** Banks and holding companies are subject to credit-risk management requirements pursuant to U.S. federal banking regulations. References: Federal Reserve *[see for example 12 CFR 208, appendix D-1, part II(C) & (D) (addressing loan documentation and credit underwriting); 12 CFR 208, subpart E (addressing real estate lending standards and setting requirements for lending policies)]; OCC [12 CFR 30, appendix A, part II (C) & (D) (addressing loan documentation and credit underwriting); 12 CFR 34, subpart D (addressing real estate lending standards and setting requirements for lending policies)]; and OTS [12 CFR 560, subpart B].* These are further developed in extensive supervisory guidance, supervisory letters, published examination manuals, and related materials. Together, these sources require that banks and holding companies establish, review, update (as appropriate), and implement credit-risk management strategies, policies, and procedures for identifying, measuring, controlling and reporting on credit risk (including counterparty risk). The board of directors is responsible for understanding the level and nature of credit risk to the bank and holding company, setting the firm's risk appetite, and ensuring that management implements appropriate risk-management practices to identify measure, monitor and control these risks. FBAs review compliance with supervisory guidance on credit-risk management as well as compliance with internal credit-risk management strategies and risk-management policies by conducting interviews, reviewing internal policies and procedures, and performing transaction testing. They review information going to the board, review board minutes and may interview board members. FBAs adhere to the UFIRS and evaluate every bank against UFIRS guidelines (CAMELS rating) during on-site examinations. UFIRS has a specific component to rate Asset Quality (A), which involves supervisory assessments of each bank's assets and the credit-risk management of those assets. These assessments incorporate quantitative measurements of the levels of delinquent, troubled, and classified assets and qualitative evaluations of the adequacy of board and senior management oversight, credit policies, procedures and limits, risk management practices, internal control mechanisms, and management information systems. The relative importance of the qualitative considerations depends on the risk characteristics and circumstances particular to the bank. Further, peer practice comparisons through off-site monitoring and data analyses are also

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integral parts of the evaluation process and, when available and relevant, may be used in assigning a rating.

Recent published reports on the crisis, and major banks that the assessors met, have noted the difficulties for boards in complex institutions to understand and oversee risk and set and monitor risk appetite statements. In certain cases, risks assumed by banks were beyond that which the boards understood them to be assuming.

Supervisors assess the performance of the board during continuous onsite supervision at larger banks, through onsite reviews at smaller and mid-size banks and through board components of horizontal reviews. Typically this involves review of material going to the board and review of board minutes. Occasionally supervisors will observe a board meeting in person. At larger banks and holding companies supervisors will also meet with key board members such as chairs of key committees.

EC 2: FBAs generally expect that the banks' and holding companies' policies and processes for managing credit risk will establish an appropriate and properly controlled credit-risk environment. FBAs expectations are enumerated in supervisory guidance and generally include the features listed in this EC. As per supervisory letters, bulletins and manuals, supervisors are expected to consider a wide range of criteria including such matters as:

- comprehensiveness and relevance of policies to a banks' strategies,
- polices regarding approval of new credit products, credit administration practices including the quality of borrower and counterparty analyses adequate documentation, accuracy of the risk rating system,
- linkage of that to management decision making, and effectiveness of individual credit, business level or portfolio level stress processes, including for credit concentrations, and
- MIS systems, policies and procedures for problem loan management, clear identification of portfolio business risks, appropriate limit structures and handling of exceptions, and adequate risk management practices with respect to third party (indirect) originations.

Agency expectations for each of the components will vary with the size and complexity of the bank or holding company. There are various longstanding processes to assess credit risk policies and processes. These are reviewed directly as part of the exam process, as is the ability to rely on loan review work by internal audit and any of their findings. Examiners review selection of loan exposures for the appropriateness of the classification and the loan loss estimates. The shared national credit program is an extensive, annual inter-agency process that reviews a wide range of syndicated loans for the accuracy of the assigned risk rating. This helps determine provisions at individual banks for these loans and helps ensure consistency of ratings across firms and agencies. A higher proportion of syndicated credits needing adjustments at a bank is an indicator of problems in that bank. FBAs have various off-site tools to assess credit quality and identify outliers on such measures as concentrations. Horizontal reviews for groups of institutions may be performed. Continuous monitoring at large banks will focus on metrics of trends in credit quality and look for evidence of how the credit risk management process is operating in practice.

During the recent period, there is broad agreement among banks, supervisors and other commentators that there was a material and widespread erosion in underwriting standards for residential mortgages in across the spectrum of banks, non-bank affiliates and among non-bank lenders. The decline in underwriting standards also affected commercial real estate and other asset categories such as C&I credits and leveraged loans (shared national credit data for loans written in 2006 and 2007 identifies this weaknesses).

For residential mortgages, this decline resulted from a variety of influences, including belief in the ability to package and distribute loans, practices of unregulated mortgage brokers and other entities, and belief in the unlikelihood of sustained house price declines following years of growth and abundant liquidity. Behavior of GSE's and other federal policies, such as affordable housing

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goals, to encourage home lending are viewed as playing a part. The build-up of risks from one year to the next over the previous decade was steady and the regular pace of the build-up may have lulled market participants and banks into a false sense of security.

There were also, for example, steady increases in concentrations of CRE amongst smaller and mid-size banks in the decade preceding the crisis. For example, data reviewed by the assessors at several agencies showed that the proportion of banks with concentrations of CRE at 300 percent, 400 percent or 500 percent or more of capital had roughly doubled from their lows in 1996 to 2002/03. By such measures, concentrations were materially higher than their previous peak. They then further increased more moderately in the next few years.

Interagency guidance did not set limits on CRE concentrations but the guidance did set 300 percent as a high-level indication of potential CRE concentration risk and indicated banks warranting intensive supervisory oversight. (A statute limits the aggregate amount of commercial loans made by federal savings associations to 20 percent of total assets, and amounts in excess of 10 percent may be used only for small business loans. 12 U.S.C. § 1464(c)(2)(A).)

A number of the issues affecting the weakness in lending standards occurred in unregulated entities, but they also occurred in non-bank affiliates of major banks. Supervisors that the assessors met agreed that non-bank affiliates of certain major banks accepted risks the banks would not have taken. Under the U.S. system, these entities are often not regulated by a functional bank regulator but fall under the holding company. For the regulator of the bank, the issue is the extent to which supervision of the bank identifies and takes account of developments outside that could affect the bank. For the holding company regulator, the issue is the extent of supervisory involvement in non-bank affiliate issues in assessing the strength of the consolidated entity. And, as noted below and further in BCP 24, there are current statutory limitations to what the holding company supervisor may review at non-bank affiliates.

As noted in CP 24, the legislative framework suggests FBAs focus on the bank or holding company and defer to some degree on functional supervisors. Discussions with FBAs suggest this signal may have lead supervisors not to focus sufficiently on inappropriate credit risk activities in non-bank affiliates.

Many acknowledge that banks of all sizes needed to look more closely at potential credit (or market) risk in off-balance-sheet entities, and more attention on credit risk in non-bank affiliates is needed. Supervisors, and representatives of bankers that the mission met, acknowledged that a range of institutions had not demonstrated risk management practices commensurate with the risks they were assuming.

While other factors in the originate-to-distribute model for sub-prime mortgages and Commercial Mortgage Backed Securities (CMBS) for example were problematic, the foundation of certain of these structures on inadequately underwritten mortgage exposures was a major contributor to the problems that subsequently arose.

At various places in the FBAs, at least some of the increased credit risk was seen and appreciated. In the period 2005–2007, agencies issued guidance in such areas as home equity lending (May 2005) sub-prime and non-traditional mortgage lending (Oct. 2006) and commercial real estate concentrations (Jan 2007). In some cases this was well after the increased risk was identified. Certain of the FBAs conducted horizontal reviews at midsize and community banks to reinforce implementation of the guidance. FBAs reported delays in finalizing guidance in some areas such as CRE concentrations because of interagency differences in views about the approach to follow and strong resistance from industry in some areas during the comment period.

A range of FBA staff that the assessors talked to agree that by this time, however, a material part of the weaker underwritten credits and loan concentrations were already on banks' books. FBAs also discussed with assessors the difficulty they had in dealing with weak credit risk management

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practices at banks in advance of serious problems emerging. This was due to such factors as supervisors operating in a period where actual losses observed were very low, and the incurred loss accounting model for loan losses. This created difficulties for examiners in getting banks to put up a reasonable allowance for loan losses in the face of resistance from the banks, and auditor requirements. Others the assessors met emphasized the contribution from other aspects of the accounting rules such as the requirement for valuing securities held by banks on an "exit price" rather than on an estimate of what willing buyers and sellers would likely transact.

Reports and discussion the assessors had with FBAs note that banks and FBAs appeared to have underestimated or not understood the risks in complex credit products at larger banks, the warehousing risk in the originate to distribute model, and risks arising from the opaqueness of structures based on sub-prime lending or leveraged loans, and issues in traded credit risk products as well as the convergence and speed of the risks. Some of these apparent credit risk issues were on products that were part of the MTM books and/or on policies and procedures around credit risk trading. The assessment of these matters is included in CP 13.

Stress testing guidance exists but practices appear to need improvement in severity and in taking account of portfolio level impacts of credit risk events that can affect banks in a variety of direct and indirect ways. While many smaller and mid-size banks do some form of simple "what if" analysis, FBAs that the assessors talked to indicate more-formalized stress analysis would be helpful. In large banks, the recent SCAP exercise conducted by the FBAs is a notable example of the agencies' increased use of stress testing.

In some cases, too much reliance was placed by banks and supervisors on ratings for products where that rating proved to be inappropriate for the true measurement of credit risk.

Certain of the FBAs are developing and enhancing their off-site and on-site tools and approaches to allow more comprehensive monitoring, supervisory credit portfolio stress testing and identification of outliers. In some cases, lack of a coordinated approach appears due to the difficulties of multi-agency coordination.

EC 3: The statutes on transactions with related parties, discussed under CP 11, require credit decisions to be made free of conflicts of interest, and on an arm's length basis. Only above a certain amount are credit decisions required to be made by the board without participation of the interested party. Terms must be in accordance with those offered to members of the general public. Compliance is reviewed as part of the normal supervisory process including transaction testing, and through reliance on internal control functions whose effectiveness is tested from time to time by FBAs. Issues in related party lending are not viewed by the FBAs as major contributors to the recent turmoil.

EC 4: Under the FBAs' statutory examination authority, supervisors may review all books and records maintained by a bank (and its affiliates) subject to the agencies' supervision. Supervisors are given full access to this information, and to all employees involved in assuming, managing, controlling and reporting on credit risk, during examinations. Banks and holding companies that do not supply requested information or access to premises and personnel may be subject to supervisory sanctions and prosecution.

AC 1: FBAs review policies and procedures to ensure that banks establish limits on their credit exposures and that limits and approval authorities are clearly defined. Supervisors ensure that credit policies describe the manner in which exposures will be approved and ultimately reported to the board. Under general principles for sound credit risk management, supervisors expect that major credit beyond a certain size be decided by senior management. They also expect those that are new products or not in line with mainstream activities to receive more senior and more formal attention, in line with the size and complexity of the bank.

AC 2: Banks and holding companies are expected to implement policies and processes to identify,

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	measure, monitor, and control counterparty credit-risk exposure, including potential future exposure sufficient to capture the material risks inherent in individual products or transactions. The expectations for these policies and processes are described in supervisory guidance. During the course of examinations, supervisors review compliance with the guidance. To adequately evaluate these factors, supervisors conduct sufficient and targeted transaction testing on activities, business lines, and products experiencing significant growth, above normal profitability or large potential future exposures. As part of transaction testing, supervisors review potential future exposure calculations to determine whether they reflect realistic measures of exposure in both normal and stressed markets and whether banks and holding companies need to enhance their methodologies. Supervisors also determine whether methodologies employed to measure exposures are applied across all products and whether appropriate management information systems are in place for counterparty credit-risk limits and monitoring. While there were some weaknesses in these processes revealed by the stressed market conditions these were not the root cause of major problems. Underlying causes of the weaknesses in counterparty credit risks are addressed in CP 7 (risk management) and CP 13 (market risk). **AC 3:** There are no specific requirements of guidance on banks' monitoring the total indebtedness of entities to which they extend credit. However, bank practice is to do this as a part of their credit granting process. And, supervisors review how a bank monitors the total indebtedness during their review of overall credit risk management.
Assessment	Largely Compliant
Comments	The FBAs have well-developed policies and processes to regulate and supervise traditional credit risk in smaller and larger banks, which is what this CP largely addresses. They are designed to establish and confirm that an appropriate and properly controlled credit risk environment exists in banks. However, there is clear evidence that in the recent turmoil, and the events leading up to it, these processes were not fully effective for certain markets and/or products. Supervisors were ineffective in preventing a widespread and material decline in underwriting standards of residential mortgage loans. Material credit concentrations emerged (including in CRE concentrations at smaller and mid-size banks) and were monitored but action was not sufficient. Weaknesses also existed in the analysis (by banks and supervisors) of complex credit products, and stress testing at large and smaller banks (appropriate to their size and complexity) was insufficiently developed. Surveillance and monitoring of credit risk needs to be enhanced (not just in banks but also in their affiliates and others they deal with). This monitoring needs to be better linked to effective action, in advance, to reduce the breadth and severity of credit risk problems in a future credit cycle. Assessors recognize that in a vibrant financial system losses can occur and those can lead to failures. The assessors have looked beyond the current experience of rising losses and failures in reaching their judgment. As well, a turmoil such as occurred in 2007–2009 will naturally expose weaknesses. But it was universally agreed in discussion with the FBAs that credit cycles in future need to be managed with less extent and severity of credit problems. Supervisory and regulatory enhancements can play a part. A coordinated strategy could reduce the extent and severity of credit risk problems resulting from a future credit cycle. Achieving this will require more of a comprehensive, strategic, and coordinated approach to supervisory and regulatory enhancements than what the assessors were presented. The additional monitoring, supervisory focus and credit risk measurement tools being developed by certain FBAs are all desirable enhancements, and would fit into such a strategy. However, a comprehensive approach would be built on understanding of why FBA processes did not consistently perform in the recent past as desired for the future. A comprehensive approach would address issues such as the forcefulness of interventions, timeliness of guidance, revisiting whether guidance needs to occasionally contain specific limits to be effective, consistency of follow-up on new guidance, and ability of the FBAs to intervene to make their views known about systemic weaknesses in credit

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	risk management practices or in contributing polices that they do not control but that may need to be addressed. Assessors did not see such a comprehensive approach being clearly articulated and shared by the FBAs. This is in contrast to the issue of improved enterprise-wide risk monitoring and risk management at major institutions (CP 7) where there is broad agreement on the sense of direction and an assessment of progress. Improvements in supervisory and bank processes are underway in this regard, and they need to be sustained and more are likely required. Implementation of Basel II is assisting in this regard for major banks. As well, improvements in accounting rules to allow more forward-looking provisioning (beyond that permitted by current GAAP) would also assist, but are beyond the total control of supervisors (see CP 21 for further discussion on this issue). Lastly, the focus on improved board oversight of risks, including credit risk, will be important for banks and FBAs to continue. FBAs have started on some improvements that would improve credit risk assessment and monitoring that the assessors viewed as promising. ALL are being built up, and FBAs are enhancing credit risk data gathering and analytics. Different FBAs were emphasizing different improvements and further coordination would strengthen these proposals. There needs to be a clear assessment of lessons learned around credit risk management and supervisory assessment of credit risk. The coordinated strategic approach should also address any other improvements in credit risk monitoring and surveillance, inter-agency processes to enhance collective assessment of emerging problems and strengthen the "will to act" and ensuring that sufficient specialist resources are available to assess complex credit risk matters in smaller and mid-size, as well as larger banks. That strategy has to be based on a realistic assessment of what progress can be expected in the near term in macro factors (such as accounting rules for loan losses), with a sense of what other actions might be taken by FBAs (e.g., in supervisory intensity or additional rules) if that progress does not occur. As well, if in certain areas (such as CRE concentrations) guidance is to continue not to include hard limits on various exposures or concentrations, then supervisors have to be satisfied that they have a timely, extensive and forceful capability to deploy well in advance of pervasive credit risk management problems arising in future. Finally, many of the Material Loss Reviews published by the Inspector Generals (IGs) of the FBAs indicate that credit risk problems in smaller and mid-size banks that failed were often identified, but intervention was not early enough and/or not forceful enough to prevent the failure. No system can be or should be failure-proof and even timely forceful interventions can be ineffective (and there are undoubtedly examples of successful supervisory intervention). However, assessors were struck by the prevalence of observations about timeliness and forcefulness. The IGs the assessors met indicated that they planned to, but had not yet fully pulled together the lessons learned from these reviews (including for agency oversight and quality control processes) and provided them to principals of the FBAs. When available, such theme reviews would provide important inputs for improvement.
Principle 9.	**Problem assets, provisions and reserves**. Supervisors must be satisfied that banks establish and adhere to adequate policies and processes for managing problem assets and evaluating the adequacy of provisions and reserves.
Description	**EC 1:** The safety-and-soundness provision of the FDI Act (FDI Act), *(12 U.S.C. § 1831p-1(b))* requires the FBAs to establish standards related to asset quality. The interagency safety-and-soundness guidelines implementing this provision require a bank to establish and maintain a system to identify problem assets and prevent deterioration in those assets. The system should be commensurate with the bank's size and the nature and scope of its operations. In addition, the bank is expected to (a) conduct periodic asset quality reviews to identify problem assets; (b) estimate the

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	inherent losses in those assets and establish allowances/reserves that are sufficient to absorb estimated losses; (c) compare problem asset totals to capital; (d) take appropriate corrective action to resolve problem assets; (e) consider the size and potential risks of material asset concentrations; and (e) provide periodic asset reports with adequate information for management and the board of directors to assess the level of asset risk. U.S. federal law provides that the accounting principles applicable to reports or statements required to be filed with FBAs generally must be uniform and consistent with U.S. generally accepted accounting principles (U.S. GAAP). In certain situations, the FBAs can prescribe alternate accounting principles, provided the alternate principles are "no less stringent" than U.S. GAAP. FBAs report prescriptions are very infrequent. U.S. GAAP includes guidance on accounting for impairment in a loan portfolio and other credit exposures. (*See Statement of Financial Accounting Standards No. 5, Accounting for Contingencies (Financial Accounting Standards (FAS) 5), and Statement of FAS No. 114, Accounting by Creditors for Impairment of a Loan (FAS 114))*. This covers assets at an individual level and a portfolio level for credits with homogeneous characteristics. The FBAs have issued and, as warranted, periodically updated interagency policy statements on the Allowance for Loan and Lease Losses (ALLL), addressing the supervisory expectations about supervised banks' application of and documentation supporting FAS 5 and 114 to bank credit portfolios. These policy statements elaborate on the asset quality obligations, noted above, set forth in the interagency safety-and-soundness guidelines. These include, among other matters (a) the responsibilities of boards of directors, management, and supervisors of banks regarding the ALLL; (b) factors to be considered in the estimation of the ALLL; and (c) and the objectives and elements of an effective loan review system, including a sound credit-grading system. The statement emphasizes that each bank is responsible for developing, maintaining, and documenting a comprehensive, systematic, and consistently applied process for determining the amounts of the ALLL and the provision for loan and lease losses. To fulfill this responsibility, each bank is expected to ensure that controls are in place to consistently determine the ALLL in accordance with U.S. GAAP, stated policies and procedures, management's best judgment, and relevant supervisory guidance. This Interagency Statement on the ALLL identifies losses that are to be estimated in accordance with FAS 5, including credit losses in off-balance-sheet credit exposures, resulting from commitments and explicit and implicit recourse. Separate interagency guidance addresses the appropriate accounting and reporting treatment for certain loans that are sold directly from the loan portfolio or transferred to a held-for-sale account. Both the Federal Reserve and the OTS expect holding companies to follow the Interagency Statement noted above and review this during examinations of holding companies. The FBAs also expect banks and holding companies to perform reasonable stress tests to identify possible events or changes in markets that could have serious adverse effects in the future. The assessors formed the impression in various discussions that there was room to improve the coherence and use of stress/scenario testing and its link to bank's decision making. In October 2009 the FBAs issued updated guidance on prudent commercial loan workouts. **EC 2:** The FBAs review the adequacy of a bank's loan classification, loss provisioning process, and overall capital adequacy during each supervisory cycle. In assigning a component rating for assets, supervisors consider the adequacy of the bank's ALLL and other asset valuation reserves as well as the adequacy of the its credit administration practices. Supervisors review the policies, procedures, and internal controls for classification of, and provisioning for, credit risk as well as compliance with laws and regulations. To support this assessment, supervisors generally conduct transaction testing to assess the effectiveness of these internal control processes. In reviewing a sample of loans they assign them to

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	categories (pass, special mention, sub-standard, doubtful and loss, and compare to the bank's classification. This can result in supervisory recommendations for additional provisions. Supervisors also review the internal and external audit reports, internal management reports, models, and model validation processes to determine that classifications and provisioning provide boards of directors and senior management an accurate and timely picture of the bank's or holding company's credit risks. The agencies' respective examination manuals contain detailed procedures that supervisors follow in conducting their reviews. The assessors reviewed this process with supervisory staff, reviewed samples of monitoring reports the agencies used, and saw evidence of it working in practice. Through the agencies' Shared National Credit Program' (SNC), teams of supervisors from the agencies conduct an annual review of the classification of large syndicated loans held by multiple banks and holding companies. These reviews are conducted on-site at agent/lead banks and holding companies with assigned classifications applicable to all participating institutions. The 2009 review covered 8,900 credit facilities with commitments totaling US$2.9 trillion. Credits held by banks and non-banks are included. The review found credit quality deteriorating to record levels. Underwriting standards in 2008 improved from previous years but there were loans with structurally weak underwriting characteristics initiated pre mid-2007 that contributed to the increase in 2009 in criticized assets (sub-standard, doubtful and loss). Leverage finance credits represented more than 40 percent of the value of criticized credits. There was clear evidence of this longstanding SNC process being effective in identifying problem assets, ensuring consistency of treatment of those assets among banks. It also is effective in identifying banks where SNC experience suggested their processes for identification of problem assets needed improvement. **EC 3:** Pursuant to the FDI Act, *12 U.S.C. § 1831n(a)(3)(C)*, all assets and liabilities, including contingent assets and liabilities, of banks and holding companies must be reported in, or otherwise taken into account in the preparation of, any balance sheet, financial statement, report of condition, or other report required to be filed with a FBA. Implementing supervisory guidance makes clear that systems for classification and provisioning should take into account off-balance-sheet exposures. The Interagency Statement on the ALLL requires the recognition of credit losses in off-balance-sheet exposures, including loan commitments, standby letters of credit, guarantees, and recourse liabilities on loan transfers. U.S. FBAs assess the structure of off-balance-sheet instruments to understand the explicit and implicit credit risk to the bank. **EC 4:** In accordance with long standing supervisory guidance the FBAs confirm that banks and holding companies evaluate the ALLL reported on the balance sheet as of the end of each quarter, or more frequently if warranted. The determination of the ALLL and the necessary provision are to be based on the bank's current judgments about the credit quality of the loan portfolio, and should consider all known relevant internal and external factors that affect loan collectability as of the evaluation date. ALLL estimates are expected to reflect rigorous quantitative analyses supplemented by management judgment. The assessors also noted that, from time to time, agencies may issue supplementary guidance for particular products or markets emphasizing the important of realistic repayment and recovery expectations, including examples of what that means in practice for that product or market. Discussion the assessors conducted showed agencies understand the importance of this issue in the current downturn. **EC 5:** Under the supervisory guidance, banks and holding companies are expected to have appropriate policies and processes, and organizational resources for the early identification of deteriorating assets, for ongoing oversight of problem assets, and for collecting on past-due

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	obligations. The FBAs require banks and holding companies to initiate additional or heightened oversight as the rating for a credit exposure deteriorates and to initiate appropriate corrective action, including potential escalation into the restructuring, foreclosure, or collection processes. Based on a combination of on-site examinations and off-site monitoring, FBAs assess the quality and timeliness of the bank's or holding company's rating system, classification process, and credit workout processes to determine if they are appropriate. Supervisors also assess the trend in credit ratings migration and may direct a bank or holding company to re-grade any credit where the rating does not reflect the credit's actual condition. The assessors discussed the operation of this processes in the current environment and saw examples of its operations. At the time of the assessment impairments and the ALLL were rising considerably across the banking system particularly for mortgage loans, leverage loans, commercial real estate exposures and C&I loans. The assessors discussed with authorities the challenges that supervisors of smaller and mid-size banks have faced in ensuring management at banks recognized impairments after the previous long period of negligible loan losses. Examples reviewed by the mission demonstrated the authorities' willingness to use enforcement tools as necessary when provisioning processes and practices are inappropriate and safety and soundness is threatened. Nonetheless, all FBAs reported on the difficulties they can face in ensuring timely provisioning in individual circumstances under the current accounting model which looks to identify losses that have been "incurred" in the portfolio (see CP 22). **EC 6:** Under the FBAs' statutory examination authority, supervisors may review all books and records maintained by a bank or holding company (and its affiliates) subject to the agencies' supervision. During the course of examinations, supervisors are provided with full access to all records and employees of the bank or holding company. This includes access to individual loan files, risk-management reports, internal and external audit reports and other material (such as board or committee minutes and reports). Banks and holding companies that do not supply requested information or access to premises and personnel are subject to supervisory sanctions and prosecution. Authorities indicated that access to information on credit classification and provisioning is not an issue. **EC 7:** If provisions are deemed to be inadequate, the FBAs will seek to employ corrective measures. In any case, the FBAs have the authority to require additional provisions or to impose other remedial measures. *See generally 12U.S.C. § 1818(b).* When a bank's or holding company's ALLL is inadequate, supervisors will require it to adjust its ALLL by an amount sufficient to bring the ALLL reported on its regulatory reports to an appropriate level as of the evaluation date, subject to the constraints imposed by accounting standards. This adjustment should be reflected in the current period provision or through the restatement of prior period provisions, as appropriate for the circumstance. *(See Interagency Statement on the ALLL)*.The FBAs can also require the addition of capital or an adjustment of capital to reflect the insufficient levels of provisions and ALLL. The mission saw ample examples of this process operating in practice in the current environment. **EC 8:** The FBAs have the authority to require additional provisions or to impose other remedial measures. Assessment of the loan classification system and the adequacy of provisions is part of every full scope examination (annually or every 18 months). Various authorities have also conducted horizontal exams for certain banks or portfolios that focus on loan classification and provisioning practices. If the supervisor concludes that the reported ALLL level is not appropriate or determines that the ALLL evaluation process is based on the results of an unreliable loan review system or is otherwise deficient, supervisors will require the bank or holding company to adjust the ALLL and address the process deficiencies. Off site activities include a variety of monitoring techniques related to groups of individual

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	institutions, peer comparisons, comparisons against benchmarks, and summary statistics (see CP 20 for further description). **EC 9:** FBAs expect banks and holding companies to establish and implement appropriate policies and procedures for periodically assessing the value of risk mitigants, including guarantees and collateral, at net realizable value. For real estate based credits, the agencies have appraisal and real estate lending standards regulations that govern collateral valuation practices, underwriting standards (e.g., loan-to-value limits), credit administration, and portfolio management expectations. **EC 10:** Pursuant to the safety-and-soundness provision of the FDI Act, *(12 U.S.C. § 1831p-1(b),)* the FBAs have established criteria for identifying an asset as "impaired." (*See Interagency Statement on the ALLL* . The accounting guidance defines impaired assets in several pronouncements—individual loans under FAS 114 and loans assessed collectively (as part of a pool) under FAS 5. Banks and holding companies have the discretion to determine which individual loans are considered for evaluation of impairment under FAS 114 and define them in their internal accounting documents. Fundamentally, an impaired loan is defined as a loan where management does not think that it will collect payment in full of contractual interest, fees, and principal payments. The amount of impairment for a pool of loans is based on a bank's or holding company's ongoing loan review process and analysis of loan performance. One method of estimating loan losses for groups of loans is through the application of loss rates to the groups' aggregate loan balances. Such loss rates typically reflect the bank's or holding company's historical loan loss experience for each group of loans, adjusted for relevant environmental factors (e.g., industry, geographical, economic, and political factors) and current conditions over a defined period of time. **EC 11:** Under the various guidance banks and holding companies should have policies and procedures in place to ensure that the board of directors receives timely and appropriate information on the condition of the bank's or holding company's asset portfolio, including classification of credits, the level of provisioning, and major problem assets. Agency supervisors determine whether bank management provides clear, concise, and timely information about the loan portfolio and its attendant risks to the board of directors. Supervisors determine that management has clearly communicated strategic objectives and risk limits to the board and that the board has approved them. Supervisors also ensure that risk levels, trends, provisioning levels, significant problem assets, policy exceptions, and compliance with laws and regulations are adequately reported to both senior management and the board. Supervisors determine whether the reports' descriptions of loan portfolio risks are sufficient to enable the board to exercise its supervisory responsibilities. The agencies expect that a unit independent of the lending function will periodically evaluate the accuracy, completeness, and timeliness of the information in these reports. **EC 12:** Pursuant to the Interagency Statement on the ALLL, banks are expected to value, classify, and allocate provisions for large exposures on an individual item basis. **AC 1:** Supervisors have issued specific supervisory classification for retail credits, (*see* "Uniform Retail Credit Classification and Account Management Policy"; 65 *Fed. Reg*. 36903 (June 12, 2000)). Under these guidelines, banks and holding companies are expected to classify loans and recognize losses when payments are contractually a minimum number of days in arrears. For personal loans these are: 90 days substandard; 120 days before write off. For credit cards these are 90 days sub-standard and 180 days before write-off. For loans not covered by the policy on retail credit the FBAs consider credit risk factors beyond just arrearage. Credits are required to be classified when well defined weaknesses that jeopardize

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	liquidation of the credit exist, as described above. Loan refinancing is not allowed to lead to an improved classification. As necessary in the current environment certain agencies have issued guidance to reinforce the appropriate treatment for accounting and supervisory purposes of troubled debt restructurings.
Assessment	Compliant
Comments	The FBAs' processes are well developed and effective. They would be materially enhanced if accounting rules were altered to permit more-forward-looking provisioning, which FBAs would welcome.
Principle 10.	**Large exposure limits.** Supervisors must be satisfied that banks have policies and processes that enable management to identify and manage concentrations within the portfolio, and supervisors must set prudential limits to restrict bank exposures to single counterparties or groups of connected counterparties.
Description	**EC 1:** Regulations define those individuals and entities whose interests will be attributed to the single borrower for purposes of computing the legal limits. OCC and OTS have discretion to apply the attribution rules in a manner which reflects actual risk exposure. Regulations also define corporate groups for purposes of lending limits. *See 12 U.S.C. §84d)(2) and 12 CFR 32.5.* There are no statutory concentration limits for holding companies, but they are monitored and subject to limits—often these are bank-internal limits—on a case-by-case basis through the supervisors' assessments of the safety and soundness of the institution. FBAs review a bank's and holding company's risk management practices to define, identify, measure, monitor and control large exposures. Defining a large exposure includes taking into account, e.g., aggregate credit exposures to individual borrowers or to related groups of borrowers; to borrowers with common characteristics; loans collateralized by a single security; and loans with a single source of repayment. **EC 2:** Laws and regulations establish limits on "loans and extension of credit and contingent obligations" to a single or a group of connected counterparties. Most off-balance sheet exposures are included. However, credit risk arising from derivatives is not explicitly included, although institutions are expected to establish internal limits for such exposures. The FBAs monitor that management establishes reasonable credit and issuer limits and monitors that it has adequate controls and management information systems to ensure that these limits are not exceeded on an individual entity or consolidated basis. **EC 3:** Banks and holding companies are expected to have management information systems (MIS) that adequately and timely identify and aggregate risk exposures, including to individual or groups of counterparties. For holding companies, these systems must provide aggregate data across legal entities. **EC 4:** Under supervisory guidance, banks and holding companies are expected to establish internal thresholds for acceptable concentration of credit and to report all material concentrations to the board for review. Supervisors review policies, management report and internal audit reports to ensure that policies and practices are adequate to control risk concentrations. **EC 5:** Supervisors obtain, through regular financial reports and on-site examinations, information on concentrations in an institution's portfolio, including sectoral, geographical and currency exposures. Supervisors may follow up by requesting additional information, or directing the bank to reduce the level of risk concentration. Also formal measures might be taken, including monetary penalties for violations of concentration limits. FBAs have issued guidance for concentration by industry, *(e.g., "Interagency Guidance on Concentration on Real Commercial Estate")*. This document provides guidance on banks' policies, information systems, risk tolerances, etc. **AC 1:** A bank's total outstanding loans and extensions of credit to one borrower or group of connected borrowers are limited to 15 percent of a bank's capital (Tier 1) and surplus funds. A further 10 percent may be extended if the loan is fully secured by readily marketable collateral. *See*

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	12 U.S.C. §84. A bank may not loan more than 50 percent of its Tier I capital and surplus funds to a corporate group, even if for some reason, the whole group would not be judged to be "connected" in which case the 15 percent limit would apply. The 50 percent limit is rarely applied. A typical situation would be when a bank makes loans to companies that are related through common control but where the companies are financially independent. Additionally, there are separate limits, 10 to 25 percent of the capital and surplus funds depending on the type of security and/or obligor, on the amount of securities issued by any one obligor that can be held by one bank.
Assessment	Compliant
Comments	There exist various reporting requirements to the FBAs on large exposures, such as for banks under the Shared National Credit Program and for the largest 10 U.S. banks. In order to increase the focus on risk concentrations and to facilitate peer reviews, harmonized reports from all banks on large exposures, e.g., the 20 largest exposures/and all exposures exceeding a certain threshold such as 10 percent of own funds, should be provided to bank management and board and to the supervisors on a regular basis, such as quarterly. In the reports, a "large exposure" should be defined to include credits, asset holdings, and other on-balance and off-balance commitments in order to provide a complete picture. The thresholds for large exposures mentioned under AC1 above are higher, i.e., allow for greater risk concentration, than international best practices, which would be 25 percent of capital funds for all aggregated exposures to a single counterparty, including credits as well as other exposures such as security holdings. In the present U.S. rules, limits for security holdings are separate and additional to those for credits. This opens the possibility for excessive risk concentrations. Hence, while the assessors find the present division of the 15 and 10 percent limits (see AC 1 above) to be a sound practice, they recommend that the additional exposures which a bank can hold in relation to the same counterpart in the form of issued securities be included in the 15 plus 10 limits. Supervisory reporting and monitoring large exposures on a sectoral basis, e.g., for CRE exposures are being assessed in CP 7 which deals with credit risk and credit risk management.
Principle 11.	**Exposures to related parties.** In order to prevent abuses arising from exposures (both on balance sheet and off balance sheet) to related parties and to address conflict of interest, supervisors must have in place requirements that banks extend exposures to related companies and individuals on an arm's length basis; these exposures are effectively monitored; appropriate steps are taken to control or mitigate the risks; and write-offs of such exposures are made according to standard policies and processes.
Description	**EC 1:** Two major sets of laws, applicable to insured depository institutions, define and establish limits on transactions with "related parties." First, sections 23A and 23B of the Federal Reserve Act are designed to prevent the misuse of an institution's resources through transactions with its affiliates, including loans, asset purchases and guarantees. Section 23A imposes quantitative and collateral requirements on transactions covered by the Act. Second, sections 22(g) and 22(h) of the Federal Reserve Act impose a number of restrictions on extensions of credit between an insured depository institution and its insiders and their controlled companies. Although the regulatory restrictions on transactions with insiders apply only to the bank subsidiaries of holding companies, the FBAs encourage banks to adopt these policies corporate-wide to avoid disadvantageous transactions with affiliates or insiders. While related party transactions that do not involve a supervised bank may be legal, the agencies still may consider them "unsafe and unsound." In addition, as consolidated supervisor, the Federal Reserve and the OTS monitor material intra-group transactions and exposures. They also ensure that holding companies have adequate risk-management processes in place for the bank as a whole pertaining to such transactions. The above mentioned statutes and implementing regulations clearly define the individuals and entities to which the restrictions apply. The definitions are broad and provide limited discretion to the supervisor to determine whether a particular individual or entity should be subject to the restrictions. Pursuant to Sections 22(g) and 22(h) of the Federal Reserve Act and its implementing regulation, "Insiders" include executive officers, directors, principal shareholders of the bank or any of its affiliates and any related interest of (that is, any company controlled by such an executive officer, director, or principal shareholder). In many situations, extensions of credit made by a bank

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	to the family of an insider will be attributed to the insider. Pursuant to sections 23A and 23B, as well as sections 22(g) and 22(h) of the Federal Reserve Act, the term "affiliate" includes any entity that directly or indirectly controls, or is under common control with, the insured depository institution. A transaction between a bank and a third party where the funds are transferred to, or used for the benefit of, an affiliate or insider is considered a transaction with that affiliate or insider. **EC 2:** Section 23A requires that all covered transactions between a bank and an affiliate be on terms and conditions that are consistent with safe and sound banking practices. Section 23B requires that financial transactions between a bank and an affiliate be on terms and under circumstances, including credit standards, that are at least as favorable to the bank, as those prevailing at the time for comparable transactions with nonaffiliates. Pursuant to section 22(h), extensions of credit by a insured depository institution to an insider must (1) be made on substantially the same terms (including interest rates and collateral) as, and following credit underwriting procedures that are not less stringent than, those prevailing at the time for comparable transactions by the bank with non-insiders and (2) not involve more than the normal risk of repayment. Violations can give rise to reimbursement or formal enforcement actions. These laws set out basic procedural and recordkeeping requirements to ensure compliance with these provisions. Supervisors determine the adequacy of the bank's procedures used to ensure that loans are not made on conditions indicating preferable treatment and otherwise satisfy the requirements of these statutes and the general obligation for all transactions to be consistent with safe and sound banking practices. **EC 3:** Extensions of credits to an insider, not including an affiliate company to the bank, must be reviewed and approved by the board if the aggregate exposure, including the proposed amount would exceed US$500,000 (a lower threshold applies for smaller banks). The insider must not participate in the preparation, discussion or the vote on the loan. There is no regulation requiring board pre-approval for most transactions with bank affiliates, nor for write-offs of related party transactions. **EC 4:** The regulatory provisions mentioned above prevent persons benefiting from the exposure or persons related to such individuals from being part of the process of granting and managing the exposure. Supervisors are expected to identify and criticize any situation in which an interested director involves himself in a matter in which he has an interest. Supervisors review policies and procedures for compliance with the regulations governing affiliate transactions and for extension of credits to insiders. **EC 5:** The sets of statutes cited above establish quantitative limits on affiliate and insider transactions and collateral requirements on affiliate transactions. The aggregate limits on exposures to affiliates are generally stricter than those for other counterparties, typically 10 percent to a single affiliate and 20 percent to all affiliates of an institution's capital funds respectively. With respect to insiders, the limit on extensions of credit to an individual insider, when aggregated with the amount of all other extensions of credit to that person's related interests, generally may not exceed 15 percent of an institution's capital funds. When aggregated, all extensions of credit to insiders by an institution may not exceed an institution's capital funds. As with any other extension of credit, the supervisor can address problems identified with such exposures by requiring their deduction from capital when assessing capital adequacy and requiring the posting of additional collateral. **EC 6:** Banks must identify, through an annual survey, all insiders of the bank and maintain records of all extensions of credit to insiders. The FBAs expect that a bank's MIS identifies and quantifies credits to related parties and that these transactions are routinely reviewed by loan review and management, if this powers is delegated from the board. **EC 7:** All BHCs and foreign banking organizations that own a U.S. subsidiary bank must file the quarterly FR Y-8 report on transactions with affiliates. Similar reporting requirements apply to thrift institutions. In addition, certain information regarding extensions of credit to insiders must be

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	included in quarterly reports made by all depository institutions to regulators and which are also publicly available.
Assessment	Compliant
Comments	The aggregate limit for lending to insiders, at a 100 percent of a bank's capital, is higher than international best practices. However, the BCP Methodology sets no explicit limit although there is an implicit expectation that exposures to related parties should not significantly exceed the corresponding limit for large exposures to non-related parties, normally 25 percent of the capital funds. A 100 percent limit means in practice that a small group of insiders, could deplete the complete own funds of a bank. (This has happened in other countries). The CP requires a higher degree of board involvement and oversight than presently required by U.S. laws (even though, in practice, U.S. authorities would expect many banks to apply a higher standard than that prescribed by the statutory requirements) e.g., for full compliance of this CP, all credits (as well as all other explicit or implicit exposures) to related parties must be monitored by the board on a regular basis and the board must be informed of all, other than insignificant, cases of payment delays, restructuring of loans, or write-offs. Exposures to related parties should be reported separately, as a distinct component of the credit exposure reports to management, board/responsible board Committee and to the supervisors, on a regular basis such a quarterly. In addition, there are no limits for holding company transactions with their affiliates. While the FBAs report that they monitor these exposures during their supervisory activities, a more formal limit framework is necessary. On the bank level there are limits for credit extensions and some other transactions to insider parties. The laws and regulations are not totally explicit on what should be included in this definition and if read narrowly the assessors do not think it is sufficiently broad. All exposures to insiders (and affiliates), including credits, asset transactions, off-balance sheet commitments, securities investments, should be included in the definition and in the limits. There are no regulated limits on insider lending from a holding company. Hence, a bank could provide a fully collateralized loan to its holding company, which then could lend the proceeds to an insider of the bank, or group, to an amount exceeding the bank's own limit for insiders. This type of transaction would violate the attribution rules in Regulation O (insider rule) and the legal lending limit rule. Such behavior would presumably be identified and could be criticized after the fact by the supervisor, citing safety and soundness concerns. Still, the lack of limits at the holding company level will make monitoring more difficult and can increase the risk of abuse. Refer also to CP 24 where some weaknesses in the conduct of consolidated supervision have been identified which may exacerbate the deficiency of the lack of limits. While the above must be regarded as weaknesses, a "Compliant" rating has been given. Although detailed and explicit laws and regulations on some of the issues are lacking, the U.S. authorities expect banks to apply a high degree of board oversight and monitoring of insider and affiliate transactions and review this as a matter of practice on offsite and onsite examinations. In addition, high exposures to insiders—even within the formally set limits—could be criticized by the supervisors for endangering the safety and soundness of the bank.
Principle 12.	**Country and transfer risks.** Supervisors must be satisfied that banks have adequate policies and processes for identifying, measuring, monitoring and controlling country risk and transfer risk in their international lending and investment activities, and for maintaining adequate provisions and reserves against such risks.
Description	**EC 1:** The system for identification monitoring measuring and control of country and transfer risk is long established. FBAs are required to evaluate banks' and holding companies' foreign country exposure and transfer risk for use in examinations and supervision. [*See 12 U.S.C. § 3903(a)]*. The agencies also must ensure that these risks are taken into account in evaluating a bank's or holding company's capital adequacy. [*See id.§ 3903(b)]*. Banks and holding companies meeting certain reporting criteria based on cross-border exposure are required to identify and monitor these risks

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	and to provide quarterly reports to supervisors on their foreign country exposure. The quarterly reports detail each bank's or holding company's significant claims on foreign entities, specifying, among other things, the types of claims and country in which the borrowers are located. Necessarily, banks and holding companies must have established policies and procedures for monitoring the countries with which they are doing business and monitoring and evaluating their exposures to those countries. Representatives of three of the FBAs (the Federal Reserve, OCC, and the FDIC) are part of an "Interagency Country Exposure Review Committee" (ICERC), which meets at least once a year and recently more frequently (the committee reserves the option to meet at any time during the year should circumstances warrant attention) to review conditions in countries that have defaulted by not complying with their external service obligations or are unable to service the existing loan according to its terms, as evidenced by failure to pay principal and interest timely and fully, arrearages, forced restructuring, or rollovers and where U.S. banks and holding companies have large exposures. Based on this review, the ICERC assigns a transfer risk rating to the country and determines whether U.S. banks and holding companies must hold a reserve (an "Allocated Transfer Risk Reserve" or "Allocate Transfer Risk Reserve (ATRR")) against exposures where the country of residence of the ultimate obligor is from the defaulting country. [*See 12 CFR 211.43 and Guide to the Interagency Country Exposure Review Committee Process (November 2008)]*. Assessors met with the chair and members of ICERC to review the system. ICERC members' expertise is also available as needed to the supervisory process. However, the statutory provisions do not apply to savings associations and SLHCs supervised by the OTS, which historically have not had large foreign country exposures and transfer risk. For purposes of CP 12, therefore, the word "bank" does not include a savings association. OTS examines large and complex SLHCs for country risk, however, and would require a SLHC to establish an ATRR pursuant to the ICERC's guidelines, if necessary. During examinations, supervisors assess the bank's or holding company's overall identification and management of country and transfer risk. Banks and holding companies are expected to assess the level of their country-risk exposure and evaluate the effect of prevailing and future economic, political, and social conditions on a country's ability to sustain external debt service, and reflect the impact of these conditions on the credit risk of individual counterparties located in the country. The agencies expect banks and holding companies to have a comprehensive risk-management system to identify their cross-border exposure by borrower and by country, and to quantify exposure, including cross-border guarantees, derivatives, and reference assets, where appropriate. In order effectively to control country risk, supervisors expect that this risk-management system includes oversight by the bank's or holding company's board of directors, well-defined policies and procedures for managing country risk, an accurate country exposure reporting system, an effective country analysis process, a country-risk rating system, established country exposure limits, and adequate internal controls. The guidance and supervisory process is on an end country/end borrower basis and considers all types of direct and indirect country exposures and exposures at various levels in a transaction chain. **EC 2:** The FBAs assess a bank's or holding company's information and risk-management systems to evaluate whether a bank or holding company has appropriate risk controls, information systems, and monitoring structure to ensure that cross-border exposures are managed consistently with the bank's or holding company's strategy and risk-management philosophy. Supervisors evaluate whether banks and holding companies have comprehensive reporting systems to accurately capture country risk exposure, ensure adherence to the directives of the board, provide for at least an annual review of portfolio composition by country, and establish a methodology for reporting exceptions. As part of the examination process, supervisors evaluate the frequency and size of exceptions to country limits imposed by banks and holding companies, and, if appropriate, discusses issues with management if weaknesses are noted. Banks and BHCs are required to report their various asset exposures quarterly on the Country Exposure report, FFIEC 009. The agencies

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	maintain an aggregated, publicly available database (FFIEC E16 report) that contains banks' and BHCs cross-border and sovereign exposure in detail by country. A restricted version of this database, which contains the same information by organization, is used by supervisors in their sovereign exposure monitoring process. **EC 3:** Supervisors exercise oversight of the setting of appropriate provisions against country risk and transfer risk through various mechanisms. The FBAs set country and transfer risk provisions for selected countries as described above. These provisions or ATRRs are determined through the ICERC process. The minimum threshold for ICERC consideration for review of a country is an aggregate exposure of US$1 billion or more for at least two consecutive quarters. In addition, countries to which aggregate exposure is between US$200 million and US$1 billion are reviewed by the ICERC if the exposure at five or more U.S. banks or bank holding companies exceeds 25 percent of Tier 1 capital plus the allowance for loan and lease losses. ICERC has developed standards for supervisors to follow in their assessment of banks' and holding companies' sovereign credit risk. The ICERC standards also provide the banking industry with general expectations for a bank's or holding company's sovereign risk management practices. In addition to the specific mandated reserves, the agencies expect banks and holding companies to evaluate the fundamental and sovereign credit profile of their foreign exposures (both cross-border and local), appropriately grade certain countries' and individual obligor exposures, and establish limits that are consistent with the bank's or holding company's strategy, risk profile, and capital. Supervisors evaluate the establishment, appropriateness, and compliance with such limits during the examination process. **EC 4:** The FBAs obtain the country exposure reports for individual banks and BHCs on a quarterly basis. These reports contain information for on- and off-balance-sheet exposure by type of obligor (government, banking, other). The agencies analyze the quarterly reports for levels, significant variations and trends. Also, FBAs evaluate, on an ongoing basis, political, economic, and social events for high impact countries. These analyses are supplemented by a more thorough review of country-risk exposure, not just to countries rated by ICERC, during regular supervisory activities.
Assessment	Compliant
Comments	
Principle 13.	**Market risk.** Supervisors must be satisfied that banks have in place policies and processes that accurately identify, measure, monitor and control market risks; supervisors should have powers to impose specific limits and/or a specific capital charge on market risk exposures, if warranted.
Description	**EC 1:** FBAs expect all banks and holding companies, to have in place comprehensive risk management policies and processes for identifying, evaluating, monitoring, and controlling or mitigating market risk. Supervisors assess each bank or holding company's exposure to and management of market risk. For most U.S. banks and holding companies interest rate risk in their banking books is the predominant market-related risk exposure. Large banks or BHCs also have much more complex and extensive market risk exposure both in their trading books and available for sale portfolios. Those with aggregate trading assets and liabilities of US$1billion or more or 10 percent of total assets are subject to market risk capital rules and related qualitative requirements that implement the 1996 Basel I Market Risk Amendment *[See 12 CFR 3, appendix B]*. Senior management is expected to fully understand the risks involved in the bank's and holding company's activities, question business line management about those risks, and have prompt and open discussions about any market-risk control problems or losses. This commitment to market-risk management is expected to be delineated in practice and codified in written policies and procedures approved by the board of directors. The agencies' expectations are documented in exam manuals and published statements regarding the implementation of internal controls including internal controls for market-risk management. The supervisory expectations as described in these written documents are implemented via

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	monitoring of risk profiles and risk management at supervised banks and holding companies as well as examinations of the banks and holding companies. Continuous monitoring and analysis by on-site teams at larger banks and holding companies entails ongoing analysis of internal reports and discussions with internal management. Supervisors review these reports to determine if the market risk is appropriately measured, monitored and controlled. A key element of continuous supervision is the review of new product policies and procedures to ensure that the risks of these products are adequately identified so that they may be incorporated into the risk measurement, management, and control processes. Examinations emphasize the need to use multiple measures of market risk and avoid the over-reliance on any single measure of risk. These should include a variety of stress tests, value-at-risk measures, position sensitivities, and balance sheet measures which may form a set of limits. FBA teams at major banks have considerable expertise in market risk and are supplemented by risk specialists as needed. Assessors reviewed off-site monitoring documents as well as examples of continuous monitoring on-site reviews related to market risk. They also discussed the approach to market risk with individual supervisory teams and risk specialist groups. Expertise was evident, though it has been necessary to reallocate some of it to deal with crisis matters and with the conversion of the former investment banks to BHC status. Monitoring material differed between agencies in quality and depth, in part reflecting the differences in market risk exposure between different types of banks. Currently, certain FBAs are conducting a horizontal review of the banks' implementation of the market risk amendment (MRA), including the quantitative and qualitative market risk management aspects. Detailed reviews of a number of products and models are part of that review. The review was motivated by weaknesses from the recent market turmoil. Prior to this, comprehensive reviews of large financial institutions adherence to the MRA requirements had not been systematically performed. Assessors reviewed the scope and planning documents for this review, which appeared appropriate. Conclusions were not available at this point as the review is ongoing, so it was not possible to judge its effectiveness. For major firms supervised as banks or holding companies, the predominance of products subject to stress and material losses were held in MTM portfolios. Discussion that the assessors had with FBAs and banks, and recent published reports (e.g., the Senior Supervisors Report) indicate material breakdowns in risk management practices related to MTM portfolios at a number of larger firms. These weaknesses were exacerbated by failures to have an enterprise-wide view of how market, credit and liquidity risks could converge (see CP 7). However, weaknesses in market risk management itself were a material contributing factor. This included weaknesses in understanding the degree of price risks certain firms were assuming, imbalance in authority and influence between risk functions and trading revenue-generating functions at certain major firms, and over-reliance on single tools to measure risk such as VaR models, without appreciating their applicability to various products and adequately supplementing them with other risk management processes and appropriate challenge and expert judgments. There were differences in firms' sophistication in the use of VaR models. In some cases interactions between various elements of market risk were missed or mis-estimated (e.g., basis risk). Improvements in these areas are underway. In some cases, especially in areas such as the balance between risk governance and risk taking, it will be necessary for there to be a period of time for supervisors and firms to confirm these are working as expected. **EC 2:** Banks and holding companies are expected to establish market-risk limits that are commensurate with their size and complexity and that reflect all material market-risk exposures. Supervisors seek to confirm that banks and holding companies have appropriate limits in place that are developed under the direction of, and approved by, senior management and the board of directors. As part of their examinations, supervisors check the adherence to these limits and discuss with senior management policies and procedures for limit exceptions. These discussions allow supervisors to assess whether senior management is aware of large risk positions and the proper

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	approvals for excesses as described in the policies and procedures of the firm have been granted. Limits need not be absolute under the regime of any U.S. supervisor; however, supervisors confirm that appropriate dialogue with non-trading senior management takes place and is documented before limits are exceeded. Supervisors also confirm that policies and procedures address the frequency of review of the limit structure, identify the authority to set and change limits, and ensure that limits are set by personnel independent of the trading activity. Supervisors check approvals for limit excesses to ensure policies are adhered to through transaction testing. **EC 3:** Guidance exam manuals and procedures, as well as fundamental U.S. GAAP requirements, address the need for banks to have systems and controls to ensure all positions are captured on a timely basis, and require that MTM positions are revalued frequently using reliable and prudent market data (or in the absence of market prices internal or industry-accepted models). All public corporations in the U.S. are expected to disclose the value of their positions quarterly on their public financial reports. Trading assets and other assets valued on a MTM basis are reported at fair value in accordance with U.S. GAAP *(FAS 157).* For banks and holding companies required to file public reports, the Sarbanes-Oxley legislation requires that all critical controls relating to financial reports must be documented and tested, and that weaknesses in these controls must be disclosed in their quarterly public financial reports. Banks and holding companies are subject to these same standards; however, the standards for control and frequency of valuation imposed by financial supervisors are higher for those banks and holding companies with significant trading operations. Prior to the crisis, independent auditors attested to valuation. Implicitly through requirements for daily VaR modeling, bank and holding company rules effectively require that trading positions be revalued daily and verified by a unit independent of the business unit on a frequent basis in order to meet the standards for risk-management control or regulatory capital. For banks and bank holding companies, the agencies' market-risk capital rules require that its VaR model is used to measure its daily VaR. The FBAs confirm that FAS 157 is appropriately applied for instruments that fall under this statement, and that the bank's or holding company's process is documented and approved by its external auditor. Recent supervisory reports indicate that many banks and holding companies found that their valuation procedures were not robust to a change in market liquidity. Their valuation procedures had established a single method to value a particular asset that may have relied on suitable prices being observed in a liquid market. When the market for these assets became illiquid, banks and holding companies found that they could not apply a method that relied on observed prices. These banks and holding companies had to develop complex pricing models that met high control standards in an expedited timeframe. This experience indicated the need to develop a "waterfall" of valuation procedures that provided the banks and holding companies with the ability to value positions under a variety of market conditions. The crisis also revealed material weaknesses in some firms' ability to aggregate MTM position across books or geographies and ensure appropriate robust disciplined pricing and valuation (linked to P&L valuation), with appropriate challenge of business units' own estimates of value of hard-to-measure holdings on a consistent basis. While these shortcomings were exacerbated by several market realities, such as a significant decline in liquidity and uncertainty on the valuation of underlying assets such as sub-prime, basic valuation processes and the IT infrastructure to support them were also weaker at some firms, in some cases because of weak integration of data resulting from multiple mergers. Discussions with firms, FBAs, and recent published reports indicate firms have made progress in remedying these deficiencies, and the situation differs among major firms, but this will take time, particularly where IT and risk infrastructure improvements are necessary. Assessors' discussions with banks and audit firms confirmed the considerable difficulties in valuation of complex instruments, the progress that has been made and the considerable ways to go.

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	EC 4: Scenario analysis, stress testing, and periodic validation of systems used to measure market risk are key components of the market risk and advanced approaches capital adequacy guidelines. The FBAs expect all banks and holding companies to perform scenario analysis or stress testing in the management of market risk, and confirm this during on-site examinations. Banks and holding companies are expected to use this in measuring the risk from trading activities even if they are not subject to the market-risk amendment. Supervisors evaluate stress tests for their use in risk management and compare established limits against stress test results. If supervisors determined that stress testing is inadequate or insufficient, corrective actions would be required. Specialty staff from the agencies is brought in to aid supervisors in the evaluation of complex models. Supervisors review the independent validation of the models during an exam, and an independent validation is required once a year of market risk measurement systems. For broker-dealer organizations, an external validation of the models is required once a year. For all banks and holding companies, the validation of market-risk models is an ongoing process that includes a number of activities. Assessors discussions with banks and FBAs, and review of various reports indicated that testing for market risks (as well as stress testing for enterprise-wide stress covered in CP 7) had weaknesses that firms are in the process of improving. This included issues in the range and seriousness of stresses considered and the effectiveness of the link between the scenario results and management of the business. **AC 1:** Under the FBAs' market risk and advanced approaches capital adequacy guidelines *[see 12 CFR 3, appendices B and C; 12 CFR 225, appendices E and G)],* banks and bank holding companies must have a risk control unit that reports directly to management and is independent from business units. In addition, banks and bank holding companies must conduct independent reviews of risk measurement and risk-management systems at least annually. Supervisors verify that the personnel responsible for independent valuation do not have their compensation determined by the business unit and report to senior management that is independent of the business unit. More granularly, supervisors check that the personnel responsible for independent valuation have the appropriate authority to contest valuations and that this ultimate authority is written into policies and procedures. Independent valuation units must have adequate resources to determine valuations without undue reliance on the business unit, and that they have sources of pricing information outside of the business unit.
Assessment	Largely Compliant
Comments	As indicated above, material weaknesses have been revealed in market risk monitoring and management. The major ones are in the areas of suitability of market risk measurement and monitoring processes and models at certain major firms, lack of reliable valuation of MTM positions and completeness and use of market stress testing. These are key issues addressed by this CP. Despite the existence of rules that are compliant with this CP, implementation has not been as effective as necessary. The weaknesses arise in essential market risk management practices, not only in weaknesses related to interaction among market credit and liquidity risk covered in CP 7. Substantive improvements are required and improvements are in progress. But in some cases these will take considerable time (including supervisory time to verify robustness) particularly where material improvements in IT or risk architecture or risk culture are involved. It will be important for banks and supervisors to confirm that the new processes operate effectively as planned, as more robust market conditions return. This will be particularly important in making sure that the balance between revenue generating functions and risk oversight functions and risk appetite operates as expected and that judgment is being mixed with analytics in risk monitoring and risk management. Better linking compensation to risk, which is only starting to be improved, is relevant to this balance.

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	FBAs have ramped up their resources to deal with additional demands in these areas but need to recognize that the ongoing resource demands will likely be considerable given the likely need for more extensive, frequent and in-depth reviews. FBAs need to complete the current horizontal assessment of the Market Risk Amendment and determine how much further in-depth horizontal review of market risk and valuation improvements at major banks is required. There is need for conducting regular, horizontal, in-depth assessments of major banks' progress, involving both on-site staff and risk specialists.
Principle 14.	**Liquidity risk.** Supervisors must be satisfied that banks have a liquidity management strategy that takes into account the risk profile of the institution, with prudent policies and processes to identify, measure, monitor and control liquidity risk, and to manage liquidity on a day-to-day basis. Supervisors require banks to have contingency plans for handling liquidity problems.
Description	**EC 1:** Liquidity issues have been a major focus of banks and the FBAs during the crisis. On June 30, 2009 the FBAs released for public comment an interagency policy statement on liquidity-risk management to provide consistent interagency expectations on sound practices for managing funding liquidity risk. The guidance summarizes the principles of sound liquidity-risk management that the agencies have issued in the past and are currently outstanding, and, brings these principles into conformance with the international guidance recently issued by the Basel Committee. Existing supervisory guidance can be found in the various agencies examination manuals and handbooks. The existing and proposed guidance covers undrawn commitments and other off balance sheet liabilities as well as on-balance sheet liabilities, and is in conformity with this criteria. The FBA's guidelines with respect to liquidity are qualitative in nature—focusing on sound practices instead of specific quantitative standards and tests. FBAs evaluate quantitative measures that banks have in place to measure and manage liquidity risk. The FBAs do not have a one-size-fits-all qualitative standard for assessing liquidity. In general, supervisors confirm that regulated banks and holding companies have a process in place for managing liquidity that is commensurate with the size and complexity of its operation and its overall risk profile. These expectations include adequate liquidity risk metrics and limits. As noted below, the FBAs collect various liquidity risk metrics in their regulatory reports that allow them to monitor banks' overall liquidity risk and funding concentrations. The FBAs expect banks and holding companies, at a minimum, to implement liquidity management programs that (a) assess, on an ongoing basis, the current and expected future needs for funds and ensure that sufficient funds or access to funds exist to meet those needs at the appropriate time; and (b) provide for an adequate cushion of liquidity to meet unanticipated cash-flow needs that may arise from a continuum of potential contingent events (company specific events as well as those that affect the broader industry and capital markets) that can range from high-probability/low-severity events that occur in daily operations to low-probability/high severity events that occur less frequently but could significantly affect a bank's and holding company's safety and soundness. EC 2/EC 3 Each FBA evaluates a bank's and holding company's liquidity risk and risk-management systems as part of their on-going supervisory programs. Systemically important institutions' liquidity levels are now monitored by the FBAs on a continuing basis. Guidance includes expectations regovernance and oversight, risk appetite, effective and timely risk monitoring, contingency planning, and stress/scenario testing. Supervisors confirm that banks and holding companies have documented strategies for managing liquidity risk and clear policies and procedures for managing liquidity risk. Assessors saw examples of reports, discussed this process with FBAs and discussed liquidity management with banks.

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	Supervisors also confirm that these policies and procedures are approved by the board of directors of the bank and holding company or an appropriate committee of the board, and reflect the objectives, risk tolerances and goals of the board of directors. These assessments are made by reviewing bank and holding company policies and procedures and management reports, as well as through discussions with the bank's and holding company's management. Supervisors' reviews will also assess whether the board and senior management: have identified lines of authority and responsibility; have articulated the bank's and holding company's general liquidity strategies and its approach to liquidity risk; understand the bank's and holding company's liquidity contingency funding plans; and periodically review the bank's and holding company's liquidity-risk profile. The UFIRS has a component to rate liquidity (L) in the CAMELS ratings. Liquidity is also evaluated in the 'financial' component of the BHC ratings system and in the "E" component of the SLHC CORE ratings system. Supervisors determine whether the critical elements of a sound liquidity-risk management process are evident. These include adequate corporate governance, including active involvement by the board of directors and senior management; appropriate strategies, policies, procedures, and limits for controlling liquidity risk; adequate systems and processes for measuring, monitoring, and reporting liquidity risk; comprehensive contingency funding plans for addressing potential adverse liquidity events and meeting emergency cash flow needs; and appropriate internal controls for all aspects of liquidity-risk management. Supervisors evaluate the customization of each of these elements seek to ensure they account for the sophistication, complexity, and business activities of the bank and holding company. In evaluating the adequacy of a bank's and holding company's liquidity position, supervisors consider the current level and prospective sources of liquidity compared with funding needs, as well as the adequacy of funds-management practices relative to the bank's and holding company's size, complexity, and risk profile. The agencies' regulatory Call Reports and Thrift Financial Reports collect information on each bank's and holding company's liability and deposit mix, including information on deposit maturities and repricing characteristics. These reports also capture the level of large deposits that may not be covered by FDIC deposit insurance, non-maturity deposits, non-deposit borrowings that may be credit sensitive, and off-balance-sheet commitments. Each agency uses, other monitoring reports and other market related data in various off-site surveillance and monitoring tools to identify banks and holding companies that may have high potential liquidity-risk exposures. The market turmoil led to considerable upgrading in the scope and frequency of liquidity reporting and monitoring, at least part of which the FBAs plan to make a permanent part of their supervisory process. The assessors discussed with the FBAs and with the banks their extraordinary efforts at monitoring and dealing with liquidity issues during the 2007–2009 period. These involved much more frequent (daily/intra-day) monitoring, more detailed and granular assessment of liquidity positions possible stresses and contingency plans, and dealing with material liquidity issues at banks and holding companies. The assessors also discussed lessons learned by banks and the FBAs and alterations in approach to liquidity risk measurement and management, and to supervision, that have been put in place as a result. Weaknesses in liquidity management were a major factor in the recent crisis. As a result of extensive hands-on work between supervisors and banks, and international discussion, the attention to liquidity risk management by banks and supervisors has heightened considerably. The FBAs indicate that they intend this will continue. Interagency efforts are underway to craft a liquidity proposal implementing BCBS recommendations. Market events during the current crisis have moved the agencies to fully assess the overall effectiveness of the implementation of the supervisory processes used in enforcing such guidance.

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	Recognizing the need for improvement in implementation of this principle, the agencies have enhanced the supervision of liquidity risk management as follows: 1) issuing consistent supervisory expectations through an interagency statement on sound practices; 2) introducing new Federal Reserve guidance on consolidated supervision that stresses a focus on group-wide as well as legal entity liquidity management; 3) introducing new SLHC rating definitions and increased emphasis on enterprise-wide assessment and risk management in the "O" and "R" components; 4) increasing monitoring of the liquidity risk profiles of banks and holding companies as well as monitoring systemically important institutions liquidity levels on a continuing basis; and 5) improving coordination among the supervisory agencies in assessing quantitative risk profiles as evidenced by the recent Supervisory Capital Assessment Program exercise. Firms have implemented improvements to deal with identified issues and are generally holding more liquidity. Given the severity and critical importance of liquidity issues to firms ongoing survival, FBAs and banks confirm that, in general, improvements are farthest advanced in this area. Some of the further progress is dependent on international processes, which the United States is taking an active part in, to further enhance international guidance on liquidity risk management including setting numerical targets. **EC 4:** Guidance noted above requires banks to establish policies and processes for liquidity risk management including net funding requirements. These include consideration of how other risks may impact banks' overall liquidity strategy. The interaction of credit, market and liquidity risk is an area that has received material additional attention by banks and supervisors as a result of recent events. Supervisors review to ensure a bank and holding company conducts stress testing or scenario analysis of its liquidity position. Supervisors evaluate that the stress tests or scenario analyses include an assessment of the potential impact of plausible stress events that are bank and holding company-specific and/or externally-driven events. Also, supervisors determine whether events are stressed under different levels of severity, funding needs are quantified, funding sources are identified, and management processes, reporting and external communication are addressed throughout a stress event. Banks and supervisors the assessors met confirm that liquidity stress and scenario testing has materially improved. Agencies do not mandate or consider specific implicit or explicit scenarios in their assessment of the liquidity position of a bank and holding company given the diversity of the U.S. banking industry. Rather, the FBAs review the robustness of the scenario analyses and stress tests conducted by banks and holding companies based on the size, complexity, and risk profile. The resiliency of a bank's and holding company's funding liquidity to firm-specific and market-wide stress conditions is also assessed through the supervisory process, which includes off-site monitoring and target examinations. Focus on liquidity stresses by banks and supervisors have understandably increased materially. **EC 5:** The FBAs. collects extensive information on foreign currency liquidity issues. The FBAs require banks and holding companies to have a system in place to measure, monitor, and control the liquidity positions for each major currency in which business is conducted. The treatment of foreign currencies in a bank's and holding company's internal liquidity assessment is largely determined by the bank and holding company. Currency mismatches are reviewed during the examination process. Banks and holding companies are expected to be able to manage, monitor, and control their currency exposures. The assumptions regarding currency convertibility are left to each individual bank and holding company to determine. Supervisors review the reasonableness of these assumptions, under both normal and stressed conditions, and supporting documentation. The ICERC process (see CP 12) and the FBAs reviews of cross-border concentrations can assist in this process.

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	EC 6: U.S. FBAs expect banks and holding companies to have appropriate contingency funding plans (CFP) in place, although specific requirements differ slightly between agencies. They expect that banks inform the supervisor as necessary, and these linkages have been reinforced during the recent crisis. Supervisors review and assess a bank's and holding company's CFP during examinations. Supervisors evaluate if the CFP is commensurate with the complexity, risk profile, and scope of operations of the bank and holding company and aligned with its business and risk-management objectives, strategies, and tactics. Supervisors confirm that senior management periodically review the CFP. Banks and FBAs the assessors met confirm that there have been material improvements in CFPs recently taking account of lessons learned from recent events. Supervisors the assessors met demonstrated a sound understanding of liquidity issues and a good ability to assess banks liquidity positions. **AC 1:** Foreign currency liquidity strategy is part of the processes described above. The FBAs require banks and holding companies to have a system in place to measure, monitor, and control the liquidity positions for each major currency in which business is conducted. Banks and holding companies may be required to utilize separate CFPs and stress tests for the holding company and the consolidated banks in a multibank holding company, for separate subsidiaries (when appropriate), or for each significant foreign currency and global political entity, as necessary. **AC 2:** Supervisors confirm that banks and holding companies establish policies that set out their liquidity risk tolerances and guidelines appropriate for the complexity and liquidity-risk profile of the bank and holding company. Supervisors evaluate if banks and holding companies employ both quantitative targets and qualitative guidelines that adjust as circumstances change. These limits, tolerances, and guidelines may include funding concentrations that address diversification issues such as large liability and borrowed funds dependency, single funds providers, market segment funds providers, and types of brokered deposits or wholesale funding. Some smaller banks and holding companies may engage in activities in stress situations (repo and/or sales of securities, asset securitization and/or sales, wholesale borrowings, and access to the discount window) that are similar to those undertaken by larger and more complex ones. However, small banks and holding companies may have fewer funding options available and therefore are more reliant on maintaining an established liquidity warehouse, which is a portion of the investment account identified as a reserve to meet both normal and stress liquidity needs. Smaller banks may also rely more heavily on secured or unsecured wholesale borrowings in the form of Federal Home Loan Bank (FHLB) advances or brokered deposits. In light of this, supervisors review and assess the bank's and holding company's concentration of borrowed funds, their capacity to borrow from the FHLB, and the availability of other wholesale funds providers.
Assessment	Largely Compliant
Comments	FBA guidance is compliant with international standards (though details of those standards are likely to evolve in the near term). Market events during the crisis moved the FBAs to assess the overall effectiveness of the implementation of the supervisory processes used in enforcing such guidance. During the crisis liquidity monitoring was greatly expanded and contingency plans tested. Improvements are required to make sure these crisis-driven measures in banks and supervisors are moved into more organized and sustainable improved liquidity risk management by banks and enhanced regular liquidity risk assessment by supervisors. As a result, formalized sustainable programs have already been instituted through the joint establishment of the same liquidity risk data templates used to collect data on institutions at both the OCC and Federal Reserve. Further progress to get to the high-quality ongoing liquidity risk management required at major complex banks including the capability for timely stress testing closely linked to decision is related

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	to progress on being better able to aggregate enterprise-wide risk and position information and link these consistently in a timely manner to P&L, financial, and balance sheet systems. Because this requires material IT and risk infrastructure investments, some further time will be necessary. While much of the enhancements in banks and FBAs to ensure effective implementation and take account of lessons learned are relatively recent, the heightened focus by supervisors has allowed them to determine that needed improvements are moving forward. Assessors confirmed in discussion with the FBAs and banks that progress is well along in banks and in the FBAs.
Principle 15.	**Operational risk.** Supervisors must be satisfied that banks have in place risk management policies and processes to identify, assess, monitor and control/mitigate operational risk. These policies and processes should be commensurate with the size and complexity of the bank.
Description	**EC 1:** The safety-and-soundness statutes, rules and guidelines are the principal legal bases for the imposition and enforcement of operational-risk management standards [*see, e.g., 12 U.S.C. § 1831p-1 and 12 CFR 30, 208, 364, and 570*]. The FBAs have issued supervisory guidance on various aspects of operational risk management, including internal controls, information technology, outsourcing of financial services, payment systems, audit, business continuity planning, compliance, insurance, and fiduciary operations. The FBAs use on-going supervision techniques, including on-site examinations and off-site surveillance, to evaluate the adequacy of the operational risk-management policies and processes. Depending on the circumstances, supervisory review may be conducted as a stand-alone examination of operational risk management, or as part of a broader supervisory review (e.g., operational aspects of credit risk management may be examined as part of a review of the bank's credit risk-management framework). The FBA's have established an interagency operational risk group that meets periodically to discuss operational risk issues, share experiences and promote a consistent approach to operational risk assessment. The agencies have formal enforcement authority to address risk-management deficiencies at banks and holding companies and evidence exists that they routinely exercise this authority when operational deficiencies threaten an institution's safe and sound operation. **EC 2:** The FBAs' examination procedures require verification that a board periodically reviews and approves significant operational risk management-related strategies, policies, and processes, and are among the routine responsibilities of the board in directing a bank's and/or holding company's activities. At banks and holding companies that are using the advanced approach under Basel II, there is a requirement that the board must at least annually review the effectiveness of and approve the organization's advanced systems. Largely through on-site examinations, supervisors review a bank's and/or holding company's operational risk-related strategies, policies, and processes and verify that they are current, reflective of the nature of the organization, and have been formally approved by the board. Additionally, supervisors evaluate the board oversight of management's effectiveness in implementing operational risk-management policies. This assessment is conducted in several ways, including review of board and committee minutes, evaluation of the frequency, coverage, and quality of external and internal audit reports, and assessment of the frequency, nature, and integrity of applicable management information systems that reflect effective policy/control implementation through reported residual risk levels. **EC 3:** The FBAs review and evaluate the same information inputs available to the bank's and holding company's board. External and internal audit reports and selected management information system reports are also reviewed and evaluated to verify that management has implemented the board approved operational risk-management strategies, policies and procedures effectively. Additionally, on a risk-focused basis and/or where warranted based on initial evaluation findings, on-site supervisors will perform select transaction testing to validate conformance with, and effectiveness of, operational risk management and control policies and processes. Where this is not the case, there is evidence of formal and informal supervisory intervention to ensure appropriate

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	corrective action is undertaken. **EC 4:** Various supervisory policies, standards, and/or guidance statements relevant to business resumption and contingency planning have been issued on an interagency basis [see, e.g., *March 2008 FFIEC Business Continuity Planning Booklet*]. The FBAs have adopted examination procedures and perform risk-focused reviews of banks' and holding companies' business resumption and contingency plans during on-site examinations, with the scope/breadth of review contingent upon the risk profile of the organization. Additionally, under certain circumstances, the business resumption and contingency plans of banks and holding companies, individually by organization and/or horizontally across groups of banks and holding companies, are the subject of both on-site and off-site supervisory activities by the FBAs. The FBAs have adopted guidelines that are outlined in the *Interagency Paper on Sound Practices to Strengthen the Resilience of the U.S. Financial System*. These guidelines outline recovery and resumption objectives for clearance and settlement activities that support critical financial markets with the specific goal of limiting systemic/disruption risk to the U.S. financial system. Supervisory programs have integrated these guidelines into their continuous monitoring program and periodic targeted control validation reviews, both of which leverage work already performed by, or conducted in concert with, other banking supervisors and functional regulators. Supervisory oversight of key financial firms—i.e., those that provide core clearing and settlement services that are the backbone of the U.S. financial and international financial systems─have dedicated supervisory teams to assess the adequacy of governance and risk management of critical business/service lines on an ongoing basis. The FBAs also consider that large holding companies should provide sufficient resiliency measures for the recovery and/or resumption of their most important business processes in the event of a business disruption. The Federal Reserve's supervisory approach focuses on the areas of the greatest systemic risk, i.e., clearing and settlement activities related to critical financial markets. The resulting supervision program establishes a mechanism to conduct ongoing evaluations of the adequacy of risk management over the resiliency and recovery of clearing and settlement activities related to critical financial markets. The supervisory program combines an examination team's continuous monitoring activities, an annual assessment of any material changes in a firm's related activities or characteristics, and periodic targeted control validation reviews. **EC 5:** Various supervisory policies, standards, and/or guidance statements relevant to risk management of IT activities have been issued on an interagency basis, many through the FFIEC's ITS, a standing subcommittee of the FFIEC Task Force on Supervision to address security and development. The FFIEC's *Information Security* booklet provides extensive guidance and examination procedures to evaluate IT security practices. The ITS develops and publishes IT-related risk-management policies and guidance statements based on industry/market trends or developments in the broader IT environment. This includes the FFIEC's *IT Examination Handbook*, as well as other more targeted guidance such as *Interagency Guidance on Authentication in an Internet Banking Environment (October 2005)*, *Guidance on the Use of Free and Open Source Software (December 2004), Internet "Phishing" Informational Brochure (October 2004), Uniform Rating System for Information Technology (March 1999),* and *Interagency Supervisory Statement on Risk Management of Client/Server Systems (October 1996*). The FBAs also published the *Interagency Information Security Standards* in May 2001. The FBAs' supervisory procedures require supervisors to test whether banks and holding companies have appropriate systems in place to address information security and system development. The FBAs each have supervisors with specialized IT skill sets who can lead or assist in examinations of banks and holding companies that have complex IT or operating environments. A special IT rating system has been developed for supervisory assessments (URSIT), as well as a rating system for Technology Service Providers.

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	EC 6: The FBAs rely upon a combination of their supervisory activities and required regulatory and public disclosures and reporting by banks and holding companies to keep apprised of developments affecting operational risk at their supervised entities. At larger banks and holding companies, this may include supervisors with specialized skills in IT or operational risk issues. Furthermore, regulations requiring a bank and holding company to file a formal, written application or notification with its primary FBA regarding proposed mergers, acquisitions, changes in control, and/or expansions into certain new activities, provide each agency with indicators of events potentially affecting the organization's inherent operational risk profile. For example, under the Bank Services Company Act, U.S. banks are required to provide regulatory notice upon entering into a third-party contract outsourcing the performance of certain functions or services. Finally, the FBAs also draw upon public disclosures of financial and managerial information and audit-related internal controls attestations required of publicly held banks and holding companies. **EC 7:** Under the FBAs' operational and managerial safety and soundness standards (*see 12 CFR 30, appendix A*), banks' and holding companies' internal controls and information systems must ensure compliance with applicable laws and regulations. Supervisors assess a bank's and/or holding company's compliance with applicable laws and regulations as part of their supervision activities. **EC 8:** The FBAs seek to apply the principle that although banks and holding companies may outsource business processes to outside parties, the banks and holding companies remain responsible and accountable for the safe and sound performance and legitimacy/legality of the outsourced activity. The FBAs' examination procedures require supervisors to evaluate, through on-site exams, that banks and holding companies establish appropriate policies and processes to assess, manage, and monitor outsourced activities. Supervisors seek to confirm that each firm's program includes conducting due diligence on potential service providers, structuring the outsourcing arrangement, assessing, managing, and monitoring of applicable risk, ensuring effective controls, and establishing and testing back-up plans. Interagency guidance on this topic has been issued through the FFIEC: while both *Guidance on the Risk Management of Outsourced Technology Services (November 2000)* and the *Outsourcing Technology Services Booklet (June 2004)* address regulatory risk-management expectations largely from the perspective of IT-related outsourcing, the FBAs seek to apply the same risk-management elements to any material outsourcing arrangement. OTS Thrift Bulletin 82a provides additional guidance on third-party arrangements. To improve the efficiency and effectiveness of their supervisory functions, the agencies pool supervisory resources to perform IT-related risk management evaluations/ examinations of data processing service providers with significant client bases comprised of supervised banks and holding companies. Deriving authority from the Bank Services Company Act, the Multi-Regional Data Processing Servicers (MDPS) Program administered by the FFIEC ITS assesses large service providers whose performance is identified as having systemic implications. Other data processing service providers with less significance, yet multiple client banks and holding companies are identified and evaluated under the Regional Technology Service Provider (Regional TSP) program administered by the agencies' regional or local offices. **AC 1:** The FBAs endeavour to ensure the existence, and evaluate the adequacy, of risk-management policies and processes across the major categories of operational risk applicable to all banks and holding companies. Given the group-wide nature of many operational risks, this requires the FBAs to cooperate and share information, both between themselves and with others, to enable a group-wide perspective to be obtained.
Assessment	Compliant
Comments	Supervision of operational risk appears to be effective overall. Supervisory assessment of a bank's operational risk management processes and practices are captured in the UFIRS (i.e., CAMELS rating) although the direct linkage of operational risk to specific component ratings is somewhat subjective (see CP 19 for further discussion on this). Ratings systems in other countries (and indeed, within the individual agencies themselves) typically provide a more defined focus on

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	operational risk. The U.S. agencies may wish to reconsider their overall approach to operational risk, particularly in light of the forthcoming move to Basel II, in which operational risk capital requirements will need to be assessed against the totality of operational risk being run by a bank. Furthermore, perhaps more than many other risks, operational risk is typically a group-wide risk which is not confined to individual legal entities or balance sheets (e.g., IT and accounting systems, physical security, disaster recovery and business continuity planning). Given the fragmented supervisory oversight which can sometimes exist of the larger banking groups in the US, there are limitations on the capacity of individual supervisors to gain a truly group-wide perspective on operational risk. This requires considerable coordination amongst the agencies to ensure that a holistic understanding of operational risk of a given banking group is available. The FBAs have recognised this, and have endeavoured to build the necessary inter-agency coordination mechanisms (although the extension to non-banking operations is more limited). Examples of good work that is currently undertaken in this regard are the FFIEC's ITS (which has produced common examination and guidance material), and the MDPS, Regional TSP and Basel II operational risk supervisory processes (which involve inter-agency supervision activities). More initiatives of this type should be encouraged.
Principle 16.	**Interest rate risk in the banking book.** Supervisors must be satisfied that banks have effective systems in place to identify, measure, monitor and control interest rate risk in the banking book, including a well defined strategy that has been approved by the board and implemented by senior management; these should be appropriate to the size and complexity of such risk..
Description	**EC 1:** Reflecting the role this risk has played in past banking crises, the safety-and-soundness statute explicitly requires the FBAs to prescribe standards for banks and holding companies relating to IRR [*see 12 U.S.C. § 1831p-1(a)(1)(D)*]. The 1996 *Joint Policy Statement on Interest Rate Risk* provides quite comprehensive additional guidance on this issue. The *OTS Thrift Bulletin 13a* also discusses desirable features of IRR measurement systems. Compliance with the interagency safety-and-soundness guidelines necessitates the development and adoption by the board of a strategy and policies and processes for identifying, measuring, monitoring, and controlling interest rate risk. The guidelines also require senior management to ensure adherence and oversee the implementation and maintenance of management information and other control systems that identify, measure, monitor, and control IRR. The FBAs confirm a bank's or holding company's compliance with their requirements during on-site examinations. Each agency has examination manuals and programs that supervisors use to assess the level and management of IRR. Each FBA also has supervisors with specialized skills in risk modelling and validation that can assist supervisors at larger, more complex banks and holding companies. Supervisory assessment of a bank's IRR risk-management processes and practices are captured in the UFIRS (the "S" in CAMELS represents Sensitivity to Market Risk). Specifically, this component reflects the degree to which changes in interest rates, foreign exchange rates, commodity prices, or equity prices can adversely affect a bank's earnings or economic capital. For the bulk of U.S. banks and holding companies, the primary source of market risk is the IRR that arises from non-trading positions in their banking book. **EC 2:** The IRR provisions of the interagency safety-and-soundness guidelines require banks and holding companies to establish policies and procedures for assessing the level of interest rate risk and for reporting on interest rate risk to management and the board of directors and management. Banks and holding companies are required to establish comprehensive IRR measurement systems and regularly validate any models and assumptions. The FBAs use supervision processes to confirm that the board and senior management are effectively managing IRR and that appropriate policies and practices are established to control and limit risks. Also, supervisors review policies to ensure they include clear lines of responsibility and authority for establishing and maintaining an IRR measurement system; formulating and executing strategies to manage IRR exposures; and authorizing policy exceptions.

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	EC 3: The FBAs require that the bank's or holding company's management consider the current level and term structure of rates and possible changes to that environment, given the historical and expected future volatility of market rates. At a minimum, the *Joint Policy Statement on Interest Rate Risk* suggests that scenarios should include an instantaneous +/-200 basis point parallel shift in market rates for a one year time horizon. Beyond that, the agencies have individually issued further supervisory requirements and/or guidance, in varying degrees of detail and prescription, on additional stress testing that they recommend. **AC 1:** The supervisory authority to review banks' internal interest rate risk measurement systems is included in section 305 of FDICIA. The FBAs' regulatory Call Reports also include maturity and repricing information on each bank's investment, loan and deposit portfolios. However, with the exception of the OTS, none of the FBAs has a standard measure for interest rate risk. Due to the high concentrations of mortgage loans and securities that savings associations hold in their portfolios, the OTS's supervisory approach to IRR is somewhat different than that of the other FBAs. The OTS uses its Net Portfolio Value (NPV) Model to monitor the IRR exposures of individual savings associations, as well as the industry as a whole, on a quarterly basis. The NPV Model is described as a non-probabilistic, value-at-risk model, where the value-at-risk is the net economic value of a savings association's portfolio of assets, liabilities, and off-balance sheet (OBS) contracts. In essence, OTS attempts to mark-to-market each savings association's balance sheet under several different interest rate scenarios to determine how the NPV of the savings association changes in response to changes in interest rates. The NPV Model is used to produce Interest Rate Risk Exposure Reports quarterly for a large number of OTS-regulated savings associations. Frequently, these reports are also used as a management tool by small savings associations that do not have their own internal IRR models. Other agencies utilize the banks' and holding companies' internal measures of risk, and use their own surveillance screens to identify those that appear to be taking excessive risk. **AC 2:** The *Interagency Policy Statement on Interest Rate Risk* states that the adequacy and effectiveness of a bank's or holding company's IRR management process and the level of its interest rate exposure are critical factors the board and senior management need to consider in evaluating that bank's and holding company's capital adequacy. **AC 3:** During on-site examinations, the FBAs assess whether stress testing regimes incorporate scenarios large enough to expose all meaningful sources of IRR although, as noted, guidance on the appropriateness of scenarios varies somewhat between agencies. Supervisors also confirm that in developing stress scenarios, banks and holding companies consider a number of factors including the level and shape of the yield curve, sufficiently wide changes in market interest rates and/or yield curve shifts and assumptions about customer behaviour and new business activity that are consistent with each scenario being evaluated. Supervisors test whether senior management and the board periodically review stress test results in order to (i) gain an understanding of the implications of various stress scenarios, (ii) facilitate the review of the entity's risk tolerances and limits, and (iii) provide the basis needed to implement strategies to mitigate the identified risk exposure and realign the risk tolerances. **AC 4:** As part of their review processes, the FBAs seek to confirm that banks establish clear lines of authority, responsibilities, and risk limits, and ensure that adequate resources are provided to support the risk monitoring, audit, and control functions. For example, supervisors seek to confirm that the persons or units responsible for risk monitoring and control functions are independent from the persons or units that create the risk exposures. If the risk monitoring and control functions are part of a treasury unit that also has the responsibility and authority to execute investment or hedging strategies to manage the bank's or holding company's risk exposure, supervisors test whether the bank or holding company has a strong internal audit and control function and sufficient safeguards in place.

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Assessment	Compliant
Comments	From the information made available to the assessors, the FBAs have been effective in the supervision of interest rate risk—an issue which is of increasing importance in the current environment. However, while broadly consistent across the FBAs in most material respects, additional benefits could be obtained from improved consistency in examination approaches and in measurement techniques. Ideally, there would be a common framework for IRR measurement across all FBAs, albeit that this common framework could still have variations to take account of the differences and complexities in measuring IRR in a large internationally-active bank versus a small community bank with a simple balance sheet. Such a framework could be used as a basis for better assessing and comparing individual banks and identifying outliers, and to improve the consistency of assessment and CAMELS rating.
Principle 17.	**Internal control and audit.** Supervisors must be satisfied that banks have in place internal controls that are adequate for the size and complexity of their business. These should include clear arrangements for delegating authority and responsibility; separation of the functions that involve committing the bank, paying away its funds, and accounting for its assets and liabilities; reconciliation of these processes; safeguarding the bank's assets; and appropriate independent internal audit and compliance functions to test adherence to these controls as well as applicable laws and regulations.
Description	**General.** The safety-and-soundness provisions of the FDI Act require the FBAs to prescribe standards relating to internal controls, information systems and audits. Interagency guidelines implement the standards. They specify that a bank and holding company should have internal controls and information systems that are appropriate to the size of the company and the nature, scope and risk of its activities and that provide for (a) an organizational structure that establishes clear lines of authority and responsibility for monitoring adherence to established policies; (b) effective risk assessment; (c) timely and accurate financial, operational, and regulatory reports; (d) adequate safeguards to manage assets; and (e) compliance with laws and regulations. A bank and holding company should also have an internal audit system that is appropriate to the size of the company and the nature and scope of its activities and that provides for (a) adequate monitoring of the system of internal controls through an internal audit function (for smaller banks: a system of independent reviews of key internal controls); (b) independence and objectivity; (c) qualified persons; (d) adequate testing and review of information systems; (e) adequate documentation of tests and findings and any corrective actions; (f) verification and review of management actions to address material weaknesses; and (g) review by the bank's and holding company's audit committee or board of directors of the effectiveness of the internal audit system. The effectiveness of internal controls, information systems, and audits is evaluated as part of the supervisory process. An agency may require the bank to submit a plan to achieve compliance, or take other supervisory actions. **EC 1:** The FBAs establish expectations on board members and senior management through law and various interagency statements. The specificities of implementation are left to the individual organizations to decide. The framework requires banks and holding companies to have clearly established responsibilities for board members and senior management with respect to corporate governance to ensure that there is effective control over a bank's and holding company's entire business. Directors have ultimate responsibility for the level of risk taken by the bank. **EC 2:** The FBAs assess the adequacy of a bank's and holding company's corporate governance framework at granting charters and as part of the supervisory process. When evaluating a bank's internal controls and audit procedures, supervisors consider, inter alia, whether: • the system of internal controls is appropriate to the type and level of risks; • the organizational structure establishes clear lines of authority and responsibility; • reporting lines for the control areas are independent from the business lines, and there is adequate separation of duties─the four-eyes' principle is adopted; • there exist processes and procedures for the safeguarding of assets and investments, also physical;

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- official structures reflect actual operating practices;
- reports are reliable and timely and exceptions are noted and promptly investigated;
- audit procedures exist for ensuring compliance with laws and regulations;
- internal audit or other control-review practices provide for independence and objectivity;
- internal controls and information systems are tested and reviewed; and
- an audit committee or the board of directors reviews the effectiveness of internal audits and other control-review activities.

EC 3: Several statutory and regulatory provisions, supplemented by supervisory guidance such as OCC *Internal Control, and Duties and Responsibilities of Directors*, make clear that the board of directors and management ultimately are responsible for the control environment. In addition, licensing and supervisory standards require that board and senior management understand the underlying risks and are committed to a strong control environment.

EC 4: Under *12 U.S.C. §1818(b),* FBAs may limit the powers of directors and management when an unsafe or unsound practice exists. Under certain circumstances *(e.g., §1818(e))* the agencies also may prohibit such persons from participating in the affairs of a bank or holding company. In general, supervisors try to address such issues by less formal means and as part of a broader effort to resolve prudential concerns, e.g., by informal talks with the board to achieve the desired results.

EC 5: Supervisors evaluate the competency and skills of personnel assigned to various control functions and the adequacy of resources available to meet the internal control objectives. Supervisory guidance cautions supervisors to be alert for indications that adverse circumstances may exist, such as inappropriate balance (including resources) and skills between operational and back office functions.

EC 6: Supervisors confirm that the compliance function is effective and independent of the business activities and has controls commensurate with the company's size and activities. The board of directors is ultimately responsible for developing, overseeing and administering a compliance management system that ensures compliance with laws and regulations.

EC 7: The interagency safety-and-soundness guidelines state that most banks and holding companies must establish a permanent internal audit unit responsible for (a) ensuring compliance with policies and procedures, and (b) assessing the continued adequacy of the policies and procedures.

EC 8: The supervisory assessment of the internal audit function is determined as part of the supervisory process. This includes resources, training, independence, reporting lines, full access to staff and records, methodology, audit plan, and monitoring of outsourced functions.

AC 1: Under the Sarbanes-Oxley Act, public companies must have non-executive directors on their boards. Under the FDI Act and related regulations, insured institutions with US$500 million or more in total assets must have outside, non-executive directors on their boards who serve on the audit committee, although this requirement can be met at the holding company level under certain circumstances. *(See 12 U.S.C. §1831m(g) and 12 CFR §363.5(a)).* Outside these two Acts, there exists no regulatory requirement that a board must include non-executive directors.

AC 2: For public companies, the Sarbanes-Oxley Act defines the scope of the audit committee's duties to (implicitly) include internal audit. (*See 15 U.S.C. §7201)*. Also for non-public companies, supervisory guidelines require that the audit committee oversees the internal audit function and evaluates its performance. Supervisors confirm the internal audit function's reporting line to the audit committee during on-site examinations by review of the organization chart as well as review of audit committee meeting minutes and through discussions with the internal auditor.

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	AC 3: For banks and holding companies with total assets of US$1billion or more, the audit committee must be comprised entirely of outside, non-executive directors. For companies with assets of US$500 million but less than 1 billion, the majority of the audit committee must be outside, non-executive directors (unless an exception is granted by the supervisors). If total assets exceed US$3 billion, audit committee members must have financial management expertise, access to the committee's own outside counsel and not be a large customer of the bank or holding company. **AC 4:** Certain laws or regulations require the bank to notify the supervisor of suspected illegal or suspicious activity. In addition, although there is no statutory requirement for it, FBAs expect that notification would be given of any circumstance involving a board or management member that has the potential to impact the safety and soundness of the bank or holding company.
Assessment	Compliant
Comments	
Principle 18.	**Abuse of financial services.** Supervisors must be satisfied that banks have adequate policies and processes in place, including strict "know-your-customer" rules, that promote high ethical and professional standards in the financial sector and prevent the bank from being used, intentionally or unintentionally, for criminal activities.
Description	**EC 1:** Various statutes and regulations require the FBAs to issue regulations and to conduct examinations to evaluate banks' compliance with laws and regulations pertaining to AML. Supervisors must also determine that banks have adequate policies and procedures to prevent criminal activities, including fraud, money laundering and terrorist financing. The agencies have enforcement authority to correct violations or deficiencies, e.g., in internal control or reporting systems. Other agencies have enforcement authority with respect to certain conduct, e.g., the Federal Trade Commission may take action against non-depository institutions involved in fraud that harms consumers. Any conduct that rises to the level of a criminal offense can result in criminal prosecution. **EC 2:** The agencies and Treasury have issued regulations that, at a minimum, require banks to: (a) establish internal controls to ensure Bank Secrecy Act (BSA) (Bank Secrecy Act) compliance; (b) conduct independent testing of compliance; (c) appoint an individual responsible for monitoring day-to-day compliance; and (d) set up training for staff. Separate regulation requires banks to establish customer identification programs (CIPs). The *Bank Protection Act*, *12 U.S.C. §1882*, requires the agencies to promulgate rules applicable to banks with respect to the installation and operation of security devices and procedures to discourage robberies, burglaries, and larcenies and to assist in the identification and apprehension of persons who commit such acts. The *Interagency Guidelines Establishing Information Security Standards* require banks to implement safeguards for the security, confidentiality, and integrity of customer information, including protecting against unauthorized access, and advise banks to perform background checks for employees with responsibilities for, or access to, customer information. Supervisors promote high ethical and professional standards in banks through various means, such as running training opportunities, or Management Letters. **EC 3:** Banks and holding companies must file a Suspicious Activity Report (SAR) (Suspicious Activity Report) with Financial Crimes Enforcement Network (FinCEN) within 30 days of the initial detection of certain facts (or 60 days if attempting to identify a subject). Specifically a bank, holding company, a holding company's non-bank subsidiary, and certain SLHCs and non-banks subsidiaries of SLHCs must file a SAR whenever they detect or suspect any federal criminal violation against the bank or involving transactions conducted through the bank if (a) an insider was involved or (b) over US$5,000 was involved and the filer can identify a suspect, or (c) over US$25,000 was involved—or if the amount exceeds US$5,000 and the transactions may violate the BSA or AML rules. In cases involving violations requiring immediate attention, law enforcement authorities must be immediately informed, in addition to filing the SAR. Also, when a SAR is filed the board of directors or the relevant board committee must be promptly informed. The agencies review SARs and other BSA data in order to prepare the examination plan for on-site

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	examinations. SARs are also reviewed to ensure that, when needed, enforcement actions are brought against institution affiliated parties, e.g., prohibiting them from further work in the banking industry. **EC 4:** Pursuant to *31 U.S.C. 5318(l),* regulations have been issued requiring customer identification programs, including verifying the identity of any persons seeking to open an account and maintaining records of such information. Banks must establish a CIP for this purpose. The CIP will include the bank's policy and procedures for responding to circumstances in which the bank cannot form a reasonable belief that it knows the true identity of a customer. For certain, notably in private banking, non-U.S. accounts and transactions, banks must identify beneficial owners. However, in practice, banks are expected, and do, apply the standards also for other accounts and transactions. Regulations generally require that copies of records and reports are kept current and maintained for a period of five years following the completion of the transaction. Supervisors determine whether the internal controls include prudent opening procedures and ongoing monitoring systems. Supervisors also review whether banks identify politically exposed persons (PEPs) and monitor their accounts on an ongoing basis at a high managerial level. All banks must establish a BSA/AML Compliance Program, which includes CIP and customer due diligence (CDD) policies, procedures and processes for all customers, more detailed procedures are required for those that present a high risk for money laundering and terrorist financing. **EC 5:** *31 U.S.C. 5318(i)* and its implementing regulation require banks to establish due diligence policies and procedures reasonably designed to detect and report money laundering through correspondent accounts established, maintained, administered, or managed in the United .States. for a foreign financial institution. In addition, banks must perform enhanced due diligence for foreign correspondent banks with certain high-risk banking licenses. This includes obtaining ownership information about certain correspondents, conducting additional scrutiny of the transactions routed through these accounts, and ascertaining whether the foreign correspondent provides access to other foreign financial institutions. *31 U.S.C. §5318(j)* prohibit U.S. banks from providing correspondent accounts to shell banks. The U.S. federal and state agencies also generally evaluate U.S. banks that offer correspondent bank services to domestic respondent banks. The reviews include the policies, procedures and processes to manage the BSA/AML risks involved in these relationships and to detect and report suspicious activities. Supervisors expect, and will verify during onsite examinations, banks to terminate their relationships with foreign correspondents whose policies and procedures and processes on BSA/AML risks are deemed as inadequate. **EC 6:** Under *12 U.S.C. §1818(s*), each FBA is required to regularly examine the institution's BSA Compliance Program. Prior to the examination, supervisors routinely conduct an off-site review of the FinCEN databases relative to bank SARs and currency transaction reports (CTRs) to determine if the bank has filed such reports and that they appear complete and timely. For complex banking organizations, the agencies maintain resident on-site supervisors who perform continuous monitoring of the control infrastructure and annually assess the organization's condition and risk assessment. The agencies also alert the industry of fraud schemes through bulletins and industry conferences. **EC 7:** An agency may take formal or informal enforcement actions to address violations of BSA/AML requirements, Office of Foreign Assets Control (OFAC) deficiencies, and unsafe and unsound practices or breaches of fiduciary duty involving failure to comply with obligations related to criminal activity. When relevant, *12 U.S.C. §1818(s)(3)* requires an agency to issue a cease and desist order to address a violation of the BSA Compliance Program or other actions to be taken to enforce compliance with the Bank Secrecy Act. The FBAs and FinCEN also has the authority to assess penalties for violations of the BSA. The Department of Justice (DOJ) has the authority to bring criminal cases against banks or holding companies for violations against criminal statutes, including parts of the BSA. **EC 8:** Banks must have adequate BSA/AML Compliance Programs in place that includes internal controls for the operation and function of the bank's program; independent testing of the bank's

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	compliance; designate an individual or individuals responsible for coordinating and monitoring day-to-day compliance of BSA/AML matters including SARs reporting; ongoing training programs on know your customer (KYC); and CIP and methods to detect criminal and suspicious activities. The agencies have issued guidelines that advise banks to perform background checks for employees in particular with responsibilities for, or access to, customer information to minimize the risk of fraud, embezzlement, money laundering and other crimes. **EC 9:** Whenever a bank files a SAR, it must promptly notify the board of directors or board committee. In addition to the SAR requirements, the audit committee of publicly held banks and holding companies that are subject to section 301 of Sarbanes-Oxley must establish procedures for the confidential, anonymous submissions by employees of concerns regarding questionable accounting or auditing matters. In its supervision, the agencies evaluate the escalation process from the point of initial detection to determine whether management's documented decisions to file or not file a SAR are within bank policy and whether SARs are filed in a timely manner. Also, agencies review MIS to insure that they inform the board, or board committee, and senior management of suspicious activities, compliance deficiencies, and corrective actions. **EC 10:** U.S. Federal Law *31 U.S.C. §5318(g)(3*) provides protection from civil liability for all reports of suspicious transactions made to appropriate authorities as well as for internal reporting within the bank. The "safe harbor" applies to SARs filed within the required reporting thresholds as well as to SARs filed voluntarily on any activity below the threshold. **EC 11:** The agencies are authorized to inform relevant authorities, including Treasury and FinCEN, of suspicious transactions. (*See 12 CFR 261, 12 CFR 4; and 12 CFR 503.2).* Within these prescribed procedures, the agencies may also share such information with judicial authorities. The Right to Financial Privacy Act provides exceptions with respect to disclosures for law enforcement purposes. **EC 12:** The agencies are authorized to share information with relevant domestic and foreign supervisory authorities and also enforcement agencies on suspected or actual criminal activities where this information is for supervisory purposes, (see e.g., *Section 8(v) of the Federal Deposit Insurance Act (12 U.S.C. 1818(v))) and 12CFR 347.207 regarding disclosure of supervisory information to foreign supervisors.* Section 15 of the *International Banking Act (12 U.S.C. §3109) and 12 CFR 261.20 and 261.21. 12 CFR 4.37* permits the OCC to share non-public information also with non-supervisory government agencies of foreign governments, subject to safeguards. **AC 1:** The agencies employ specialist personnel, e.g., for addressing compliance with AML regulations. The agencies have also fraud experts to handle fraud cases and liaise with law enforcement such as the DOJ and FBI.
Assessment	Compliant
Comments	The Compliant rating is based on the following: 1. Banks, in particular large banks, maintain comprehensive programs, policies and procedures to reduce the risk of endangering the safety and soundness of the bank through abuse of its operations and services, including physical safety. 2. Supervisors monitor effectively, in their full-scope or targeted examinations, that banks comply with their undertakings. Internal audit and internal controls will also contribute to overall oversight. There exist adequate reporting requirements on, e.g., suspicious transactions, both within the bank, to the supervisors, and to relevant judicial authorities. 3. The assessors perused supervisory examination reports and can confirm that these were sufficiently comprehensive and deep.

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	On the relationship between CP 18 and the FATF assessments: A. AML/CFT issues constitute only a part of CP 18, which encompasses all issues of abuse, including fraud, embezzlement, robbery, phishing and more. B. Only those AML/CFT issues which are clearly relevant to the safety and soundness of the bank are relevant to CP 18. C. A separate FATF assessment was conducted in 2006 and an IMF update is part of the current FSAP. The BCP assessors were informed that the authorities have addressed several of the earlier identified weaknesses. Below, a number of deficiencies identified in the 2006 assessment are quoted. These are, indeed, relevant to banks but the assessors did not deem them to be of sufficient materiality, in the sense of the BCP/CP 18 methodology, to warrant a downgrade. That said, the assessors support FATF's recommendation that these deficiencies be remedied. • Obligations to identify beneficial owners are limited to specific circumstances, such as correspondent banking and private banking for non-U.S. clients. • No measures in place to ensure that there is adequate, timely and accurate information on the beneficial ownership and control of legal persons that can be obtained or accessed in a timely fashion by the competent authorities. • Minimal information concerning the beneficial owners of trusts that can be obtained or accessed by the competent authorities in a timely fashion. • No explicit obligation to conduct ongoing due diligence, except in certain defined circumstances • Customer identification for occasional transactions limited to cash deals only. • Verification of identity until after the establishment of the business relationship is not limited to circumstance where it is essential not to interrupt the normal course of business. • No explicit obligation to terminate relationship if verification process cannot be accomplished. • No obligation to require senior management approval when opening individual correspondent accounts.
Principle 19.	**Supervisory approach.** An effective banking supervisory system requires that supervisors develop and maintain a thorough understanding of the operations of individual banks and banking groups, and also of the banking system as a whole, focusing on safety and soundness, and the stability of the banking system.
Description	**EC 1:** Banking laws vest the FBAs collectively with broad, but not unlimited, authority to regulate and supervise banks and holding companies subject to their jurisdiction. The FBAs use their authority to conduct on-site reviews and off-site analyses to develop a thorough understanding of the risk profile of banks and holding companies. The primary tool of supervision is the on-site examination. Under U.S. law, the FBAs conduct full-scope on-site examinations of banks at least once every year (for banks that have assets of less than US$500 million and that are considered well-managed and well-capitalized, this may extend to 18 months). Bank holding company inspection cycles are mandated depending upon size, complexity, and rating. SLHC examinations are conducted concurrently with the OTS examination of its subsidiary savings associations. A full-scope examination addresses all key areas of a bank's operations. For many larger banks and

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	holding companies, one or more of the banking agencies maintains a full-time, on-site examination staff to monitor the activities (for the very largest banks, this could aggregate across the FBAs to as many as 80 people full-time; this is supplemented even further by additional rotating examiners during the course of the examination cycle). In these cases, full scope examinations/inspections consist of a series of targeted reviews during the examination cycle which culminate in a roll-up process where ratings are assigned based upon the results of these targets and the continuous monitoring activities. The requirements and mandates for these on-site activities are contained in the individual agencies' examination manuals and other guidance to examiners. During the period of time in between full-scope, on-site examinations, the FBAs use off-site surveillance to maintain their understanding of the bank's and holding company's risk profiles. CP 20 provides further detail of the sources of information used for off-site analysis. These sources may be supplemented by discussions with the banking organization's management, meetings with its internal and external auditors, and, where no full-time on-site examination staff is maintained, targeted on-site visits to maintain an up-to-date understanding of the financial condition. In addition, the agencies maintain various systematized analytical tools that can help identify emerging risks or changes in the risk profile that may require specified follow-up steps (Fed – SABR; OCC – Canary; FDIC – SCOR; OTS – RMS). These tools are used to alert examination staff to potential risks or issues that need to be reviewed as a matter of priority. As noted elsewhere, all of these mechanisms are constrained to some extent when the individual agency is not the supervisor of the entire group, or part of the group is subject to the primary oversight of another functional regulator. The GLB Act imposes a responsibility on the FBAs to defer to another functional regulator where the latter exists, except in exceptional circumstances. Ad-hoc information sharing mechanisms have been established between agencies to try to ensure a broader, group-wide perspective of a bank's or holding company's risk profile can be developed. **EC 2:** Using aggregations of quarterly data collections, each agency completes analyses addressing overall conditions within their regulated portfolio. Within the capacity of the data collected, these analyses highlight issues such as earnings performance, capitalization levels, and lending concentrations, and are used to assess trends, developments, and risks for the system as a whole. Each agency also employs a variety of higher level committees and coordination mechanisms to evaluate and assess the risks facing the system and provide feedback to supervisory staff. The FBAs also seek to maintain contacts with a variety of market and industry analysts to obtain insights on emerging risks that may affect the banking system and financial markets as a whole. The FBAs consult with the supervisors of major non-bank organizations in the United States, including the SEC in the case of broker-dealers and the state insurance authorities in the case of insurance companies, to help to evaluate the impact of these institutions' activities on the condition of holding companies. At this stage, however, the agencies have not chosen to employ the 'supervisory college' concept domestically (involving relevant banking and non-banking regulators) for the largest, most diverse and most complex banking groups. All agencies noted the challenge they faced in developing a good overall assessment of the state and direction of the banking industry, given (i) the limits of their own individual mandates, (ii) the unknown risks and activities associated with non-bank activities within the group or holding company, (iii) the banking industry's size and complexity, and (iv) the sophistication and inter-connectivity of the broader U.S. financial system. **EC 3:** During each supervisory cycle, the FBAs formally assess the risk profile of each bank and holding company in order to determine the supervisory strategy to be followed by examination staff and prioritization of agency resources. Risk assessments are updated on a regular basis through off-site monitoring programs and on-site examinations, although typically the formal re-assessment (e.g., of the composite CAMELS ratings) occurs on an annual cycle. Banks and holding companies showing signs of significant deterioration or making significant changes in their business focus may be subject to immediate on-site or targeted examination, or the supervisory

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	plan for the period ahead intensified, depending on the circumstances. The agencies' Uniform Bank Performance Report or Uniform Thrift Performance Report allows supervisors and supervisory staff to compare financial trends across groups of peer banks to identify outlier or high risk banks. The FBAs also use the UFIRS (i.e., CAMELS rating system) to provide a methodology and terminology for assessing and assigning risk ratings across banks. Additional uniform rating systems are used to assess information technology (URSIT ratings), trust (MOECA), and consumer compliance systems. Bank holding companies receive RFI ratings, SLHCs receive CORE ratings and the **R**isk Management; **O**perational Controls; **C**ompliance; and **A**sset Quality (ROCA) rating system is used for foreign banking organizations. Many of these ratings, however, do not appear to be sufficiently responsive to changing risk profiles, or to adequately distinguish between banks of varying risk profiles. For example, based on the statistics presented to the assessors, more than half of all banks in the United .States. are rated within a single CAMELS grading category (and more than three-quarters sit within two rating grades). This limits the usefulness of the key rating tool as means of distinguishing between banks, and developing risk-based resource allocation. The assessors noted that each agency has developed its own internal tools to better assess evaluate the risk profiles of individual banks; at least in some cases, these internal ratings tended to be more influential on oversight and resource allocation than the UFIRS. **EC 4:** During regular on-site examinations, the FBAs complete a series of testing procedures, contained in each agency's examination manuals, to confirm banks' and holding companies' compliance with prudential regulations and other legal requirements. In addition, compliance with some rules is monitored on an ongoing basis through the collection and analysis of financial and structure reports that must be filed. The FBAs also seek to confirm that banks and holding companies maintain policies and procedures designed to ensure their compliance with applicable laws and regulations. The FBAs have developed and maintain extensive supervisory guidance to evaluate compliance programs and specific areas including internal controls, audit, consumer protection, fair credit reporting, home mortgage disclosure, real estate settlement procedures, and anti-money-laundering, among others. **EC 5:** The FBAs generally expect banks and holding companies to notify them of any substantive changes in their activities, structure and overall condition, or as soon as they become aware of any material adverse developments, including breach of legal or prudential requirements. Further, statute or the FBAs may impose specific notification requirements on banks. Examples (which may not be common to all FBAs) include requirements to establish or relocate a branch, for corporate reorganizations, or to establish or acquire a subsidiary. In the case of new banks and holding companies, the FBAs routinely include a condition in their approval orders that requires prior notice of any change to the new organization's business plan during the first three years of operation. After this period, changes in the activities, if permissible under state and federal law, would generally be subject to review during periodic safety-and-soundness examinations, although some new activities would continue to require a notice or application. CP 4 and CP 5 provide further detail regarding transfer of significant ownership and for major acquisitions. **EC 6:** Each FBA maintains a set of databases containing examination, financial, and structure data to facilitate the processing, monitoring, and analysis of prudential information. These data sources are used through a number of agency-specific surveillance tools to support ongoing off-site analysis of, and follow-up action on, banking conditions both at banks and holding companies and within the industry as a whole. For example, agency exam databases can identify for banks and holding companies matters requiring the bank's, holding company's or their respective board's attention for agency follow-up. A reasonable amount of this information is shared between the agencies, although full access to each other's information is usually seen as unnecessary. Specific to financial data, each bank is required to file complete financial data to the Central Data Repository (CDR) on a quarterly basis. The format utilized for this process is known as the Call

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	Report. The data contained within the report is processed within the CDR by the FFIEC and is then utilized in a multitude of distinctive formats across each of the regulatory agencies, and even by the general public. The resulting data provide the agencies the ability to produce high level reports of the condition of the banking system in various formats. **AC 1:** Through their ongoing risk assessment processes, the agencies look for risks that may be increasing or risk-management systems that may need improvements. Each of the FBAs also employs well defined off-site surveillance procedures that focus heavily on identifying banks and holding companies that are exhibiting problems or deteriorating so that examination resources can be directed to troubled organizations or emerging threats. The FBAs conduct annually a joint review of the largest, complex credits that are shared by three or more banks. This annual review provides an opportunity for the agencies to identify trends in underwriting and credit classification practices, as well as overall commercial credit conditions, across the banking system (see CP 9 for details of the scale of this program).
Assessment	Largely Compliant
Comments	The recent market turmoil has highlighted important areas where regulatory oversight and coordination need to be strengthened. The current supervisory structures and mandates have not assisted in allowing supervisors to develop and maintain a thorough understanding of the operations of individual banking groups, and also of the banking system as a whole. For example, although only a minor proportion of subprime and nonprime mortgages were originated directly by chartered banks, an additional substantial proportion of origination occurred in non-bank affiliates which appeared to have not received the same degree of oversight as banks despite being owned within banking groups (e.g., according to statistics in a 2009 GAO report, more than half of the mortgages originated by the top 25 subprime and nonprime lenders in 2006—which themselves accounted for 90 percent of originations—were originated by banks and their affiliates). In addition, consistent with the spirit and intent of the GLB Act, activities within bank-affiliated broker-dealers were largely unsupervised by the FBAs. The U.S. Treasury Department's financial reform package proposes to strengthen the capacity for consolidated oversight of financial groups, but the supervisory intensity of the non-banking parts of banking groups will also need to increase. Internationally, the concept of a supervisory college has been widely endorsed as a means of bringing together supervisors for different parts of a complex group, with a view to sharing information and (potentially) aligning supervisory activity schedules. Given the fragmented nature of the U.S. regulatory system, the assessors consider that domestic colleges would have considerable merit, at least for the large and complex banking groups. Unlike international colleges, which focus on banking supervisors, domestic colleges should include all relevant functional supervisors if they are to be truly effective. For most supervisors with advanced financial systems, a common rating system is a key tool in the development of an overall risk assessment, as well as providing a mechanism for risk identification, increased management oversight, and resource prioritization. The UFIRS is, relative to the rating systems now used by overseas peers, somewhat outdated. Compared to rating systems used elsewhere, the CAMELS methodology is heavily subjective, relying on high level and fairly broad descriptions. The system does not distinguish between inherent risk and risk controls. Guidance on assigning the component ratings also tends to overlap, leading to a very high degree of correlation between the ratings of individual components. Ratings also appear slow to adjust to developments (reflecting the annual cycle of review) and 'sticky' over time (overall, the CAMELS ratings suggested the risk profile of the banking system was at best flat, and perhaps even improved, between 2003 and 2007). This lack of differentiation might possibly reflect the multiple uses to which ratings are put (e.g., ratings influence deposit insurance premiums, deposit-gathering capacity, and branching/acquisition approval requirements). Importantly, the multiple uses of the CAMELS system can create incentives for supervisors not to lower ratings quickly in anticipation

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	of potential problems. The FBAs consider that the UFIRS and their own risk rating systems serve two distinct purposes and, when combined, provide more complete information than either would provide individually about the condition and evolution of the industry. However, it is not clear why this information cannot be conveyed in a single measure and, in any event, the supplementary risk rating systems differ by agency and are not readily comparable. The assessors recommend that either (i) the UFIRS be overhauled, building on the good work that has been done by individual agencies in developing their own more granular and risk-based rating systems, or (ii) that, if the FBAs consider the UFIRS is too embedded in the broader regulatory system to be easily changed, greater effort be directed to developing a consistent, more granular, forward-looking risk rating system that at least provides a 'common language' across the FBAs.
Principle 20.	**Supervisory techniques.** An effective banking supervisory system should consist of on-site and off-site supervision and regular contacts with bank management.
Description	**EC 1:** Supervision is accomplished through a combination of on-site examinations and off-site reviews. In general, the primary FBA conducts annual, on-site examinations of the banks within its jurisdiction [*see 12 U.S.C. § 1820(d).*] Smaller banks that satisfy certain qualifying criteria, including having less than US$500 million in total assets, may be examined on an 18-month cycle. However, FBAs retain authority to examine a bank as frequently as they deem necessary. In their role as holding company supervisors, the Federal Reserve and the OTS also conduct inspections and make risk assessments of a holding company's operations [*see 12 U.S.C. § 1842a and 1467a*], although the Federal Reserve may only conduct off-site reviews for all bank holding companies with smaller (less than US$1 billion in assets) banks. In certain cases, there is overlapping examination authority among the FBAs. For example, *12 U.S.C. § 1820(b)(3)* gives the FDIC and the Federal Reserve the authority to examine any bank, and, if necessary, to independently determine the condition of that bank for the FDIC's deposit insurance purposes. In addition, there is also overlap with state banking supervisors; in some cases the FBAs will alternate or combine examinations with the state regulators. Examination areas for all banks and holding companies include any cross-border operations. All of the FBAs may examine bank service companies [*see 12 U.S.C. § 1867*]. The primary FBAs generally have the authority to examine affiliates of the bank under their supervision [*see 12 U.S.C. §§ 338, 1464, 1820, 1467, 1844*]. However, under the GLB Act all of the FBAs must rely to the fullest extent possible on the functional supervisors of the securities and insurance subsidiaries and any other subsidiary that is subject to comprehensive supervision by a federal or state authority for supervisory information to minimize duplication and unnecessary regulatory burden on regulated entities. The primary FBA can conduct an examination of a functionally regulated subsidiary only if the agency has reasonable cause to believe the subsidiary is engaging in activities that pose a material risk to the bank or is not in compliance with any Federal law that it has specific jurisdiction to enforce against such subsidiary, or for other prudential reasons and the information cannot be obtained from the functional supervisor [*see 12 U.S.C. § 1844(c)*]. During the time period in between on-site examinations, the agencies conduct ongoing off-site surveillance of each supervised bank and holding company and may follow up with additional on-site work and testing. Generally, the balance between on- and off-site supervisory activities is dictated by the condition and size of the subject bank or holding company, with more on-site examination work being conducted at larger or more problematic banks and holding companies. Off-site supervision involves periodic surveillance and assessment of information from a variety of sources, including the supervised bank and holding company. CP 21 discusses regulatory reporting in more detail. Off-site surveillance also includes a review of reports of recent examinations and inspections, internal management and internal and external auditor reports, reports filed by public companies, application materials, and other publicly available material. In addition, it includes information obtained from regular discussions with management, internal and external auditors, and other supervisors, both foreign and domestic.

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	The primary FBA makes risk assessments with respect to the bank's operations. For larger banks and holding companies, the FBA maintains resident on-site supervisors who provide continuous supervision of the banking organization and at least quarterly updates on the banks and holding company's condition and risk. Each agency has the authority to take an enforcement action if, in the agency's opinion, the bank, holding company or any institution-affiliated party (IAP) is engaging in an unsafe or unsound practice, or is violating the law [*see 12 U.S.C. §§ 1813 and 1818*]. The FBAs have all implemented quality assurance programs designed to monitor the success of their on- and off-site supervisory efforts. The agencies are also subject to considerable public scrutiny (primary by Material Loss Review reports of the respective Offices of the Inspector General) whenever an institution fails. **EC 2:** Each of the FBAs maintains written guidance for planning and executing on-site and off-site activities. Generally, agencies develop on- and off-site examination strategies and goals based on the risk profile of the bank or holding company. Guidance can be found in each of the agencies' examination manuals. The guidance specifies the objectives and expected actions and outputs for these activities, and also details basic procedures for completing on-site reviews and implementing off-site surveillance programs. Coordination and information sharing between on- and off-site supervision functions is facilitated by formal off-site monitoring programs that trigger follow-up by the on-site function when banks and holding companies meet various screening thresholds. In addition, supervisory policies require the consideration of off-site monitoring results when supervisors are determining the scope and procedures of on-site reviews. **EC 3:** The FBAs utilize on-site examinations extensively. These endeavor to address all key areas of a bank's and holding company's operations. Examinations incorporate independent verification of the effectiveness of risk management, internal controls, management reporting, and overall corporate governance. In addition, examination procedures may be directed to validating the reliability and accuracy of financial data reported to the agencies. Also, at each examination, supervisors evaluate any follow-up to supervisory concerns raised at prior examinations or as a result of off-site monitoring. During on-site examinations, the FBAs review the most recent external auditor's assessment of the banks or holding company's financials and the work of the loan review function and internal audit. Typically, supervisors review audit testing of financial and Call Report reconcilements and accuracy. **EC 4:** As part of formal, off-site monitoring programs, the FBAs use automated screening systems, regulatory reports, standardized financial reports detailing key financial ratios and measures, and public sources of financial information to monitor the performance and condition of supervised banks and holding companies and promptly identify those requiring heightened supervisory attention. Supervisors periodically (e.g., quarterly) communicate with the bank's or holding company's management to discuss emerging issues or concerns. Examination staffs also use off-site surveillance tools and reports to plan the scope of, and determine priorities for, on-site examination work, as well as to monitor the progress in responding to matters requiring further attention. **EC 5**: During the course of on-site examinations, the FBAs communicate regularly with the bank's and holding company's management, including heads of individual business units and control functions. At the conclusion of each examination, the supervisor will meet with the banks or holding company's management and board of directors to discuss findings and any significant issues found and to obtain management's and board's commitment to correct any weaknesses noted. The agency also provides the banks or holding company's board of directors a written RoE for review by all directors and senior officers. The RoE conveys the overall condition and risk profile of the bank and provides conclusions on the assigned supervisory CAMELS ratings;

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	identifies any violations of law; assesses compliance with other regulatory requirements. The ROE also discusses significant deficiencies, violations, and excessive risks, and details corrective action to which the board or management must commit to. All agencies employ the practice of having the director's sign and acknowledge the overall supervisory assessment flowing from a full-scope examination. For large banks and holding companies and those exhibiting a higher degree of risk, the amount of communication by the agencies with all levels of a bank's and holding company's corporate governance structure is expanded, with the frequency and scope of this contact determined based on the size or risk profile of the bank or holding company. This contact may include an ongoing, on-site presence to enable monitoring by CPC and EIC teams. **EC 6:** The evaluation of the quality of management and the adequacy of board of directors' oversight of a bank's or holding company's activities is central to the regular full scope on-site examinations. In addition, when management or the board of directors exhibit deficiencies, banks and holding companies are subject to heightened off-site monitoring and more in-depth testing as part of on-site work. Supervisors evaluate Management during the regular on-site examination process. Conclusions about management are often assigned as a result of assessments of each of other areas, under the concept that the financial condition of the bank or holding company as well as related internal controls, risk-management processes, and degree of adherence to the bank's or holding company's policies and regulations is a representation of board and management performance. The UIFRS ratings system (CAMELS) captures the quality of the board and management under the 'M' rating. **EC 7:** The FBAs assess the quality and scope of every bank's and holding company's internal audit function, whether or not audits are performed by the banks or holding company's own staff or an outside vendor. These assessments include consideration of the independence of the function, the appropriateness of the risk assessment program for addressing the activities and risks of the bank or holding company, the size and quality of staffing, and the effectiveness and completeness of audits performed. The results of this assessment are used in determining how reliable the resulting internal audit work product is and whether it may be relied upon in developing a supervisory assessment of a bank's or holding company's soundness. Further detail on the assessment of internal audit is contained in CP 17. **EC 8:** Findings of supervisory activities are written in report format and delivered to and discussed with the bank's and holding company's management and the board of directors each examination cycle. The supervisory ratings (CAMELS and agency-specific) assigned to the bank and holding company as a result of supervisory activities are also provided within the written examination reports. Typically, examiners would meet with the board of directors at least at the conclusion of each examination cycle. **AC 1**: At the conclusion of an on-site examination cycle, FBAs meet with senior management and the board of directors to discuss findings of the examinations and communicate supervisory ratings assigned. Where necessary, supervisors may also meet separately with independent board members. This communication focuses primarily on the findings of supervisory reviews and testing conducted by the FBAs and any recommended follow-up actions, but may also encompass a discussion of any significant findings of the external audit. In addition, communication with management is generally much more frequent for larger banks and holding companies, and those exhibiting a higher risk profile or deteriorating condition.
Assessment	Compliant
Comments	Individually, each of the FBAs employs standard supervisory techniques in a broadly consistent manner. Each agency supplies its supervisory staff with extensive manuals, guidance and other assessment mechanisms which supervisor can use to develop their assessments and judgments.

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	These appear well embedded in each agency's practices. There are, however, areas where the agencies could improve consistency between their operating processes, designed to develop a 'best of breed' model for supervision. There appear to be unnecessary differences in examination manuals, each agency uses (as noted in CP 19) supplementary assessments and rating systems designed to support the CAMELS framework, and different off-site surveillance models. The assessors have not been able to form a complete judgment in the time available on the extent to which they impact on the evenness of supervision applied to banks under various regulators but the scope for inconsistent practices and therefore inconsistent risk assessments undoubtedly exists. The FFIEC has been established to promote uniformity in the supervision of financial institutions. In general, most significant supervisory guidelines, policies and rules are developed and issued on an interagency, collaborative basis. This work is often facilitated through various work groups and task forces within the FFIEC. However, the FFIEC, and the agencies it represents, could perhaps consider a stocktaking of existing supervisory manuals and guidance with a view to eliminating unnecessary differences and promoting good practice across all agencies.
Principle 21.	**Supervisory reporting.** Supervisors must have a means of collecting, reviewing and analyzing prudential reports and statistical returns from banks on both a solo and a consolidated basis, and a means of independent verification of these reports, through either on-site examinations or use of external experts.
Description	**EC 1:** A major part of the FBAs' off-site surveillance of banking organizations is the collection, review, and analysis of regulatory reports required to be submitted to the agencies on a periodic basis. This reporting appears quite extensive, and includes information about balance sheet items, off-balance-sheet exposures, profit and loss, capital adequacy, liquidity, asset quality, loan loss provisioning, interest rate risk sensitivity and market risk. Subject to the limitations imposed by the GLB Act, the agencies' authority to require the submission of information is collectively quite broad, extending to affiliates of a bank or holding company and including information on a bank's and holding company's domestic and foreign activities and operations. The framework for standard reporting is that individual banks are required to submit quarterly reports on a consolidated basis (i.e., capturing the bank and its subsidiaries). BHCs with consolidated assets of US$500 million or more and SLHCs of all sizes must also submit quarterly financial and supervisory information on a consolidated basis. A parent BHC must submit reports that include financial statements on a solo basis (large BHCs quarterly; small BHCs semi-annually). There is, however, no bank reporting on a solo basis. Nor, as a result of the Federal Reserve's cost-benefit analysis, is there any consolidated reporting for small BHCs (unless specifically requested from individual BHCs due to supervisory concerns). **EC 2:** By statute, banks are required to apply accounting principles that are no less stringent than U.S. GAAP in preparing and submitting financial reports [*see, e.g., 12 U.S.C. § 1831n(a)(2)*]. Although it has the power to adopt more stringent requirements, the FBAs have generally chosen to adopt U.S. GAAP for regulatory reporting for banks and holding companies. This requirement is reiterated in the general instructions to the relevant regulatory reports. There are some minor exceptions, which allow for the option of U.S. GAAP, IFRS or local accounting standards, depending on the nature of the report being filed and the domicile of the reporting entity. **EC 3:** As noted in EC 2, the FBAs have generally chosen to adopt U.S. GAAP for regulatory reporting. The accounting rules allow for certain assets and liabilities to be reported on a historical cost, or amortized cost basis, while the application of fair value accounting, or the lower of cost or fair value, is required under certain circumstances. For example, loans held for investment are accounted for at amortized cost, loans held for sale are valued at the lower of cost or fair value, and trading assets and liabilities are valued at fair value. The definition of fair value in U.S. GAAP is similar to the definition of fair value in IFRS (differences include the accounting treatment of "day one" gains for certain financial instruments, and the eligibility requirements for use of the fair value option).

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EC 4: The FBAs collect and analyze information quarterly from all banks, bank holding companies with consolidated assets of US$500 million or more, and SLHCs of all sizes. If the BHC is below the US$500 million threshold, then it submits a parent-only report on a semiannual basis. In addition, reports from other subsidiaries, such as non-bank subsidiaries, in the BHC are required to be submitted either quarterly or annually, depending of the size and nature of the subsidiary.

At large banks or holding companies where the FBAs have continuous on-site examination teams, supervisors receive frequent risk management reports that allow them to monitor the bank's or holding company's condition and trends in key portfolios and risk segments. Similarly, the agencies may direct individual banks and holding companies to provide information on a more frequent basis, depending on their risk profile. An example has been daily liquidity reporting which has been instituted for key institutions during the financial crisis.

EC 5: The FBAs collect reports on the same dates for all entities in the consolidated holding company. While the frequency may differ given the size and nature of the entity, the reporting dates are as of the calendar quarter end. Banks and holding companies are required to complete reports using a standard set of reporting instructions, thereby ensuring comparability of reported items between banks and holding companies.

The agencies also work together to ensure, to the extent possible, that the information reported at the subsidiary level is comparable to information that is collected at the consolidated holding company level. Under the auspices of the FFIEC, the FBAs meet during the year to determine what revisions, if any, need to be made to regulatory reports. Revisions are usually made during the first calendar quarter of the following year, although in some circumstances changes to regulatory reports may be implemented at other times.

EC 6: Collectively, the FBAs have broad statutory authority to obtain a broad array of information from supervised banks and holding companies (see CP 1(4), EC 2). Banks and holding companies must provide supervisors with full and complete access to their books, records, and employees (including directors); failure to do so can result in the imposition of administrative sanctions.

Under their statutory authorities, the FBAs have the power to request and receive any relevant information from banks and holding companies, irrespective of their activities, where the supervisor believes that it is material to their financial situation, or to the assessment of the risks of the bank or holding company. This includes internal management information [*see, e.g., 12 U.S.C. § 161(a) and (c)*]. However, this authority is limited by the GLB Act requirement that the FBAs must rely to the fullest extent possible on the functional supervisors of the securities and insurance subsidiaries and any other subsidiary that is subject to functional supervision by a federal or state authority [*see, e.g., 12 U.S.C. §§ 1831v and 1844(c)(2)(E)*.]

EC 7: The FBAs have the authority to review all books and records of a bank or holding company that are deemed necessary for supervisory purposes. The agencies have access to the banks or holding company's board, management, and staff when required to discuss supervisory matters. Furthermore, the agencies have the authority to require a bank or holding company to submit any information if there is a supervisory need, even when a particular bank or holding company would not be otherwise required to submit such information.

EC 8: Banks and holding companies are required by statute to comply with reporting requirements and information disclosure requests of FBAs. A failure to comply (including by submitting an untimely report or for misreporting or persistent errors) can provide the basis for informal or formal enforcement measures. Under certain circumstances, a culpable IAP (i.e., related party) also may be subject to suspension and debarment [*see, e.g., 12 U.S.C. §§ 1817(a) and 1818(b) and (i)*]. The agencies can require banks and holding companies to amend previously filed reports when material errors have occurred, although the OTS typically adopts an approach of not seeking

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	resubmission of corrected data beyond the prior quarter. Annually, for banks with assets of US$500 million or more, the FBAs require (1) audited financial statements, (2) a statement of management's responsibilities for preparing the bank's annual financial statements, for establishing and maintaining an adequate internal control structure and procedures for financial reporting, and for complying with laws and regulations relating to safety and soundness and (3) an assessment by management of the bank's compliance with such laws and regulations during the fiscal year. In addition, for banks with assets of US$1 billion or more, the FBAs also require assessments by management and the independent public accountant of the effectiveness of such internal control structure and procedures as of the end of the fiscal year [*see 12 CFR 363.2*]. The requirements above do not apply to holding companies, although statutes and regulations provide that, in certain instances, the audit requirements may be satisfied at the holding company level. In addition, the FBAs have issued an interagency policy statement addressing external auditing programs [see *Interagency Policy Statement on External Auditing Programs of Banks and Savings Associations*, (Sept. 1999)]. The agencies apply this statement to all banks and holding companies. The agencies also apply this statement to encourage all banking organizations not subject to other audit requirements to adopt an external auditing program. In addition, banks and holding companies that are also public companies are required to file reports with the SEC or the appropriate FBA and are required by the Sarbanes-Oxley Act of 2002 to obtain an annual audit of the financial statements and the internal controls over financial reporting. Public company officers must acknowledge in writing that they have evaluated the company's internal financial controls and the CEO and CFO are required to sign and certify that they have reported to the independent auditors and to the audit committee all information regarding significant deficiencies in internal controls that could adversely affect the company's ability to provide accurate financial reports [*see 15 U.S.C. § 7241*]. **EC 9:** The FBAs review and verify regulatory reports during the course of on-site examinations of banks and holding companies. In addition, the FBAs utilize extensive off-site automated programs that provide validity and quality checks against the regulatory reports submitted by banks and holding companies. Some edits check the mathematical accuracy of certain areas of the regulatory reports while others review relationships between various aspects of the reports and certain qualitative measures. All edit exceptions must either be corrected or explained. If an edit explanation provided by the reporting bank or holding company is found to be unacceptable by the FBA, additional investigative work is performed until the edit exception is resolved (sometimes resulting in amended reports). There cannot be any validity edits exceptions on the regulatory reports and all quality edit exceptions must be considered reasonable by the FBA before the report is accepted by the FBA. **EC 10:** The FBAs generally do not utilize external experts to perform supervisory tasks, although they may do so in special cases. Where this occurs, the tasks and deliverables of the external experts(s) are outlined in a formal contract with a defined timeline. Further, these roles are typically filled with former supervisors or subject matter experts who are supervised by agency personnel. **EC 11:** When the FBAs engage consultants or external experts, such experts and consultants are under the direct supervision of on-site agency personnel and, as a result, their findings are promptly reported to the agencies. The information required to be provided by banks and holding companies is required to be accurate. To ensure accuracy and reliability, banks and holding companies must establish and maintain adequate financial record-keeping systems [*see, e.g., 12 U.S.C. §§ 161, 1831m*].
Assessment	Compliant
Comments	The FBAs are compliant overall with this principle, although the assessors noted some areas where

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	the U.S. authorities could strengthen their practices. Most notable is that the FBAs do not currently collect information from banks at the solo level (i.e., consolidated data is collected, but no information is collected at the level of the bank excluding its subsidiaries), meaning regulatory requirements (capital adequacy, large exposures, etc.) cannot be tracked relative to the balance sheet of the bank excluding its subsidiaries. The exemption from quarterly reporting for smaller BHCs should be reviewed, given no similar exemption is granted for SLHCs. The exemption granted to smaller banks from providing an annual assessment of their internal controls could also be reviewed. In discussions with supervisory staff, the decision to align regulatory reporting with U.S. GAAP, particularly with respect to the allowance for loan losses, was repeatedly criticized. Because U.S. GAAP applies an incurred loss model for loan loss allowances, which does not permit consideration of future events when estimating loan losses, examination staff of all agencies expressed frustration at the limitations on their ability to require banks to report what they considered to be appropriate loan loss reserves from a safety-and-soundness perspective. The assessors noted that the same outcome—larger buffers against loan losses─could be achieved by imposing higher minimum capital requirements if loan loss allowances measured in accordance with U.S. GAAP were not adequate to address supervisory concerns, but supervisory staff felt this was more difficult to implement and was better addressed by an 'above the line' charge to explicitly recognize the potential for future loan losses. The current framework also undermines the efficacy of the PCA regime, as the thresholds for regulatory intervention are aligned to U.S. GAAP reporting (the assessors noted numerous instances of 'well capitalized' banks being subject to regulatory sanctions for being insufficiently capitalized). Depending on the outcome of the current work by accounting standard-setters on this issue, the U.S. authorities should consider further the interaction between accounting standards and regulatory requirements. While there is good reason to align accounting and regulatory reporting standards to the greatest extent possible, the FBAs need to ensure this does not undermine the effectiveness of their supervisory regime.
Principle 22.	**Accounting and disclosure.** Supervisors must be satisfied that each bank maintains adequate records drawn up in accordance with accounting policies and practices that are widely accepted internationally, and publishes, on a regular basis, information that fairly reflects its financial condition and profitability.
Description	**EC 1:** The information required to be provided by banks and holding companies is required to be accurate. To ensure accuracy and reliability, banks and holding companies must establish and maintain adequate financial record-keeping systems [*see, e.g., 12 U.S.C. §§ 161, 1831m*]. Banks and SLHCs exceeding a minimum asset threshold (currently, US$500 million or more) are required to prepare annual financial statements in accordance with U.S. GAAP, unless the FBAs direct otherwise. These financial statements must be audited by an independent public accountant to determine and report whether the financial statements are presented fairly under U.S. GAAP. In addition, external audited financial statements are required of savings associations with consolidated assets of less than US$500 million that have a composite CAMELS rating of 3, 4, or 5 and are required of SLHCs that control subsidiary savings associations with aggregate consolidated assets of US$500 million or more. [See 12 CFR 562.4(b)]. Furthermore, publicly traded institutions registered with the SEC are required to undergo a quarterly review of their financial statements by an independent public accountant, who must report findings to the bank's or holding company's audit committee. If a bank has assets of US$500 million or more, that committee, in turn, must provide the accountant's report to the relevant FBAs [*see, 12 U.S.C. § 1831m*]. Each bank exceeding the minimum asset threshold is also required to submit an annual report to the appropriate FBA containing a report signed by the CEO and the CFO of the bank which includes a statement of management's responsibilities for preparing financial statements, establishing and maintaining an adequate internal control structure and procedures for financial reporting; and complying with designated safety-and-soundness laws and regulations [*see, e.g., 12 U.S.C. §*

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	1831m(b)(2) and 12 CFR 363.2(b)]. The report must include (i) an assessment by management of the bank's compliance with the designated safety-and-soundness laws and regulations during the fiscal year and (ii) for banks with assets of US$1 billion or more, assessments by management and the independent public accountant of the effectiveness of such internal control structure and procedures as of the end of the fiscal year. The requirements above do not apply to holding companies, although statutes and regulations provide that, in certain instances, the audit and reporting requirements may be satisfied at the holding company level. In addition, the FBAs have issued an interagency policy statement addressing external auditing programs, which recommends that boards of directors establish and maintain such programs [see *Interagency Policy Statement on External Auditing Programs of Banks and Savings Associations*, (Sept. 1999)]. The agencies apply this statement to all banks and holding companies. The agencies apply also this statement to encourage all banking organizations not otherwise subject to an audit requirement to have an external audit of the financial statements. **EC 2:** The FBAs require independent external audits of annual financial statements and related internal controls based on prescribed asset-size thresholds, regardless of whether the bank is public or non-public. Banks and holding companies that are publicly registered also must comply with SEC requirements, including the Sarbanes-Oxley Act, to obtain an annual audit of the financial statements and the internal controls over financial reporting and are subject to the SEC's reporting requirements, including public reporting of quarterly and annual financial reporting. The audited annual financial statements, as well as quarterly financial statements, are subject to CEO and CFO certification and are made publicly available by the SEC for public holding companies and by the FBAs for certain banks. The FBAs require banks and holding companies to file accurate financial reports including financial statements and reports of condition. Some of these reports, for both public and non-public banks and holding companies, are made public by the FBAs. Such financial reports are required to be certified by the bank's or holding company's CFO and a specified number of directors (trustees). **EC 3:** The accounting principles applicable to reports or statements required to be filed with the FBAs by all banks and holding companies are uniform and must be consistent with, or no less stringent than, U.S. GAAP. The FBAs issue reporting instructions for required regulatory financial reports. Those reporting instructions require, amongst other things, that banks and holding companies report pre-tax income net of the provision for loan and lease losses. As with the IASB, the FASB is reviewing its accounting standards in light of the lessons learned from the recent financial crisis. **EC 4:** In general, external auditors must determine and report whether the financial statements of certain banks are presented fairly in accordance with U.S. GAAP. Further, the external audits must meet or exceed the scope and procedures required by generally accepted auditing standards (GAAS) [*see 12 U.S.C. § 1831m*]. Supervisory discretion to establish the scope and standards of an external audit of an individual bank is available in circumstances where 12 USC § 181 applies, e.g., unsafe or unsound practices. **EC 5:** External audits are required to meet or exceed the scope and procedures required by GAAS. External audits may have to comport with additional requirements, as determined by regulation, guideline, guidance, or other related materials. As noted above, the FBAs require certain banks and holding companies to obtain annual audits of financial statements performed in accordance with GAAS and external audits of internal controls over financial reporting. Financial statement audits cover areas such as loans, allowance for loan losses, and asset valuations as appropriate to enable the auditor to provide an opinion on whether the financial statements as a whole are presented fairly in accordance with U.S. GAAP. The FBAs reported that approximately 97 percent of consolidated assets of U.S. bank holding companies were audited as of year-end 2007.

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	For a smaller bank not subject to the audit requirements, a non-audit agreed-upon procedures engagement is commonly used. Alternatively, an attestation engagement may be performed for all internal controls relating to the preparation of annual financial statements or specified schedules of the bank's regulatory reports. This type of engagement is performed under generally accepted standards for attestation engagements. **EC 6:** The FBAs may remove, suspend, or bar an independent public accountant, upon a showing of good cause, from performing the required audit services for a bank [*see 12 U.S.C. § 1831m(g)(4) and 12 CFR 19.243*]. "Good cause" would exist, for example, when the external auditor is determined to have inadequate expertise or independence or not to be subject to or follow established professional standards. Each bank exceeding the minimum asset threshold or registered with the SEC is required to provide the appropriate FBA(s) with notice of the engagement, and the resignation or dismissal, of an independent public accountant (and must include a statement of the reason for resignation/dismissal). An independent public accountant must also notify the appropriate FBA(s) if its services are terminated, and the reasons for the termination [*see 12 CFR 363.4(d) and 363.3(c)*]. In the US, the supervisors may review the audit work papers. If a supervisor concludes, based on the review of the specific work performed, discussions with the audit firm, or other documentation, that the external auditor does not have the requisite expertise, independence, or does not follow established professional standards, the supervisor discusses these findings and the actions the agency may take with the bank's senior management, board of directors (or audit committee), and the external auditor. If the issue cannot be resolved, then the FBA can bar the accountant from performing further audits. **EC 7:** Banks and SLHCs that exceed the minimum asset threshold (currently US$500 million) are required to obtain an independent external audit of their annual financial statements. Annual financial statements must be prepared in accordance with U.S. GAAP and external audits must be performed in accordance with GAAS [*see 12 U.S.C. § 1831m and 12 CFR 363.2 and 363.3*]. External audited financial statements are required of savings associations with assets less than US$500 million that have a composite CAMELS rating of 3, 4, or 5 and of SLHCs that control subsidiary savings associations with aggregate consolidated assets of US$500 million or more. [see 12 CFR 562.4(b)]. Otherwise, non-public banks under the prescribed threshold generally are not required to produce audited financial statements, but nonetheless need to provide reliable information on their financial position to the FBAs, who make such information public. Public banks and holding companies are also subject to SEC disclosure requirements, including in relation to audited financial statements. **EC 8:** The FBAs require the periodic public disclosure of information by banks and holding companies that adequately reflect their financial condition. The disclosure requirements are broadly applicable, subject to uniform submission deadlines, and ensure the timeliness and relevance of information. Uniform requirements ensure comparability of information. Accuracy and reliability are ensured by separate requirements regarding the adequacy of financial record-keeping systems; adherence to these requirements is reinforced by the specter of substantial remedial consequences for submitting misleading or false information. Furthermore, banks and holding companies registered with the SEC or the appropriate FBA under the federal securities laws have additional quarterly and annual financial reporting and disclosure requirements. The FBAs review regulatory reports on a periodic basis and if the agencies determine that the information or disclosures are incorrect, they may require that the bank or holding company restate regulatory reports. Information in regulatory reports may differ from that required in audited financial statements. **EC 9:** U.S. GAAP provides guidance on financial reporting and disclosure matters, including qualitative and quantitative information. Financial reports of publicly traded banks and holding companies include financial statements with all U.S. GAAP disclosures and Management's

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	Discussion and Analysis. Regulatory reports (such as the Call Report, TFR, and the FR Y-9C) consider the size and complexity of a bank's or holding company's operations in the scope and content of required information and the commensurate level of disaggregation and detail. For example, banks with a significant amount of trading activity (trading assets and trading liabilities that exceed a prescribed threshold) are required to complete a detailed trading schedule. In addition, some of the regulatory reports provide the opportunity for the reporting banks to provide footnotes or narrative disclosures, which may be either quantitative or qualitative in nature. **EC 10:** The statutes require that banks comply with reporting requirements and information disclosure requests of the FBAs. Failure to comply can provide the basis for informal or formal enforcement measures [*see 12 U.S.C. §§ 1813(u), 1817, and 1818*]. The SEC has the primary responsibility for ensuring review of public disclosures of public holding companies and for taking enforcement action, as necessary. The appropriate FBA has this responsibility for public banks. The SEC coordinates with the appropriate FBA on enforcement matters affecting public holding companies. The Public Company Accounting Oversight Board (PCAOB) reviews the auditors of public companies to ensure that the auditors comply with prescribed auditing and ethics standards. **EC11:** For each bank, the FBAs publish Uniform Bank Performance Reports (UBPR) and the OTS publishes the Uniform Thrift Performance reports (UTPR), which are primarily based on the information reported on the Call Reports and TFRs. These reports are also made publicly available by the FBAs, and include various indicators and ratios involving financial position, financial performance, and capital for each bank and its peer group, including deposit composition and stability, ratios of loan commitments to total loans and of standby letters of credit to total loans, the loan-to-deposit ratio (at community banks), the ratio of temporary investments to volatile liabilities, and the ratio of pledged securities to total securities. A similar report is produced by the Federal Reserve for aggregated BHC information, the Bank Holding Company Performance Report (BHCPR). **AC 1:** The FBAs meet periodically with external audit firms as well as the FASB, American Institute of Certified Public Accountants (AICPA) and the PCAOB to discuss accounting, audit, and financial disclosure issues related to banks and holding companies. Supervisors also meet periodically with external audit firms with respect to individual banks and holding companies to discuss general and specific issues with respect to their accounting and disclosure practices. In addition, external auditors will typically ask to speak to the supervisors before signing off on annual financial statements to ensure that the supervisors do not have information that would preclude their sign-off. **AC 2:** There is no statutory obligation on auditors to report matters to the FBAs, nor any associated protection for auditors should they seek to do so. Auditors of public companies are required to file reports with the SEC if company management fails to take remedial action, however, and are protected from liability related to doing so. [see 15 U.S.C. § 78j-1(b) & (c)]. As a backstop, supervisors review communication to management and the audit committee made by the external auditors. Supervisory guidance gives federal banking supervisors access to communications between the auditor and the bank client. In addition, FBAs have the authority to review auditors' workpapers. **AC 3**: It is unlawful for a registered public accounting firm to provide audit services to an issuer if the lead (or coordinating) audit partner responsible for the audit, or the audit partner responsible for reviewing the audit, has performed audit services for that issuer in each of the 5 previous fiscal years of that issuer [*see 15 U.S.C. § 78j-1*]. In addition to the five-year rotation requirement of the lead and concurring audit partners, the SEC

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	has adopted rules that also mandate a five-year "timeout" period after rotation. The rules specify that certain other significant audit partners will be subject to a seven-year rotation requirement with a two-year "timeout" period. There are minor exceptions for small audit firms. Auditors of banks with assets of US$500 million or more are required to satisfy the independence requirements of the SEC, PCAOB and AICPA. For smaller non-public banks that are not otherwise required to have an annual independent audit, an external auditor must meet only the AICPA independence standards. **AC 4**: There is no explicit requirement for non-public banks to have a formal disclosure policy, although it will be expected in those banks adopting the Advanced approaches under Basel II. More broadly, a bank is required to have an appropriate governance and control structure over the preparation of financial reporting and disclosures. This includes properly approved written policies that provide clear guidelines on accounting and disclosure matters, consistent with U.S. GAAP and the bank's regulatory requirements. **AC 5:** External auditors of large banks are required to agree to provide related audit working papers, policies, and procedures to supervisors, if requested [*see 12 U.S.C. § 1831m(G)(3)(a)*]. As a matter of best practice, supervisors expect all banks, regardless of asset size, to obtain agreement of an independent public accountant or other external auditor in the engagement letter to grant supervisors access to all the accountant's or auditor's work papers and other material pertaining to the bank prepared in the course of performing the completed external auditing program [see the *Interagency Policy Statement on External Auditing Programs of Banks and Savings Institutions*].
Assessment	Compliant
Comments	Many countries provide for a statutory obligation on the external auditors of banks to promptly advise the bank supervisor should they encounter any issues during the course of the audit work which could potentially represent a risk to the safety and soundness of the bank. This obligation is typically accompanied by an associated statutory protection ('whistleblower' protection) for such reporting. The authorities should consider the merits of introducing a similar regime for reporting directly to bank supervisors in the U.S.
Principle 23.	**Corrective and remedial powers of supervisors.** Supervisors must have at their disposal an adequate range of supervisory tools to bring about timely corrective actions. This includes the ability, where appropriate, to revoke the banking license or to recommend its revocation.
Description	**EC 1:** Generally, the FBAs identify problems during on-site and off-site examinations. Most issues are solved informally during the examination (or in the ongoing discussions between the bank and the EIC/ CPC where relevant), when the bank or holding company takes steps to address the regulatory concerns. At the conclusion of the examination the supervisors send an ROE to the bank for review by all directors and senior officers. The ROE assesses conditions of the "CAMELS" components, identifies violations of law, assesses compliance with the Bank Secrecy Act, consumer laws, and the Community Reinvestment Act. The narrative of the ROE also calls attention to other matters that need to be dealt with (e.g., MRA = Matters Requiring Attention). Some problems, especially if serious, pervasive or repeated, may need to be addressed through formal supervisory action, which always is expressed in a written document from the supervisors. All formal supervisory actions are publicized, at a minimum, on a monthly basis (with exceptions only in very specific circumstances such as when publication would be contrary to the public interest). Detailed policies and action plans with specific target dates may be requested from a bank or holding company, and supervisors will review the institution's board's plan for sufficiency and examine written progress reports by the bank, against key milestone dates. Progress will also be assessed through ad hoc or normal onsite examinations. **EC 2:** The FBAs have authority to appoint a conservator or receiver under a variety of circumstances, including when the bank is critically undercapitalized or is undercapitalized and has no reasonable prospect of becoming adequately capitalized; is unable to meet depositors' demand for payment or is operating in an unsound or unsafe condition that would likely cause insolvency or substantially dissipate the bank's assets. By law, the FDIC is always appointed the receiver for

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	closed insured banks. **EC 3:** The FBAs have a range of supervisory options when a bank or holding company is not complying with laws, regulations or supervisory decisions, or is engages in an unsafe and unsound practices. The agencies may take prompt remedial action and impose penalties. The range of tools is applied in accordance with the gravity of the situation. If there are serious or repeated deficiencies, or when management has not acted sufficiently on an informal request, the agencies may take formal enforcement action. Such actions include: (i) Formal agreements; (ii) Cease and Desist Orders; (iii) Safety and Soundness Orders (iv) Capital Directives; (v) PCA directives; and (vi) Civil Money Penalty Assessments. Formal enforcement actions are legally enforceable and remain in effect until modified or terminated. *See 12 U.S.C. § 1818 (u).* In cases where there is an immediate threat to the bank or holding company or to the depositors' interests, an agency may take immediate action by issuing a temporary order to cease and desist. **EC 4:** Possible remedial measures include restricting the current activities or operations; withholding or conditioning approval of new activities or acquisitions; restricting or suspending payments to shareholders or share repurchases; restricting asset transfers; barring individuals from banking; replacing or restricting the powers of managers, board directors or controlling owners; facilitating a takeover by, or merger with, a healthier bank; providing for the interim management of the bank; and revoking the bank license. The selection of an enforcement actions typically aim at the bank's specific problems or deficiencies. Common provisions require the bank to cure specified violations, correct risk management or board of director oversight weaknesses, submit a plan to increase or maintain capital, provide for an adequate allowance for loan and lease losses, employ qualified officers and employees, and restrict the payment of dividends. The agencies have power to place a bank into conservatorship or to close a bank under a variety of circumstances. **EC 5:** A PCA regime applies to those instances in which a bank's capital falls below the prescribed minimum ratios. The regime provides a backstop against regulatory forbearance. For example, a bank that is less than adequately capitalized must not pay dividends and must submit a capital restoration plan. The PCA regime provides for mandatory as well as discretionary actions by the supervisors [for more details see EC 6 under Principle 6]. In addition, *12 U.S.C. § 3907* requires FBAs to "achieve and maintain capital," e.g., by establishing minimum capital levels on a case-by-case basis for individual banks, e.g., to reflect higher risks such as from higher risk concentrations or poor risk management systems. The agencies also have powers to intervene even before the minimum capital ratio is breached, for example when loan quality reviews indicate a need to maintain capital above the statutory minimum. As an indicator of timely actions by the authorities, the rapid resolution of some major banks (and non-banks) during the present crisis can be noted. **EC 6:** Remedial penalties and sanctions may be applied to banks and holding companies and, when appropriate, to management, board members, employees and other individuals who participate in a bank's or holding company's affairs (Institution-Affiliated Partners, or IAPs) **AC 1:** The PCA statute sets out clear triggers for mandatory and discretionary supervisory actions. Hence, an undercapitalized bank must submit a capital restoration plan within 45 days and the agency must review the plan within 60 days and determine if it is acceptable. A critically undercapitalized bank must be closed within 90 days according to the PCA. Aside from PCA, there are no specific statutory requirements that establish timetables for supervisory action. Individual FBAs have recently implemented stricter time limits—such as 45 days for normal cases and 60 days for cases involving supervisory actions—for the completion of the onsite examination and the agency's consideration of the examination report, including, when relevant, taking supervisory action. **AC 2:** The FBAs have the authority to impose conditions on the relationship between a bank and any other entity in order to prevent or address a threat to the safety and soundness of the bank. For example, actions may limit or prohibit payments from a bank to its holding company or affiliates.

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	AC 3: The Federal Reserve and the OTS, as the "umbrella supervisors" of holding companies and their subsidiaries, rely on the federal and state supervisors of functionally regulated subsidiaries to examine those subsidiaries and take supervisory action when appropriate. Where possible, the Federal Reserve and the OTS coordinate their actions and share information with other U.S. supervisors, foreign supervisors and with other functional supervisors to effect supervisory action and reduce regulatory redundancies.
Assessment	Compliant
Comments	In many cases supervisors, while adhering to regulations and supervisory guidelines, will assess banks as being capital deficient and will require an infusion of capital, while at the same time the bank is defined as "well capitalized" under the definitions of the PCA. This dichotomy (which has been discussed more fully in CP 21) weakens the credibility of enforcement actions and should be rectified.
Principle 24.	**Consolidated supervision.** An essential element of banking supervision is that supervisors supervise the banking group on a consolidated basis, adequately monitoring and, as appropriate, applying prudential norms to all aspects of the business conducted by the group worldwide.
Description	**General.** The Federal Reserve is responsible for consolidated supervision for U.S. BHCs, including FHCs. Comprehensive guidance is provided in the document *"Consolidated Supervision of Bank Holding Companies and the Combined U.S. Operations of Foreign Banking Organizations."* OTS is responsible for the consolidated supervision of SLHCs. All BHCs and SLHCs are subject to supervision on a consolidated basis. **EC 1:** The Federal Reserve and the OTS are expected to rely, to the extent possible, on relevant primary supervisors and functional regulators for information about financial institutions within holding companies. They obtain this information at the time of formation of a holding company, authorization of a new activity or activity in a new supervisory jurisdiction, changes in a bank's or holding company's structure, in the course of ongoing supervision, in identifying and addressing supervisory concerns, in crisis situations, and as part of periodic and ad hoc meetings among supervisors and with the bank's management. Among other things, agencies are familiar with the banking group's legal structure and entities, nature and locus of activities, interrelationships among entities (transactions among affiliates), and methods for exercising oversight over domestic and cross-border operations (including manner of implementing policies and procedures, such as by or across legal entities). **EC 2:** The BHC Act and the HOLA grants the Federal Reserve and the OTS, respectively, broad authority to inspect and obtain reports from holding companies and their subsidiaries. Federal law authorizes the agencies to take action against a holding company or a nonbank subsidiary to address violations of the law or to prevent these entities from engaging in unsafe and unsound activities. The Federal Reserve has established consolidated capital standards for BHCs. The OTS does not impose standards, but assesses whether SLHCs maintain capital levels, on a case by case basis, that are sufficient to support the risk profile of the overall SLHC enterprise (see CP 6). The consolidated supervisor has broad powers to review, through off-site or on-site monitoring, activities whether domestic or cross-border (subject to the limitations of the GLB Act). This extends to obtaining information on affiliates of a domestic bank, wherever located, necessary to assess the impact on the bank and holding company. (That said, the information should first be sought from the primary supervisor of the entity, which might be a functional regulator. For functionally regulated subsidiaries, the GLB Act provides the opportunity for the banking supervisor to ask the bank directly, if the information cannot be accessed from the functional supervisor). The U.S. FBAs are authorized to regulate and supervise the foreign activities of banks. **EC 3:** The FBAs have implemented a supervisory framework that seeks to evaluate the risks non-banking activities may pose to the consolidated organization. This stems from the overarching duty to protect the safety and soundness of banks (*12 U.S.C. §1831p-1).* For all significant non-banking subsidiaries and non-banking activities of the parent holding company, the Federal Reserve and the OTS use off-site monitoring activities and periodic review examinations to (i) maintain an

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understanding of operations, financial condition, inherent risks and risk-management practices and (ii) assess the adequacy of risk management and internal controls.

EC 4: There are no requirements for consolidated application, including the holding company level of large exposures limits, insider lending limits, general lending limits. However, through their onsite examinations supervisors monitor the aggregated volume of exposures, such as on large exposures, insider lending and general lending, on a risk-based basis adapted to the size and character of the business of the affiliates to determine that holding companies and non-bank affiliates in a group do not endanger the group.

EC 5: See Principle 1(6) on information-sharing both domestically with banking and functional regulators, and with foreign banking supervisors. Under these information-sharing arrangements, the FBAs may receive information on the financial condition and adequacy of risk management and controls of the different entities of the bank or holding company.

EC 6: As discussed under Principles 3, 23 and 25, the FBAs have the power, at authorization or as a remedial measure, to limit the range of activities a bank or holding company may conduct and the locations in which activities can be conducted. This is additional to the general legal restrictions, to which banks or holding companies are subjected. The supervisor uses this power to determine that the activities are properly supervised and that the safety and soundness of the bank is not compromised.

EC 7: An assessment of cross-border operations is incorporated into the evaluation of key corporate governance functions and primary firm-wide risk management and internal control functions. In some instances, privacy concerns have led to limits on information that can be shared by a foreign office with its parent holding company. In such cases, strong local internal controls and audit processes are particularly important. Constraints on providing information may lead to communications between the FBAs and host country supervisors.

EC 8: U.S. banks and holding companies are required to provide FBAs with specific information regarding their foreign operations and any other information that supervisors deem necessary to determine compliance with U.S. banking laws. Assessments of banks and banking organizations encompass the entirety of domestic and foreign operations. As noted under EC 7, the agencies evaluate key functions such as controls and systems, including audit and MISs, and effectiveness of management and board oversight across the organization. In addition, testing and verification procedures are performed in locations with the highest risk exposure. Accordingly, although there is not a separate and distinct requirement for assessing managers' oversight of foreign operations, in practice such oversight may occur when considered necessary, based on a risk-focused assessment.

EC 9: Where material impediments exist, the supervisors can take remedial measures, including imposing additional limits on foreign operations or requiring the closing of such operations. Such an impediment may exist when management oversight and/or supervision by the host supervisor is not adequate relative to the risks the foreign operations present, or when necessary information is not forthcoming.

EC 10: The agencies evaluate risk-management processes for bank activities across legal entities and perform testing procedures where the exposure or risk is greatest. In implementing this risk-based approach, the authorities may choose not to focus on a jurisdiction even though its supervisory regime may be different.

AC 1: The consolidated supervisors have the power to review the activities of parent holding companies and of companies affiliated with those. They also have the authority to evaluate the suitability of owners and senior management of holding companies.

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	AC 2: FBAs assess the quality of supervision conducted in the countries in which its banks and holding companies seek to establish material operations. Once operations are established the agencies informally evaluate host country supervisors through ongoing communication as well as evaluation and inspection of the cross-border establishments. **AC 3:** FBAs regularly inspect foreign offices where the risks are deemed to be greatest. On these occasions they will meet with host supervisors. Agencies may also require audits or special reports from foreign offices. Less significant foreign offices, in terms of size or risks, are visited less frequently and often in the form of "sweeps" in which several banks in a region are visited simultaneously.
Assessment	Largely Compliant
Comments	As noted in the U.S. Treasury White Paper on Financial Regulatory Reform, "the GLB Act impedes the Federal Reserve's ability, as a consolidated supervisor, to obtain information from or impose prudential restrictions on subsidiaries of a BHC that already has a primary supervisor" (page 26). The same is true with respect to the OTS's ability to act as consolidated supervisor of SLHCs. Restrictions, both statutory and practical, on access to information on various parts of a group make it difficult to assess risks from a group-wide perspective. While some steps have been taken to endeavor to overcome this drawback, clear, ready and direct access for whichever agency is responsible for consolidated supervision is desirable. The ability in the existing legislation for supervisors to get around these restrictions when there is 'a material risk to the bank' is not workable—since it is difficult to expect an FBA to know there is a material risk if they cannot supervise directly. Assessors saw evidence of major efforts by the FBAs, to enhance their supervision of all aspects of complex groups. This included comprehensive assessments of the former investment banks that have converted to BHC status. While some further supervisory work on these former investment banks is underway, assessors are clear that the degree of supervision currently is much more extensive and robust than under the former voluntary SEC program. However the danger is that, without changes in the GLB legislation, this crisis-induced activity falls away and a more restrictive interpretation of the law emerges again. In removing GLB restrictions on consolidated supervision, consideration should be given to increasing access to non-bank entities in a banking group for both the bank and holding company supervisors. That said, although efficient consolidated supervision must be the priority, the primary supervisors of affiliates still play an important role and the division of responsibilities and accountabilities between the prudential supervisors must be clear. As noted under CP 19, beyond the statutory and regulatory framework, supervisory approaches to include non-banks, including non-financial institutions, in the consolidation need to be strengthened aiming to avoid "silo treatment." In order to improve coordination, particularly amongst functional supervisors where information-sharing is less common, the "supervisory college" concept could be implemented for domestic financial groups, joining all the relevant supervisory authorities including functional supervisors, responsible for each financial group. (Here, assessors refer to the institutional and organizational aspects of a supervisory college and leaves aside the scope of the substantive issues to be dealt with in a college). There are no regulations to apply quantitative limits on a consolidated basis to BHCs/SLHCs, e.g., for large exposures, and lending to related parties. Nor does the OTS apply consolidated capital requirements for SLHCs; however, the supervisors apply and monitor such group-wide exposures and lending on a case-by-case basis using an approach mainly based on an institution's financial position. That said, the assessors deem that this will not necessarily ensure sufficient robustness in the application.
Principle 25.	**Home-host relationships.** Cross-border consolidated supervision requires cooperation and information exchange between home supervisors and the various other supervisors involved,

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	primarily host banking supervisors. Banking supervisors must require the local operations of foreign banks to be conducted to the same standards as those required of domestic institutions.
Description	**EC 1:** As discussed in Principle 1(6) the FBAs have clear authority, although subject to the limitation of not impinging on the "U.S. interest," to share confidential supervisory information with foreign banking and other sector supervisors. The information must be used for lawful supervisory purposes, and the recipients must keep the information confidential. FBAs provide adequate data and information to host country supervisors about U.S. banks and holding companies, to enable the host country to supervise the overseas operations of the U.S. banks. The FBAs have ongoing contact with supervisors in other countries in which U.S. banks have material operations, including periodical visits to discuss supervisory issues. Information sharing by U.S. agencies as both home and host supervisors involves sharing significant supervisory concerns and supervisory documents; providing information to assist with the authorization process and with investigations; discussing and coordinating supervisory plans and strategies; managing and participating in bilateral and multilateral meetings; developing joint enforcement actions; and participating in "colleges." Additionally, U.S. supervisors visit foreign supervisory authorities to discuss supervisory issues. **EC 2:** Typically, the FBAs identify other relevant supervisors at the time a banking organization seeks authority, or provides notice of its intent, to establish operations in a foreign jurisdiction. The agencies will establish formal or informal arrangements, as appropriate, for sharing of information regarding the bank's operations in the home or host country. Such arrangements are made available to the public through the Freedom of Information Act process. The existence of institution- or group-specific arrangements is disclosed to the involved bank but is not otherwise made publicly known. Information sharing arrangements are in place with supervisors in many foreign jurisdictions and more are in process. These arrangements are not required by law, but they support the agencies' efforts to oversee the operations of U.S. banks abroad and foreign banks operating in the US. There is also an informal system which relies on peer-to-peer contact. **EC 3:** The FBAs provide information to host supervisors in response to specific requests regarding their supervision. This applies to the conduct of actual supervision and to descriptions of developments to the framework of supervision. They also provide information on significant problems which may have a material effect on the subsidiaries or branches in the host country. As appropriate, there is also cooperation during the licensing process, in the supervision of ongoing activities, and in the handling of problem banks. FBAs endeavor to inform host country supervisors in a timely manner about events that could endanger the stability of the cross-border establishments in the host country. If deemed relevant for the host country affiliate, the agencies also inform host country supervisors when penalties have been imposed or enforcement actions have been taken against a U.S. bank or holding company. However, according to U.S. legislation, U.S. authorities may not act against "the U.S. interest." **EC 4:** As host country supervisors the agencies cooperate with the home country supervisors of FBOs with U.S. banking operations in order to facilitate the consolidated supervision. Under the FBO Supervision Program the Federal Reserve and the OCC provide copies of essential supervisory products to home country supervisors. This includes the comprehensive annual assessment of the combined U.S. operations of the FBO. Where specifically requested by the home authority supervisors, copies of examination reports of an FBO's U.S. operations may also be provided to them. If deemed to have a potentially material impact on the parent bank, the agencies will apprise home supervisors of significant concerns and impending supervisory actions. The actions taken on liquidity issues during the recent crisis is a typical example of situations leading to cross-border communications and, indeed in many cases, international coordination. **EC 5:** The International Banking Act (IBA) provides for "national treatment" of foreign banks doing business in the United States (Also savings associations owned or controlled by FBOs are subject to "national treatment"). Hence, the U.S. law generally accords the same treatment to FBOs as it does to domestic banks. However, a number of regulations do not apply to FBOs that do not have U.S. retail operations. Vice versa, there is a requirement for FBO branches in the United

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	States to maintain a small portion, not exceeding three percent of third party liabilities, of their assets in the branch, mainly in U.S. Treasuries. **EC 6:** The Federal Reserve (or the OTS for savings associations) routinely contacts the home country supervisor during the application process and takes into account whether the home country supervisor has approved, or expressed no objection, to the proposal. If the foreign entity is a foreign bank, the relevant agency must determine that the bank, and any foreign bank parent, is subject to comprehensive and global consolidated supervision by its home country supervisor. The assessment of whether a home supervisor practices global consolidated supervision depends on a methodological analysis conducted by the primary U.S. agency. The method is known as Comprehensive Consolidated Supervision (CCS). The quality of home country supervision is evaluated at authorization and as part of on-going supervision. Consideration of home country supervision and head office monitoring is part of regular risk assessment. **EC 7:** Nothing in U.S. federal law would prevent a home supervisor from conducting on-site inspections of U.S. offices and subsidiaries of foreign banks to assess the banking organization's safety and soundness and compliance with KYC requirements. Foreign supervisors are expected to contact the relevant U.S. agencies in advance of the visit. With minor exceptions (e.g., due to laws applicable to state-chartered banks) foreign supervisors will have access to all information relevant for the purposes of the examination. Vice versa, U.S. agencies expect on-site access to foreign offices and subsidiaries of U.S. banks' and holding companies' foreign operations. They inform host supervisors in advance of visits. Memoranda of Understanding (MOUs)/SOCs contain provisions regarding on-site examinations. **EC 8:** The establishment of "shell banks" is not permitted in the US, and no legacy shell banks or booking offices exist in the US. In addition, the U.S. has taken legal and other measures to prevent foreign shell banks from indirectly or directly accessing the U.S. financial system. **EC 9:** The FBAs work within a communication framework that demands continuous coordination and consideration. In cases of cross-border information exchanges and requests for actions and options, the agencies would thus always confer, and if possible coordinate actions, at the appropriate level and to the appropriate extent with the foreign supervisor before taking any action. That said, exceptional acute problems in banks may necessitate immediate action without advance information sharing. **AC:** The FBAs establish communication strategies through formal processes (i.e., MOUs and SOCs) and informal processes (e.g., Basel II and Financial Stability Board supervisory colleges). The scope and nature of the strategies reflect the size and complexity of the relevant cross-border operations. For example, in relation to Basel II, the U.S. supervisors hold periodic meetings with host supervisors. Also, the U.S. supervisors have convened supervisory colleges with host supervisors of significant operations of U.S. banks.
Assessment	Compliant
Comments	The concept of "in the U.S. interest" should be interpreted broadly by the U.S. authorities. For example, it would in many cases be in the U.S. interest to obtain a solution for the whole international financial group, working together with foreign authorities, rather than "ring-fencing" the U.S. operations and thus aggravating the problems of the group as a whole.

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I. Recommended Action Plan and Authorities' Response

Recommended action plan

Table 3. Recommended Action Plan to Improve Compliance with the Basel Core Principles

Reference Principle	Recommended Action
1. Objectives, independence, powers, transparency, and cooperation	
1.1 Responsibilities and objectives	Consider formally setting out the mandate and objectives of the FBAs in legislation. Ensure core safety and soundness mandates and individual accountability for each FBA are clear. Clarify expectations and accountability for the primary federal bank regulator and the holding company regulator as they are inextricably linked in the case of large complex banking groups. Strengthen inter-agency coordination of supervisory processes, pursue opportunities for: more integrated supervision planning; more commonality of forward-looking risk rating systems, more sharing of off-site surveillance methodology and results, and more joint reviews.
1.2 Independence, accountability and transparency	Develop a more forward-looking detailed resource plan that takes account of risk assessments, lessons learned, and new and existing priorities. Focus senior governance within and between agencies on improvements in supervisory process. Improve public performance reporting. Alter the governance rules at Reserve Banks to remove appearance of industry influence. Raise threshold for triggering material loss reviews and consider the themes from those reviews (e.g., timeliness and forcefulness of intervention) to improve performance.
1.6 Cooperation	Strengthen channels for cooperation, coordination, and learning from best practices—within and between FBAs and functional supervisors.

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Reference Principle	Recommended Action
3. Licensing criteria	Strengthen interagency agreement to prevent inappropriate charter conversions. Monitor developments to see if said agreement needs further strengthening. Deepen assessment and presentation to chartering decision-makers on the operational plan for the applicant bank. Increase the (absolute) minimum capital requirement for new banks
6. Capital adequacy	Work with the BCBS and domestically to strengthen the definition of what counts as Tier 1/core capital especially for holding companies. Revisit ability for banks and thrifts to have a large part of their Tier 1 capital composed of intangibles by capping the percentage allowed at a lower level. Put in place formal capital rules for SLHCs.
7. Risk management process	Conduct regular inter-agency horizontal detailed assessment of all risk monitoring, management and risk governance improvements at major complex banking groups. Include detailed testing of the robustness of improvements. Include all large complex banking organizations in these regular assessments. Publish regular reports and guidance to reinforce supervisory expectations. Ensure adequate ongoing resources for these reviews.
8. Credit risk	Develop a clear comprehensive strategy to reduce the extent and severity of credit risk problems resulting from a future credit cycle and building on (and extending across agencies) improvements in credit risk monitoring and surveillance already started. This strategy should address: timeliness and forcefulness of supervisory interventions, timeliness of guidance, revisiting whether guidance needs to occasionally contain specific limits to be effective, consistency of follow-up on new guidance; ability of the FBAs to intervene to make their views known about systemic weaknesses in credit risk management practices or in contributing polices that they do not control but that may need to be addressed by authorities more broadly; strengthen inter-agency processes to enhance collective assessment of emerging problems; and, ensure that sufficient specialist resources are available to assess complex credit risk matters in smaller and mid-size, as well as larger banks.

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Reference Principle	Recommended Action
10. Large exposure limits	Include all exposures within the limits and reporting of large exposures. Strengthen reporting requirements on large exposures. Advance supervisory guidance further on sectoral and geographical concentration risk identification and management.
11. Exposure to related parties	Strengthen regulations on board oversight and involvement. Enhance reporting requirements to board and to the supervisors. Lower the current limit on the aggregate amount of loans to all insiders. (It now equals a bank's own funds plus "surplus" funds.) Incorporate all exposures to insiders (and affiliates) in the definition of insider transactions and in the limits.
13. Market risks	Complete the current horizontal assessment of the Market Risk Amendment and determine how much further in-depth horizontal review of market risk and valuation improvements at major banks is required. Conduct regular, horizontal, in-depth assessments of banks' progress in market risk enhancements.
14. Liquidity risk	Make sure the crisis-driven improvements in banks and supervisors liquidity risk processes are transitioned into organized, sustainable, improved liquidity risk management and supervisory monitoring and assessment. Update the supervisory program, and conduct regular supervisory assessments of risk management and crisis and contingency plans at banks.
15. Operational risk	Consider a more holistic and structured approach to operational risk assessment, utilizing enhanced cross-agency mechanisms.
16. Interest rate risk in the banking book	Consider the capacity to improve the assessment of interest rate risk by introducing a more consistent measurement approach.
18. Abuse of financial services	Rectify certain CP 18-relevant deficiencies as identified by the FATF.
19. Supervisory approach	Improve the capacity for group-wide oversight of financial groups, including unregulated entities. Introducing domestic "supervisory colleges" involving all main regulators (not just the FBAs) of major banking groups may assist, although broader reform is necessary. An overhaul of risk rating systems, with a view to improve their capacity to distinguish between banks, is also recommended.
20. Supervisory techniques	Review, perhaps under the auspices of the FFIEC, existing supervisory manuals and processes to remove unnecessary differences and develop a "best of breed" approach.

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Reference Principle	Recommended Action
21. Supervisory reporting	Review the solo reporting requirements to ensure prudential requirements can be monitored relative to an individual bank's balance sheet. Also consider the implications of U.S. GAAP for the effectiveness of supervision and the PCA regime.
22. Accounting and disclosure	Consider the introduction of statutory reporting ("whistleblower") obligations for external auditors, along with associated protections.
24. Consolidated supervision	Make changes in legislation and practices to ensure effective conduct of consolidated supervision of financial groups. Also, regulatory limits and reporting of adherence to those should be introduced on the consolidated group level, including at the holding company level, for large exposures, and related lending.

Authorities' response to the assessment

66. The U.S. authorities wish to express their appreciation to the IMF and its assessment teams for the dedication, time and resources committed to this assessment. The authorities strongly support the Financial Sector Assessment Program, which promotes the soundness of financial systems in member countries and contributes to improving supervisory practices around the world. The U.S. assessment has presented a challenging and complex task, and the IMF has worked professionally and in a spirit of collaboration to produce the assessment. The U.S. authorities appreciate the opportunity to provide the following comments.

67. As recognized by the Report, it is important to consider the U.S. assessment in context. The assessment follows in the wake of a severe financial crisis and economic downturn, and these severe stresses have tested the resilience of the U.S. financial sector and its supervisory framework. The assessment properly holds the United States to a higher standard, given the maturity, complexity, and significance of our financial sector. Additionally, it is important to recognize that the United States is the first highly complex economy to have been evaluated under the Core Principles as updated in 2006. The revised Core Principles place a greater emphasis on risk management, and the methodology requires assessors to consider the practices of banks as well as the policies and practices of banking agencies. The authorities are pleased that, even under these more stringent Core Principles, and when applying a higher standard to the complex U.S. financial system, the IMF's assessment of the U.S. system is that it is broadly in compliance with the Core Principles. The few areas that are identified for improvement are acknowledged and are recognized; much is underway to address these known concerns.

68. The Report acknowledges that, while many of the identified weaknesses are being addressed by the U.S. federal banking agencies and by legislative reforms, it was not possible for the assessment to incorporate, or give credit for, these actions or reforms. For example,

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the Report acknowledges that a number of the firms that experienced major problems (i.e., the government sponsored enterprises and various investment banks before they became BHCs) were not subject to oversight by any of the federal banking agencies and that failures in risk management at these companies were a major contributor to the financial crisis. The U.S. federal banking agencies have, in multiple forums, expressed their desire to move forward expeditiously with legislative changes to address identified concerns.

69. Aside from supporting legislative reforms the U.S. federal banking agencies are making substantial progress in the oversight of risk management practices. Initiatives related to credit, market, and liquidity risk, and consolidated supervision are recognized in the Report. These changes, combined with proposals for legislative reforms that would enhance the ability to supervise institutions on a consolidated basis, address many of the deficiencies cited. It is equally important, however, to acknowledge that actions supervisors took as the magnitude of the crisis became clear and have continued to take since the crisis, are at least as important in judging the supervisors' effectiveness as any assumptions made about their oversight based on risk management weaknesses of supervised institutions. For these reasons, and for reasons noted earlier, the U.S. authorities take issue with the "Materially Non-Compliant" rating for CP 7, Risk Management Process.

70. The authorities believe each FBA has both statutory and organizational mandates and objectives which are clear and do provide specific roles and authority for the conduct of supervision of regulated entities. In addition, each agency has very specific authority to take steps to compel organizations to make improvements in risk management and other processes and as noted in the DAR we are actively working with institutions to improve these processes as well as regulatory policy in these same areas.

71. The IMF's assessment of CP 6, the Capital Adequacy standard, as Largely Compliant does not fully reflect aspects of U.S. bank supervision, both immediately before the crisis and once the crisis emerged. U.S. banks are held to a higher capital standard than international standards because of U.S. Prompt Corrective Action law and regulation. Currently, approximately 96 percent of U.S. banks, representing approximately 99 percent of total bank assets, hold 50 percent or more capital than international minimums. In addition, the quality of capital held by U.S. banks has generally been higher than in many other jurisdictions. Prior to the crisis most U.S. banks, including the largest, had Tier 1 capital composed mostly of common equity (80–90 percent or higher). In contrast, banks in other countries had common equity levels closer to the Basel predominance standard of 50 percent common shareholders' equity with the remaining component of Tier 1 capital generally consisting of tax-deductible hybrid securities. Moreover, as a result of the Supervisory Capital Assessment Program (SCAP), the largest U.S. banks now have risk-based ratios of Tier 1 capital and Tier 1common equity that far exceed Basel minimum capital requirements.

72. Finally, the federal banking agencies have taken a number of substantive actions that are not fully reflected in the Report. These include:

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United States: Publication of Financial Sector Assessment Program Documentation—Detailed Assessment of Observance of IAIS Insurance Core Principles

This Detailed Assessment of Observance of IAIS Insurance Core Principles for the United States was prepared by a staff team of the International Monetary Fund. It is based on the information available at the time it was completed in May 7, 2010. The views expressed in this document are those of the staff team and do not necessarily reflect the views of the government of the United States or the Executive Board of the IMF.

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FINANCIAL SECTOR ASSESSMENT PROGRAM

UNITED STATES OF AMERICA

IAIS INSURANCE CORE PRINCIPLES

DETAILED ASSESSMENT OF OBSERVANCE

MAY 2010

INTERNATIONAL MONETARY FUND
MONETARY AND CAPITAL MARKETS DEPARTMENT

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Contents Page

Glossary 3

I. Executive Summary, Key Findings, and Recommendations 4
A. Introduction 4
B. Information and Methodology Used for Assessment 4
C. Institutional and Market Structure—Overview 6
Recent performance 7
Regulatory arrangements 9
Guaranty funds (policyholder compensation arrangements) 13
D. Main Findings 14
E. Recommended Action Plan and Authorities' Response 21

II. Detailed Assessment 26

Tables

1. U.S. Insurance Companies—Capital Adequacy 8
2. Summary of Observance of the Insurance Core Principles 16
3. Recommended Action Plan to Improve Observance of the Insurance Core Principles 21
4. Detailed Assessment of Observance of the Insurance Core Principles 26

Appendix

I. Technical Note on Accounting and Actuarial Framework for Insurance 68

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GLOSSARY

AAA	American Academy of Actuaries
ABCD	Actuarial Board for Counseling and Discipline
AICPA	American Institute of Certified Public Accountants
AML/CFT	Anti-Money Laundering/Combating the Financing of Terrorism
APPM	Accounting Practices and Procedures Manual
ASB	Actuarial Standards Board
ASI	Annual Statement Instruction
ASOP	Actuarial Standards of Practice
ACL RBC	Authorized Control Level Risk-Based Capital
CPA	Certified Public Accountant
ERISA	Employee Retirement Income Security Act
FAST	Financial Analysis Solvency Tools
GAAP	Generally Accepted Accounting Principles
GLBA	Gramm-Leach-Bliley Act
GWP	Gross Written Premium
FATF	Financial Action Task Force
FAWG	Financial Analysis Working Group
IAIS	International Association of Insurance Supervisors
ICP	Insurance Core Principle
IFRS	International Financial Reporting Standards
MoU	Memorandum of Understanding
NARAB	National Association of Registered Agents and Brokers
NICB	National Insurance Crime Bureau
NIPR	National Insurance Producer Registry
PCAOB	Public Company Accounting Oversight Board
RBC	Risk-Based Capital
RIRS	Regulatory Information Retrieval System
RRG	Risk Retention Groups
SAD	Special Activities Database
SAO	Statement of Actuarial Opinion
SAP	Statutory Accounting Principles
SMI	Solvency Modernization Initiative
SSAP	Statements of Statutory Accounting Principles
SVO	Securities Valuation Office
TAC	Total Adjusted Capital
TALF	Term Asset-Backed Securities Loan Facility
TARP	Troubled Asset Relief Program
TRIA	Terrorism Risk Insurance Act

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I. Executive Summary, Key Findings, and Recommendations

1. **Insurance regulation in the United States, which is mostly carried out by states, is generally thorough and effective, although there are areas where significant development is needed**. Strong regulation contributed to the overall resilience of the insurance sector during the financial crisis. There is generally a high level of observance of the Insurance Core Principles. Aspects of regulatory work such as data collection and analysis in relation to individual insurance companies are world-leading. There are mechanisms to ensure individual states implement solvency requirements effectively. However, there is a need for development of the policy framework in relation to insurance and financial stability and international issues; and for extensive reform to the laws governing state insurance departments, including on appointment and dismissal of commissioners, to secure the independence of regulatory work. The approach to supervision of groups needs significant development.

A. Introduction

2. **This assessment of the U.S.'s compliance with International Association of Insurance Supervisors (IAIS) Insurance Core Principles (ICP) was carried out as part of the 2010 U.S.A., Financial Sector Assessment Program (FSAP)**. The assessment was carried out by Tom Karp, insurance expert and a former Executive General Manager, Australian Prudential Regulatory Authority, and Ian Tower, Monetary and Capital Markets Department, IMF.

3. **While insurance regulation is principally a responsibility of the states, the assessment addresses national compliance with the ICPs**. Regulatory responsibility is shared by 50 states, the District of Columbia and the five U.S. territories. Although certain departments of the U.S. government maintain an interest in insurance, for example in relation to external trade (where states have no authority) and anti-money laundering, federal authorities have limited regulatory powers over the insurance sector. This assessment addresses insurance regulation nationally and does not assess individual state authorities.

B. Information and Methodology Used for Assessment

4. **The assessment was based on information available in November 2009 at the time of an FSAP mission**. The National Association of Insurance Commissioners (NAIC) contributed a self-assessment and further information in response to requests before and during the mission. Documentation, including relevant laws and regulations,[1] was supplied. The assessment has been informed by discussions with regulators and market participants. The assessors met with staff from the NAIC and with selected insurance commissioners[2] and

[1] The model laws of the National Association of Insurance Commissioners were the main documentary resource for this assessment but the assessors have also referred to select individual state laws.

[2] The term 'insurance commissioner' is used throughout this report to refer to the most senior official responsible for insurance regulation in each state, district, or territory. Actual titles vary.

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their staffs; with government, insurance companies and intermediaries; and with industry and actuarial bodies. The assessors are grateful for the full cooperation extended by all.

5. **The assessment was based on the 2003 version of the IAIS Insurance Core Principles and Methodology**. It took into account relevant IAIS standards and guidance in addition to the ICPs. The assessment of ICP 28 (anti-money laundering, combating the financing of terrorism (AML/CFT)) has been informed by the assessment carried out in 2006, of U.S. compliance with the Financial Action Task Force (FATF) AML/CFT standards, using the 2004 Methodology.

6. **The approach to this assessment reflects the large market size and state-based system of insurance regulation**. As the assessment addresses national compliance and the assessors were not able to hold discussions or review material from more than a few state authorities, reliance has been placed on discussions with:

- NAIC staff on regulatory practices across the states, based on an NAIC self-assessment which addresses compliance with the ICPs for the United States as a whole; and on the processes and procedures used by the NAIC (i.e., the commissioners of insurance acting collectively and the staff of the association) in their support for state regulators (see paragraphs 20 to 21); and

- A selection of insurance commissioners and their staff in the states of Illinois, Iowa, New York, and West Virginia. While discussions in all these states were wide-ranging, they paid particular attention respectively to life insurance supervision, the property and casualty sector (including brokers), coordination with foreign regulators, and challenges faced by smaller states.

- The assessors also met with officials from the U.S. Department of the Treasury to discuss their overview of the system in the context of evolving plans for the reform of U.S. regulation in response to the financial and economic crisis.[3]

7. **Findings from these discussions (and documents made available to the assessors) have been used to inform the overall assessment of observance of the ICPs in the United States**. The well-developed procedures of the NAIC have made it possible to take a view, in particular for financial regulation, of the degree of uniformity, in extent and quality of regulation, across the states. Nonetheless, the assessors note that their conclusions are subject to unavoidable limitations on their ability to verify practices across the country (particularly in the implementation of regulatory requirements) that result from a state-based system with over 50 separate authorities.

[3] In particular, the mission discussed the proposals set out in the document "Financial Regulatory Reform: A New Foundation," U.S. Department of the Treasury, June 2009.

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C. Institutional and Market Structure—Overview

8. **The U.S. insurance market is the largest in the world**. There were 7,948 licensed insurance companies at the end of 2008. Total premium volume in 2008 of US$1.24 trillion accounted for 29 percent of the global market (Japan and the United Kingdom were second and third largest with 11 percent and 10 percent shares respectively). On insurance density measures (premiums per capita), the United States ranked ninth at US$4,078 in 2008 and thirteenth on insurance penetration (premiums as a percentage of GDP) at 8.7 percent.[4] There are three main sectors—life, property and casualty (divided between personal and commercial lines), and health insurance. Key specialist insurance lines (i.e., those which must be written in separate companies) are: financial guaranty (bond insurance—the "monoline insurers"); mortgage insurance; and title insurance. The sector also includes captive insurance companies and Risk Retention Groups (RRGs). Total employment in insurance companies was 1.6 million at the end of 2008.

9. **Most U.S. insurers write primary insurance on U.S. risks**. The U.S. market is characterized by:

- low market concentration in most sectors, indicating a high degree of competition, which has been supported by provisions allowing certain risks, mostly in commercial lines, that are hard to insure ("excess and surplus lines") to be written free of some of the general regulatory requirements and coverage by guaranty funds, provided that cover has previously been sought by an agent but cannot be obtained in the regulated ("admitted") market;

- limited private sector capacity in certain "hard to insure" risks, particularly those related to severe weather, natural catastrophes, and some classes of medical risks, which has led to the creation of certain "residual market" mechanisms, such as joint underwriting arrangements and programs provided directly by state or federal government; at federal level, these cover, in particular, terrorism losses (TRIA), flood risk and crop loss; and, at state level, mainly workers compensation or property risks in areas exposed to natural catastrophes and reinsurance for hurricane losses (the Florida Hurricane Catastrophe Fund);

- limited international insurance business (so most business written by U.S. insurers is in relation to U.S. risks) and a relatively small reinsurance capacity—58 percent of all premium ceded to reinsurers by U.S. insurers is to markets in Europe and Bermuda (85 percent, if premium ceded to offshore affiliates of U.S. companies is included); and

[4] All data from Swiss Re: World Insurance in 2008.

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- relatively few cross-sector groups offering insurance as well as other financial services: while the 1999 Gramm-Leach-Bliley Act (GLBA) reformed the regulatory framework to accommodate cross-sector groups, there are only 17 groups headed by a bank holding company regulated by the Federal Reserve (because they offer insurance and banking), while 42 contain a thrift regulated by the Office of Thrift Supervision.

10. **Distribution of insurance products is mainly through agents and brokers**. Intermediaries distributing insurance in the United States are generally referred to as "producers." They may act as agents of one or more insurance companies (captive agents or independent agents) or as brokers—i.e., acting on behalf of the customer. Banks may also distribute insurance products but have limited market share.

Recent performance

11. **Overall, the insurance sector, and the property and casualty companies in particular, has been resilient through the financial crisis**. Capital and surplus, the key measure of the buffer available in case insurance company reserves prove inadequate to ensure that policyholder claims can be paid, has fallen by 6.7 percent in life and 8.5 percent in property and casualty between end-2007 and mid-2009. Companies whose capital adequacy, measured by the regulators' risk-based capital (RBC) requirements, fell to regulatory intervention levels[5] accounted for only 3 percent of the total in 2008. While there have been several firms placed in receivership, only one company has been subject to receivership for causes and with a timing directly related to the financial crisis.[6] The property and casualty sector suffered from investment market falls, but losses from natural catastrophes so far in 2009 have not been as high as in some recent years. As Table 1 shows, while absolute dollar amounts of capital have fallen, so has the required risk-based capital, leading to capital coverage ratios in the sectors falling more slowly. Actual capital in each of the sectors is many times greater than required RBC levels and, on average, about two to three times the capital levels at which regulatory intervention would occur.

12. **However, there have also been significant stresses in the insurance sector in the last two years**. Writers of financial guaranty business (the monoline insurers) lost the previously high ratings on which much of their business depended after serious losses on business related to impaired structured finance products. The American International Group (AIG) was supported by the federal authorities after major losses at its capital markets affiliate. Two other insurance groups with federally regulated banking or thrift subsidiaries were granted federal government capital support under the Troubled Asset Relief Program (TARP) (others had applied for funds). Insurers also benefited from Federal Reserve

[5] The basis for calculating capital adequacy—Risk-Based Capital (RBC)—is described and assessed under ICP 23 in Table 4 (the detailed assessment) and the system of control levels (triggers for intervention) is described and assessed under ICP 14.

[6] See the assessment of ICP 16 for an account of receivership and other enforcement powers.

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programs, particularly the Term Asset-Backed Securities Loan Facility (TALF) that supported liquidity in the markets in which they had invested.

Table 1. United States: U.S. Insurance Companies—Capital Adequacy

Year End	2008	2007	2006	2005	2004
Life					
Total adjusted capital (US$ billions)	337.9	382.6	363.5	344.4	340.2
RBC requirement (US$ billions)	44.6	47.7	44.8	42.3	43.9
Industry aggregate RBC ratio (TAC as % of RBC)	758%	802%	811%	814%	775%
Median RBC ratio of insurers (TAC as % of RBC)	910%	1009%	996%	975%	940%
Number of companies in action levels	23	13	13	11	17
Percentage of companies in action levels	2.7%	1.5%	1.4%	1.1%	1.7%
Property and Casualty					
Total adjusted capital (US$ billions)	578.9	640.7	599.3	523.8	484.8
RBC requirement (US$ billions)	96.8	102.7	98.6	94.2	93.6
Industry aggregate RBC ratio (TAC as % of RBC)	598%	624%	608%	556%	518%
Median RBC ratio of insurers (TAC as % of RBC)	992%	977%	935%	877%	828%
Number of companies in action levels	79	71	75	86	108
Percentage of companies in action levels	3.0%	2.7%	2.9%	3.4%	4.3%
Health					
Total adjusted capital (US$ billions)	75.2	79.9	72.2	61.6	46.8
RBC requirement (US$ billions)	12.7	12.2	10.9	9.6	8.1
Industry aggregate RBC ratio (TAC as % of RBC)	592%	655%	662%	642%	578%
Median RBC ratio of insurers (TAC as % of RBC)	545%	589%	582%	574%	548%

13. **Life insurance has been particularly affected**. In addition to large unrealized investment losses, some companies experienced downward pressure on regulatory capital ratios that raised concerns over possible widespread ratings downgrades. Regulators were approached for relief and firms were granted some individual modification ("permitted practices"). The strains were related to recent strong growth in non-traditional savings products such as variable annuities (Box 1), many of which contain generous guarantees. Life insurers were also affected by the illiquidity in asset markets, including pressures in securities lending (cash collateral had been reinvested by some firms in illiquid instruments, causing liquidity strains when the collateral was recalled). New business volumes have been falling sharply.

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Box 1. Variable Annuities

Variable annuities products are investment-linked products with some form(s) of guarantee (accumulation, income, death or withdrawal) which are sold by life insurers into the retirement and investment market. In the United States, the most common guarantee offered is that on withdrawal. The customer's initial capital paid into such a product is invested in a sub-account at the customer's discretion. The customer can withdraw guaranteed periodic amounts up to the amount of the initial capital. The product terminates once the initial capital has been withdrawn with any remaining funds in the sub-account returned to the customer at maturity. So the sub-account value fluctuates with movements in the underlying assets and decreases with withdrawals.

The product therefore effectively combines an annuity, in the form of guaranteed periodic withdrawals, with a call option on the underlying residual sub-account at maturity. So, while the customer who owns the sub-account carries much of the investment risk, the insurer is carrying the risk that the sub-account will not be adequate to fund the guaranteed withdrawal amounts**.**

The NAIC has been developing its approach to the treatment of such products with complex guarantees in its capital adequacy requirements. In 2000, an internal models based approach was added to the previously factor-based capital approach to capture interest rate risk. This was refined in 2005 to capture equity risk.

These changes have automatically been applied by all states, as the NAIC risk-based capital system is referenced in all state laws. Work is currently under way further to refine the reserving requirements for such products. Over the last few years, and especially since the financial crisis, insurers have reduced their writing of such products and scaled back the types and levels of guarantees offered.

14. **While pressures have eased, there remain challenges**. The recovery in many markets since March 2009 has brought relief to the insurance sector. However, risks remain.

- Life companies in particular remain significantly exposed to possible further problems if economic downturn continues. Their commercial property exposure is high, both in loans and investments, as is exposure to banks. A prolonged low interest rate environment would exacerbate strains. However, as life companies have shifted to savings products, their insurance risks (mortality and longevity) have become less significant.

- Health insurers are subject to significant uncertainty arising from the proposed federal government reforms to health insurance.

- Property and casualty risks are more dispersed. While the United States is exposed to major natural catastrophes, their impact is regional; and while some companies are heavily exposed to particular events, national companies have diversified risks and the largest catastrophe risks are carried by reinsurers outside the United States.

Regulatory arrangements

15. **Insurance is a predominantly state-regulated activity in the United States**. While the foundation for state responsibility goes back to 1851, a key event was the legislative reaction to a Supreme Court decision in 1944. The court declared that insurance was interstate commerce and, hence, under the U.S. constitution, subject to federal regulation,

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including federal laws such as the Sherman Act and other antitrust laws. This prompted calls on Congress to override the decision and the 1945 enactment of the McCarran-Ferguson Act, which reinstated the regulatory authority of the states "on matters of the business of insurance" and exempted the "business of insurance" as regulated by the states from federal anti-trust laws. A key consequence of this exemption is that insurance companies are able to pool data for use in underwriting risks.

16. **There are also some federal government responsibilities**. While state regulation has not been substantially challenged since 1945, the federal government has enacted various measures affecting insurance. The 1974 Employee Retirement Income Security Act (ERISA) imposed federal reporting requirements and enforcement powers for employer-sponsored retirement plans and other related benefits. The Gramm-Leach-Bliley Act of 1999 preserved state regulation by reaffirming the McCarran-Ferguson Act, but pressed the states to achieve licensing reciprocity in insurance intermediary licensing or accede to federal intervention. The 2002 U.S.A. PATRIOT Act extended aspects of the Federal Bank Secrecy Act to insurance and gave examination powers in relation to anti-money laundering and certain specified insurance business to federal authorities.

17. **States carry out insurance regulatory functions within the state administration**. The insurance departments or similar units within state administrations carry out licensing and oversight work for insurance companies and intermediaries under powers set out in state legislation and in accordance with state budgets. A commissioner heads the department and exercises all formal powers. Some commissioners are elected, but most are appointed by the state governor. While arrangements vary among states, funding is usually raised from the insurance markets via fees and levies. (Fees are usually for specific activities, such as licensing and examinations, and are generally paid directly to the insurance department. Levies usually form part of state government revenue and are either dedicated to funding the insurance department or flow to general revenue with insurance department budgets subject to normal state budgeting processes). Insurance departments also collect premium taxes for the states, a significant part of state governments' total revenues.

18. **Businesses must obtain a license in each state where they are writing risks**. An insurance company is said to be "domiciled" in the state that issued its primary license; it is "domestic" in that state. Once licensed in one state, it may seek licenses in other states as a "foreign" insurer. An insurer incorporated in a foreign country is called an "alien" insurer in the U.S. states in which it is licensed. "Multistate companies" (the vast majority by premium income) are those that write business in more than one state. The extent of mutual recognition (known as reciprocity) varies by state and requirement, but financial regulation is mostly carried out by the state where the insurer is domiciled.

19. **State insurance departments carry out both financial and market conduct regulation**. States set reserving and capital requirements—the rules and associated reporting frameworks are complex and details are set out in an appendix to this assessment. States carry out financial analysis and onsite examinations—which are required by law every five years at minimum (or three years in some states). Most states have some review or approval authority over policy forms and, in the case of property and casualty insurers, they also often regulate premium rates. In respect to rates, the objective is to ensure that they are

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not inadequate, excessive, or unfairly discriminatory. Departments also respond directly to consumers' complaints and requests for information. They license and oversee insurance intermediaries. States have extensive powers to enforce their financial and market conduct requirements.

20. **The NAIC plays an important coordinating role for state regulators**. The NAIC is the vehicle through which the state insurance commissioners act as a group. The commissioners have established a not-for-profit organization to assist them in respect of their regulatory responsibilities, by centralizing some functions to achieve economies and greater uniformity, to pool resources and to obtain and share expertise. The objective is to enable the states to develop regulation in ways they could not achieve by acting individually. The NAIC itself employs some 430 staff, which compares with nearly 12,000 employed by the states. Key functions of the NAIC, in relation to this assessment, are:

- processes and procedures to develop and agree model laws and regulations, which now total over 200. States contribute to the development of these laws via NAIC working groups. While states are not obliged to implement model laws and regulations in state law, the process creates an expectation that state legislation will broadly mirror the requirements agreed by commissioners at NAIC meetings. In practice, states often implement the models with variations, which are particularly significant in market conduct and producer licensing;

- the Financial Regulation Standards and Accreditation Program (referred to in this report as "the accreditation program"). This is an extensive process aimed at ensuring that states meet certain minimum standards in respect to financial regulation. It covers, in relation to financial issues, laws and regulations (including 18 of the NAIC model laws) and key provisions on accounting and solvency; regulatory practices, including offsite and onsite supervision; and organizational and staffing practices. Standards on insurance company licensing will be added in 2012. In order to achieve and retain accreditation, states undergo a detailed review by independent examiners (many are accountants or retired senior regulators) once every five years; interim annual reviews are also required. Final decisions on accreditation are taken by a committee of commissioners. All 50 states and the District of Columbia are accredited. Formally, the effect of accreditation is to enable states to accept examinations undertaken by the domestic state rather than carrying out their own, although individual states may still impose additional standards on "foreign" companies (i.e., accreditation does not guarantee reciprocity). There are also reputational implications; and

- the centralized process of financial analysis operated through the mechanism of the NAIC's Financial Analysis Working Group (FAWG). This is a group of 18 senior financial experts who meet to discuss reports from NAIC staff covering all "nationally significant companies" (around 1,600 companies representing 85 percent of the market) based on annual and quarterly statements and other information. The

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objective is to challenge domestic state regulators, who retain responsibility for any action, on their analysis of companies and their regulatory response. A similar process is being developed for market conduct regulation.

State regulators, through the NAIC, maintain a number of databases covering financial information (most companies submit statements direct to the NAIC), data on producers, etc.

21. **As they are the most likely to be fully and effectively implemented by states, this assessment highlights measures subject to accreditation program**. The assessors have relied heavily on the accreditation program, because it is widely seen as assuring that minimum standards are met in all accredited states. In assessing statewide compliance with other NAIC model laws and other measures, the assessment distinguishes between those implemented in most, many and some states. However, as mentioned above, states have not been assessed individually and there is therefore a degree of uncertainty about the assessment of compliance across the country in these cases.

22. **State regulators, through NAIC coordination mechanisms, have been taking initiatives to modernize key aspects of their approach, although progress has been mixed**. In addition to continuing development of their requirements, state regulators have been engaged since 2000 on a broad-based regulatory modernization plan. This includes shifting from predominantly compliance/audit examinations of insurers to more forward-looking assessments of risk. This important change will be formally part of the accreditation program from January 1, 2010. Many of the objectives of the wider modernization plan have been met, but others, such as those relating to greater uniformity in producer licensing, have not been fully met.

23. **The mixed progress reflects structural features of the regulatory framework**:

- In a state-based system, state administrations and legislatures are not bound to implement NAIC model laws and regulations; while local variations are often appropriate given the varying market conditions, it can be hard to achieve uniformity where it is necessary or desirable (in particular to reflect the essentially national reach of many large insurance companies and some intermediaries).

- While the NAIC processes appear to be thorough and to deliver appropriate change, the need to involve many stakeholders and achieve consensus significantly slows the delivery of change, except where it is particularly urgent.

- Regulatory requirements are heavily rules-based, which, while it has advantages in making requirements clear and comprehensive, increases the time required to make regulatory changes; the heavy use of rules also risks creating a tendency for regulators to engage in micro-management of insurers as each issue or problem that arises is addressed by adding even more rules.

24. **A major new review, the Solvency Modernization Initiative (SMI), is now under way**. In 2008, the NAIC launched the SMI as a review of financial requirements. This will include a study of solvency regimes and developments in other countries and the EU. The

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aim is to deliver a framework consistent with best practices and, if possible, more closely aligned with regimes in other countries and with accounting standards. The SMI is wide-ranging, covering:

- capital requirements, including reviewing the design and calibration of current requirements and considering whether to require regulatory reporting of companies' economic capital levels and information about the development of the companies' target capital;

- international accounting, particularly the implications of the joint project on insurance contract accounting of the U.S. Financial Accounting Standards Board (FASB) and International Accounting Standards Board (IASB); insurance regulators are required to review all changes to GAAP accounting and to determine what changes should be made to their own system of statutory accounting;

- insurance valuation, including a project to move toward more principles-based reserving in life insurance; and consideration of making capital requirements reflect individual company risk characteristics more;

- reinsurance—implementing a modernization framework developed in 2008, once pending federal legislation is in place; a new Reinsurance Supervision Review Department will be charged with assessing non-U.S. regulatory regimes under a mutual recognition framework; and

- group solvency issues—considering potential revisions to the current approach to supervision of groups, the use and potential improvement of supervisory colleges with regulators from around the world, and group-wide supervision requirements, which may include group-wide capital requirements.

Consideration will also be given to the development of corporate governance principles for insurance companies and the establishment of risk management requirements. These are all major initiatives that have the potential to transform U.S. insurance regulation in the future.

25. **Other reforms will address issues highlighted by the financial crisis, and insurance will be included in the scope of future system wide regulatory reforms**. Reforms are pending to the requirements applying to bond insurers (monolines) and to securities lending, to take account of crisis events. Action has already been taken and more is under consideration to reduce the former reliance on ratings of the major credit rating agencies. Congress and the administration are working on regulatory reform in response to the crisis and proposals to date include certain reforms affecting insurance regulation. The details of these wider reforms were under discussion at the time of this assessment.

Guaranty funds (policyholder compensation arrangements)

26. **Insurance policyholders are protected against the insolvency of insurance companies by guaranty associations in each state**. All U.S. insurance companies are required to be members of associations covering life and health insurance and, through

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separate organizations, property and casualty. These associations are established by state laws (there are NAIC models). Payments are triggered by the insolvency of an insurer, although, in practice, associations seek to obtain continuity of coverage by transferring policies to other companies. Laws differ on the extent of coverage and maximum amount payable per policyholder. Associations rely on assessments of other insurers writing the same class of business, i.e., they are not pre-funded. State laws set limits on assessment—typically, for life insurance, 2 percent of each insurer's prior year premium income in the state per year.

D. Main Findings

27. **Insurance regulation in the United States is generally thorough and effective, although there are areas where development is needed**. Strong regulation contributed to the overall resilience of the insurance sector during the financial crisis. Insurance regulators are responding to lessons from the crisis. In relation to compliance with the Insurance Core Principles:

- The preconditions for effective insurance supervision are generally met—reflecting the highly developed legal and institutional framework within which it operates and the scale and liquidity of U.S. financial markets; but there is a need for development of the policy framework in relation to insurance and financial stability and international issues.

- There is a need for institutional reform in the laws governing state insurance departments, including on appointment and dismissal of commissioners, the budgetary framework and remuneration policies, in order to secure the independence of regulatory work.

- While insurance regulation is carried out openly and transparently, there is a need for measures (including providing free access to more information and documents about the NAIC's model laws and their implementation) to foster improved stakeholder understanding of the state-based regulatory approach.

- There is a comprehensive set of requirements and processes for insurance company licensing, but some gaps in the requirements relating to suitability of persons with reliance on supervisory work to identify concerns and take action where necessary.

- Requirements in relation to governance, internal controls, and risk management are limited and should be extended, but departments are focusing closely on these issues in the risk-focused examination process currently being rolled out.

- NAIC data collection and analysis capabilities are world-leading, although the absence of complete group-wide consolidated data for insurance groups and broader financial conglomerate groups hinders the ability of supervisors to analyze and monitor market-wide events of importance for the stability of insurance markets.

- Financial examinations (i.e., onsite supervision) are generally thorough and well documented. Examinations also appear to identify the important issues. The rollout of

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a risk-focused examination approach is requiring major changes from examiners and implementation needs to be closely monitored by the NAIC.

- The approach in relation to enforcement is comprehensive and applied by regulators in practice as necessary; there is no explicit authority for supervisors to fine individual directors or senior managers of insurers, or to bar them from acting in responsible capacities in the future.

- The approach to supervision of groups needs significant development. The U.S. supervisors do not currently make a comprehensive and consistent assessment of the financial condition of the whole group of which a licensed insurance company is a member. Risk-focused examinations are not yet generally focusing on group issues; and supervisory colleges are not meeting for all U.S.-based international groups.

- The liability reserving methods and bases generally lead to conservative estimates and, in combination with capital requirements, provide a sizable buffer against adverse experience. However, for general transparency and for international comparison, consideration should be given to specifying a target safety level for reserving and an associated target safety level for capital.

- While producer (i.e., intermediary) regulation is less uniform than it is for insurance companies, states have in place the core requirements—licensing, examinations and powers to take action in case of producer misconduct. There is a need to extend broker trust fund arrangements across states, to develop a uniform approach to the regulation of major brokers and to complete the current work on a consistent approach to the regulation of commission disclosure.

- Consumer protection work is moving to a more proactive approach to market conduct of insurers. This transition has further to go, particularly in respect of the ability of departments to identify and respond quickly to wider market issues. As with producer licensing, there is a lack of uniformity across states in the market conduct area. However, core consumer protection requirements are apparently in place in most states.

- Requirements on fraud, including making insurance fraud a crime, are in place across states, and the capacity of departments to address fraud-related issues is increasing as market conduct exams are undertaken and the availability of fraud data increases.

- The authorities have only recently brought relevant insurance business within the scope of federal anti-money laundering regulatory requirements. There were significant gaps in the framework when the most recent FATF work was undertaken in 2006. The need to increase resources available for examinations and the effectiveness of cooperation between state and federal regulators, are being addressed through discussions on new procedures and information sharing arrangements.

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Table 2. Summary of Observance of the Insurance Core Principles

Insurance Core Principle	Grading	Comments
ICP 1– Conditions for effective insurance supervision	LO	The preconditions for effective insurance supervision are generally met—reflecting the highly developed legal and institutional framework within which it operates and the scale and liquidity of U.S. financial markets. But there is a need for some development of the policy framework in relation to insurance and financial stability and to international issues. Whereas insurance regulation is state-based, the broader regulatory and financial sector policy framework falls to federal authorities. On international insurance regulatory issues, there is a mismatch between the authority reserved to the federal government to enter into international agreements and that of the states to regulate the insurance sector, taking account of such agreements.
ICP 2 – Supervisory objectives	LO	The objectives of departments are generally not established explicitly by law. They reflect the evolution of their roles and responsibilities over the years, the risks and challenges in insurance business in different states and the political preferences of state legislatures. There are differences in the ways individual departments view their objectives, which may hamper moves toward greater uniformity of state regulation. There is also some scope for conflict of objectives. There is a need to balance objectives of achieving financial safety and soundness and consumer protection with the desirability of fostering market efficiency and competitiveness.
ICP 3 – Supervisory authority	PO	The vesting of regulatory powers in the commissioner in principle ensures that departments are operationally independent. However, the ability of the governor in most states to dismiss commissioners at any time, and without a public statement of reasons, exposes departments to potential political influences. Elected commissioners may be subject to the pressures of the electoral cycle. In addition, departments are dependent on state legislatures in respect of principal legislation and for budgetary resources, which cannot always be allocated according to the departments' own priorities. Departments are exposed to budgetary cuts during economic downtowns, when workloads tend to rise (although income from examination work charged to companies can mitigate such pressures). The use of statewide remuneration policies constrain departments' ability to hire specialist skills and can result in extensive and (for companies being examined) costly reliance on external experts.
ICP 4 – Supervisory process	LO	Insurance regulation is carried out openly and transparently, with clear accountability to the state administration and legislature and rights of appeal (and judicial review), which balance the need for due process with the importance of regulators being able to act swiftly and decisively where necessary to achieve regulatory objectives. But there is a need for measures (including providing free access to more information and documents about the NAIC's model laws and their implementation) to foster improved stakeholder understanding of the state-based regulatory approach.
ICP 5 – Supervisory cooperation and information sharing	LO	Although the main focus of information exchange with other regulators has traditionally been on cooperation with other insurance departments, regulators are able to share information with relevant federal authorities and with regulators abroad. There is a need to continue developing the

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		network of MoUs. All state insurance departments should ensure laws are updated to enable them to protect information received from foreign regulators.
ICP 6 – Licensing	O	While approaches in individual departments vary, the core requirements adopted by all states represent a comprehensive set of requirements and processes for insurance company licensing. The extension of the accreditation process to licensing standards in 2012 should nonetheless provide assurance that the core licensing requirements continue to be complied with in practice by state departments.
ICP 7 – Suitability of persons	LO	Departments take a view on all significant owners, Board members, senior management, auditors, and actuaries and take appropriate action where concerns arise. However, the approach is based on assessment of the fitness and propriety of key functionaries at the point of application for a license, and on an ongoing basis through the examination process, rather than the approval of individuals (which is the approach taken in some other countries). There are gaps in the specific requirements—companies do not have to notify departments of concerns about the fitness and propriety of key individuals and departments cannot disallow functionaries from holding two positions that could result in material conflict.
ICP 8 – Changes in control and portfolio transfers	O	There are extensive requirements and related reporting governing changes in control and portfolio transfers.
ICP 9 – Corporate governance	LO	Corporate governance standards for publicly-traded U.S. companies, including insurers, are set and enforced by the SEC, while requirements for all insurance companies will be introduced from January 2010. Departments have been increasing their focus on governance issues, mainly as a more risk-based approach to examinations has started to be implemented. Examinations had previously focused more on financial condition and related controls, while corporate governance has historically received less attention. The new examination approach is still being rolled out but the risk-based approach becomes part of the accreditation standards in 2010.
ICP 10 – Internal controls	LO	Other than controls relating to financial reporting, departments have few requirements relating to internal controls on insurers at present. For publicly-traded companies, the Sarbanes-Oxley provisions provide a general framework of detailed control requirements and testing of controls. From January 1, 2010, much of this framework will be extended to all insurers, with the exception of smaller companies, but these requirements will take time to implement in full. Departments are increasingly looking to ensure sound internal controls at insurers via the risk-based examination process, but this approach is still being implemented.
ICP 11 – Market analysis	LO	The absence of complete group-wide consolidated data for insurance groups and broader financial conglomerates hinders the ability of supervisors to analyze and monitor market-wide events of importance for the stability of insurance markets. The lack of analysis of developments outside the U.S. markets, given that it relies so heavily on offshore reinsurers, needs to be addressed. Otherwise, the NAIC data sources and analysis capabilities are world-leading. They should be more used in international supervisory college discussions to better understand U.S. insurer exposures in a group and to encourage insurance regulators in other

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		jurisdictions to develop similar capabilities.
ICP 12 – Reporting to supervisors and off-site monitoring	LO	The NAIC data collection and analysis capabilities in relation to authorized insurance companies are world-leading. The affiliate transaction requirements provide a strong means of identifying and controlling intra-group dealings and exposures. However, there are no formal reporting requirements for complete group-wide consolidated data for insurance groups and broader financial conglomerate groups which would allow insurance regulatory style financial condition assessment.
ICP 13 – On-site inspection	O	Financial examinations are generally thorough and well documented. Examinations also appear to identify the important issues. The rollout of a risk-focused examination approach will require examiners to make more qualitative judgments about insurer risks and controls, including scoring them for inclusion in the risk matrix. Effective implementation will not be easy because of the changes it demands of examiners. The NAIC might consider undertaking an assessment of the implementation of the risk-focused examination approach in the near future (e.g., in the course of 2012).
ICP 14 – Preventive and corrective measures	O	The structure of prompt corrective action triggers and required actions is thorough and is rigorously applied. While it could not, and should not, prevent insurers ever failing, it does lead to reduced insurer shortfalls in any failure (guaranty fund data suggests most shortfalls are in the 5–15 percent of liabilities range). It also provides clear messages to the insurers of the consequences of their reducing capital levels.
ICP 15 – Enforcement or sanctions	LO	There is no clear authority for the supervisory authority to fine individual directors or senior managers of insurers or to bar them from acting in responsible capacities in the future.
ICP 16 –Winding-up or exit from the market	O	There is a strong focus by the supervisory authorities on ensuring individual policyholder obligations are met. Customer complaints handling facilities in supervisory authorities, readily available information on the progress of insurer receiverships and a network of insurer guaranty funds provide a high level of policyholder protection. The arrangements for insurer wind-up and exit from the market are clear, have worked effectively and in conjunction with guaranty fund arrangements provide strong protection against policyholder loss if an insurer fails.
ICP 17 – Group-wide supervision	PO	The U.S. approach is focused on securing the financial soundness of individual insurance companies. While this has not been unusual among insurance regulators internationally, many have been supplementing their strong solo company focus with financial and other requirements and more supervisory focus applied at group level and U.S. supervisors should do the same. They do not currently make an assessment of the financial condition of the whole group of which a licensed insurance company is a member. Risk-focused examinations are not yet generally focusing on group issues; and supervisory colleges are not meeting for all U.S.-based international groups.
ICP 18 – Risk assessment and management	LO	While the desired outcomes for this ICP are essentially achieved in practice owing to comprehensive examination of insurers, it is increasingly important that the risk management function of insurers is of high quality

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		and given significant focus and influence within insurers. There is no requirement that an insurer have in place comprehensive risk management policies and systems capable of promptly identifying, measuring, assessing, reporting, and controlling their risks.
ICP 19 – Insurance activity	LO	The relevant laws or regulations do not explicitly provide that an insurer must have in place strategic underwriting and pricing policies approved and reviewed regularly by the Board. Boards are not required to set the strategic limits on these core insurance functions within which management should operate. There is a risk that the prior notification requirement may lead to undue 'prior approving' of many reinsurance transactions, which could be an ineffective use of supervisory resources.
ICP 20 – Liabilities	O	The liability reserving methods and bases generally lead to conservative estimates, which is in line with the conservative, book value nature of statutory insurance accounting in the United States Elements of the reserving methods adopted involve stochastic modeling or scenario analysis techniques to estimate the reserves required under moderate adverse conditions. However, there is currently no particular or specified safety level which is targeted for reserving – or capital. For general transparency and for international comparison, it is recommended that consideration be given to specifying a target safety level for reserving and an associated target safety level for capital. This should also assist in keeping margins for conservatism in reserves more similar across insurance classes and assist with peer comparisons of reserving.
ICP 21 – Investments	O	The regulatory requirements for investments are robust and likely to have contributed to the limited number of major investment problems for insurers in the financial crisis. As insurers move to a more principles-based approach, it will be important to ensure that all aspects of investment risk, especially asset/liability mismatching risks, are well covered in the reserving and capital requirements.
ICP 22 – Derivatives and similar commitments	O	The requirements relating to derivatives use in insurers are robust and sensible in that they allow derivatives to be used for purposes which would enhance an insurer's investment management and returns without exposing it to undue risk of losses. There are no requirements on derivatives use at a holding company level outside the licensed insurer (but this is not required by the ICPs).
ICP 23 –Capital adequacy and solvency	LO	There are no requirements to address inflation of capital through multiple gearing (i.e., holding company debt raisings injected as equity into insurance subsidiaries). These should be included in the law, regulation or rules. Insurance company reserves are determined conservatively and the regulatory capital is then required in addition. The combination of reserving and capital provides a sizable buffer against adverse experience. In the absence of a specified safety level which is targeted for reserving plus capital, it is difficult to determine the level of adversity that the combination of reserves and capital can cover, but it appears to be commensurate with or higher than in many other insurance jurisdictions.
ICP 24 – Intermediaries	LO	While producer (i.e., intermediary) regulation is much less uniform than it is for insurance companies, most states have at least the core requirements

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		– licensing, requirements in relation to producer skills and expertise, and powers to undertake examinations and to take action in case of producer misconduct. The general legal framework provides safeguards for client money where intermediaries act as agents (and this has been tested in numerous cases). There is less uniformity on the safeguards applying to money held by brokers, but separate accounts with trust status are required in at least two states where large commercial lines brokers are domiciled.
ICP 25 – Consumer protection	O	Departments have been increasing the scope of their consumer protection work in recent years, moving away from a traditional focus on financial issues (and handling of consumer complaints) to a more proactive approach to market conduct of insurers. Established regulatory tools from the financial area, and the model of cooperation and challenge between state insurance departments, have been extended to market conduct. This transition has further to go, however, particularly in respect of the ability of the departments to identify and respond quickly to wider market issues as well as problems at individual companies. As with producer licensing, there is a marked lack of uniformity across states in the market conduct area. However, core consumer protection requirements are apparently in place in most states.
ICP 26 – Information, disclosure and transparency toward markets	O	While there are no regulatory requirements in relation to disclosure, full financial information, including the actuarial opinion and auditor's statement, are readily available to stakeholders. This reflects the relative ease of access and concentration of data that has resulted from financial statements being submitted directly to the NAIC. However, there is scope to improve the availability of information to policyholders without access to databases, ratings, etc, while the NAIC should also consider reviewing the benefits of developing a set of explicit disclosure requirements.
ICP 27 – Fraud	O	While approaches vary by state, core requirements (such as making insurance fraud a crime) are in place across states. The capacity of departments to address fraud-related issues is increasing as market conduct exams are undertaken and the availability of data on fraud improves with the development of databases. Remaining gaps in the framework—for example, where departments do not require an anti-fraud plan from insurance companies—should be addressed as soon as possible.
ICP 28 –Anti-money-laundering, combating the financing of terrorism	PO	The authorities have only recently brought relevant insurance business within the scope of anti-money laundering regulatory requirements. Implementing the approach has taken time. There were significant gaps in the framework when the most recent FATF work was undertaken in 2006. The Internal Revenue Service (IRS), as the examination authority in this area, is now carrying out examinations. As its resources available for this work are limited, it is cooperating with state insurance departments to make use of their expertise. However, the effectiveness of cooperation between state and federal regulators is limited pending the consideration of legal issues arising from their collaboration and agreement of new procedures and information sharing arrangements. Both the federal government and state insurance departments wish to increase information sharing of examination information. This work has been given a high priority by the federal and state agencies but no deadline as yet. (A factual update on developments since the 2006 FATF work is being undertaken separately as part of the FSAP work.)
Aggregate: Observed (O) – 11, largely observed (LO) – 14, partly observed (PO) – 3, not observed (NO) –zero, not applicable (N/A) – zero.		

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E. Recommended Action Plan and Authorities' Response

Recommended action plan

Table 3. Recommended Action Plan to Improve Observance of the Insurance Core Principles

Principle	Recommended Action
ICP 1 – Conditions for effective insurance supervision	The authorities should (i) increase information-sharing and coordination between state regulators and federal authorities, including representation of state regulators in national bodies with responsibilities for system wide oversight and financial stability; (ii) agree policies and procedures for the regulation of systemically important institutions, markets and instruments, where assessed to exist in the insurance sector; and (iii) make new arrangements to increase the authority of federal authorities in relation to the implementation of international agreements.
ICP 2 – Supervisory objectives	Insurance departments, the NAIC and state legislatures should develop a clear, joint statement of the objectives of insurance regulation, taking into account good practice internationally, and align the objectives of individual state departments with these objectives. This work should address whether there are potential conflicts between existing objectives and how to manage them and the need to balance the objectives of achieving financial safety and soundness and consumer protection with the desirability of fostering market efficiency and competitiveness.
ICP 3 – Supervisory authority	The NAIC and state legislatures should make reforms including (i) providing for fixed terms to be standard for commissioner appointments, with dismissal mid-term to be possible only for prescribed causes and with publication of reasons; (ii) making departments fully self-funding, subject to continued accountability to and oversight by state legislatures, while allowing them greater flexibility to hire staff with specialist skills and reduce reliance on external experts; and (iii) extending the rule-making powers of departments to a wider range of technical issues (for example valuation and risk-based capital), and subject to appropriate consultation and requirements for due process.
	State laws should be changed, where this has not already been done, to extend the protection of information received from other government agencies to foreign agencies, which is essential to support the widest scope of information-sharing internationally. The NAIC and state legislatures should consider extending the protection of confidentiality, to the extent consistent with the wider legal environment, to all relevant information which is received by departments, rather than limiting protection according to the source of the information, as at present.

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Principle	Recommended Action
ICP 4 – Supervisory process	To further improve the transparency of its work, the NAIC should: (i) make publicly available some information that is currently available only on payment of a fee or by subscription (for example the NAIC model laws and material on how states have adopted them); (ii) publish summary information on their assessment of states' compliance with accreditation standards (even if scores remain private); and (iii) commit to publication on a regular basis (maybe every two years) of their self-assessment of compliance with IAIS Insurance Core Principles. These measures would help to foster improved understanding of state regulation and the role of the NAIC. In addition, the NAIC could also consider developing its approach to regulatory impact analysis and making such work a routine part of its analysis of proposed new or changed requirements.
ICP 5 – Supervisory cooperation and information sharing	The states and NAIC should continue to develop the network of MoUs. As mentioned in connection with ICP3, all state insurance departments should ensure that laws are updated to enable them to protect information received from foreign regulators. This will ensure that overseas regulators are not deterred from sharing information freely.
ICP 7 – Suitability of persons	Specific requirements in relation to individuals' fitness and propriety should be adopted. Gaps in the requirements of departments should be filled—companies should have to notify the department of concerns about the fitness and propriety of key individuals and departments should be able to disallow functionaries from holding two positions that could result in material conflict.
ICP 9 – Corporate Governance	As examiners gain experience, the NAIC and/or departments should consider issuing more guidance on good and bad practices in corporate governance for insurers. This would help examiners and firms to develop a clearer expectation of what constitutes effective governance for insurance business, including for groups.
ICP 10 – Internal controls	As examiners gain experience, the NAIC and/or departments should consider the scope for issuing guidance on good and bad practices in internal control. They should also make it a formal requirement for insurers to have an internal audit function. Such a function is now widely considered as an important part of a good control framework—similarly to audit committees, where there are now extensive requirements of all but the smaller insurers.
ICP 11 – Market analysis	Regulators should collect more complete group-wide consolidated data for insurance groups and broader financial conglomerates. They should develop further their analysis of developments outside the U.S. markets.
ICP 12 – Reporting to supervisors and off-site monitoring	Collection of group-wide consolidated data for insurance groups and broader financial conglomerate groups should be introduced.
ICP 15 – Enforcement or sanctions	The insurance laws should be changed to provide the supervisory authority with powers to fine individual directors and senior managers of insurers, and to bar them from acting in responsible capacities in the future.

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Principle	Recommended Action
ICP 17 –Group-wide supervision	U.S. supervisors should (i) include fuller assessment of the financial condition of the whole group of which a licensed insurance company is a member; this may involve quantitative techniques and practices in use internationally; (ii) extend the risk-focused approach to examinations of solo insurance companies to groups, again starting with U.S. groups—in effect extending the lead regulator and college of regulators arrangements already in widespread use for such groups within the framework developed by the NAIC; (iii) ensure that colleges of supervisors for the U.S. groups with major international operations are established and functioning effectively—and led by U.S. regulators with appropriate insurance expertise. It may also be desirable for insurance regulators to be given additional powers, such as clear authority to license insurance holding companies, apply insurance capital requirements to the consolidated insurance group and direct the insurance holding company to make changes at the group level to rectify any shortcomings.
ICP 18 –Risk assessment and management	The relevant laws, regulations or standards should be changed to include a requirement that an insurer have in place comprehensive risk management policies and systems capable of promptly identifying, measuring, assessing, reporting and controlling their risks.
ICP 19 – Insurance activity	The relevant laws or regulation should explicitly provide that an insurer must have in place strategic underwriting and pricing policies approved and reviewed regularly by the Board.
ICP 23 – Capital adequacy and solvency	For general transparency and for comparison, it is recommended that consideration be given to specifying a target safety level for reserving and an associated target safety level for capital. This should assist not only with peer comparisons of reserving and capital across insurers, but also comparisons against other insurance regimes internationally. Requirements to address inflation of capital through multiple gearing (i.e., holding company debt raisings injected as equity into insurance subsidiaries) should be included in the law, regulation or rules. Further development of stress testing could be considered, using the experience gained from exercises undertaken during the financial crisis.
ICP 24 – Intermediaries	Some strengthening of the approach to producer regulation is recommended: (i) to extend broker trust fund arrangements across states (where not already in place) to ensure that client funds are fully protected; (ii) to develop a uniform approach to the regulation of major brokers which reflects the important role which large brokers play in the commercial lines market; and (iii) to complete the current work on a consistent approach to the regulation of commission disclosure. In addition, producers should be required to make disclosures to customers of the status under which they are doing business, including which insurance companies have appointed them.
ICP 28 - Anti-money-laundering, combating the financing of terrorism	It is recommended that a timetable is set for the agreement and implementation of new arrangements between state insurance departments and federal authorities that will deliver greater resourcing of supervisory activities as well as necessary information exchange.

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Authorities' Response to the Assessment

28. The U.S. authorities welcome the opportunity to take part in the U.S. FSAP and the IMF's assessment of a high level of observance of the IAIS Insurance Core Principles (ICPs). It has provided insurance regulators in the United States with a timely opportunity to undertake a comprehensive self-assessment of the U.S. insurance regulatory system against international standards, and has contributed to ongoing internal reviews and assessments of regulatory practices. In addition, the FSAP has served as a useful platform for providing an overview of the U.S. insurance regulatory system and its multi-jurisdictional structure. The authorities appreciate the recognition by the IMF of the strengths in the regulatory system including areas that the IMF itself has coined as "world leading."

29. As recognized by the Report, it is important to consider the U.S. assessment in context. The assessment of the U.S. supervisory framework was undertaken in the wake of a severe financial crisis, and movements toward significant changes in supervisory practices have gained momentum as a result of the financial crisis and circumstances emanating from the crisis, including with respect to group-wide supervision. The IMF's assessment of U.S. compliance with ICP 17, the group-wide supervision standard, goes beyond the scope of the current ICP assessment in that it assesses compliance with a group supervision structure, which is still under discussion and development in most jurisdictions and within the IAIS, where revision of the insurance ICPs that may reflect these changes may not be finalized until 2011.

30. Insurance regulators in the United States are working with regulators around the world on initiatives to enhance group supervision, and have in place inter-regulatory cooperation processes, such as the use of lead state supervisory structures and the Financial Analysis Working Group of the National Association of Insurance Commissioners (NAIC). In addition, the Report acknowledges the comprehensive review underway with the Solvency Modernization Initiative which takes into account international and cross-sectoral practices in the analysis of possible additions or modifications to current insurance regulatory practices.

31. U.S. authorities remain strongly committed to prudential regulatory independence and accountability, including continually striving to improve ways to effectively balance these two objectives. Transparent rulemaking with opportunity for stakeholder involvement, for example, has proven a particularly effective way to provide accountability and improve the regulatory environment, while respecting regulatory independence. As reflected in the assessment of ICP 3, the Supervisory Authority standard, the assessment appears to rely on structural characteristics while failing to fully recognize the effective operational independence of state insurance regulators. In practice, the U.S. multijurisdictional approach to insurance regulation holds regulators accountable to each other in a peer review process that includes on-going nation-wide monitoring through the NAIC, regular dialogue among all regulators, and the ability of states to question the actions of fellow state insurance regulators.

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32. Within the assessment, there appear to be philosophical preferences for a principles-based, rather than rules-based, approach to regulation, yet assessment recommendations inconsistently apply those preferences by variously seeking more, as well as fewer, rules. Further, there appears to be no empirical evidence to suggest that one approach is superior to the other or that the choice of approach affects the U.S. regulators' ability to meet the standards set out in the various ICPs. U.S. authorities fully support a regulatory environment based on principles and made operational by rules that can provide consistent standards throughout the marketplace, yet remain flexible enough to adapt to new developments.

33. The IMF's assessment of ICP 28, the AML and CFT standard, identified some areas where U.S. AML requirements may be improved upon, but fails to fully recognize the robust protection provided U.S. citizens against money laundering activities. Of note, the United States has a bifurcated regulatory scheme regarding AML regulation. As noted, the federal government has primary jurisdiction of AML statutes while the regulation of insurance and expertise in financial examination of insurance is the responsibility of the states. Although both state and federal authorities have agreed to work together to review the current examination process, it is important to note and remember that an in-depth legal analysis has yet to be undertaken on this subject.

34. U.S. Authorities appreciate the assessment and will thoroughly review the Report's recommendations and take them into account when initiating and implementing any insurance regulatory reforms. We look forward to engaging in continuing ongoing dialogues with the IMF on how to best collectively improve international financial stability and supervision of the global financial services sector.

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II. Detailed Assessment

Table 4. Detailed Assessment of Observance of the Insurance Core Principles

Conditions for Effective Insurance Supervision	
Principle 1.	**Conditions for effective insurance supervision** **Insurance supervision relies upon**: - a policy, institutional and legal framework for financial sector supervision - a well developed and effective financial market infrastructure - efficient financial markets.
Description	Insurance regulation is carried out against the background of a highly-developed legal and institutional framework and mature and liquid financial markets. While insurance regulation is principally a responsibility of the states, there is a developed national framework of coordination across state insurance departments (see introduction to this assessment). Policy on wider financial sector issues, including the maintenance of financial stability, is handled at the federal level, in Congress and by relevant agencies of the executive branch, including the President's Working Group on Financial Markets. Certain federal legislation has regard to the insurance sector. For example, the 1999 Gramm-Leach-Bliley Act (GLBA), which established the framework for the regulation of cross-sector conglomerates, provides for federal regulation of conglomerates containing insurers, while preserving the regulation of individual insurance companies as a state responsibility. There is regular dialogue between the NAIC and federal banking supervisors, building on the increased cooperation that followed, and is required under, the GLBA. The provisions of the federal Bank Secrecy Act on anti-money laundering apply to certain insurance business (see assessment of ICP 28). However, because it is mostly a state responsibility, insurance regulation is not directly represented in federal discussions of wider financial sector issues, particularly financial stability policy. Expertise on insurance issues in the Treasury Department, although growing, has traditionally been focused on federal programs such as TRIA, and on insurance dialogues with foreign governments. During the financial crisis, to the extent that the insurance sector was affected, the monitoring of the sector and most of the action to address issues has been carried out by states. However, federal support for financial institutions under the Troubled Assets Recovery Program (TARP) has been extended to insurance groups, although only where there was a federal regulator (because the group also contained at least one institution federally chartered as a bank or thrift). The intervention in the insurance conglomerate American International Group (AIG), which also included a thrift, was undertaken by federal authorities. The administration and Congress are working on proposals for reform that would strengthen federal government capacity in insurance through a new office dedicated to insurance issues within the Treasury Department. One function of such an office may be to take the lead on international policy and coordination in relation to prudential supervision of insurance. Staff from state insurance departments and from the NAIC, rather than the federal government, negotiate in international fora on insurance regulation (but not on trade issues) at present, although under the U.S. constitution, only the federal government has powers to conduct foreign policy. The reforms may also result in some insurance groups being brought within the scope of federal

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regulation aimed at systemically important institutions. Insurance issues affecting financial stability would be handled by the Secretary of the Treasury, supported by the new office within the department, on a proposed new Financial Services Oversight Council of financial regulators which would be responsible for identifying emerging systemic risks and improving interagency cooperation.

These discussions on regulatory reform were continuing at the time of this assessment.

The legal and court system, at state and federal level, provide for disputes on insurance issues to be heard and resolved through enforceable decisions. There is extensive insurance expertise in the legal profession. Mechanisms for alternative dispute resolution are rare by comparison with many other countries. In respect of retail consumer complaints against insurance companies and intermediaries, a key focus of such mechanisms in other countries, departments themselves take a direct role in hearing and adjudicating on complaints and requiring companies and intermediaries to take appropriate action, where the department judges necessary.

There is also an extensive framework of accounting, actuarial and auditing standards and relevant professional bodies. Their standards are in compliance with international standards.

- Accounting for insurance assets and liabilities for regulatory purposes has to be undertaken using standards (Statutory Accounting Principles—SAP) developed under NAIC processes, codified in the NAIC's Accounting Practices and Procedures Manual (APPM) and implemented in state laws and regulations. Regular financial reports to the regulator must be drawn up using these standards. These are available to the public via insurance departments or the NAIC. U.S. GAAP accounting (FASB) standards also set out accounting requirements for insurance but applies only to publicly-traded insurance companies. There is extensive dialogue between insurance regulators, FASB and practicing accountants, particularly on the development of SAP.

- There is an extensive body of actuarial standards—ASOPs—set by the Actuarial Standards Board (ASB). This is a non-statutory self-regulatory body established by the five actuarial professional bodies to promulgate standards which actuaries must use when providing professional services in the U.S. ASOPs provide a principles-based framework to support professional advice, mainly in the form of guidance. They are not formally part of regulatory requirements (and may potentially conflict with such requirements) but reference is made to them in regulatory requirements such that actuarial work and opinions required for regulatory purposes must in practice comply with ASOPs.

- The requirement for use of ASOPs is contained in the (separate but identical) Codes of Professional Conduct which the professional bodies adopt and apply to members. Ethical standards are set and enforced by the professional bodies themselves.

- A separate body, the Actuarial Board for Counseling and Discipline (ABCD) hears disciplinary cases and makes recommendations for action to the professional bodies themselves. Since it began work in 1992, the ABCD has recommended severe sanctions (public reprimand or expulsion) in 18 cases. There is extensive cooperation between the actuarial profession and NAIC, particularly on technical issues.

- Auditing standards applicable to insurance are the same as for companies generally—for publicly-traded companies, those of the Public Company Accounting Oversight Board (PCAOB), as modified or supplemented by the SEC; and for others, those of the Auditing Standards Board of the American Institute of Certified Public Accountants (AICPA). PCAOB standards are applied and enforced by the PCAOB on auditors of publicly-traded companies under the Sarbanes-Oxley Act of 2002. The AICPA requires members to use its standards

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	through its binding Code of Professional Conduct. Accounting, actuarial and auditing standards are publicly available. Insurance departments monitor the quality of accounting, actuarial and auditing work and report individuals and firms to professional bodies where they have serious concerns. Regulatory standards and practices are updated to reflect market wide concerns—for example, disclosures have been extended in response to concerns over potential under-reserving in certain business lines. There is a generally an adequate supply of professional services available to support the business of insurance and insurance regulation. There are over 16,000 members of the actuarial profession. There is wide availability from public sources of the basic economic, financial data and social statistics relevant to insurance and insurance regulation. For example, data on mortality are made available by the actuarial bodies. The money and securities markets provide for the variety of short and long term instruments necessary to back insurance liabilities—with some exceptions, as in other countries, for example in relation to the particularly long term liabilities associated with some annuity contracts.
Assessment	Largely Observed
Comments	The preconditions for effective insurance supervision are generally met—reflecting the highly developed legal and institutional framework within which it operates and the scale and liquidity of U.S. financial markets. But there is a need for some development of the policy framework in relation to insurance and financial stability and international issues. Because insurance regulation is state-based, whereas the broader regulatory and financial sector policy framework, including international relations, falls to federal authorities, there is a risk of a lack of coordination on insurance regulatory matters. This risk arises particularly in relation to the impact of insurance groups and the insurance market on system wide stability, where there are at present no explicit responsibilities or coordination arrangements. On international insurance regulatory issues, there is a mismatch between the authority reserved to the federal government to enter into international agreements and that of the states to regulate the insurance sector, taking account of such agreements. This has not prevented sensible and practical arrangements, for example to enable states and the NAIC to contribute their expertise to the negotiation of international agreements. However, current arrangements have led to some ambiguity and uncertainty, particularly outside the United States, about the status of the NAIC and state regulators in relation to international agreements. In this context, there is a need for: (i) increased information-sharing and coordination between state regulators and federal authorities, including representation of state regulators in national bodies with responsibilities for system wide oversight and financial stability; (ii) agreed policies and procedures for the regulation of systemically important institutions, markets and instruments, where assessed to exist in the insurance sector; and (iii) new arrangements to increase the authority of federal authorities in relation to the implementation in the United States of international agreements.
The Supervisory System	
Principle 2.	**Supervisory objectives** The principal objectives of insurance supervision are clearly defined.
Description	There is no single statement of supervisory objectives for insurance regulation across the states. The 1945 McCarran-Ferguson Act, which returned regulatory jurisdiction over "the business of insurance" to the states, while exempting it from most federal antitrust law to the extent that it was

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	regulated by state law, did not set out regulatory objectives. Nor are regulatory objectives generally set out explicitly in state legislation (i.e., in the insurance codes of individual states). As it is not itself a regulator, the NAIC's objectives are expressed in relation to its role in providing assistance and support for state regulators in achieving their goals. Insurance departments express their objectives (or mission) individually and differently, for example on their websites. The protection of consumers of insurance products is central to all departments' understanding of their role. This is usually defined as ensuring the financial soundness of insurance companies, so as to limit consumers' exposure to loss due to financial failure, and promoting appropriate standards of market conduct (by companies and producers). The focus on consumer protection is reinforced in the NAIC's accreditation process with its objectives of ensuring there are "adequate solvency laws and regulations in each state to protect insurance consumers." In addition, individual departments have objectives such as: the maintenance of competitive insurance markets; eliminating fraud, other criminal abuse or unethical conduct in the industry; focusing on consumers' needs for affordable and available products; and fostering the development of the insurance industry. The McCarran-Ferguson Act's focus on the application of federal antitrust law informed an early emphasis in insurance regulation on promoting competition but the approach to consumer protection has since greatly widened. Many states now have a role in ensuring that insurance is available to consumers when private markets are unable or unwilling to underwrite risks—through the organization of "residual markets" (see the introduction to this assessment) or through subsidies and other support for particular risks, such as health cover for certain otherwise hard to insure or uninsurable groups. Some states assign development of the insurance sector (including attraction of more companies to do business in the state) to insurance departments—because that is where insurance expertise is located. Insurance departments generally explain how their activities support different objectives. Funding arrangements make significant deviations from objectives unlikely. Budgets allocated to departments by legislatures are linked to particular tasks—such as examinations or direct consumer services—which link back to objectives. Departments may draw attention to conflicts between objectives (for example, between consumer protection and industry development), where new objectives are under discussion.
Assessment	Largely Observed
Comments	The objectives of departments are generally not established explicitly by law. They reflect the evolution of their roles and responsibilities over the years since the McCarran-Ferguson Act, the risks and challenges in insurance business in different states and the political preferences of state legislatures. The close cooperation of departments through the NAIC processes has helped align core objectives. Departments have a clear understanding that their primary role is to promote consumer protection and the role of departments in this regard appears to be well-understood by the industry and by consumers. However, there are differences in the ways individual departments view their objectives, which may hamper moves toward greater uniformity of state regulation and limit understanding of U.S. insurance regulation, both domestically and abroad. There is also some scope for conflict of objectives, in particular given states' financial interests in attracting more insurance business. There should also be an explicit acknowledgment of the need to balance the objectives of achieving financial safety and soundness and consumer protection with the desirability of fostering market efficiency and competitiveness.

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	Departments, the NAIC and state legislatures should develop a clear, joint statement of the objectives of insurance regulation, taking into account good practice internationally, and align the objectives of individual state departments with these objectives. This work should address whether there are potential conflicts between existing objectives and how to manage them.
Principle 3.	**Supervisory authority** The supervisory authority: - has adequate powers, legal protection and financial resources to exercise its functions and powers - is operationally independent and accountable in the exercise of its functions and powers - hires, trains and maintains sufficient staff with high professional standards - treats confidential information appropriately.
Description	State legislation clearly identifies authorities – state insurance departments for most insurance supervisory work (other authorities, including at federal level, also have certain supervisory responsibilities). Insurance departments have extensive powers to license, supervise and take enforcement action against insurance companies. They also have powers to make rules—mostly in the form of regulations covering many detailed requirements under delegated authority from state legislatures. The legislatures themselves enact most of the principal regulatory requirements. Insurance departments have wide-ranging powers to enforce their own rules and state laws (see ICPs 14 to 16). Departments can and do take urgent action—including using receivership powers against companies—where required to protect policyholders. Governance structures at insurance departments vary (for example, to take account of whether the Commissioner is elected or appointed—see below). But in all departments, authority to exercise functions and use powers under state law and regulations is granted to the commissioner, i.e., to an individual rather than a body such as a Board of Directors or commission. (Some state laws also give certain authority explicitly to a chief examiner). Departments have varying approaches to internal control. Powers may be delegated, for example to the chief examiner. Many departments have their own internal auditor (reporting direct to the commissioner) and all are subject to the audit arrangements of the state administration. There are explicit procedures for the appointment of commissioners: 12 of the 56 are directly elected and the others are appointed by the state governor, with the advice and consent of the state senate, generally to hold office until the term of office of the appointing governor expires. Appointed commissioners hold office at the governor's pleasure—and can therefore be dismissed at any time. Relationships with the legislature and executive authorities are clear—legislatures enact state laws and generally set spending limits (see below). Departments are accountable to legislatures as well as state governors and produce annual reports to legislatures on their activities (which are also publicly available). In general, insurance departments act independently of both state legislatures and other state executive offices in their day to day regulation. Powers are vested in the commissioner and there are no decisions that require the involvement of executive officers outside the department, for example. Independence from other executive officers may be greater where the commissioner is elected. As parts of state administrations, all departments are subject to state budgetary authority. Spending limits are set by the state legislature. Departments also collect a large amount of revenue for the states—totaling over US$18 billion in 2008. The largest element, the state insurance premium tax, is passed in full to the general fund of

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	the state but other elements (fees and assessments) are in most states retained by departments as funding for their regulatory and other operations. Fines and penalties usually go into the state's general fund. In many states, amounts raised in excess of spending limits may be retained and used to build up a reserve (this approach is known as a "dedicated funding system"); in other states, excesses must be passed to the state general fund (a "quasi-dedicated system"). Shortfalls in revenue collection have to be addressed through spending cuts or by transfers from reserves. In practice, however, legislatures and governors generally determine spending limits according to current priorities and financial conditions independent of the availability of dedicated funding. Some departments have, for example, experienced significant cuts in spending because of the effect of economic recession on state finances. There are limits on departments' discretion to allocate resources as they choose. Some state legislatures restrict certain funding to particular purposes or programs. For example, funds allocated to direct consumer services (handling complaints, for example) may not be used for the regulation of firms—or vice versa. Departments have substantially increased resources in recent years. Total budget for all the departments was US$1.6 billion in 2008, a 50 percent increase on the 2002 level, and staff totaled over 11,905 at the year end. Many contract staff and staff from other agencies are also used—totaling a further 1,325. (Detailed data on staff numbers, grades and pay ranges by state are published annually in the NAIC Insurance Department Resources Report.) In addition, the NAIC employs just over 400 staff, many of them in IT support for the extensive NAIC databases. The adequacy of state staff resources is considered under the accreditation process. Overall resources are greater, in proportion to the size of the market, than at any other national insurance regulator in G–7 markets, although comparability among departments and with other regulators globally is hampered by the wide and varying functions, regulatory and other, undertaken by departments. Resources appear adequate for core tasks, including financial analysis and examinations. But departments face some pressures to recruit and retain more highly skilled staff—qualified actuaries for example, and staff equipped for the demands of a more risk-focused approach to supervision (see ICP 13). The accreditation standards include an expectation that departments have specialist resources and that these are used on examinations of more complex companies or where there are concerns about financial condition. Departments are able to hire external experts and outsource work to supplement staff resources, where legislation specifically permits it—in particular to support examinations (the model law specifies a wide range of professional competencies) or action taken in response to a breach in minimum RBC requirements (a Regulatory Action Level event—see ICP 14). Staff remuneration is generally linked to the general pay grades for state employees. Some states have limited flexibility to pay above normal rates to meet particular needs. Most are free to pay market rates for consultants for examination work, for which costs are charged to companies. Partly as a result, use of experts is particularly common for examinations. External experts are subject to the same confidentiality requirements, under the terms of their contracts, as staff in respect of their work for insurance regulators. Staff have legal protection from lawsuits resulting from specific actions taken in the course of regulatory work. For example, the Model Law on Examination, #390, provides for immunity from liability for statements made or conduct performed in good faith while carrying out the provisions of the Act. Insurance departments protect staff from the costs of defending their actions, where this is necessary. Insurance supervisory work, like administration generally in the United States, is subject to a strong presumption that information should be made publicly available, absent specific provisions

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	requiring confidentiality. The ability of departments to maintain the confidentiality of relevant supervisory information varies. Information gathered from companies using the powers of examination is protected in all states as are RBC returns (the accreditation process addresses this issue). All states are able to protect information received from other government agencies, including other state regulators ("derivative confidentiality"). Following an NAIC initiative in 2000 on confidentiality and information sharing internationally, provisions of several model laws were changed to provide for the protection of information received from international regulators.
Assessment	Partly Observed
Comments	While the vesting of regulatory powers in the commissioner in principle ensures that departments are operationally independent, the ability of the governor in most states to dismiss commissioners at any time, and without a public statement of reasons, exposes departments to potential political influences. Elected commissioners may be subject to the pressures of the electoral cycle. In addition, departments are dependent on state legislatures in respect of principal legislation (where they compete for time with many other state legislative priorities) and for budgetary resources, which cannot always be allocated according to the departments' own regulatory priorities (although income from examination work charged to companies can mitigate budgetary pressures). Departments are exposed to budgetary cuts during economic downtowns, when workloads tend to rise. The use of statewide remuneration policies constrain departments' ability to hire specialist skills and can result in extensive and (for companies being examined) costly reliance on external experts, including consultants. The NAIC and state legislatures should make reforms such as (i) providing for fixed terms to be standard for commissioner appointments, with dismissal mid-term to be possible only for prescribed causes and with publication of reasons; (ii) making departments fully self-funding, subject to continued accountability to and oversight by state legislatures, while allowing them greater flexibility to hire staff with specialist skills and reduce reliance on external experts; and (iii) extending the rule-making powers of departments to a wider range of technical issues (for example valuation and risk-based capital), and subject to appropriate consultation and requirements for due process. This last approach may also help deliver faster implementation of NAIC model laws. State laws should be changed, where this has not already been done, to extend the protection of information received from other government agencies to foreign agencies, which is essential to support the widest scope of information-sharing internationally. The NAIC and state legislatures should consider extending the protection of confidentiality, to the extent consistent with the wider legal environment, to all relevant information which is received by departments, rather than limiting protection according to the source of the information, as at present.
Principle 4.	**Supervisory process** The supervisory authority conducts its functions in a transparent and accountable manner.
Description	Laws and regulations are developed, at state level and at the NAIC (for model laws), through an open process that allows for extensive input from interested parties, and opportunities to influence decisions, at both state and national levels. Administrative measures (including regulations made by departments under authority from legislatures) are subject to Administrative Procedures Acts in each state which require departments to publish proposed rules and regulations and accept public comment. There is no requirement for quantitative analysis of the costs or benefits of proposed new requirements (or regulatory impact assessment of any kind). Such work is carried out occasionally rather than routinely. All laws and regulations of individual states are published and accessible on relevant websites and are updated as requirements change. In this respect, departments are bound by state policies and

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	procedures which mandate a high degree of openness and availability of information. The NAIC is similarly committed to openness and model acts and other material are available, although for the most part only on payment of a fee. Summary information on the NAIC's accreditation process is publicly available—a 14 page pamphlet sets out the standards and processes. This publication mentions that all states and the District of Columbia are currently accredited. However, reports and scores relating to individual departments are not available to the public (even states themselves see only the reports and not the scores). The NAIC also publishes: • a report, Model Laws, Regulations and Guidelines, which includes, for each instrument, a "state action page" citing each state's enacted model or similar and related legislation. This makes it possible to monitor differences between model laws and state measures; and • a Compendium of State Laws on Insurance Topics which sets out in chart form state laws on specific issues, allowing cross-state comparison by topic. These publications are available for a fee. The NAIC carries out periodic self-assessments of the compliance of U.S. regulation with IAIS Insurance Core Principles. However, until recently, the most recent published self-assessment related to 2001 and the version of the Insurance Core Principles issued in October 2000, which has since been revised and extended. Within individual departments, governance arrangements (which differ by state) are in place to maximize consistency of decision-taking. Key decisions may be delegated to chief examiners or referred to the commissioner only with the evidence of sign off from all relevant departments and officers. Decisions on the use of regulatory powers are subject to appeal and to judicial review. This is provided for by individual model laws. Companies may also appeal against findings in draft examination reports. Initial appeals are normally to the commissioner but may be heard by other senior staff in the department (not the relevant analyst or examiner); or an officer may be designated in law to hear appeals. Beyond that, cases can be litigated through the courts. (See in particular NAIC Model Regulation to Define Standards and Commissioner's Authority for Companies Deemed to be in Hazardous Financial Condition, section 4 C, which gives an insurer a right to a hearing; and section 5, which prescribes judicial review of any order or decision of a commissioner in relation to this regulation; the Insurance Holding Company System Model Act (#440) by contrast provide for judicial review on commissioner decisions on application to a court). Separate procedures apply in the case of receiverships—see Insurer Receivership Model Act, section 205, which provides for appeal to the receivership court. Once a receivership decision is confirmed by the court, departments are not required to await the outcome of an appeal before appointing a special deputy receiver to manage the company. Internal processes allow for urgent decision-taking where required to expedite action that is required to meet regulatory objectives. Regulatory actions are published. A number of model laws and regulations give commissioners discretion to exempt insurers or transactions from requirements by order or regulation (see for example, section 4 J of the Insurance Holding Company System Model Act (#440)). In the area of accounting, departments may, on application of an insurance company, agree to a modification of requirements. These "permitted practices" are published in full by individual companies, including the impact of the modification on surplus, and in some years have been published on the NAIC's website soon after the end of the year to which they relate.

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	The departments publish annual reports on activities and performance. The NAIC publishes both an annual report and the Insurance Department Resources Report which catalogues resources available to individual state departments and regulatory actions taken in the course of the year. Information on the role of the departments is made available on websites and the role of most departments in handling consumer complaints has promoted an awareness of their regulatory role in protecting consumers.
Assessment	Largely Observed
Comments	Insurance regulation is carried out openly and transparently, with clear accountability to the state administration and legislature and rights of appeal (and judicial review) which balance the need for due process with the importance of regulators being able to act swiftly and decisively where necessary to achieve regulatory objectives. However, measures could be considered to foster improved understanding of the work of the states and NAIC and to increase regulatory impact analysis. In particular, the NAIC should: (i) make publicly available some information that is currently available only on payment of a fee or by subscription (for example the NAIC model laws and material on how states have adopted them); (ii) publish summary information on their assessment of states' compliance with accreditation standards (even if scores remain private); and (iii) commit to publication on a regular basis (maybe every two years) of their self-assessment of compliance with IAIS Insurance Core Principles. These measures would help to foster improved understanding of state regulation and the role of the NAIC. In addition, the NAIC should develop its approach to regulatory impact analysis and make such work a routine part of its analysis of proposed new or changed requirements.
Principle 5.	**Supervisory cooperation and information sharing** The supervisory authority cooperates and shares information with other relevant supervisors subject to confidentiality requirements.
Description	There is extensive sharing of information between individual insurance departments and between departments and the NAIC. The NAIC developed a Master Information Sharing and Confidentiality Agreement for its members, into which all states have entered. The accreditation process assesses whether departments have policies and procedures for sharing information. The standard requires that information be shared with regulatory officials of any state, federal agency or foreign country providing that the recipients are required, under their law, to maintain its confidentiality. The extension to foreign countries followed an NAIC initiative to update the confidentiality and information sharing provisions of several key model laws to allow for the sharing of information with international regulators. Specifically, the Model Examination Law, Standard Valuation Law, Risk-Based Capital For Insurers Model Act and Insurance Holding Company System Regulatory Act were revised. There is extensive information sharing with federal agencies. These include banking supervisors (particularly in relation to the nine groups with bank holding companies regulated by the Federal Reserve and the 42 groups which also contain a thrift regulated by the Office of Thrift Supervision). A Joint NAIC/Federal Banking and Thrift Regulatory Agencies Forum meet quarterly. There is also cooperation with federal authorities responsible for the various government programs—Treasury Department (TRIA), FEMA (flood insurance), Department of Agriculture (crop insurance), and the Department of Labor (workers compensation). Generally, however, departments, and particularly the NAIC whose involvement results from its role in managing the extensive databases on insurance companies across the country, provide information to these agencies in a one way flow. The amount of reciprocal exchange and discussion of issues is limited—except where events force such exchanges. There were, for example, extensive exchanges in relation to the crisis at AIG and in its aftermath.

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	There is no requirement for the signing of a Memorandum of Understanding or other formal agreement prior to sharing of information with another supervisor, domestic or foreign. The scope of information exchange can be wide, encompassing confidential financial data and factual material on companies, their officers etc. There is no requirement for reciprocity of information exchange – departments will exchange information without requiring information to be provided in return. Departments have to ensure that the recipient of information can keep it confidential before releasing the information. In respect to information-sharing with foreign regulators, the NAIC has developed with the EU a model information sharing agreement for use as a basis of bilateral MoUs generally. All MoUs are signed with foreign regulators directly by individual insurance departments. The current body of MoUs reflects the key international relationships in respect of major global groups with operations in the United States and major U.S. companies' operations abroad. MoUs are also in place between some states for which global reinsurance providers are of particular importance (because of the significance of catastrophe risks) and the countries where the global reinsurance companies are located. However, departments would exchange information on request with other regulators provided that they are assured it will be treated as confidential. Partly because many MoUs have been put in place in response to particular needs for regular information exchange relating to particular groups or markets, such exchanges are taking place, bilaterally and, in some cases, within the framework of supervisory colleges. These actual exchanges at present focus on these particular needs—and departments are not likely to take the initiative to inform home or host supervisors of changes in supervisory practice that would affect relevant groups. They would inform home or host regulators in advance of taking regulatory action, taking into account the materiality and likely impact of the action in the other jurisdiction.
Assessment	Largely Observed
Comments	Although the main focus of information exchange with other regulators has traditionally been on cooperation with other insurance departments, regulators are able to share information with relevant federal authorities and with regulators abroad. There is a need to continue developing the network of MoUs. Many have been put in place only recently and the network is not comprehensive. As mentioned in connection with ICP 3, all state insurance departments should ensure that laws are updated to enable them to protect information received from foreign regulators. This will ensure that overseas regulators are not deterred from sharing information freely.
The Supervised Entity	
Principle 6.	**Licensing** An insurer must be licensed before it can operate within a jurisdiction. The requirements for licensing are clear, objective and public.
Description	The insurance business that requires licensing is defined, for each state, in the state insurance codes, in terms of lines of business that are permitted to be undertaken. States adopt broadly similar, but not uniform approaches. The scope of the licensing requirement is broad and covers most of what would generally be regarded as insurance business. Typical exclusions are product warranties, certain pet insurance and prepaid funeral plans. Entities owned by state governments that write insurance business may be subject to licensing requirements but this varies by state as do miscellaneous exemptions, for examples for certain charitable organizations. Life insurance must be undertaken in a different corporate entity from property and casualty business (there is one company which still operates as a composite, having been subject to grandfathering when the new approach was introduced). Insurance companies may be established

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	as corporates or as mutual companies. Under state insurance law, there are few restrictions on a licensed insurer's ownership by, or affiliation with, other financial or non-financial companies provided the owner meets criteria through the regulatory approval process. An exception is a widespread prohibition on foreign government ownership of an insurer. Insurance companies generally have to obtain a license (known as a certificate of authority) to conduct business from each jurisdiction in which the company wants to underwrite insurance. The exceptions are surplus lines business (see introduction to this assessment) and reinsurance, where provided the company has a license in one state, it can undertake business in other states without a separate license (it may be subject to other requirements of the host state in which it is writing business). Insurance companies based outside the United States have to be licensed in the states in which they propose to write business, whether as a subsidiary or a branch. Reinsurance may be written directly by an overseas reinsurer with a primary insurer based in the United States (although it may not attract credit in the primary insurance company's financial statements). Departments consult with the home supervisor before licensing a company (or a company with a parent) based outside the United States and obtain necessary information on the status of the company and the business which it is licensed to write in the home market. Minimum conditions for licensing are set out in state legislation. There is no NAIC model law on licensing nor is licensing covered by the accreditation process at present. New accreditation standards related to company licensing have been agreed and will take effect on January 1, 2012. Requirements in state law generally refer to minimum ongoing requirements—for example, that applicants meet the requirements for surplus funds set out in the general requirements. There may be certain overriding criteria that are less objective in nature—for example enabling the commissioner to refuse to issue or renew a license if such refusal is judged to promote the interests of the people of the state. The NAIC has developed a standard form and process for application – the Uniform Certificate of Authority Application (UCAA), which all states accept for all lines of insurance except Health Maintenance Organizations (HMO). Under the UCAA arrangements, a distinction is made between: • a primary application—where a company is applying to establish for the first time as a corporate entity in a state or is moving its corporate location to that state ("redomesticating"); and • an expansion application—where the company is already licensed in one state and wishes to do business in another. • The process provides for more time to consider a primary application (90 days) than an expansion application (60 days)—in both cases, more time may be required, and if so, will be taken in practice. • The UCAA is a NAIC guideline and not a model law. Individual states may impose additional licensing requirements. Under the UCAA process, applications must include information that will enable insurance departments to assess the standing and financial condition of the insurance company. Information has to be submitted covering: the business profile of the applicant; any management offices that exercise control over insurance operations and any operation that is delegated to an affiliate or third

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	party; the plan of operation setting out the product lines planned by the applicant. The applicant must submit a "Biographical Affidavit" on behalf of all officers, directors and key managerial personnel of the applicant and individuals with a ten percent (10 percent), or more, beneficial ownership in the applicant and the applicant's ultimate controlling parent (see ICP 7). In considering applications for licenses, departments investigate litigation, criminal, Uniform Commercial Code and bankruptcy records in respect of these officers. Typically, at least one business character reference must be obtained for each individual, such as from an attorney, partner or other business associate familiar with the business dealings of the individual. Some states require additional information including fingerprints in the license application. States require various degrees of experience to fulfill state seasoning requirements before an insurer can be licensed to conduct business. Time periods may be reduced for special exceptions or if an applicant demonstrates sufficient business experience. • The UCAA also requires that the applicant show it meets each state's statutory minimum paid-in capital and surplus requirements. The level of surplus required is determined after considering the applicant's product line, operating record and financial condition. Additional surplus above the statutorily prescribed minimum may be required of individual applicants. • Applications for expansion or redomestication must include a copy of the most recent Annual Statement, actuarial opinion, audited report performed by a CPA who is not an employee of the applicant. • If an applicant, its parent or its ultimate holding company is publicly traded, it has to submit a copy of the applicant's most recent U.S. GAAP consolidated financial statements. Applicants who are members of a holding company system (see ICP 17) have to include a comprehensive debt-to-equity ratio statement. A summary of the applicant's reinsurance program, listing all reinsurance agreements and providing a basic explanation of each agreement also has to be included with the application.
Assessment	Observed
Comments	While approaches in individual departments vary, the core requirements embodied in the UCAA process adopted by all states represent a comprehensive set of requirements and processes for insurance company licensing. (See ICP 24 on producer, i.e., intermediary, licensing). Differences between state requirements, on licensing and other issues, could in principle encourage companies to choose for their domestic regulator a state with less onerous requirements and to redomesticate as individual state requirements or their business needs develop. In practice, departments and the NAIC staff appear alert to these risks and, for example in relation to redomestication applications, consult with the previous domestic state on the circumstances of the application before agreeing to a license. The system of retaliatory taxes may discourage redomestication for tax reasons. The number of redomestications is monitored—at an average of 50 per year in 2006–8, it is less than 1 percent of the total of nearly 8,000 companies at end-2008. The extension of the accreditation process to licensing standards in 2012 should nonetheless provide assurance that the core licensing requirements are being complied with in practice by state departments.

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Principle 7.	**Suitability of persons** The significant owners, Board members, senior management, auditors and actuaries of an insurer are fit and proper to fulfill their roles. This requires that they possess the appropriate integrity, competency, experience and qualifications.
Description	Departments focus on the fitness and propriety of significant individuals in the course of reviewing applications from new companies and in their examination work in respect of licensed companies. There are no requirements for individuals themselves to seek authorization or approval (licensing of producers, by contrast, is done on an individual basis). Nor are there detailed provisions in law defining when an individual will be regarded as fit and proper. In relation to significant owners, departments' requirements are based on the Insurance Holding Company System Model Act (#440), which in Section 1 defines control in terms of "the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person." In addition, "Control shall be presumed to exist if any person, directly or indirectly, owns, controls, holds with the power to vote, or holds proxies representing, ten percent (10 percent) or more of the voting securities of any other person." Fitness and propriety is assessed at application and on change of control (see ICP 8). The process for considering individuals in connection with applications is described under ICP 6. On an ongoing basis, licensed insurers are required to report changes in officers, directors and key managerial personnel. After such changes are reported, supervisors may then request biographical affidavits for newly appointed officers, directors and other key management personnel. There is no specific requirement on companies to notify the department when they become aware of issues in relation to the fitness and individual of a key functionary. As part of the on-site examination process conducted at least once every five years, the suitability of the Board of Directors, management, auditors and actuaries is assessed. The approach to be taken is set out in the Financial Condition Examiners Handbook, which is publicly available for a fee. This assessment focuses on the independence, experience and background and ethics of these individuals and functions. Individuals are interviewed to assess suitability. If deficiencies are identified, the examination team makes recommendations for improvements to the insurer and adjusts its ongoing solvency monitoring of the insurer accordingly. Through the use of tools such as increased reporting requirements or more frequent examinations, regulators aim to provide a strong incentive for the insurer to make changes in those areas where unsuitable individuals are identified. Where an insurer is deemed to be in a hazardous financial condition, the department can use specific powers under their implementing measures to order companies to "adopt and utilize governance practices acceptable to the commissioner." (Model Regulation to Define Standards and Commissioner's Authority for Companies Deemed to be in Hazardous Financial Condition, #385). Requirements as to the integrity, competency, qualifications and experience of the company's appointed actuary are included in the NAIC Actuarial Opinion and Memorandum Regulation (#822) for Life Insurers and in the NAIC Annual Statement Instructions for Property & Casualty Insurers. Adoption of these two items is required under the accreditation program. This guidance requires insurers to utilize an appointed actuary who is a member in good standing with either the American Academy of Actuaries or the Casualty Actuarial Society. The guidance also prohibits actuaries who have committed specific violations from acting as the appointed actuary. Departments refer concerns about particular actuaries to the professional bodies. Under the NAIC Annual Financial Reporting Model Regulation (#205), which is covered by the accreditation standards, departments impose independence and experience requirements on auditors, but do not prior approve appointments of auditors. However, departments can prohibit auditors who have committed specific violations or who do not meet other qualification standards

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	from performing insurance company audits. As part of this process, the auditor must submit a letter of qualifications indicating their knowledge and experience in the industry to the supervisor on an annual basis. Departments may also refer CPAs, where they have concerns, to their professional body (the American Institute of Certified Public Accountants) or to the state's Board of Accountancy which has oversight responsibility for audit work (the PCAOB covers auditors on publicly-traded companies). There are no specific provisions enabling departments to disallow actuaries, auditors and senior managers from simultaneously holding two positions that could result in material conflict. Departments would use powers and procedures described above to prevent or rectify such conflicts based on their assessment of circumstances at each firm.
Assessment	Largely Observed
Comments	Departments take a view on all significant owners, Board members, senior management, auditors and actuaries and take appropriate action where concerns arise. However, the approach is based on assessment of the fitness and propriety of key functionaries at the point of application for a license, and on an ongoing basis through the examination process, rather than the approval of individuals (which is the approach taken in some other countries). Specific requirements in relation to individuals' fitness and propriety should be adopted. There are also gaps in the specific requirements—companies do not have notify departments of concerns about the fitness and propriety of key individuals and departments cannot disallow functionaries from holding two positions that could result in material conflict.
Principle 8.	**Changes in control and portfolio transfers** The supervisory authority approves or rejects proposals to acquire significant ownership or any other interest in an insurer that results in that person, directly or indirectly, alone or with an associate, exercising control over the insurer. The supervisory authority approves the portfolio transfer or merger of insurance business.
Description	Change in the control of an insurance company is subject to supervisory approval process performed during the off-site monitoring process as required by the NAIC Insurance Holding Company System Regulatory Act and Insurance Holding Company System Model Regulation with Reporting Forms and Instructions (#440 and #450). Adoption of these two models is required under the accreditation program. Section 1 of the Act defines control in terms of "the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person." In addition, "Control shall be presumed to exist if any person, directly or indirectly, owns, controls, holds with the power to vote, or holds proxies representing, ten percent (10 percent) or more of the voting securities of any other person." Fitness and propriety is assessed at application and on change of control (see the assessment of ICP 8). The model laws require departments to evaluate a potential acquirer of control for compliance with fit and proper requirements. The acquiring individual or entity is required to complete the Acquisition of Control Form (Form A) requiring background information of each applicant. The proposed acquisition is approved by the domestic supervisor. There are minimum requirements for resources, both financial and non-financial, and a requirement that background information on applicants is provided. In addition, there are requirements to ensure that adequate competition continues after a change of control and to make sure that policyholders are not adversely impacted. Within the Holding Company Act, regulators have clear criteria for denying a change in control. The Act provides that regulators can deny an application for change of control for any of the

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	following: • After the change of control, the domestic insurer referred would not be able to satisfy the requirements for the issuance of a license to write the line or lines of insurance for which it is presently licensed; • The effect of the merger or other acquisition of control would be substantially to lessen competition in insurance in the state or tend to create a monopoly; • The financial condition of any acquiring party is such as might jeopardize the financial stability of the insurer, or prejudice the interest of its policyholders; • The plans or proposals which the acquiring party has to liquidate the insurer, sell its assets or consolidate or merge it with any person, or to make any other material change in its business or corporate structure or management, are unfair and unreasonable to policyholders of the insurer or not in the public interest; • The competence, experience and integrity of those persons who would control the operation of the insurer are such that it would not be in the interest of policyholders of the insurer and of the public to permit the merger or other acquisition of control; or • The acquisition is likely to be hazardous or prejudicial to the insurance-buying public. These requirements cover acquisition of control, whether the party proposing to acquire control is located inside or outside the state, or outside the United States. The NAIC recently adopted accreditation standards related to change in control and these standards will become effective January 1, 2012. The standards relate to a state insurance department's review of the Form A filing. The standards will require that the filing be reviewed in a timely manner and that the department have sufficient, qualified staff to perform this review. Further, the standards require that the state have appropriate and sufficient procedures to perform this review, including an analysis of many of the items discussed above. It also requires use of the Form A database, which is a communication tool on these filings used by the state insurance department to collect and organize information. **Portfolio transfers** The Holding Company Act requires that the domestic insurance department must be notified of major transactions with affiliated entities, which departments interpret as including material portfolio transfers between related parties. Assumption reinsurance and bulk reinsurance statutes establish thresholds by which material transfers of all or most of an insurer's business, either in total or within a specific line, are subject to review and approval. In some cases, such transfers may be subject to approval by non-domestic state regulators. Also, state laws concerning the cancellation and non-renewal of an entire book of business or specific line of business may require the insurer to provide notice and/or seek approval from state regulators for transfers of business. Insurers are also required to provide notice to their policyholders of such transfers. The NAIC Disclosure of Material Transactions Act (#285) requires insurers to report to their domestic regulator other significant asset and reinsurance transactions that otherwise may not have been subject to approval. These approval and notification requirements may prompt additional inquiry and assessment by regulators and possibly disapproval of such transactions.
Assessment	Observed
Comments	There are extensive requirements and related reporting forms governing changes in control and

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	portfolio transfers.
Principle 9.	**Corporate governance** The corporate governance framework recognizes and protects rights of all interested parties. The supervisory authority requires compliance with all applicable corporate governance standards.
Description	Corporate governance standards for publicly-traded U.S. companies, including insurers, are set and enforced by the SEC, including requirements in relation to expertise and independence for the audit committee as well as requirements to maintain effective internal controls over financial reporting. Provisions based on SEC requirements will be introduced for all insurance companies through revisions to the NAIC Annual Financial Reporting Model Regulation (#205), which take effect in January 2010. (See ICP 10). There are currently no NAIC model laws or regulations that address corporate governance directly. Departments assess governance mainly in the context of applications for licenses from new insurers and producers, in requiring and reviewing annual statements, in conducting examinations, in approving mergers or other changes of control involving domestic insurers, and in the assessment of solvency. Of increasing importance in this regard is the risk-based examination process. Under the relevant provisions of the Financial Condition Examiners Handbook, examiners must consider and evaluate the insurer's corporate governance and risk management processes. Discussions will be held with Board members and with senior management. The Handbook provisions distinguish between the role of the Board in providing oversight and the responsibility of senior management to manage the business. • Issues assessed by examiners in connection with the role of the Board include knowledge and experience of directors, independence from management; whether there are adequate Board committees, Board oversight of the determination of compensation for executive officers and their appointment and termination; sufficiency and timeliness of information provided to the Board; and the Board's role in establishing the appropriate (what the Handbook refers to as) "tone at the top" including the development and enforcement of a code of conduct. • Issues assessed in connection with the senior management include knowledge and experience of management; turnover in key management positions; the nature of business risks accepted and the company's risk assessment processes; access to adequate financial and operating information to identify trends or variations from budgets; attitudes and actions toward financial reporting and internal controls; and management's role in developing, communicating and enforcing a code of conduct. If deficiencies in the corporate governance practices of a company are identified, the examiners make recommendations to the company, and update the insurer summary profile and supervisory plan accordingly. The department may adjust its ongoing solvency monitoring of the insurer. In situations where an insurer is deemed to be in a hazardous financial condition, the insurer can be ordered to correct the situation as outlined in the NAIC Model Regulation to Define Standards and Commissioner's Authority for Companies Deemed to be in Hazardous Financial Condition (#385).
Assessment	Largely Observed
Comments	Corporate governance standards for publicly-traded U.S. companies, including insurers, are set and enforced by the SEC, while requirements for all insurance companies will be introduced from January 2010.

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	Departments have been increasing their focus on governance issues, mainly as a more risk-based approach to examinations has started to be implemented (see ICP 13). Examinations had previously focused more on financial condition and related controls, with corporate governance receiving more limited attention. The new examination approach is still being rolled out but the risk-based approach becomes part of the accreditation standards in 2010. Both regulators and companies are adjusting to the need to make evaluations in an area of examination where there are few rules against which to assess individual company practice—and where, in the case of insurance groups, many governance and control functions are organized at group rather than solo company level. As examiners gain experience, the NAIC and/or departments should consider issuing more guidance on good and bad practices in corporate governance for insurers. This would help examiners and firms to develop a clearer expectation of what constitutes effective governance for insurance business, including for groups.
Principle 10.	**Internal control** The supervisory authority requires insurers to have in place internal controls that are adequate for the nature and scale of the business. The oversight and reporting systems allow the Board and management to monitor and control the operations.
Description	For publicly traded companies, standards relating to internal controls over financial reporting are set and enforced by the SEC. Under the 2002 Sarbanes-Oxley Act, management and the external auditor must report on the adequacy of the company's internal control over financial reporting. The report must contain an assessment, as of the end of the company's most recent fiscal year, of the effectiveness of the internal control structure and procedures of the issuer for financial reporting. A similar requirement has recently been adopted for use in insurance regulation through revisions to the NAIC Annual Financial Reporting Model Regulation (Model #205), which is required under the Accreditation Program. These revisions will require companies exceeding an annual premium threshold (set at US$1,000,000 per year in the model law), inter alia: • to have an independent audit committee—the model law sets out detailed requirements as to the composition and scope of work of the committee (and smaller companies covered by the requirements are exempt from having to have any independent members of the committee); and • to rotate their audit partner on a regular basis—as in the Sarbanes-Oxley Act, there is a five years limit. In addition, insurers with US$500 million or more in premium are required to issue Management's Report of Internal Control Over Financial Reporting, attesting to the adequacy of internal controls. Similar to the SEC requirements, the attestation must be based on documentation and testing of the company's internal controls, through diligent inquiry. However, unlike the SEC rules, this report will not be subject to a separate attestation by the company's external auditor. The revisions to the model law are scheduled to go into effect on January 1, 2010. To avoid duplication, companies subject to and in compliance with Sarbanes-Oxley Act equivalent requirements are broadly exempt. In addition, all insurance entities are required to receive an annual audit in accordance with the Annual Financial Reporting Model Regulation (#205). As part of each audit, as required by the American Institute of Certified Public Accountants, the CPA must understand and assess an entity's internal controls over financial reporting. When material weaknesses in an insurer's internal control processes are identified during an audit, this model regulation requires the weaknesses to be reported to the insurance supervisor for further review. As with corporate governance (see ICP 9), internal controls are increasingly being assessed as part

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	of the new risk-based examination process currently being implemented by departments. Use of the Examiners Handbook is required under the accreditation program, although the risk-based approach takes effect only in 2010. The overarching principles set out in the handbook include the need for adequate and clear policies, authorization limits and procedures; comprehensive internal controls; and processes to assure compliance with laws and regulations. Under the risk-based examination process, the examiner must identify and assess all significant inherent risks faced by the insurer, whether they relate to financial reporting issues or to business and operational issues. The examiner then identifies and assesses the internal control processes that can mitigate each risk. Controls are assessed by considering both their design and operating effectiveness. The Examiners Handbook sets out an extensive list of the issues to be addressed in the examination including: delegation of authorities and segregation of duties; the role of internal audit and the external auditor in the overall control framework; the role of the Board in establishing internal controls and monitoring their effectiveness. There is detailed guidance on the importance of assessing the risk in outsourcing of critical functions. This emphasizes that it is the responsibility of management to determine whether processes which have been outsourced are being effectively and efficiently performed and controlled. Although the adequacy of the function is assessed in relation to the risks and control frameworks of individual companies, there are no requirements either that an insurer has an internal audit function or in relation to the scope of the work which such a function should carry out. Examiners require access to internal audit reports when carrying out their work. When weaknesses in the company's internal controls are identified during the assessment process, the company is asked to make corrections to its processes and the supervisor adjusts its ongoing solvency monitoring of the insurer accordingly. Through increasing reporting requirements, increasing the frequency of examinations, and other means, the regulators aim to provide an incentive for the insurer to address internal control weaknesses. In situations where an insurer is deemed to be in a hazardous financial condition, the insurer can be ordered to correct the situation as outlined in the NAIC Model Regulation to Define Standards and Commissioner's Authority for Companies Deemed to be in Hazardous Financial Condition (#385), which is a required model under the Accreditation Program.
Assessment	Largely Observed
Comments	Other than controls relating to financial reporting, departments have established few rules and requirements relating to internal controls on insurers at present. For publicly-traded companies, the Sarbanes-Oxley provisions provide a general framework of detailed control requirements and testing of controls. From January 1 2010, much of this framework will be extended to all insurers, with the exception of smaller companies—after extensive debate with the industry, these were excluded from the new approach on the basis that costs would be disproportionate to benefits. These requirements will take time to implement in full. Departments are increasingly looking to ensure sound internal controls at insurers via the risk-based examination process. As mentioned under ICPs 9 and 13, this approach is still being implemented. As examiners gain experience, the NAIC and/or departments should consider the scope for issuing guidance on good and bad practices in internal control. They should also make it a formal requirement for insurers to have an internal audit function. Such a function is now widely considered as an important part of a good control framework—similarly to audit committees, where there are now extensive requirements of all but the smaller insurers.

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Ongoing Supervision	
Principle 11.	**Market analysis** Making use of all available sources, the supervisory authority monitors and analyzes all factors that may have an impact on insurers and insurance markets. It draws the conclusions and takes action as appropriate.
Description	State insurance supervisory authorities, and thus the NAIC, receive detailed quarterly and annual statistical and financial information. The majority of this information is stored in the NAIC FDR database. It is readily accessible to all state supervisory authority staff, and is therefore available for quantitative analysis of the market. The NAIC Insurance Analysis and Information Sources Department produces each half year separate industry commentaries for each of the life and accident and health insurance industry and the property and casualty insurance industry. Each commentary is about 6–8 pages and includes quantitative analysis and qualitative explanatory comment on issues such as industry size and growth; premium income by major business class and line; operational performance; investment income; insurance liability reserves; liquidity and capital as well as market share and market concentration information. Trend analysis on key indicators, such as capital and surplus, is commonplace in the commentaries. While the commentaries are for supervisory authority use only, the extremely rich database allows the NAIC to make available publicly not only much industry aggregate data but also individual insurer data. The latter are often available at a cost, but this does not appear to prevent significant further analyzes, repackaging and on-selling of this data. So the U.S. market is the most analyzed insurance market in the world. The NAIC also has the expertise and IT capability quickly to analyze its databases to obtain answers to supervisory queries about the insurance markets', and individual insurers', ability to deal with market events (e.g. a collapse or default of a major counterparty to which insurers are exposed through investments or reinsurance, and the downgrading and devaluation of a certain asset class). These commentaries are one input used by the NAIC Financial Analysis Working Group (FAWG) to decide which sectors of the insurance market may be becoming problematic, or potentially more vulnerable to adverse market trends. On occasions this has led the FAWG to require the NAIC Insurance Analysis and Information Sources Department to produce special market sector reports (e.g., reports on medical malpractice insurance and on financial guaranty insurance) to decide if supervisory authority action (sector-wide or only for specific insurers) is required or if temporary monitoring is all that is needed. There are several NAIC databases which can be so analyzed, including those for consumer complaints, insurance producers (i.e., intermediaries), supervisory authority actions and ratings agency actions. Especially because of the exposure of the U.S. property and casualty insurance market to natural catastrophes, the NAIC has built an impressive mechanism to facilitate specific event data collection and analysis. Individual states or the NAIC can decide if a special data call is needed. Once it has been decided what data or information is to be collected, the call is made using the authority under the state's financial examination laws. It is then shared among supervisory authorities pursuant to the Information Sharing and Confidentiality Agreement among the states. Aggregate and by company data are published (see ICP 26). Some industry stress testing has been performed by the NAIC using these capabilities (see ICP 23).
Assessment	Largely Observed
Comments	The absence of complete group-wide consolidated data for insurance groups and broader financial

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	conglomerate groups hinders the ability of supervisors to analyze and monitor market-wide events of importance for the stability of insurance markets. The lack of analysis of developments outside the U.S. markets, given that it relies so heavily on offshore reinsurers, needs to be addressed. Otherwise, the NAIC data sources and analysis capabilities are world-leading. They should be more used in international supervisory college discussions to better understand the risks that U.S. insurers might create to international groups of which they are members and to encourage insurance regulators in other jurisdictions to develop similar capabilities.
Principle 12.	**Reporting to supervisors and off-site monitoring** The supervisory authority receives necessary information to conduct effective off-site monitoring and to evaluate the condition of each insurer as well as the insurance market.
Description	The NAIC Model Law # 205 Annual Financial Reporting Model Regulation is designed to improve the states' surveillance of the financial condition of insurers by requiring an annual audit of financial statements reporting the financial position and the results of operations of insurers by independent certified public accountants, communication of internal control related matters noted in an audit, and management's report of internal control over financial reporting. The Law specifies that the notes to the financed statements are those required by the NAIC Accounting Practices and Procedures Manual (APPM) and Annual Statement Instructions (ASIs). The ASIs specify the requirements for, and contents of, the Statement of Actuarial Opinion (SAO) and statistical information to be filed. So regulators clearly have the ability to obtain the necessary information to undertake regular financial analysis of an insurer's financial condition. It also authorizes supervisory access to auditor work papers, lays down membership requirements for insurer audit committees and requires senior management attestation to the accuracy and fair representation of the financial reports and associated filed material. Because of its sweeping ambit for examinations, which can be conducted at the "sole discretion of the commissioner," NAIC Model Law # 390 on examinations provides the legal authority for the collection of any other information from insurers, even though information collection is not specifically referred to in the law. Differences among the requirements for financial reports and other information reporting reflect the different categories of insurance business undertaken, rather than the particular legal form of insurers. All insurers must file information, and the model examinations law effectively allows the supervisory authority to obtain information on any subsidiary of the insurer. Group information and financial statements are required to be filed via NAIC Model Law # 450 Holding Company System Reporting. However, reporting of consolidated group-wide financial and other data, which would allow monitoring of insurance regulatory capital compliance for an insurance only group, is not required. The ASIs do specify comprehensive reporting of transactions which can lead to off-balance sheet exposures. NAIC Model Law # 440 Insurance Holding Company System Regulatory Act requires transactions between affiliates to be reported before they are entered into. It specifies criteria which they can be assessed against, which are designed to ensure arms length dealings. It also provides that the insurer cannot enter into the transaction if the supervisory authority disapproves of the transaction.
Assessment	Largely Observed

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Comments	NAIC data sources and analysis capabilities are world-leading. The affiliate transaction requirements provide a strong means of identifying and controlling intra-group dealings and exposures. However the prior notification requirement may lead to undue 'prior approving' of many transactions and may represent an ineffective use of supervisory resources (although U.S. regulators have found such transactions to be abused in the past). Reporting of consolidated group-wide financial and other data should be required—see also ICP 17 as there is no complete group-wide consolidated data for insurance groups and broader financial conglomerate groups.
Principle 13.	**On-site inspection** The supervisory authority carries out on-site inspections to examine the business of an insurer and its compliance with legislation and supervisory requirements.
Description	The NAIC Model Law # 390 Examinations (included in the accreditation process) provides the authority for the supervisory authority to undertake on-site inspections, which are referred to as examinations. The commissioner has absolute discretion to require an examination and the form and scope of the examination. The law requires that examinations of each insurer must be conducted at least every five years (three years in some states). Examinations are conducted to comply with this requirement in the law, but also according to priorities developed from off-site analyzes of insurer financial and other data. Beginning in 2001, the NAIC began work to move from examinations of an audit/compliance nature to risk-focused examinations. This shift is well advanced but still underway. It was formally agreed by the NAIC to make this move and in 2007 the NAIC Financial Condition Examiners Handbook, which was revamped to reflect this, was approved. The application of this handbook became an accreditation standard from January 1, 2010, with accreditation examinations of the states commencing then. Major states have begun early adoption of this new approach and there has been considerable retraining of examination staff. Market conduct examinations are also conducted and there is a NAIC Market Conduct Examiners Handbook. Depending on the resources and structure of the state supervisory authority, this examination work may be undertaken in conjunction with the financial condition examination or separately. Irrespective of which approach is taken, the outcome of market conduct examination work is an important consideration in assessing the inherent and residual risks in an insurer. The Financial Condition Examiners Handbook outlines seven major phases of the new risk-focused approach; namely: (1) understanding the company and identifying key functional activities to be reviewed, (2) identifying and assessing inherent risk in activities, (3) identifying and evaluating risk mitigation strategies/controls, (4) determining residual risk, (5) establishing/conducting examination procedures, (6) updating prioritization and supervisory plan, and (7) drafting the examination report and management letter based on findings. It also contains substantial amounts of supporting administrative (e.g., sources of material to analyze before and during an on-site examination, content of and approach to examination reports and management letters to insurers) and technical material (e.g., on reinsurance) to assist examiners. Examination reports of insurers are available to the public, but examination work papers and management letters to insurers are generally not public, although they are available to other state supervisory authorities. However, in some states there is some concern that work papers and management letters could in fact be obtained under freedom of information and similar state laws.

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	There are extensive supporting NAIC systems for planning, documenting, following up and reporting on individual examinations as well as on examination activity in aggregate. Tables 19 through 22 of the NAIC Insurance Department Resources Report 2008 provide statistics on examinations by type and by state, which show there is extensive exam work occurring.
Assessment	Observed
Comments	The Financial Condition Examiners Handbook is comprehensive, well presented and easy to read. It has been sensibly designed to provide concepts and broad steps to follow, and deliberately emphasizes the need for examiners to think about issues and risks in the particular insurer in order to tailor what is examined in depth, rather than follow a checklist approach. From discussions with supervisory authorities and examiner staff and from inspection of examination work papers and reports, it is clear that financial examinations are thorough and well documented. Examinations also appear to identify the important issues. Consideration could be given to how to strengthen the confidentiality of examination work papers and findings to ensure that examiners can be frank in their findings and assessments of the financial condition of insurers. This will become more important as the risk-focused examination approach is rolled out, as proper implementation will require examiners to make more qualitative judgments about insurers' risks and controls, including scoring them for inclusion in the risk matrix. The move to risk-focused examinations involves a quantum shift in examination approach, mindset and skills. It is a progressive approach which should allow examiners' assessments to become more forward-looking. But effective implementation will not be easy because of the changes it demands of examiners. Therefore it is recommended that the NAIC assess the implementation of the risk-focused examination approach in the near future (e.g., in the course of 2012).
Principle 14.	**Preventive and Corrective Measures** The supervisory authority takes preventive and corrective measures that are timely, suitable and necessary to achieve the objectives of insurance supervision.
Description	NAIC Model Law # 385 Regulation to Define Standards and Commissioner's Authority for Companies Deemed to be in Hazardous Financial Condition (included in the accreditation process) lays down standards or criteria that the supervisory authority can use to determine if an insurer is in a hazardous financial condition. These are all appropriate criteria or trigger points and include such criteria as reserve adequacy, reinsurance adequacy and collectability, fitness and propriety of officers and directors, timely and accurate return filing, adequacy of administrative systems, liquidity and appropriateness of affiliate transactions. This model law also outlines the actions the supervisory authority can require an insurer to take to remedy its financial condition, which may include adjusting reinsurance, reducing or suspending acceptance and renewal of business, increasing capital and surplus, suspending dividend payments out of the insurer, increasing the frequency of financial reports, providing additional detailed reports, providing a new business plan, adjusting premium rates, changing investments and correcting corporate governance practice deficiencies. The regulatory compliance of insurers and the current position and trend of insurers' financial condition can be determined from the regular financial analyzes, examinations, market conduct surveillance and examinations and the reasonably regular contact supervisory authorities have with insurers. In practice, supervisors raise issues and inappropriate practices with insurers when they become aware of them, especially during and following an examination, and they follow up to check on insurers' responses. Therefore they take appropriate and proportional corrective action when it is needed.

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	As well as laying down the structure of the regulatory capital requirements the NAIC Model Law # 312, Risk-Based Capital (RBC) for Insurers sets down four action levels and the types of company or regulatory action which must be taken. The levels and associated types of event are: • Company Action Level ➢ Trigger event—insurer capital less than 200 percent of the RBC amount; or for life and/or health insurers, capital is less than 250 percent of RBC and has a negative trend; or for property and casualty insurers, capital is less than 300 percent of RBC and triggers the negative trend. ➢ Action required—insurer must prepare and submit an RBC Plan which identifies what contributed to reaching the trigger event; corrective action proposals; financial projections for at least 4 years out (both without and with the corrective action); key assumptions; and the problems associated with the insurer's business. • Regulatory Action Level ➢ Trigger event—insurer capital less than 150 percent of the RBC amount. ➢ Action required—insurer must prepare and submit an RBC Plan or revised RBC Plan: supervisory authority must examine the insurer's financial condition and review its RBC Plan; supervisory authority must issue a "corrective order" specifying the corrective actions the insurer must take. • Authorized Control Level ➢ Trigger event—insurer capital less than 100 percent of the RBC amount. ➢ Action required—as for Regulatory Action Level, or place the insurer under regulatory control (i.e., under formal rehabilitation or liquidation) if this is considered to be in the best interests of the policyholders, creditors and the public. • Mandated Control Level ➢ Trigger event—insurer capital less than 70 percent of the RBC amount. ➢ Action required—supervisory authority must place the insurer under regulatory control (i.e., under formal rehabilitation or liquidation), except for property and casualty insurers in run-off where the supervisory authority may allow the run-off to continue under its supervision.
Assessment	Observed
Comments	The structure of prompt corrective action triggers and required actions is thorough and is rigorously applied. While it could not, and should not, prevent insurers ever failing, it does lead to reduced insurer shortfalls in any failure (guaranty fund data suggests most shortfalls are in the 5–15 percent of liabilities range). It also provides clear messages to the insurers of the consequences of their reducing capital levels.
Principle 15.	**Enforcement or sanctions** The supervisory authority enforces corrective action and, where needed, imposes sanctions based on clear and objective criteria that are publicly disclosed.
Description	As described under ICP 14, there is a formal structure of prompt corrective action levels to ensure that the deteriorating financial condition of an insurer is addressed early to help prevent insurer failure and loss to policyholders. Once an insurer is deemed by the supervisory authority to be in a hazardous financial condition, the supervisory authority can take a range of actions, such as: • requiring the insurers capital levels to be increased; • restricting dividend and other payments out of the insurer;

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	• directing the issuing of new, or renewing of current, policies to stop; • restricting the insurer dealing with investments and other assets, or require specific investments and other assets to be dealt with in a certain manner; and • requiring changes in management. NAIC Model Law # 558, Administrative Supervision Model Act, allows the supervisory authority to place an insurer under administrative supervision by the authority if continuance of the business is hazardous to the public or insured parties, the insurer has exceeded its powers or breached requirements, the insurer's business is being conducted fraudulently, or the insurer gives its consent. Administrative supervision essentially allows the supervisory authority to exert direct control over insurers' transactional activity related to investments, any dealing with assets, merger or consolidation of business, premium rates, reinsurance contracts, policy surrenders, premium refunds, management changes and insurer staff remuneration. In addition, NAIC Model Law # 555 Insurer Receivership Model Act allows supervisory authorities to place insurers into rehabilitation or receivership, which is then supervised by the court, but with the supervisory authority as the rehabilitator or receiver. Supervisory authorities use their authority to put an insurer under administrative supervision, rehabilitation or even liquidation to effect compulsory transfer of obligations from a failing insurer to another insurer. This is often done by keeping a failing/failed insurer in run-off and under administrative supervision and arranging a reinsurance transaction with the accepting insurer, or improving the financial condition of the problem insurer sufficiently for the accepting insurer legally to take ownership. The supervisory authority can and does use persuasion, civil penalties, follow up action and more detailed or focused examinations to prevent insurer breaches and inappropriate practice from recurring. Tables 23 through 25C of the NAIC Insurance Department Resources Report 2008, which provide statistics on actions taken against insurers, formal hearings with insurers, insurers in run-off, insurers under supervision or rehabilitation or in liquidation, demonstrates supervisory authorities are active in these areas. Throughout the model laws, there are penalty provisions which allow the supervisory authority to fine insurers. However, the authority to apply penalties to individuals (apart from producers) for breaches of insurance laws is limited. Issues of dishonesty and other felonies are dealt with mostly through laws other than insurance laws. In practice the supervisory authority does persuade insurers that certain individuals in senior management should leave the insurer, but there is no specific authority to bar individual directors or management of insurers from acting in responsible capacities in the industry in the future.
Assessment	Largely Observed
Comments	There is no clear authority for the supervisory authority to fine individual directors or senior managers of insurers, and to bar them from acting in responsible capacities in the future. The insurance laws should be changed to provide the supervisory authority with such clear powers.
Principle 16.	**Winding-up and exit from the market** The legal and regulatory framework defines a range of options for the orderly exit of insurers from the marketplace. It defines insolvency and establishes the criteria and procedure for dealing with insolvency. In the event of winding-up proceedings, the legal framework gives priority to the protection of policyholders.
Description	As described under ICP 15, the legal and regulatory framework provides a clear structure for the points at which it is no longer permissible for an insurer to continue its business.

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	The procedures for dealing with insolvency and the winding-up of an insurer are clearly set out, with NAIC Model Law # 555 Insurer Receivership Model Act (included in the accreditation process) providing specific requirements for the conservatorship, rehabilitation and liquidation of insurers. Policyholders are given the highest priority in wind-ups after the fees of the receiver are met. The broad and comprehensive powers of the supervisory authority for dealing with insurer insolvency and wind-up allow for strongly effective protection of policyholder obligations and minimal disruption to policyholders in the meeting of these obligations.
Assessment	Observed
Comments	There is a strong focus by the supervisory authorities on ensuring individual policyholder obligations are met. Customer complaints handling facilities in supervisory authorities, readily available information on the progress of insurer receiverships and a network of insurer guaranty funds provide a high level of policyholder protection. The arrangements for insurer wind-up and exit from the market are clear, have worked effectively and in conjunction with guaranty fund arrangements provide strong protection against policyholder loss if an insurer fails. There are not the same clear arrangements for dealing with the exit from the market of a financial conglomerate group with insurance subsidiaries (but this is not required by the ICPs).
Principle 17.	**Group-wide supervision** The supervisory authority supervises its insurers on a solo and a group-wide basis.
Description	The U.S. approach to supervision reflects a long-established focus on securing the financial soundness of individual insurance companies, if necessary by ring-fencing them from other operations in the group. This approach in part reflects the fact that insurance companies are generally less exposed than banks to contagion from problems elsewhere in the group. The United States has developed an extensive set of tools aimed at monitoring and, as necessary, controlling transactions with the holding company. It also has extensive powers to obtain information about U.S. entities that are a part of the same group as licensed insurers. Key requirements in relation to groups are set out in The Holding Company Act (#440) which creates the concept of an insurance holding company system—defined as consisting of two or more affiliated persons or entities, one or more of which is an insurer. (An affiliate is an entity that directly or indirectly, through one or more intermediaries, controls, is controlled by, or is under common control with another entity. Control is presumed to exist when an entity or person, directly or indirectly, owns, controls, holds with the power to vote, or holds proxies representing 10 percent or more of the voting securities—see ICP 8). Groups containing one or more insurance companies may also be covered by the definition of financial holding company in the GLBA and the related regulatory requirements. Extensive information is collected on holding companies within an insurance holding company system and on transactions between the licensed insurer and the rest of the group. For example, the Annual Statement must include a detailed organization chart and summary of various types of transactions within the holding company system. The annual and quarterly statements also require disclosure of whether an insurer is affiliated with one or more banks, thrifts or securities firms (i.e., financial conglomerate/financial holding company). In addition, consolidated financial statements of the ultimate parent are required to be filed with the state of domicile by any company that is part of a holding company group. This information is included in the regular financial analysis of insurance companies, which draws on guidance for analysts in the Financial Analysis Handbook. Insurers are also required to submit ad hoc reports covering:

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	• holding company registration (an insurer must register when it becomes a member of an insurance holding company system and annually thereafter); • notice of certain affiliate transactions – which are reviewed to determine if they are fair and reasonable to the interests of the insurer. Material transactions include sales, purchases, exchanges, loans, extensions of credit, guarantees, investments, reinsurance, management agreements, service agreements and cost-sharing agreements and there are rules on what is considered material; • notification of certain merger and acquisitions; and • prior approval of any extraordinary dividend or other extraordinary distribution to shareholders (definitions of what constitutes "extraordinary" vary by state). A lead state is designated for each insurance group to coordinate regulatory activities in their review of insurance groups. Insurers in a corporate group are required to file consolidated financial statements for their ultimate parent. However, these are based on US GAAP, not SAP, and are not required at an intermediate insurance holding company level. So they do not allow any group assessment against insurance regulatory financial requirements. Supervisors have not traditionally looked at internal controls or risk concentrations at group level. They are now focusing more on group management and controls in the context of the new approach to risk-focused examinations currently being rolled out (see ICPs 9, 10 and 13). Some of the internal control requirements applicable to insurance companies may be satisfied by compliance at the group level—for example, the requirement for audit committees that takes effect on January 1 2010 (see ICP 10) recognizes a group audit committee as meeting the requirement. As host supervisors in relation to U.S. operations of groups based in other countries, departments have been greatly increasing their cooperation with home regulators in the course of the crisis. There are regular exchanges of views and information. Departments have sent representatives to colleges of supervisors of groups based in Europe with significant U.S. business. International colleges of supervisors have met for some, but not for all (or even all the largest) U.S.-based insurance groups with international operations. A new NAIC working group is considering possible changes to the Holding Company Model Act in response to financial crisis lessons and developments internationally. The group is considering the need for group wide requirements and improved cross-border communication and coordination (both internationally and between states) among supervisors, including supervisors of other financial sectors where appropriate.
Assessment	Partly Observed
Comments	The U.S. approach is focused on securing the financial soundness of individual insurance companies. While this has not been unusual among insurance regulators internationally, many have been supplementing their strong solo company focus with financial and other requirements and more supervisory focus applied at group level and U.S. supervisors should do the same. They do not currently make an assessment of the financial condition of the whole group of which a licensed insurance company is a member. Risk-focused examinations are not yet generally focusing on group issues; and supervisory colleges are not meeting for all U.S.-based international groups. It is recommended that U.S. supervisors: (i) include fuller assessment of the financial condition of the whole group of which a licensed

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	insurance company is a member; this may involve quantitative techniques and practices in use internationally; it would improve U.S. insurance regulators' ability to identify weaknesses in groups which may have an impact on the insurers; in the absence of global reserving and solvency standards for insurers, this will not be easy to do on an international basis (i.e., for the relatively few U.S-based international insurance groups) but may be introduced more readily for domestic groups—at least by applying the U.S. RBC requirements to the consolidated domestic insurance group balance sheet; (ii) extend the risk-focused approach to examinations of solo insurance companies to groups, again starting with U.S.-led groups—in effect extending the lead regulator and college of supervisors arrangements already in widespread use for such groups within the framework developed by the NAIC (a group wide approach to examinations is already being taken in some cases but is not standard across the states); and (iii) ensure that colleges of supervisors for the U.S.-led groups with major international operations are established and functioning effectively—and led by U.S. insurance regulators (existing arrangements under which agencies with limited insurance expertise have been designated as global lead supervisors have been shown to be inadequate). Adding this group wide focus to U.S. insurance regulation will be a significant change, maybe equal to that involved in the development of risk-focused examinations. It will require attention to skills and training. It may also be desirable for insurance regulators to be given additional powers, such as authority to license insurance holding companies, apply capital requirements to the consolidated insurance group and direct the insurance holding company to make changes at the group level to rectify any shortcomings.
Prudential Requirements	
Principle 18.	**Risk assessment and management** The supervisory authority requires insurers to recognize the range of risks that they face and to assess and manage them effectively.
Description	The supervisory authorities do not explicitly require insurers to have comprehensive risk management policies and systems in place; however, the insurer's risks and its systems to measure and manage those risks are reviewed through the on-site examination process. It is clear from the NAIC Financial Examiners Handbook, from discussions with examination staff and from supervisory authority examination work papers that the review of risk assessment and risk management systems and controls in insurers is a large component of the examinations. Under the new risk-focused examination approach a large range of insurer risks are to be assessed, as well as risk mitigation strategies and approaches so that examiners can rate an insurer's residual risks.
Assessment	Largely Observed
Comments	The relevant laws, regulations or standards should be changed to include a requirement that an insurer have in place comprehensive risk management policies and systems capable of promptly identifying, measuring, assessing, reporting and controlling their risks. While the desired outcomes for this ICP appear to be achieved in practice owing to the comprehensive approach to examination of insurers, it is increasingly important that the risk management function of insurers is of high quality and given significant focus and influence within insurers.
Principle 19.	**Insurance activity** Since insurance is a risk taking activity, the supervisory authority requires insurers to evaluate and manage the risks that they underwrite, in particular through reinsurance, and to have the tools to establish an adequate level of premiums.
Description	The supervisory authority does not specifically require in any law or standard that the Board of Directors approve and regularly review the insurer's strategic underwriting and pricing policies.

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	However, it is expected that an insurer has detailed underwriting, pricing, expense and reinsurance systems and controls, and these are inspected in some detail during an examination of an insurer. The NAIC Financial Examiners Handbook contains guidance on this in its Examination Repository (Section 4) which has considerable detailed material on how to examine activities relating to premiums, losses and benefits, and reinsurance for each of life, health and property/casualty classes. While there are variations across states, most states have some review or approval authority over policy forms and, in the case of property and casualty insurers, they also often regulate premium rates; in some cases, insurers must simply file rates and forms before using them; in other cases, both must be approved in advance. In respect to rates, the objective is to ensure that they are not inadequate, excessive or unfairly discriminatory to consumers. Through this process there are considerable analyzes undertaken of an insurer's proposed pricing for specific products. (See also ICP 25). Details of all reinsurance contracts must be lodged with the supervisory authority so their degree of protection to the ceding insurer can be assessed for its adequacy. Much of this is simply examined and the supervisory authority intervenes or withholds approval only if there are concerns. The Examiners Handbook has a section (Section 6) dedicated to reinsurance and one of its sub-sections (i.e., sub-section VI) provides specific guidance on the evaluation of risk transfer, including the cash flow testing evaluation approach.
Assessment	Largely Observed
Comments	The relevant laws or regulations do not explicitly provide that an insurer must have in place strategic underwriting and pricing policies approved and reviewed regularly by the Board. Boards are not required to set the strategic limits on these core insurance functions within which management should operate. There is a risk that the prior notification requirement may lead to undue 'prior approving' of many reinsurance transactions, which could be an ineffective use of supervisory resources. The relevant laws or regulation should be amended to provide that an insurer must have in place strategic underwriting and pricing policies approved and reviewed regularly by the Board.
Principle 20.	**Liabilities** The supervisory authority requires insurers to comply with standards for establishing adequate technical provisions and other liabilities, and making allowance for reinsurance recoverables. The supervisory authority has both the authority and the ability to assess the adequacy of the technical provisions and to require that these provisions be increased, if necessary.
Description	The NAIC Model Law # 820 Standard Valuation Law (included in the accreditation process) is the primary authority for determining adequacy of reserve liabilities for life and accident and health insurance companies. This is supported by further regulations and requirements. Reserve requirements for property and casualty insurers are outlined in the NAIC Accounting Practices and Procedures Manual (APPM—included in the accreditation process). The Annual Statement Instructions (ASIs – included in the accreditation process) also require that a Statement of Actuarial Opinion (SAO—included in the accreditation process) on an insurer's reserves is provided and that actuarial work on calculating reserves and opining on them is done in accordance with Actuarial Standards of Practice (ASOPs). There is also a specific ASOP on data quality. The SAO must be supported by a detailed actuarial report, which spells out the particular actuarial valuation methodologies used, the actuarial assumptions used and discusses the recent experience of the business compared with what was expected. This detail extends down to lines of business, and where necessary, even sub-lines of business where it is expected that loss experience may be substantially different. Reserves have to be calculated both gross and net of reinsurance.

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	For life and health insurance, there is a set minimum standard valuation for most life and health insurance products. Generally this is a conservative net premium valuation, so statutory reserves for life insurance are mostly highly conservative. As this approach is not entirely satisfactory for more complex life products with numerous policyholder options and guarantees (e.g., variable annuities with living benefits), the NAIC and the actuarial profession have developed and are continually refining more sophisticated statutory reserving approaches (which include asset adequacy assessments, cash flow testing and stochastic modeling) for such products, to ensure interest rate risks and equity risks in the products are adequately reserved for. These are in addition to the overall required actuarial opinion statement mentioned above. This work is now leading to a more Principles Based Approach (PBA) for life reserving (not in effect at the time of this assessment), but also to adjustment to capital requirements for such products. For property and casualty insurance, there is not a set minimum standard valuation, rather the insurer will set its reserves on advice from its actuary. The actuaries must do their calculations and give their advice according to ASOPs. The actuary's SAO must also state the actuary's point estimate and high and low range for reserves along with the point estimate actually adopted by the insurer. Generally property and casualty insurance statutory reserves are determined on an ultimate cost basis (i.e., not discounted to produce present values) allowing for claims inflation, including 'superimposed inflation'. This approach should normally produce conservative reserves for highly predictable lines of business. Examinations of insurers do cover reserving and the handbook has significant guidance on how examiners can check the insurer's process for determining reserves. In carrying out the annual audit the external auditor will usually obtain its own actuarial advice, which generally involves the auditor's actuary reviewing the work of and opinion of the insurer's actuary. Actuaries within the supervisory authorities read all the SAOs and the actuarial reports (which the insurer must keep available for seven years) if there is a need to. If the supervisory authority has any concerns about an insurer's reserving they can obtain further independent actuarial advice on the reserves and ultimately can require the insurer to increase reserves to a level which they believe is adequate. See also Appendix – Technical Note: Accounting and Actuarial Framework for Insurance.
Assessment	Observed
Comments	The liability reserving methods and bases generally lead to conservative estimates, which is in line with the conservative, book value nature of statutory insurance accounting in the United States Elements of the reserving methods adopted involve stochastic modeling or scenario analysis techniques to estimate the reserves required under moderate adverse conditions. However, there is currently no particular or specified safety level which is targeted for reserving—or capital. For general transparency and for international comparison, it is recommended that consideration be given to specifying a target safety level for reserving (and an associated target safety level for capital). This should also assist in keeping margins for conservatism in reserves more similar across insurance classes and thus assist with peer comparisons of reserving.

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Principle 21.	**Investments** The supervisory authority requires insurers to comply with standards on investment activities. These standards include requirements on investment policy, asset mix, valuation, diversification, asset-liability matching, and risk management.
Description	Investment activities of insurers are regulated by one of two approaches to achieve diversification, namely: • defined limits – whereby restrictions are placed on the amount of an insurer's financial assets which can be invested into particular asset classes and lower grade investments. This is provided for in the NAIC Model Law #280 Investments of Insurers Model Act (Defined Limits Version) (included in the accreditation process); and • defined standards – whereby a more principles-based approach is used by requiring the Board of an insurer to establish and monitor an investment policy which meets specific criteria. This is provided for in the NAIC Model Law #283 Investments of Insurers Model Act (Defined Standards Version) (included in the accreditation process). Detailed information and statistical data on investments, including data on all individual investments held, bought and sold, has to be filed annually and is stored in the NAIC databases. This allows for extensive analysis of the investments and investment exposures of an individual insurer, as well as the insurance market. The Investments of Insurers Model Act (Defined Standards Version) contains requirements for insurers to monitor and manage asset/liability positions. Where an insurer is subject to the Defined Limits version of the model law, supervisors look for and expect to see these arrangements in place. In addition, the Annual Statement is required to include a Management's Discussion and Analysis section, in which liquidity, asset/liability matching and capital resources must be discussed in detail. Financial examinations of insurers involve detailed scrutiny of insurers' investment systems, reports and controls. The NAIC Financial Condition Examiners Handbook has specific guidance for examiners on this. The NAIC has established a Securities Valuation Office (SVO) which has expert staff to provide specific advice on, and standards for, the valuation of different types of securities. The APPM and ASIs require that securities owned by insurers be valued according to the SVO valuation standards. Requirements on securities lending, or sale and repurchase arrangements, are contained in the NAIC Model Law #280 Investments of Insurers Model Act (Defined Limits Version). Essentially, it is allowed up to 40 percent of an insurer's admitted assets with exposure to any single business entity through such transactions limited to 5 percent of admitted assets. Before undertaking such transactions an insurer must have a written investment plan for such activity which covers: • apart from dollar roll (i.e., short term sell/purchase) transactions, the need for a written agreement; • how the cash received will be invested; and • the operational procedures to be used to manage interest rate risk, counterparty default risk, the conditions under which proceeds from reverse repurchase transactions may be used in the ordinary course of business and the use of acceptable collateral in a manner that reflects the liquidity needs of the transaction. See also Appendix – Technical Note: Accounting and Actuarial Framework for Insurance.

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Assessment	Observed
Comments	The regulatory requirements for investments are robust and they are likely to have contributed to the limited number of major investment problems for insurers from the financial crisis. As insurers move more to the defined standards investment model (i.e., a more principles-based approach), it will be important to ensure that all aspects of investment risk, especially asset/liability mismatching risks, are well covered in the reserving and capital requirements.
Principle 22.	**Derivatives and similar commitments** The supervisory authority requires insurers to comply with standards on the use of derivatives and similar commitments. These standards address restrictions in their use and disclosure requirements, as well as internal controls and monitoring of the related positions.
Description	As well as the detailed requirements contained in the two model laws on investments (see ICP 21), there is a specific NAIC Model Law # 282, Derivative Instruments Model Regulation (which is, however, not included in the accreditation process), which sets standards for the prudent use of derivative instruments. This regulation contains requirements on: • insurer internal guidelines and control procedures—including requiring approval of these by the supervisory authority; • derivative transaction documentation; and • trading requirements. The two model laws on investments specifically prohibit the use of derivative instruments for any purposes other than hedging or income generation, in which case, derivative investments are restricted to covered transactions and limited to a percentage of the insurer's admitted assets. The NAIC Financial Examiners Handbook contains specific guidance on derivatives within its guidance on investments. This covers in detail activities that can be undertaken to examine derivatives dealing, pricing and valuation, hedge effectiveness, documentation, auditing and accounting disclosures. The ASIs require detailed reporting of derivative exposures and transactions. See also Appendix – Technical Note: Accounting and Actuarial Framework for Insurance.
Assessment	Observed
Comments	The requirements relating to derivatives use are robust and sensible in that they allow derivatives to be used for purposes which would enhance an insurer's investment management and returns without exposing it to undue risk of losses. There are no requirements on derivatives use at a holding company level outside of an insurer, but this is not required by the ICPs.
Principle 23.	**Capital adequacy and solvency** The supervisory authority requires insurers to comply with the prescribed solvency regime. This regime includes capital adequacy requirements and requires suitable forms of capital that enable the insurer to absorb significant unforeseen losses.

Description	There has for many years been a set of Risk-Based Capital (RBC) requirements for insurers. RBC requirements are covered under the accreditation process. The RBC rules differ between life and health insurance and property and casualty insurance. The risks covered by the RBC requirements are:
	
	• life and health
	  o asset value risk (essentially credit risk in the assets);
	  o insurance risk (essentially adverse experience in the insurance obligations);

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	o interest rate risk (essentially due to changes in interest rates which lead to losses due to mismatching of assets and liabilities); and o all other business risks. • property and casualty insurance o asset value risk (essentially credit risk in the assets); o credit risk (essentially counterparty risk in reinsurance receivable); o underwriting risk (essentially adverse experience in the insurance obligations); and o all other business risks. An insurer's risk-based capital is calculated by applying factors to various asset, premium, claim, expense and reserve items. The factor is higher for those items with greater underlying risk and lower for less risky items. The adequacy of a company's actual capital can then be measured by a comparison to its risk-based capital as determined by the formula. Capital and surplus of an insurer is essentially the excess of regulatory admitted assets over liabilities. The APPM specifies which assets of an insurer cannot be 'admitted' for statutory accounting purposes and thus will not count toward capital and surplus. Non-admitted assets include intangible type assets which cannot be readily realized in a liquidation; reinsurance which is disapproved, from an 'alien reinsurer' and not collateralized, or does not meet effective risk transfer criteria; investments in excess of regulatory limits. Unrealized gains/losses on investments are generally not brought to account, or are deferred by mechanisms such as an asset maintenance reserve or interest maintenance reserve for gradual release. They are therefore not counted as capital or surplus immediately. Some realized gains and losses are treated similarly. There is not a classification of capital into tiers as there is for banking. As described under ICP 14, there is a formal structure of prompt corrective action levels to ensure that the deteriorating financial condition of an insurer is addressed early to help prevent insurer failure and loss to policyholders. There are no specific or indirect requirements which address inflation of capital. The regulatory requirements are heavily structured to ensure tight "ring fencing" of an insurer's operations and total assets (see also ICP 17). There are elements of stress testing and other forward-looking analysis built into the reserving and capital adequacy frameworks. For example, for asset adequacy testing of the reserves in relation to certain product lines, tests must be performed and reported on in the SAO and Memorandum. Otherwise, stress tests are performed on an occasional basis but are being used more systematically in response to financial crisis. See also Appendix I – Technical Note: Accounting and Actuarial Framework for Insurance.
Assessment	Largely Observed
Comments	Insurance company reserves are determined conservatively and the regulatory capital is required in addition. So the combination of reserving and capital provides a sizable buffer against adverse experience. In the absence of a specified safety level which is targeted for reserving plus capital, it is difficult to determine the level of adversity that the combination of reserves and capital can cover, but it appears to be commensurate or higher than in many other insurance jurisdictions. For general transparency and for international comparison, it is recommended that consideration be given to specifying a target safety level for reserving and an associated target safety level for capital. This should assist not only with peer comparisons of reserving and capital across insurers,

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	but also comparison against other insurance regimes internationally. Further development of stress testing could be considered, using the experience gained from exercises undertaken in the financial crisis.
Markets and consumers	
Principle 24.	**Intermediaries** The supervisory authority sets requirements, directly or through the supervision of insurers, for the conduct of intermediaries.
Description	Intermediaries are generally referred to as producers in the United States. While distribution channels vary, producers may act as agents of one or more insurance company (captive agents or independent agents) or as brokers—i.e., acting on behalf of the customer. Banks may also distribute insurance products. The NAIC's Producer Licensing Model Act (#218) contains a provision that states must license producers, as well as the licensing standards. This law has been implemented in a majority of the states but with a relatively high level of significant variations. A national system for producer licensing has been contemplated by the U.S. Congress—the Gramm-Leach-Bliley Act of 1999 (GLBA) placed a new federal mandate on states to achieve a prescribed degree of uniformity, or reciprocity (i.e., mutual recognition), in insurance producer licensing within three years or face federal intervention in the form of a federal preemptive insurance sales force licensing system, the National Association of Registered Agents and Brokers (NARAB). Although unable to meet the "uniform" test, a majority of states adopted the necessary laws and reciprocity arrangements to meet the "reciprocity" test, and thus prevented the triggering of NARAB. In the effort to promote uniformity, the NAIC has established a process of certification of state producer licensing regimes and currently 47 jurisdictions are assessed as meeting the reciprocity mandate of the GLBA. There is currently legislation before Congress that would revive NARAB. All individuals who sell, solicit or negotiate insurance are required by law to be licensed. Both the individual and the business entity through which the producer operates must be licensed. Resident applicants must pass a test specific to their line of business to ensure a minimal level of competency. Some state insurance regulators also require pre-licensing education before a resident applicant can sit for an examination. Sixteen states fingerprint their applicants to identify any prior criminal activity. (Discussions continue on achieving greater uniformity in this area to address a significant obstacle to uniformity in producer agent licensing—states that do extensive vetting of prospective licensees, including fingerprint checks are reluctant to grant reciprocity to states with weaker requirements.) Producers must also obtain a license in each non-resident state where they wish to sell, solicit or negotiate insurance (other requirements may also be applied in states which have not adopted the reciprocity provisions of the model law). Insurance producers who work as agents for one or more companies must, in most states (the model law provision is optional), obtain formal appointments with the companies they represent. Insurance companies are then required to notify relevant states of each appointment. Once licensed, producers must satisfy ongoing continuing education requirements in their resident state. They are required to provide appropriate disclosure on the products they sell and their potential impact on the consumer if purchased and to assess the needs of their clients and suitability of particular products. Under the Unfair Trade Practices Act model law (#880), producers must not misrepresent the benefits and conditions of a policy. However, producers are not required to make disclosures to customers of the status under which they are doing business, for example whether they are independent and which insurance companies have appointed them.

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	Under the model law, state insurance regulators have various powers to address misconduct by intermediaries (section 12 of the model law lists types of misconduct). These include suspension or revocation of both a resident and non-resident license as well as the levying of fines. In addition, a Federal law, 18 U.S.C. 1033, imposes a lifetime ban from the business of insurance for criminal whose crime involves dishonesty or breach of trust. Departments analyze and respond to consumer (and insurer) complaints about particular agents. A license may be suspended or revoked when a producer has misappropriated a client's money. However, states do not generally require an intermediary to have a separate account for the deposit of clients' funds; and there is no NAIC model law provision in this area. Where the producer is acting as agent, the legal framework relating to agents provides that monies paid to producers acting as the agents of insurers are liabilities of the insurer. Insurers in practice will make customers good where agents they have appointed fails to pass on premium payments. Some states have adopted their own provisions requiring brokers to establish separate accounts (premium trust fund accounts) to be used to hold money that has not yet been paid to insurers or which is to be remitted to clients. In many states, agents and brokers have a legal responsibility in relation to such funds in a fiduciary capacity—and may be required not to mingle their own and client funds. Producers are not subject to financial requirements or reporting – although some states impose surety bond requirements on individual producers. Examinations of producers are not mandated as they are for insurance companies; and departments have discretion whether and how often to carry them out (there is no NAIC examination manual for producers). Examinations of insurers may extend to producers acting as agents for the insurer, in particular where (i) the insurer has appointed one or more managing general agent (MGA) – i.e., agents, usually focused on commercial risks, which may have authority from the insurance companies who have appointed them to accept business on their behalf and may also handle claims or help place reinsurance; and (ii) the producer is a large broker focusing on commercial lines. Four major groups of mainly commercial lines brokers are subject to more intensive oversight as a result of settlement agreements in 2006 with Attorneys General and regulators in a number of states. These arrangements stipulate various business reforms required of these brokers including disclosure of commission and a ban on contingent commissions. While discussions continue on a general reform of requirements applying to all firms in this area that was envisaged at the time of the settlement arrangements with the four major groups, no measures have yet been enacted. While there are some provisions on disclosure in the Producer Licensing Model Act (#218) and most jurisdictions have some kind of disclosure requirement related to compensation or the role of the producer, the limited scope of the 2006 settlement agreements mean that there are not consistent commission disclosure requirements applying to brokers across the market. All information about producers is stored in a national database.
Assessment	Largely Observed
Comments	While producer regulation is less uniform than that it is for insurance companies, in respect of both requirements in law and the supervisory work of departments, most states have at least the core requirements—licensing, requirements in relation to producer skills and expertise, and powers to undertake examinations and to take action in case of producer misconduct. The general legal framework provides safeguards for client money where intermediaries act as agents (and this has been tested in numerous cases). There is less uniformity on the safeguards applying to money held by brokers but separate accounts with trust status are required in at least two states where large commercial lines brokers are domiciled.

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	The major commercial lines brokers (including those with large global presences) are otherwise subject to relatively limited supervision, other than that provided for in the 2006 settlement arrangements. While these institutions should clearly not be regulated in the same way as major insurance companies (because they are not risk carriers), closer oversight would be appropriate to reflect the importance of their role in the commercial lines market. Some strengthening of the approach to producer regulation is recommended: (i) to extend broker trust fund arrangements across states (where not already in place) to ensure that client funds are fully protected; (ii) to develop a uniform approach to the regulation of major brokers which reflects their important role; and (iii) to complete the current work on a consistent approach to the regulation of commission disclosure. In addition, producers should be required to make disclosures to customers of the status under which they are doing business, including which insurance companies have appointed them.
Principle 25.	**Consumer protection** The supervisory authority sets minimum requirements for insurers and intermediaries in dealing with consumers in its jurisdiction, including foreign insurers selling products on a cross-border basis. The requirements include provision of timely, complete and relevant information to consumers both before a contract is entered into through to the point at which all obligations under a contract have been satisfied.
Description	There is an extensive set of provisions and processes aimed at protecting consumers entering into insurance contracts. Major elements are: • the producer licensing requirements (see ICP 24) – which address point of sale issues, since insurance products are mostly distributed through agents and brokers; • rate and form regulation: departments exercise at least some review or approval authority over policy forms and, in the case of property and casualty insurers, they also often regulate premium rates; in some cases, insurers must simply file rates and forms before using them; in other cases, both must be approved in advance. In respect to rates, the objective is to ensure that they are not inadequate, excessive or unfair to consumers. For certain life insurance, annuity, disability and long term care products, a central approval process has been developed under the 2006 Interstate Insurance Product Regulation Commission (IIPRC) which 34 states have so far joined; • requirements in insurance codes applicable to insurance business – drawn from the NAIC Unfair Trade Practices Act (#880) and Unfair Claims Settlement Practices Act (#900), although implementation is not uniform across states; the requirements focus on the prohibition of an extensive list of specific misconduct and of unfair trade and claims practices (see below); other measures cover issues with particular products—for example, the Suitability in Annuity Transactions Model Regulation; • market conduct examinations which departments undertake on individual companies and producers – which cover conduct issues in underwriting, claims handling, marketing and other areas (see ICP 13); • data collection from insurers on market conduct issues – the NAIC Market Conduct Annual Statement (MCAS), introduced in 2004 is used by companies (again, not uniformly across states) to report data such as length of time taken to settle claims and replacement rates for some product types (persistency); it is used to target market wide responses and examinations; and as input to the Market Analysis Working Group (MAWG), a cross-state group of

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	regulators that operates on similar principles to the FAWG; • databases to enable departments to record and retrieve information on producers and companies—such as the Regulatory Information Retrieval System (RIRS) and the Special Activities Database (SAD) which is used to check applicants' background; • direct consumer services, particularly complaints handling but also consumer information and consumer education programs. Departments analyze and respond to complaints, taking up issues with companies or producers and requiring redress where appropriate. In respect of insurance claims handling, states uniformly require insurance claims to be settled in an equitable and fair manner. Specific acts are listed as "unfair claims practices," including knowingly misrepresenting relevant facts or policy provisions relating to coverage, not attempting in good faith to effectuate prompt, fair and equitable settlement of claims submitted in which liability has become reasonably clear; and attempting to settle or settling claims for less than the amount that a reasonable person would believe the insured or beneficiary was entitled by reference to material accompanying an application. Insurance regulators may levy civil penalties or take civil action in cases of unfair trade practices. In addition, policyholder protection in case of insolvency of an insurance company is provided by state guaranty associations covering individual life and health and property and casualty markets in each state. The scope and extent of the coverage of these organizations varies across states. With limited exceptions, they operate on the basis that insurance companies are assessed for contributions to the compensation paid to policyholders of an insolvent institution as payments become due. The annual assessment per insurer is capped, in most states at 2 percent of annual premium income. To date, actual assessments have been well below the cap.
Assessment	Observed
Comments	Departments have been increasing the scope of their consumer protection work in recent years, moving away from a traditional focus on financial issues (and handling of consumer complaints) to a more proactive approach to market conduct of insurers. Established regulatory tools from the financial area, and the model of cooperation and challenge between departments within an NAIC framework, have been extended to market conduct—for example in market conduct exams, MAWG and the extensive use of shared databases. Departments have tackled collectively some significant market conduct abuses at large multistate companies and across the market in respect of certain products and practices. This transition has further to go, however, particularly in respect of the ability of departments to identify and respond quickly to wider market issues as well as problems at individual companies. As with producer licensing, there is a marked lack of uniformity across states in the market conduct area, both in the requirements adopted by departments (including rate and form approval), and their participation in cross-state initiatives such as the IIPRC and MCAS. The absence of accreditation standards in this area makes it hard to judge the full impact of these variations, although it is clear that they create significant inefficiencies for multistate insurance companies and producers. However, as with the approach to producer licensing, core consumer protection requirements are apparently in place in most if not all states.
Principle 26.	**Information, disclosure & transparency toward the market** The supervisory authority requires insurers to disclose relevant information on a timely basis in order to give stakeholders a clear view of their business activities and financial position and to facilitate the understanding of the risks to which they are exposed.
Description	Insurance companies are not subject to any formal requirements from insurance regulators on their disclosure of financial or other information. Those which are publicly-traded companies or part of

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	groups headed by such a company are subject to SEC requirements on publication of financial statements and other information. Stakeholders do, however, have access to information through other means. Financial information can be obtained from the NAIC for a fee of US$2 per company by rating agencies and data vendors. Policyholders and other stakeholders may also obtain information on individual companies from the NAIC free (summary data and full financial statements on up to five companies) or a charge (more than five full statements). They can also approach relevant insurance departments direct, who make available financial statements direct but also refer enquirers to the NAIC. Reports describing the findings of examinations (principally matters of fact rather than examiners' judgments) are also available on departments' websites.
Assessment	Observed
Comments	While there are no regulatory requirements in relation to disclosure, full financial information, including the actuarial opinion and auditor's statement, are readily available to stakeholders. This reflects the relative ease of access and concentration of data that has resulted from financial statements being submitted direct to the NAIC. However, to improve the availability of information, in particular to policyholders without access to databases, ratings etc, and the understanding of insurers' risks, the NAIC should consider making publicly available for free more of the information which is currently subject to charges. The NAIC should consider a review of the benefits of developing a set of explicit disclosure requirements.
Principle 27.	**Fraud** The supervisory authority requires that insurers and intermediaries take the necessary measures to prevent, detect and remedy insurance fraud.
Description	Efforts to combat insurance-related fraud encompass a wide range of state, federal and private sector initiatives aimed at criminalizing fraudulent claims and other frauds, and committing resources to detect and prosecute cases of fraud. The NAIC model law Insurance Fraud Prevention Model Act (#680): • sets out a prohibition on insurance fraudulent acts; • gives investigative and other powers to the commissioner; • establishes mandatory reporting to the regulator; • provides for the confidentiality under law of relevant documents and information and for information to be shared with other agencies; • provides for the creation of fraud prevention units within departments; and • requires companies to take antifraud initiatives to detect, prosecute and prevent fraudulent insurance acts. As at April 2009, all states that had implemented the model had done so with significant variations and several had taken no action yet. The model is not covered by accreditation standards. There is also some federal legislation, such as measures against fraud in healthcare insurance. The model law does not explicitly refer to insurance claims fraud but defines "insurance fraudulent act" sufficiently widely (for example, with reference to presentation of false information) to cover such fraud. Departments may prosecute those found to have carried out insurance fraudulent acts themselves or refer the evidence to law enforcement agencies (for example where the department

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	does not have a prosecutor on its staff). Insurance regulators may levy civil penalties or take civil action using powers available in cases of unfair trade practices, where these are relevant. Antifraud initiatives required of companies include an antifraud plan, which must be submitted to the commissioner. Most insurance companies now have special investigation units (SIUs) to identify and investigate suspicious claims. Most departments have fraud prevention units (or fraud bureaus), whose function includes initiation of independent investigations and reviews of reports or complaints of alleged fraudulent insurance activities from federal, state and local law enforcement and regulatory agencies and insurers. Some of these fraud bureaus have significant resources in relation to the total available to departments. Financial and market conduct examinations are tasked to identify evidence of fraud. Guidance is provided to examiners in the NAIC Market Conduct Examiners Handbook. Examiners look at the anti-fraud plan and assess the adequacy of the resource commitments (and training) it sets out. The overall control framework (including, for example, internal audit), is assessed for its effectiveness in controlling against fraud, which is treated as part of operational risk for the purposes of risk-focused reviews (see ICP 13). An exhibit in the handbook sets out how fraud assessments should be undertaken and presented. The reporting of fraud by insurers to departments must cover external, internal and suspected claims fraud. The NAIC provides (for use by consumers as well as insurers) an online system, the Online Fraud Reporting System (OFRS). A report made in OFRS is delivered to all states in which the relevant insurer does business. The National Insurance Crime Bureau (NICB), a not-for-profit organization supported by the property and casualty insurance companies, works with insurers and law enforcement agencies to facilitate the identification, detection and prosecution of insurance crime. As well as managing databases of insurance crime, it organizes training, and promotes public awareness. It also undertakes investigations in cooperation with companies and law enforcement agencies. The NICB shares suspected fraud claims information with the NAIC who make it available to states. Regulators have statutory authority to share information regarding investigations, actions and examination results with other insurance regulators, other state, federal and international regulatory agencies and law enforcement agencies. Departments maintain relationships with state and federal law enforcement agencies and cooperate on investigations. Federal authorities are typically closely involved and are more likely to take the lead where there are international issues.
Assessment	Observed
Comments	While approaches vary by state, core requirements (such as making insurance fraud a crime) are in place across states. The capacity of departments to address fraud-related issues is increasing as market conduct exams are undertaken and the availability of data on fraud improves with the development of databases. Remaining gaps in the framework – for example, where departments do not require an anti-fraud plan from insurance companies – should be addressed as soon as possible.

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Anti-money laundering, combating the financing of terrorism	
Principle 28.	**Anti-money laundering, combating the financing of terrorism (AML/CFT)** The supervisory authority requires insurers and intermediaries, at a minimum those insurers and intermediaries offering life insurance products or other investment related insurance, to take effective measures to deter, detect and report money laundering and the financing of terrorism consistent with the Recommendations of the Financial Action Task Force on Money Laundering (FATF).
Description	Insurance companies are subject to the relevant AML/CFT provisions of the Bank Secrecy Act (BSA). In 2001, the USA PATRIOT Act amended the BSA to require that all businesses defined as financial institutions implement anti-money laundering (AML) programs. Insurers subject to the Act, including life insurance companies and other investment related insurers, are now required to comply with the provisions of the BSA, in particular, the AML program and suspicious activity reporting (SAR) provisions in respect to relevant business. The Financial Crimes Enforcement Network (FinCEN), a bureau of the U.S. Department of the Treasury, is responsible for the administration of the BSA and AML activities. The Internal Revenue Service (IRS) is the delegated examination authority for the insurance sector. FinCEN retains enforcement authority, including referral of cases to criminal law enforcement agencies. In 2005, the U.S. Treasury Department issued implementation rules as required under the amended BSA. The "Financial Crimes Enforcement Network; Amendment to the Bank Secrecy Act Regulations – Anti-Money Laundering Programs for Insurance Companies" (31 CFR 103.137) apply only to those insurance companies offering covered products. Covered products include: • a permanent life insurance policy, other than a group insurance policy; • any annuity contract, other than a group annuity; and • any other insurance product with features of cash value or investment. Since these requirements took effect in May 2006, each insurance company issuing or underwriting a covered product has had to develop and implement an anti-money laundering program reasonably designed to prevent the insurance company from being used to facilitate money laundering or the financing of terrorist activities. The insurer's program has to cover only the insurer's covered products. Key requirements are: • The program must incorporate policies, procedures, and internal controls based upon the insurance company's assessment of the money laundering and terrorist financing risks associated with its covered products. • The insurer is required to integrate the company's agents and brokers into its anti-money laundering program. Insurance agents and brokers themselves are not required to have separate anti-money laundering programs. However, the insurer is responsible for monitoring compliance by the company's agents and brokers with their obligations under the anti-money laundering program. (Certain insurance products fall within the definition of securities under the Securities Exchange Act and may only be sold by registered broker dealers who are subject to the separate anti-money laundering requirements of their regulators). • The insurance company must designate a compliance officer to be responsible for implementing and monitoring compliance of its anti-money laundering program including its agents and brokers. • The insurance company must provide training for appropriate persons.

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- The insurance company must provide for independent testing of the program on a periodic basis to ensure that it complies with the requirements of the rule.

- The program must be in writing and be approved by senior management. The written program must be made available to the Department of the Treasury, FinCEN, or their designee upon request.

The expectation of the authorities (see the supplementary information published with FinCEN Regulations in the Federal Register, November 3, 2005) is that policies and procedures adopted by insurance companies in their anti-money laundering and suspicious activity reporting programs will provide for obtaining all relevant customer-related information and appropriate assessment of customers and customer-related information (although the regulations do not explicitly refer to "customer due diligence"). In addition, the U.S. risk-based system requires enhanced measures with respect to higher-risk customers, and the general AML record-keeping requirements apply.

A limited number of anti-money laundering examinations have been conducted by the IRS under an MOU with FinCEN since 2007. These have covered insurance companies' processes in relation to agents and brokers. Results have been shared with FinCEN. There have been no cases taken forward for enforcement action as yet. Foreign branches and subsidiaries are not examined.

In parallel with further development of the IRS examination program, FinCEN and the IRS are now cooperating with the NAIC and state insurance departments on the development of procedures and information-sharing arrangements (MOUs). This may in due course result in the state regulators covering BSA anti-money laundering issues more fully in their examinations. At present, state regulators in their examinations determine whether insurers have established an anti-money laundering program that has been approved by senior management and contains the required elements. (Insurance departments may also look at how the company's compliance function takes account of money laundering risks.) If the examiner determines that the company has not established or is not maintaining such an anti-money laundering program, then they have the authority to refer this information to the appropriate federal authorities.

The NAIC has formed a subgroup to discuss a number of issues with FinCEN, including review of the examination handbook, possible educational assistance and consideration of examination collaboration.

Insurance companies also have to file reports in appropriate situations of the receipt of currency over US$10,000. This is in lieu of a requirement to file Currency Transaction Reports. They also have to make Suspicious Activity Reports as part of their anti-money laundering program. FinCEN has issued guidance on possible suspicious activity, including the purchase of an insurance product inconsistent with the customer's needs; unusual payment methods, such as cash, cash equivalents, or structured monetary instruments; and early termination of a product (including during the "free look" period), especially where it results in a cost to the customer.

FATF Mutual Evaluation Report (MER), published in June 2006, identified various issues in the insurance area, in part relating to the division of responsibilities between the federal and state levels. They were regarded by the evaluators as significant weaknesses in the overall context of the 2006 AML/CFT evaluation. The relevant weaknesses identified were:

- Obligations to identify beneficial owners are limited to specific circumstances, such as correspondent banking and private banking for non-U.S. clients, and do not extend to insurance business.

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	• There are no measures in place to ensure that there is adequate, timely and accurate information on the beneficial ownership and control of legal persons that can be obtained or accessed in a timely fashion by the competent authorities. • No explicit obligation to conduct ongoing due diligence, except in certain defined circumstances. • Customer identification for occasional transactions limited to cash deals only. • No requirement for life insurers issuing covered insurance products to verify and establish the true identity of the customer (except for those insurance products that fall within the definition of a 'security' under the federal securities laws). • Verification of identity until after the establishment of the business relationship is not limited to circumstance where it is essential not to interrupt the normal course of business. • No explicit obligation to terminate relationship if verification process cannot be accomplished. • The existence of a US$5000 threshold for reporting suspicious activity (too high). • Measures relating to politically-exposed persons (PEPs) do not explicitly apply to the insurance sector. • No explicit requirement requiring life insurers to have policies and procedures for non-face-to-face business relationships and transactions; • There is no obligation under BSA for financial institutions to implement employee screening procedures. • For introduced business, no obligation on relying institution to obtain identification/verification information from introducer. • For insurance, no specific requirement to establish and retain (for five years) all of the written records set out in the FATF Recommendations; life insurers of covered products are only required to keep limited records of SARs, Form 8300s, their AML Program and related documents. • In the insurance sector, there is no specific requirement to establish and retain written records of transactions with persons from/in countries that do not or insufficiently apply the FATF Recommendations. In addition, at a number of points in the evaluation report, it was noted that "the effectiveness of applicable measures in the insurance sector (which went into force on May 2, 2006) cannot yet be assessed." Published updates provided to the FATF by the U.S. authorities do not provide additional information on implementation. State insurance fraud bureaus have access to the Federal Bureau of Investigation Law Enforcement On-Line (LEO) website. This website contains training information related to a number of topics, including AML. Through LEO, the state insurance fraud bureaus facilitate inquiries regarding suspicious activities with life insurance policies in death or missing person cases. State insurance fraud bureaus work closely with the federal government when suspected money laundering activities are discovered. Both state and federal regulators have the authority to cooperate and share information relating to AML investigations.
Assessment	Partly Observed

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Comments	While money-laundering in connection with insurance has long been a criminal offence, the U.S. authorities have only recently brought relevant insurance business within the scope of anti-money laundering regulatory requirements (the Bank Secrecy Act). Implementing the approach has taken time, partly because of the careful consideration that has been given to the anti-money laundering risks in insurance. There were significant gaps in the framework when the most recent FATF MER was undertaken in 2006, particularly the absence of specific requirements in relation to customer information, while planned federal examinations had not then started. The IRS is now carrying out examinations. As its resources available for examinations are limited, it is cooperating with state insurance departments to make use of their expertise in this area. However, the effectiveness of cooperation between state and federal regulators is limited pending the consideration of legal issues arising from their collaboration and agreement of new procedures and information sharing arrangements. Both the federal government and state insurance departments wish to increase information sharing of examination information. This work has been given a high priority by the federal and state agencies but no deadline as yet. The regulatory approach also remains heavily reliant on requirements for insurance companies to include key processes, including customer due diligence, in anti-money laundering programs. It is recommended that a timetable is set for the agreement and implementation of new arrangements between state insurance departments and federal authorities that will deliver greater resourcing of supervisory activities as well as necessary information exchange. (A factual update on developments since the 2006 FATF work is being undertaken separately as part of the FSAP work.)

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APPENDIX I: TECHNICAL NOTE ON ACCOUNTING AND ACTUARIAL FRAMEWORK FOR INSURANCE

Introduction

There is a well established and comprehensive framework of accounting and related actuarial requirements, which supports insurance regulation. While it is heavily rules-based, it is beginning to move toward more of a principles-based approach.

Regulatory insurance accounting is driven by the NAIC-established Statutory Accounting Principles (SAP), which are contained and elaborated on in the NAIC *Accounting Practices and Procedures Manual* – March 2009 (APPM), which in turn utilizes the framework of Generally Accepted Accounting Principles (GAAP) established by the United States Financial Accounting Standards Board (FASB). However, GAAP pronouncements do not become part of the SAP until and unless they are specifically adopted by the NAIC.

SAP vs. GAAP

While GAAP is designed to meet the varying needs of the different users of financial statements, SAP is specifically designed to address the concerns of regulators. Therefore, SAP stresses the ability to pay insurance claims in the future, while GAAP stresses the measurement of emerging earnings of a business from period to period (i.e., matching revenue to expenses). Put another way, SAP is balance sheet driven, whereas GAAP is performance statement driven.

As regards measurement, SAP is conservative in some respects, but not unreasonably conservative over the span of economic cycles. Areas where the differences between SAP and GAAP are most evident are:

- **Policy Reserves** – statutory policy reserves are intentionally established on a conservative basis, emphasizing the long-term nature of the liabilities. Under GAAP, the experience expected by each company, with provision for the risk of adverse deviation, is used to determine the reserves it will establish for its policies. GAAP reserves may be more or less than the statutory policy reserves.

- **Assets** – GAAP has recognized certain assets which, for statutory purposes, have been either non-admitted or immediately expensed. Policy acquisition costs are expensed as incurred under SAP since the funds so expended are no longer available to pay future liabilities. Insurance company financial statements prepared in accordance with GAAP defer costs incurred in the acquisition of new business and amortize them over the premium recognition period.

- **Deferred Income Tax Assets** – historically these have not been recognized under SAP.

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- **Reinsurance** – the methods of accounting for certain aspects of reinsurance under GAAP may have varied from SAP (e.g., credit for reinsurance in unauthorized companies is not given under SAP).

APPM

The NAIC's APPM is a codification of all of the insurance regulatory accounting requirements and it incorporates much other material. It is maintained by the NAIC Accounting Practices and Procedures Task Force (APPTF), but the promulgation of new SAP guidance by the NAIC ultimately requires adoption by the NAIC membership. The APPTF employs two working groups with distinctly different functions to carry out the maintenance. The Statutory Accounting Principles Working Group (SAPWG) has the exclusive responsibility of developing and proposing new Statements of Statutory Accounting Principles (SSAPs). The Emerging Accounting Issues Working Group (EAIWG) responds to questions of application, interpretation, and clarification that are generally much narrower in scope than development of a new SSAP.

Concepts

The following concepts provide a framework to guide the NAIC in the continued development and maintenance of the SAP:

- **Conservatism** – statutory accounting should be reasonably conservative over the span of economic cycles and valuation procedures should, to the extent possible, prevent sharp fluctuations in surplus;

- **Consistency** – meaningful, comparable financial information to determine an insurer's financial condition requires consistency in the development and application of statutory accounting principles;

- **Recognition**

  - Assets having economic value other than those which can be used to fulfill policyholder obligations, or those assets which are unavailable due to encumbrances or other third party interests should not be recognized on the balance sheet but rather should be charged against surplus when acquired or when availability otherwise becomes questionable;

  - Liabilities require recognition as they are incurred; and

  - Revenue should be recognized only as the earnings process of the underlying underwriting or investment business is completed.

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Structure of APPM

The manual is large (about 3,500 pages), has some duplication, shows signs of much evolution and addition, and is thus in need of an overhaul to improve readability and navigation. However, it is comprehensive and thorough. The main elements to its structure are:

- **SSAPs** – the primary accounting practices and procedures promulgated by the NAIC; these are contained in the body of the APPM;
- **Guidance for specific SSAPs** – contained in APPM Appendix A;
- **Interpretations of the EAIWG** – contained in APPM Appendix B;
- **Actuarial guidelines** – contained in APPM Appendix C (NB these are only for business written in life and health insurers);
- **GAAP cross-reference to SAP** – contained in APPM Appendix D;
- **Issues papers** – usually the first step in developing new SSAPs and contain a recommended conclusion, discussion and relevant literature section; contained in APPM Appendix E;
- **Policy statements** – these are for information only as they relate to the process of maintaining and updating the APPM; so they are not accounting requirements or guidance; contained in APPM Appendix F; and
- **Audit implementation guide** – to supplement the NAIC Annual Financial Reporting Model Regulation related to auditor independence, corporate governance and internal control over financial reporting, which is proposed to become effective in 2010.

Hierarchy of APPM elements

The following is the specified hierarchy of how the various elements of the APPM are to be applied:

- **Level 1 -** Statements of Statutory Accounting Principles (SSAPs)—the primary accounting practices and procedures promulgated by the NAIC, which are generally the result of issue papers that have been exposed for public comment and finalized. If differences exist between an underlying issue paper and the resultant SSAP the SSAP

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prevails and shall be considered definitive. Also includes specific GAAP material[7] adopted by the NAIC, namely:

- *Category a* – FASB Statements and Interpretations, FASB Staff Positions, APB Opinions, AICPA Accounting Research Bulletins;
- *Category b* – FASB Technical Bulletins, AICPA Industry Audit and Accounting Guidelines, AICPA Statements of Position; and
- *Category c* – Consensus positions of the FASB Emerging Issues Task Force, AICPA Practice Bulletins;

- **Level 2 -** Consensus positions of the NAIC EAIWG;
- **Level 3 -** NAIC Annual Statement Instructions (ASI);
- **Level 4 -** NAIC Statutory Accounting Principles Statement of Concepts; and
- **Level 5 -** GAAP reference material below Category c in the GAAP Hierarchy.

Annual Statement Instructions (ASIs)

The NAIC issues ASIs for annual statements, which insurers must file with the NAIC, and which are available to all States through the NAIC's databases and systems. There are separate ASIs for each category of insurer or insurance business undertaken (i.e., life, health, property and casualty, fraternal, title). The type of the information and data to be provided is specified in detail in each ASI and the appropriate format for filing the annual statement data with the states and the NAIC is provided in the Annual Statement Blanks (Blanks). The ASIs specify how the Blanks are to be signed, the state insurance authority specifies which directors, officers and trustees are required to sign, and the Blanks require signing individuals to attest to the accuracy of the statements.

The type of information and data to be filed is:

- Actuarial Opinion—this is in relation to the insurance reserves (see below for more details);
- Annual Audited Financial Reports—there must an annual audit by an independent certified public accountant and an audited financial report must be filed as a supplement to the annual statement (see below for more details of audit);

[7] FASB has recently completed a major 5-year project of *Accounting Standards Codification*™ resulting in the Codification, which from 1 July 2009 is the single source of authoritative nongovernmental U.S. generally accepted accounting principles and replaces all previous U.S. GAAP standards. The NAIC APPM does not yet reflect this.

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- Management's Discussion and Analysis—this must discuss the reporting entity's financial condition, changes in financial condition and results of operations in order to assist regulators properly understand and assess the insurer's financial condition. The items required to be covered include:

  - material historical developments;
  - explanation of operating performance, including long term trends;
  - prospective information, especially that which is likely to have a material impact on the insurer's business volumes, net income and surplus;
  - reasons for material changes in line items;
  - liquidity, asset/liability matching and capital resources;
  - loss reserves (property & casualty only);
  - off-balance sheet arrangements;
  - participation in high-yielding, highly-leveraged or non-investment grade transactions or investments; and
  - preliminary merger and acquisition negotiations.

- Financial Statement—usual items (assets, liabilities, surplus/capital, operating statement, cash flow statement), but also detailed analyzes, exhibits or notes (which vary by category of business), such as:

  - breakdowns by line of business;
  - breakdowns of major line items (e.g., expenses, premiums, reinsurance);
  - changes in reserves;
  - non-admitted assets; and
  - five-year historical data.

- Investment Schedules—these cover summary information by asset class, but also detailed of the individual assets currently owned, acquired and/or disposed of during the year; and

- Annual Supplements—some are for all categories of business and some are specifically only for one category;

  - director and senior officer compensation (i.e., total compensation for each such individual)—all categories;

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- allocation of insurance expenses to lines of business (to assist in assessing profitability by line of business)—all categories,
- investment risk interrogatories (to assist in identifying and analyzing the risks inherent in the entity's investment portfolio)—all categories;
- various claims experience analyzes for specific lines of business; and
- actuarial opinion certificates.

These ASIs are almost identical across the categories of insurance business, but do contain some variations in the detail in the financial statements and annual supplements.

Actuarial requirements

Statements of Actuarial Opinion (SAO) and Actuarial Memorandum

In all categories of insurance business the insurer must obtain, and file as part of its annual statement, a Statement of Actuarial Opinion (SAO) by a qualified actuary on the insurance reserves. The precise form of the SAO varies by category of insurance, but includes:

- the identification of the actuary providing the opinion;
- which reserves are covered by the opinion;
- any reliance the actuary has placed on others in forming the opinion;
- the actuary's opinion on if the reserves:
  - meet the requirement of the insurance laws;
  - are computed in accordance with accepted actuarial standards and principles;
  - make a reasonable provision for all insurance obligations of the insurer; and
  - the adequacy of a life or health insurer's reserves and other liabilities in light of supporting assets and under moderately adverse conditions—a number of asset adequacy analysis methods are available to, and used by, actuaries. The most widely used method is cash flow testing.
- relevant comments by the actuary (e.g., material assumption changes, risk of material adverse deviation).

The SAO needs to be supported by some form of actuarial report and work papers (often described as the "Actuarial Memorandum"). The Actuarial Memorandum should provide sufficient narrative detail to clearly explain to company management, the regulator, or other authority the findings, recommendations and conclusions, as well as their significance. It should also provide sufficient technical documentation and disclosure for another actuary

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practicing in the same field to evaluate the work. This technical component must show the analysis from the basic data to the conclusions.

Both the SAO and Actuarial Memorandum must be consistent with the appropriate Actuarial Standards of Practice (ASOPs) issued by the Actuarial Standards Board (ASB),[8] and any other relevant standards or principles issued by the relevant actuarial professional body.[9]

The SAO is publicly available, but the Actuarial Memorandum is confidential, and thus only available for regulatory examination.

Qualified Actuary

A qualified actuary generally needs to be a member in good standing of the American Academy of Actuaries (AAA) or a person recognized by the AAA as qualified for such an actuarial valuation. For property and casualty business the qualified actuary can be a member in good standing of the Casualty Actuarial Society. Qualified actuaries must also meet requirements related to their experience in working on such actuarial valuations, under the review of other qualified actuaries.

Appointment of and reporting by the qualified actuary

The qualified actuary must be appointed by the insurer's Board of Directors, or its equivalent, or by a committee of the Board and the NAIC must be notified each year of the qualified actuary which the insurer will be using for its categories of insurance business. If a qualified actuary is replaced the insurer must urgently notify the insurance regulatory authority, including stating if there have been any disagreements with the previous qualified actuary over the preceding two years, The insurer must also in writing request the previous qualified actuary to provide a letter to the insurer stating if the actuary agrees with the insurer's statement, or not, and then provide the actuary's response letter to the insurance regulatory authority.

When there is a change of qualified actuary, the incoming qualified actuary would generally consult with the previous qualified actuary, and the code of conduct of the AAA requires the previous qualified actuary to cooperate.

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[8] The ASB establishes and improves Actuarial Standards of Practice (ASOPs), which identify what the actuary should consider, document, and disclose when performing an actuarial assignment. Members of the ASB are appointed by the presidents and presidents-elect of the various U.S. actuarial bodies.

[9] These are the American Academy of Actuaries, the American Society of Pension Professionals and Actuaries, the Casualty Actuarial Society, the Conference of Consulting Actuaries, and the Society of Actuaries.

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The qualified actuary must report to the Board of Directors or the audit committee each year on the items within the scope of the SAO. The SAO and the Actuarial Memorandum must be made available to the Board of Directors. The minutes of the Board of Directors should indicate that the qualified actuary has presented such information to the Board or the audit committee and that the SAO and the Actuarial Memorandum were made available.

Actuarial Discipline

The Actuarial Board for Counseling and Discipline (ABCD) was established by the U.S. actuarial bodies to strengthen members' adherence to the recognized standards of ethical and professional conduct. The ABCD has two primary functions: it responds to actuaries' request for guidance on professional issues, and it considers complaints about possible violations of the actuarial Code(s) of Professional Conduct. The ABCD is authorized to counsel actuaries concerning their professional activities and to recommend to the relevant actuarial body any disciplinary action.

Legal authority

NAIC Model Law #205 *Annual Financial Reporting Model Regulation* (Law #205) in Section 5 requires that the annual audited financial report shall report the financial position of the insurer as of the end of the most recent calendar year and the results of its operations, cash flows and changes in capital and surplus for the year then ended in conformity with statutory accounting practices prescribed, or otherwise permitted, by the department of insurance of the state of domicile. The annual audited financial report shall include the following:

A. Report of independent certified public accountant.

B. Balance sheet reporting—admitted assets, liabilities, capital and surplus.

C. Statement of operations.

D. Statement of cash flow.

E. Statement of changes in capital and surplus.

F. Notes to financial statements. These notes shall be those required by the appropriate ASIs and the APPM. The notes shall include a reconciliation of differences, if any, between the audited statutory financial statements and the annual statement filed with a written description of the nature of these differences.

G. The financial statements included in the audited financial report shall be prepared in a form and using language and groupings substantially the same as the relevant sections

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of the annual statement of the insurer filed with the commissioner, and the financial statement shall include comparatives.

Through Law #5, the SSAPs and all the detailed requirements of the APPM, as well as the ASIs obtain their legal authority. All 50 states and the District of Columbia have adopted this model law.

Life and health insurers are required by NAIC Model Law #820 *Standard Valuation Law* to value reserves for the liabilities for all their outstanding insurance policies. It specifies valuation methods and minimum standards for the computation of the reserves. It, along with NAIC Model Law #822 *Actuarial Opinion and Memorandum Regulation,* requires a SAO to be submitted as part of the annual statement of an insurer, and it specifies the substance and the form of the SAO. These SAO requirements are also contained in the life ASI.

For property and casualty insurers a number of SSAPs[10] specify for various types of business and types of reserves how the reserves should be calculated. They obtain their legal authority through Law #205. The SAO requirements in relation to property and casualty reserves are contained in the property and casualty ASI.

Move to a principles-based approach (PBA)

Legislation on the calculation of insurance reserves began in the United States in the 1850s. It covered only life insurance contracts and the initial commissioner chose a net level premium reserve method using a specified mortality table for expected death claims and specified interest rate for discounting future cash outflows and inflows. For life and health insurance, there has been little change over the last 150 years. So for traditional life and health insurance contracts the minimum reserve is still based on a formula approach with prescribed mortality and interest rates, although mortality varies by type of product and interest rate varies by year of issue. No actuarial judgment is allowed in determining the minimum reserves. The prescribed actuarial assumptions are mostly conservative leading to conservative reserves. Generally, minimum reserve standards have been established to be sufficient to cover future claims 75 percent-85 percent of the time.[11] In the 1990s an asset adequacy analysis test was added to the required SAO to test the adequacy of the formulaic reserves in the light of the supporting assets.

The formula-based system for calculating reserves relies on a static formula that may not capture all the risks of the contract. It is slow to respond to new and complex products or economic developments. It follows a 'one size fits all' approach, thereby restricting the use

[10] SSAPs 5, 53, 55, 57, 58, 60, 62, and 65.

[11] AAA presentation: *Introduction to Principles –Based Approach to life reserves and capital* – September 2009.

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of actuarial judgment to incorporate the insurer's risk profile. Ideally the reserving and capital requirements need to take account of the insurer's actual product and business practice risks.

The first steps toward principle-based capital standards were C–3 Phase I (addressed interest rate risk in fixed annuities) in 2000 and C–3 Phase II (addressed interest rate and equity risk in variable annuities) in 2005. The first step toward principle-based reserves was VA CARVM (variable annuity Commissioner's annuity reserve valuation methods) in 2008 which is a framework of insurer-specific calculation for variable annuity reserves.

A principles-based approach can better allow for the insurer's 'tail' risks, where low probability events can have large adverse impact. It is generally more in line with how an insurer designs and prices its products, manages its investments, and internally reports and manages its performance and exposures. It is similar to using internal models for reserving and capital. So it involves identifying risks, generating economic scenarios, designing risk models, determining assumptions with appropriate margins, running models to do sensitivity testing of material risks, and documenting the results and processes. Using this approach to determine reserves and capital also requires a determination of the probability of sufficiency or safety desired in the level of desired reserving and the level of desired capital.

The project underway to develop the PBA for life insurance is part of the solvency modernization initiative of the NAIC, but involves considerable input from the U.S. actuarial profession. The approach to this project is to modify the standard valuation law to enable principles-based reserving to be used, by referring to a valuation manual which can then be amended as needed by the NAIC. The valuation manual would include detailed reserving requirements, will be implemented in phases and apply only to specific products. It will also be necessary to develop principles-based capital requirements to mesh with the principles-based reserving requirements. The principles-based capital requirements will also be developed in phases by risk type and product, commencing with interest rate mismatch and equity risk (C–3).

The basic framework for what will be developed is that the reserve will be the greater of a deterministic component and a stochastically derived component. The deterministic component will use a single economic scenario and acts as a floor under the stochastic component. The stochastic component will allow the reserving to be more closely related to each product's risks, it will be determined using multiple economic scenarios to capture tail risk and the reserve level will be targeted at a conditional tail expectation of 70 percent (i.e., the reserve amount is that needed to meet payouts from the average of the highest 30 percent of the economic scenario results).

It will also be necessary to adjust the capital requirements to mesh well with the new reserving requirements. Initially only the C3 capital requirement will be adjusted for those

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products for which PBA reserving will apply. The capital requirement will be determined stochastically and the statutory reserves plus capital will be targeted at a conditional tail expectation of 90 percent.

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Statement by the IMF Staff Representative on the United States
July 22, 2010

1. **This note reports on information that has become available since the staff report (SM/10/189) was issued and does not alter the thrust of the staff appraisal**.

2. **Incoming data since the completion of the Article IV consultation in mid-June point to a continued but subpar recovery, with further downside risks to the staff's forecast**. First-quarter GDP growth was revised down by 0.5 percent (saar), mainly owing to weaker final demand. Recent data also indicate softening consumer confidence, dwindling tailwinds from the inventory cycle, weak private sector employment growth, and reduced housing activity on the expiry of the homebuyer tax credit. In addition, imports picked up strongly relative to exports in June, although this could partly be attributable to temporary factors such as the expiry of an export VAT rebate in China. All told, activity in the second quarter has been weaker than expected, with GDP growth in the second quarter of 2010 tracking below the WEO estimate. On fiscal policy, the Senate has approved another temporary extension of unemployment benefits, and the authorities plan to unveil their mid-session budget update on Friday, July 23.

3. **The Dodd–Frank Wall Street Reform and Consumer Protection Act of 2010 was cleared to be signed into law by President Obama**. Most major provisions of the Dodd–Frank Act—the new inter-agency Council, the resolution mechanism for systemic financial firms, the wider regulatory perimeter and stronger consolidated supervision, and the new regulatory framework for derivatives market—are in line with U.S. FSAP recommendations, which was conducted as this law took shape. That said, as flagged in the FSAP, the U.S. regulatory system remains complex, and the effectiveness of the reform will hinge on its implementation.

4. **Risk aversion continues to drive financial conditions**. Stock prices have fallen below end-2009 levels, the dollar remains elevated relative to the start of the year, and Treasury yields have declined on flight to quality. Consumer credit fell in June and a Fed survey recorded easier credit terms, although terms remained tighter than at end-2006. Second-quarter earnings for financial institutions were largely disappointing, with meager trading revenues, and continued high (albeit easing) credit costs.

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IMF Executive Board Concludes 2010 Article IV Consultation with the United States

On July 26, 2010, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the United States.[1]

Background

Thanks to a massive policy response, the U.S. economy is recovering from the worst financial crisis since the Great Depression. Monetary policy has maintained a highly accommodative tilt, with policy rates near zero and asset purchases that have helped to ameliorate financial strains. Fiscal policy has been very stimulative, with the American Recovery and Reinvestment Act imparting stimulus of about 5 percent of GDP during 2009–2011, supplemented by measures targeted to housing, labor and auto markets. Meanwhile, measures to stabilize financial markets, capital injections, guarantees, and stress testing dramatically improved financial conditions. As a result, GDP grew an average 4 percent (seasonally adjusted annual rate) in the second half of 2009 before slowing to 2.7 percent (saar) growth in the first quarter of 2010. The U.S. current account deficit shrank on the back of weak domestic demand, lower oil prices, and the cumulative effect of the depreciation trend in the dollar since early 2002.

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the First Deputy Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

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However, the economic recovery has been slow by historical standards—consistent with past experience in the aftermath of housing and financial crises—and the outlook remains uncertain. In particular, private demand has been sluggish, while the unemployment rate has receded only modestly from near post-Depression highs. As a result, inflation has remained contained, with core inflation easing amid wide economic slack. Recent market volatility from the sovereign crisis in Europe has tightened financial conditions somewhat despite safe-haven flows that have reduced Treasury yields. Looking ahead, risks are elevated and tilted to the downside (as clear from the most recent batch of economic indicators), with particular risks from a double dip in the housing market and spillovers if external financial conditions worsen.

Macroeconomic policies are set to remain accommodative in the near term. The draft FY2011 budget includes allowances for further targeted support for growth, while proposing measures aimed at reducing the deficit to 4 percent of GDP by the middle of the decade. A new Fiscal Commission will recommend measures aimed at further reducing the deficit to roughly 3 percent of GDP and stabilizing the ratio of debt to GDP over the medium term. Most of the special liquidity facilities have been phased out and the Fed ended its mortgage-backed securities purchase program without disrupting markets, while signaling continued low policy rates for an extended period.

Progress has been made in addressing long-term challenges. The health care reform widens coverage and introduces cost-containment measures, and seeks to reduce near-term deficits as well as the long-term fiscal gap. The financial regulation reform, which is broadly consistent with proposals in the IMF's Financial Stability Assessment Program, includes a broadening of the regulatory perimeter to all systemic institutions and markets, a new council of regulators to improve systemic risk detection and resolution, tighter prudential regulation parameters, and stronger resolution mechanisms for nonbank financial institutions.

Executive Board Assessment

Executive Directors noted the economic recovery underway in the United States, aided by a massive policy response. However, with recovery still dependent on policy support, rising downside risks, and substantial long-term fiscal and financial-sector challenges, further decisive action is needed to achieve stable medium-term growth and limit risks of adverse international spillovers.

Directors saw near-term tradeoffs between supporting recovery and addressing long-term legacies. Macroeconomic support remains appropriate for this year, given still-weak demand, high unemployment, and lingering financial strains, although the envisioned withdrawal in 2011 is appropriate. Monetary support can be sustained for longer, given quiescent inflation expectations and forthcoming fiscal drag. However, Directors saw scope for a smaller up-front fiscal adjustment if downside risks materialize, complemented by measures to bolster medium-term credibility.

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Setting public debt on a sustainable path is a key macroeconomic challenge. Directors welcomed the authorities' commitment to fiscal stabilization, but noted that a larger than budgeted adjustment would be required to stabilize debt-to-GDP under staff's economic assumptions, requiring revenue and expenditure measures. They urged the authorities to accompany the 2011 adjustment with a strong commitment to medium-term stabilization, perhaps including further entitlement reform. Some Directors welcomed the creation of the Fiscal Commission and the Independent Payment Advisory Board as useful steps. A number of Directors encouraged the authorities to set debt-to-GDP on a declining path in the longer term.

Directors welcomed the health care reform, including enhanced coverage and measures to control costs, the key long-term fiscal risk. However, with payoffs highly uncertain, close monitoring of costs and remedial actions, if needed, will be essential. Further action is also necessary on Social Security, where needed measures are well known and payoff more certain.

Directors welcomed the FSAP assessment, which acknowledged that the financial system has strengthened but remains vulnerable to shocks. Private securitization is still impaired and banks may lack balance-sheet strength to support future credit demand. Accordingly, banks must fully recognize balance-sheet risks and have sufficient capital to support recovery.

Directors welcomed the major financial reform, which is broadly consistent with FSAP recommendations, but noted that strong implementation will be crucial. Close coordination among regulatory agencies is essential, as the reform missed the opportunity to consolidate the complex array of regulators. Directors also underscored the importance of containing counterparty risks in OTC derivatives markets; revitalizing private securitization; and moving ahead with reforms to the housing finance system, including the GSEs.

Directors saw the Federal Reserve as well placed to manage the monetary exit given its expanded toolkit. The Fed has credibly communicated its commitment to sustaining accommodative monetary conditions while preparing for the exit. Continued clear communication is essential as the exit evolves.

Directors saw a key role for the United States in promoting multilateral economic management. U.S. economic policy could help secure medium-term global growth and stability mainly through medium-term fiscal consolidation, which could also help reduce the current account deficit, and strengthening the financial sector. On trade policy, Directors welcomed the authorities' limited recourse to protectionist measures and encouraged them to redouble efforts to conclude the Doha round.

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This Technical Note on Selected Issues on Liquidity Risk Management in Fedwire Funds and Private Sector Payment for the United States was prepared by a staff team of the International Monetary Fund. It is based on the information available at the time it was completed in May 7, 2010. The views expressed in this document are those of the staff team and do not necessarily reflect the views of the government of the United States or the Executive Board of the IMF.

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FINANCIAL SECTOR ASSESSMENT PROGRAM

UNITED STATES OF AMERICA

SELECTED ISSUES ON LIQUIDITY RISK MANAGEMENT IN FEDWIRE FUNDS AND PRIVATE SECTOR PAYMENT SYSTEMS

TECHNICAL NOTE

MAY 2010

INTERNATIONAL MONETARY FUND
MONETARY AND CAPITAL MARKETS DEPARTMENT

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Contents Page

Glossary 3

Executive Summary 4

I. Overview 7

II. Central Bank Policy in Providing Liquidity to Payment Systems and Critical Market Infrastructures 9
- A. Observations on the Current Daylight Credit Policy 10
- B. Main Features of the New Daylight Credit Policy 12
- C. Assessment of the New Daylight Credit Policy of the Fed 13

III. Efforts to Reduce Late-Day Settlement in Payment Systems and Market Infrastructures 13
- A. Liquidity Saving Mechanism in Fedwire Funds 14
- B. Reducing End-of-Day Settlement in CHIPS 15

IV. Risk Management 17
- A. Concentration of Settlement 17
- B. Stress Testing and Simulations 18
- C. Operational Resilience 19
- D. Access of Systemically Important Infrastructures to Central Bank Services 20
- E. Interdependencies 20

Tables

1. Overview of the Large Value Payment Systems Operating in the United States 7
2. Comparison of Intraday Credit Policies Between the U.S. and Selected Countries 10
3. Key Elements of the Current and Revised PSR Policy for Daylight Credit 12

Box

1. Overview of the CHIPS Settlement Model 16

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GLOSSARY

CHIPS	Clearing House Interbank Payments System
CLS	Continuous Linked Settlement
CMS	Collateral Management System
CPSIPS	CPSS Core Principles for Systemically Important Payment Systems
CPSS	Committee on Payment and Settlement Systems
DTC	Depository Trust Company
EPN	Electronic Payments Network
FBOs	Foreign Banking Organizations
Fed	Federal Reserve
FICC	Fixed Income Clearing Corporation
FX	Foreign Exchange
IOSCO	International Organization of Securities Commissions
MCA	Monetary Control Act
PRC	Payment Risk Committee
PSR	Payment System Risk
RTGS	Real Time Gross Settlement System
SSS	Securities Settlement System
WCAG	Wholesale Customer Advisory Group

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EXECUTIVE SUMMARY[1]

The U.S. payment and settlement systems continued to function smoothly during the 2007-2008 period of market stress. This owed both to the robustness of the systems' risk management and infrastructure and to the actions by the Federal Reserve (Fed) to sharply increase balances held at the Federal Reserve Banks by financial institutions (reserve balances).

However, especially as the Fed's extraordinary liquidity support is withdrawn, underlying vulnerabilities within the system will need to be addressed, most notably:

- Intraday credit from the Fed is largely in the form of uncollateralized but capped daylight overdrafts (where uncollateralized intraday overdraft caps are generally set as a percentage of the capital of the financial institution), subject to an administered fee. Caps and fees encourage some large depository institutions to delay settlement of large-value funds payments over Fedwire Funds (the Fed's Real Time Gross Settlement (RTGS) system) until late in the day, especially for fees avoidance purposes.
- The fact that the Fedwire Funds system provides neither a central queuing/payment offsetting mechanism nor other liquidity saving features exacerbates the problem of late payments in Fedwire Funds.[2]

These issues pose risks both domestically and internationally. Domestically, the increase in late-in-the-day payments leaves the payment system as a whole more vulnerable in case of a late-in-the-day operational disruption. Internationally, the end-of-day closure of U.S. payment systems effectively means the worldwide "end-of day" so a liquidity disruption in the U.S. system could constitute a critical shock that could propagate systemic risk at the following day opening in Asia and Europe.

The new intraday liquidity policy of the Fed, to be implemented late 2010 or early 2011, will help address some of the risks presently facing the payment system. The new Payment System Risk (PSR) policy promotes the collateralization of intraday credit. Collateralized overdrafts under the new policy will not be charged a fee and will therefore work both to reduce the incentive to delay certain payments until late in the day, as well as to reduce the Fed's credit risk from providing intraday credit. Although substantial, the effectiveness of these changes (and others underway) in encouraging Fedwire participants to send payments earlier in the day will need to be assessed over the medium term, and it remains to be seen whether additional steps to amend the intraday credit framework (e.g., relaxing further or removing net debit caps) would also help.

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[1] This Technical Note was prepared by Frédéric Hervo (external expert, Banque de France).

[2] Some of this functionality is, however, provided by CHIPS, a private-sector funds transfer system.

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While an asymmetric treatment of foreign banking organizations (FBOs) exists regarding the calculation of the capital measure for caps and the fee deductible, policy provisions implemented in March 2009 substantially addressed this asymmetry. For example, highly-rated FBOs are eligible for a fee deductible based on 100 percent of worldwide capital, the same capital measure used for U.S. chartered institutions, and highly-rated FBOs are eligible for additional collateralized capacity under a streamlined process. Additionally, under the new policy, the fee deductible is eliminated for all institutions—FBOs and U.S. chartered institutions. While these changes represent substantial progress toward the equitable treatment of FBOs, additional steps could be considered to provide a more level playing field relative to U.S. banks while ensuring an adequate level of comfort with respect to credit risk mitigation.

Steps are needed to amend Fedwire's settlement procedures for tri-party repo transactions, Depository Trust Company (DTC), and Clearing House Interbank Payments System (CHIPS) to discourage late-in the-day payments. The Fed identified a four-prong approach, including revising the PSR policy, exploring the introduction of a liquidity saving mechanism for Fedwire Funds, and making liquidity improvements for CHIPS and DTC, to move payments earlier in the day.[3] The CHIPS system has been successful in reducing the amount of payments processed late, especially by encouraging its participants voluntarily to provide supplemental funding earlier. However, further efforts in this area should be encouraged especially since the underlying risks may re-emerge as liquidity levels return to normal.

ONGOING EFFORTS AND RECOMMENDATIONS

Ongoing efforts

- Over the past several years, the Fed has outlined steps to improve the payment system, including the following:
    - Implement and take further steps, as appropriate, to increase collateralized intraday credit and reduce uncollateralized overdrafts as a way to (i) strengthen the credit risk management of the Reserve Banks, (ii) incentivize institutions to send large-value funds payments earlier in the day, and (iii) further align the treatment of FBOs and U.S. chartered banks.
    - Explore the introduction of liquidity-saving features in Fedwire Funds.
    - Support the continued efforts by the private sector to reduce late-in-the-day settlements associated primarily with tri-party repo and settlement processes in DTC and CHIPS.

[3] 73 FR 79110, December 24, 2008.

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Recommendations

- In line with the Administration's proposal, the Fed Banks should be granted the legal right to give access to accounts and liquidity to systemically important post-trade market infrastructures as an additional buffer to mitigate systemic risk.
- The Fed, in cooperation with other relevant agencies, should continue to review the ability of payment, clearing, and settlement systems to cope with extreme liquidity stress scenarios in light of the lessons of the crisis, on the basis of stress testing scenarios and simulations, taking into account the concentration of payment and settlement services, as well as the complex interdependencies among systems.

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I. Overview

1. **The U.S. wholesale payment infrastructure comprises two systems, which are of a systemic importance and settle in central bank money.** The Fed Banks' Fedwire Funds Services (Fedwire) is a real time gross settlement system (RTGS) operated by the Fed, while the Clearing House Interbank Payments System (CHIPS) is a private sector system combining net and gross real time settlement. In addition to these domestic systems, payments services are offered by Continuous Linked Settlement Bank International (CLS Bank), which operates payment versus payment settlement services in 17 currencies mainly for foreign exchange (FX) related transactions.[4]

Table 1. Overview of the Large Value Payment Systems Operating in the United States

System	*Average daily value (Q2 2009 – USD trillion)*	*Percentage change from one year ago*	*Average daily volume (Q2 2009 – thousands)*	*Percentage change from one year ago*	*Number of direct participants*
Fedwire Funds	2.49	- 15.8	498	- 5.6	7,300
CHIPS	1.43	- 33.2	330	- 9.7	48
CLS*	3.34	- 20.6	590	+ 15.9	59

*CLS data excludes Memorial Day, a U.S. dollar holiday.

2. **In contrast, the U.S. retail payment infrastructure is more fragmented.** There are two national Automated Clearing House operators: the Reserve Banks and Electronic Payments Network (EPN, a private sector entity) and several regional and interregional check image exchanges and card payment schemes.

3. **The U.S. wholesale payment infrastructure is at the heart of a complex network of critical interdependencies, both from domestic and international perspectives**. The most significant example is CLS Bank, which is linked for funding purposes to the RTGS systems of the 17 central banks for the currencies currently eligible in the system.

4. **U.S. payment and settlement systems were a source of strength throughout the 2007-2008 period of market stress**. The systems performed well, including the implementation of participant failure management procedures, despite the significant challenges arising from unprecedented financial market stresses, higher than normal and more variable payment and settlement volumes and values, the financial difficulties of a number of

[4] Although this report covers issues related to CLS, a full review of CLS risk management is beyond its scope.

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individual financial institutions, and a higher degree of uncertainty regarding counterparty risk. Despite these challenges, the U.S. systems were able to complete settlement on the day of value.

5. **The settlement and operational risk management frameworks for the U.S. payment systems appear to be robust.** A formal assessment of the compliance of the various systems with international standards, namely the Committee on Payment and Settlement System (CPSS) *Core Principles for Systemically Important Payment Systems (CPSIPS)*, was not performed. Self-assessments of Fedwire Funds, CHIPS and CLS Bank, conducted prior to the mission, suggested a full compliance of the three systems with CPSIPS.[5]

6. **During the turmoil, the Fed, the Securities and Exchange Commission, the Commodity Futures Trading Commission, the Treasury Department and other regulators undertook significant action to help ensure the smooth functioning of the financial markets, including the payments system.** These included massive liquidity injections to help address the dislocation of the interbank market from September 2008 onwards, as well as obtaining Congressional approval for an accelerated implementation of payment of interest on reserves. As a result, reserve balances rose from an average of around US$9 billion in early 2008 to over US$1 trillion in October 2009. This increase in reserve balances did not prevent, however, a temporary increase in the demand for intraday credit during the crisis, likely reflecting among other factors an increase in values transferred over the Fedwire Funds and Securities services, and risk aversion. For instance, during the period which followed the collapse of Lehman Brothers (between September 15 and October 24, 2008) the use of daylight overdrafts by Fedwire Funds participants increased about 50 percent compared to the previous quarter.

7. **In recent decades, the increased use of gross settlement and real time finality in payment systems have mitigated or even eliminated a large part of settlement risk but have created additional structural demand for intraday credit.** The emergence of some categories of time-critical payments as a risk management tool for some systems (e.g., CLS Bank funding requirements) that have to be completed within tight intraday deadlines have also increased intraday liquidity pressures.

8. **Increased demand for intraday credit, which has been observed in most industrial countries, is exacerbated by specific features in the United States**. Starting in the late 1980s, financial institutions began decreasing their overnight reserve balances. More recently, late-in-the-day payments associated with the settlement of tri-party repo grew, and settlement procedures in CHIPS and DTC tended to lock up significant amounts of liquidity until late in the day.

[5] See http://www.treas.gov/offices/international-affairs/standards/standards.shtml.

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II. Central Bank Policy in Providing Liquidity to Payment Systems and Critical Market Infrastructures

9. **Since the 1980s, the Fed was explicit in its desire to limit its provision of intraday credit, reflecting a desire to insulate the Fed System from credit risk.** As a result, while daylight overdrafts are uncollateralized**,** access is capped and subject to a fee.[6] Collateral is typically required for overdrafts above the net debit cap (but still subject to a maximum cap).[7] The control over the level of intraday credit provided and fees are the main tools used by the Fed to minimize the use of daylight overdrafts by participants.[8] This differs from most central banks in other major financial centers, where the practice is typically to provide collateralized intraday credit without a fee or cap.

10. **In 2008, the Board of the Governors approved a revision to its PSR policy that permits and encourages the collateralization of intraday credit for all depository institutions.** Provisions significantly improving the equity of the policy's treatment of FBOs went into effect in March 2009, and the remaining provisions of the new policy will go into effect upon the implementation of the full policy in late 2010 or early 2011. These changes build on a review process and formal public consultation that was initiated in 2001 (the proposals are discussed below). In the revised PSR policy, the Board maintains its policy objectives of balancing safety and efficiency and explicitly recognizes the role of the central bank in providing intraday credit to healthy depository institutions.[9]

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[6] The net debit cap is based on a multiple of the capital measure of the institution that is linked to an assessment of creditworthiness. The cap can be increased based on business need and the institution's risk characteristics.

[7] Overnight loans from the discount window facility of the Federal Reserve are, however, fully collateralized, and potential borrowers establish standing pools of collateral to cover these loans. The Federal Reserve has a general lien upon any unencumbered discount window collateral to cover a failure to extinguish an uncollateralized daylight overdraft.

[8] During the public consultation on revisions to the PSR policy in 2008, the Board shifted its approach from treating intraday credit as inherently undesirable to acknowledging the role of the central bank in providing intraday credit to healthy depository institutions: "In the past, the Board also had concerns that accepting collateral to address Reserve Bank credit risk for daylight overdrafts would not provide strong incentives to reduce the level of intraday credit. In particular, there was concern that because of the wide range of collateral accepted by the Reserve Banks, depository institutions would have weak incentives to reduce their use of intraday credit. Under the new strategy, the purpose of Reserve Banks accepting collateral is not to control the *level* of overdrafts per se, but to mitigate credit risk to the Reserve Banks when they provide intraday balances and credit needed for the smooth operation of the payments system." The revisions will be implemented in late 2010 or early 2011, but until the revisions take effect, the policy continues to state that "the Board expects depository institutions to manage their Federal Reserve accounts effectively and minimize their use of Federal Reserve daylight credit."

[9] 73 FR 79109, December 24, 2008.

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Table 2. Comparison of Intraday Credit Policies between the U.S. and Selected Countries

	Use of Collateral	Maximum Amount/cap	Fee/Interest
Canada	Collateralized (pledge)	No	Free
Eurosystem	Collateralized (pledge/repo)	No	Free
Japan	Collateralized	No	Free
United Kingdom	Collateralized (repo)	No[10]	Free
United States (current policy)	Only for problem institutions and institutions with maximum caps	Yes	Yes

A. Observations on the Current Daylight Credit Policy

11. **Many large depository institutions defer until late in the day sending a significant number of large-value funds transfers due to a number of market factors and to avoid daylight overdraft fees.** The Fedwire Funds system does not provide a queuing/payment offsetting mechanism to its participants, making the completing of payments in the RTGS payment system highly dependent upon the availability of a sufficient daylight overdraft capacity or balances. Although Fedwire Funds has one of the widest operating hours among major RTGS payment systems (i.e., the operating day of Fedwire Funds for the value date D starts on D-1 at 9:00 p.m. ET and closes at 6:30 p.m. on D), more than 60 percent of payment value in 2008 was settled after 3:30 p.m., more than 40 percent after 4:30 p.m. and more than 30 percent after 5:00 p.m. The share of the value of payments sent after 5:00 p.m. grew by 10 percentage points between 1998 and 2007, driven largely by the largest payments, including the funds transfers used to complete the daily cycle of financial market settlement payments. Late-day payments are related to a number of factors, including efforts to avoid fees on daylight overdrafts from the Fed. These late-day payments raise potential systemic concerns, given the uncertainty this leaves with regard to completion of large and critical payments at value date.

12. **An additional concern is that access of depository institutions to uncollateralized daylight overdrafts leaves the Fed subject to credit risk.** However, the Fed has a robust program in place to mitigate the risks posed by extending daylight overdrafts and no credit losses have been experienced to date.[11] The Fed's exposure to daylight overdrafts has

[10] However, if more than £ 1 billion is to be borrowed, the borrowing institution must ensure that the securities of any single issuer (other than the U.K. government and the Bank of England) comprise no more than 25 percent of the total collateral it has repoed to the Bank.

[11] The Reserve Banks monitor the financial condition of institutions to ensure they meet the safety and soundness requirements to access intraday credit. Monitoring tools include, but are not limited to, supervisory information, analytical reporting, and predictive models. Net debit caps establish limits on the amount of

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decreased in 2009, owing to the increase in reserve balances held by banks. In 2007 the average daily overdraft of the banking system as a whole was approximately US$60 billion and the average daily peak overdraft US$160 billion. In 2009, the average and peak daylight overdrafts stood at US$10 and US$55 billion, respectively.[12] While demand for daylight overdrafts is not expected to remain at 2009 levels, the future demand for daylight overdrafts is unclear for a number of reasons, including the level of balances that banks will hold as banking conditions normalize, as well as changes resulting from the revised PSR policy.

13. **The Fed's daylight credit policy has also imposed administrative and technical costs**. The largest users of intraday credit (representing less than 3 percent of institutions with intraday credit but comprising the most active players in Fedwire Funds) must undertake a comprehensive self-assessment of their creditworthiness in order to justify their net debit cap (see "Guide to the Fed's Payment System Risk Policy on Daylight Credit"). In addition, participants are subject to fees on daylight overdrafts, which stood at US$32.2 million in 2003, peaked at US$65 million in 2007, and dropped to US$5 million in 2009. Therefore, some participants, primarily a handful of the largest users, have built systems to manage internal queues of payments and monitor intraday liquidity usage, in order to minimize fees paid on the use of their daylight overdraft capacity.

14. **The existing daylight credit policy also does not ensure a completely level playing field between domestic-chartered institutions and foreign participants in their use of Fedwire.** Until March 2009, the capital used in determining the net debit cap for FBOs was limited to 35 percent of the capital of the parent company of the U.S. branch or subsidiary of the FBO (instead of 100 percent of the capital for U.S. domestic institution), even for the most-highly rated ones.[13] In 2007, FBOs as a group incurred average peak overdrafts that were less than 50 percent of their single day capacity. Although FBOs are generally unconstrained by their caps, some FBOs may have approached their limits on certain liquidity intensive payment days, before the crisis. This lower cap also reduces the so-called "deductible" amounts, i.e., a waiver reducing the fee applied to the daylight overdraft, since it is calculated with reference to a capital measure. During the mission, some anecdotal evidence was provided by private sector participants suggesting that some FBOs limit or refrain from self-clearing in the payment system and channel their payment flows to U.S. chartered banks, or delay non-time-critical payments as late in the day as possible. In March 2009, the most creditworthy FBOs were granted a streamlined process for receiving additional collateralized capacity up to the value of their net debit cap calculated on 100 percent of their capital. Additionally, these FBOs were granted a fee deductible based on

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intraday credit to any institution. Finally, institutions that pose elevated credit risk are placed on a "watch list" for more frequent monitoring and additional targeted risk mitigation steps, as appropriate.

[12] Source for daylight overdraft data: http://www.federalreserve.gov/paymentsystems/psr_dlod.htm.

[13] In countries where the provision of intraday credit is unlimited but fully collateralized, foreign participants are usually treated like domestic participants.

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100 percent of capital. The reasons stated in the PSR policy for the differential treatment are the greater difficulty in assessing the creditworthiness of FBO and the greater risk that may be implied by foreign insolvency laws. However, alternative tools may be considered, including a jurisdiction-by-jurisdiction analysis of the materiality of these risks, which may at the same time provide for adequate risk containment without raising the same level-playing field concerns as a blanket penalty.

B. Main Features of the Future Daylight Credit Policy

15. **The Fed's new strategy would explicitly encourage the use of collateral to contain credit risk in providing daylight overdrafts**. Collateralized daylight overdrafts would be charged a zero fee, and to encourage collateralized borrowing, the fee for uncollateralized daylight overdrafts would be increased to 50 basis points (annual rate) from the current 36 basis points. In addition, the two-week average net debit cap would be eliminated, while retaining the higher single-day cap for healthy depository institutions, which would effectively raise caps by approximately 50 percent. Access to daylight credit would continue to be available only to institutions with regular access to the discount window, with the same collateral eligibility criteria and haircuts used for both overnight and intraday credit. Unencumbered collateral pledged for discount window purposes could be used to support intraday credit.

Table 3. Key Elements of the Current and Revised PSR policy for Daylight Credit

Main patterns	Current policy	Revised policy
Collateral	Required for problem institutions and institutions with max caps	Pledging collateral will be explicitly encouraged through a more favorable pricing of collateralized daylight overdrafts
Fee for collateralized daylight overdrafts	36 basis points	Zero fee
Fee for uncollateralized daylight overdrafts	36 basis points	50 basis points
Deductible amount (subtracted from fees levied on daylight overdrafts)	10 percent of an institution's capital measure	Replaced by zero fee for collateralized daylight overdrafts and fee waiver
Fee waiver	Up to US$25 biweekly	US$150 biweekly
Net debit cap	Two-week average limit and higher single-day limit. Ex-post counseling if exceed limit	Two-week average limit eliminated; single-day limit retained. Flexibility in ex post counseling if fully collateralized
Max cap	Additional collateralized capacity above net debit cap for self-assessed institutions	Streamlined process for certain FBOs up to a limit (effective March 26, 2009). Minor changes apply for all institutions
Penalty fee for ineligible institutions	136 bps	150 bps

Source: Notice of the Federal Reserve Board of Governors of December 24, 2008 on the revised PSR Policy.

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C. Comments on the Future Daylight Credit Policy

16. **Experience will determine whether the new policy sufficiently encourages participants to move to voluntary collateralized daylight credit and reduce late-in-the-day payments.** The higher fee for uncollateralized overdrafts would need to be compared with the opportunity costs of delivering collateral. Because the range of collateral accepted by the Fed is very broad relative to other liquidity sources, the opportunity cost of pledging new collateral will likely not be significant.[14] As of end 2009, US$1.2 trillion in assets were pledged with the Reserve Banks mainly for discount window purposes, most of which was unencumbered by loans, with no real opportunity cost. Less than 60 percent of mid-to-large users have collateral pledged for discount window purposes (less than 50 percent of total users) although more than 90 percent have documents signed with the Reserve Banks to do it. Most of the largest users of daylight overdrafts, however, have sufficient unencumbered collateral pledged to the Reserve Banks to cover their average level of daylight overdrafts.

17. **The changes implemented in March 2009 have already helped to ease the significantly stricter limitations faced by FBOs**. The calculation of the deductible, which was the main concern for FBOs, has been aligned with U.S. chartered institutions for the highest-rated FBOs (these represent 10 percent of foreign participants and 40 percent of FBOs' use of intraday credit). FBOs will continue to be monitored at their cap level in real time, whereas only 5 percent of institutions are monitored in real time (for the others there is *ex post* control and corrective measures required in case of need). When there is real time monitoring of an institution, any outgoing Fedwire Funds transfer that exceeds available funds is rejected.

18. **The Board of Governors may consider further changes to increase the use of collateralized intraday credit over the medium term and following appropriate cost benefit analysis**. Although the new policy will relax some aspects of the net debit cap program, caps on total intraday credit will remain. As mentioned in the revised PSR Policy, "*the Board may in the future consider the costs and benefits of moving further toward a fully collateralized structure.*"

III. Efforts to Reduce Late-Day Settlement in Payment Systems and Market Infrastructures

19. **The Fed is working on three other areas to help address late-in-the-day payments and liquidity pressures in the payment systems**. When in 2008 the Fed approved the revised PSR policy, there was an expectation that the financial industry would continue to review market clearing and settlement practices and pursue the elements of a so-

[14] The range of assets eligible to be pledged as collateral to the Federal Reserve, includes ABS, AAA collateralized debt obligations, commercial mortgage-backed securities, loans, and certain foreign currency-denominated assets. See http://www.frbdiscountwindow.org/discountmargins.cfm?hdrID=21&dtlID=83.

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called "four-prong strategy" to address intraday liquidity, and operational and credit risks in the wholesale payment and settlement system. The three other efforts cover the potential development of a liquidity saving mechanism for Fedwire Funds, reducing the aggregate value of end-of-day settlement in CHIPS, and improvements in intraday liquidity usage for DTC.[15]

A. Liquidity Saving Mechanism in Fedwire Funds

20. **The Fed Banks have been exploring with the industry the possibility of developing a liquidity-saving mechanism for Fedwire Funds**. Over the past decade, the trend in the new generation of RTGS payment systems, e.g., in Europe and Japan, has been to incorporate queuing and offsetting arrangements, which save a large amount of the liquidity needed to complete settlement while retaining the immediate finality of gross real time systems. Fedwire Funds is currently a traditional RTGS system, without any queuing mechanism or liquidity saving features.

21. **Introducing a liquidity-saving mechanism would economize on the amount of intraday credit and collateral needed to settle a given value of transactions**. It could also encourage the coordinated release of payments held in the liquidity queues of participants by reducing the total liquidity (and collateral in the new intraday credit policy to be implemented soon) used to fund those payments. In the current framework, where participants manage internal payment queues, there is no visibility of the incoming payments queued by their counterparties, which complicates intraday liquidity management.[16]

22. **The implementation of a liquidity-saving mechanism in Fedwire Funds would need to be economically viable.** Under the Monetary Control Act (MCA) of 1980, fees for the financial services provided by the Reserve Banks (which include the operation of Fedwire Funds and Securities) must be set, over the long run, to recover the actual costs incurred to provide the services, as well as costs the Reserve Banks would have incurred and imputed profits they would have expected to earn if they were private sector firms. These legal requirements are seen by the Fed and by the users as a powerful tool to promote efficiency and provide for equitable competition. The recent decline of volumes in Fedwire

[15] These initiatives have been a collaborative effort by the Federal Reserve and the industry, especially elaborated in the context of the Payment Risk Committee (PRC) and of the Wholesale Customer Advisory Group (WCAG). The PRC is sponsored by the Federal Reserve Bank of New York and works to identify and analyze issues of mutual interest related to risk in payments and settlement. The WCAG advises the Wholesale Product Office of the Federal Reserve Bank of New York, which is in charge of the management of Fedwire Funds and Securities. The composition of both PRC and WCAG consists of the largest institutions, domestic and foreign.

[16] In the context of the PRC and WCAG work, the development of a liquidity-saving mechanism was supported by most of the largest institutions, especially the foreign participants as efficiency gains of moving payments from individual institution queues to a centralized queue that would enable timely matching, offsetting of payments and increased transparency. Some institutions, however, expressed a different view, emphasizing that CHIPS already provides liquidity-saving features and that there is no interest in having also such an arrangement in Fedwire Funds.

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Funds (as in most payment and settlement systems in the U.S. and in industrialized countries) and the implications of policy actions could make full cost recovery more challenging.

B. Reducing End-of-Day Settlement in CHIPS

23. **The settlement model used by CHIPS is very robust and eliminates the settlement risk associated with classical net deferred settlement systems**. From a liquidity management perspective, the system is also very efficient as it minimizes the amount of funding in central bank money that is needed to complete the settlement of large values and volumes of underlying payments, thanks to its offsetting algorithm.

24. **The smooth functioning of the system and its ability to avoid trapping liquidity until the end of the day is, however, dependent upon the behavior of its participants to**: (i) send on a given day payments in CHIPS that do not significantly differ from their average profile used by the central system to calculate their initial prefunding requirement; (ii) provide supplemental pay-in funding as needed during the day to avoid gridlocks and queuing payments until the end-of-day; and (iii) fulfill their end-of-day final prefunding to permit the settlement of the remaining payments.

25. **Until recently, the value of payments that remain pending until the end of the day was significant.** A few hundred payment messages were still queued after the cut-off of CHIPS and many were significant in value terms (ranging between US$85 billion to US$100 billion on average in 2007). The completion of payments in the queue after the cut-off of CHIPS is contingent on the participants in a negative closing position paying in additional funds, which averaged in aggregate between US$50–60 billion.

26. **These pending payments have adverse consequences in terms of liquidity management.** Since some large value payments are only settled and final at the end of the day, it prevents the re-use of the funds by the receiving banks earlier in the day, including the possibility for long banks in CHIPS to withdraw and re-use the liquidity for completing payments in Fedwire Funds. This represents an additional obstacle for settlement in Fedwire earlier in the day.

27. **Two initiatives have helped reduce end-of-day pending payments**. On the receiving side, CHIPS has experimented with increasing the cap on participants' current positions (which limits the maximum amount of liquidity that any participant can accumulate to twice its initial position before the 5:00 p.m. closure of the system) and releasing the cap constraint earlier in the day. In several steps, the cap was increased to 6 times the initial position) from twice the initial position and the cap constraint was released earlier, moving from 5:00 p.m. to 3:00 p.m. On the sending side, CHIPS has also encouraged its participants to provide voluntarily more supplemental funding within the day, without waiting for the end-of-day final funding. From April 2008 to September 2009, the amount of supplemental

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Box 1. Overview of the CHIPS Settlement Model

The settlement model implemented by CHIPS since 2001, though partly on a bilateral or multilateral net basis, allows for immediate finality of payments, thanks to a pre-funding arrangement in central bank money. This reflects the trend observed in many countries for the past decade, to combine the benefits of RTGS settlement to provide real time finality with the liquidity saving features of net settlement systems.

To facilitate the settlement process, CHIPS maintains an account at the Federal Reserve Bank of New York on behalf of its participants. Each CHIPS participant must prefund the account each day in the amount of an opening primary position requirement, which, once funded via Fedwire funds transfer to the CHIPS account, is used to settle payment orders throughout the day. The amount of the initial prefunding is calculated weekly by CHIPS based on the size and number of transactions by the participant and cannot be removed by participants during the day.

During the operating day, participants submit payment orders to a centralized queue maintained by CHIPS. Each payment is settled immediately if the transaction does not result in either a negative primary position for the sender or a position for the receiver that is greater than twice its initial primary position (half of the value and more than 90 percent of payments are settled on this gross basis). If a payment cannot be settled using the funds in the CHIPS account, an optimization algorithm attempts to match the payment order with other payments in the queue against which it can be bi- or multilaterally offset and released with finality at the time of release from the queue. Debits and credits to the current primary position are reflected only in CHIPS's records and are not recorded on the books of the Federal Reserve Bank of New York.

Payments remain in the queue until they can be settled by the funds in the participant's position, offset against another payment, or deleted by the participant. The sender can also intervene to release queued payments by transferring more funds from its Fedwire account to feed a CHIPS balance, called the supplemental position, that is separate from the primary position. Supplemental prefunding can be withdrawn by the participant from CHIPS, subject to the constraint that the amount withdrawn must be the lesser of their current supplemental position and the total supplemental prefunding paid-in by the participant. The sender can also earmark payments with "urgent" or "preferred" priorities to be released immediately from the queue by tying funds from the supplemental position to these payments ahead of time.

At 17:00 ET, CHIPS attempts to match, net, set off, and release as many of the remaining payment orders in the queue as possible without putting any participant in a negative position. A multilateral net position for the residual payments pending in the queue is provisionally added to each participant's current combined position (which is the aggregation of the participant's primary position and supplemental position) to calculate the final net position. Each participant with a negative final position has 30 minutes to transfer that amount, called final prefunding, to the CHIPS account through Fedwire. Once all of the final prefunding transfers have been received, CHIPS uses this liquidity to release and settle all remaining payment orders in the queue. CHIPS then transfers the remaining positive balances to the participants through Fedwire. If any participant fails to make its final prefunding payment (which happened only once since 2001), CHIPS attempts to settle as many payments as possible using the available funds in the system.

The CHIPS settlement model greatly minimizes the settlement risk at stake in traditional deferred net settlement systems, which are exposed to the settlement failure of participants in a debit position. A failure in these systems has the effect of deferring or impeding final settlement of all balances stemming from the system, and ultimately of unwinding the operations of the defaulter(s). This may lead to unexpected changes in positions of non defaulting participants, late in the day with associated liquidity pressures that may cause second round defaults and systemic risk propagation.

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funding was increased by more than eight times. These two initiatives have reduced significantly the volume and value of payments pending in the CHIPS queue at the end of the day (under US$20 billion in September 2009, less than 1½ percent of the total value settled daily) and also the amount of final funding (around US$12 billion) required to release pending payments.

28. **Further efforts in this area should be encouraged**. One issue is the fact that supplemental funding during the day remains voluntary, and is not subject to a binding rule. The criticality of this may become obvious as clearing balances return to more normal levels.

IV. Risk Management

29. **The crisis illustrates the need for robust risk management.** This includes: (i) taking into account the consequences of the high concentration of settlement activities; (ii) maintaining up-to-date stress testing liquidity scenarios to review the adequacy of risk management controls and increase awareness of risks with participants; (iii) continuing on-going actions aimed at strengthening operational resilience; (iv) ensuring adequate access to central bank liquidity; and (v) taking account of critical interdependencies.

A. Concentration of Settlement

30. **The U.S. large-value payment systems exhibit a significant level of concentration of flows among a few key participants.** In Fedwire Funds, whereas there are about 7,500 participants, the largest participant represented in 2008 on average around 20 percent of settled value, the top five participants represented 63 percent, and the top 10 participants represented 79 percent. In CHIPS, 64 percent of the value is settled by the top five participants. Concentration levels in both systems are comparable to those in most other major industrial countries. This concentration can be related to several factors, including concentration of the banking system and of the correspondent banking business. However, such concentration is a potential source of vulnerability. Even in Fedwire Funds and CHIPS, where settlement patterns expose participants to little or no credit risk, the unexpected unavailability of a major participant (because of an operational failure or due to an insolvency or liquidity problem) for an operating day would likely raise substantial liquidity pressures for the other participants.

31. **Similar concentration risks arise in the case of CLS Bank, which provides a settlement system for foreign exchange transactions.** The CLS system is designed to ensure a simultaneous exchange of both legs of an FX transaction in order to eliminate settlement risk. Its risk management framework relies *inter alia* on a settlement model backed by: (i) funding requirements in central bank money calculated on a multilateral net basis; and (ii) a set of position limits aimed at ensuring that the net values of the short positions of participants could not exceed their funding capacity and the capacity of CLS

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Bank to draw on liquidity facilities from liquidity providers.[17] However, the level of concentration in settlements among settlement members is very high in the CLS system, due in part to some settlement members settling for third parties that represent very large positions.[18]

32. **Nonetheless, CLS Bank performed well during the crisis.** Major dislocations were avoided since the settlement member that represented Lehman Brothers did not exercise its right to rescind the transactions entered on behalf of Lehman Brothers and completed its settlement obligations on Lehman's behalf. Even when a settlement member acting on behalf of a third party did exercise its right to rescind the transactions, as in the case of Refco's failure, the CLS system continued to function. In part this reflects the fact that CLS Bank does not guarantee settlement as a CCP would do.

33. **CLS Bank and its members should take advantage of the current review to consider providing more direct access to some of the largest third parties,** to the extent consistent with possible legal limitations to direct membership. Direct access of large-scale or systemically important third parties (e.g., CCPs) is being discussed within the CLS community, and this step would reduce the counterparty risk borne by third parties on their intermediary settlement member.

B. Stress Testing and Simulations

34. **CLS Bank conducts a range of stress and back-testing scenarios to review the adequacy of its risk management procedures**. The simulations include *inter alia* the

[17] Pay-in requirements in the 17 currencies have to be completed by specified times, because of the time-zone differences which oblige CLS Bank to have a funding period compatible with the overlapping opening hours of the different RTGS systems. However, the settlement of the USD funding, which intervenes at a period of time where there are very few competing payments to complete clearly puts less pressure on banks' intraday liquidity management than the funding in European and especially in Asian currencies. Another source of liquidity pressure is the so-called CLS Pay-In Call, which is the first means of raising additional liquidity in the event that a settlement member fails to satisfy its funding requirements. "Pay-In Call for settlement" would be issued to settlement members that have unsettled payment instructions with the failing settlement member, in order to maximize the number and value of settled payment instructions for that date. Pay-In Calls could pose significant liquidity issues because they are unexpected. The multilateral aspect of funding has substantially decreased the amount of liquidity necessary to settle with finality underlying FX transactions. CLS Bank has provided a liquidity management tool for reducing further the settlement members' funding obligations. This tool is the In/Out swap program, which permits settlement members to enter into bilateral intra-day FX swap transactions to reduce their short positions in certain currencies and other settlement members' long positions in those same currencies. The "out" leg of this I/O swap being settled outside CLS, it re-introduces settlement risk. One solution to mitigate this risk would be to create an additional same-day settlement session, which would allow settling in CLS Bank the "out" leg of the I/O Swaps. However, this project, which has been discussed for some time, may in turn create more liquidity pressure for funding in certain currencies.

[18] The terms on which a member agrees to provide such services to third parties are governed through private arrangements that do not directly involve CLS Bank. The increase in the number of third parties in recent years has been one important avenue to broaden the system's penetration in the FX market (which is estimated to be around 55 percent of the value of total trades in April 2006 according to the CPSS report "Progress in Reducing Foreign Exchange Settlement Risk," May 2008).

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adequacy of haircuts and the failure of the settlement member with the single largest funding obligation in a single currency. In light of the crisis, CLS Bank is working on some more extreme scenarios, like the failure of all settlement members of a given currency to complete their funding and the simultaneous failure of the liquidity providers in the same currency. The enrichment of stress testing scenarios is welcome as it is useful to continuously adjust the risk control measures.

35. **CHIPS and its parent Clearing House are developing stress testing programs.** CHIPS, in particular, has instituted a program to ensure that participants understand the consequences of a failure of one or more banks to honor their closing positions and to encourage participants to develop liquidity contingency plans. The Clearing House is also running and sharing with its participants simulations of the inability of participants to fund their positions in CHIPS. These scenarios include simulations of the failure of one or more banks to pay all their funding of the day or their closing position requirements, and the results are presented to the CHIPS business committee.

C. Operational Resilience

36. **The three payment systems operating in the U.S. have in place state of the art and highly resilient arrangements to mitigate operational risk.** Fedwire, CHIPS and CLS Bank maintain very high levels of availability exceeding 99.9 percent, comprehensive business continuity plan (BCP) arrangements, capacity planning and apply best practices in terms of security requirements**.** CHIPS and CLS Bank have full synchronous mirroring of data between their two respective data centers, which allows for a quick recovery from the back-up site, in case of a disruption in the primary site, while Fedwire has multiple out-of-region back-up data centers. BCP arrangements cover a wide range of threats, including pandemic ones. Alongside the implementation of the 2003 interagency paper on sound practices to strengthen the operational resilience of the U.S. financial system, issued in the post 9/11 context, additional measures have been undertaken to strengthen further the operational resilience of payment systems, including action by CHIPS to establish a new, remote data center in 2008.

37. **Another important issue is to consider the occurrence of an operational problem in the context of a stressed market situation.** During the crisis, systems were able to process unexpected peak volumes without major problem. However, there is still the question of how market participants would react to a major operational problem, e.g. affecting a key participant in a payment system, occurring in a general context of serious concerns about credit and liquidity risks. Adequate preparation for such a scenario requires continuous initiatives to strengthen operational resilience of systems and their participants. Bank supervisors address these issues on an ongoing basis as part of the supervisory process.

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D. Access of Systemically Important Infrastructures to Central Bank Services

38. **The Administration's proposed legislation (Title VIII) would also entitle the Fed to open an account and provide access to discount window credit for financial market utilities designated as systemically important.** The current framework limits account access to state member banks, other depository institutions, and certain other institutions specified by statute. Therefore, while bank-chartered infrastructures may maintain an account with the Fed, other non-bank financial market infrastructures cannot have accounts. For instance, the Fixed Income Clearing Corporation (FICC), which is the central counterparty for government bonds, is not allowed to open an account either in Fedwire Funds or in Fedwire Securities. This leads to a greater reliance on commercial banks by financial market infrastructures to perform settlement.[19] Allowing systematically important market infrastructures to settle in central bank money would limit settlement risk. In addition, financial market infrastructures may face extreme stress scenarios for which an adequate access to central bank credit (on terms and conditions to be decided by the Board) would be an additional buffer to mitigate systemic risk.[20]

39. **Measures which would facilitate settlement in central bank money for systemically important infrastructures and access to credit are recommended.** Giving non-bank financial market infrastructures access to a central bank account and liquidity under terms and conditions established by the Federal Reserve Board would need to be coupled with a strong oversight framework and full compliance of the systems with U.S. regulatory requirements regarding risk management and, as appropriate, consistent with international standards.

E. Interdependencies

40. **The U.S. payment systems are highly interconnected globally.** This reflects the participation of a large number of both U.S. and foreign internationally-active institutions, as well as the critical role that the CHIPS and (especially) the CLS systems play in settling cross border payments. Moreover, U.S. payment systems represent the worldwide end of day, which means that a disruption there could have important spillover effects at the following day opening of systems in Asia and Europe.

41. **Given the importance of these interdependencies, the U.S. authorities should continue on-going initiatives with a view to carry out a comprehensive risk mapping exercise.** It is important to take into account of all types of interdependencies within

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[19] For more details, see the assessment of FICC against CPSS/IOSCO Recommendations for Securities Settlement System (SSSs).

[20] Examples of such risk include difficulties in timely liquidation or obtaining liquidity against collateral because of a market dislocation, or the difficulty for a CCP to find depository banks to hold safely margins collected from its participants.

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settlement systems and across systems (e.g., funding linkages between CHIPS and Fedwire Funds).

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FINANCIAL SECTOR ASSESSMENT PROGRAM

UNITED STATES OF AMERICA

SELECTED ISSUES ON OVERSIGHT OF PAYMENT, CLEARING, AND SETTLEMENT SYSTEMS

TECHNICAL NOTE

MAY 2010

INTERNATIONAL MONETARY FUND
MONETARY AND CAPITAL MARKETS DEPARTMENT

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Contents Page

Glossary 3

Executive Summary 4

I. Scope of Current Federal Reserve Oversight 6

II. Federal Reserve's Adherence to the Responsibilities of the Central Bank in Applying the CPSS Core Principles and the CPSS General Oversight Principles 7

A. Responsibility A and General Oversight Principles A and B: Transparency and Disclosure of Central Bank Objectives, Policies and Roles with Respect to Oversight of Systemically Important Systems 7

B. Responsibility B and General Oversight Principle D: Consistent Implementation of Oversight Standards to Systems Operated by the Central Bank 9

C. Responsibility C and General Oversight Principle C: Ability to Carry Out Oversight of Private-Sector Systemically Important Systems 11

D. Responsibility D and General Oversight Principle E: Cooperation with Other Central Banks and with Other Relevant Domestic and Foreign Authorities 15

III. Legislative Reform Proposals Concerning Oversight of Systemically Important Payment, Clearing and Settlement Systems 17

Figures

1. Governance and Oversight Framework for Fedwire Funds and Securities 10
2. Overview of Internal Federal Reserve Functional Relationships and External 17

Box

1. Overview of the Administration's Proposal (Title VIII) on Payment, Clearing and Settlement Supervision 19

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GLOSSARY

ACH	Automated Clearing House
BAC	Committee on Federal Reserve Bank Affairs
CCPs	Central Counterparties
CFTC	Commodity Futures Trading Commission
CHIPS	Clearing House Interbank Payment System
CLS	Continuous Linked Settlement
CPSS	Committee on Payments and Settlement Systems
CPSIPS	Core Principles for Systemically Important Payment Systems
DTC	Depository Trust Company
DTCC	Depository Trust & Clearing Corporation
FFIEC	Federal Financial Institutions Examination Council
FICC	Fixed Income Clearing Corporation
FRA	Federal Reserve Act
IOSCO	International Organization of Securities Commissions
MCA	Monetary Control Act
NSCC	National Securities Clearing Corporation
OCC	Options Clearing Corporation
OTC	Over the Counter
PSR	Payment System Risk
RBOPS	Reserve Bank Operations and Payment Systems
RTGS	Real Time Gross Settlement System
SEC	Securities and Exchange Commission
SSSs	Securities Settlement Systems
TCH	The Clearing House

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EXECUTIVE SUMMARY[1]

This technical note reviews the Federal Reserve's oversight of payment, clearing and settlement systems.[2] Although the focus of the note is on payment systems oversight, it addresses, where relevant, the oversight of clearing and settlement systems due to their impact on financial stability and the strong interdependencies with payment systems. In doing so, the note refers to the four Responsibilities of the Central Bank in applying the Core Principles for Systemically Important Payment Systems (CPSIPS) and the Committee on Payment and Settlement Systems (CPSS) Principles for Effective Oversight.[3]

As is typical for central banks, the Federal Reserve plays multiple and important roles in payment and settlement systems. As a service provider, the Federal Reserve supplies a variety of payment services to depository institutions, the government and other entities. The Federal Reserve operates both the real time gross settlement system (RTGS)—Fedwire Funds—for payments, the Fedwire Securities system for book entry transfers of government securities, the National Settlement Service for settlement of private-sector systems, and on the retail payments side, an Automated Clearing House (ACH) and check collection services. These services are overseen by the Federal Reserve Board under authority provided in the Federal Reserve Act. The Federal Reserve also exercises a supervisory and regulatory responsibility over certain private-sector payment and settlement systems that have bank charters subject to Federal Reserve supervision or that fall under relevant supervisory provisions for bank service companies. Finally, the Federal Reserve fosters improvements in payment and settlement systems through a variety of means, including conducting research, promoting dialogue, providing leadership and acting as a catalyst for changes to private sector practices.

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[1] This Technical Note (TN) was prepared by Frédéric Hervo (external expert, Banque de France).

[2] This TN does not cover other U.S. agencies competences in the field of payment, clearing, and settlement systems.

[3] The four CPSIPS responsibilities are: A: the central bank should define clearly its payment system objectives and should disclose publicly its role and major policies with respect to systemically important payment systems; B: the central bank should ensure that the systems it operates comply with the core principles; C: the central bank should oversee observance with the core principles by systems it does not operate and it should have the ability to carry out this oversight; and D: the central bank, in promoting payment system safety and efficiency through the core principles, should cooperate with other central banks and with any other relevant domestic or foreign authorities.

The CPSS report on Central Bank Oversight of Payment and Settlement Systems of May 2005 has set five general principles for oversight (General oversight principle A: Transparency: "Central banks should set out publicly their oversight policies, including the policy requirements or standards for systems and the criteria for determining which systems these apply to;" General oversight principle B: "International standards: Central banks should adopt, where relevant, internationally recognised standards for payment and settlement systems;" General oversight principle C: Effective powers and capacity: "Central banks should have the powers and capacity to carry out their oversight responsibilities effectively"; General oversight principle D: Consistency: "Oversight standards should be applied consistently to comparable payment and settlement systems, including systems operated by the central bank;" General oversight principle E: Cooperation with other authorities: "Central banks, in promoting the safety and efficiency of payment and settlement systems, should cooperate with other relevant central banks and authorities") and five principles for international cooperative oversight, which update the 1990 Lamfalussy principles for international

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A key conclusion of this note is the need to broaden the Federal Reserve's legal authority and powers to oversee systemically important payment, clearing and settlement systems that extend beyond systems with bank charters that fall within its prudential supervisory authority. The systemic importance of payment and settlement systems and the extent to which these extend beyond the banking system argues in favor of enhancing the central bank's role in overseeing these systems. Encouragingly, the Administration's 2009 legislative proposal (Title VIII) recommends providing the Federal Reserve with the authority, in consultation with other relevant U.S. regulators, to designate systemically important financial market utilities. In cooperation with relevant U.S. regulators and complementary to existing supervisory and regulatory provisions, the Federal Reserve would have the authority to set risk management standards, and oversee such infrastructures irrespective of their charter. Such authority should help to improve the United States' ability to assess systemic risk, ensure consistent application of international risk management standards across systems, and coordinate its policy actions among relevant and interested regulators, on a national basis and with those abroad.

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I. Scope of Current Federal Reserve Oversight

1. **This note reviews the Federal Reserve's oversight function, using the internationally agreed definition of central bank's oversight of payment and settlement systems.** As defined in the CPSS report, "oversight of payment and settlement systems is a central bank function whereby the objectives of safety and efficiency are promoted by monitoring existing and planned systems, assessing them against these objectives and, where necessary, inducing change."[4] Under this definition, "the concept of payment and settlement oversight is therefore distinct from prudential supervision and regulation, which focuses on the soundness of individual financial institutions." The scope of the internationally agreed definition of oversight is intended to cover at least payment and settlement systems, including central counterparties (CCPs) and securities settlement systems (SSSs).

2. **The oversight policy of the Federal Reserve is primarily addressed to systemically important payment and settlement systems.** These include the two systems (Fedwire Funds, the RTGS payment system and Fedwire Securities, which is the Securities Settlement System for government securities) operated by the central bank as well as private sector payment and settlement systems, provided they are organized and chartered as a bank or Edge corporation subject to the prudential supervisory authority of the Federal Reserve.[5]

3. **Systemically important payment and settlement systems falling under the oversight authority of the Federal Reserve should adhere to internationally agreed standards**. The Federal Reserve's oversight policy states that systemically important payment and settlement systems subject to Federal Reserve authority should comply with the international standards as incorporated in the policy. Among other things, these systems should demonstrate their compliance by completing and disclosing self-assessments, which are reviewed by the Federal Reserve. Compliance with the international standards is also considered when conducting supervisory examinations of systems. Rather than a stand-alone function, oversight of payment and settlement systems is considered by the Federal Reserve as a process involving several functional areas coordinating to prevent systemic risk and

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[4] See the CPSS report on "Central Bank Oversight of payment and Settlement Systems" Bank for international Settlements, Basel, 2005.

[5] Bank charters subject to Federal Reserve supervision include Edge Act corporations and state member banks. In addition, the Federal Reserve exercises certain supervisory responsibilities under the Bank Services Company Act, covering certain bank outsourced services. The Federal Reserve has supervisory responsibilities for CLS Bank (foreign exchange settlement system), the Depository Trust Company (a central securities depository), ICE Trust U.S. (a CCP for OTC credit derivatives), Warehouse Trust (a trade repository for OTC credit derivatives), and CHIPS (a large value funds transfer system, supervised a third party service provider, see paragraph 29). The Federal Reserve also has some limited supervisory authority to examine affiliates of the Depository Trust Company, namely the National Securities Clearing Corporation (a CCP for equities and corporate securities) and the Fixed Income Clearing Corporation (a CCP for U.S. government securities); both of those CCPs are subject to regulation by the SEC.

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ensure the adequacy of the risk management framework of systemically important payment and settlement systems, and which requires close cooperation with external domestic and foreign authorities.

II. Federal Reserve's Adherence to the Responsibilities of the Central Bank in Applying the CPSS Core Principles and the CPSS General Oversight Principles

A. Responsibility A and General Oversight Principles A and B: Transparency and Disclosure of Central Bank Objectives, Policies and Roles with Respect to Oversight of Systemically Important Systems

4. **The objectives and policies of the Federal Reserve regarding payment and settlement systems are disclosed transparently, through the Federal Reserve Policy on Payment System Risk ("PSR policy").** The PSR policy is comprised of two parts. The first one on "risk management in payments and settlement systems" sets the scope of the Fed's policy towards payment and settlement systems, the general policy expectations and the standards used by the central bank. The second part is dedicated to the Federal Reserve daylight credit policies.

5. **The high level objectives of the Federal Reserve are to foster the safety and efficiency of payment and settlement systems.** This PSR policy sets out the related principles and minimum standards, regarding the management of risks in payment and settlement systems, including those operated by the Reserve Banks. The Federal Reserve Board encourages payment and settlement systems, and their primary regulators, to take the principles and minimum standards into consideration in the design, operation, monitoring, and assessing of these systems.

6. **The PSR Policy is amended from time to time, using a formal consultation process.** The Board publishes a request for comments on all proposed policy changes in the *Federal Register* (the official journal of the U.S. Federal Government). Comments received are made available publicly on the Federal Reserve Board's website and the final action to adopt any policy changes includes comprehensive explanations about how the comments received during the public consultation have been considered.

7. **The PSR policy clearly defines the criteria used to determine which systems the policies of the Federal Reserve are applied to.** These criteria encompass quantitative and qualitative elements. The Fed's policy applies to public and private sector payment and settlement systems that expect to settle a daily aggregate gross value exceeding US$5 billion during the next 12 months. These systems may be organized, located, or operated within the United States (domestic systems), outside the United States (offshore systems), or both (cross-border systems) and may involve other currencies in addition to U.S. dollar (multi-

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currency systems). The policy also applies to any system based or operated in the United States that engages in the settlement of foreign currencies transactions if that system would be otherwise subject to the policy. The policy defines a system as a multilateral arrangement and does not apply to bilateral relationships between financial institutions and their customers, such as traditional correspondent banking and government securities clearing services. Accordingly, the two clearing banks are not currently overseen as systems although their role in the clearing and settlement of securities transactions and tri-party repos is of a systemic importance and may be compared to an infrastructure.[6]

8. **The threshold of a daily turnover of US$5 billion is a necessary but not a sufficient condition for a system to be defined by the Federal Reserve as being of a systemic importance and accordingly to fall within its PSR policy.** Systems that are subject to the Federal Reserve Board's authority may be considered systemically important upon consideration of additional qualitative factors stated in the policy, including whether:

- the system has the potential to create significant liquidity disruptions or dislocations should it fail to perform or settle as expected;
- the system has the potential to create large credit or liquidity exposures relative to participants' financial capacity;
- the system settles a high proportion of large-value or interbank transactions;
- the system settles transactions for important financial markets;
- the system provides settlement for other systems; and
- the system is the only system for settlement of a given financial instrument.

Systems above the US$5 billion threshold that are not considered systemically important are monitored and the system's potential systemic importance is periodically reassessed.

9. **The Federal Reserve uses the international standards for the oversight of payment and settlement systems.** The Board encourages and expects payment and settlement systems within the scope of its policy to implement a risk management framework appropriate for the risks the system poses to the system operator, system participants, and other relevant parties as well as the financial system more broadly. In addition to establishing a risk management framework, the Board expects systemically important systems subject to its authority to meet as "policy expectations" the Core Principles for Systemically Important Payment Systems, the Recommendations for Securities Settlement Systems and the Recommendations for Central Counterparties, as applicable. The three sets of international standards are explicitly adopted by and quoted in the PSR policy statement.

[6] The clearing banks are subject to prudential supervision by the relevant banking regulators.

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10. **The international standards are supplemented in the area of operational risk management by the interagency paper on sound practices to strengthen the operational resilience of the U.S. financial system**. This paper was issued in 2003 by the Federal Reserve, the Office of the Comptroller of the Currency, and the Securities and Exchange Commission in the post 9/11 context and focuses on restoration of settlement activities after a wide-scale disruption. The sound practices focus on the appropriate back-up for recovery and resumption of clearance and settlement activities in wholesale financial markets.

B. Responsibility B and General Oversight Principle D: Consistent Implementation of Oversight Standards to Systems Operated by the Central Bank

11. **The Federal Reserve Act (FRA)[7] provides the authority for the Federal Reserve Board (Board) to exercise general supervision over the Federal Reserve Banks, including their provision of payment and settlement services.** It also requires the Board to order at least once a year an examination of each Reserve Bank and to order an annual independent audit of the financial statements of each Reserve Bank.

12. **Under the authority provided by the FRA, the Board oversees and examines the Reserve Banks' provision of payment and settlement services, and, for those services of systemic importance, their compliance with the principles and minimum standards incorporated in the PSR Policy.** The Board publishes an assessment against the relevant international standards for the Fedwire Funds and Securities Services on the same frequency (every two years as a minimum) as that expected of self assessments by private-sector systemically-important systems.

13. **The Board is thus responsible for the oversight of Federal Reserve payment and settlement services, while the Reserve Banks are responsible for the provision of these services.** This legal separation of oversight and provision of services facilitates the Board's oversight of the Reserve Bank's payment and settlement services by ensuring that oversight is autonomous from the governance, management and operational arrangements of the systems.

14. **To complement its oversight and policy responsibilities on payment system issues, the Board has established two internal committees.** The Committee on Federal Reserve Bank Affairs (BAC) is in charge of the general supervision over Reserve Bank

[7] The Board's oversight authority over the Reserve Banks is set forth in several provisions of the Federal Reserve Act, including Section 11(a), which provides the Board authority to examine the Reserve Banks and obtain Reserve Bank records and information; Section 11(j), which provides the Board's authority to exercise general supervision of the Reserve Banks; Section 11B, which requires the Board to order an annual independent audit of the financial statements of each Reserve Bank; and Section 21(7), which requires the Board to order an examination of each Reserve Bank at least annually.

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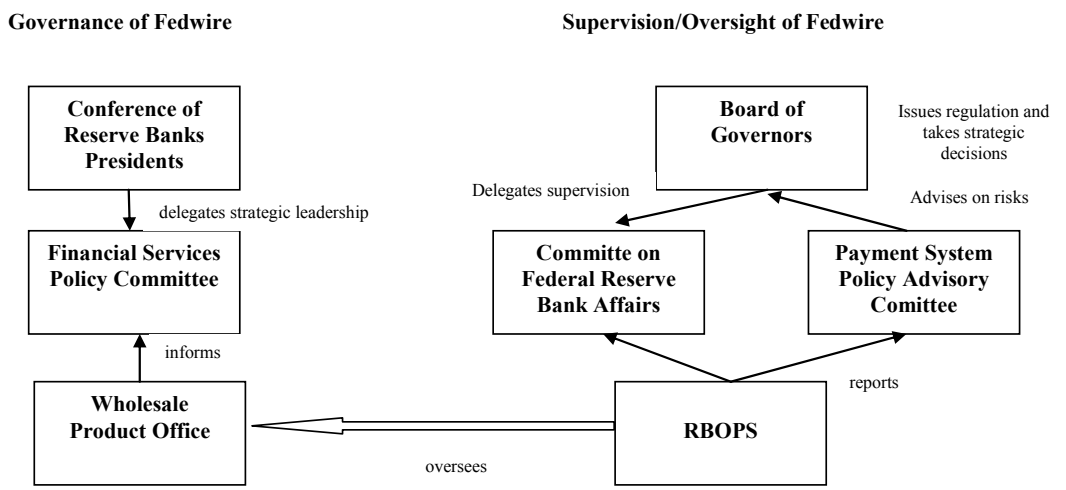
operations, including budgets, the pricing of payments services and strategic plans. The Payments System Policy Advisory Committee advises the Board on issues related to risk management and the relationships between wholesale payment systems and financial markets. The oversight responsibilities of the Board over certain payment and settlement systems, including the operation of Fedwire Funds and Securities, are carried out by the Division of Reserve Bank Operations and Payment Systems (RBOPS). Figure 1 below illustrates these organizational relationships.

Figure 1: Governance and Oversight Framework for Fedwire Funds and Securities



15. **The RBOPS division carries out its oversight tasks for Fedwire Funds and Securities in various ways.** Typical oversight activities include the conduct of on-site and off-site reviews of Reserve Banks, oversight of major projects and initiatives, assessments of Reserve Banks' annual budgets and performance, and assessments of Fedwire against relevant international standards. In carrying out these activities, RBOPS assesses the extent to which the services are provided in a secure, resilient, and well controlled manner and the extent to which the services comply with relevant policies and standards. Additionally, a significant oversight responsibility is to monitor the Reserve Banks' expenses and revenues, as well as to review compliance with the Board's pricing policy and the Monetary Control Act (MCA) of 1980. The MCA requires that fees for Reserve Bank payment services to depository institutions, over the long run, recover actual and imputed costs incurred to provide the services. The Board also conducts a competitive impact analysis when the Reserve Banks are considering operational changes to their priced services, to determine any potential adverse effect on the ability of other service providers to compete effectively with the Reserve Banks in providing similar services.

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C. Responsibility C and General Oversight Principle C: Ability to Carry Out Oversight of Private-Sector Systemically Important Systems

Legal powers

16. **Under the current U.S. legal framework, there is no single statutory provision granting a general oversight authority to the Federal Reserve or any other regulator over the full range of systemically important payment, clearing and settlement infrastructures in the United States.** Whereas the oversight authority of the Board on Fedwire Funds and Securities derives from the provisions of the Federal Reserve Act regarding the supervision of Reserve Banks operations, the current basis for the Federal Reserve's oversight of private sector systems derives from a range of statutory responsibilities for banking supervision and the provision of payment and settlement services. The Federal Reserve's oversight with respect to private sector systems, therefore, depends on whether or not the system is organized and chartered as a bank or Edge corporation subject to the prudential supervisory authority of the Federal Reserve. The basis of regulation and supervision by the Securities and Exchange Commission and the Commodity Futures Trading Commission, however, is determined by whether a system clears or settles securities or futures products. Some clearing and settlement systems are dually regulated depending on their charters and the markets they clear for.

17. **Currently, the Federal Reserve supervises several payment, clearing, and settlement systems that are organized as banks, including Continuous Linked Settlement (CLS) Bank, Depository Trust Company (DTC), ICE Trust (a CCP for credit derivatives), and Warehouse Trust (a trade repository for credit derivatives).** Federal Reserve supervision in these cases is due to the legal status of these entities rather than the activities they are engaged in. However, regulation and supervision of securities and futures clearance and settlement systems in the U.S. is based on activity (*i.e.*, securities clearing agencies are regulated by the SEC and futures clearing houses are regulated by the CFTC). CLS Bank is an Edge corporation headquartered in New York, and DTC, ICE Trust, and Warehouse Trust are limited purpose trust companies, chartered in New York and member banks of the Federal Reserve System. DTC as a securities settlement system is a clearing agency registered with and regulated by the SEC in conjunction with the Federal Reserve.

18. **Clearing House Interbank Payment System (CHIPS), operated by The Clearing House (TCH), is not chartered as a bank, but is supervised by the Federal Reserve and other banking supervisors as a third-party service provider.** The federal banking supervisors have authority under the Bank Services Company Act to examine service providers to which banks have outsourced key services to the same extent as if the services were being performed by the bank itself on its own premises. This gives grounds for the bank supervisors of CHIPS' participants to examine CHIPS operations and the manner in which the clearing and settlement services that banks have outsourced to CHIPS are conducted. The

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agencies contributing to the examination of CHIPS are the relevant banking supervisors for the various CHIPS participants, i.e., the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, the New York State Banking Department, and the Federal Reserve.

19. **The Federal Reserve has only a limited examination authority over the two CCP affiliates of DTC,** the National Securities Clearing Corporation (NSCC) and the Fixed Income Clearing Corporation (FICC)[8], and no authority over the CCPs for exchange-traded derivatives such as the Chicago Mercantile Exchange Clearing House and The Options Clearing Corporation (OCC). Those CCPs are subject to regulation by the SEC and CFTC. NSCC, FICC, and OCC clear and settle securities transactions and, accordingly, are registered with the SEC as clearing agencies under the Exchange Act and are supervised and regulated by the SEC; CCPs for exchange traded futures and options on futures are supervised and regulated by the Commodity Futures Trading Commission (CFTC). The OCC also clears a small volume of transactions in futures and options on futures and, accordingly, is also registered with the CFTC as a derivatives clearing organization.

20. **Despite the functional similarities of these systems, no single authority oversees all critical systems from a systemic risk perspective.** The supervision and oversight of payment, clearing and settlement systems is spread across several regulators depending on the system's charter or the markets it clears for. As part of the financial regulatory reform, it is desirable to clearly entrust the Federal Reserve with an oversight authority for all systemically important payment, clearing and settlement systems, irrespective of their legal status. In cooperation with other agencies and complementary to existing supervisory and regulatory provisions, this would allow the Federal Reserve to address systemic risk consistently and to strengthen its authority to induce change where necessary. More details are provided in Chapter III.

Methodology and resources

21. **The Federal Reserve conducts its oversight of private sector systems by mobilizing and coordinating among its various relevant competencies and functions within the Federal Reserve System.** This approach involves coordination and cooperation among the banking supervision function and payment policy function of the Federal Reserve Bank of New York, and the banking supervision function and payments oversight function of the Board of Governors. While this cooperative framework is not formalized, it operates effectively.

[8] FICC is the CCP for trades in government securities (and provides clearing services for mortgage-backed securities). NSSC is the CCP for trades in equities, corporate and municipal bonds, exchange-traded and unit investment funds. See for more details the assessment of DTC against CPSS/ISOCO Recommendations for SSS and the assessments of FICC and NSCC against the CPSS/IOSCO Recommendations for CCPs.

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22. **In line with their respective charters, the Federal Reserve's day-to-day supervision over CLS Bank, ICE Trust, Warehouse Trust and DTC is conducted by the banking supervisory department of the Federal Reserve Bank of New York**. The unit in charge of "large complex banking organizations" covers these four entities and one of the two major clearing banks. This organizational approach takes into account the highly specialized activities and risk profiles of the entities involved in clearing and settlement. Based upon an assessment of the ranking of the different risks relevant for each of the systems, a yearly supervisory program is defined, encompassing a comprehensive review of the activities, a range of more focused discrete examinations, and an assessment of new products developments. This program is formally submitted for approval each year to a senior Federal Reserve committee that reviews the program and discusses required supervisory resources. The on-site and off-site examinations are performed by joint teams, gathering resources from the different supervisory and oversight functions of the Federal Reserve Bank of New York and of the Board of Governors. The examinations are based upon the standards in the Federal Reserve oversight policy and applicable supervisory standards, such as the Federal Reserve Commercial Bank Examination Manual and Federal Financial Institutions Examination Council (FFIEC) standards and methodologies. The overall assessment of the system leads to define a comprehensive rating of the risk management of the operator. Once achieved, the assessment is shared with the management and the board of directors for the system, through a formal process. In case of gaps, an action plan including a timetable for its implementation is required from the system. The implementation of the corrective measures is subject to a follow-up. Continuous monitoring of the systems involves, among other things, regular meetings with managers of the different functions of the systems' operator. In the case of DTC, Federal Reserve supervisors also work closely with the SEC under the framework set forth in the Securities Exchange Act of 1934.

Analysis of Fed's oversight approach and authority

23. **The strong linkage between the Fed's oversight of payment and settlement systems and its bank supervision powers is a source of strength**. The Fed's statutory powers and tools to obtain sufficient information and induce change are very strongly-founded and effective on those systems chartered as a state member bank or Edge corporation, namely CLS Bank, ICE Trust, Warehouse Trust and DTC. The conduct of the Fed's oversight of these systems is informed by the possibility for Federal Reserve payment system overseers to take part in on-site examinations conducted by Federal Reserve banking supervisors, which is not a widespread oversight practice among central banks. Both the Fed's supervisory and oversight assessments of these systems also benefit from the various perspectives and expertise of the different functions within the Federal Reserve System.

24. **The supervisory resources allocated to carry out oversight of the private sector payment systems falling within the authority of the Federal Reserve System appear sufficient and adequate**. Full time supervisory staff is dedicated to each Federal Reserve

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supervised system. Supervisory staff can also, when needed, draw on additional and more specialized expertise (technology, legal, modeling, risk experts, etc.).

25. **The Federal Reserve's present approach to payment system oversight also has the benefit of facilitating close cooperation between payments systems oversight and banking supervision.** This reflects the important responsibility that the Federal Reserve Board has as a banking supervisor.

26. **An important drawback is the limited authority of the Federal Reserve over nonbank, systemically important payment and settlement systems**. The oversight ability of the Federal Reserve is strongest for systems chartered as banks and falling under its direct banking supervisory authority. For systems without bank charters, the Federal Reserve's oversight authority is limited. This limitation does not seem consistent with (i) the tight interdependencies between payment and settlement systems, (ii) the strong rationale for the central bank to have a comprehensive and holistic view on all potential sources of systemic risk at stake in the settlement infrastructure, as well as (iii) the need for the Federal Reserve to have the same authority to enforce its oversight policy and induce change where necessary, irrespective of the way the system is chartered. CHIPS, which is not chartered as bank, is one example of a system over which the Federal Reserve has somewhat more limited oversight authority. The CHIPS system is supervised by the federal banking supervisors, including the Federal Reserve, as a "third party service provider," under the Bank Services Company Act (see paragraph 18). The December 2007 self-assessment of CHIPS against CPSIPS suggests that TCH has voluntarily agreed to some form of supervision.[9] Both the limitations of the Bank Services Company Act and CHIPS "voluntary" view could complicate or even limit the enforcement of recommendations resulting from the oversight findings of the Federal Reserve over CHIPS.

27. **The extent to which the bank supervisory methodology for examining payment and settlement systems fully addresses issues covered by the international oversight standards is unclear**. Although the Federal Reserve's PSR policy explicitly states that it will be guided by the international standards when exercising its supervisory authority, there is no procedure or manual that provides explicit mapping between examination procedures and the PSR policy standards.

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[9] The assessment states that "PaymentsCo has agreed to be subject to the Comptroller's supervision and examination. PaymentsCo also invites the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Reserve Bank of New York, the Office of Thrift Supervision, and the New York State Banking Department to conduct examinations of its information-technology operations." OCC and Federal Reserve staff believes the statutory authority to conduct CHIPS exams is sound. Authority to enforce supervisory findings directly against the service provider (CHIPS), however, is lacking (nonetheless, the agencies have direct enforcement authority over CHIPS participants, and could limit their use of the service provider if the provider rejects supervisory findings).

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28. **There is scope for enhancing the disclosure of the Federal Reserve's assessments of the payments system.** Pursuant to the PSR policy, systemically important payment and settlement systems are expected to complete, disclose publicly the results and update at a minimum every two years a self-assessment against the applicable set of international standards (the CPSIPS for payment systems). This policy helps ensure appropriate risk management principles and facilitates access by interested stakeholders to information based upon standardized international standard. Pursuant to the PSR policy, this self-assessment framework does not preclude the Federal Reserve to independently assess compliance of systemically important systems under its jurisdiction. The Board discloses its assessment of the compliance of Fedwire Funds and Securities but does not disclose its assessments of other systems. This reflects the constraints of Board regulations regarding the confidentiality of bank supervisory information, which prevent public disclosure of supervisory information including assessments based on such information. The various stakeholders (including systems' participants) have therefore no means to check to which extent the self-assessments disclosed by the systems reflect and comply with the Board's own assessments. Therefore, consideration could be given to steps to ensure that potential gaps, if any, in these assessments are closed in a transparent manner.

D. Responsibility D and General Oversight Principle E: Cooperation with Other Central Banks and with Other Relevant Domestic and Foreign Authorities

29. **The criticality of cooperation both domestically and internationally in the oversight process of Federal Reserve is acknowledged by the PSR policy**. The PSR Policy states that "where the Board does not have direct or exclusive supervisory or regulatory authority over systems covered by this policy, it will work with other domestic and foreign financial system authorities to promote effective risk management in payments and securities settlement systems. The Board encourages other relevant authorities to consider the principles embodied in this policy when evaluating the payments and securities settlement risks posed by and to the systems and individual system participants that they oversee, supervise, or regulate."

30. **The Federal Reserve's oversight process involves close cooperation among various functions within the Federal Reserve as well as with other domestic regulators**. As illustrated in Figure 2, payment system experts, bank supervisors, market experts, and monetary staff as well as economic researchers contribute to the policymaking and to the implementation of the oversight of payment and settlement systems. This brings appropriate skills to bear in assessing the various sources of risks and inefficiencies in the clearing and settlement process, and also ensures that different supervisory perspectives are taken into account. Indeed, in its oversight of payment and settlement systems, the Federal Reserve cooperates closely with other banking supervisors (for TCH/CHIPS the Office of the Comptroller of the Currency, the Office of Thrift Supervision, the Federal Deposit Insurance Corporation, and the New York State Banking Department), and also with market regulators,

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the SEC and the CFTC.[10] Furthermore, the established framework for the regulation of securities clearance and settlement systems in the Securities Exchange Act of 1934 gives joint authority to the SEC and the Federal Reserve with respect to certain SEC registered clearing agencies that are organized as banks, such as DTC.

31. **The Federal Reserve also cooperates internationally**. In working with foreign financial system authorities, the Board is guided by the international principles for cooperative oversight, namely the central bank Responsibilities in applying the CPSIPS, the Recommendation 18 of the Recommendations for Securities Settlement Systems, and the "Principles for Cooperative Central Bank Oversight of Cross-border and Multi-currency Netting and Settlement Schemes" and related documents.[11]

32. **The Federal Reserve leads a cooperative oversight arrangement for CLS Bank, composed of the G-10 and other central banks of issue for the currencies eligible for settlement in CLS**. The Protocol adopted in 2008 for the Cooperative Oversight Arrangement of CLS provides an arrangement for the central banks of issue of currencies eligible for settlement in the CLS system to fulfill their oversight responsibilities, including exchange of information.

33. **The Federal Reserve is currently working with relevant foreign and other domestic authorities to develop a formal cooperative oversight arrangement for the DTCC Warehouse Trust, the trade repository for credit derivatives.** It also continues to facilitate a number of cooperative regulatory forums on over-the-counter (OTC) derivatives clearing and participates in a cooperative oversight arrangement, led by the National Bank of Belgium, for SWIFT.

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[10] For more details on the arrangements for securities clearing and settlement systems as well as an assessment of their effectiveness, see IMF assessments of DTC and Fedwire Securities against CPSS/IOSCO Recommendations for SSSs and IMF assessments of NSCC and FICC against the CPSS/IOSCO Recommendations for CCPs.

[11] Usually referred to as "Lamfalussy principles for international cooperative oversight," these principles which guide cooperative oversight between central banks were set out in the 1990 "*Report of the Committee on Interbank Netting Schemes of the central banks of the Group of Ten countries*" and updated in the 2005 CPSS report on "*Central Bank Oversight of Payment and Settlement Systems.*" They recommend: (i) informing other central banks that may have an interest in the prudent design and management of the cross-border and multi-currency system; (ii) assigning the primary oversight responsibility to a central bank (iii) periodically assessing the design and operation of the system as a whole to be performed by the central bank with the primary responsibility in consultation with the other central banks, (iv) leaving the determination of the adequacy of a system's settlement and failure-to-settle procedures in a currency as a joint responsibility of the central bank of issue and the authority with primary responsibility for oversight of the system and (v) leaving scope for a central bank to discourage the use of an unsound system.

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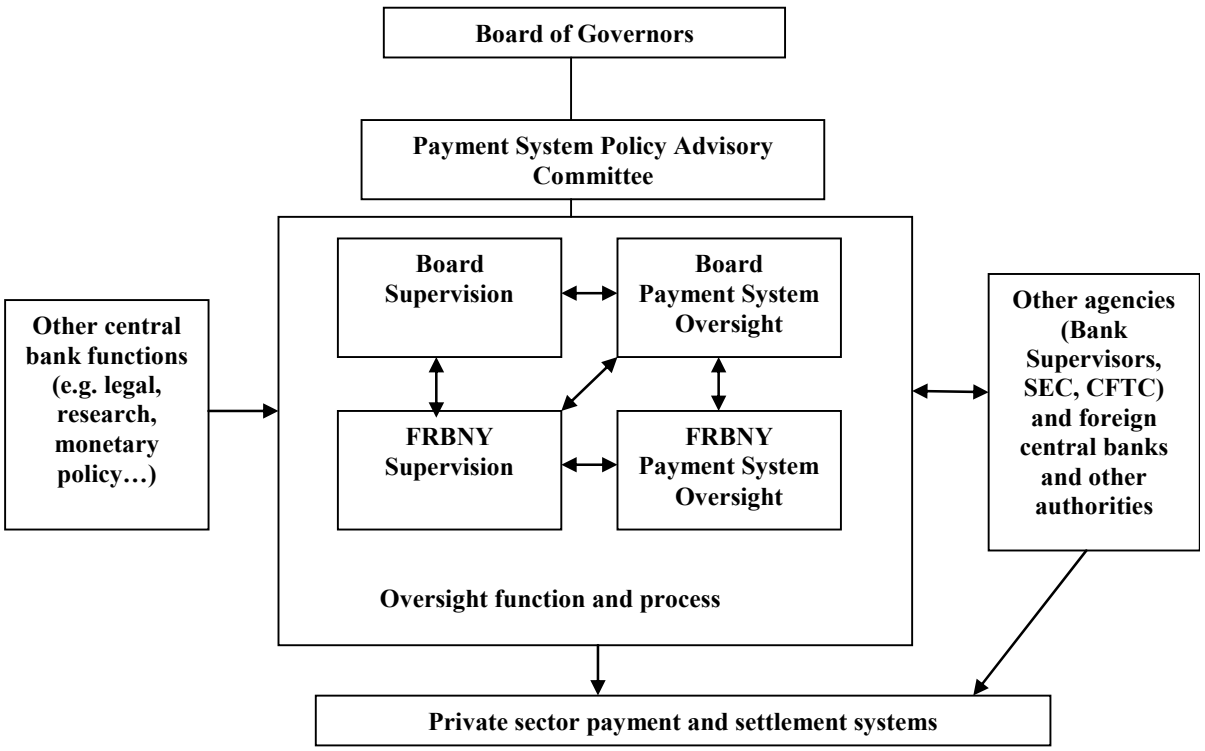
Figure 2. Overview of Internal Federal Reserve Functional Relationships and External Cooperation for Oversight of Private Sector Systems



III. Legislative Reform Proposals Concerning Oversight of Systemically Important Payment, Clearing and Settlement Systems

34. **Recent legislative proposals concerning oversight of systemically important payment, clearing, and settlement systems and activities would help improve the United States' ability to assess systemic risk arising from market infrastructures.** The Administration's 2009 legislative proposals recommend providing the Federal Reserve with the authority, in consultation with the Financial Services Oversight Council, which would be comprised of other relevant U.S. financial regulators, to designate payment, clearing and settlement systems as systemically important, to prescribe risk management standards, and to oversee such systems from a systemic risk perspective in conjunction with the systems' primary supervisor. Such authority should help to improve the United States' ability to assess systemic risk, ensure consistent application of international risk management standards across systems, and coordinate policy actions among relevant and interest regulators. This enhanced authority would be in addition to existing supervisory and regulatory authority of other agencies. Its implementation would therefore further facilitate the cooperation already in place with other relevant agencies (e.g., SEC and CFTC).

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35. **A strengthened legal authority would help the Federal Reserve better monitor, mitigate and respond to systemic risk arising from payment, clearing, and settlement systems and activities**. More specifically, it should enable (i) strengthened oversight of CHIPS by providing a federal agency with a direct authority over the system; (ii) more consistent oversight, from a systemic risk perspective, of both bank-chartered and nonbank payment, clearing, and settlement systems; and (iii) a better alignment of the United States' oversight framework for all payment, clearing, and settlement systems of a systemic importance, including strengthened coordination among relevant supervisors. These proposals would also give the Federal Reserve an enhanced role in the oversight of systemically important payment, clearing, and settlement activities, including the payments role of the two, systemically important clearing banks. Box 1 below provides a summary of the Administration's proposal, as available at the time of the mission.

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Box 1. Overview of the Administration's Proposal (Title VIII) on Payment, Clearing and Settlement Supervision

In order to mitigate systemic risk in the financial system and promote financial stability, the Administration's proposal would provide the Board of Governors of the Federal Reserve System (Board) with an enhanced role in supervising risk management of systemically important financial market utilities and of systemically important payment, clearing, and settlement activities conducted by financial institutions.

The Board would be authorized to designate a financial market utility or a payment, clearing, or settlement activity as systemically important, and established procedures and criteria for making and withdrawing such a designation. Criteria for designation and rescission of designation include the aggregate monetary value of transactions processed and the effect that a failure of a financial market utility or payment, clearing, or settlement activity would have on the financial system. The Board would have to consult with the Financial Services Oversight Council and the relevant supervisory agency before making a designation.

In consultation with the Financial Services Oversight Council, the Securities and Exchange Commission, and the Commodity Futures Trading Commission, the Board would be able to set risk management standards for the designated financial market utilities and for the designated payment, clearing, and settlement activities of financial institutions.

The law would not modify the primary responsibility currently entrusted to the different regulatory and supervisory agencies of the respective payment, clearing and settlement systems. However, the Board would be allowed to participate in examinations made by other agencies and would be the supervisory agency for designated financial market utilities that do not otherwise fall within the authority of an agency. The Board would also be granted back-up authority to conduct examinations and to take enforcement actions against a designated financial market utility if there were an imminent risk of substantial harm to the financial system.

The Board would be entitled to collect information from financial market utilities and financial institutions engaged in designated payment, clearing, or settlement activities in order to assess systemic importance. Sharing of relevant information and coordination among financial regulators would also be facilitated.

Federal Reserve Banks would also be entitled to open an account, provide access to the discount window credit and pay interest on balances maintained for a designated financial market utility. The extension of central bank credit facilities to financial market utilities would provide for an additional liquidity buffer in case of abnormal market conditions and link this possibility to their adequate oversight and strict observance of risk management standards.

[Summarized on the basis of the Administration's proposed legislation dated 22 July 2009. Subsequent legislative proposals have revised certain aspects of Title VIII.]

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FINANCIAL SECTOR ASSESSMENT PROGRAM

UNITED STATES OF AMERICA

BASEL II IMPLEMENTATION PREPAREDNESS IN THE UNITED STATES

TECHNICAL NOTE

MAY 2010

INTERNATIONAL MONETARY FUND
MONETARY AND CAPITAL MARKETS DEPARTMENT

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Contents Page

Glossary 3

A. Introduction 4
B. Overall Conclusion 5
C. Plans and Resources 6
D. Capital Definition, Scope of Application, and Impact 12
E. Standardized Approach to Credit Risk 15
F. Internal Ratings Based Approach to Credit Risk 16
G. Advanced Measurement Approach (AMA) for Operational Risk 19
H. Pillar 2: Supervisory Review Process 20
I. Pillar 3: Disclosure and Market Discipline 23

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GLOSSARY

AIRB	Advance Internal Ratings Based
AMA	Advanced Measurement Approach
BCBS	Basel Committee for Banking Supervision
BCP	Basel Core Principles
BHC	Bank Holding Companies
CP	Core Principles
DI	Depository Institution
FBAs	Federal Banking Agencies
FRB	Federal Reserve Board
FSAP	Financial Sector Assessment Program
FTE	Full Time Equivalent
ICAAP	Internal Capital Adequacy Assessment Process
IMF	International Monetary Fund
IRB	Internal Ratings Based
LDCE	Loss Data Collection Exercise
LTV	Loan-to-Value Ratios
OCC	Office of the Comptroller of Currency
QIS	Quantitative Impact Studies
QT	Qualification Teams
SCAP	Supervisory Capital Assessment Program
U.S.	United States

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A. INTRODUCTION

1. **As part of the Financial Sector Assessment Program (FSAP) of the United States, the International Monetary Fund (IMF) assessment team performed a high-level assessment of preparedness for implementation of Basel II in the United States[1].** At the time of the FSAP, Basel II (advanced approaches only) had been adopted (in 2007) as a rule for certain "mandatory" or "core banks" and their Bank Holding Companies (BHCs). However, implementation of these rules was not complete, in the sense that banks' capital calculations at the time of the FSAP assessment were based on Basel I. Accordingly, implementation of Basel II was not formally assessed as part of the FSAP. Instead, the assessors adapted a simplified set of Basel II implementation assessment criteria from the full criteria normally used by the IMF (as agreed with the Basel Committee for Banking Supervision (BCBS)) for a stand-alone Basel II assessment. The authorities agreed to submit a self-assessment against these simplified criteria. Assessors focused on the advanced approaches rule as that is the only Basel II rule that the United States has currently implemented.

2. **The assessment team met with staff of Federal Banking Agencies (FBAs) involved in Basel II implementation and reviewed certain documents.** Currently, the Federal Reserve Board (FRB) and the Office of the Comptroller of Currency (OCC) are primarily involved in the implementation process because they are the primary supervisors of the banks moving to Basel II. In future, depending on which other banks become core banks or opt in to Basel II, other FBAs will also be involved in detailed implementation. As well, the assessment team met with certain banks that are implementing Basel II. As a technical note that is not part of the Basel Core Principles (BCP) assessment, no ratings were assigned related to Basel II implementation. Findings for some Core Principles (CPs) in the FSAP are relevant for Basel II implementation, and were taken into account in this note.

3. **This note and assessment relates to Basel II rules and implementation as they existed at the time of the assessment in October 2009.** The BCBS proposed various enhancements to the Basel II framework in 2009. Some of these have been agreed and some others are in the comment phase before final adoption by the BCBS. The U.S. authorities have been active in the development of these proposals. As they were only recently promulgated by the BCBS, the rules related to trading book exposures and other matters were not assessed. FBAs indicated they intend to implement those by year-end 2010, in line with the schedule proposed by the Basel Committee.

4. **The body of this technical note follows the order of the criteria that were used.**

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[1] The main author of this note is Nicholas Le Pan, IMF Consultant; ex-Head of the Office of the Superintendent of Financial Institutions, Canada and ex-Vice Chairman of the Basel Committee for Banking Supervision).

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B. Overall Conclusion

5. **The FBAs are conducting a high quality implementation of the advanced approaches for core banks.** The skills and resources being brought to bear are impressive and substantial. While inter-agency disagreement in policymaking regarding Basel II has been a factor in the run-up to the implementation and may not have been fully resolved, inter-agency coordination between the main FBAs currently involved (the FRB and OCC) is of high quality and a model for other inter-agency endeavors. In part, this is due to the sustained level of focus that Basel II has received from FBAs at all levels of these organizations.

6. **There remains uncertainty in banks about the status of Basel II in the United States going forward**. For banks, some of this relates to how the implementation will work in practice, whether banks will ever be permitted to exit parallel runs or the floors, the extent to which the FBAs will actually use Pillar 2 assessments that banks perform, or whether this will be a compliance exercise, and what, if any of the standardized approach will be implemented. Apprehensions related to this uncertainty are understandable. Despite the leading role played by the United States in developing Basel II, considerable and protracted inter-agency disagreement delayed U.S. implementation, and these interagency disagreements still do not appear to be fully resolved. Moreover, industry and market uncertainty have been exacerbated by the recent crisis and the significant adjustments that are happening to the Basel II standards. To ensure success, it will be important for the authorities to adopt policies and processes that will reduce these uncertainties. The agencies have indicated they are continuing to work domestically and with the Basel Committee to strengthen the Basel II framework, including issues associated with the use of internal models for determining capital requirements.

7. **Certain policy choices the authorities have made or may make related to allowing banks to choose the capital regime that applies to them (beyond the options in the Basel II structure) may open up arbitrage possibilities that the authorities need to take into account going forward.** Assessors encourage the FBAs to finalize the rest of their Basel II adoption/implementation process in order to reduce uncertainty for banks.

8. **This note contains a number of suggestions for the FBAs to enhance their review of progress in implementation of advanced approaches in the next one to two years so as to ensure they remain on track for a high-quality implementation.** Those recommendations concern such matters as having sufficient ongoing resources, desirable cross-system detailed reviews of implementation in various areas, and use of the Pillar 2 process to enhance capital adequacy assessments by banks.

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C. Plans and Resources

9. ***Criteria:*** *The supervisor should be able to demonstrate a feasible plan for robust project management, disclosure, good governance, and oversight of Basel II implementation. This includes a Basel II implementation strategy objective and plans that: fit into a country's overall supervisory priorities; appropriately take account of the readiness and capacity of the supervisory authority and the banking system; and are disclosed to the public and discussed with banks.*

10. **On December 7, 2007, the FBAs issued a final rule (advanced approaches rule) implementing the advanced approaches of the Basel Committee's Basel II capital adequacy framework (Basel II or New Capital Adequacy Framework).** In the United States, the advanced approaches rule is mandatory for certain banking organizations (core banks) and voluntary for others (opt-in banks). *(See 72 FR 69288).* Core banks are required to implement the advanced Internal-Ratings Based (AIRB) approach, Advanced Measurement Approach (AMA), and the market risk rule in Pillar 1. They also must implement Pillar 2 and Pillar 3 requirements. Core banks account for a substantial portion of the banking system assets in the United States.

11. **Banks and BHCs are subject to the advanced approaches rule if they meet either of two independent threshold criteria:** (i) consolidated total assets of US$250 billion or more; or (ii) consolidated total on-balance sheet foreign exposures of US$10 billion or more, each as reported on the most recent year-end regulatory reports. Authorities describe these banks as "the most internationally active." Assessors believe that other non-core banks may eventually be deemed to be sufficiently important, or sufficiently internationally active and should be strongly encouraged, at an appropriate time, to opt in to the advanced approaches rule

12. **As at the time of assessment, there are 14 banking groups that meet these core criteria.** In addition, the advanced approaches rule allows other banks who meet the Basel II qualifying criteria for advanced approaches to opt in to this rule in the United States. The FBAs indicated that there are two to three banks that have indicated their intention to opt in (typically banks with foreign parents on Basel II) and two to three more have expressed an interest in doing so.

13. **Each Depository Institution (DI) subsidiary of a core or opt-in bank/BHC is itself required to apply the advanced approaches rule** unless specifically exempted from this requirement by its primary federal supervisor.

14. **Under the rule, a core bank must plan to complete its parallel run within 36 months of becoming subject to the rule: for the initial group of core banks, this implies beginning parallel run no later than April 2010.** After a bank successfully exits its parallel run (which requires approval), the advanced approaches become the formal minimum capital requirements for the bank, subject to floors that are in place for a minimum three-year period.

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15. **In July 2008, the FBAs issued guidance related to the overall qualification process (qualification guidance).** This guidance addressed: the need for banks to have all systems and processes functioning well prior to the start of parallel run; the need for a robust and dynamic implementation plan as a key communication tool for dialogue between the bank and its supervisors; the need for robust qualitative and quantitative validation; and reiterated the numerous options and approvals that are embedded in the rule. FBAs also issued guidance on Pillar 2 in 2008.[2]

16. **Additionally, in 2007, the FBAs proposed for comment a rule to allow non-mandatory banks to adopt the Basel II standardized approach for credit risk and the basic indicator approach for operational risk.** The proposed rule was optional for those banks—that would also be permitted to remain on the current risk-based capital rule, which is based on Basel I. This proposal contained high-level Pillar 2 requirements and additional disclosures based on Pillar 3. The main difference in the U.S. proposed standardized approach, relative to the Basel II standardized approach, is a more granular treatment of exposures to residential mortgage exposures based on loan-to-value (LTV) ratio bands. For some LTV ratios, the proposed capital treatment would be higher than under Basel II standardized, which authorities indicated they believed was appropriate for the U.S. market. Certain other countries such as Australia and Brazil have followed a similar approach.

17. **The standardized rule remains at the proposal stage.** Comments have been received, but there is no indication from the authorities of their intention as to whether or when the proposal will be adopted, and if it proceeds, what alterations might be introduced. Assessors did not focus on this proposal during the assessment.

18. **The overall strategy for Basel II remains somewhat in flux in the United States with banks, and others the assessors met, indicating that they would benefit from greater clarity about the status of Basel II going forward.** The rules now in place were implemented after a long period of discussion, and with considerable inter-agency difference of views. There also remains a difference of views between FBAs about Basel II today, including among those with whom the assessment team met.

19. **The assessment team discussed with FBAs the policy of allowing banks the possibility of being on one of three separate capital rules**. This policy is understandable given the heterogeneity within the U.S. banking sector, but it introduces risks of inappropriate results. For example, some complex banks that choose not to opt in to the advanced approaches may be doing so to avoid detailed operational and risk management requirements and related capital charges. Additionally, allowing banks to opt out of the standardized approach and remain on the Basel-I based existing capital rules, means that those banks would not face additional capital charges for higher-LTV mortgages that would

[2] *http://www.federalreserve.gov/boarddocs/srletters/2008/SR0804a1.pdf*

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apply under the Basel II standardized approach. They would also avoid capital charges for operational risk.

20. **For the advanced approaches rule, the FBAs have robust plans and processes in place to ensure effective oversight of Basel II implementation and qualification, including program managers and dedicated staff responsible for Basel II oversight.** The individuals involved in implementation are responsible for developing and communicating each agency's respective supervisory strategies and ensuring consistency in approach across the FBAs as well as across firms. Staff and senior leaders that the assessors met demonstrated a comprehensive and sound understanding of Basel II implementation challenges and effective ways to meet them.

21. **Each agency has a well-articulated overall Basel II strategy that has been disseminated to appropriate supervisory staff and communicated to relevant banking organizations.** At the largest institutions, the dedicated staff has developed firm-specific supervisory strategies that focus on the specific implementation status, issues, knowledge gaps, and concerns for that institution. There appeared to be excellent interaction and involvement and integration of front-line supervisory teams, risk specialists, and Basel II specialists.

22. **Supporting these strategies are high-quality examination documentation requirements that ensure examiners address all aspects of the rule, and provide a common framework for summarizing an individual firm's readiness.** Program management capabilities appear to be well-developed and working well in practice.

23. **FBAs involved in the current implementation of the advanced approaches rule (the FRB and OCC) demonstrated a very high degree of cooperation and coordination in implementation efforts.** Several commentators on the U.S. system noted that recent Basel II efforts were a model for supervisory cooperation going forward.

24. **It will be important to extend this framework for cooperation and coordination to other FBAs when they will be required to assess implementation as banks they supervise opt in to the advanced approaches under Basel II.**

25. **Under the U.S. advanced approaches rule, a core bank must adopt a board-approved implementation plan that incorporates completing a parallel run within 36 months of the bank becoming subject to the rule**. For the initial group of core banks, this implies adopting implementation plans by October 2009 and beginning parallel runs no later than April 2010. Approval is required to exit parallel run and enter a three-year period where the bank's capital calculation is according to Basel II subject to declining floors. Approval is required to move between floor stages and to exit the floor period. At the time of the assessment, one bank had commenced its parallel run period.

26. **In implementing Basel II for core banks, the U.S. has looked for a high proportion of the banks' portfolios to be compliant with the advanced approaches.** It has not made use of the partial roll-out flexibility to any considerable degree. As a general

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policy, FBAs have also looked for Basel II preparedness at banks to be of high quality *before* banks enter parallel running.

27. ***Criteria:*** *Assessors should be satisfied that the supervisor has adequate resources to implement Basel II, including a budget that permits effective Basel II implementation. This includes staff in sufficient numbers and with skills commensurate with the size and complexity of the institutions implementing Basel II, and appropriate for the Basel II approaches being implemented.*

28. **Assessors saw evidence that material amounts of resources have been deployed in the implementation effort.** The level of resources appears appropriate given the size and complexity of implementation for mandatory banks. Each of the two main FBAs involved has allocated some five or six FTEs per core bank in implementation efforts. Considerable high-quality expertise in risk quantification and risk analytics is also available to the teams.

29. **FBAs face challenges over the next few years as a "hump" of assessment of implementation plans, parallel runs periods, and approvals relating to floor periods will be required.** This additional work will occur in a period when "normal" supervisory intensity will remain high due to the aftermath of the financial crisis and the remedial actions that have been found necessary as a result. FBAs are well aware of these challenges and are gearing up to face them. The FBAs believe that efficiencies they can gain from experience in dealing with the first few cases can assist in reducing the resource demands. It is likely that there will be other demands going forward on the analytical and technical resources that have been made available for Basel II implementation.

30. **While efficiencies are undoubtedly possible based on learning from the initial cases, assessors believe that the FBAs may be underestimating the resource challenge.** In 2010, FBAs should more explicitly consider the likely multi-year resource demands they will face in Basel II implementation and ensure that sufficient resources are available.

31. **Basel II requires supervisors to determine on an ongoing basis that the qualifying conditions are being met.** As well, certain aspects of Basel II implementation for advanced approaches, including Pillar 2, normally require some adjustment in supervisory programs. This can be more important in the early years of implementation. It is usually not possible to implement the advanced approaches without some permanent additional resources being committed.

32. **Both management in charge of Basel II implementation and senior management in charge of FBAs are aware that, after initial approval processes are complete, the level of ongoing resources in supervision of core banks will have to be higher than pre-Basel II.** There is not a high degree of precision as to what increased need may be and the FBAs are, to some extent, rightly waiting to determine this when information on resource demands of this phase are clearer. More generally, FBAs tend to use a current year and one-year forward budget process. The drawback of this approach is that explicit consideration of Basel II resource demands necessary to sustain the high quality

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implementation can be lost. FBAs should explicitly take account—in each budget cycle for the next few years—of the resources being used in Basel II implementation and assess their adequacy against experience to date. This should be based on explicit monitoring of the resource implications of Basel II for supervisory teams and specialist resources.

33. **In addition to the program management role described above, the FBAs are coordinating their Basel II efforts at each banking organization to make the reviews more efficient and to ensure consistent application of the advanced approaches rule across all entities within the organization.** The supervisory teams that the assessors met are aware of their responsibilities. On-site supervisory teams are responsible for the ongoing supervision of the institutions, including Basel II, and appeared to have skills commensurate with the size and complexity of the institutions that they supervise. Many team members have particular skills in advanced risk management practices. These on-site teams are augmented by input and assistance provided by experts in the area of policy and quantification, as well as other staff with specialized skills from within and across the FBAs.

34. **The United States appears to be managing well the hand-off and coordination challenge between various groups within each FBA.** Assessors saw ample evidence of appropriate levels of skills and awareness in the supervisory teams that they met. Supervisory team leaders are aware that Basel II implementation is one of their top priorities.

35. **The FBAs have developed a comprehensive training program, with training targeted across skill and experience levels.** Classes are generally aligned along risk dimensions, ranging from high level introductory and overview courses, to in-depth and advanced level seminars. Staff within each agency has access to online training tools covering the breadth of the framework. In some cases, classroom and individual training is augmented by applied workshops that partner risk experts with field staff to discuss specific institutional issues and challenges, and to share experiences and knowledge across teams and FBAs.

36. ***Criteria:*** *Adaptations of supervisory systems should take account of initial approval requirements and the need for ongoing monitoring and assessment of Basel II in banks.*

37. **The ongoing qualification requirements are described in Section 23 of the advanced approaches rule.** Each agency has developed, or is developing, processes for reaching the numerous decisions involved in initial and ongoing qualification. Staff involved with the Basel II qualification decision process is made aware of these processes through discussions and training.

38. **The ongoing adjustments in supervisory processes necessitated by Basel II have not been fully determined at this stage.** Assessors encourage FBAs to finalize these during 2010.

39. ***Criteria:*** *Supervisors should have the experience and expertise to analyze bank plans for Basel II implementation, and effectively challenge them, when appropriate. Assessors should ask for examples of such challenges.*

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40. **Staff at each of the FBAs is experienced in reviewing, analyzing, and providing detailed feedback on banking organizations' draft implementation plans.** The advanced approaches rule articulates high expectations for implementation plans and is supported by the qualification guidance that includes a section specifically addressing implementation plans. The FBAs view the implementation plan as an important benchmark for measuring compliance with the advanced approaches rule. To date, the FBAs have reviewed all core banks' implementation plans. Detailed feedback was provided to each institution on their draft implementation plan and gap analysis. In many cases, the FBAs asked for, and received, modifications or amendments to the plans.

41. **Staff of the FBAs, whom the assessors met, demonstrated a high degree of expertise in Basel II and related matters.** Assessors were satisfied that FBAs were able to exercise effective challenge of banks plans and implementation. Expertise and ability to make appropriate judgments were evidenced in the quality of staff assessors met.

42. ***Criteria:*** *Supervisors should have adequate systems to ensure due process, analysis and review of banks' Basel II options and models, as well as quality control over treatment of banks applications for use of Basel II options and models. Supervisors must have the experience and expertise necessary to exercise sound judgment in treating these applications.*

43. **FBAs have developed processes to review and analyze each banking organization's implementation of the advanced approaches during and after the parallel run.** The FBAs also have due process in place to allow for notice and response to the banks of results from the review and analysis. In practice, the supervisory processes have been evidenced through on-site examination work that has been conducted at one banking organization during its parallel run period. Staff with appropriate expertise have reviewed each approach subject to approval and provided applicable feedback.

44. **Assessors discussed the FBAs' approach to ensuring consistency of approach in reviewing implementation plans and are satisfied that it was effective.** Ensuring consistency on an ongoing basis will be more challenging as banks are not in the parallel run period at the same time. Ensuring consistency requires not only the same standards, but also the processes to enhance the confidence that the standards and judgments are being applied consistently, and that differences in treatment are commensurate to the differences between banks. As international experience suggests, being able to consider several banks at the same time in a peer comparison process can be very helpful in this regard, but is rendered more difficult in a sequential process. Having constancy of core staff and a strong review process, as the FBAs have, can partially compensate for this.

45. **Assessors discussed with FBAs the review process with respect to supervisory and approval decisions, and are satisfied that it is effective and robust.** As more of the responsibility for Basel II work transfers to on-site supervisory teams and continuous supervision, it will be important that FBAs review their process for internal review and oversight to satisfy themselves that goals for high quality and consistent implementation continue to be met. Banks that the assessment team met reported some issues of

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inconsistency, but these did not seem to be out of line with experience elsewhere. As other FBAs become more active in Basel II implementation (as the number of qualifying banks expands), it will be important for links to be built with the FRB and OCC to ensure ongoing consistency.

D. Capital Definition, Scope of Application, and Impact

46. ***Criteria:*** *Supervisors should require the framework to be applied to internationally active banks on a fully consolidated basis consistent with paragraphs 20–39 of the Basel II framework. The consolidation perimeter should include any holding company that is the parent entity in a banking group which includes banking, insurance, and/or other financial subsidiaries.*

47. **In general, U.S. implementation of the advanced approaches rule meets the consolidation requirements of the Basel II Accord, or is more conservative.**

48. **The advanced approaches rule excludes assets held in an insurance underwriting subsidiary of a BHC from the asset threshold criterion because the rule was not designed to address insurance underwriting exposures.** However, insurance subsidiaries and their assets must be consolidated for purposes of determining the BHC's risk-weighted assets and calculating its capital requirements under the advanced approaches rule.

49. **As required by statute,[3] assets and liabilities of a financial subsidiary of a depository institution (DI) are not consolidated with those of the DI for risk-based capital purposes. Moreover, the DI must deduct its equity investment (including retained earnings) in the financial subsidiary from regulatory capital—50 percent from Tier 1 capital and 50 percent from Tier 2 capital.** Conversely, a BHC generally fully consolidates the assets and liabilities of financial subsidiaries of its subsidiary DIs, and does not deduct from its regulatory capital the DI's equity investments in their financial subsidiaries.

50. **In recognition of potential burden issues, the rule allows the FRB to exempt any BHC from mandatory application of the advanced approaches.** The FRB will make such a determination in light of the BHC's asset size (including subsidiary DI asset size relative to total BHC asset size), level of complexity, risk profile, or scope of operation. Similarly, the rule allows a primary federal supervisor to exempt any DI under its jurisdiction from mandatory application of the advanced approaches. A primary federal supervisor will consider the same factors in making its determination. To date, no exemptions from the advanced approaches rule have been approved across the FBAs, but several have been requested. FBAs advised the assessment team that any exemptions would be rare.

51. **U.S. subsidiaries of foreign banks that are on Basel II in their home country are not required to be on Basel II in the United States, unless the subsidiary meets the**

[3] 12 USC 24a(c)(1).

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criteria for a core bank. Such subsidiaries may opt in to the advanced approaches rule, and a few will do so in future. As Basel II standardized and foundation approaches are not available in the United States, subsidiaries of foreign banks are using the Basel I-based rule and then performing various adjustments to calculate Basel II capital at the parent company level. This would often necessitate two capital calculations for the subsidiary.

52. ***Criteria:*** *Significant minority interests in these types of financial institutions, as well as significant investments in commercial entities, should be consolidated to the extent envisaged by the framework, and deductions from capital made according to the framework.*

53. **Assessors discussed the approach to consolidation/deduction with the FBAs.** The advanced approaches rule's consolidation and deduction requirements are substantially consistent with the Basel II. Any departures result in more conservative capital calculation, as noted in paragraph 49 above, than envisaged in the New Capital Adequacy framework.

54. ***Criteria:*** *Supervisors should require application of the framework to any internationally active bank at the sub-group level (paragraph 22).*

55. **As described above, each DI subsidiary of a core or opt-in bank is itself required to apply the advanced approaches rule unless it receives a specific exemption from its primary federal supervisor.**

56. ***Criteria:*** *Supervisors should also be able to demonstrate that they periodically test the adequacy of capital of banks on a stand-alone basis.*

57. **The U.S. supervisory process expects examiners to evaluate an institution's capital separately at the BHC and at each DI in the banking group.** Public quarterly reporting of capital ratios is required at each DI in the banking group, as well as the top-tier U.S. banking holding company. Additionally, the U.S. rule works to require an Internal Capital Adequacy Assessment Process (ICAAP) at each level in the banking group, though the bank-ICAAP can be based on relevant parts of the group-wide ICAAP. Assessors were not able to review how the ICAAP assessment within a group works in practice at this stage of implementation.

58. ***Criteria:*** *Supervisors should have performed one or more quantitative impact studies (QIS), within or outside the Basel-sponsored framework, to assess the impact of Basel II on banks' capital adequacy levels. The results should have been analyzed in advance of implementation, and thereafter through ongoing analysis during parallel running. Supervisors should be able to demonstrate that they understand the prudential implications of material changes in capital, and that they are satisfied that capital levels will remain adequate to buffer underlying risk.*

59. **The FBAs initiated several quantitative impact studies prior to implementation of the advanced approaches rule in the United States.** A fourth quantitative impact study was initiated in 2004 with the objective of gaining a better understanding of the potential effects of a Basel II risk-based capital regime on U.S institutions. The subsequent analytical

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work focused on identifying the extent to which the reduction and dispersion in minimum risk-based capital requirements indicated by the study reflected the risks facing institutions, differences in the state of institutions' data systems, and their overall readiness to implement the Basel II framework, as well as aspects of the framework itself that might produce results that did not appropriately reflect underlying risks. *(See QIS-4 Summary Findings at: http://www.federalreserve.gov/boarddocs/press/bcreg/2006/20060224/attachment.pdf.)*

60. **The FBAs committed by regulation to undertake a study to evaluate the advanced approaches and determine if there are any material deficiencies.** An institution would generally not be permitted to exit the third transitional floor period if the study determines there are material deficiencies that cannot be addressed by then-existing tools or by amendment to the advanced approaches.

61. **The FBAs developed extensive supervisory reports to collect data in addition to the disclosures required under Pillar 3 from banking organizations using the advanced approaches.** Currently, one banking organization is in parallel run and is submitting these reports; a number of banking organizations are expected to follow suit in 2010.

62. **Assessors noted the considerable, high-quality work done by FBAs in the period leading up to the rulemaking to assess impacts.** However, some of this is now dated. Recent stress conditions have underscored the importance of ensuring data inputs are representative of economic downturns and the supervisory formulas are calibrated appropriately. Once a number of banks are in parallel run, it will be possible for the FBAs to update their assessment of impacts. Such an assessment should be possible at year-end 2010 and 2011. The assessment team supports the FBAs' intention to perform such an analysis.

63. **There has been no assessment on an aggregate basis of the impact of adopting the Basel II standardized approaches for smaller banks** (there were specific analyzes of competitive impacts done previously). If the authorities do proceed to implement the standardized approaches for smaller banks, it would be desirable to perform some assessment of impacts and the possibility for arbitrage between approaches.

64. **In 2008, the FBAs participated in an Operational Risk Loss Data Collection Exercise (LDCE) sponsored by the Basel Committee's Standards Implementation Group**. LDCE participants included 23 U.S. financial institutions. The LDCE collects data on individual loss events and loss scenarios, as well as capital estimates. Among other purposes, the LDCE is being used to benchmark capital estimates to make sure they fully reflect banks' actual operational risk exposures.

65. ***Criteria:*** *The capital definition should be set out in regulations, and be consistent with paragraph 41 of the framework. Where supervisors allow the inclusion of non-traditional capital elements, they should satisfy themselves that they meet, in substance, the relevant criteria for inclusion set out in the Basel framework and associated documents.*

66. **Tier 1, Tier 2, and total capital are defined in the advanced approaches rule.** They incorporate by reference, the elements of capital and many of the deductions in the

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general risk-based capital rules, and are generally consistent with paragraph 41 of the New Accord. However, as noted in the BCP assessment, the general risk-based capital rule, and thus the advanced approaches rule, allows certain intangibles to count for a very high portion of Tier 1 capital.

67. **Additionally, until March 31, 2011, banks under the advanced approaches rule are allowed to continue to have up to 25 percent of their Tier 1 capital in so-called innovative or hybrid instruments, compared to the international standard of 15 percent.**

E. Standardized Approach to Credit Risk

68. ***Criteria:*** *Regulations and a supervisory process should be in place to require banks to meet the requirements and risk weights for calculating capital for credit risk using the standardized approach for individual claims, in a way which is consistent with the Basel II framework. Any differences should reflect a more conservative approach based on local default experiences.*

69. **The standardized approach is not currently allowed in the United States.** While a proposal was made in 2006 to implement the standardized approach on an optional basis for banks not subject to the advanced approaches, the proposal has not been finalized. The status of the proposed rule is not clear. The FBAs advised they are in the process of developing another version of the standardized approach for public comment.

70. **The assessment team did, however, review the proposed standardized approach at a high level.** The rule is consistent with the standardized approach outlined in the New Accord and more conservative in some respects as noted below (leaving aside definition of capital issues that are covered elsewhere in this note and in the BCP assessment). The material difference is the proposal's treatment of residential mortgages, which is based on LTV ratios. Risk weights for residential mortgages would range from 20 percent to 150 percent, depending on the LTV for a given residential mortgage exposure. As proposed, significantly more mortgages would receive a higher than 35 percent risk weight than would be the case under the approach outlined in the New Accord. The FBAs believe that the wider range of risk weights proposed in the U.S. standardized approach is more risk sensitive and conservative than the single 35 percent risk weight assigned to residential mortgage exposures in the New Accord. The assessment team supports this approach.

71. **In general, the U.S. standardized approach proposal is more conservative than the Accord in the treatment of national discretion items related to retail exposures and commercial real estate lending.** For retail exposures other than residential mortgages, a 75 percent risk weight would be assigned only where such exposures do not exceed US$1.0 million and where the exposure is part of a well-diversified portfolio. In the proposal, the FBAs sought public comment on appropriate measures of concentration for regulatory retail portfolios. Commercial real estate exposures would not be eligible for a 50 percent risk weight.

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72. **The U.S. continuous supervision approach already allows considerable verification of capital position of banks.** It should be relatively easy to adapt this to the implementation of the standardized approach, should it be decided to proceed. Certain adjustments in supervisory approach/reporting/off-site analysis will be needed to verify, on a periodic basis, the appropriateness of institutions' use of various credit risk mitigation techniques not currently permitted under risk-based capital rules.

73. **If the authorities proceed with the standardized approach on an *optional* basis, they should give careful consideration to the inherent cherry-picking opportunities in this policy.** In particular, banks with mortgage exposures could decide whether or not to adopt the new rule based on its treatment of these assets compared to the current risk-based capital rule.

F. Internal Ratings Based Approach to Credit Risk

74. ***Criteria:*** *Supervisors should have an effective process in place for determining that banks are meeting the requirements for calculating capital for credit risk using the internal ratings-based (IRB) Approach, including the mechanics of the IRB Approach; rules for corporate, sovereign, bank, retail, and equity exposures; rules for purchased receivables and treatment of expected losses; and recognition of provisions, consistent with the Basel II framework. To meet the criteria, there are three requirements: (i) the country's rules must not deviate materially from the framework; (ii) the country must have an effective approach for verifying bank compliance with the rules; and (iii) the country must have an approach for verifying the accuracy of bank calculations.*

75. **The advanced approaches rule does not deviate materially from the Basel II framework.** National discretion choices are few and generally result in more conservative capital treatment.

76. **The approval requirements to exit parallel run or to move between floors in the qualification period afford ample opportunity for FBAs to assess how the IRB is working in practice.** The FBAs have developed an ongoing process to verify bank compliance with the AIRB requirements established by the advanced approaches rule. The goal of the process in each FBA is to ensure that, at each stage of the implementation process, and on an ongoing basis, the bank has met the requirements of the advanced approaches rule, has systems that are working as intended, and is fully prepared before moving to the next phase of qualification. The review process appears robust and includes reports by validation groups and internal audits within the bank, the annual assessment of the controls around Basel II that is presented to the institution's board of directors, and supervisory verification in the form of both Basel II-specific and non-Basel II-specific reviews that evaluate whether the bank continues to satisfy the rule requirements. As only one bank is now in parallel run, it was not possible for assessors to view this process in practice.

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77. **At the largest banking organizations, the Basel II process is led by the on-site supervisory team and supported by FRB and OCC qualification teams (QTs), as well as agency policy and quantification resources**. These teams were developed by the FRB and OCC to ensure consistency of approach across the largest core banks, where a higher degree of coordination is considered essential to the overall program. The teams comprise staff from multiple areas of and cover the wholesale, retail, securitization, trading book/counterparty credit risk, Pillar 2, and operational risk areas and use a standardized supervisory program. The ability to file accurate, complete, and timely regulatory reports on advanced approaches calculations is a critical consideration in assessing a bank's compliance with the qualification requirements. The accuracy of bank calculations is reviewed through on-site examination work, as well as off-site surveillance based on the regulatory reports.

78. ***Criteria:*** *Assessors should be satisfied that the supervisor has processes in place for ensuring that the banks meet the appropriate IRB requirements at the outset and on an ongoing basis (paragraph 388)*[4] *, and that the mechanics of computing the IRB numbers meet the specific rules set out in the framework.*

79. **The processes already described apply to banks on an ongoing basis as well as during the qualification and parallel run period.** Experience in other countries suggests that it is difficult to maintain the degree of focus on Basel II processes that is used in the qualification period to reasonably ensure ongoing compliance. Indeed, that level of ongoing focus may not be necessary. However, when the United States has more banks in the qualification period, it should develop and communicate a more formal expectation for supervisory teams about the extent and nature of high-level and in-depth reviews that are expected and on what cycle, to remain comfortable about the quality of implementation.

80. ***Criteria:*** *Assessors should seek evidence from supervisors of a robust system to validate the models and outputs of rating systems at the approval stage and when models are modified.*

81. **Validation is the responsibility of the banking organizations.** The FBAs have a robust system for reviewing the results of the validation activities of each bank and providing comments when validation efforts are inadequate. The advanced approaches rule requires a banking organization to conduct ongoing validation of its advanced systems—supervisory review of the validation function is conducted prior to parallel run (if available), during parallel run, and post-parallel run when the institution has qualified. Review of validation documentation and output is a long-standing component of supervisory activities in the United States. Validation process reviews by FBAs are extensive. In addition to process reviews, there are material drill-down reviews on a selection of models chosen for their importance. FBAs also review the validation function when there are significant changes to the models. As is required by Section 23 of the advanced approaches rule, institutions must

[4] Basel II: International Convergence of Capital Measurement and Capital Standards: A Revised Framework - Comprehensive Version (June 2006) http://www.bis.org/publ/bcbs128.pdf

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notify the FBAs when changes are made to the advanced systems that would result in a material change in the bank's risk-weighted asset amount for an exposure type, or when the bank makes any significant change to its modeling assumptions. As in other jurisdictions, FBAs and banks report that achieving the robust high-quality validation is a challenge, but assessors saw evidence of the seriousness with which this is being taken, and the excellent understanding of validation issues. FBAs should ensure that there is consistency in expectations among them going forward.

82. ***Criteria:*** *Supervisors should verify that the IRB (and AMA) models are actually used by the banks in the context of their capital planning and risk management, and are not primarily a compliance exercise. Internal ratings and loss estimates of IRB banks must be seen to play an essential role in the banks' internal processes and banks must have a credible track record in the use of internal ratings information.*

83. **The advanced approaches rule requires that the systems and processes used by a bank for risk-based capital purposes be consistent with the bank's internal risk management processes and management information reporting systems.** Examiners are expected to identify any differences between AIRB systems and other internal risk management systems and to understand the materiality of these differences. Supervisors expect use of AIRB and AMA systems to identify, monitor, measure, and control risk at the bank.

84. ***Criteria:*** *Supervisors should have in place a methodology for satisfying themselves that IRB banks' own validation processes are robust. There should, therefore, be evidence of effective challenge functions exercised by banks internally (e.g., by the risk management and/or internal audit functions) as well as by supervisory authorities. Supervisors should be able to articulate their strategy for testing rating systems for reasonableness and show how this strategy operates in practice.*

85. **The advanced approaches rule places significant emphasis on the need for robust validation processes.** The banks' validation process must be independent of the advanced systems' development, implementation, and operation—or the validation process must be subjected to an independent review. In the rule, validation includes an evaluation of conceptual soundness, an ongoing monitoring process, and an outcomes analysis process that includes back-testing. To ensure that banks have robust validation processes, supervisors examine banks' ongoing validation of the AIRB framework, including the risk rating process and parameter estimation. Examiners are expected to determine if the wholesale/retail framework is functioning as intended and if the bank incorporates the findings of validation, audit, and other independent review into their process. Evaluation of the conceptual soundness includes examination of the developmental evidence, model assumptions, and specifications. In practice, the reasonability of risk rating and/or segmentation systems is confirmed through examination of credit risk management and rating processes and transaction testing. This includes appropriate drill-down activities such as replication testing of ratings and examination of override experience.

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86. ***Criteria:*** *Supervisors should be satisfied that AIRB banks have a methodology for the treatment of downturn conditions that is reasonable and prudentially sound, and produces acceptable results in terms of capital held by banks (see paragraph 468*[52] *and Basel Committee documents on downturn conditions). This methodology should be in line with good industry practice and reflect the conditions in the country.*

87. **The FBAs have processes in place to verify that the methodologies with respect to downturn conditions used at each institution are reasonable**. Generally, bank methodologies for the treatment of downturn conditions include statistical tests to identify downturn periods, significant segmentation of portfolios to which downturn conditions adjustments apply, use of internal and external data relevant to identifying appropriate downturn adjustments and back-testing, and validation which is subject to review by the FBAs. Assessors encourage the FBAs to make sure that, in addition to this methodology, there is adequate room for judgment to be applied by FBAs in identifying major portfolios subject to market conditions necessitating downturn adjustments.

G. ADVANCED MEASUREMENT APPROACH (AMA) FOR OPERATIONAL RISK

88. ***Criteria:*** *A bank must be required to meet an extensive and stringent set of quantitative and qualitative standards to be permitted to use the AMA, and must have monitored the performance of its internal operational risk management for a sufficient period of time before applying the AMA to its operations. Supervisors should be able to demonstrate an effective process for satisfying themselves that banks are meeting the requirements and that results are a reasonable reflection of risks assumed. In particular, banks' data on operational risk experience need to be robust and of sufficient duration and granularity.*

89. **As with the AIRB, a banking organization must satisfy the extensive AMA requirements in the advanced approaches rule before qualifying to use the advanced approaches to calculate its risk-based capital requirements**. Assessors discussed the state of industry preparedness with FBAs. A bank must meet the AMA requirements during the four (or more) quarters that make up its parallel run period. In addition, as a condition of exiting parallel run, the bank must demonstrate that it can meet the criteria on an ongoing basis. To the extent that there are issues, supervisors highlight the concerns to the bank and expect the bank to remediate them within a clearly defined time horizon. U.S. supervisors have been systematically monitoring banks' progress on AMA since 2004, when the first AMA benchmarking exercise took place. The FBAs also conducted/participated in several operational risk LDCEs, the most recent of which took place in 2008. The 2008 LDCE collected detailed information on internal operational loss event data, scenario data, exposure estimates, and range of practice information.

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[5] Basel II: International Convergence of Capital Measurement and Capital Standards: A Revised Framework - Comprehensive Version (June 2006) http://www.bis.org/publ/bcbs128.pdf

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90. ***Criteria:*** *A bank's AMA should be subject to a period of initial monitoring by its supervisors before it can be used for regulatory purposes. Supervisors should be satisfied that a bank's internal system is estimating unexpected operational losses with reasonable accuracy based on internal and external data, scenario analysis, and bank specific inputs. The system must also be capable of supporting an allocation of economic capital for operational risk across business lines and ultimately of improving operational risk management.*

91. **Banks are subject to initial and ongoing monitoring of their AMA frameworks to ensure that the requirements of the advanced approaches rule are met.** This extended monitoring allows supervisors to ensure that a bank's internal system is estimating unexpected operational losses with reasonable accuracy, based on a solid foundation of internal and external loss event data, scenario analysis, and a clear understanding of the business environment across the enterprise. This must be demonstrated during and after parallel run.

92. ***Criteria:*** *Depending on the operational risk variants used by banks in their jurisdiction, supervisors must have a sufficient number of staff adequately trained in operational risk approaches and must also have a process that allows them to assess on an ongoing basis whether banks continue to meet the quantitative and qualitative standards for application of the AMA.*

93. **Those in the FBAs with responsibility for work on Basel II implementation have an appropriate understanding of the requirements and what must be in place to qualify a bank using the AMA.** All of the FBAs have staff directly responsible for AMA. In each of the core banks, there are individuals on the relationship teams that have specific responsibility for ongoing supervision of the AMA framework. In addition, supporting the relationship teams are AMA quantification experts who provide on- and off-site assistance, and policy experts that assist in examination work and also provide input on interpretative matters.

94. **There is an extensive process supporting the ongoing assessment of whether banks continue to meet the quantitative and qualitative requirements for the AMA.** In particular, the AMA benchmarking process will continue after the implementation phase of Basel II and be used to guide examiners in ongoing reviews.

H. PILLAR 2: SUPERVISORY REVIEW PROCESS

95. ***Criteria:*** *Supervisors should have appropriate processes, evidenced by plans and actions, for review of bank processes to assess capital adequacy, risk positions, and quality of capital held. These reviews should cover the four elements referred to in this Principle (adequacy of risk assessment, assessment of capital adequacy, assessment of control environment, compliance with minimum standards). As supervisors will normally adopt a process that is, in part, risk-based and reliance-based and is integrated into their supervisory*

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system, supervisors should be able to explain to assessors how these processes meet the Pillar 2 requirements.

96. **The FBAs' supervisory program for Pillar 2 is a continuation of their long-standing emphasis on the need for institutions to conduct an internal assessment of capital adequacy—beyond minimum regulatory measures—capturing their full risk profile.** Consistent with the New Accord, the advanced approaches rule requires that banking organizations subject to the rule have an ICAAP. In July 2008, the FBAs issued final supervisory guidance for Pillar 2, providing institutions with a description of a satisfactory ICAAP. The guidance covers the four elements of Pillar 2 laid out in the Basel II framework. The guidance places particular emphasis on the need for a sound underlying risk management foundation in the ICAAP. It outlines issues that banking organizations should consider when estimating capital needs during times of stress, and notes that banks should be aware that certain capital instruments do not have the same capacity to absorb losses in times of stress as common equity. The guidance also notes the importance of strong corporate governance, including validation and internal audit, as well as the need to hold capital buffers above minimum regulatory capital requirements due to the inherent uncertainty in assessing overall needs.

97. **Assessors reviewed this guidance which is comprehensive.** As detailed formalized Pillar 2 assessments were not available at the time of assessment, assessors were not able to judge whether the necessary supervisory processes (including appropriate judgment by banks and supervisors) were in place to adequately assess the actual capital levels held by banks. Assessors recommend that FBAs use the Pillar 2 assessment process, and the discussion it leads to with banks, as a tool to assist in ensuring that major banks are holding adequate capital so that Pillar 2 does not become merely a compliance exercise. Considering Pillar 2 approaches by banks in a cross-system, cross-agency process on a regular basis (including at a senior level in FBAs) is desirable. FBAs should conduct such a cross-agency, cross-system review as soon as a sufficient number of Pillar 2 approaches by banks are available, and at regular intervals (at least annually) thereafter.

98. **FBAs report that they expect banks to have a fully-functioning Pillar 2 process in place before entering parallel run.** The ongoing capital planning and analysis work within financial institutions and recent SCAP exercise has assisted in Pillar 2 development, though the BCP review more generally suggested that stress testing by banks, which is a core Pillar 2 requirement, needs further development. Pillar 2 requires considerable judgment by banks and supervisors. Experience elsewhere suggests that inculcating Pillar 2 into bank capital planning, risk assessment, and strategy requires a period of adjustment to be effective. Accordingly, assessors believe that the FBAs' approach may encourage a more compliance-oriented approach to Pillar 2 by banking organizations than is desired. FBAs should take stock of Pillar 2 implementation with these factors in mind in the near future to ensure that the benefits of an effective Pillar 2 are being realized. This should be one of the matters considered in the cross-system review of Pillar 2 implementation suggested above.

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99. **The standardized approach proposed rule does not contain a well-elaborated Pillar 2 requirement.** The existing, generally-worded supervisory expectations are that banks will assess their capital in relation to their risks. As noted in the BCP assessment, the current prompt corrective action provisions of U.S. regulations, and supervisory expectation, mean that all banks are effectively expected to have capital above the minimum ratios. In addition, there are clear abilities for authorities to take action related to capital deficiencies. Currently, capital is assessed in the supervisory process.

100. **If the standardized approach proceeds, further Pillar 2 guidance would be required to meet the spirit of Principles 1 and 2 of Pillar 2 for small and medium-size banks.** Assessors discussed with FBAs their approach to Pillar 2, if the standardized approach was to be adopted. FBAs indicated supervisory expectations would have to be developed based in part on the Pillar 2 guidance now in place for larger banks. Authorities should not underestimate the challenge in developing and implementing an ICAAP-like process for smaller and mid-size banks that is effective in encouraging banks that are outliers to allocate appropriate capital. Nor should they underestimate the adjustments in their own monitoring, analysis, and supervisory tools to consider Pillar 2 issues for those banks.

101. ***Criteria:*** *Supervisors should be able to demonstrate how banks are required to manage important risks not directly addressed in Pillar 1. This includes interest rate risk in the banking book, credit concentration risk, counterparty credit risk, and other aspects such as stress testing noted in Pillar 2. Supervisors should demonstrate a sound knowledge of these areas in their banks, and of appropriate practices.*

102. **Pillar 2 guidance includes risks not addressed in Pillar 1.** The FBAs place particular emphasis on risk concentrations, both intra-risk and cross-risk. With respect to credit risk, banks must include both single-name as well as sectoral/geographic concentrations in their estimates of overall capital needs relating to credit risk—especially during times of stress. Banks must also be able to understand the potential for cross-risk concentrations (often latent during benign periods) to affect overall capital needs during stressful periods. These issues are highlighted clearly in the U.S. Pillar 2 supervisory guidance and are among the issues given greatest attention by the FBAs in their Pillar 2 evaluations. Banks should be able to assess the potential for all risk types to affect capital adequacy. Even though capital may not be an effective mitigant for all types of risk, all risks may have the potential to affect capital adequacy. Liquidity, reputational, and strategic risks may be among those risks difficult to quantify in terms of specific capital attributions, however their impact on overall capital adequacy can still be substantial.

103. **The FBAs emphasize that stress testing is an integral part of assessing overall capital adequacy.** Even the best quantitative modeling has limitations and shortcomings that need to be supplemented by additional risk measures such as stress tests. Importantly, the FBAs expect banking organizations to hold capital buffers above estimated capital needs—even if quantitative models are robust and have been fully validated—because of the inherent uncertainty in assessing overall capital adequacy.

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104. **For some of these risks, core banks are using economic capital methodologies to estimate their impact on capital.**

105. **In a number of these areas, as in other jurisdictions, further advancements need to be made in relating capital to risk.** However, assessors are of the view that banks and supervisors are fully capable of making that progress. FBAs should conduct targeted regular cross-system focused reviews in these areas going forward to assess banks against best practice and supervisory expectations. The results of these reviews should be considered by senior FBA staff in their assessment of system-wide performance, and as an input into the possible need for further guidance.

I. Pillar 3: Disclosure and Market Discipline

106. ***Criteria:*** *Supervisors should be able to demonstrate to assessors that rules have been put in place, not necessarily by the regulator, to require banks to make qualitative and quantitative Pillar 3 disclosures with at least the minimum frequency, as a result of some combination of: accounting principles, regulatory requirements, formal supervisory requirements, condition of qualifying for a particular Basel II approach, publication of parts of supervisory reports, supervisory guidance, or moral suasion. In particular, supervisors should be satisfied that banks are meeting IRB disclosure requirements. Any gaps should be sufficiently immaterial so as not to undercut the effectiveness of Pillar 3.*

107. **Pillar 3 has been fully incorporated into the advanced approaches rule.** The disclosures included in the rule are consistent with the Pillar 3 requirements of the Basel II Accord.

108. **Each consolidated banking organization (except if they are a subsidiary of a non-U.S. banking organization subject to comparable disclosure requirements in its home country) is subject to the disclosure requirements once they have qualified to use the advanced approaches rule for regulatory capital purposes.** Disclosures are quarterly, with qualitative disclosures that typically do not change each quarter disclosed annually (provided any significant changes to these are disclosed in the interim). FBAs have not dictated the specific location or medium where the disclosures must be provided.

109. **The Pillar 3 disclosure requirements for the proposed standardized approach are generally consistent with the Basel II Accord.**

110. ***Criteria:*** *Supervisors should have a periodic process in place to satisfy themselves that they, or qualified third parties, validate the comprehensiveness and accuracy of bank disclosures relative to Pillar 3 standards, and that banks are provided with any appropriate feedback.*

111. **The primary FBA will determine if a bank is meeting the Pillar 3 disclosure requirements through its ongoing supervision process.** In addition, institutions are required to have a formal disclosure policy approved by the board of directors that addresses its approach to determining the disclosures they make. The policy must address the

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associated internal controls, disclosure controls, and procedures. The board and senior management are responsible for establishing and maintaining an effective internal control structure over the disclosures required. One or more members of the senior management team must also attest that the disclosures made by the institution meet the requirements of the advanced approaches rule.

112. **It is too early for assessors to see this process in action at banks or by supervisors.** However, given the way the U.S. continuous supervision process operates, as reviewed during the FSAP, assessors believe this plan for Pillar 3 implementation is appropriate. Once a significant number of mandatory banks are making Pillar 3 disclosures, FBAs should conduct a cross-system, cross-agency review of these and satisfy themselves as to their appropriateness. This would accord the needed priority and forge consistency in supervisory consideration, and such reviews of disclosures should be repeated from time to time.

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United States: Publication of Financial Sector Assessment Program Documentation—Detailed Assessment of Implementation of the IOSCO Objectives and Principles of Securities Regulation

This Detailed Assessment of Implementation of the IOSCO Objectives and Principles of Securities Regulation for the United States was prepared by a staff team of the International Monetary Fund. It is based on the information available at the time it was completed in May 7, 2010. The views expressed in this document are those of the staff team and do not necessarily reflect the views of the government of the United States or the Executive Board of the IMF.

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FINANCIAL SECTOR ASSESSMENT PROGRAM

UNITED STATES OF AMERICA

THE IOSCO OBJECTIVES AND PRINCIPLES OF SECURITIES REGULATION

DETAILED ASSESSMENT OF IMPLEMENTATION

MAY 2010

INTERNATIONAL MONETARY FUND
MONETARY AND CAPITAL MARKETS DEPARTMENT

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Contents Page

Glossary 3

I. Summary, Key Findings, and Recommendations 5
Preconditions for Effective Securities Regulation 11
Recommended Action Plan and Authorities' Response 22

II. Detailed Assessment 29

Tables
1. Summary Implementation of the IOSCO Principles—Detailed Assessments 16
2. Recommended Action Plan to Improve Implementation of the IOSCO Principles 22
3. Detailed Assessment of Implementation of the IOSCO Principles 29

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GLOSSARY

Advisers Act	Investment Advisers Act of 1940
ALJ	Administrative Law Judge
AML	Anti-Money Laundering
APA	Administrative Procedures Act
ATS	Alternative Trading System
AUM	Assets under Management
BD	Broker Dealer
BSA	Bank Secrecy Act
CBOE	Chicago Board Options Exchange
CCO	Chief Compliance Officer
CCP	Central Counterparty
CDS	Credit Default Swaps
CEA	Commodity Exchange Act
CFMA	Commodity Futures Modernization Act of 2000
CFTC	Commodity Futures Trading Commission
CIS	Collective Investment Schemes
CPSS	Committee on Payment and Settlement Systems
CME	Chicago Mercantile Exchange
CPO	Commodity Pool Operator
CP&P	Compliance Policies and Procedures
CTA	Commodity Trading Advisor
CTR	Complaints, Tips and Referrals
COT Report	Commitment of Traders Report
CSE	Consolidated Supervised Entities
DCM	Designated Contract Market
DCO	Derivatives Clearing Organization
DOJ	Department of Justice
DSRO	Designated Self-regulatory Organization
DTEF	Derivatives Transaction Execution Facility
EBOT	Exempt Board of Trade
ECM	Exempt Commercial Market
ECN	Electronic Communications Network
ECP	Eligible Contract Participant
EDGAR	Electronic Data Gathering, Analysis and Retrieval System
Exchange Act	Securities Exchange Act of 1934
FASB	Financial Accounting Standards Board
FCM	Futures Commission Merchant
FDIC	Federal Deposit Insurance Corporation
Federal Reserve	Board of Governors of the Federal Reserve System
FINRA	Financial Industry Regulatory Authority
FOIA	Freedom of Information Act
GAAP	Generally Accepted Accounting Principles

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GAAS	Generally Accepted Auditing Standards
GLBA	Gramm-Leach-Bliley Act
IA	Investment Adviser
IASB	International Accounting Standards Board
IB	Introducing Broker
ICA	Investment Company Act of 1940
ICE	Intercontinental Exchange
IG	Inspector General
IFRS	International Financial Reporting Standards
IOSCO	International Organization of Securities Commissions
IOSCO MMOU	IOSCO Multilateral Memorandum of Understanding
ISG	Inter-market Surveillance Group
Joint Report	Joint Report of the SEC and CFTC on Harmonization of Regulation issued October 16, 2009
LLC	Limited Liability Company
MSRB	Municipal Securities Rulemaking Board
MOU	Memorandum of Understanding
NASD	National Association of Securities Dealers
NASDAQ	National Association of Securities Dealers Automated Quotations
NAV	Net Asset Value
NFA	National Futures Association
NMS	National Market System
NYSE	New York Stock Exchange
OCIE	Office of Compliance, Inspections, and Examinations (SEC)
OTC	Over-the-Counter
PCAOB	Public Company Accounting Oversight Board
RFA	Registered Futures Association
RSA	Registered Securities Association
PWG	President's Working Group
RER	Rule Enforcement Review
RFPA	Right to Financial Privacy Act
SEC	Securities and Exchange Commission
Securities Act	Securities Act of 1933
SFP	Securities Futures Product
SIPA	Securities Investor Protection Act of 1970
SIPC	Securities Investor Protection Corporation
SOX	Sarbanes-Oxley Act of 2002
SPDC	Significant Price Discovery Contracts
SRO	Self-regulatory Organization
Treasury	Department of the Treasury
UIT	Unit Investment Trust
White Paper	Department of the Treasury Blueprint for a Modernized Financial Regulatory Structure

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I. Summary, Key Findings, and Recommendations

Introduction

1. **An assessment of the United States securities and futures market regulatory system was conducted by Susanne Bergsträsser, Richard Britton, and Tanis MacLaren from October 7 to November 3, 2009 as part of the Financial Sector Assessment Program (FSAP).**

Information and methodology used for assessment

2. **The assessment was conducted based on the International Organization of Securities Commissions (IOSCO) Objectives and Principles of Securities Regulation and the associated methodology adopted in 2003, as updated in 2008.**[1] An assessment of the securities settlement systems under the Committee on Payment and Settlement Systems (CPSS)/IOSCO Recommendations was conducted separately; thus Principle 30 was not assessed here.

3. **The conclusions below are based on information and findings as of November of 2009.** As noted below, important reforms have been introduced in the past year, some of which have already been implemented and are beginning to take effect. However, while these promise to address many of the issues identified in this assessment, it would still be important to establish a consistent track record before their efficacy could be judged.

4. **The assessment team relied on number of sources in carrying out this assessment.** The assessment was based on a review of the relevant legislation, self-assessment questionnaires prepared by the Commodity Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC) prior to the mission, detailed discussions with CFTC and SEC staff, with staff of the various self-regulatory organizations, securities and futures exchanges, law enforcement agencies and representatives of industry, and the law and accounting professions. We also reviewed the Joint Report of the SEC and CFTC on Harmonization of Regulation issued October 16, 2009 (Joint Report) and the Department of the Treasury Blueprint for a Modernized Financial Regulatory Structure (White Paper). Staff of the regulators was generous in making themselves available for discussions which were helpful, frank, and forthcoming. Assistance from market representatives was also extremely helpful.

5. **The assessment did not address the securities regulatory regime that is imposed at the state level to any significant degree.** State regulation plays a more minor role, mostly aimed at consumer protection. In certain areas, such as new issues of securities, state blue sky

[1] The IOSCO methodology was amended in 2008 to update footnotes to reflect recent IOSCO publications. Currently IOSCO is undergoing a substantive review of the Principles, which will be followed by a review of the methodology.

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laws have largely been preempted by legislative amendments at the federal level. In others, the state regulatory activities run parallel to federal ones, such as in the area of enforcement and registration of intermediaries and their representatives.

6. **The assessment has been challenging given the complexity of the U.S. system and the task of the regulators in this jurisdiction.** The methodology notes that "markets with a single or a few issuers, that are totally domestic in nature, or that are predominantly institutional, will pose different questions and issues as to the sufficiency of application of the Principles and as to the potential vulnerabilities likely to arise from their non-application, than jurisdictions where there are substantial numbers of retail participants, intermediaries frequently are part of complex groups, issuers are established in other jurisdictions, or the markets have other international or cross-border components." The methodology was therefore applied taking into account that a higher quality of supervisory and regulatory oversight is needed where financial systems are large and complex, as is the case in this jurisdiction. While the assessment has been done against internationally agreed standards, care is needed in comparing the results with those for other countries because of this level of complexity. Further, the methodology has undergone changes (in 2003 and in 2008) and finally the application of the standards in this and other recent cases has necessarily also taken into account the lessons of the recent financial crisis.

7. **The assessment was carried out in a post-crisis environment, which had a clear impact on the findings.** The financial crisis of 2008 exposed a number of underlying issues in the U.S. financial markets, some of which were causally related to the crisis—such as the lack of ability of U.S. investment banks to withstand shocks to liquidity—while others arose as a result of secondary effects of the crisis—such as the exposure of a giant fraud because of the precipitous contraction of investment in-flow during the crisis. The system was tested in a way that most systems are not and this testing has revealed weaknesses that might otherwise have gone undetected. The authorities have been under extraordinary pressure; first to respond to the crisis and then to undertake reforms. An assessment is rarely carried out in such circumstances—a reading of the findings must give this due consideration.

8. **The uncommon level of transparency in the jurisdiction has also affected the assessment findings.** The mission had access to a range of official reports, internal evaluations of the regulatory framework, and regulatory practice. Given the size and importance of the markets, there are many sources of analysis available from the private sphere as well. The information made available through this unusual level of transparency and 'self-criticism' was taken into consideration by mission, and this context is also important to understanding the findings.

Institutional and market structure—overview

9. **The legislative framework in place in the jurisdiction provides a comprehensive, but complex, framework for the types of activities undertaken in the public markets**. The responsibility for regulation of the markets at a federal level is split between two agencies created under separate statutes. The CFTC is responsible for the supervision of

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commodity futures market—the commodity exchanges, the intermediaries and the futures products offered in the public markets—under the Commodity Exchange Act (CEA) as modified by the Commodity Futures Modernization Act (CFMA). The SEC regulates securities markets, issuers, and participants. Its authority flows from several statutes including the Securities Act of 1933 (Securities Act), Securities Exchange Act of 1934 (Exchange Act), Trust Indenture Act of 1939, Investment Company Act of 1940 (ICA), Investment Advisers Act of 1940 (Advisers Act), and Sarbanes-Oxley Act of 2002 (SOX). All of these federal statutes are supplemented by an extensive body of regulations, rules, guidance, court decisions, and regulatory no-action letters. In addition, there are state securities regulators involved in both licensing and enforcement activities. Further, other law enforcement agencies, such as the Department of Justice (DOJ) and state Attorneys General, participate in enforcement activities.

10. **The CFTC and SEC rely to a significant degree on self-regulatory organizations (SROs) for the regulation of the markets and their participants**. These entities include exchanges, clearing organizations, and securities or futures associations, each of which has authority over their members' activities. The Financial Industry Regulatory Authority (FINRA) is the registered securities association with authority over broker-dealers (BDs), and the National Futures Association (NFA) is the registered futures association for commodity futures intermediaries and commodity pool operators.

Market data

11. **The number of futures and options contracts, and the volume of trading in these contracts have increased dramatically since the CFMA was passed in 2000 (by 570 percent and 594 percent respectively)**. Over the same time period, client funds held by futures commission merchants (FCMs)—one measure of risk in the system—rose by 354 percent. The number of exchanges has been roughly stable which reflects both consolidations among existing exchanges and the creation of new exchanges. The four exchanges in the Chicago Mercantile Exchange (CME) group now account for over 90 percent of total volume. There has been substantial growth in exempt marketplaces that are not subject to formal designation or licensing and are subject to more limited ongoing regulation once operational. During this period, the number of full time equivalent staff at the CFTC has declined by 18 percent.

12. **In comparison, the equity market showed more modest growth until 2008.** Between 2000 and 2007, daily volumes increased by only 62 percent. During the market crisis of 2008, volumes increased by 52 percent over 2007, taking the 10-year growth to 255 percent. This was still only 44 percent of the growth rate of the volume of trading of on-exchange futures markets. Not included in these statistics was the 780 percent increase in the number of shares of "pink sheet" OTC stocks traded on a daily basis between 2001 and 2008. Although compared to the main markets the values are small (US$200 million in 2001 and US$540 million in 2008), pink sheet stocks are a major source of securities fraud. In the securities markets, as of March 2010, there were 11 registered national securities exchanges,

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79 registered alternative trading systems (ATS), and 4 electronic communications networks (ECNs).[2]

Futures Statistics

	2000	2001	2002	2003	2004	2005	2006	2007	2008
Volume of contracts traded (millions)	580	723	1,004	1,225	1,518	1,920	2,421	3,085	3,446
Number of contracts	266	250	278	538	662	906	1,135	1,365	1,521
Client funds held by FCMs (in US$ billions)	56.7	59.7	64.3	75.6	94.5	116.7	138.0	155.4	201
Commodity exchanges				15	18	13	12	12	13
Exempt markets									
ECMs				11	11	12	17	19	19
EBOTs				2	3	5	8	8	10
CFTC full time equivalent staff	546	514	521	497	517	491	493	437	448

Source: CTFC.

Daily Average Volume of Shares Traded
(In millions of shares)

Year	2000	2001	2002	2003	2004	2005	2006	2007	2008
Vol.	2,851	3,206	3,257	3,217	3,323	3,458	4,004	4,769	7,282

Source: SIFMA.

13. **SEC staff numbers, although 24 percent up in this period peaked in 2005 and fell back subsequently; they increased somewhat in 2008/9.**

SEC Staffing

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
SEC full time equivalent staff	2,840	2,936	3,009	3,060	3,550	3,851	3,695	3,465	3,511	3,656

Source: SEC.

[2] One ECN (Direct Edge) is in the process of converting from an ECN into two separate registered exchanges. The SEC has granted exchange status to those two exchanges, though they are not yet operational. The SEC has recently approved the registration of a third new exchange (C2) which also is not yet operational. This will bring the total number of exchanges from 11 to 14.

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14. **The United States has a system of specialized intermediaries with separate categories across the futures and securities regimes.** Intermediaries trading as principals or agents are registered as BDs under the Exchange Act or FCMs and introducing brokers (IBs) under the CEA. Advisers are registered as IAs or commodity trading advisers (CTAs) under the securities or futures legislation, respectively. The operators of Collective Investment Schemes (CIS) are registered as IAs under the Advisers Act or commodity pool operators (CPOs) under the CEA.

15. **The number of registered intermediaries participating in the market has grown only slightly over the past five years.** The number of registered commodity futures firms and BDs has declined, with more marked drops in the number of CFTC registrants. This reflects both consolidation in and departures from the industry. The data for CFTC registrations also reflects a migration of CPOs to providing services that do not require registration. The number of BDs has declined 6 percent over the 5-year period, while the total net capital of these firms has increased nearly 80 percent and the total number of registered persons at FINRA member firms has remained relatively constant. Substantial growth has been seen in the number of registered IAs and the assets these firms have under management (32 percent and 79 percent). If unregistered firms—such as hedge fund and ones that are only registered at the state level—are added in, the growth rate in assets under management over the period likely would be much higher.

16. **The U.S. CIS market is the largest in the world with nearly US$10 trillion in assets under management in the funds that are registered with the SEC.** There was a sharp drop in assets under management in 2008 (-20 percent) reflecting substantial declines in equity markets. However, by the end of September of this year, the total assets under management had recovered somewhat. During 2008, assets in funds moved from long-term funds (equity and bond funds) to money market funds with portfolios consisting only of short-term government paper and cash. Since the beginning of 2009, that trend has reversed and the growth is in equity and bond funds.

17. **In contrast, commodity pools operated by registered CPOs have experienced steady declines over the past five years.** The number of commodity pools reporting to the CFTC is down 52 percent with their aggregate assets under management down 77 percent over the 5-year period. This reflects both responses to adverse market conditions (trading losses, decreased new contributions, and ceasing business) and conversions of funds to ones exempt from reporting to the CFTC.

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Futures and Securities Intermediaries

Year (As at September 30)

Intermediary Category[1]	2004	2005	2006	2007	2008
CFTC[2]					
FCMs	211	211	210	197	179
IBs	1,664	1,711	1,740	1,699	1,647
CTAs	2,640	2,635	2,589	2,601	2,534
CPOs	1,810	1,782	1,570	1,416	1,353
SEC					
BDs	5,219	5,134	5,052	4,969	4,923
IAs	8,535	9,017	10,662	10,817	11,292
Total Net Capital of BDs (in US$ millions)	87,127	101,334	102,969	128,244	155,468
Total AUM by Reg'd IAs (in US$ trillions)	24	27	32	38	43
Median AUM of Reg'd IAs (in US$ millions)	99	108	116	123	125

Sources: CTFC, SEC, and SIFMA.

[1] Only includes firms registered with one of the two agencies, not firms exempt from registration or only registered at a state level.

[2] A firm registered in more than one category is counted in each category.

Mutual Fund Assets

(US$ billions)

	Equity	Hybrid	Bond	Money Market	Total Assets
2004	4,384.0	519.3	1,290.4	1,913.2	8,106.9
2005	4,940.0	567.3	1,357.4	2,040.5	8,905.2
2006	5,911.4	653.1	1,494.3	2,354.8	10,413.6
2007	6,521.4	713.4	1,678.9	3,085.8	11,999.5
2008	3,708.1	494.2	1,567.2	3,832.3	9,601.8
Sept '09	4,511.2	576.6	1,973.1	3,551.8	10,612.7
%Change Sept '08 –Sept'09	-20.0%	-13.1%	12.7%	1.8%	-8. 4%

Mutual Fund Net New Cash Flow[1]

(US$ billions)

	Equity	Hybrid	Bond	Money Market	Total	Total Long-Term Funds
2004	177.9	42.7	-10.8	-156.6	53.2	209.8
2005	135.5	25.2	31.3	63.1	255.2	192.0
2006	160.1	7.1	60.6	247.5	475.2	227.8
2007	95.6	22.2	108.6	661.5	887.9	226.4
2008	-237.7	-21.7	33.0	631.7	405.2	-226.4
Sept '09	12.4	3.1	220.1	-291.3	-55.7	235.6
%Change Sept '08 –Sept'09	118.1%	-49.24%	128.6%	-184.7%	-114.7%	595.0%

Source: Investment Company Institute.

[1] New sales (excluding reinvested dividends) minus redemptions, combined with net exchanges.

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Commodity Pools

	Number of pools (to nearest hundred)	Aggregate net asset value reported for all pools (US$ billions)
2004	3,100	$1,348
2005	2,600	$564
2006	2,100	$513
2007	1,700	$573
2008	1,500	$316

Source: CFTC.

Preconditions for effective securities regulation

18. **The general preconditions for effective securities regulation in the United States are present.** There are no significant barriers to entry and exit for market participants. Competition is encouraged and foreign participation is welcomed. The legal and accounting system supports the implementation of requirements and effective regulation of market participants. The commercial law is up-to-date and is capable of supporting the demands posed by cross-border trade, modern financial instruments, and current corporate governance standards. The legislation regarding bankruptcy, insolvency, and winding up in the jurisdiction and the professionals associated with those matters are sophisticated. The regulators have legally enforceable powers of decision and action, the limits of which have been tested frequently by the courts. The taxation framework is supportive to the operations of the industry in the jurisdiction.

Main findings

19. **Complexity is a key challenge.** The U.S. securities and futures markets are very complex. The regulatory framework and system that has developed equally complex. This is evident in the division of responsibility between the agencies and in the way that each is structured. There is a high degree of specialization evident at each agency. Although specialization may have benefits in a complex environment, regulators may be challenged to appropriately assess overall issues that cross specialization lines—both within an agency and between agencies. A greater focus on systemic issues relating to both securities and futures markets would make the overall regulatory system more robust.

20. **The chairmen of the CFTC and SEC have both recognized the need for change and have taken steps toward strengthening their institutions.** However, institutional culture is not easy to transform. Moreover, the agencies are under strong and continuous pressure, including from industry, and the agencies' challenge will be to respond to market developments and develop a reform agenda in an independent manner.

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21. **These issues manifest themselves in some key areas** (such as in the enforcement function or in regulation of over-the-counter derivatives markets) but the problems affect the entire system.

22. **As a matter of priority, the system should work toward simplification of internal and institutional structures.** Within the agencies, better internal management structures and improved communication between departments should be established to facilitate a regulatory culture of continuous learning and response.

23. **Principles relating to the regulator (Principles 1–5):** The responsibilities of the CFTC and SEC are clearly stated in law. There are gaps in coverage of the wide range of activity in the U.S. markets and in the scope of authority of both agencies. There are also differences between the futures and securities regimes in how similar instruments are regulated. There are also gaps between the authority of the SEC and the Federal Reserve with respect to the regulation and oversight of investment bank holding companies which added to the fragility of the overall system in the recent crisis. These gaps should be reduced as much as possible. The legal system grants the CFTC and SEC sufficient protection for their independence and the agencies operate independently on a day to day basis. There is a strong system of accountability to Congress. Neither agency has sufficient funding nor does the method of funding provide sufficient assurance of continuing funding levels to be able to commit to long-term capital projects, such as building new market surveillance systems, which are necessary to keep pace with changes in the industry. The CFTC and SEC activities and processes are transparent and there is public consultation regarding their regulations. They are active in investor education. CFTC and SEC staff and commissioners are subject to codes of ethics and other requirements to ensure a high standard of conduct.

24. **Principles relating to self-regulation (Principles 6–7):** SROs play a very significant role in the supervision of markets and their participants. Exchanges and clearing organizations perform important self-regulatory functions, as do registered associations. SROs are subject to an authorization regime based on eligibility criteria that address issues of integrity, financial viability, capacity, governance, and fair access—although the regimes are different for exchanges in the securities and futures markets. The CFTC has insufficient authority regarding exchanges following the coming into force of the CFMA. The CFTC has limited ability to intervene in the introductions of a new product or changes in rules, such as those governing trading. There is also no opportunity for stakeholders whose interests may be negatively affected to have their views taken into account in advance of a new product listing or rule change. These deficiencies have been recognized and are now being addressed via recommendations for legislative change set out in the Joint Report. Unlike securities exchanges, some demutualized futures exchanges have retained full member regulation powers. Some in the industry are concerned this may be used to restrain member dissent in the pursuit of shareholder interests. The CFTC publicly examined this issue from 2003 through 2009, which resulted in the adoption of acceptable practices for exchanges to follow in addressing conflicts of interest.

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25. **Principles relating to enforcement of securities regulation (Principles 8–10):** The anti-fraud provisions under the U.S. federal securities laws, as enforced by the SEC via Rule 10b–5[3] and supported by the courts, have proved to be a very effective tool for prosecuting offences under the securities laws. Private litigation is also an unusually powerful tool for securing compliance and obtaining redress in case of breach. The CFTC and SEC have broad investigative and surveillance powers over regulated entities, exchanges, and regulated trading systems. They can conduct on-site inspections without prior notice and can obtain information of all types without the need for a court order. The CFTC and SEC have broad enforcement powers, including the power to seek injunctions, bring an application for civil proceedings, and compel information and testimony from third parties. They also can impose administrative sanctions and refer matters to criminal authorities. The CFTC and SEC have implemented a system of supervision of markets and market participants including conducting on-site examinations. Significant shortcomings were identified in the SEC enforcement program. However, the SEC's extensive and wide-ranging program to implement the IG's recommendations and other changes is beginning to generate improvements and such efforts should be brought to a conclusion as a matter of high priority. Resources dedicated to the examination of SEC-registered IAs (a program currently conducted solely by the SEC) are insufficient, thus reducing the effectiveness of the program. Therefore, resources should be increased to at least enable the SEC to match the frequency and scope of the periodic examination of BDs where the responsibility is shared between the SEC and FINRA. Resources for criminal prosecution of securities fraud are too limited.

26. **Principles for cooperation in regulation (Principles 11–13):** The CFTC and SEC have broad authority to share information with both domestic and foreign regulators, even without having memoranda of understanding (MOUs) in place. Both agencies are signatories of the IOSCO MOU and also have many bilateral MOUs in place with other regulators. The CFTC and SEC have the authority to assist foreign regulators in obtaining information that is not in their files, using the powers that are available for their own investigative activities.

27. **Principles for issuers (Principles 14–16):** Companies that issue securities in the public market must provide extensive financial and other disclosure on initial offerings and most are subject to detailed continuing disclosure obligations in line with IOSCO standards. Liability provisions are in place to ensure that issuers are held responsible for all disclosure provided. This responsibility is enforced by the SEC, the exchanges and by civil suits by investors. However, there is limited authority over municipal government issuers. Holders of voting securities of a public issuer are generally treated fairly.

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[3] Rule 10b–5 under the Exchange Act makes it unlawful for any person, directly or indirectly, to use any device, scheme or artifice to defraud, to make any untrue statements of material fact or to omit to state a material fact necessary in order to make the statements made not misleading, and to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

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28. **Principles for collective investment schemes (Principles 17–20):** Operators and marketers of CIS offered to the public are subject to registration requirements. Initial eligibility criteria for CIS and their operators should be more extensive, and should be demonstrated prior to registration. The initial and ongoing disclosure requirements for CIS are extensive, however, the update requirements under the CEA are not timely. Assets of CIS are valued in accordance with U.S. generally acceptable accounting principles (GAAP) and verified by an independent auditor at least annually. The custodian of CIS assets is not required to be an arm's length party.

29. **Principles for market intermediaries (Principles 21–24):** There are minimum entry standards for all market intermediaries that include criteria relating to integrity. Capital and internal control requirements apply to FCMs, IBs that are not fully guaranteed by an FCM, and BDs; these are assessed prior to licensing by the SROs. Advisers are not subject to capital requirements or to operational capacity assessments prior to licensing. The applicable capital requirements vary by the chief risks undertaken by the FCMs, IBs, and BDs (largely market and credit risk). The ability of the prudential requirements (capital formulae and risk management requirements) to address the full range of risks (funding, liquidity, reputational, and affiliate risks) appears to need improvement. The regulators should strive to ensure that both capital and risk management requirements adequately address risks under stress. The crisis brought to light weaknesses in the framework governing investment bank holding companies, but the conversion of the remaining entities into bank holding companies has eliminated the practical need for the securities regulators to address these problems immediately. There are procedures in place at both agencies to address failures of intermediaries, and these have been tested in practice.

30. **Principles for the secondary market (Principles 25–30):** Securities and futures exchanges are subject to authorization and oversight. ATSs are authorized and regulated as BDs. Under the CEA, there are categories of futures trading systems which are exempt from authorization (exempt commercial markets or ECMs), although recent legislative amendments have enabled the CFTC to strengthen oversight of operational ECMs where appropriate. The SEC should join the CFTC in considering the introduction of explicit and comprehensive financial resources requirements for exchanges. In the securities markets, post trade transparency (details of completed transactions) is comprehensive as is publicly displayed liquidity or pre-trade transparency (best bids and offers). However, 25 percent of liquidity is not publicly displayed (i.e., dark pool ATSs and broker dealer internalization of trading on behalf of clients). The SEC's concern that a two-tier market may be emerging—that provides valuable order information on the best prices for NMS stocks only to selected market participants—is justified. Its current broad review of and public consultation on equity market structure is therefore timely. It should accurately establish the needs of investors of all classes. It also needs to reach actionable conclusions promptly. Analysing these issues and those related to advanced trading technologies requires the SEC to be better informed. Any proposed rule changes should be supported by independent factual evidence. Market surveillance by the securities and futures exchanges and FINRA is effective and has kept pace with technological developments in markets. A comprehensive surveillance system for securities trading to be used by the exchanges, ATS, and the SEC

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(such as exists in the futures markets) would be beneficial for the detection of market abuse and also for identifying indicators of developing stress points. The CFTC and the futures exchanges have been able to construct such a system despite the CFTC's serious budget constraints. Market manipulation is generally well policed in both markets. For insider trading, the legislation should be more comprehensive in futures markets. The approach to insider trading for securities and futures should be different given the differences in the nature of the markets. Implementing the recommendations in the Joint Report for expanding the insider trading provisions of the CEA will be an important step. Whether additional expansion of coverage is warranted, should be studied. While the IOSCO Principles do not require all markets in financial products to be transparent, the opacity of the OTC derivatives market contrasts with the relative transparency of OTC securities markets for equities and bonds.

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Table 1. Summary Implementation of the IOSCO Principles—Detailed Assessments

Principle	Grading	Findings
Principle 1. The responsibilities of the regulator should be clearly and objectively stated.	**PI**	The responsibilities of the CFTC and SEC are clearly stated in the laws. However, there are gaps in coverage of products and services in the market, differences in treatment of similar products, and gaps in the scope of each agency's authority. They should be reduced as much and as soon as possible.
Principle 2. The regulator should be operationally independent and accountable in the exercise of its functions and powers.	**BI**	The CFTC and SEC are operationally independent. There is a strong system of accountability to Congress. The funding method for the authorities does not provide funding sufficient to meet their regulatory and operational needs on a long-term basis.
Principle 3. The regulator should have adequate powers, proper resources, and the capacity to perform its functions and exercise its powers.	**PI**	Both authorities have extensive powers over their areas of responsibility, but there are gaps. The CFTC and SEC need additional resources in order supervise the very large and complex U.S. securities and futures markets. For example, neither agency has the resources to make full use of electronic systems to oversee the market or upgrade their market surveillance systems.
Principle 4. The regulator should adopt clear and consistent regulatory processes.	**FI**	The CFTC and SEC are subject to a high degree of transparency including public consultation regarding their regulations. They are active on investor education.
Principle 5. The staff of the regulator should observe the highest professional standards.	**FI**	The CFTC and SEC have developed codes of ethics. These include investment limitations on staff and, in the case of the SEC, reporting obligations. There are mechanisms to monitor compliance.
Principle 6 The regulatory regime should make appropriate use of SROs that exercise some direct oversight responsibility for their respective areas of competence and to the extent appropriate to the size and complexity of the markets.	**FI**	The effectiveness of the regulatory regime is to a large degree dependent on the skills and resources of the SROs. They play a very significant role in the supervision of markets and their participants. Exchanges and clearing agencies perform important self-regulatory functions as do registered associations.
Principle 7. SROs should be subject to the oversight of the regulator and should observe standards of fairness and confidentiality when exercising powers and delegated responsibilities.	**BI**	SROs are subject to an authorization regime based on eligibility criteria that address issues of integrity, financial viability, capacity, governance, and fair access—although the

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Principle	Grading	Findings
		regimes are different for exchanges in the securities and futures markets. Following the coming into force of the CFMA, the CFTC has had insufficient authority over exchanges. This deficiency is now being addressed via recommendations for legislative change set out in the Joint Report. However, corrective measures should balance prior product or rule approval with the exchanges' ability to quickly bring innovative products and rules to the marketplace. Unlike demutualized securities exchanges, the dominant futures exchange group (also demutualized) has retained member regulation responsibility. The CFTC should remain aware of industry concerns that this power may be used to restrain member dissent in the pursuit of shareholder interests.
Principle 8. The regulator should have comprehensive inspection, investigation, and surveillance powers.	**FI**	The CFTC and SEC have broad investigative and surveillance powers over regulated entities, exchanges, and regulated trading systems. They can conduct on-site inspections without prior notice. They can obtain books and records and request data or information without a court order.
Principle 9. The regulator should have comprehensive enforcement powers.	**FI**	The CFTC and SEC have broad enforcement powers. These include the power to seek injunctions, bring an application for civil proceedings, and compel information, documents, records, and testimony from third parties in the course of their investigations. They can impose administrative sanctions and refer matters to criminal authorities.
Principle 10. The regulatory system should ensure an effective and credible use of inspection, investigation, surveillance, and enforcement powers and implementation of an effective compliance program.	**PI**	Significant shortcomings were identified in the SEC enforcement program. However the current extensive and wide-ranging program of change—including measures to implement the recommendations made in the report by the SEC's Office of Inspector General (OIG)—is beginning to generate improvements. Important elements, such as the restructuring of complaints handling processes remain "work in progress." The CFTC and SEC have implemented a system of supervision of markets and market participants including conducting on-site inspections/examinations. However, resources for the examination of registered

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Principle	Grading	Findings
		IAs by the SEC are insufficient, thus reducing the effectiveness of these efforts. Resources for criminal prosecution of securities fraud are too limited.
Principle 11. The regulator should have the authority to share both public and non-public information with domestic and foreign counterparts.	**FI**	The CFTC and SEC have broad authority to share information with both domestic and foreign regulators. They can do so without having MOUs in place. Both agencies have shared information extensively with international counterparties.
Principle 12. Regulators should establish information-sharing mechanisms that set out when and how they will share both public and non-public information with their domestic and foreign counterparts.	**FI**	The CFTC and SEC are signatories of the IOSCO MMOU. They also have bilateral MOUs with other regulators.
Principle 13. The regulatory system should allow for assistance to be provided to foreign regulators who need to make inquiries in the discharge of their functions and exercise of their powers.	**FI**	The CFTC and SEC have authority to assist foreign regulators in obtaining information that is not in their files.
Principle 14. There should be full, timely, and accurate disclosure of financial results and other information that is material to investors' decisions.	**BI**	There is extensive initial and ongoing disclosure for most public issuers. However, there is limited direct authority over municipal government. On-going disclosure requirements do not apply to all public issuers.
Principle 15. Holders of securities in a company should be treated in a fair and equitable manner.	**FI**	Holders of voting securities of a public issuer generally are treated fairly.
Principle 16. Accounting and auditing standards should be of a high and internationally acceptable quality.	**FI**	U.S. GAAP is widely recognized as an acceptable accounting standard for use by public issuers and the generally accepted auditing standards (GAAS) of the U.S. Public Company Accounting Oversight Board (PCAOB) also are widely accepted globally.
Principle 17. The regulatory system should set standards for the eligibility and the regulation of those who wish to market or operate a collective investment scheme.	**PI**	Operators and marketers of CIS are subject to registration requirements. Eligibility criteria are not comprehensive. In addition, at present the resources and internal controls of a CIS would be subject to an examination by the regulator only sometime after the fund began operation, but are not preconditions to the original approval. Resources at the SEC, CFTC, and NFA do not allow routine examination of the operators to take place with sufficient frequency.

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Principle	Grading	Findings
Principle 18. The regulatory system should provide for rules governing the legal form and structure of collective investment schemes and the segregation and protection of client assets.	**BI**	There are requirements governing the legal form of CIS and addressing protection of client assets. Notice of changes that affect investor rights should be given prior to the effective date of the change, whether or not investor approval is required. The material change requirements set out in CEA are not timely. The custodian of a CIS's assets is not required to be an arm's length party.
Principle 19. Regulation should require disclosure, as set out under the principles for issuers, which is necessary to evaluate the suitability of a collective investment scheme for a particular investor and the value of the investor's interest in the scheme.	**FI**	The disclosure required for public commodity pools and securities CIS is extensive and is updated throughout the period when the CIS is offering its securities to the public. However, the CEA requirements regarding updating the Disclosure Documents are not timely. The information disclosed is sufficient for investors to assess suitability and the value of their investments in the CIS.
Principle 20. Regulation should ensure that there is a proper and disclosed basis for assets valuation and the pricing and the redemption of units in a collective investment scheme.	**FI**	Assets of CIS are valued in accordance with U.S. GAAP and verified by an independent auditor at least annually. The prices of the instruments are made available to the investors periodically. No guidance is provided on how pricing errors in commodity pools should be addressed.
Principle 21. Regulation should provide for minimum entry standards for market intermediaries.	**BI**	There are minimum entry standards for market intermediaries but only some types of intermediaries are subject to standards relating to financial capacity or assessed with respect to their internal controls, risk management, and supervisory systems in place before licensing.
Principle 22. There should be initial and ongoing capital and other prudential requirements for market intermediaries that reflect the risks that the intermediaries undertake.	**PI**	Capital requirements apply to FCMs, non-guaranteed IBs, and BDs that vary by certain of the risks undertaken by the firm. The capital formulae and other prudential requirements do not address fully the complete range of risks to which a firm may be exposed. The regulators should strive to ensure that both capital and risk management requirements adequately address risks posed when firms are under stress.
Principle 23. Market intermediaries should be required to comply with standards for internal organization and operational conduct that aim to protect the interests of clients, ensure proper	**BI**	There are standards of conduct and internal control requirements for the protection of clients of intermediaries. Management must supervise the business of the intermediary

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Principle	Grading	Findings
management of risk, and under which management of the intermediary accepts primary responsibility for these matters.		appropriately. The risk management expectations for BDs and FCMs should be reexamined, particularly with regard to management of liquidity, funding and reputational risks under stress.
Principle 24. There should be a procedure for dealing with the failure of a market intermediary in order to minimize damage and loss to investors and to contain systemic risk.	**FI**	There are procedures in place at both the CFTC and SEC to address failures and these have been put to the test.
Principle 25. The establishment of trading systems including securities exchanges should be subject to regulatory authorization and oversight.	**BI**	Securities and futures exchanges and trading system operators are subject to authorization and oversight. However, under the CEA, there are categories of trading systems, ECMs, and EBOTs, which are exempt from authorization. Exempt markets are not registered with, or designated, recognized, licensed, or approved by the CFTC. Under the Exchange Act, operators of securities market trading systems can elect to be regulated as exchanges or as ATSs (which must, among other things, register as BDs). The authorization of so called "dark pool" ATSs under Regulation ATS whereby they are not required to publicly display their best-priced orders in NMS stocks, does not provide for adequate pre-trade transparency of trading interests. Thus, the consultation currently being conducted by the SEC on equity market structure, including issues related to "dark pools," is timely. See also Principle 27.
Principle 26. There should be ongoing regulatory supervision of exchanges and trading systems, which should aim to ensure that the integrity of trading is maintained through fair and equitable rules that strike an appropriate balance between the demands of different market participants.	**FI**	The ongoing supervision of ECMs was an excessively light-touch regime, although the CFTC has recently sought and obtained regulatory change which has enabled it to strengthen oversight where appropriate. As to futures exchanges, CFTC staff is working with Congress to get explicit statutory authority to impose financial resource requirements on designated contract markets (DCMs). The SEC's focus on two elements of an exchange's financial resources risk, namely information technology (IT) and the self-regulatory functions, while necessary risks missing evaluating other exposures such as affiliate risk. A more holistic approach to

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Principle	Grading	Findings
		capital adequacy would be preferable.
Principle 27. Regulation should promote transparency of trading.	**FI**	The CEA and CFTC regulations have not been updated to reflect modern concepts of transparency. However, the practice in futures markets, consistent with the Principle, is real time publication. In the securities markets, post trade transparency (details of completed transactions) is comprehensive as is publicly displayed liquidity or pre-trade transparency (best bids and offers). However, 25 percent of liquidity is not publicly displayed (i.e., dark pool ATSs and broker dealer internalization of trading on behalf of clients). The Principle has been assessed as fully implemented but the judgment was finely balanced. The SEC's concern that a two-tier market may be emerging (that provides valuable order information on the best prices for NMS stocks only to selected market participants) is justified. Its current public consultation on these issues is therefore timely. Analyzing these issues and those related to advanced trading technologies requires the SEC to be better informed. Any proposed rule changes should be supported by independent factual evidence. See also Principle 25.
Principle 28. Regulation should be designed to detect and deter manipulation and other unfair trading practices.	**BI**	Insider dealing law is too narrowly focused in the derivatives markets. If accepted, the recommendations in the Joint Report will be an important advance. Additional study is recommended to consider whether further restrictions would be appropriate. Market surveillance is carried out to a high standard by the exchanges and FINRA, and is particularly comprehensive in the futures markets. The SEC and CFTC are constrained by technology limitations.
Principle 29. Regulation should aim to ensure the proper management of large exposures, default risk and market disruption.	**FI**	The timely and comprehensive information flows available in futures markets provide for effective early warnings. In securities markets, tracking large exposures and other potential sources of market disruption is more difficult and should be improved.

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Principle	Grading	Findings
Principle 30. Systems for clearing and settlement of securities transactions should be subject to regulatory oversight and designed to ensure that they are fair, effective, and efficient and that they reduce systemic risk.	**N/A**	A separate CPSS-IOSCO assessment was conducted for the securities markets. Arrangements in the futures markets were not assessed.
Aggregate: Fully implemented (FI) – 16, Broadly implemented (BI) –8, Partly implemented (PI) – 5, Not implemented (NI) – 0, Not applicable (N/A) – 1		

Recommended action plan and authorities' response

Recommended action plan

Table 2. Recommended Action Plan to Improve Implementation of the IOSCO Principles

Principle	Recommended Action
Principles relating to the regulator (Principles 1–5)	Decisions should be taken promptly on the recommendations of the Joint Report to enhance investor protection and improve cooperation between the CFTC and SEC. Legislative and regulatory gaps identified in the Joint Report should be closed. Funding of both authorities needs to be increased and the method of funding should be reviewed. The annual appropriations process seems inadequate to meet the needs for funding necessary long term projects. Annual funding makes it difficult to commit to major investments in software development which takes place over several years. Consideration should be given to moving to direct self-funding (i.e., ability to capture fee income for own funding rather than remitting it to general government revenue and relying on a government budget). The total fee income at the SEC presently generated from its activities far exceeds the combined budgets of the SEC and the CFTC. Taking into account the size and complexity of the markets and the number of registrants they oversee, both agencies need more resources—human, informational and technological—to fulfill their regulatory functions efficiently and effectively.
Principles relating to self-regulation (Principles 6–7)	As recommended in the Joint Report, the CEA should be amended to provide the CFTC with greater powers over product and rules approval of the futures exchanges and to provide greater scope for public consultation prior to their introduction. Corrective measures should recognize the need to balance prior product or rule approval with the exchanges' ability to benefit from their innovative endeavors in a competitive market. The CFTC should remain aware of industry concerns regarding the retention of member regulation by demutualized DCMs.

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Principle	Recommended Action
	The SEC should consider delegating sole registration authority for BDs to FINRA.
Principles relating to enforcement of securities regulation (Principles 8–10)	Although many improvements have been made or are under way within the SEC, the current program in the Enforcement Division and Office of Compliance, Inspections and Examinations (OCIE) to implement the 21 recommendations set out in the 2009 report of the OIG and other improvements should be completed as a matter of high priority. The SEC also may want to consider adding enforcement staff with more accounting and economics backgrounds. Mixed teams with different skill sets and experience in the Enforcement Division could enhance its performance. The number of staff dedicated to the periodic examination of registered IAs (whether at the SEC alone, or in combination with FINRA and/or state regulators) should be increased at least to a level where the percentage of IAs examined annually matches the percentage of BDs examined by the SEC and FINRA. The enforcement division of the CFTC would benefit from more resources. Given the current limited scope of its remit and the integrated market surveillance systems it operates in close cooperation with the DCMs this is not a pressing problem though it will become one if its remit is expanded (e.g., to include OTC derivatives). The securities unit of the fraud section in the criminal division of the DOJ should be given additional resources to prosecute securities fraud.
Principles for issuers (Principles 14–16)	Continuous disclosure requirements should apply to all public issuers. The SEC should have the power to mandate both initial disclosure requirements and on-going obligations directly on municipal government issuers.
Principles for collective investment schemes (Principles 17–20)	The eligibility criteria for CIS and their operators should include the human and technical resources to carry out the required functions, the appropriate financial capacity and adequate internal management and controls. These should be assessed before a CIS or its operator is permitted to begin operations. The resources at the relevant regulators (statutory or SRO) for routine examinations of operators and CIS should be increased. CPOs should be required to have policies in place to avoid or mitigate conflicts. Notice of changes that affects investor or participant rights should be given prior to the effective date of that change, whether or not prior approval is required. Prompt changes to commodity pool disclosure documents should be required when material changes occur. Consideration should be given to requiring the custodian of a CIS's assets to be an arm's length party. Requiring an auditor of a CIS to have relevant prior experience might also be considered. The CFTC should provide guidance to the industry on how to address pricing errors in the valuation of commodity pools.

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Principle	Recommended Action
Principles for market intermediaries (Principles 21–24)	The threshold for review of the fitness of control persons of an intermediary should be the same under the CEA and Exchange Act; the lower 10 percent threshold should be adopted. There should be an assessment of the back-office capabilities, internal controls and policies and procedures of all futures intermediaries and IAs prior to the grant of registration. FINRA should have clear authority to examine and address all securities-related activities of members, including their registered IA activities. Consideration should be given to requiring that custodian be at arm's length to the IA. The proposed changes to the futures capital rules to address gaps relating to cleared OTC derivatives and improve the sensitivity of the formula to the actual risks undertaken by the firm should be implemented promptly. The capital rules and other prudential requirements, such as risk management standards, should be reexamined to ensure all risks, including funding, reputational, liquidity and affiliate risks are addressed fully. The regulators should strive to ensure that both capital and risk management requirements adequately address risks posed when firms are under stress. Consideration should be given to reviewing the rules governing BD custody of client assets. The CFTC should have authority to review and approve/disapprove margin requirements set by the DCMs.
Principles for the secondary market (Principles 25–30)	In addition to pursuing legislative change to secure the enhanced powers as set out in the Joint Report the CFTC should consider seeking an authorization power over entities seeking to set up ECMs and Exempt Boards of Trade (EBOTs). However ongoing legislative initiatives are considering the abolition of the ECM and EBOT market categories. The SEC's current broad review of equity market structure to determine whether the rules have kept pace with changes in trading technology and practices should be prioritized with a view to encouraging the broadest public debate while reaching actionable conclusions promptly. It will be essential that the review be conducted on the basis of comprehensive and independent evidence in order to establish accurately the needs of investors of all classes. The recommendations in the Joint Report regarding insider dealing and Chinese Walls in derivatives markets should be implemented. The CFTC should undertake a study to consider whether expansion of the insider trading prohibition in the futures markets beyond the recommendation in the Joint Report is warranted given the current state of the markets, contracts and investors. Such a study would complement the current debate in Europe as to the appropriate coverage of insider trading laws in derivatives markets. The SEC should review the extent to which the absence of additional offences of insider trading is a limiting factor in the SEC's enforcement effort

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Principle	Recommended Action
	in this area. Current discussions among the securities exchanges and FINRA on creating a consolidated surveillance structure to oversee the consolidated market should be given greater priority with a view to reaching a positive conclusion in a timely manner. Consideration should be given to amending the regulations to provide the SEC and the securities exchanges with accurate and timely information on large holders of and traders in securities as the CFTC and the futures exchanges have in their markets. This would support surveillance and identify emerging market stress points in a timely fashion. The SEC should join the CFTC in considering the introduction of an explicit and comprehensive financial resource requirement for exchanges.

Authorities' response to the assessment

31. The U.S. authorities appreciate the effort, time, and resources committed by the IMF to prepare the FSAP. The FSAP is intended to promote the soundness of financial systems in member countries and to contribute to improving supervisory practices around the world. The U.S. assessment has presented a challenging and complex task. In light of the financial crisis as well as the maturity, complexity and significance of the U.S. financial system, we understand that the U.S. regulatory system was subject to a more stringent standard than in previous IMF assessments. Nevertheless, it is essential that regulators hear from third parties to gauge their effectiveness. We are grateful for the opportunity to provide the following comments regarding the IMF's Report, although as discussed below we take exception to a number of the findings.

32. As recognized in this Report, the U.S. FSAP is occurring at a critical and extraordinary time. According to the G20 leaders in April 2009, major failures in the financial system, including in regulation and supervision, were fundamental causes of the crisis. The last 18 months have taught regulators around the world much about the new realities of our financial markets. We have learned the limits of foresight and the need for candor about the risks we face. We were reminded that transparency and accountability are essential. Only through strong, intelligent regulation—coupled with aggressive enforcement mechanisms—can we fully protect the American public and keep our economy strong. Given the global nature of markets, we recognize that U.S. leadership remains critical to the stability of markets worldwide.

33. The financial crisis left regulators with enormous challenges and a heightened interest in strengthening regulation. Perhaps most importantly, as the Report recommends, comprehensive regulatory reform of the OTC derivatives marketplace is essential. The financial crisis highlighted how opaque markets can threaten the financial system and the

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broader public. The U.S. authorities agree with the Report's strong recommendation for increased resources for the CFTC and the SEC should the U.S. Congress expand the agencies' missions to include the regulation of OTC derivatives. The CFTC and SEC additionally need greater resources to keep up with the growth of securities and futures markets in the United States. The U.S. authorities also agree with the assessment that the CFTC and SEC should enhance cooperation and coordination and already have taken steps to do so.

34. While change is needed, the U.S. regulatory system nevertheless helped ensure that the world's largest and most complex exchange-listed equity, commodity futures, and options markets continued to function properly and withstood the ultimate stress test during the financial crisis. The system has served as a model for regulatory authorities worldwide. Moreover, some of the proposed reforms to address risk in OTC derivatives—for example, requiring standardized products to trade on regulated trading platforms and to be cleared by central counterparties—reflect long-standing elements in the U.S. approach to regulating financial markets.

35. In addition to supporting reform, U.S. regulators have taken action under existing authority to remedy problems and to make improvements. For example, in the area of disclosure, the SEC proposed new rules that would improve the quality and timeliness of disclosure in municipal markets. In the area of investment management, the SEC sought to provide greater protections to investors by adopting new custody control rules that include surprise inspections to verify assets held by money managers. Finally, in the past year, the SEC launched a robust and vigorous review of equity market structure, including issues such as dark pools. The CFTC is continuing to improve and extend its world-class system of risk surveillance by requiring large trader reporting in the cleared OTC markets. This effort will allow the CFTC to conduct financial surveillance in this area consistent with its existing risk program for on-exchange trading.

36. The overall ratings in the Report, however, do not reflect the CFTC's and SEC's regulatory successes and, in some cases, suggest a misunderstanding of the U.S. regulatory system. Thus, the Commissions strongly disagree with many of the ratings in the Report. By way of example, while the IOSCO Principles recognize that regulators may use different approaches to accomplish the same objectives, the Report's rating on market intermediaries is based on the assumption that every intermediary must be regulated the same way. That is, they must undergo an extensive review prior to registration. This requirement, however, cannot be found in the Principles or the assessment Methodology. The Report rejects a legitimate risk-based approach to a registration requirement and oversight of futures and securities intermediaries without evidence that the approach is ineffective. The Report also states that capital requirements for futures and securities firms do not fully address risk, yet provides no evidence that the CFTC's and SEC's current requirements do not already exceed recognized international best practice as reflected in the Principles.

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37. In particular, the Report suggests that only systems that call for review of the "fitness and properness" of CIS operators are acceptable. The Report finds that the regulatory framework in the United States does not address the adequacy of the CIS operators' human and technical resources, financial capacity and internal management and controls. However, this finding does not take into account key and unique features of the U.S. system. The U.S. system mandates disclosure by CIS operators and also relies on oversight by a separate entity, a CIS board, which generally consists of a majority of independent directors. The CIS board serves as an initial check on the fitness, resources, and internal controls of the CIS operator. Moreover, both the CIS operators and CIS boards are subject to fiduciary duties, which are enforced by the SEC and by private litigants. This system offers an ongoing review of the fitness, resources, and internal controls of a CIS operator instead of a one-time "fit and proper" check. The Report disregards these important features of U.S. market regulation, and the effects they have on how regulated entities operate.

38. As a related matter, the IOSCO Principles make clear that they apply to futures markets "where the context permits." For instance, the Principles relating to CIS were written for publicly offered funds, such as mutual funds. The CIS Principles were not intended to cover privately-offered funds, such as the vast majority of CFTC-regulated commodity pools. The pools that are publicly offered represent a small percentage of total pools regulated by the CFTC. The ratings in this area are misplaced given the de minimis number of publicly offered funds.

39. In addition, some of the Report's adverse conclusions about the U.S. regulatory system are not based on objective criteria. For example, the Report finds that per Principle 10 the U.S. system fails to "ensure an effective and credible use of inspection, investigation, surveillance and enforcement powers." This conclusion appears to be based solely on an SEC Office of Inspector General (OIG) Report issued in August 2009 that reviewed the failings of a specific high-profile investigation, and then extrapolates those failings to all SEC enforcement activities. In so doing, the Report overlooks the SEC's overall success in the area of enforcement. In fiscal year 2009, SEC enforcement actions yielded: (1) orders that required wrongdoers to disgorge ill-gotten gains in the amount of approximately US$2.09 billion; (2) orders that imposed money penalties on wrongdoers in the amount of approximately US$345 million, a 35 percent increase over the previous fiscal year; and (3) the filing of 664 cases against 1,787 persons. SEC enforcement actions also have resulted in the return of billions of dollars to injured investors since the agency received "Fair Fund" authority in 2002. During fiscal year 2009 alone, the SEC distributed approximately US$2.1 billion to harmed investors from both disgorgement funds and Fair Funds.

40. These performance measures are a testament to the credibility and effectiveness of the SEC enforcement program in relation to the U.S. securities markets—a level of enforcement activity and investigative aggressiveness that far exceeds that of any other securities regulator in the world. These facts are inconsistent with a conclusion that the SEC enforcement program broadly fails to satisfy Principle 10. Granted, the metrics set forth above may not be the only objective measures by which to judge the effectiveness of the SEC's enforcement program. But, the Report fails to articulate any objective metrics on which to base the rating.

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41. To be sure, the OIG Report highlights a major failure. The SEC, however, has taken action in response. In the past year, the SEC, among other things, restructured the Enforcement Division and streamlined its procedures. The SEC also took steps to improve its inspection program and place greater reliance on risk assessment. The SEC is actively working to improve its technology and modernize the way it handles the massive number of tips and complaints it receives each year. The Report's rating fails to give full credit for these improvements. In short, the effectiveness of an enforcement program should not be measured by zero tolerance for failure. There are many effective criminal justice systems around the world that are held in high esteem, not because of an absence of crime or a perfect record, but because, among other things, they apply considerable resources and visible effort to prevent, investigate, and prosecute crime.

42. In conclusion, the SEC and CFTC recognize a number of the areas that the IMF identified for improvement. Much is already underway to address these concerns. However, these types of suggestions in the Report are the exception rather than the rule.

43. Further, the SEC believes that the Report's conclusions are seemingly at odds with those of investors from around the world, both large and small. Capital markets essentially function to allocate capital. In making decisions about capital allocation and the premiums charged for such investments, investors make judgments about the quality of the regulator, the breadth and depth of disclosure, the efficacy of the enforcement regime and the fairness of the marketplace, among other things. Judging by the degree of global investment in the U.S. market and taking into account the cost of capital in the United States, it would appear that those whose money is at stake view the U.S. regulatory system in a different, more positive light—even in light of recent regulatory failings.

44. In sum, the U.S. authorities firmly believe that the overall ratings are not reflective of the U.S. system for the regulated marketplace. Nonetheless, the U.S authorities will continue to evaluate and, as appropriate, enhance their regulatory programs. The CFTC and SEC look forward to a continuing dialogue with the IMF to advance our shared goal of strengthening financial regulation and enhancing supervision of the global financial services sector.

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II. Detailed Assessment

Table 3. Detailed Assessment of Implementation of the IOSCO Principles

Principles Relating to the Regulator	
Principle 1.	The responsibilities of the regulator should be clear and objectively stated.
Description	Since the 1930s, securities and futures have been subject to separate federal regulatory regimes in the United States; the U.S. CFTC has exclusive jurisdiction over futures and commodity option transactions, whereas the U.S. SEC has oversight of the securities market. Both authorities make use of SROs for supervision of trading systems (including exchanges) and intermediaries. There also is regulation at the state level for securities, primarily with a consumer protection focus. **CFTC** The CFTC is an operationally independent federal agency established under the CEA. The responsibilities, powers, and authority assigned by law to the CFTC are clearly defined and transparently set out in the CEA and CFTC regulations. It is the mission of the CFTC to protect the public interest by providing a means for managing and assuming price risks, discovering prices, and/or disseminating pricing information through trading in liquid, fair, and financially secure trading facilities for commodities. In order to foster the public interest, the CFTC endeavours to detect and prevent price manipulation or any other disruptions to market integrity; to protect all commodity market participants from fraudulent or abusive sales practices and misuses of customer assets; and to promote responsible innovation. The CFTC, which has about 500 staff members, is divided into three divisions and across several offices. The CFTC´s headquarters is in Washington, D.C., with three regional offices in Chicago, Kansas City, and New York. The CFTC can interpret how to apply the authority granted to it by the CEA and is engaged in rulemaking. The criteria for interpreting the CFTC's authority are clear and transparent. The CFTC largely interprets the CEA based on the plain meaning of the statute and available legislative history as it relates to relevant markets and market participants. CFTC staff may also provide guidance to market participants and practitioners on a variety of legal and regulatory matters. Although not legally binding on the CFTC, these staff interpretations provide useful direction to market participants on the CEA and related issues. Domestically, the CFTC participates in a variety of committees, working groups, and intergovernmental partnerships with other regulators, governmental agencies, and federal law enforcement entities on matters of common interest. The CFTC is, for example, a member in the President's Working Group (PWG)—a key forum for the coordination of regulation across financial markets with participants from the Secretary of the Treasury, Federal Reserve, SEC, National Economic Council, Council of Economic Advisors, Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, and Federal Reserve Bank of New York. The CFTC has established several MOUs with national authorities (see Principle 12). **SEC** The responsibilities, powers, and authority assigned by law to the SEC are clearly defined and transparently set out in several federal securities statutes (Securities Act; Exchange Act; Trust Indenture Act of 1939; ICA, Advisers Act, and SOX), and in the rules and regulations that the SEC has adopted under these statutes. Generally, these statutes are broadly drafted, establishing basic principles and objectives. To ensure that the intent of Congress is carried out in specific circumstances and to address technological, market, product, and service developments, the SEC engages in rulemaking. The mission of the SEC is to protect investors; maintain fair, orderly and

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efficient markets; and facilitate capital formation. The agency's functional responsibilities are organized into four divisions and 19 offices, each of which is headquartered in Washington, DC. The SEC's approximately 3,500 staff is located in Washington, DC and across 11 regional offices located in New York, Boston, Philadelphia, Atlanta, Chicago, Miami, Fort Worth, Denver, Salt Lake City, Los Angeles, and San Francisco.

The SEC participates in a variety of committees, working groups, intergovernmental partnerships with other regulators, governmental agencies, and federal law enforcement entities on matters of common interest. The SEC is also a member, for example, in the PWG, as described above. The SEC has entered into several MOUs with national authorities (see also Principle 12).

Multi-authority issues

There are many aspect of securities market regulation for which more than one regulator has responsibility.

In some cases, the responsibilities are clearly defined and there do not appear to be cooperation deficits, for example in the division of responsibility between federal and state regulation of securities activities. In particular, investment advisers with less than US$25 million in assets under management are prohibited from registering with the SEC as investment advisers and must register under state law. Securities offerings made solely within a single state, where the issuer of such security is a person resident in (or, if a corporation, incorporated in) and doing business within that state are not required to be registered under the Securities Act.

However, in some areas, where more than one regulator is assigned responsibility, gaps and cooperation deficits exist. The CFTC and the SEC self-assessments as well as the Joint Report, identified several differences with respect to powers and disparate regulation of similar types of financial instruments. These differences exist, not only between the futures and securities regulators, but between the securities regulators and the Federal Reserve, as detailed below.

Aiding and Abetting: The Joint Report identified a gap between the enforcement powers of the CFTC and SEC in the context of civil actions, and recommended legislation to close the gap. Specifically, it recommends that the SEC should be granted specific statutory authority to pursue persons for aiding and abetting offences in civil actions under the Securities Act and the ICA. This would match the specific statutory enforcement authority for civil actions of the CFTC regarding aiding and abetting all violations of the CEA and CFTC rules and regulations.

Municipal Securities: There is a regulatory gap with respect to the regulation of municipal securities. Currently, the Municipal Securities Rulemaking Board (MSRB), an SRO, writes the rules regulating securities firms and banks involved in underwriting, trading, and selling municipal securities, but does not have the authority to apply these rules to other professionals and intermediaries in the municipal finance market. Moreover, under a provision of the federal securities laws known as the "Tower Amendment," the SEC and the MSRB are prohibited from directly requiring state and local government issuers of municipal securities to comply with disclosure requirements or file any document prior to the initial sale of securities.

Economically-Similar Products and Services: Under the current regulatory structure, the rights and remedies applicable to the sale of the same or economically-similar products depend on, among other things, the type of intermediary selling the product. In a few instances, this has resulted in the imposition of different regulatory regimes on similar products. For example:

Foreign Currency (forex) Transactions: The regulation of off-exchange retail forex transactions depends upon the entity offering the product. The CFTC has jurisdiction over such transactions where the entity is an FCM or retail foreign exchange dealer, but transactions with "otherwise regulated" entities such as banks, BDs, and insurance companies are overseen by their respective regulators. The CFTC is currently consulting on measures intended to increase the level of client protection when these products are offered by entities subject to CFTC registration. There are no unifying standards for forex trading activities across regulators, leading to possible inconsistencies

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in the regulation of the participants and different levels of protection afforded to clients.

Gramm-Leach-Bliley Act (GLBA) and Bank "Broker" Activity: The GLBA amended several federal statutes governing the activities and supervision of banks, bank holding companies, and their affiliates. Among other things, it lowered barriers between the banking and securities industries erected by the Glass-Steagall Act. With respect to the definition of "broker," the GLBA amended the Exchange Act to provide 11 specific exceptions for banks. Each of these exceptions permits a bank to act as a broker or agent in securities transactions that meet specific statutory conditions. In particular, there are conditional exceptions from the definition of broker for banks that engage in certain securities activities such as third-party brokerage arrangements; trust and fiduciary activities; permissible securities transactions; certain stock purchase plans; sweep accounts; affiliate transactions; private securities offerings; safekeeping and custody activities; identified banking products; municipal securities; and a *de minimis* number of other securities transactions. The same activity carried on by a bank and the BD may be subject to very different regimes, such as consumer protection requirements and compensation schemes in the event of the failure of the intermediary.

Regulation of Derivatives and Securities: Certain economically-identical investment products are regulated differently depending on their classification as securities (SEC-regulated) or commodities derivatives (CFTC-regulated). As trading in commodity futures has evolved to include derivatives on financial instruments and as the SEC has maintained jurisdiction over security options (which can be economically equivalent to certain commodity derivative products), the lines between securities and commodities regulation have blurred. This has also led to jurisdictional disagreements between the SEC and CFTC.

SEC – Federal Reserve: The GLBA divided responsibility for the supervision of financial holding companies that were primarily investment banks between the Federal Reserve and the SEC. The recent crisis and the evident lack of financial resilience of the investment bank holding companies highlighted gaps in the efficacy of both the regulatory regime and resolution framework for these entities.

Additionally, other products resembling securities and commodities derivatives are generally unregulated. For example, certain qualifying transactions among "eligible contract participants" or "eligible commercial entities" for contracts subject to individual negotiation fall within a broad definition of "swaps" and are traded in the OTC market. These swaps, as defined in the CEA and the securities laws, are largely excluded or exempted from regulation by the SEC or CFTC. The anti-fraud and anti-manipulation provisions of the federal securities laws only apply to a subset of swap agreements, known as security-based swaps. The CFTC also has anti-fraud and anti-manipulation authority over some markets.

Inter-agency cooperation

Joint Advisory Committee

The CFTC and SEC have, for many years, attempted to work together on a cooperative basis to the extent permitted by the evolving formulations of the CEA and Exchange Act. This has not always been an easy task to carry out in practice. The CFTC and the SEC have entered into several MOUs and initiatives to enhance coordination and cooperation between the two authorities. The most recent initiative took place in November 2008, when the SEC, Federal Reserve, and CFTC entered into an MOU related to credit default swaps (CDS) and central counterparties (CCPs). There is an MOU between the CFTC and SEC, dated March 11, 2008, addressing "novel" derivative products to enhance legal certainty, share information permit the trading of these products—in either or both a CFTC- or SEC-regulated environment—and to provide for regular meetings of staffs to discuss particular issues and products.

There also is an MOU in place between the two agencies regarding the oversight of security futures product ("SFP") trading and the sharing of SFP information. The MOU provides for notice of any

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	planned examinations and the reasons for that examination, sharing of examination-related information, and the conduct of joint examinations, if feasible. The MOU also provides for notice of significant issues arising from these markets and the sharing of trading data and related information for SFP activity. The Joint Report recommends legislation to authorize the SEC and the CFTC to jointly form, fund, and operate a Joint Advisory Committee. According to the Joint Report, this committee would identify emerging regulatory risks and assess and quantify their implications for investors and other market participants, and provide recommendations for solutions. The committee would serve as a vehicle for discussion and communication on regulatory issues of mutual concern affecting CFTC- and SEC-regulated markets; the industry generally; and their effect on the SEC's and CFTC's statutory responsibilities. The SEC and CFTC already have requested and received statutory authority to jointly form, fund, and operate a Joint Advisory Committee as recommended by the Joint Report. (See also the discussion of cooperation with other domestic regulators under Principles 11 and 12.)
Assessment	Partly implemented.
Comments	No single issue was determinative of the grade under this Principle; rather, when considered together, the totality of the matters identified raised significant concerns. The regulatory infrastructure described briefly above is highly complex. In many areas, this complexity does not produce gaps or inequity. However, in some of the instances of legislative and institutional divisions of responsibility set out above, that is not the case. As detailed above, there are gaps in the authority of agencies to cooperate, such as on aiding and abetting, and on the supervision of financial holding companies operating primarily as investment banks. There are also differences in the regulation of economically similar products and services such as foreign exchange transactions, the treatment of banks vis-à-vis brokers when carrying out the same activity, and the regulation of securities and derivatives. The gaps and differences in treatment should be reduced as much as and as soon as possible. In addition, the rapid development of the market in complex derivatives, such as CDS, large parts of which neither agency has had the authority to regulate, has created significant regulatory gaps as discussed at length in the Treasury White Paper and noted in the Joint Report. This issue is currently the subject of deliberation in Congress. Regarding effective management of the division of responsibilities between CFTC and SEC, the Joint Report has laid out a way forward and both agencies' staff appears to be fully supportive of change. In addition to seeking legislative authority to establish a Joint Advisory Committee, the Joint Report makes recommendations on how to improve coordination and cooperation between the agencies, in ways which do not require new legislation and could therefore be achieved quickly. They include establishing: • A Joint Agency Enforcement Task Force to harness synergies from shared market surveillance data to improves market oversight, enhance enforcement, and relieve duplicative regulatory burdens. • Cross-agency training programs for enforcement personnel. • A program for regular sharing of staff. • A Joint Information Technology Task Force to pursue linking information on CFTC and SEC regulated persons and entities. Historically, legislation lacked clarity as to the scope of the powers of the SEC and CFTC over particular types of derivative instruments and markets. Consequently, the commissions found it difficult to work in a cooperative and coordinated fashion. The recommendations in the Joint Report mark a strong commitment to establish a new, more effective way of working together.
Principle 2.	The regulator should be operationally independent and accountable in the exercise of its functions and powers.

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Description	**CFTC** The CFTC is an operationally independent regulatory commission of the U.S. government, accountable to, and subject to the oversight of, U.S. Congress. By law, the five commissioners are appointed by the President with the consent of the Senate. Each CFTC Commissioner holds office for a term of five years. Not more than three commissioners may be members of the same political party. The President also appoints one of the commissioners as chairman, with the consent of the Senate. The President may replace the chairman at any time and the former chairman may complete his or her term as a CFTC Commissioner should he/she choose to do so—which seems unlikely. The criteria for removal of a commissioner are not set out in statute. However, case law regarding independent regulatory agencies suggests that the President has the power to remove a commissioner for "cause" such as neglect of duty or malfeasance in office. The CEA prohibits any CFTC Commissioner or employee from accepting employment or compensation from any person, exchange, or clearinghouse subject to regulation by the CFTC and from participating, directly or indirectly, in any contract market operations or transactions subject to CFTC regulation. The CFTC may consult with any department or agency of the government. In specific instances, the consultation process is established by law. For example, the CFTC may not designate a board of trade as a DCM or register a derivatives transaction execution facility (DTEF) in U.S. government-issued or guaranteed securities until the shorter of 45 days after the CFTC provides a copy of the application to Treasury, and the Federal Reserve or the CFTC receives comments from those agencies. The CFTC's budget is part of the federal budget that is prepared by the President and submitted to Congress. The budget is subject to review and recommendation at several levels, including House and Senate committees, and must be adopted by Congress annually. The budget has not kept pace with the growth in the futures market. The CFTC Chairman has testified about the commission's need for more resources and the Administration and U.S. Congress are considering the agency's need for more resources. Federal law provides federal employees with immunity from individual liability for torts committed in the scope of their employment. In order to insulate CFTC staff from individual liability for possible violation of constitutional or statutory duties that are not shielded by statute, the CFTC has adopted indemnification rules. The CFTC is accountable for its conduct to U.S. Congress primarily through reporting to House and Senate committees. In general, these committees handle, in the first instance, the reauthorization, budget, and funding decisions for the CFTC, as well as bills affecting the CEA. By law, the CFTC is subject to reviews and audits by the government. The CFTC is also required to deliver a written report to Congress within 120 days after the end of each fiscal year detailing CFTC operations of that fiscal year. In addition, CFTC operations are subject to ongoing review by an independent OIG with offices in the CFTC headquarters. It has four staff members. OIG conducts and supervises audits and investigations of programs and operations of the CFTC and reviews existing and proposed legislation and regulations. OIG recommends policies to promote economy, efficiency and effectiveness in CFTC programs and operations and to prevent and detect fraud and abuse. OIG keeps the Chairman of the CFTC and Congress informed about any problems, deficiencies and the progress of corrective action in programs and operations. The CFTC must comply with the Administrative Procedures Act (APA), which requires administrative agencies to give affected parties notice of proposed actions, and an opportunity to make submissions prior to a decision being made and provide written decisions setting out its findings of fact, conclusions of law, and the reasons for its decisions. Additionally, the APA creates the right of judicial review over agency actions. A person suffering legal wrong because of

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	an administrative agency's action, or adversely affected by its decision, is entitled to a judicial review of the action. The CFTC also has extensive rules of procedure to ensure fairness in the conduct of hearings and other administrative activities. **SEC** The SEC is an operationally independent federal agency headed by a bipartisan five-member commission, comprised of the chairman and four commissioners, who are appointed by the President and confirmed by the Senate for staggered five-year terms. By law, no more than three of the commissioners may belong to the same political party. All SEC Commissioners and staff are subject to the federal criminal law conflict of interest statutes including a specific prohibition from participating personally and substantially in particular matters that would have a direct and predictable effect on their financial interests or one that is imputed to them. The Exchange Act also expressly prohibits any commissioner from engaging in any other business, vocation, or employment than that of a commissioner. There are matters of regulatory policy which require consultation with or approval by other authorities, such as the requirement for joint rule-making with the Federal Reserve in connection with the implementation of the GLBA. Where consultation is required, the process is clear and the criteria are transparent. Despite these requirements to consult, the SEC has the authority to make day-to-day decisions on technical matters without the need to consult with other government authorities. The SEC's budget is part of the federal budget that is prepared by the President and submitted to Congress annually. The budget estimate is subject to review and approval by OMB before it is forwarded to Congress as part of the overall budget request of the President. The budget is subject to review and recommendation at several levels, including House and Senate committees and must be adopted by Congress annually. The budget has not kept pace with the growth in the securities market. Presently, in light of the events in the financial markets over the past year, the SEC, the Administration, and U.S. Congress are reexamining the SEC's need for more resources. The SEC chairman, in her recent appropriations testimony, presented the SEC's fiscal 2010 budget request with specific reference to the need for additional resources to match significant growth in the size and complexity of the securities industry, including the BD and IA industries. Statute law and various principles of sovereign and qualified immunity provide significant protection to the SEC, commissioners, and staff. All commissioners, including the chairman are appointed by the President and confirmed by the Senate. The chairman is designated by the President and can be replaced as chairman at any time, but would then complete the remainder of his/her term as a commissioner should he/she choose to do —which seems unlikely. There are no statutory provisions governing removal of a commissioner. However, there is case law regarding independent regulatory agencies that says a commissioner may only be removed for cause. The SEC is subject to the oversight by committees of Congress and the Senate. It also provides information to Congress and the President, including information on pending enforcement matters of interest to Congress or the Executive. The SEC's receipt and use of funds are subject to regular audit by the Government Accountability Office (GAO) and the SEC's OIG. The OIG is an independent office inside the SEC; the Inspector General is appointed by the SEC chair, but can only be removed by Congress. There are 19 staff members. The OIG has investigative powers and staff members are required to cooperate with investigations. The results of these audits are reported to agency management, made available to Congress and the Office of Management and Budget (OMB) and generally are made public on the Internet. The SEC must comply with the APA (see the description above under the CFTC). The securities laws themselves also require the SEC to issue orders in its administrative proceedings. Final orders of the SEC may be appealed to the courts. The agency also has extensive rules of procedure to

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	ensure fairness in the conduct of hearings and other administrative activities.
Assessment	Broadly implemented.
Comments	Both agencies are subject to an annual appropriations process at the legislature. The experience has been that the funding provided to the CFTC and SEC by this process has not been subject to wide fluctuations year to year. However, the funding has not kept pace with the growth in the markets, let alone their increasing complexity. The annual process and resulting lack of assurance of continuing funding prevent the agencies from committing to necessary long-term capital projects, such as building new market surveillance systems to replace the existing outdated systems at the agencies. Both chairmen are on record saying their agencies are underfunded and need more resources to increase staff levels. Each agency is tasked with regulating markets where the technology used by market participants is cutting edge; and products, markets, and trading techniques are changing at an accelerating rate. In this environment, regulators need to have sufficient resources in order to develop and maintain highly sophisticated electronic tools to support their supervisory tasks. One alternative to provide more assurance of longer-term funding would be to consider moving to direct self-funding. It is clear that the revenue generated by SEC routine activities would be sufficient to meet its funding needs. The total fees presently generated from activities such as filings, registrations, etc., at the SEC far exceed the budgets of both agencies.
Principle 3.	The regulator should have adequate powers, proper resources, the capacity to perform its functions, and exercise its powers.
Description	**CFTC** The legal framework for the CFTC provides it with sufficient powers to regulate and supervise the futures market and its participants within the parameters of the CEA as presently written. The CFTC has the power to obtain information regarding regulated markets, institutions, financial products, customers, and parties to transactions. In addition, it has the power to conduct investigations and to sanction violations of the CEA. Administrative sanctions may include orders suspending, denying, revoking, or restricting registration and exchange trading privileges, and imposing civil monetary penalties and orders of restitution. The CFTC has the power to conduct direct surveillance of those markets and financial institutions that fall within its regulatory jurisdiction. The CFTC also can obtain certain information on the affiliates of FCMs, whether those entities are unregulated or subject to regulation by other authorities such as the SEC, the banking regulators, or foreign authorities. The CFTC has the power to direct "registered entities" such as DCMs to alter or supplement their rules and to take such action as it deems to be necessary to maintain or restore orderly trading. The CEA authorizes the CFTC to suspend or revoke the designation of a DCM, DTEF, or derivatives clearing organization (DCO) based on non-compliance with any of the provisions of the CEA, CFTC regulations, or CFTC orders. The CFTC states in its self-assessment that the recent financial crisis has illustrated the need to modernize consumer and investor protection requirements; to expand those requirements to previously unregulated areas; and establish structural mechanisms to ensure that gaps are addressed as soon as new products are developed. Recent draft legislation, such as the "Over the Counter Derivatives Markets Act of 2009" that is based on the White Paper, seeks to close some of those gaps. <u>OTC Derivatives</u>. Under the CEA as presently drafted, the CFTC has no jurisdiction over contracts or transactions in an "excluded commodity" entered into by ECPs ("OTC derivatives"). Excluded commodities consist of interest rates, exchange rates, currencies, securities, security indices, credit risks or measures, and other indices based solely on commodities that have no cash market or on prices, rates, values, or levels that are not within the control of any party to the relevant transaction.

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	In addition, the CEA provides an exclusion from CFTC jurisdiction for electronic trading facilities that execute OTC Derivatives traded on a principal-to-principal basis between ECPs. OTC derivatives based on exempt commodities (e.g., energy, metals, chemicals) are subject to basic anti-fraud and anti-manipulation prohibitions when executed off organized trading facilities, but are not otherwise subject to regulatory oversight. OTC derivatives in exempt commodities that are executed on trading facilities are subject to various CFTC filing and reporting requirements and, when they become significant price discovery contracts (SPDC) as determined by the CFTC following public consultation, are subject to both CFTC regulatory oversight and self-regulatory responsibilities. Strengthening Requirements for Clearing Organizations. The CFTC is pursuing the adoption of stronger and more detailed core principles for DCOs to enhance the CEA regulatory regime for CCPs, and to ensure that U.S. law is consistent with international standards for CCPs. Ensuring Greater Transparency of the Marketplace. The CFTC recently announced several initiatives designed to bring greater transparency to the market regarding participation by non-commercial participants (such as commodity index funds, swaps dealers, and others); positions of traders of contracts determined to perform a significant price discovery function; and positions for contracts listed by foreign boards of trade (FBOTs) that are linked to the settlement price of domestic contracts. Applying Consistent Position Limits. The CFTC recently held public hearings on whether federal speculative limits should be set by the CFTC for commodities of finite supply, particularly energy commodities. The CFTC also recently requested public comment on whether a "bona fide hedge exemption" should continue to apply to persons using the futures markets to hedge risks other than risks arising from the actual use of a commodity and CFTC staff is considering the extent to which swap dealers should continue to be granted exemptions from position limits. Enhancing Conditions for FBOT Trading Linked Energy Contracts. To enhance its ability to conduct market surveillance and to maintain market integrity, the CFTC recently announced additional amendments to the terms under which an FBOT is permitted to make its electronic trading and order matching system available to exchange members in the United States. Strengthening Regulation of Retail Off-exchange Commodity Transactions. The CFTC is working on legislative amendments to extend the commission's anti-fraud authority for off-exchange retail foreign exchange transactions to transactions in other commodities. The CFTC currently employs approximately 580 career staff. This is just under the commission's peak levels in the early 1990s. In the period 1998 to 2008, the agency shrank by approximately 20 percent in head count, while the markets grew five-fold and the number of contracts grew six-fold. Further, the complexity of the market has increased markedly over this period. The budget for this year and next should allow for staff numbers to increase, but additional funds are needed. (See also the discussion of funding under Principle 2.) The complexity of the market imposes significant demands on the regulator to hire, train, and retain staff with a high degree of expertise. The CEA permits the CFTC to provide additional compensation and benefits to employees if the same types of compensation or benefits are provided by another comparable agency; this enables the CFTC to maintain compensation and benefits that are comparable to that paid by other federal financial regulators. Even at the best paid federal regulators, salary levels are far below industry salaries, which make it challenging to attract staff with market experience and to retain skilled staff. There are regular in-house educational/training seminars keyed to the primary mission of the CFTC. Technical and computer skills are also provided to employees as needed. In addition, employees may also use various on-line, web-based, and in-house educational materials to maintain and increase proficiency.

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SEC

The SEC's extensive powers and authorities are delineated in various federal securities statutes and in the rules and regulations that the SEC has adopted under these statutes.

As the SEC staff stated in its self-assessment, the recent financial crisis has illustrated the need to modernize consumer and investor protection requirements, expand those requirements to previously unregulated areas and establish structural mechanisms to ensure that gaps are addressed as soon as new products are developed. Areas identified that need to be addressed include:

OTC Derivatives. The issue and trading of OTC derivatives, such as swap agreements, are largely unregulated in the United States. While this is true in some other developed jurisdictions, the U.S. market for these instruments is significantly larger than elsewhere.

Hedge Funds. Hedge funds are significant participants in the securities markets, both as managers of an estimated US$1.5 trillion in assets and as traders of securities. However, their activities, and the activities of other private investment pools, are largely "below the radar" (as in many other jurisdictions). Under the current regulatory structure, hedge funds usually operate using exemptions from the registration and disclosure requirements of the statutes. As noted in the White Paper, requiring registration with the SEC would allow data to be collected that would permit an informed assessment of how such funds are changing over time and whether any funds have become so large, leveraged or interconnected that they require regulation for financial stability purposes. This registration would promote greater transparency in the markets, improve the ability to deter and detect fraud, and provide better oversight of the hedge fund industry by regulators and the markets.

Municipal Securities. As noted above under Principle 1 and discussed in more detail under Principle 14, there is a gap in the SEC's powers with respect to the direct regulation of disclosure requirements applicable to issues of municipal securities.

BDs vs. IAs. IAs and BDs are regulated by the SEC under different statutory and regulatory frameworks, even though the services they provide may be virtually identical from a retail investor's perspective. Retail investors are confused about the differences between IAs and BDs and the varying legal duties that financial professionals owe investors. The White Paper noted that a consistent standard should apply to any CTA, FCM, IB, BD, or IA that provides similar investment advisory services.

While the SEC's funding has increased in late years, the chair has indicated a need for additional resources to match significant growth in the BD and IA industries. The SEC has some degree of autonomy on reallocating its budget among activities. For major changes consent of the relevant legislative committees is required. Permission to reallocate funds has been granted on request in the past. (See also the discussion of funding under Principle 2.)

The complexity of the market imposes significant demands on the regulator to hire, train, and retain staff with a high degree of expertise. The SEC's ability to attract and retain experienced and skilled staff was significantly improved by the 2002 enactment by Congress of "pay parity" legislation that authorizes the SEC to create a compensation system similar to the systems of other federal financial regulators. As a result of the SEC's new pay system, the staff turnover rate has diminished significantly. At the same time, pay parity has placed pressure on the funding process to obtain the necessary budget increases to match the personnel compensation levels at other federal financial regulators, such as the Federal Reserve. It should be noted that the Federal Reserve is self-funded and not subject to the annual appropriations process. Salary levels even at the best paid federal regulators are far below industry salaries, hampering the ability of the agency to hire personnel with significant industry experience and retain skilled staff.

The SEC training program provides significant training opportunities to all staffs. Several divisions inside the SEC organize their own comprehensive training programs for new and existing staff which are especially designed for their individual needs. Every new employee and commissioner

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	receives education and training on ethics.
Assessment	Partly implemented
Comments	The funding of the CFTC and SEC does not provide sufficient resources to meet the needs of the regulators in supervising markets of the size and complexity of the U.S. markets. Both agencies need more resources—human, informational, and technological—in order to fulfill their present regulatory functions more effectively. Each agency is tasked with regulating markets where the technology used by market participants is cutting edge; and products, markets, and trading techniques are changing at an accelerating rate. In this environment, regulators need to have sufficient resources in order to develop and maintain highly sophisticated electronic tools to support their supervisory tasks. The expansion of responsibilities contemplated in the White Paper and reform legislation will result in even greater funding needs. (See also the comments under Principle 2 regarding the need for assured longer term funding and the discussion under Principles 10, 17, and 21 regarding the resource needs of the examination programs.) While pay parity with other federal financial institution regulators has improved the ability of the CFTC and SEC to hire and keep skilled staff, the agencies still cannot compete with industry compensation levels. Consideration should be given to ensuring the agencies have sufficient compensation flexibility to attract and retain employees with the specialized skills and experience needed. The CFTC and SEC have extensive powers within the scope of authority currently granted to the agencies by the statutes under which they operate. However, as noted in Principles 1, 2, 14, and elsewhere in this assessment, there are gaps in that authority that is of concern—both between the agencies and within the ambit of responsibility of each. Both agencies identified several areas of concern in their self-assessments and the Joint Report and made recommendations in the latter to address the issues. The White Paper and the proposed regulatory reform legislation also will provide additional authority to the agencies. Given the size, complexity, and importance of the U.S. capital markets, it is important that these gaps be addressed promptly. The complexity of the market demands expertise and drives a tendency for specialization. This was particularly evident among SEC staff, which showed a very high degree of specialization. However, care needs to be exercised to ensure the resulting "silos" of expertise do not limit the ability to see the bigger picture when analyzing problems and developing policy responses. It also demands strong management controls to overcome fragmented organizational structures to ensure the public interest is served. It was not clear that the required level of controls were in place at the SEC to manage these issues effectively. The SEC's ability to make policy determinations would be enhanced by a greater use of its authority to request raw data and to develop empirical analysis based on this data rather than relying on data generated and processed by exchanges, SROs, and others.
Principle 4.	The regulator should adopt clear and consistent regulatory processes.
Description	Overall, the CFTC and the SEC work under a high degree of transparency. **CFTC** The law provides various procedural rules for disciplinary proceedings and the reparations program, among other matters. The CFTC has implemented the laws that require open meetings of the commission. The CFTC also has adopted regulations to provide objective due process procedures to ensure that its programs are conducted with fairness and impartiality. The general criteria for granting, denying or revoking a license are contained in the CEA and the CFTC regulations and so are public. Those affected by the licensing process are entitled to a hearing with respect to the regulator's decision to grant, deny, or revoke a license and the decision may be

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appealed to the courts.

CFTC rulemaking must comply with the procedural requirements of the APA, which generally require the CFTC to publish a notice of Proposed Rulemaking and provide interested persons with an opportunity to participate in the rulemaking through submission of written data, views or arguments. The CFTC sometimes holds an open forum to permit the public to give its views on proposed rules of particular significance. The APA requires an agency to give its rationale and policy purpose in proposing or adopting a rule. In addition, the CFTC generally articulates the rationale for all interpretations, exemptions, orders or policy changes.

Before an agency rule can take effect, federal agencies must submit to each House of Congress and to the Comptroller General a report containing a copy of the rule, a concise statement relating to the rule (including a cost-benefit analysis and whether it is a major rule) and the proposed effective date.

The CFTC has created various advisory committees as a mechanism for public consultation with interested members of the commodities industry and users of the futures markets. The CFTC also holds informal roundtables and formal public hearings on issues from time to time.

All CFTC regulations are published in the U.S. Code of Federal Regulations and are available at the CFTC's website.

CFTC regulations provide that the CFTC may decline to publish or make available to the public any "non-public" record. In general, this type of information concerns trade secrets, national defence or foreign policy concerns, personal privacy, various financial statement forms and pending investigations. In addition, CFTC regulations outline the procedures by which a person submitting information to the CFTC may request confidential treatment of that information. CFTC rules implement the Privacy Act, which provides protections for information concerning an individual.

The CFTC website provides information about the regulatory mandate of the CFTC, the economic role of the futures markets, new market instruments, market regulation, international regulatory developments and cooperative initiatives, enforcement actions, customer protection issues and the diverse functions of the CFTC. In addition to issuing press releases and advisories covering the CFTC's regulatory and enforcement activities, the CFTC's web site provides an Education Center that highlights and explains important policy issues and initiatives and salient aspects of the CFTC's regulatory mandate.

The CFTC publishes brochures and educational materials about the CFTC, the futures industry and the futures and commodity option markets. The CFTC conducts research and publishes reports from time to time on major policy issues facing the futures markets.

SEC

Under the Freedom of Information Act (FOIA) all agencies, including the SEC, are required to: (1) publish certain types of information in the Federal Register, such as procedural rules and substantive rules of general applicability; (2) make available for public inspection and copying other types of information such as adjudicative opinions and staff manuals; and (3) make available to the public other types of information upon specific request for that information.

The U.S. Constitution requires administrative agencies like the SEC to conduct their proceedings with due process. All final SEC rules are accompanied by a release that is published in the Federal Register, with an explanation of the reasons for adoption and responses to the more salient issues raised in the comment letters.

The SEC also occasionally provides guidance on topics of general interest to the business and investment communities by issuing "interpretive" releases, in which the SEC publishes its views and interprets the federal securities laws and SEC regulations. These interpretations are disclosed to the public via the SEC website and the Federal Register and, in some instances, may include a

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	request for comment. As is required for the CFTC, the law provides that most meetings of the SEC must be open to the public and requires the SEC to provide advance notices of such meetings. The SEC videocasts all open SEC meetings on the Internet. The SEC is subject to similar requirements under the APA as is the CFTC regarding rule-making. The SEC hosts public roundtables to which experts are invited to share their views with the SEC and the public about approaches to certain issues affecting the securities markets. Finally, the SEC has created and utilized various federal advisory committees. The SEC considers the costs of compliance of all rules it adopts, both when the rule is proposed and when the rule is adopted. The SEC is subject to both statutory provisions and its own rules that are intended to ensure the fairness of its processes. For example, the SEC is subject to restrictions relating to ex parte contacts and is required to maintain a separation of certain functions under both the APA and its own rules. The SEC is required to give written reasons for its decisions that affect the rights and interests of others. These decisions must include a statement of findings and conclusions and the reasons or basis for such, on all material issues of fact, law or discretion that are presented on the record. The SEC's criteria and application processes for registration of various entities and products are made public under SEC rules and regulations. Affected persons are entitled to hearings. Both the Exchange Act and Advisers Act contain statutory provisions that are designed to safeguard the confidentiality of information obtained in the course of examinations or investigations. The SEC also has adopted rules under the Exchange Act to permit confidential treatment of requests for certain information. The Privacy Act provides procedures for agencies when they obtain, maintain and disseminate personal information concerning members of the public. It requires that the SEC make certain disclosures to any individual from whom the SEC requests or seeks to compel information and that the SEC maintain a record of information released to persons outside the SEC. The Privacy Act generally forbids disclosure of information concerning an individual, subject to several important exceptions. The SEC plays an active role in investor education. Its investor education programs includes producing and distributing educational materials; participating in educational seminars and investor-oriented events; and partnering with federal agencies, state regulators, consumer groups, industry associations and others on financial literacy initiatives.
Assessment	Fully implemented.
Comments	While publishing its enforcement manual on the SEC website may enhance the transparency of the agency and its procedures, there is some risk that it might compromise the effective implementation of the enforcement program.
Principle 5.	The staff of the regulator should observe the highest professional standards including appropriate standards of confidentiality.
Description	CFTC members and staff of the CFTC and the SEC are subject to a code of ethics and professional conduct requirements which deal with issues of integrity, procedural fairness, and prevention of conflict and confidentiality. **CFTC** CFTC Commissioners and employees fall under the jurisdiction of several sets of ethical standards. Each of these establish that public service is a public trust and that all government employees must avoid both explicit conflicts of interests as well as even the appearance of impropriety in the conduct of their official business. Regulations issued by the U.S. Office of Government Ethics apply to CFTC employees and set

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	basic obligations concerning gifts from outside sources, gifts between employees, conflicting financial interests, impartiality in performing official duties, seeking other employment, misuse of position, and outside activities. In addition, an Executive Order of the President mandates high principles of ethical conduct for government employees. Additionally, the CFTC has adopted specific standards of conduct for commissioners and employees, including restrictions on business and financial transactions and interests; restrictions concerning the receipt and disposition of foreign gifts and decorations; prohibitions on the disclosure of non-public commercial, economic, or official information to any unauthorized person; and restrictions of the ability of former CFTC employees to practice or otherwise represent a person before the CFTC. CFTC regulations generally provide that no member or employee of the CFTC may participate directly or indirectly in any transaction involving commodity futures and commodity options. It is a felony for a CFTC employee or commissioner to pass on or benefit from information received in the course of employment which may affect or tend to affect the price of commodities. The CEA prohibits the CFTC from publicly disclosing information that would separately disclose the business transactions or market positions of any person and trade secrets, or names of customers. CFTC rules contain recordkeeping and access requirements, including requirements governing the handling and protection of non-public information. The CEA makes it a felony punishable by a fine of up to US$500,000 or imprisonment for up to five years, or both, for a CFTC employee or commissioner to trade commodity futures and options, or to participate directly or indirectly in any investment transaction in an actual commodity if non-public information is used in the transaction or if prohibited by CFTC regulations. The CFTC has adopted rules of procedure addressing many aspects of the CFTC's program, as for example, procedural regulations relating to the review of exchange disciplinary, access denial or other adverse actions; regulations of practice that are generally applicable to adjudicatory proceedings before the CFTC under the CEA; regulations specifying the conditions for conduct of CFTC business, with a presumption of open CFTC meetings; and procedures applicable to the review of NFA decisions etc. **SEC** All staff, including commissioners, is subject to the criminal law conflict of interest statutes which prohibit them from participating personally and substantially in particular matters that would have a direct and predictable effect on their financial interests or one that is imputed to them. This statute has been implemented and supplemented by regulations issued by the U.S. Office of Government Ethics. In addition the rules applying to all governmental agencies, all SEC employees and commissioners must follow the SEC's Standards of Ethical Conduct, which is enforced by the SEC's Ethics Office. Various divisions have implemented ethics guidelines specific to the special nature of their programs (e.g., enforcement and examinations). Unlike the CFTC, SEC staff is allowed to trade in securities subject to the agency's jurisdiction but they have to comply with comprehensive rules regarding their securities holdings and transactions which were recently—after some irregularities—enhanced. These rules apply to staff, commissioners, and any of their spouses, dependent children, or other persons residing in the same household who are related to the employee by blood or marriage. The regulation also prohibits the misuse of non-public information and the purchase of a security of an issuer that the employee knows to be involved in SEC litigation or investigation. To bolster these requirements, the SEC now requires employees to certify in writing before any trade that they do not possess any non-public information about the company being traded. The SEC's regulation requires the reporting of securities transactions within five days of the receipt of the confirmation of the trade. In addition to this regulation, certain other employees are subject to government-wide financial disclosure rules.

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	Employees who have the greatest risk of creating harm by misusing information or having conflicts of interest must file a confidential financial disclosure form annually. The SEC's Conduct Regulation prohibits the unauthorized disclosure of confidential and non-public information. Violations of the conflict of interest restrictions may be enforced either civilly or criminally. Violations of administrative rules can result in disciplinary action including discharge. Officers and employees of the SEC are prohibited from making confidential information or documents or any other non-public record of the SEC available to anyone outside the SEC. This includes information received from foreign regulators. SEC officers or employees who fail to comply with SEC regulations may, upon conviction, be fined up to US$1 million and/or imprisoned for a period not exceeding ten years. The government ethical standards require impartiality in the performance of official duties. In addition, the SEC's Rules of Practice establish standards of procedural fairness. An additional protection of procedural fairness may be found in other SEC codes. The Congressional review process for final SEC rules is set out in legislation and has safeguards designed to protect the integrity of the process.
Assessment	Fully implemented.
Comments	
Principles of Self-Regulation	
Principle 6.	The regulatory regime should make appropriate use of SROs that exercise some direct oversight responsibility for their respective areas of competence and to the extent appropriate to the size and complexity of the markets.
Description	The effectiveness of the regulatory regime is to a large degree dependent on the skills and resources of the SROs. **CFTC** There are several categories of organizations authorized by the CFTC which have self-regulatory responsibilities: futures exchanges or DCMs, DCOs, and the NFA as a Registered Futures Association (RFA). In order to trade futures contracts (the regulated activity), a market must be designated as a "contract market" under the CEA. A DCM designs the terms and conditions of futures contracts (consistent with CFTC Guideline 1) and determines the mechanism and terms of trading and execution, as well as which DCO would provide clearing and settlement services. It must also carry out surveillance of the operation of its market. There are currently 15 DCMs though the number is growing as new DCMs are being set up. With one exception, DCOs are owned by or are affiliates of DCMs. Ninety percent of derivatives contracts are cleared though one DCO, which is part of the CME. The NFA is the only existing RFA. The CEA provides that the CFTC may approve rules that require persons eligible for membership to become members of at least one registered futures association. Under CFTC regulations, all FCMs which are the type of financial intermediary for U.S. commodity futures transactions that are permitted to hold customer funds, are required to be members of the NFA. The CFTC has delegated the registration functions for all commodity futures intermediaries to the NFA on behalf of the CFTC. Under CFTC regulations, examination and monitoring of members' compliance with financial and reporting requirements may be performed under agreement between SROs to reduce multiple monitoring and auditing for compliance. The CEA provides Designation Criteria for DCMs, including that such a contract market establish trading rules, discipline violators, and ensure the financial integrity of transactions and member intermediaries. Through the Joint Audit Agreement, DCMs and the NFA divide up primary SRO responsibility for monitoring the financial condition and rule compliance of joint members.

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	SEC The regulatory system makes extensive use of SROs as required by the Exchange Act. By law, national securities exchanges (exchange) and registered securities associations (RSA) are self-regulatory organizations. The principal function of an association is regulating its members through a continuous program of rulemaking and interpretation, surveillance and enforcement of the applicable federal securities laws, and its own ethical standards through its disciplinary process. In a process similar to that applied to national securities exchanges, the SEC evaluates the self-regulatory authority of an association in determining whether the association and through the association its members, are fulfilling their statutory and regulatory obligations. FINRA is currently the only RSA. There are 20 other SROs, including 3 clearing agencies and the MSRB. The number is growing because of the creation of new national securities exchanges. Some are also coming together in groups to organize their regulatory functions collectively. Generally, a BD generally must register with the SEC and become a member of at least one SRO which can be a national securities exchange or FINRA. FINRA is the result of the consolidation of the member firm regulatory functions of the New York Stock Exchange (NYSE) and National Association of Securities Dealers (NASD). With limited exceptions, FINRA is responsible for regulating all securities firms that do business with the public, including with respect to professional training, testing and licensing of registered persons, arbitration, and mediation. BDs that do business with the public must be members of FINRA unless they limit their transactions to securities traded on an exchange of which they are a member or unless they limit their business to one state. BD registrations with the SEC, states, and FINRA are maintained on a central data base operated by FINRA.
Assessment	Fully implemented.
Comments	IOSCO has indicated that there are no criteria for this Principle. Assessment is subsumed within the assessment of Principle 7.
Principle 7.	SROs should be subject to the oversight of the regulator and should observe standards of fairness and confidentiality when exercising powers and delegated responsibilities.
Description	The SEC and CFTC employ structurally different regimes to register and oversee exchanges. The SEC uses a traditional “rules-based” approach; the CFTC uses a “principles-based” approach. **CFTC** An applicant for registration as an exchange (DCM) must demonstrate that it complies with 8 Designation Criteria and 18 Core Principles set out in the CEA. DCM Designation Criterion 1 requires a DCM to demonstrate to the CFTC that the DCM meets initially and on an on-going basis the Designation Criteria and the Core Principles. A DCM must establish and enforce rules defining the manner of operations of the trade execution facility maintained by the DCM and demonstrate that the trade execution facility operates in accordance with the rules of the DCM. The eight Designation Criteria cover the range of standards required of an SRO by the IOSCO Principles, including prohibiting market manipulation; promoting fair and equitable trading; enforcement of its rules and the law; ensuring the financial integrity of transactions; and establishing appropriate disciplinary mechanism including fairness. The 18 Core Principles, with which a DCM must comply on a continuing basis, cover similar ground and also deal with other matters such as conflicts of interest; the governance of mutually owned exchanges and dispute resolution; and other futures exchange specific matters as discussed under Principles 25 and 26. The CFTC has provided additional information and guidance to applicants on how DCMs can remain in compliance with the Core Principles and Designation Criteria. An RFA application is processed in a traditional rules-based approach. The requirements largely replicate those applied to DCMs, with the exception of the exchange specific requirements. The

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	CEA provides for less flexibility as to how an RFA meets the requirements. The CEA requires that the prospective RFA demonstrate that the rules of the association provide that its members and persons associated with its members shall be appropriately disciplined, by expulsion, suspension, fine, censure, being suspended, or barred from being associated with all members, or any other fitting penalty, for any violation of its rules. Following review, the CFTC may by order grant the registration if the requirements are satisfied or, after appropriate notice and opportunity to be heard, deny such registration if the application is deficient. The designation process for a DCO is described in Principle 29. Unlike the SEC, the CFTC has delegated to the registered association, in this case NFA, responsibility for processing and granting applications for registration of various categories of registrants under the CEA. The NFA has adopted the CFTC's standards defining the scope of evidence that may be presented by the applicant or registrant to challenge allegations of statutory disqualification, as well as the standards to be followed by the party reviewing the matter and making determinations. Wherever NFA has modified those procedures, the CFTC's review concluded that the modifications would not adversely affect the rights of applicants and registrants. The CFTC requires RFAs to demonstrate a capability to promulgate rules and conduct proceedings which provide a fair, equitable, and expeditious procedure, through arbitration or otherwise, for the voluntary settlement of customers' claims or grievances brought against any member of the association or any of their employees. A prospective RFA must demonstrate that its rules assure a fair representation of its members in the adoption of any rule of the association or amendment thereto, the selection of its officers and directors, and in all other phases of the administration of its affairs. In addition, various CFTC regulations impose standards of procedural fairness on SRO programs. DCMs are required to monitor and enforce compliance with the rules of the contract market, including the terms and conditions of any contracts to be traded and any limitations on access to the contract market. A DCM must have arrangements, resources, and authority for effective rule enforcement. DCMs are required to establish and enforce rules to protect market participants from abusive practices committed by any party acting as an agent for the participants. DCMs should have rules prohibiting conduct by intermediaries that is fraudulent, non-competitive, unfair, or an abusive practice in connection with the execution of trades; and a program to detect and discipline such behavior. DCMs should have methods and resources appropriate to the nature of the trading system and the structure of the market to detect trade practice abuses. SROs are required to maintain the confidentiality of material non-public information and information obtained from the CFTC in connection with the exercise of their self-regulatory responsibilities. They must provide for appropriate limitations on the use or disclosure of material non-public information gained through the performance of official duties by board members, committee members, and contract market employees; or gained through an ownership interest in the contract market. Criminal sanctions can apply for certain breaches of the confidentiality requirements set out in the CEA. A DCM is required to establish and enforce rules to minimize conflicts of interest in the decision making process of the contract market and establish a process for resolving such conflicts of interest. The CFTC has provided guidance on how to comply. The CFTC ensures compliance by NFA with its self-regulatory obligations and DCMs with Core Principles, by conducting periodic reviews of NFA's compliance programs and Core Principle oversight reviews of DCMs. NFA oversight reviews focus on the specific program responsibilities of NFA, including review of the financial and sales practice compliance programs for FCMs, IBs, CPOs, and CTAs, as well as review of NFA's programs for arbitration, registration and fitness, and

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disciplinary actions. The CFTC's audit and review of DCMs also encompass the market surveillance, audit trail, and trade practice surveillance functions. The CFTC provides the SROs with minimum standards for carrying out their surveillance of compliance by FCMs with applicable financial and related reporting requirements.

CFTC staff conducts on-site inspections, meets with NFA or DCM staff, and reviews program materials and databases, evaluates procedures and performs reviews of samples of NFA's or the DCM's files to determine whether the SRO's procedures are consistent with its regulatory obligations; whether the SRO has properly executed its program; and that the files contain sufficient documentation. The results of these reviews are presented to the CFTC and reported back to NFA or the DCM. Every two to three years, the CFTC's Division of Market Oversight (DMO) conducts a review of a DCM's ongoing compliance with Core Principles through the self-regulatory programs operated by the exchange in order to enforce its rules, prevent market manipulation, customer and market abuses, and ensure the recording and safe storage of trade information. Upon completion of a review, a report is issued and submitted to the CFTC for approval for issuance to the SRO. These reports also are made available to the public, which provides an opportunity for external comment on the findings, critical or otherwise.

The CFTC examines FCMs to ensure that DSROs are carrying out their member regulation responsibilities and also examines FCMs for its own purposes and not necessarily just "for cause." The CFTC is authorized to abrogate any rule of the NFA if it appears to the CFTC that such abrogation is necessary or appropriate to assure fair dealing by the members of the association, to assure a fair representation of its members in the administration of its affairs, or to effectuate the purposes of the CEA. The CFTC also may alter or supplement NFA rules after notice and hearing. The CEA provides that the CFTC may suspend the registration of the NFA if it finds that the rules thereof do not conform to the requirements of the CFTC.

SEC

A national securities exchange, national securities association, and clearing agency must be registered with and have its rules reviewed by the SEC for compliance with the Exchange Act. The test is whether the entity is organized and has the capacity to carry out the purposes of the act. An SRO also must be able to enforce compliance with the act, the rules and regulations thereunder, and the SRO's own rules by its members and their associated persons. The SEC evaluates whether applicants for registration as a national securities exchange or an association which operates a market have adequate computer system capacity, integrity, and security to support the operation of the exchange.

An SRO may deny membership to a BD or bar from association with a member a natural person who is subject to a "statutory disqualification." The rules must not permit unfair discrimination between customers, issuers, and BDs or impose any burden on competition that is not necessary or appropriate in furtherance of the purposes of the act. Clearing agencies also may not permit unfair discrimination in the admission of participants or among participants in the use of the clearing agency.

Further, an exchange or association may deny membership to a BD that does not meet financial responsibility or operational capability standards, or that does not have the minimum level of training, experience, or competence prescribed by the exchange's rules. In addition, an exchange or association may deny membership to a BD that has engaged or is likely to engage in acts or practices that are inconsistent with just and equitable principles of trade.

The act requires that the rules of an exchange, association, and clearing agency must provide for a fair procedure for disciplining members and persons associated with members, denying membership and prohibiting or limiting access to services, and for exchange and associations barring persons from being associated with members.

SROs are required to have implemented measures to ensure that information obtained during the

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	course of carrying out SRO regulatory functions is not misused. These measures include internal policies or rules regarding ethical conduct on the part of staff, the preservation of the confidentiality of information that is not public, and prohibitions on the use of such information for personal benefit. The SEC reviews SRO rules and other proposals and examines SRO operations to evaluate any potential harmful impact that conflicts of interest may have on the effective oversight of the securities markets. In particular, the SEC reviews an SRO's ownership and regulatory structure and any proposed changes, with the objective of identifying conflicts of interest that the SRO may have between regulating its members and operating its business. The SEC has also taken steps to ensure that the SEC has effective tools to oversee an exchange that is controlled by an entity not fully subject to its jurisdiction. The designation process for a clearing agency is described in Principle 29. The SEC reviews all prospective exchange, association, MSRB, and clearing agency rules to evaluate whether the mandated standards have been met. Under the act, an SRO must file any proposed rule changes, additions, or deletions with the SEC. Once filed, the SEC must publish a notice of the filing in the Federal Register and give the public an opportunity to submit comments on the proposal. The SEC must approve a proposed rule change if it finds that the proposed rule change is consistent with the requirements of the Exchange Act. As part of the registration process, securities professionals who work for BDs (including prospective officers of the firm and other management and supervisory personnel involved in the day-to-day operation of the firm's investment banking or securities business) must pass an examination administered by FINRA to demonstrate competence in the areas in which they will work. These mandatory qualification examinations cover a broad range of subjects on the markets. The rules of an exchange, association, or clearing agency must provide for a fair procedure for disciplining members and persons associated with members, denying membership, barring persons from being associated with members, and prohibiting or limiting access to services offered by the exchange or its members. If the SEC finds that an exchange, association, or clearing agency has failed, without reasonable justification or excuse, to enforce compliance with any such provision by a member or person associated with a member, it may impose sanctions against the SRO including suspension, revocation, censure, and limitation of activities. If an SRO fails to take appropriate disciplinary action against a member, the SEC has its own authority to take action against such member under the Exchange Act, Advisers Act, and the ICA. As regards the governance of SROs, the Exchange Act requires that the rules of an SRO must ensure fair representation of members in the selection of the SRO's directors and the administration of its affairs. One or more directors of an exchange must be representative of issuers and investors and not associated with a member of the exchange. In order to satisfy itself that an SRO is in compliance with the obligations and responsibilities set out above, the SEC has a surveillance, examination, and enforcement program to oversee the activities of the SROs, including exchanges, associations, and clearing agencies. SEC staff conducts periodic inspections of the SROs to evaluate whether they and their members comply with applicable federal securities laws and SRO rules. These inspections focus on the SRO's regulatory programs, including: market surveillance, investigative and disciplinary programs, member examination programs, and listing and arbitration programs, among others. In practice, at least one themed inspection generally is underway at any point in time. Staff also examines an SRO's disciplinary actions against members and denials of membership in, or access to, the SRO. The SEC examines BDs to ensure that SROs are carrying out their member regulation responsibilities and also examines BDs for its own purposes and not necessarily just "for cause." The SEC has recently introduced more rigorous processes to prevent examinations remaining open

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	for excessive periods without good cause and to provide BDs with better and timelier feedback. **Outsourcing** Under the CEA, a DCM may comply with any applicable Core Principle through delegation of any relevant function to the NFA or another DCM or DCO. The CFTC also permits DCMs to meet their self-regulatory obligations by using persons under contract to perform specified duties subject to the DCM "maintaining a sufficient degree of control over the persons under contract" and the "person under contract having no conflict of interest." In both cases, the DCM remains responsible for the performance of its obligations under the CEA and is overseen by the CFTC accordingly. The SEC oversees arrangements between SROs whereby responsibilities are allocated between them. These arrangements may take two forms. In the first, the delegating SRO remains responsible for meeting its regulatory obligations under the Exchange Act. In the second and subject to SEC approval, the obligations can be transferred to the second SRO. Currently, there are no third parties other than SROs performing regulatory services.
Assessment	Broadly implemented.
Comments	There are marked differences in the powers that the SEC and CFTC can exercise over SROs that are exchanges. The Joint Report published on October 16, 2009 highlighted differing authority regarding new product approval and the procedures for reviewing and approving the rules of exchange SROs. • New derivatives products listed on a securities exchange that are novel and therefore do not fit within existing listing standards must be approved in advance by the SEC. Trading rules must be pre-approved. The SEC reviews the proposal against the Exchange Act and the regulations and must take account of the views of respondents to the mandatory public consultation process. Absent a positive finding, a rule is not approved. • The CFTC has more limited authority. The CEA generally allows for the introduction of new products or changes in trading rules by a self certification process whereby the DCM files a notice with the CFTC containing an assertion that the product or change does not violate the CEA or CFTC regulation. Notification to the CFTC can be as short as the day before the product is introduced or the rule is changed. Although the CFTC reviews all new products and rules after the fact, its power to delist or require a rule to be amended is dependent on the CFTC determining that the implemented rule or newly introduced product violates the CEA. The Joint Report has identified this as one area of deficiency in the CFTC's powers and has recommended that the CEA be amended to provide the CFTC with a power equivalent to that of the SEC for rule changes; extend (from 1 day to 10, or possibly to 90 days) the advance notice requirement for new or amended rules and products; and provide the CFTC with clear authority to bring an enforcement action against an exchange (or clearing organization) for violation of a Core Principle. Self certification was introduced by Congress in the CFMA in recognition of the need to enable the futures exchanges to act quickly to benefit from their innovative endeavors in a competitive market. In the view of the assessors, implementation of the Joint Report's recommendations, while necessary, will need careful delineation to preserve this ability. There were some comments from industry participants that inflexible prior approval of rules can sometimes be used to avoid taking a decision on a politically or commercially sensitive issue or one on which the staff of the regulator are unwilling to admit that that they do not have the expertise to analyze properly. IOSCO Principle 7 accommodates a broad spectrum in the balance of power between a statutory regulator and an SRO. For example, prior approval of rules and rule changes is not mandatory, subject to the regulator determining that it is not necessary. The CFTC lacks this power as regards new products and associated rule changes. In addition, the CFTC is unable to require public comment in advance of an exchange's introduction of new products and trading rules unless the Commission stays a rule's effectiveness. IOSCO's Principles Methodology also notes that in the

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	case of for-profit demutualized exchanges (as is typical in the United States for both securities and futures markets), there may be increased concern regarding conflicts of interest and inappropriate use of self-regulatory resources which call for enhanced powers of oversight by the regulator. Futures exchanges (including the exchange with a 90 percent plus market share) have retained regulatory responsibility for all aspects of their members' conduct. There are industry concerns that a demutualized exchange will abuse its powers over members to restrain dissent over important structural or other changes, which will have a negative effect on the interests of a particular member or a group of members. However, the CFTC thoroughly examined and reviewed this issue as part of a study that commenced in 2003 and culminated in 2009 with the adoption of acceptable practices for Core Principle 15 (which requires that exchanges adopt and enforce rules to minimize conflicts of interest in the decision-making process). The review included extensive public consultation. The adopted acceptable practices recognize exchanges' unique public interest responsibilities as SROs and remind all exchanges that they bear special responsibility to regulate effectively, impartially and with due consideration of the public interest. The acceptable practices include instituting boards of directors composed of at least 35 percent public directors and establishing oversight of all regulatory functions through regulatory oversight committees consisting exclusively of public directors. The acceptable practices also set forth minimum disciplinary panel composition standards to include at least one public person and define the term "public director." In the equity markets in contrast, the association (FINRA) has taken over the work of supervising BDs almost entirely, with the merger of NASD Regulation and NYSE member regulation activities (with NYSE Euronext retaining only market regulation and the listing function), which provides for full independence of the self regulatory function. Differences also exist in the licensing of BDs and FCMs. BDs must register with the SEC and then must join an SRO, which must be FINRA if they do business with the public. In the case of FCMs and others in the futures business, the CFTC has delegated the registration function in its entirety to NFA and then monitors NFA to satisfy itself that the NFA is meeting its responsibilities under the CEA. This would appear to be a more efficient approach which the SEC might wish to consider.
Principles for the Enforcement of Securities Regulation	
Principle 8.	The regulator should have comprehensive inspection, investigation, and surveillance powers.
Description	The CFTC and the SEC have comprehensive inspection, investigation, and surveillance powers. **CFTC** The CFTC has access to records, including non-public and public information, held by individuals and entities regulated by the CFTC (FCMs, floor brokers, floor traders, IBs, CTAs, CPOs, associated persons, and exchanges) including information about customers and persons that do business with regulated individuals and entities. The CFTC has access to these records using its inspection powers. No judicial action or suspected misconduct is required. The CFTC conducts a market surveillance program to detect and prevent price manipulation in futures and commodity option markets. The principal goals of market surveillance are to spot adverse situations in these markets and to pursue appropriate remedial actions, in coordination with the exchange, to avoid market disruption. The heart of the CFTC's market surveillance system (and also as an important component of its financial surveillance system) is the large-trader reporting system. In order to identify potentially disruptive futures positions, staff uses the reporting system to collect and analyze data on large trader positions in all commodities. Reportable positions—daily reports of futures positions above specified reporting levels—are obtained from FCMs, clearing members, and foreign brokers. CFTC regulations and NFA rules also impose comprehensive record creation, retention, and

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reporting requirements to ensure that all transactions in futures and options can be reliably documented and reconstructed and are readily available to investigating authorities without prior notice. All books and records required to be kept must be retained for five years and must be "readily accessible" during the first two years of that period. In addition, the CFTC can obtain information from certain ECMs.

Registrants must keep a record of the identity of the owners, controllers, and principals of accounts carried by or introduced to or by them. Principals of registered intermediaries, defined as each person who is a holder or beneficial owner of 10 percent or more of the outstanding shares of any class of stock, or has contributed 10 percent or more of the capital of the entity, must provide the CFTC with identifying information. Moreover, CTAs and CPOs must provide the CFTC with names and addresses of all partners, officers, directors, and persons performing similar functions.

The CFTC has delegated both inspections and enforcement functions to the SROs. (See the descriptions of these SROs in Principle 7.) However, the CFTC has full access to information concerning the SROs, and the SROs are subject to confidentiality provisions.

SEC

The SEC has sufficient legal powers to conduct surveillance, undertake examinations, inspections and investigations, obtain information, and take enforcement actions. In particular, the SEC can:

a. conduct on-site inspections of all entities registered with the SEC ("registrants"), including books and records, without prior notice;
b. obtain books and records and request data for information without the need for a judicial action even in the absence of suspected misconduct; and
c. supervise exchanges and regulated trading systems, even if the frontline responsibility for overseeing daily trading activities and regulatory compliance on the exchanges lies with SROs.

SROs have market surveillance responsibilities and have primary surveillance authority over their marketplaces. Under the Exchange Act, SROs are obliged to comply with the act and the rules and regulations thereunder, as well as the SRO's own rules.

All entities regulated by the SEC are subject to books and recordkeeping obligations, both by statute (Exchange Act, ICA, and Advisers Act), the SEC's and SRO's rules. In general, the books and recordkeeping obligations require these entities to keep the documents for the period specified by applicable SEC rules. The maintained documents permit tracing of funds and securities in and out of brokerage and bank accounts related to securities transactions. The SEC has authority to pursue violations of the record keeping and record retention requirements via enforcement action.

All registrants are required to maintain certain records concerning client identity under the Bank Secrecy Act (BSA). The U.S.A. Patriot Act requires financial institutions to establish written customer identification programs (CIP). SEC-registered IAs are not subject to the CIP obligation. However, under the Advisers Act, an IA must maintain certain records that, as a practical matter, include the identities of its clients. The Advisers Act permits IAs to maintain the confidentiality of the identity of their clients: even during examinations by SEC staff, the IA does not have to reveal client identities. However, the SEC has the authority under various statutes and rules to determine or access the identity of all customers of registrants, such as those rules requiring registered entities to maintain specified books and records and the SEC's statutory authority to examine such books and records. The SEC may bring enforcement actions for violations of certain reporting, record keeping and record retention requirements promulgated under the BSA, including those that relate to a BD's CIP.

The SEC conducts inspections of SROs to assess their compliance with federal securities laws, rules and regulations and to evaluate the SRO's programs for overseeing, enforcing and disciplining its members for compliance with federal requirements and the SRO's own rules. The Exchange Act requires that SROs, upon request of any representative of the SEC, promptly furnish

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	to such representative copies of any documents the SRO makes or receives in the course of its self-regulatory activity. The SEC can issue an inspection report to the SRO noting the deficiencies and recommending that the SRO take corrective action. The SRO must submit a written response describing the corrective measures it plans to implement with respect to each deficiency noted in the inspection report. In some cases, an SRO may enter into a Regulatory Services Agreement with a registered third-party SRO whereby the third-party SRO agrees to perform certain regulatory obligations of the procuring SRO. In such cases, the procuring SRO remains responsible for meeting its regulatory obligations under the Exchange Act. As such, the SEC conducts inspections that focus on the procuring SRO to ensure that it is appropriately overseeing compliance for all activities on its exchange, including those activities directly monitored by the third-party SRO under the Regulatory Services Agreement, as well as inspections that focus on the third-party SRO to ensure that it is appropriately administering its contracted regulatory obligations. The SEC can also cause changes/improvements to be made in SRO processes by using its authority to review SRO rule-change filings under the Exchange Act and SEC rules. The SEC may bring an enforcement action against an SRO for failure to act or adequately perform required functions.
Assessment	Fully implemented.
Comments	
Principle 9.	The regulator should have comprehensive enforcement powers.
Description	The CFTC and the SEC have comprehensive enforcement powers. Both have quasi-criminal authority. **CFTC** Under the CEA, the CFTC has comprehensive power to conduct investigations to ensure compliance with laws and regulations. The CFTC can administer oaths and affirmations, subpoena witnesses, compel their attendance, take evidence, and require the production of any books, papers, correspondence, memoranda, or other records that the CFTC deems relevant or material to the inquiry. If an individual or firm named in a subpoena refuses to comply with its terms, the CFTC may apply to a federal district court to enforce the subpoena. The CFTC has the authority to file a civil enforcement action in federal district court or an administrative enforcement proceeding in an administrative tribunal to ensure compliance with the CEA. The CFTC has the power to seek: a. preliminary and permanent injunctions barring future violations of the CEA and CFTC regulations; b. an *ex parte* order (i) prohibiting any person from destroying, altering or disposing of, or refusing to permit authorized representatives of the CFTC to inspect any books and records or other documents; (ii) prohibiting any person from withdrawing, transferring, removing, dissipating or disposing of any funds, assets or other property; or (iii) appointing a temporary receiver to administer such restraining order; c. the imposition of civil penalties; d. the appointment of a permanent receiver to administer a person's estate; e. an order directing that a person disgorges ill-gotten gains; f. an order directing that a person makes restitution to customers; g. an order rescinding contracts entered into by a person with a customer; h. an order directing that the person makes an accounting of the person's estate; and i. an award of pre-judgment interest on any sums to be disgorged or paid in restitution. <u>Sanctions</u>: All administrative complaints contain notice of the possible sanctions that may be imposed if liability is found. The following sanctions are available in administrative actions: a. an order prohibiting a person from trading on or subject to the rules of any contract market and requiring all contract markets to refuse such person all trading privileges for a period specified in the order;

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b. an order suspending (for a period of not more than six months), revoking or restricting a person's registration with the CFTC;
c. an order assessing civil monetary penalties against a person, not to exceed US$140,000 per violation (US$1 million for manipulation);
d. an order directing that a person makes restitution to customers of damages proximately caused by the person's violations; and
e. an order directing a person to cease and desist from violating the CEA or a CFTC regulation.

The CFTC has the power to refer matters for criminal prosecution to the Department of Justice (DOJ).

Private persons can seek their own remedies for any misconduct relating to the CEA, including exercising a right of action for damages. The CEA:

a. permits anyone complaining of a violation of the CEA or the CFTC's rules to apply to the CFTC for an order awarding damages caused by the violation;
b. permits private rights of action under certain circumstances;
c. permits private damage actions against anyone other than a SRO who violates, or wilfully aids and abets a violation, of the CEA; and
d. establishes a private damage remedy against SROs and their officials, which in bad faith refuse to enforce their own rules, or enforce their own rules in violation of the CEA, and cause monetary loss.

To the extent relevant information is available from another federal or state agency, such as a state securities regulator, the SEC or the CFTC may obtain this information by seeking access to the public and non public information in that agency's files.

SEC

The SEC has broad authority to investigate actual or potential violations of the federal securities laws and to determine the scope of its investigations and the persons subject to investigation. The SEC can rely on voluntary cooperation to obtain documents or testimony. If the SEC relies on voluntary cooperation, it generally does not issue subpoenas or require or administer oaths or affirmations, although it may do so in some circumstances. Alternatively, the SEC can authorize a formal order of investigation, which grants the SEC staff the power to issue subpoenas and administer oaths, take testimony and compel the production of documents.

The SEC is responsible for civil (non-criminal) enforcement of the federal securities laws and prosecutes cases in U.S. federal courts and in administrative proceedings. If the SEC decides to institute enforcement proceedings, it has several options.

A. Civil Action: The SEC may bring a civil injunctive action against a person or an entity that the SEC believes has violated or is violating the federal securities laws. In its civil actions, the SEC can obtain disgorgement by which a wrongdoer is required to give up any illegal profits gained as a result of violations of the laws. The SEC also has the authority to seek civil monetary penalties. In fiscal year 2008, the SEC obtained orders in judicial and administrative proceedings requiring securities laws violators to disgorge illegal profits of US$774 million and to pay civil penalties of US$256 million. The SEC may bar individuals from serving as officers or directors of public companies under the Exchange Act. In fiscal year 2008, the SEC sought orders barring 132 defendants and respondents from serving as officers or directors of public companies.

B. Administrative Action: The SEC has the ability to institute various types of administrative proceedings against a person or an entity that it believes has violated the law. This type of enforcement action is brought by the Enforcement Division and is litigated before an SEC administrative law judge (ALJ). The ALJ's decision is subject to appeal directly to the SEC and the SEC's decision is in turn subject to review by a U.S. Court of Appeals. Administrative proceedings provide for a variety of relief. For regulated persons and entities, such as BDs, IAs,

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	and persons associated with them, sanctions include censure, limitation on activities, suspension of up to 12 months, and bar or revocation of registration. For professionals such as attorneys and accountants, the SEC can order that the professional be censured, suspended or barred from practicing before the SEC. Against any person who violates or is a cause of a violation of a provision of the federal securities laws, the SEC may impose a cease and desist order. The SEC can obtain disgorgement and civil money penalties in administrative proceedings. C. Criminal Action: The SEC can refer the matter to DOJ and the individual U.S. Attorney's offices for criminal prosecution. A criminal prosecution does not preclude the SEC from taking civil action for the same conduct; and similarly, SEC action does not preclude a subsequent criminal prosecution. The SEC's enforcement powers do not compromise private rights of action seeking remedies under the federal securities laws. The laws provide for express remedies in favor of private parties who claim damages as result of specific violations of these laws. The Securities Act imposes liability: • for misstatements or omissions in registration statements; • for the sale of unregistered securities and for fraud in the sale of securities; and • on controlling persons. Additionally, private persons can seek remedies under the Exchange Act, which imposes liability: • for specified manipulations of exchange-traded securities; • for "short-swing" profits; and • for misleading statements in periodic reports filed with the commission. Private persons also can seek remedies under the Exchange Act, which: • imposes liability on controlling persons; and • imposes insider trading liability on contemporaneous traders. Federal courts have "read in" private rights of action under certain statutory provisions that, on their face, do not provide actions for monetary damages. The most significant of these is the implied private right of action under Exchange Act for securities fraud. To state a claim for securities fraud a plaintiff must prove: (1) a material misrepresentation or omission by the defendant; (2) intent; (3) a connection between the misrepresentation or omission and the purchase or sale of a security; (4) reliance upon the misrepresentation or omission; (5) economic loss; and (6) loss causation.
Assessment	Fully implemented.
Comments	
Principle 10.	The regulatory system should ensure an effective and credible use of inspection, investigation, surveillance and enforcement powers and implementation of an effective compliance program.
Description	**CFTC** The front line regulation (inspections, enforcement actions) of FCMs, IBs, CTAs, and CPOs is done by the SROs subject to oversight by CFTC. The NFA has oversight responsibility for CPOs and CTAs and has a program in place to monitor compliance by CPOs with all applicable CFTC regulations and NFA rules—both through on-site inspections and off-site reviews. Most new CPOs are examined in their first two years of operation and then every three to four years, based on an assessment of their risk. For FCMs and IBs, the NFA and other SROs conduct regular on-site exams of their member firms. Every member firm is to be inspected every 9 to 18 months. The CFTC does not have a routine examination program, but might conduct an on-site exam in response to an early warning notice or for other causes. Ongoing financial and other supervision of FCMs and IBs that are members of more than one SRO are shared by the relevant DCMs and NFA, with the NFA primarily responsible for FCMs that are not members of a DCM. The CFTC also conducts its own

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investigations and takes action where breaches are found.

The operational integrity of exchanges is addressed through the CFTC's periodic Rule Enforcement Reviews (RER) that address market surveillance, trade practice surveillance, and disciplinary programs. There are regular reviews of each DCM's ongoing compliance with the Core Principles set out in the CEA through the self-regulatory programs operated by the DCM in order to enforce its rules, prevent market manipulation and customer and market abuses and ensure the recording and safe storage of trade information. Periodic RERs normally examine a DCM's audit trail, trade practice surveillance, disciplinary and dispute resolution programs for compliance with the relevant Core Principles.

Other periodic RERs normally examine a DCM's market surveillance program for compliance with principles on monitoring of trading and position limits or accountability levels. On some occasions, these two types of RERs may be combined in a single RER. The CFTC also conducts horizontal RERs of the compliance of multiple exchanges in regard to particular Core Principles. In conducting an RER, staff examine trading and compliance activities at the exchange in question over an extended time period, typically the twelve months immediately preceding the start of the review. Staff conducts extensive review and analysis of documents and systems used by the exchange in carrying out its self- regulatory responsibilities; interview compliance officials and staff of the exchange and prepare a detailed written report of their findings. In nearly all cases, the RER report is made available to the public and posted on the CFTC website.

In an emergency, the CFTC may direct a DCM or ECM to take such action as in the CFTC's judgment is necessary to maintain or restore orderly trading in or liquidation of any futures contract. The CFTC may alter or supplement the rules of a DCM under certain (limited) circumstances. In order for the CFTC to take such action, the CFTC must first make a written request to a contract market. If the CFTC determines that a DCM is violating Core Principles, it will provide notice to the entity in writing of such determination and afford the entity an opportunity to make appropriate changes to come into compliance, after which the CFTC may take further steps, including suspension or revocation of certification.

The CFTC has over 95 attorneys and 18 investigators in the Enforcement Division who are charged with investigating and prosecuting violations of the CEA. As part of the commission's efforts to bolster staffing levels, an additional 14 professional staff are scheduled to join the division. Currently, there are more than 200 pending investigations. Taking into account the size and the growth of the market, the division does not appear to have adequate resources. Considering the CFTC recommendation in the Joint Report to expand the insider dealing scope and to enhance its authority with respect to disruptive trading practices, the need for an increased staff level is even more pressing.

When an investigation indicates that there is reason to believe that violation has occurred, the CFTC files either an administrative or civil injunctive enforcement action against the alleged wrongdoers. In an administrative action, wrongdoers who are found to have violated the CEA or CFTC regulations or orders can be prohibited from trading on U.S. futures markets and, if registered, have their registrations suspended or revoked. Violators also can be ordered to cease and desist from further violations, to pay civil monetary penalties of US$140,000 per violation (US$1 million for manipulation) or triple their monetary gain and to pay restitution to those persons harmed by the misconduct. In civil injunctive actions, defendants can be enjoined from further violations, their assets can be frozen, and their books and records impounded. Defendants also can be ordered to disgorge all illegally obtained funds, make full restitution to customers and pay civil monetary penalties.

As the CEA does not generally prohibit insider trading in the commodity futures and options markets, there have been no enforcement cases charging insider trading. The premise has been that insider trading has limited applicability to futures trading because it would defeat the market's basic economic function of allowing traders to hedge the risks of their commercial enterprises.

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Nevertheless, the CEA does recognize certain duties in connection with trading relationships. Thus, trading ahead or front running has been charged by the CFTC under the CEA's general anti-fraud provisions when persons traded for their own account (or through an associated account) ahead of a customer or an employer for whom the person was trading.

Each year, the CFTC initiates between 40 and 50 enforcement actions. In fiscal year 2008, the CFTC brought 40 enforcement cases. These cases target certain program areas, for example: (1) allegations of manipulation, attempted manipulation, trade practice violations, and false reporting; (2) misconduct by commodity pools, hedge funds, CPOs, and CTAs; and (3) financial, supervision, recordkeeping, and other violations committed by registered entities.

Overall Civil Monetary Penalties: During FY2008, a total of US$234 million in civil monetary penalties (CMPs) was imposed in the CFTC's enforcement actions, which included both administrative and federal district court cases. Of that amount, the CFTC collected US$141 million, or 60 percent of the amount imposed.

Commodity Pools and Hedge Funds: From October 2000 through September 2008, the CFTC filed a total of 73 enforcement actions alleging misconduct in connection with commodity pools and hedge funds and the CFTC has obtained penalties of US$564 million in these actions. The majority of the commission's commodity pool/hedge fund fraud cases are brought against unregistered CPOs and/or CTAs (40 of 73 cases filed).

Cooperative Enforcement: During FY2008, cooperative efforts resulted in 31 cases being filed by other domestic criminal and civil law enforcement authorities that included cooperative assistance from the CFTC.

From December 2001 through December 2008, the CFTC filed a total of 98 enforcement actions against 181 firms and 193 individuals selling illegal forex futures and option contracts. To date, the CFTC has obtained approximately US$562 million in civil monetary penalties and US$453 million in restitution in these enforcement actions.

Energy Market Manipulation: From December 2002 to September 2009, the CFTC filed a total of 43 enforcement actions charging a total of 73 respondents/defendants (42 companies and 31 individuals) with misconduct in the energy markets. The CFTC has obtained US$446 million in civil monetary penalties in settlement of these enforcement actions.

SEC

The SEC conducts five types of inspections/examinations of intermediaries, CIS, and their operators:

- routine examinations designed to test a registrant's overall compliance;
- "cause examinations" based upon complaints, tips, press reports or other information suggesting the registrant might be violating securities laws, rules or regulations;
- risk-targeted sweep examinations, in which multiple firms are reviewed for a particular compliance risk;
- special purpose examinations, in which examination staff review a firm for a potential issue or risk; and
- SRO oversight examinations of registered BDs, during which SEC examiners analyze and sample a BD's records from the same time period and focus areas that the SRO reviewed during its examination of the BD. SEC examiners may also review the firm's activities following the SRO examination to identify new problematic behaviour or additional risks. In addition, SEC examiners may review the firm's current activities to determine whether it implements any corrective measures recommended by the SRO.

The SEC communicates with the Federal Reserve when the SEC conducts examinations of certain large entities and coordinates some examinations with state regulators. The SEC has an examination program that covers both CIS and their operators. Examinations are conducted primarily to determine whether CIS and their operators continue to meet eligibility standards and

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	conduct their activities in compliance with the law. The SROs examine their own members; the SEC examines the SROs to determine whether they are meeting their responsibilities. By rule, SROs are permitted to file with the SEC a plan to allocate the responsibilities among the SROs to: receive regulatory reports from persons who are common members of the SROs, examine such persons or enforce compliance of such persons with the federal securities laws. Where a firm is a member of FINRA, FINRA is generally the responsible SRO. FINRA inspects its BD members cyclically; the frequency of examination depends on the types of business the BD engages in and the perceived risk of those businesses. For instance, FINRA generally inspects BDs that hold customer funds and securities at least once every year. Other BDs are subject to less frequent on-site examinations. In addition, the FINRA reviews a BD's capital levels when periodic reports are filed. The SEC is the sole regulator for SEC registered IAs. There is no SRO to share the work as is the case with SEC registered BDs. The SEC uses a scoring process to risk-rate IAs. The SEC attempts to risk-rate IAs based on filing information, including whether the IA has custody of client assets, charges performance-based fees, its disciplinary history, the results of previous exams, and other information available to the staff. In recent years, those IAs with a higher risk profile are placed on a three-year examination cycle. However, their Office of Compliance, Inspections, and Examinations (OCIE) is currently working to create a more flexible risk management process. Once fully implemented, the frequency of examinations of "higher risk" IAs may change. Other IAs are chosen randomly for routine examinations on a less frequent basis and may also be examined as part of cause, sweep, or special purpose examinations. In order to satisfy itself that an SRO is in compliance with the obligations and responsibilities imposed upon it, the SEC has a surveillance, examination, and enforcement program to oversee the activities of the SROs, including exchanges, associations, and clearing agencies. The standard is set in the Exchange Act which mandates that each SRO complies with and enforce compliance with law and the SRO's own rules, "absent *reasonable justification or excuse*." SEC staff conducts inspections of the SROs to assess the adequacy of the SRO's regulatory programs. These inspections focus on the SRO's regulatory programs, including: market surveillance, investigative and disciplinary programs, member examination programs, and listing and arbitration programs, among others. Staff may also examine an SRO's disciplinary actions against members and denials of membership in, or access to, the SRO. Oversight of SROs is carried out by SEC staff which conducts several types of examinations and inspections as for intermediaries above. The SEC has the authority to inspect both the SROs and market participants to determine whether the various anti-fraud, anti-manipulation, and reporting regulations are being complied with. The SEC can also obtain surveillance and/or trading data from the SROs. An SRO must have procedures to survey its market and its members for securities laws violations, including violations to the SRO's own rules. On a continuing basis, the SEC will consider whether an applicant has adequate surveillance measures, as well as sufficient resources, including staff expertise and capital, to monitor its markets. Surveillance mechanisms are not standardized among the markets and the SEC recognizes that surveillance procedures may vary depending on the nature and structure of the market and the securities traded on a particular exchange. At a minimum, the SEC has said that an applicant should demonstrate that the officers that manage the day-to-day surveillance function must be familiar with federal securities laws and the role of the SRO. In addition, as part of its surveillance responsibilities, an SRO must have the capability to maintain an order audit trail for all transactions in its system. In addition to national securities exchanges, the SEC and SROs regulate ATSs for compliance with Regulation ATS and other applicable federal securities laws. Regulation ATS includes rules and obligations that provide the SEC with information necessary to monitor trading activity on these systems. Clearing agencies are SROs under the Act. See Principle 29 for a detailed description of

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the SEC's oversight of these entities.

If the SEC finds that an exchange, association, or clearing agency has failed, without reasonable justification or excuse, to enforce compliance with any of its rules by a member or person associated with a member, it may impose sanctions against the SRO. The SEC has the authority to suspend an SRO for a period of up to twelve months, revoke a SRO's registration, or censure or impose limitations upon its activities, functions and operations if the SEC finds that the SRO has violated or is unable to comply with the provisions of the law or its own rules.

Among other remedies and sanctions, SEC enforcement actions may seek censures, suspensions, or bars from the securities industry for violations of federal securities laws. SEC suspensions are up to 12 months, while bars are permanent with a right to reapply. In addition, an adverse adjudication in an SEC enforcement action results in an automatic disqualification from association with any SRO member. Independent of SEC actions, but in a complementary fashion, SRO enforcement actions may seek suspensions or expulsions of its member firms or individuals for violations of membership rules. The overall structure and dynamic for regulating the securities markets is dependent on vigorous SRO enforcement programs.

The investigation by the OIG of the SEC into the SEC's conduct concerning the huge Ponzi scheme which came to light in 2008 identified several areas in the SEC Division of Enforcement that were problematic. These have been documented in public reports which had to be considered by the assessors. According to the OIG's report, the SEC failed to detect the scheme despite 6 substantive complaints over 16 years that raised significant red flags. One missed enforcement case, no matter how large, can happen anywhere and does not necessarily mean an enforcement program is ineffective. However, if the findings show deeper flaws, there will be concerns about the effectiveness of the whole program. The OIG report found such systemic problems. It stated that enforcement staff:

- lacked adequate guidance on how to analyze complaints;
- did not always exercise due diligence in their handling of critical information;
- assigned to investigate the complaint were inexperienced in investigating Ponzi schemes;
- did not always seek assistance from other offices and divisions as needed;
- lacked supervision;
- failed to verify information provided by the suspect with independent sources;
- did not adequately evaluate additional information received by the SEC; and
- did not complete administrative tasks associated with opening and closing the investigation promptly.

Furthermore, the investigation of this case revealed that the complaint handling system to detect fraud via handling of complaints, tips, and referrals (CTRs) needs improvement. The SEC receives hundreds of thousands of investor complaints each year, including letters, calls, and emails. In the fiscal year 2008, the Enforcement Division received approximately 618,000 CTRs. Enhancements are in the process of being implemented.

The OIG made 21 recommendations, with which the SEC concurred. The SEC is taking actions to strengthen its enforcement program. Based on a self-assessment and the recommendations from the OIG, the Division of Enforcement has implemented a number of important improvements. These improvements include: (1) the establishment of specialized enforcement units targeting complex products, transactions and markets, including asset management, large-scale insider trading and other market abuses, structured products and derivatives, municipal securities and violations of the Foreign Corrupt Practices Act; (2) flattening management to dedicate more resources to the core mission of enforcement investigations; and (3) offering cooperation agreements and other tools to encourage persons with knowledge of wrongdoing to cooperate in enforcement investigations.

Further improvements are under way in other areas. Currently, the SEC is implementing systems to add certain qualitative measures to the current quantitative measures for assessing the enforcement program's effectiveness in enforcing regulatory requirements and in meeting program objectives.

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Specifically, systems are being implemented to track whether enforcement cases of the utmost importance are bring brought, whether enforcement cases are being brought in a timely manner and whether enforcement resources are being used efficiently to meet its objectives. The SEC is also seeking to develop more sophisticated metrics to measure the deterrent impact of the enforcement cases brought. Finally, the SEC is starting to develop systems that would measure changes in industry behavior as a result of the SEC's enforcement actions.

In FY2009 the Division of Enforcement had just over 1,200 full time employees, of which 782 were attorneys. Enforcement attorneys investigate and prosecute violations of the federal securities laws. On September 30, 2009, the last day of FY2009, enforcement had over 4,300 active investigations. Each year the SEC brings between 500 and 675 enforcement actions. The SEC brought 664 enforcement actions in FY2009. In FY2008, the SEC brought 671 enforcement actions, the second highest number in its history.

Market and/or Price Manipulation

In the 2008 fiscal year, the SEC brought 52 market manipulation cases (in 2007: 36, in 2006: 27).

Insider Trading

In fiscal year 2008, the SEC brought 61 insider trading cases (in 2007: 47 insider trading cases, in 2006: 46) The distribution of the 664 enforcement cases filed in FY2009 across core enforcement areas are as follows:

Type of Case	Number	% of Total Cases
Issuer Reporting	143	22
Securities Offering	141	21
Market Manipulation	39	6
Broker-Dealer	109	16
Investment Adviser/ Investment Company	81	12
Insider Trading	37	6
Delinquent Filings	92	14
Contempt/Other	22	3
Total	**664**	**100**

CFTC and SEC

Given the size of the market, relatively few cases have been taken for criminal prosecution and even fewer have resulted in criminal sanctions.

In the United States, at state and federal level, many charges concerning securities fraud are settled. The defendant in the action neither admits, nor denies the allegations[4] in the complaint, but may have sanctions imposed on them, such as disgorgement, monetary penalties and/or restrictions on the ability to associate with registered entities. Settlements have the advantage of not requiring the regulator to prove that the elements of the offence have been committed, but at the same time, have the disadvantage that they produce less case law that would help to develop interpretation of the laws and give more certainty about the scope of the laws. However, in matters resolved by

[4] The SEC and CFTC have formal policy established by rule that does not permit a defendant to settle an action while denying the allegations. However, settlements are permitted if the defendant states it "neither admits nor denies" the allegations.

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	settlement, the final orders contain findings of fact and conclusions of law that provide guidance on the type of behavior that the regulators consider to be in violation of the law. In administrative cases, settlement orders also contain an analysis of how the law applies to the facts. While not binding precedent, these orders have been cited in court decisions as evidence of an agency's interpretation of the law. The Securities Regulators of All States brought 8,365 enforcement actions (including administrative, civil, and criminal cases) in the last three years. They resulted in • US$178 million fines and penalties (including civil and criminal). • US$1.8 billion ordered to be returned to investors (includes restitution, rescission and disgorgement). • 2,765 years of incarceration sentenced.
Assessment	Partly implemented.
Comments	When assessing a jurisdiction's implementation of the enforcement principles, assessors do not normally have access to such a comprehensive, detailed, and painstaking independent analysis of the weaknesses in a regulator's enforcement and examination programs as that contained in the 2009 report of the SEC's IG. Indeed this assessment may be unique in that respect. Nor do assessors normally have the time or the resources to probe in depth behind a regulator's (usually positive) self assessment, and its data on enforcement cases etc., beyond some limited discussions with capital market participants on their views of the regulator's effectiveness and credibility. It remains the case, however, that assessors have generally found this Principle to be partly implemented in a relatively high proportion of jurisdictions. It is also an indication of the high level of transparency embedded in the U.S. system that the IG's detailed report was published and extensively discussed. The Division of Enforcement of the SEC has taken significant action on all of the recommendations contained in the IG's report. By the end of March 2010, it believes that over 50 percent of the recommendations will have been completed. The division's completion or "closing" of each recommendation remains subject to the approval of the IG. Implementation of the remaining initiatives will, the assessors believe, fully restore the SEC's standing as an effective and credible enforcer of the securities laws and its regulations. Enforcement SEC: As contemplated by the Principles and the Methodology assessors may make use of a variety of sources to assess the effectiveness of an enforcement program. In the case of this assessment, the assessors have looked at quantitative indicators such as the number of cases brought by the SEC, the number and amount of the fines imposed, relative to the size of the overall market. Such indicators have limited value as proxies for performance, and thus the assessors have supplemented this analysis with other publicly available information, including the OIG report mentioned earlier, and with interviews of SEC staff and market participants. All of these factors led the assessors to conclude that the SEC enforcement program has significant shortcomings, which should be addressed as a matter of priority. The assessors note that the SEC has given high priority to this task and is in the process of implementing a program of improvements. The recent SEC OIG report, which examined the failed investigation into Madoff, determined there were systemic shortcomings in the program as a whole. The OIG made 21 recommendations to improve the SEC enforcement program, the SEC concurred in all of the recommendations. Pursuant to the published timeline, all planned improvements should be implemented by mid-2010. It is also carrying out a range of internally generated improvements not explicitly recommended by the IG. The SEC also may want to consider adding staff with more accounting and economics backgrounds; the division of enforcement is largely staffed by lawyers and setting up teams with different skill sets and experience could enhance its performance. CFTC: Taking into account the size and growth of the market, the enforcement division needs

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	more resources. Given the current limited scope of its remit and the integrated market surveillance systems it operates in close cooperation with the DCMs, (as described under Principle 28) this is not a pressing problem though it will become one if its remit is expanded (e.g., to include OTC derivatives). DOJ: Securities fraud cases are prosecuted primarily in the 94 States Attorney Offices located across the United States. Those offices are staffed by about 5,500 to 5,600 federal prosecutors. They have the authority to prosecute a full range of federal crimes, including securities fraud. In practice, other higher profile crimes (murder, drug trafficking, etc.) may take priority over securities fraud. The main office of the DOJ in Washington, D.C. has a securities fraud unit with only about ten attorneys. Complaints Handling To upgrade the complaint handling systems, the SEC has employed consultants to conduct a comprehensive review of the agency's systems and procedures for evaluating and tracking CTRs and to make recommendations as to how the process can be improved to ensure that enforcement leads and areas for high risk examinations are identified more effectively. Improvements will include implementation of a centralized information technology solution that will provide the agency with an automated mechanism for, among other things, tracking and reporting on CTR handling activities on an agency-wide basis. However, this remains "work in progress." Examinations Although the OCIE makes maximum and creative use of the resources at its disposal, lack of sufficient resources currently has a major negative impact on the effectiveness and credibility of the inspection and examination systems of the SEC with regard to IAs. The legal basis for funding this activity may also be an issue; the SEC does not charge IAs for examinations. The SEC is the sole examiner of over 11,000 IAs—a responsibility it attempts to meet with approximately 425 examiners. Only 14 percent of IAs was examined in 2008 compared to 57 percent of BDs (in the latter case most examinations are carried out by FINRA). In FY 2008, approximately 38 percent of fund/IA exams conducted by the staff resulted in significant findings (e.g., deficiencies that may cause harm to customers or clients of a firm, have a high potential to cause harm, or reflect recidivist misconduct). Extrapolated to funds/IAs in total there may be substantial undetected risk to investors. Furthermore, SIPC protection is not available to these investors when losses arise from the failure of an IA. However, SIPC coverage applies to IA client assets that are custodied at a broker-dealer.[5] Although all IAs file annual statements with the SEC, which provides input for the risk based examination system, the information collected is not comprehensive. In addition until recently, IAs identified as "higher risk" based on this and other information were placed on only a three-year examination cycle. OCIE is currently working to create a more flexible risk management process. The impact on frequency of examinations of 'higher risk' IAs would need to be examined once fully implemented. The assessors understand one of the recent regulatory reform proposals included raising the

[5] As applied to IAs, the term "custody" is defined in Advisers Act Rule 206-4(2) ("Custody of Funds or Securities by Investment Advisers"). *See also*, SEC Release IA-2176 (Sept. 25, 2003); 68 Fed. Reg. 56692–01 (Oct. 1, 2003). Among other requirements, Rule 206(4)–2 requires that IAs with custody of client funds or securities maintain those assets with broker-dealers, banks or other qualified custodians. In addition, on December 31, 2009, the SEC adopted amendments to Advisers Act Rule 206(4)–2. The amendments are designed to strengthen controls over the custody of client assets by registered investment advisers and to encourage the use of independent custodians. The SEC also adopted related amendments to Rule 204–2, Form "ADV," and Form "ADV-E" that will improve the staff's ability to oversee advisers' custody practices. For additional discussion regarding these amendments, see SEC Final Rule Release No. IA-2968 available at http://www.sec.gov/rules/final/2009/ia-2968.

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	threshold for registration under the Advisers Act, thereby reducing the number of registrants in this category subject to oversight by the SEC. This would shift some of the burden to the state regulators. The SEC might also want to consider making use of the FINRA examination program when the IA is also a BD member of FINRA. As regards BDs, which are subject to examination by the SEC and FINRA, the assessors were informed by firms that from time to time there are subject matter overlaps and annual reviews which begin before the final report from the previous year had been received. Some overlap may be necessary, for example where the SEC is conducting an oversight exam of an SRO's exam program, but these overlaps should be minimized. The OCIE has recently introduced enhanced examination review processes to minimize unnecessary duplication and to provide BDs and IAs with timely feedback where appropriate. It also engages in an active program to inform and educate Compliance Officers as to the SEC's objectives in carrying out examinations and what constitutes good compliance practice.
Principles for Cooperation in Regulation	
Principle 11.	The regulator should have authority to share both public and non-public information with domestic and foreign counterparts.
Description	**CFTC** The CFTC has authority to share public and non-public information with domestic and foreign regulators for regulatory, surveillance, technical assistance, or enforcement purposes, in connection with matters of authorization, licensing or approvals, market conditions and events, client identification, and regulated entities. External approval is not needed. The CFTC can exchange all types of information, including information and records identifying the person or persons beneficially owning or controlling bank accounts related to derivatives transactions and brokerage accounts. There are no domestic laws which impede international cooperation. An independent interest in the subject matter of the inquiry is not a precondition for the exchange of information. In order to grant access, the CFTC asks that, in the absence of a formal MOU between the CFTC and the requesting authority, the domestic authority provide a written access request setting out its need for the requested information and providing confidentiality undertakings. When exchanging information with foreign authorities, the CFTC takes into account the status of the requesting authority, the confidentiality provided, restriction of use of the information for the purposes stated within the request and reciprocity. The existence of an MOU is not precondition for information sharing. Neither does the CFTC impose a dual illegality requirement, which means, the facts stated in the request need not also constitute a violation of the laws of the United States. The CFTC can share information on an unsolicited basis. **SEC** Pursuant to the Exchange Act and SEC rules, the SEC may share public and non-public information with domestic and foreign counterparts, provided the SEC receives assurances of confidentiality from the person receiving non-public information. The SEC does not need external approval to share information. There are no limitations on the type of information that the SEC can share in connection with authorization, licensing and registration, surveillance, market events, regulated entities, listed companies, and companies that go public. This includes information concerning the beneficial ownership or control of a bank or brokerage account, provided the requesting authority shows that such information is needed and provides the SEC with assurances of confidentiality. The act authorizes the SEC to provide assistance to a foreign securities authority if reciprocity is provided and compliance with the request is not against public interest, without regard to whether the facts as stated in the foreign securities authority's request constitute a violation under U.S. laws. The SEC can share information on an unsolicited basis. The existence of an MOU is not precondition for information-sharing. There are no domestic laws which impede

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	international cooperation.
Assessment	Fully implemented.
Comments	To the extent that non-public information sought by a foreign or domestic authority includes electronic communications subject to the Electronic Communications Privacy Act (ECPA) or bank records subject to the Right to Financial Privacy Act (RFPA), notice of the subpoena must be given to the bank account holder or subscriber, as appropriate. However, a government agency may delay notifying the account holder or subscriber of an administrative subpoena to a financial institution or service provider for renewable periods of 90 days. It should be noted that documents covered by the ECPA are unlikely to include bank, brokerage, or beneficial ownership information within the scope of the IOSCO MOU. Before sharing the records with foreign or domestic authorities, the commissions must ascertain that the material is relevant to a legitimate law enforcement inquiry of the requesting agency and, for domestic authorities, ensure that there is a valid access request granted to that agency that includes RFPA and/or ECPA material. There is no requirement in the ECPA that a government entity gives notice to a subscriber if the information is shared with another government entity (either foreign or domestic). The RFPA does require that a government entity gives notice to the account holder within 14 days of transferring the information to another domestic government agency, but there is no such notice requirement for sharing the information with foreign authorities.
Principle 12.	Regulators should establish information sharing mechanisms that set out when and how they will share both public and non-public information with their domestic and foreign counterparts.
Description	**CFTC** The CFTC can enter into information-sharing arrangements (MOUs) to facilitate consultation and cooperation and to establish the conditions for the public or non-public exchange of information with domestic and foreign authorities. The CFTC has entered into more than 30 bilateral information sharing arrangements that support surveillance, enforcement and regulatory cooperation. The MOUs are in writing and publicly available on the website of the CFTC. In addition, the CFTC is a signatory to the IOSCO MMOU, the first worldwide multilateral enforcement cooperation arrangement among 55 securities and derivatives regulators. Pursuant to the various confidentiality provisions of the CEA, the CFTC can protect the confidentiality of information transmitted consistent with its uses. The CEA only permits the CFTC to disclose to foreign authorities information in the CFTC's possession when it is satisfied that the information will not be publicly disclosed except in an adjudicatory action or proceeding to which the authority is a party. Fiscal year 2008: The CFTC cooperative efforts resulted in 31 cases being filed by other domestic criminal and civil law enforcement authorities that included cooperative assistance from the agency. The CFTC made 120 requests for assistance to 38 different foreign authorities and received and responded to 47 requests from 18 different jurisdictions. **SEC** The SEC can enter into MOUs to facilitate consultation, cooperation and the exchange of public and non-public information with domestic and foreign authorities in both enforcement and supervisory matters. The SEC requires assurances of confidentiality which do not restrict the foreign authority's ability to use the information for the purposes of its investigation and/or proceeding or any resulting proceedings or its ability to transfer the information to criminal law enforcement authorities and self-regulatory organizations. The SEC has entered into over 30 bilateral information-sharing arrangements with foreign

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	regulators. In addition, the SEC is a signatory to the IOSCO MMOU. The SEC enters into the negotiation of bilateral MOUs for enforcement cooperation only if a foreign securities authority is empowered to provide assistance beyond what is required by the IOSCO MMOU, such as the ability to compel testimony or the gathering of Internet service provider, phone and other records other than bank, broker, and beneficial owner information on behalf of the requesting authority. The SEC entered into four regulatory MOU with other domestic regulatory agencies under the terms of which the SEC is actively sharing regulatory and supervisory information. All MOUs are public and on the website of the SEC. Fiscal Year 2008: The SEC handled 414 requests for enforcement assistance from foreign authorities and made 594 requests to foreign authorities. In addition, the SEC answered 374 requests from foreign regulators for technical assistance.
Assessment	Fully implemented,
Comments	Disclosure to Congress: As the U.S. Congress has oversight responsibility for the CFTC and SEC, it is entitled to obtain all information from the CFTC's and SEC's files. Should the CFTC and SEC staff learn of an impending demand from Congress for production of non-public information provided by a foreign authority, the staff would recommend to their respective Commissions that the agency informs Congress that: (i) the agency has undertaken to keep the information non-public; and (ii) disclosure could harm the agency's relationship with the foreign authority and adversely impact the agency's ability to obtain information from its counterpart in the future. Disclosure Under the FOIA: The CFTC and the SEC are able to protect from public disclosure information regarding requests made by foreign securities authorities as well as information received from foreign securities authorities. Any records obtained from a foreign securities authority are explicitly exempted from disclosure under the FOIA.
Principle 13.	The regulatory system should allow for assistance to be provided to foreign regulators who need to make inquiries in the discharge of their functions and exercise of their powers.
Description	**CFTC** Under the CEA, the CFTC has the authority to conduct an investigation, including the use of compulsory powers, on behalf of a foreign futures authority on regulatory matters in its jurisdiction. This includes compelling (a) the production of documents (including, but not limited to, bank records, trading records, and records identifying beneficial owners that are critical to such investigations) and (b) the taking of statements and testimony under oath. The CFTC does not need an independent interest in the alleged violations. In exercising its statutory authority to provide such assistance, the CFTC is directed by Congress to consider whether (1) the requesting authority has agreed to provide reciprocal assistance in futures matters to the CFTC and (2) compliance with the request would prejudice the public interest of the United States. The CFTC has the authority to assist a foreign authority in obtaining a court order, including in urgent circumstances. **SEC** The SEC may conduct an investigation and use its compulsory powers under the Exchange Act as it would in its own investigations. These powers include requiring the production of documents held by regulated entities as well as the ability to use the SEC's subpoena powers to compel the production of documents or testimony from any person or entity anywhere within the United States. This information includes records sufficient to reconstruct all securities and derivatives transactions, including records of all funds and assets transferred into and out of bank and brokerage accounts relating to those transactions, the name of the account holder, the person authorized to transact business, the amount purchased or sold, the time of the transaction, the price of the transaction, the individual, and the bank, or broker and brokerage house that handled the transaction and the beneficial owner. An independent interest is not a precondition for the

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	exchange of information. The SEC can assist in advising a foreign authority on how to initiate a proceeding in civil court or request to the DOJ to pursue assistance in obtaining court orders through a Mutual Legal Assistance Treaty.
Assessment	Fully implemented.
Comments	As discussed under Principle 28, the scope of the explicit insider trading prohibitions under the CEA is rather narrow and focuses solely on employees and agents of the CFTC, SROs, and markets that are regulated by the CFTC. However, this limited scope does not raise concerns concerning the ability to cooperate with foreign regulators as the CFTC can provide assistance to a foreign authority even if the matter would not constitute a violation of the laws of the United States. Moreover, as described under Principle 10, the CFTC can and does bring a wide range of actions under the CEA. Right to Financial Privacy Act: The CFTC and the SEC can obtain bank records through their subpoena authority; however if seeking bank account records of a customer, defined as an individual or a small partnership of five or fewer individuals, from a financial institution both authorities must follow procedures set out in the RFPA. The RFPA requires the customer notification prior to such disclosure. If an investigative subpoena is issued, the customer must receive a copy of the subpoena. The CFTC and the SEC may also obtain bank records for a customer without first notifying the customer through a delayed notice provision which requires an ex parte hearing in front of an appropriate court in order to delay notice to the customer. In practice, this statute does not hamper the ability of CFTC and SEC to cooperate. Most foreign requests concern trading accounts with a BD to which the RFPA does not apply. Fewer requests from foreign authorities relate to bank saving or cash accounts. If such a request is received, the requesting authority is asked to decide if the customer can be notified and in most cases they agree to that. If the requesting authority does not want to have the customer informed, the CFTC or the SEC may file with an appropriate court in order to delay notice to the customer. The process of obtaining a court order takes several days.
Principles for Issuers	
These principles do not apply generally to futures under the jurisdiction of the CFTC. Futures contracts are issued by the exchange on which the instrument is traded. The disclosure provided goes to the nature of the contract and the underlying commodity, rather than the characteristics of the issuer.	
Principle 14.	There should be full, accurate and timely disclosure of financial results and other information that is material to investors' decisions.
Description	There are extensive disclosure requirements in the legislation and regulations that apply to public offerings of most securities, including very detailed requirements that apply to prospectuses, registration statements, annual and interim financial reporting and proxy disclosure. There are also specialized disclosure regimes for particular types of securities, such as asset backed securities. Virtually all disclosure documents are filed with the SEC via the internet on an Electronic Data Gathering, Analysis, and Retrieval System (EDGAR) maintained by the SEC and are available to the public almost immediately after filing. In addition, disclosure documents are available to investors in paper form and may be provided through issuer websites. The review of these disclosure documents takes place on a selective basis, meaning not all documents are reviewed by the SEC. Listed securities also must be registered with the SEC under the Exchange Act and are also subject to the listing standards—initial and on-going—of the relevant exchange. Both NASDAQ and the NYSE have extensive and high quality continuing disclosure standards that apply to the companies that are listed on their respective exchanges. The exchanges monitor that disclosure to ensure issuers continue to meet their requirements. Only equity securities (as that term is defined in the

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Exchange Act) registered under the Exchange Act are subject to continuing disclosure requirements. An issuer that only has sold equity or debt securities to the public that are held by fewer than 300 persons would not be subject to the continuing disclosure requirements under this statute. Legislation requires public company's continuing disclosure documents to be reviewed by the SEC at least once every three years.

Annual audited financial statements are due within 60–90 days of the issuer's year-end; interim statements are due within 40–45 days of the end of each of the first three quarters. Most companies make public announcement of the fourth quarter results, which triggers a requirement to file a report on EDGAR. The shorter time periods apply to larger issuers.

All disclosure is to be full, fair and contain all material facts. Anti-fraud provisions in securities legislation require "prompt" updating of public disclosure to ensure information is not misleading. Reports on material changes are required to be filed with the SEC within four days of the event being reported, while the NYSE and NASDAQ require such changes to be publicly disclosed immediately. These standards are backed up by extensive liability provisions and a very active plaintiff's bar. There are also detailed rules that govern advertising of offerings (other than via the prospectus).

Derivatives are actively traded in the jurisdiction, both over-the-counter and on-exchange. Standardized options and futures are exchange traded. Swap agreements (security-based or not) are expressly stated not to be securities under the Exchange Act and so not subject to the issuer disclosure requirements. Even derivatives that would qualify as securities under legislation often are sold using one of the disclosure exemptions and so no prospectus is prepared.

Options and futures that are traded on securities and futures exchanges are sold using standardized disclosure documents that include a description of the terms of the contracts, mechanics of trading and risks. In addition, customers proposing to trade in these standardized contracts through a BD (for options) or an FCM or IB (for futures) would be given a specified risk disclosure statement that provides additional information regarding the risks associated with the instruments.

The issuer's most recent financial period statements (annual or interim) generally are required to be included in a registration statement once the financials are available. There are slightly different requirements that apply to initial public offerings of securities. Other financial information contained in the registration statement is to be as of a date that is as close to the date of the document as is practicable. Non-financial information is required to be "current."

Disclosure by issuers is promoted through:

- SEC review of filings;
- stock exchange listing requirements and oversight activities;
- required certification of the content of disclosure (financial and registration statements) and eligibility to use certain specific disclosure regimes;
- the loss of certain benefits if disclosure obligations are not met consistently and on time; and
- investigation and possible enforcement actions concerning violations of the requirements.

Certification of financial statements and registration statements by officers, directors and other persons attracts liability to sanctions by the SEC and civil suits by injured investors. If a registration statement contains a material misstatement or omission, purchasers may sue all or any of the issuer, its directors, any officer who signed the registration statement, the underwriters, auditor and any expert whose opinion is included in the disclosure document, such as a geologist. Issuers are subject to strict liability. All others may be able to plead a defense of due diligence.

Very limited exemptions from full disclosure exist. Information (such as parts of material contracts) may be filed on confidential basis if specified conditions are met under the FOIA—such as for trade secrets.

The SEC can issue temporary cease trade orders. Stock exchanges have rules in place to halt

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	trading in a company's securities temporarily while a material announcement is made. Trading in securities on insider information is subject to both criminal and civil sanctions. Regulation also imposes obligations on issuers to make prompt public disclosure if material information has been disclosed selectively. There is a separate disclosure regime for "foreign private issuers" (essentially, foreign corporate issuers) that produces disclosure that largely is equivalent to that for U.S. public companies for public offerings of securities and annual reports. The financial statements of foreign private issuers may be presented in accordance with (i) U.S. GAAP, (ii) another comprehensive body of accounting standards reconciled to U.S. GAAP, or (iii) IFRS as issued by the IASB. Each company may elect the basis of presentation. The statements must be audited by an auditor who is registered with the PCAOB and the audit must be in compliance with U.S. GAAS. The disclosure regime for municipal securities (those securities issued or guaranteed by U.S. state or municipal governments or agencies) is very different from that described above. By law, the SEC has no authority to impose disclosure requirements on these issuers. However, the information voluntarily made available to the public in connection with these offerings is viewed by the SEC as being insufficient for investors to make informed choices. To improve the disclosure for these offerings, the SEC imposes obligations on any BD acting as underwriter of an issue to ensure the certain information is made available. These "official statements" are not certified by the municipal issuer, but are made available, along with the financial statements and other continuing disclosure of the issuer, to the public through a website maintained by the MSRB. The disclosure guidance for these official statements is principles-based and far less detailed than that which would apply to a corporate issuer. However, the anti-fraud provisions of securities laws apply if the disclosure contains a misrepresentation or material omission. The issuer may be audited by an independent auditor or by the state auditor and the financial statements may or may not be prepared in accordance with U.S. GAAP.
Assessment	Broadly implemented.
Comments	While the initial and continuing disclosure regime in the United States is extensive, it is not comprehensive. There are certain limitations in the application of both the initial and continuing disclosure requirements, the timeliness of material change notices, and the disclosure regime for complex structured securities that gave rise to the assessment rating. Not all companies that have issued their securities to the public are required to provide ongoing disclosure to their investors. A public issue of securities under the Securities Act requires extensive initial disclosure and continuing disclosure for the first year thereafter, but only registration of a class of equity shares of that issuer under the Exchange Act gives rise to ongoing disclosure requirements under securities legislation. Listed securities are required to be so registered, as are equity securities that are held by more than 300 investors. Below that threshold, the only applicable requirement may be corporate law provisions that mandate delivery of annual and interim financial statements. This system creates gaps in disclosure to investors holding publicly offered securities and should be re-examined. There may be a need to reassess the disclosure regime governing distributions of complex structured products, particularly with respect to initial and on-going risk disclosure, to ensure investors and the marketplace have sufficient current information to make informed investment decisions. It would be preferable for the SEC to have authority to regulate directly the disclosure provided to investors regarding new issues of municipal securities. The SEC should have the power to mandate both initial disclosure requirements and on-going obligations on these issuers to provide the necessary financial and other information about the securities and the issuer. (See also the discussion of this issue under Principles 1 and 3.)

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Principle 15.	Holders of securities in a company should be treated in a fair and equitable manner.
Description	The rights of security holders of public companies are set out in a combination of state corporate law, securities laws, stock exchange rules for listed companies, and judicial decisions. Provisions of state corporate law may differ, do not apply to issuers that are not corporations, and may not provide significant protections to holders of securities other than voting securities. Each of the enumerated topics set out in key question 1 of the Assessment Methodology is covered by one or more of these requirements and generally results in equitable treatment of voting security holders. Generally, security holders have the right to vote on changes that affect the terms of the securities they hold and on certain other fundamental changes. The company must provide reasonable notice and material information about all matters to be voted on at a security holder meeting. Both registered and beneficial owners must receive this proxy related information. The term "tender offer" is not defined under the federal securities laws or the SEC's rules. Judicial decisions have defined a tender offer as any direct offer to purchase securities from security holders where certain other criteria are present. The purpose of tender offer regulation is to provide disclosure and procedural safeguards to equity shareholders who hold securities that are registered under the Exchange Act and are subject to an offer. If a transaction meets the tests for a tender offer, the offer must be made to all holders and all must get the same (best) price. Special rules apply if the offer is made by the issuer and these rules apply even if the securities sought to be repurchased are not registered under the act. In most cases, change of control transactions would be subject to federal securities laws and/or state corporate law. However, a private agreement to acquire securities from a very limited number of shareholders may not meet the test to be a "tender offer" or trigger any other legislative provisions designed to protect the interest of security holders. For example, a purchaser may acquire control of a public company by buying the securities of an existing controlling shareholder at whatever price, without triggering an obligation to offer similar terms to other shareholders or other requirements under state law. The only statutory requirement that may be triggered by these types of transactions would be subsequent insider reporting obligations on the seller and purchaser. While there is no explicit compulsory bid rule, there are a number of features of the legal system that tend to dissuade acquirers from proceeding via private agreement. In particular, provisions of various state laws (including that of Delaware and New York) create serious obstacles for such a controlling stockholder. In essence these statutes prohibit an "interested stockholder"—an acquirer of 15 percent (for Delaware) or 20 percent (for New York) ownership—from engaging in a wide variety of transactions with the corporation, including mergers, purchases of assets, issuances of additional securities, and "any receipt … of the benefit, directly or indirectly (except proportionately as a stockholder of such corporation), of any loans … or other financial benefits … provided by or through the corporation or any direct or indirect majority-owned subsidiary," for three years (for Delaware) or five years (for New York) after becoming an interested stockholder. Both of these statutes permit the board of directors of the corporation to waive the statutory moratorium in advance of the acquirer's becoming an interested stockholder. In determining whether to grant such a waiver, the directors' fiduciary obligations require them to take into account the interests of all stockholders, not just those of the controller. Decisions that favour the controller would likely be tested in court and the directors would be required to demonstrate that their waiver decision was entirely fair to the minority shareholders. All material information relevant to a shareholder's voting decision must be disclosed for annual meetings, special meetings, and in the tender offer scenario. The rules address the time to be given to equity shareholders to make their decisions. Directors are generally subject to fiduciary duties of loyalty, good faith, and candor that are owed to the corporation and its shareholders. If a director fails to act appropriately, whether in the takeover context or otherwise, the corporation may take action against that director. Further,

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	derivative actions may be brought by shareholders if the corporation fails to take action against a director for a breach of his duties. The registration statement and the annual report must include information on any shareholder holding more than five percent of any class of voting securities of the issuer. "Holding" is defined as beneficial ownership or the right to vote or dispose of the shares. There are also timely public disclosure requirements that apply to these shareholders—both initial requirement on acquiring five percent of the shares and on any change in holdings. Most holders have to disclose within 10 days, but passive institutional investors only have to disclose within 45 days after December 31 of the year the threshold was exceeded. Material changes to holdings are to be disclosed; 1 percent of the class of securities is deemed to be material. Persons acting together by agreement to buy, sell, or hold securities are deemed to be a single person and their collective holdings are subject to the reporting requirements. Holdings of voting securities by directors and senior management also are subject to disclosure requirements—both individually and collectively. The issuer is subject to requirements to disclose officer and director holdings in its registration statement and update this annually. A director or executive officer of the issuer has an individual obligation to disclose all equity securities of the issuer in which he or she has a direct or indirect opportunity to profit immediately upon becoming a director or officer. If the positions change, an amended report must be filed by the end of the second business day following the transaction. Directors and officers may also be required to pay to the issuer any profit they obtain on short-term trading in the issuer's securities. All of these insider filings are on EDGAR and available to the public promptly. If a foreign private issuer has a class of securities registered under the Exchange Act, it is required to include in its registration statement (under "risk factors") information regarding differences in shareholder rights between the foreign jurisdiction and the U.S. It must also note the existence of provisions of foreign corporate law or in the issuer's incorporating documents that have a material effect on shareholders' ability to pursue remedies or other matters affecting shareholder rights. Other foreign private issuers may, but are not specifically required, to make similar disclosure.
Assessment	Fully implemented.
Comments	
Principle 16.	Accounting and auditing standards should be of a high and internationally acceptable quality.
Description	Issuer registration statements and annual reports must contain audited financial statements. The financial statements must include a balance sheet and profit and loss statement as well as a statement of comprehensive income, a statement of cash flows and a statement of changes in equity, plus all necessary notes. All financial statements, whether audited or unaudited, interim or annual, for U.S. issuers are required to be prepared and presented in accordance with U.S. GAAP. See the description in Principle 14 of the rules that apply to foreign private issuers. The SEC performs selective reviews of the accounting disclosure included in the financial reporting of public companies to ensure necessary information is included and presented in a manner that will be understandable by investors. To promote consistency and comparability in period to period reporting, specific guidance is provided for presentation and disclosure associated with reclassifications and changes in accounting policies, changes in estimates, changes in reporting entity and other conditions which affect comparability. The auditor is required to comment in the audit report on material changes in accounting. The SEC has the power to set standards of accounting, auditing and financial reporting for companies that file information and reports with the SEC. However, historically it has relied on the work of the accounting standard setters. Legislation sets criteria that must be met in order for the SEC to recognize the work product of an accounting standard-setting body as "generally accepted."

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	The standards of the U.S. Financial Accounting Standards Board (FASB) have been so recognized for the purpose of the U.S. federal securities laws. The auditing standards used by auditors of public companies in the U.S. are the standards of the PCAOB, as modified or supplemented by the SEC. The PCAOB adopted the auditing and related professional practice standards of the Accounting Standards Board as they existed in April 2003 as interim professional standards. In addition, unaudited interim financial statements are required to be reviewed by an independent public accountant registered with the PCAOB. Independence of the external auditor is required under the U.S. system and detailed tests for independence are prescribed. FASB is part of a structure that is independent of other business and professional organizations. However, given the recent actions on fair value accounting after lobbying by companies, particularly banks, FASB's independence might be questioned. Legislation established the PCAOB to be an independent overseer of the audit of public companies that are subject to U.S. securities laws. The SEC selects the five board members of the PCAOB. SEC staff oversees the operation of the PCAOB and also monitors its standard setting work. Both FASB and the PCAOB are funded via an annual accounting support fee assessed against issuers. Both boards also provide extensive transparency with respect to their activities and standard-setting. The audit committee of the board of directors of a public company is required to oversee the selection and appointment of its external auditor. All directors on the audit committee must be independent and the tests for independence of audit committee members are more stringent than those that apply to other independent directors. The company is required to file a notice with the SEC within four days if the external auditor has resigned during a current audit, declined to stand for re-election after the completion of the audit or was dismissed by the company being audited. The SEC can use both formal (enforcement action or obtain court orders) and informal mechanisms (seek additional disclosures, agreement to make changes to future filings or restatements) to enforce compliance with accounting standards. The SEC has the authority to bar accountants from acting as an auditor or as a preparer of financial statements (such as a chief financial officer or comptroller) of a public company. These orders are posted on the SEC website. In addition, the PCAOB carries out inspections of registered audit firms and takes action where deficiencies are found.
Assessment	Fully implemented.
Comments	
Principles for Collective Investment Schemes	
Principle 17.	The regulatory system should set standards for the eligibility and the regulation of those who wish to market or operate a collective investment scheme.
Description	**CFTC** The operator of a commodity pool must be registered under the CEA as a CPO and the registration function has been delegated to the NFA by the CFTC, subject to appeal to the CFTC and the courts. The commodity pool may be marketed by registered persons (the CPO, an IB, FCM or a BD registered with the SEC). The CEA sets out certain disqualifications from registration (mostly based on prior history of disciplinary/criminal offences)—both at the firm level and the level of principals/associated persons, including shareholders holding more than 10 percent of the voting shares. The NFA performs an extensive background check to determine whether a disqualification exists. No subjective inquiry is performed with respect to the business model or management capabilities of the applicant for registration. No on-site inspection is required to be done prior to registration. Prior to registration, the NFA does not routinely conduct on-site or off-site reviews of the operational capacity of a CPO applicant.

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	There are no initial or ongoing minimum capital requirements for CPOs. The NFA may consult with foreign regulatory authorities to assess the fitness of applicants for registration whose applications disclose prior employment with a non-U.S. firm, or where the U.S. registrant has foreign principals. This is done either directly by the NFA, or where necessary, through the CFTC. Clear authority is granted to the CFTC and delegated to NFA with respect to registration of CPOs and authorization of commodity pools, inspections, investigations and the taking of remedial actions in the event of any breach. The CFTC also takes action directly—particularly with respect to investigations and remedial action. The CFTC and the NFA have an array of tools available to address breaches of the law. They may take administrative proceedings against CPOs, impose civil penalties and restitution to customers or cease and desist orders and refer matters for criminal prosecution. The NFA has oversight responsibility for CPOs and has a program in place to monitor on-going compliance by CPOs with all applicable CFTC and NFA rules and regulations—both through on-site inspections and off-site reviews. Most new CPOs are examined in their first two years of operation and then every three to four years, based on an assessment of their risk. During fiscal years 2007, 2008, and 2009, the NFA conducted examinations of 179, 250, and 211 CPOs respectively (about 20 percent per year). Off-site supervision activities include reviews of disclosure documents, financial statements, pool performance data services, hiring patterns for employees and principals, customer complaints, annual questionnaire data, and website monitoring. Each registrant firm or applicant for registration must promptly correct any deficiency or inaccuracy in its registration information, including information about its principals and associated persons. The NFA also requires CPOs to provide annual updates regarding their registration information and business operations. Very few commodity pools are offered to the retail public, although the practice is not prohibited. Most commodity pools are marketed to sophisticated persons and are private offerings under federal securities laws. Approximately 3.3 percent of the pools offered by CPOs are publicly offered pools, and these pools have reported about 5.2 percent of the total aggregate net asset value ("NAV") of all pools. As of December 31,2008, approximately 1,350 CPOs registered with the CFTC and filed annual reports for about 1,500 pools with a reported aggregate NAV of about US$316.3 billion. Of the 1,350 registered CPOs, 20 CPOs offered approximately 50 public pools with a reported aggregate NAV of about US$16.6 billion. CPO regulation is not comparable in scope to requirements under the ICA applicable to SEC-regulated investment companies (i.e., mutual funds). Pools offered to the public are subject to the disclosure requirements imposed under the CEA, those of the NFA and the requirements of the Securities Act. The Disclosure Document requirements across all three sets of rules are consistent, although if a pool is subject to the Securities Act, some additional information must be provided. Most pools are offered by way of private placement and so are exempt from the registration statement requirements of the Securities Act. Registered CPOs are required to file Disclosure Documents regarding the commodity pool and annual financial statements with the NFA for review. NFA reviews 100 percent of the initial and renewal/updated Disclosure Documents. During fiscal years 2007, 2008 and 2009, the NFA received and reviewed 1,372, 1,365, and 1,512 pool Disclosure Documents respectively. As part of the CFTC's oversight of the NFA, CFTC staff regularly reviews a sample of Disclosure Documents to determine the efficacy of the NFA's review. No Disclosure Document is required if the only participants in the pool are Qualified Eligible Persons (largely institutional investors). If the CPO is currently soliciting potential pool participants and is not operating under an exemption, the pool's Disclosure Document must be updated within 21 days of a material change.

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	There is no general obligation to issue a press release or other public notice of the change. The periodic account statement distributed to participants monthly or quarterly must disclose any material business dealings involving the CPO and any other person providing services to the pool if they have not previously been disclosed to the pool's participants. The Disclosure Document must contain a full description of any actual or potential conflicts of interest regarding any aspect of the pool. CFTC regulations do not mandate that a CPO take any actions to minimize conflicts of interest; the only requirement is full disclosure. The CPO must adhere to any information set out in the Disclosure Document with regard to best execution, trade allocations, related party transactions, etc. Bunched trades are to be allocated on an objective and fair basis. There also are rules governing closing out positions and offsetting trades that require netting of positions. Each CPO must keep books and records relating to the pool as well as to its operations as a CPO. The CEA and CFTC regulations do not prohibit a CPO from delegating functions to another person or entity. If the delegate is carrying on operator functions, it must be registered as a CPO. The delegating CPO remains primarily responsible for its obligations. The CPO is required to disclose information about entities and individuals who provide services to the commodity pool as well as any conflicts of interest that may arise. The NFA has an expanded reporting rule that will go into effect in 2010 that will require CPOs to provide some additional information on their service providers such as custodians and administrators and to update that information quarterly. **SEC** The CIS operator must register with the SEC as an IA under the Advisers Act. The shares of a CIS may be marketed by the CIS itself, its operator (if any) or a BD. Each of these entities is required to be registered with the SEC. A person may not be registered if a statutory disqualification is present—largely related to that person's history of criminal or disciplinary sanctions. Statutory provisions do not address all the criteria for eligibility to operate a CIS set out in the Assessment Methodology. There are no eligibility criteria that address the competence to carry out the functions and duties of the operator (i.e., human and technical resources); financial capacity; and adequacy of internal management procedures that are assessed by the regulator prior to licensing. Under the ICA and the Advisers Act, the SEC does not assess the qualifications of persons or firms seeking to become CIS operators, except as noted. The fact that an entity is registered with the SEC as an operator does not represent a determination by the SEC as to the fulfilment of criteria for eligibility to operate CIS that are listed above. The SEC does not make registration determinations based on those factors, except to the extent noted. The responsibility for assessing the fitness and competence of a CIS's operator is placed primarily upon the CIS's board of directors and their fiduciary duties to the CIS and its shareholders. Under the ICA, there must be written contract between the CIS and its operator but there is little guidance on what must be covered by that contract. The terms of a CIS operator's contract (and any renewal) must be approved by a vote of a majority of the CIS's independent directors. The CIS operator's contract also must be approved by a vote of a majority of the holders of the CIS's outstanding voting securities. The ICA also requires CIS directors to request and evaluate such information as may be reasonably necessary to assess the terms of the advisory contract and the operators must furnish this information to CIS directors. When shareholder approval of the CIS operator's contract is sought certain information regarding the CIS operator and the contract, including the compensation to be paid under the contract, must be provided in the proxy statement provided to shareholders. The Advisers Act requires operators that seek to become registered with the SEC to make certain public disclosures. In the case of a CIS, an operator generally provides the CIS's board of directors with a copy of the operator's disclosure form. A CIS also must disclose in its registration statement

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	certain information regarding the operator, including the operator's experience as an operator, the operator services that it provides to the CIS and a description of the compensation that the operator receives. A CIS may not issue its securities to the public unless it has a net worth of at least US$100,000. State law may impose proficiency requirements on individual representatives of IAs resident or carrying on business in that state. CIS and their operators must have written compliance policies and procedures in place that are reasonably designed to prevent violations of the law, including policies and procedures designed to ensure that the CIS's board has at least a minimum of 40 percent independent directors. In practice, most CIS have a majority of independent directors in order to be able to rely on certain exemptions. Both the CIS and the securities it issues must be registered; the CIS must be registered under the ICA and its securities must be registered under the Securities Act. There is a common disclosure form under both acts. The registration statement for a CIS consists of three parts: prospectus, statement of additional information and supplementary information (material contracts, incorporation documents etc.). Selective reviews of registration statements, post-effective amendments, proxy statements and other periodic reports are carried out by the SEC. The reviews cover registration statements and other reports to assess, among other things, the continued eligibility of the CIS and its operator. No sales of a CIS's shares may be made before its registration statement is effective. The SEC has the authority to inspect CIS and their operators, investigate suspected breaches and take remedial action under the ICA and Advisers Act via administrative proceedings or civil and/or criminal court actions. There are a full range of penalties that may be applied for breach of the legal requirements, such as civil fines. (See also the discussion under Principles 8 and 9 above.) A CIS operator has a general and continuing obligation to report to the SEC, either prior to or after the event, information relating to material changes in its management or organization that are described in the operator's Form "ADV." The information in that form is required to be kept current. CIS and CIS operators are required to maintain books and records. All books and records kept are subject to examination by the SEC at any time. Various methods are used to address conflicts of interest, from direct legal prohibition of particular transactions to disclosure by the operator to independent review or approval by the board of directors of the CIS or its auditor. Certain transactions with affiliates are not permitted even if disclosure is made. Other conflicts between an operator and a CIS that are not specifically prohibited must be disclosed to the board of directors and may be disclosed to investors. As a fiduciary, an operator has an obligation to seek to obtain "best execution" of a CIS's transactions. The method of allocation of trades across the accounts managed by the operator must be fair, reasonable, and consistently applied on a timely basis. CIS operators are subject to the anti-fraud provisions that would prohibit churning. The major SROs have rules prohibiting churning and excessive trading that would apply to BDs executing trades for the CIS. There is no statutory prohibition on delegation of CIS operator functions to other persons if the advisory contract between the operator and the CIS permits the delegation. Systematic and complete delegation of core functions of the CIS operator is not prohibited. There is no specific requirement that the operator maintains adequate capacity or monitors the delegate. However, the delegate would be an operator of the CIS, and be required to be registered with the SEC and may perform services for the CIS only under a written sub-advisory contract that is approved by a majority of the CIS's shareholders and a majority of its independent directors. As an IA, the delegate would have a fiduciary duty to the CIS. The directors of the CIS are expected to oversee the performance of the operator and any service provider to the fund. By rule, CIS boards must

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	approve the policies and procedures of fund service providers, including the investment adviser and to review the implementation of the service providers' policies and procedures on an annual basis. Whether the CIS operator is responsible for the actions of the delegate depends on the advisory and sub-advisory contracts. Both the operator and the delegate may be responsible for the actions of the delegate under some contracts; in other cases only the delegate is responsible. The SEC can bring an enforcement action against a CIS operator for failure to supervise a delegate if the delegate violates the law and is subject to the CIS operator's supervision. If the delegate is a sub-adviser, the statute does not permit the operator to terminate the contract without approval by either a majority of the CIS directors or its shareholders. If the delegate is another service provider, the ability to terminate the contract depends on the terms of the relevant contract. Disclosure to investors of the delegation arrangements and the identity of the delegates is made as part of the shareholder vote approving the sub-advisory contract. In addition, a CIS generally must disclose the same information about the delegate in its registration statement as for its operator. The same provisions to prohibit, restrict or disclose certain conduct likely to give rise to conflicts of interest above apply equally to delegates of a CIS.
Assessment	Partly implemented.
Comments	To meet the standards set out in the Assessment Methodology, regulators should establish specific eligibility criteria for CIS and their operators that include the necessary human and technical resources to carry out the required functions, the appropriate financial capacity, and adequate internal management and controls. In addition, the Methodology requires that the regulator be responsible for ensuring compliance with the eligibility standards. At present, the resources and internal controls of a CIS would be subject to an examination by the regulator only sometime after the fund began operation, but are not preconditions to the original approval. Neither regime imposes any initial or ongoing financial capacity requirements on the CPO or IA acting as operator. The resources at the SEC, CFTC, and NFA do not allow routine examination of the operators to take place with sufficient frequency. These weaknesses should be addressed. (See also the comments under Principle 10.) The requirements under the CEA with regard to conflicts of interest at a commodity pool need to go beyond simply requiring disclosure of the conflicts among various parties to require actions to be taken to avoid or mitigate conflicts.
Principle 18.	The regulatory system should provide for rules governing the legal form and structure of collective investment schemes, and the segregation and protection of client assets.
Description	**CFTC** The commodity pool almost always is a limited liability company or a limited partnership and is required to be a separate entity from its CPO. There is no restriction on the legal form that it may take. All relevant material facts and risks are to be set out in the Disclosure Document that is reviewed by the National Futures Association (NFA) and provided to investors. Any important risks associated with the pool's legal form would be included. As a matter of course, the organizational documents for the pool are provided with the Disclosure Document to the regulators and investors. The Disclosure Document cannot be used without being accepted by the NFA. All information contained in the Disclosure Document must be current as of the date of the document, including information relating to rights of participants. If the CPO is currently soliciting potential pool participants and is not operating under an exemption, the pool's Disclosure Document must be updated within 21 days of a material change. There is no general obligation to issue a press release or other public notice of the change. Also, a CPO must disclose all material information to existing or prospective pool participants even if the information is not specifically

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required by CFTC regulations. The CPO must file any amendments to the Disclosure Document, including any changes made to the rights of commodity pool participants, with NFA.

All funds, securities and property received by a CPO must be received in the name of the commodity pool. No CPO may commingle the property of any commodity pool with the property of any other person. The Disclosure Document must set out the identity of the custodian or other entity (e.g., FCM, bank, or BD) which will hold the pool's assets. Detailed records of the operations of the CPO and the pool must be kept.

The NFA's periodic examinations of CPOs include testing, on a sample basis, the reporting of assets in a pool's financial statements. The NFA tests all material and unusual assets, liabilities, cash inflows and cash outflows, revenues, and expenses included in a pool's financial statements. The testing of a pool's financial statements also includes confirmation of material balances with third parties. The NFA recently adopted a rule to require CPOs to report limited pool performance and operational data on a quarterly basis to enhance monitoring capabilities. This rule is designed to provide NFA with current information related to commodity pools so that risk trends can be identified and appropriate audit priorities assigned.

The financial statements of the commodity pool that are required to be set out in the periodic and annual reports must be presented in accordance with U.S. GAAP and the annual report must be certified by an independent public accountant. The auditor of a commodity pool need not be registered with the PCAOB because the Sarbanes-Oxley Act established the PCAOB to oversee the audits of public companies.

The CFTC has the power to obtain court orders to freeze pool and/or CPO assets and have receivers appointed to operate the commodity pool for the benefit of participants.

SEC

Open-end CIS must offer securities that entitle a CIS investor to redeem the shares held at the NAV per share upon demand. Closed-end CIS do not issue redeemable securities. There are no specific requirements on the legal form of an open-end or closed-end CIS. They usually are organized as corporations, business trusts or statutory trusts. All CIS, regardless of their legal form, are required to have a board of directors or a functional equivalent of that body. At least 40 percent of those directors must be independent of the CIS operator and other CIS affiliates. In practice, usually a majority of directors are independent. Independent directors are charged with various significant oversight responsibilities.

A CIS must state whether it is an open-end, closed-end or unit investment trust (UIT) fund in its registration statement and disclose information about the redeemability of its shares, as well as the name of the jurisdiction in which it is organized. The registration statement contains exhibits, including copies of its organizational documents that would include information about its legal form and structure.

The responsibility for ensuring that the structure requirements are observed rests primarily with the CIS and those who signed its registration statement. CIS registration statements are reviewed by the SEC on a selective basis to ensure the requirements are met. The SEC does not approve or disapprove a CIS registration statement based upon the merits of an investment in the CIS, the qualifications of a CIS operator or the legal structure of the CIS.

A CIS is not required to give its existing shareholders prior notice of changes that do not require shareholder approval. A CIS that is making a continuous offering of its securities must maintain a current registration statement, including its prospectus. Open-end CIS and UITs must update their registration statements, including prospectuses, immediately to reflect any material changes that have been made to investor rights. Material changes include, among other things, changes in the CIS's investment objectives or fundamental policies, suspension of sales or redemption of shares, termination of an advisory contract and the resignation of the CIS's independent auditor.

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	All CIS registration statements are available on the SEC's website. CIS using a summary prospectus must provide updated prospectuses on their own websites. In practice, open-end CIS generally provide updated prospectuses annually to all existing shareholders. The general objective of the rules governing the custody of CIS assets is to separate the assets of a CIS from the assets of any other person, including its operator. CIS assets are to be held by an eligible custodian, such as (a) a federal or state bank that has capital of at least US$500,000; (b) a member of a national securities exchange; (c) a securities depository; (d) a futures commission merchant or commodity clearing organization; and (e) a foreign bank or securities depository subject to certain conditions. An eligible custodian may deposit CIS assets with another eligible custodian, such as a registered clearing agency acting as a securities depository. A UIT may not maintain custody of its own assets and must designate one or more banks as trustees or custodians. There is no requirement that a CIS's custodian be legally or functionally independent from the CIS's operator. If a CIS operator or its affiliate acts as a CIS's custodian, the CIS is deemed to have "self custody" of its assets and additional requirements apply including depositing the securities in the safekeeping of, or in a vault or other depository maintained by, a federally or state supervised financial institution, segregation, limited access by staff and special recordkeeping. In addition, the CIS must employ an independent public accountant to verify the CIS's assets at least three times during the year by actual examination. The auditor must send a certificate to the SEC stating that the examination has been made and describing the nature and extent of the examination. Further, a CIS must maintain a fidelity insurance bond against larceny and embezzlement involving CIS assets. Current accounts, books, and other documents relating to the CIS's assets must be kept. The CIS must keep records for all securities transactions and ledgers for all of the CIS's accounts and detailed shareholder records. Independent accountants registered with PCAOB must conduct an annual audit of a CIS's financial statements. CIS are not required to employ internal auditors. To deregister, the CIS must obtain an order from the SEC declaring that it has ceased to be a CIS and that its registration is no longer in effect. The SEC has authority to impose conditions on deregistration as necessary for the protection of investors. Prior orders have generally been based on a finding that the company has distributed substantially all of its assets to shareholders and is winding up its affairs or that the company has sold substantially all of its assets to another CIS or merged into or consolidated with another such CIS.
Assessment	Broadly implemented.
Comments	There are very few circumstances where securities legislation or the CEA requires investors in commodity pools or mutual funds to be given notice of a change that affects their rights prior to the effective date of that change, other than where prior approval of the investors is required. Under the CEA, where a material change takes place, existing participants must receive notice of the change within 21 days of that change. This is not timely disclosure and the notice period should be shortened considerably. There is no requirement under securities or commodities legislation that the custodian of CIS assets and cash be independent of the operator or other service providers to the CIS. Both regimes do require the assets to be segregated and held in a manner that makes the CIS's interests evident, which is consistent with the standards set out in the IOSCO Principles. However, strong consideration should be given to requiring the custodian be an arm's length party, which would avoid complications if a corporate group containing a CIS operator and its custodian got into financial difficulty. Under both the securities and futures regimes, any registered entity or registrant may be audited by anyone who is qualified to render an audit opinion under state law and is independent of the party being audited. Auditors of securities mutual funds must be registered with and subject to inspection

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	by the PCAOB. However, the audit of a CIS (or for that matter the audit of a market intermediary) may need someone who has specific experience in the area. While U.S. auditing standards require an auditor to ensure that the engagement team (which includes the audit partner in charge) has the necessary competencies, consideration should be given to requiring the audit partner in charge of the audit have some relevant experience.
Principle 19	Regulation should require disclosure, as set out under the principles for issuers, which is necessary to evaluate the suitability of a collective investment scheme for a particular investor and the value of the investor's interest in the scheme.
Description	**CFTC** Commodity pools, if offered publicly, are subject to both the CEA and the Securities Act, meaning the prospectus/Disclosure Document must meet requirements of both acts. However, the majority of pools are distributed by private placement and so would only be subject to the CEA/NFA requirements outlined here. If the pool is offered only to Qualified Eligible Persons (largely institutional investors), the Disclosure Document is not required and there are less onerous periodic reporting requirements. The information contained in any Disclosure Document must not be misleading. CPOs must provide a detailed Disclosure Document to prospective participants before accepting their subscriptions for interests in a commodity pool. The disclosure requirements set out specific information that must be included and there is a general requirement that all material information be provided. NFA rules require the use of plain language. The Disclosure Document requirements address the range of topics enumerated in the Assessment Methodology. Prior to using a Disclosure Document, a CPO must submit the Document to NFA and receive an acceptance letter confirming that the Document can be used to solicit. If the Document does not meet regulatory requirements, NFA will provide notice of deficiencies. The Document may not be used until all issues are addressed. There are rules regarding advertising and marketing materials that include rules that prohibit any false or misleading communications with the public. No Disclosure Document may be used that is more than nine months old. See also the material change update requirements set out in Principle 18. The CPO is required to provide the commodity pool's annual audited financial statements and annual report within 90 days of the pool's year end to its participants and the regulators. It must also provide periodic account statements to its participants, either monthly for pools with assets greater than US$500,000, otherwise quarterly, within 30 calendar days of the end of each reporting period. These periodic reports and annual financial statements must be prepared in accordance with U.S. GAAP and annual reports must be audited in accordance with U.S. GAAS. **SEC** Key information is required to appear in plain English in a standardized order at the front of a CIS's prospectus. Under a new disclosure regime that is in the process of being implemented, an investor may get the key information in the form of a summary prospectus so long as the full prospectus is easily accessible on a website. A CIS's prospectus must include all information that would be material to an investment decision by a prospective investor. The specified disclosure items include the full range of topics enumerated in the Assessment Methodology. A prospectus must be delivered to an investor purchasing a CIS in a primary distribution. An open-end CIS may describe the types of investors for whom the CIS is intended or the types of investment goals that may be consistent with an investment in the CIS. In addition, FINRA rules impose suitability requirements on any BD that recommends to investors that they purchase a CIS's securities. The registration statement must include extensive disclosure on all of the disclosure items set out in the Assessment Methodology. There are some differences in requirements across the various

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	types of CIS, as some items are not applicable to all types of CIS, particularly UITs. The SEC may intervene in an offering if it appears that the registration statement includes an untrue statement of material fact or omits to state any material fact required to be stated or necessary to make the statements not misleading. It may issue stop orders or cease and desist orders to stop offerings. It also can institute a proceeding against a person or seek an injunction in federal court for violations of the ICA or Securities Act. A CIS may use brochures or advertisements and may market through the full range of media. Like offering documents, all marketing materials are subject to the anti-fraud provisions of the law and may not contain material misstatements or omissions. There are specific, detailed requirements that apply to various types of advertising. Copies of all advertisements and sales literature must be filed with the SEC. If a CIS's shares are sold by a FINRA member BD, FINRA requires the BD to file any advertisement or sales literature that it uses to market the company. These advertisements and sales literature are reviewed by FINRA. Advertisements and sales literature filed with the SEC may be reviewed. Each open-end CIS always must have a current, effective registration statement. An open-end CIS must amend its registration statement at least annually to include updated financial information or more frequently, if necessary, to reflect material changes in its operations. The Securities Act requires a CIS to maintain a "current" statutory prospectus, any prospectus used more than nine months after the registration statement's effective date must contain financial and other information as of a date not more than sixteen months prior to such use. CIS prepare and send annual and semi-annual reports to their shareholders. The reports must include full financial statements for the CIS prepared in accordance with U.S. GAAP, including a schedule of portfolio holdings that shows the amount and value of each security owned by the CIS on that date. The annual report must include audited financial statements, accompanied by a certificate of an independent public accountant that is a member of the PCAOB. There is also a semi-annual financial reporting requirement to investors and a requirement that the CIS's portfolio statement be sent to the SEC quarterly. CIS must transmit reports to shareholders and file information with the SEC within 60 days after the end of the period for which each report is made. The auditor is required to include procedures designed to detect illegal acts, identify related party transactions and evaluate the CIS's ability to continue as a going concern. If the auditor becomes aware that an illegal act has occurred, the accountant has obligations to promptly notify the CIS's operator and ensure that the CIS's audit committee or directors. In some circumstances, the auditor must report the issues directly to the SEC.
Assessment	Fully implemented.
Comments	See comments under Principle 18 regarding the timing of notice of material changes under the CEA.
Principle 20.	Regulation should ensure that there is a proper and disclosed basis for asset valuation and the pricing and the redemption of units in a collective investment scheme.
Description	**CFTC** The NAV of a commodity pool must be calculated using U.S. GAAP, consistently applied. Valuations are to be reported in the Statement of Changes in Net Assets included in the periodic and annual reports of the pool. U.S. GAAP requires the use of Statement of Financial Accounting Standards (FAS) 157, *Fair Value Measurements*. This statement includes provisions for fair value of commodity pools, establishes a framework for measuring fair value under U.S. GAAP and expands disclosure about fair value measurements. Information in the CIS's annual report on the valuation of the assets and calculation of NAV must be audited by the independent auditor. The NAV of a pool is disclosed to participants in the

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periodic account statements provided by the CPO.

The Disclosure Document must contain a complete description of any restrictions on the transferability of a participant's interest in the pool and the frequency, timing and manner in which a participant may redeem interests in the pool. This must include how the redemption value of a participant's interest will be calculated, the conditions under which redemption will be made (including time between request for redemption and payment) and any restrictions on redemption.

There are no specific requirements that govern pricing errors, other than what would be covered by the general disclosure and audit requirements. The suspension and deferral of routine valuation, pricing and redemptions are covered by disclosure requirements and otherwise are not subject to review or involvement by the regulators. However, the CFTC and NFA have the power to take action where necessary. The CFTC has the authority to take court action under the CEA, and the NFA may take a Member Responsibility Action pursuant to NFA Compliance Rules. In 2010, new NFA rules on quarterly reporting requirements for CPOs will require CPOs to provide the NFA with notice of the suspension or deferral of redemption rights.

The CFTC and NFA have and exercise the authority to enforce requirements regarding asset valuation and pricing. Regular reviews are conducted by NFA of CPO operations that would cover the CPO's valuation and pricing practices and procedures. Actions have been taken where breaches have been found.

SEC

CIS assets must be marked to market or otherwise valued at fair market value as required by U.S. GAAP. As is the case for commodity pools, FAS No. 157, *Fair Value Measurements* applies. There is no specific requirement regarding the frequency of calculation of the NAV of a CIS.

Open-end CIS may be redeemed only at a price based on the NAV of such security next computed after receipt of a redemption request (forward pricing). The ICA generally prohibits a closed-end CIS from issuing its common stock at a price below its current NAV.

A CIS's independent auditors must verify the CIS's NAV calculations and test the process by which the CIS values its portfolio securities as part of the CIS's annual audit. The SEC has issued detailed guidance on how this audit verification is to be conducted.

The CIS' board is responsible for overseeing the valuation of CIS portfolio securities, must approve the valuation criteria and are responsible for reviewing the CIS's valuation methods to assure that the valuations of the CIS's portfolio securities are fair and accurate.

Federal securities laws do not require that the prices of a CIS be disclosed or published on a regular basis to investors other than in the CIS' annual or semi-annual reports. In practice, the current price of a CIS is generally available in financial publications and websites every business day.

There are industry rules of practice on pricing errors that have been adopted by some CIS boards of directors. These set out when price adjustments should or do not need to be made (i.e., set *de minimis* standards). The valuation procedures of a CIS generally provide for the reporting of any material pricing errors to the board and may call for the board to review or approve any corrective action that was taken. Pricing errors that are not considered material would be corrected on a going-forward basis. A CIS typically would not report pricing errors to the SEC unless the error is required to be reflected in its financial statements, i.e., is material.

CIS may, but are not required to, suspend redemptions and postpone payment for redemptions already tendered for any period during which the NYSE is closed. A CIS also may suspend redemptions for any period during which (a) trading on the NYSE is restricted, or (b) an emergency exists, as determined by the SEC, as a result of which it is not practicable for the CIS to liquidate its portfolio securities, or fairly determine the value of its net assets. Otherwise, a CIS cannot suspend the right of redemption or postpone the date of payment more than seven days after the tender of the security to the CIS or its redemption agent. The CIS must amend its prospectus to

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	discuss any suspension or deferral of redemption rights. Such an update would be filed with the SEC. If a CIS wants to suspend redemptions for any reason other than those discussed above, it must request an order from the SEC, which will be granted only if the order is necessary for the protection of the CIS's shareholders. The SEC has the power to enforce compliance with the rules on asset valuation and pricing through its examinations and enforcement actions. The SEC reviews CIS asset valuation and pricing during its examinations of CIS, CIS operators and third-party administrators that perform operational and administrative functions for CIS. The SEC has taken enforcement actions against entities for having inadequate review procedures to identify pricing deviations or where pricing practices breach the law—such as for late trading. The SEC has the authority to intervene when the suspension of redemptions is in breach of the law and in certain other situations. It also has the authority to seek a court order to suspend redemptions.
Assessment	Fully implemented.
Comments	The CFTC should consider providing guidance to the industry on how to address pricing errors in the valuation of commodity pools.
Principles for Market Intermediaries	
Principle 21.	Regulation should provide for minimum entry standards for market intermediaries.
Description	**CFTC** Legislation requires anyone carrying on business as an FCM, IB, CPO, or CTA to be registered with the CFTC. If these firms are dealing with the public they must also be members of the NFA. The CFTC has delegated the responsibility to the NFA to receive and review registration applications and grant or deny registrations, subject to appeal to the CFTC and the courts. The CFTC oversees the operations of the NFA. (See also the discussion under Principle 7.) There are published minimum standards that require information be provided to ensure that no statutory bar to registration is present (such as a criminal record or certain financial sector offences) and other proficiency requirements are met, such as courses and experience etc. for individuals. This assessment extends to principals who beneficially own 10 percent or more of the equity of the firm. The regulators have authority to refuse licensing if one of the statutory bars is present. The NFA also has minimum educational and other requirements that apply to specified personnel at all FCMs, IBs, CPOs, and CTAs. An assessment of the internal controls, back office capabilities, record keeping systems, etc., of applicants is not mandatory before registration is granted. The NFA's practice is to perform an off-site review of an FCM's or non-guaranteed IB's policies and procedures as part of the licensing process. DCOs and DCMs generally perform reviews of the internal controls and back office capabilities of applicants for clearing membership. Applicants that are required to provide audited financial statements must have those statements certified by an independent auditor. This certification process involves review of the firm's accounting system, internal accounting controls and procedures for safeguarding customer or firm assets. If material inadequacies come to light, the certifying accountant must notify the applicant/registrant, who must notify NFA, the firm's designated self-regulatory organization (DSRO), and the CFTC. Each firm registrant or applicant for registration must promptly correct any deficiency or inaccuracy in its registration information, including information about its principals and associated persons. Only FCMs and non-guaranteed IBs have minimum capital requirements and each of these types of firms is required to give immediate notice if it falls below the required on-going capital thresholds. Various actions may be taken by the regulators as a result. (See the discussion under Principles 22 and 24.) The firm must give notice within 20 days of any new principal of the firm. If the principal is not suitable, the regulator may take action against the firm to ensure the

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principal ceases to be associated with the firm.

Detailed information on firms and individuals is publicly available on the NFA website. Information available on the site extends to the disciplinary history of both firms and individuals.

CTAs may manage client assets on a discretionary basis but they are not permitted to have custody of those assets. There are no capital requirements for CTAs. They must keep accurate and current records concerning their clients and their activities. They must disclose specific information to clients, including the business background of the CTA and its principals who will make trading or operational decisions, any material actions against the CTA and principals, a description of the trading program and related risk factors, fees, any actual or potential conflicts of interest and past performance of its client accounts. The usual warning that past performance does not predict future returns must be included if performance information is provided to clients. The disclosure also must include a full description of any actual or potential conflicts of interest regarding any aspect of the CTA's trading program and other material conflicts of interest. The general anti-fraud standards also apply to disclosures made by these firms. Unlike IAs registered with the SEC, CTAs are not automatically fiduciaries, although that standard may apply if the common law tests of trust and reliance are met.

SEC

Any person engaged in the business of effecting transactions in securities for the account of others or of buying and selling securities for his own account, through a broker or otherwise, must register with the SEC as a BD and be a member of at least one SRO. If the BD carries on customer business it must be a member of FINRA. State law may require BDs and their personnel to register with state securities authorities.

There are some exceptions from the definition of a BD, including banks engaged in certain limited activities, persons trading solely on their own account, and issuers. There are also exemptions from the registration requirement for foreign brokers only carrying on limited activities; BDs operating only intra-state; or a BD only trading in exempted securities, commercial paper, bankers' acceptances, or commercial bills.

The application form for a BD requires extensive information about the background of the applicant, its principals, controlling persons (defined as having at least 25 percent of the voting shares of the company) and employees, the type of business it proposes to engage in and discipline history of any of these persons or affiliates.

To carry on business as an IA (in the business of providing advice, making recommendations, issuing reports, or furnishing analyses on securities, either directly or through publications), a person must register with the SEC or a state securities authority. There are the usual exceptions for banks, lawyers, accountants, journalists, etc. Firms that manage investments on a discretionary basis register as IAs. In specified circumstances, an advisor may choose not to register. For example there is a *de minimis* exemption for an adviser that has fewer than 15 clients, does not hold itself out generally to the public as an IA and does not act as an IA to a registered investment company or certain other persons.

An adviser is **prohibited** from registering with the SEC unless the adviser has assets under management of US$25 million or more; advises a registered investment company; or is exempt from the prohibition by SEC rule or order. Smaller IAs generally must register with the securities authorities in the state in which they are organized and in each of the states in which they do business as an IA. Note that even if registered with the SEC, IAs are still subject to state laws regarding anti-fraud, filing of materials as with the SEC and the payment of fees to states.

The IA registration process is disclosure based. An IA registers with the SEC by filing an application for registration on Form "ADV" under the Advisers Act. The form requires extensive information regarding the adviser's background and business practices. Part II of the Form must be provided to the IA's clients. The SEC may deny registration if a statutory bar is present. (See also

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	the discussion under Principle 17.) An assessment of the internal controls, back office capabilities, record keeping systems, etc. of applicants for IA registration is not mandatory before registration is granted. A BD applicant must comply with net capital and other requirements established by SEC rules and any SRO requirements that may be higher. FINRA requires most BD employees directly involved in investment banking or brokerage sales to register with FINRA and have suitable experience/have passed required proficiency exams. OTC derivatives dealers are exempt from certain BD requirements such as SRO membership, regular BD margin rules and the application of the Securities Investor Protection Act (SIPA). They are subject to special requirements including limitations on the scope of their securities activities, specified internal risk management and control systems, recordkeeping obligations and reporting responsibilities. These dealers may calculate their net capital based on the use of Value at Risk models. The SEC does not have authority under the Advisers Act to impose initial or on-going capital requirements on IAs. Only the IA firm, not the persons who are associated with the adviser, must register with the SEC. There are no minimum proficiency standards for individuals acting for an IA under the federal regime, although individual states impose requirements as part of their registration process. FINRA requires applicants to have: • financial controls to ensure compliance with the federal securities requirements and the SRO's rules; • compliance, supervisory, operational and internal control practices and standards that are consistent with those regularly employed in the securities business, for the nature and scope of the applicant's proposed business; • appropriate systems of customer protection, risk management and internal controls; • a written business continuity plan with procedures that are reasonably designed to enable it to meet its existing obligations to customers in the event of an emergency or a significant business disruption; • a supervisory system, including written supervisory procedures, internal operating procedures (including operational and internal controls) and compliance procedures designed to detect and prevent violations of the applicable standards; • an explicitly delineated supervisory hierarchy, including the designation of a direct supervisor for each representative and the assignment of specific supervisory responsibilities; and • measures to monitor compliance with its policies and procedures under FINRA rules; and • a designated chief compliance officer. These are checked by FINRA before membership is granted; the SEC does not conduct any separate assessment of these matters. The BD is also required to certify annually to FINRA that the BD has a process to establish, maintain, test, and modify its supervisory procedures. Registered IAs must adopt and implement written compliance policies and procedures (CP&P) reasonably designed to prevent the violation of the legislation by the IA or any of its supervised persons and address potential conflicts of interest with its clients and other compliance factors creating risks for clients. An IA must designate a single chief compliance officer (CCO) to administer the CP&P. The CP&P must be reviewed annually by the IA for adequacy and effectiveness. These IA requirements apply to registered firms and are not assessed by SEC prior to the grant of registration, but may be reviewed on an examination. The SEC can refuse an applicant a license as a BD or IA if its application is incomplete, contains false information or a statutory bar to registration exists. It may also deny an IA's registration if the firm is prohibited from registering with the SEC. The SEC's registration decisions are subject to

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	judicial review. The SEC has the authority to withdraw, suspend or condition a registration if the firm breaches the law, has ceased to carry on business or is no longer eligible to be registered. If a new controlling shareholder does not qualify for registration, the SEC (and FINRA for BDs) may suspend or impose conditions on the firm's license. FINRA is the front line regulator of BDs. The SEC reviews/approves all SRO rules, plus inspects its membership and licensing processes. (See the detailed discussion under Principle 7.) Generally, IAs are not members of SROs, unless they are also BDs. A BD must promptly file an amendment to its registration form if the information changes. An IA must file an annual updating amendment to its registration form. Also, the registration form must be amended to keep it current. If material information on the form becomes inaccurate, it must be amended promptly. There is no specific guidance on what "promptly" means. For IAs, other corrections or updates, including a required annual update, must be made within 90 days of the IA's fiscal year end. Completed registration forms and annual audited financial statements for BDs are publicly available. The form indicates the types of business conducted by a BD, the states and SROs with which it is registered and information on its senior managers etc. FINRA maintains regulatory information about its BD members and their associated persons and make much of this information publicly available on its website. The public may confirm an IA's registration status with the SEC through the SEC's web site or by consulting the staff. The public may confirm state registration status by consulting with the relevant state securities commission. Information on the IA's activities, directors, officers and controlling shareholders are set out in its registration form. See the discussion of the examination programs that apply to intermediaries set out under Principle 10. An IA with custody of client funds or securities must hold the client assets at a "qualified custodian," (a similar list of entities as for an eligible custodian for a CIS) and subject to conditions regarding segregation of assets, reporting to clients and periodic checks/verifications by an independent auditor. The qualified custodian is not required to be at arm's length to the IA. There are also special record keeping requirements that apply to an IA with custody of client assets regarding client transactions and positions. Part II of Form "ADV" that must be given to clients of the IA must contain detailed disclosure on: the adviser's educational qualifications, relevant industry experience, disciplinary history (if any), investment strategies, fee structure and other client charges, potential conflicts of interest, and past investment performance. A guarantee of future investment performance would generally be unlawful as a fraudulent, deceptive, or manipulative act. Misuse of client assets also would violate the anti-fraud provisions of the law. IAs are subject to examinations by the SEC using a risk-based assessment model. Those with a higher risk profile are placed on a three-year examination cycle. Other IAs are chosen randomly for routine examinations and may also be examined as part of cause, sweep or special purpose examinations. However, there are over 11,000 IAs registered with the SEC and only about 300 examiners available. These resource constraints limit the frequency of the reviews of the operations of these market participants, particularly for routine reviews.
Assessment	Broadly implemented.
Comments	The standards of this Principle regarding intermediary entry requirements are met for registered BDs and FCMs, each of which is required to be a member of an SRO and is thereby subject to entry requirements. For other futures intermediaries and IAs there are gaps in the entry requirements and/or the process of verification of compliance with those standards prior to registration being granted.

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	Although the SROs may review certain policies and procedures of an FCM applicant before granting registration, there is no general requirement that on-site or off-site examinations of the back-office capabilities and internal control of applicants under the CEA be performed, prior to registration. The practice at the DCOs, NFA, and DCMs is to conduct such examinations prior to granting an FCM membership in the SRO. These reviews are neither required, nor routinely carried out for other categories of firms under the CEA prior to registration. Compliance with the required standards would be assessed as part of the examination process after the registration was granted. FINRA performs these reviews for all BD applicants for membership; no one performs these tasks for IA applicants. See the comments under Principle 10 above regarding the effectiveness of the examination program for firms, particularly for IAs. FINRA should have clear authority to examine and address all securities-related activities of members, including their registered IA activities. The SEC and the CFTC use differing ownership thresholds to identify those persons who are presumed to control an intermediary or applicant. The CFTC requires detailed information be provided on all persons who exercise a controlling influence over the firm or, among other things, own 10 percent or more of the voting securities of a firm. The BD registration form requires a listing of all persons who own more than 5 percent of a firm's shares and presumes control to exist (subjecting the person to detailed scrutiny) where a person owns 25 percent or more of the firm's voting securities. The CFTC's lower threshold is the one more commonly seen in other jurisdictions and adoption of this lower figure by the SEC would enhance the common standards across the two agencies. If an IA holds or has authority to obtain client funds or securities, those assets are to be held at a qualified custodian but the custodian is not required to be independent of the IA. These custody rules were under review at the time the assessment was performed. Under the new rules that were implemented in March of 2010, additional safeguards are required if the assets are not held at an independent custodian. If the custodian is not at independent, the IA must receive an annual report from an independent public accountant on the custodian's internal controls on its custody functions such as Type II SAS–70. In addition, if the custodian is not independent of the IA and not 'operationally independent' from the IA, the IA must also engage an independent public accountant to perform a surprise examination of client assets during the year. The auditor must certify to the SEC that the examination has been completed and describe the nature and extent of the examination. If discrepancies are found, the auditor must give notice to the SEC within one business day. The independent auditor that prepared the internal control report and performs the surprise examination would be required to be registered with the PCAOB and subject to that entity's quality standards and oversight process. The assessors understand that SEC staff is reviewing recommendations to enhance the rules governing BD custody of customer assets.
Principle 22.	**There should be initial and ongoing capital and other prudential requirements for market intermediaries that reflect the risks that the intermediaries undertake.**
Description	**CFTC** Only FCMs and IBs must meet the minimum financial requirements that the CFTC prescribes. Each FCM and IB must maintain adjusted net capital in an amount that meets or exceeds the greatest of several alternative amounts. There are no initial or ongoing capital requirements for CPOs or CTAs. IBs do not require capital if their obligations are guaranteed by an FCM and they deal only through that FCM. For FCMs, the minimum capital requirement is the greatest of: US$250,000; the minimum amount of net capital required by the NFA (US$500,000); 8 percent of customer plus 4 percent of non-customer maintenance margin requirements; or, if an FCM is also registered as a BD by the SEC, the amount of capital required by the SEC. For IBs the minimum is the greatest of US$30,000; the minimum amount required by the NFA (US$45,000); and for IBs also registered as BDs, the amount of capital required by the SEC. The CFTC has proposed substantial increases in these

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	minimum capital amounts because as the amounts were adopted in 1996, they do not reflect inflation and no longer are consistent with the regulatory objective of requiring registrants to maintain a minimum base of liquid capital from which to meet their financial obligations, including those to customers. In reality, the capital a firm is required to hold is higher, as there are early warning thresholds that must be met that are 10 to 50 percent above these minimum amounts. The definition of capital is net liquid capital—current liquid assets (discounted by the required haircuts) less all liabilities. The terms and calculations are consistent with those used by the SEC for BDs. The capital calculation based on maintenance varies with market risks and is directly related to increases in margin requirements for the futures and options positions held by the firm. The capital calculations require all positions to be marked to market. The CFTC's net capital regulation includes provisions that address certain asset liquidity, funding, and affiliate risks. The capital regulation generally addresses these risks by imposing specific deductions (or haircuts) on the value of assets for purposes of determining whether the firm meets minimum capital requirements. Funding risk is reflected through the application of a haircut on proprietary futures and options on futures positions that is equal to 100 percent or more of the margin requirement of the position, and a haircut for margin calls made to customers and non-customers (generally affiliates) that are not satisfied within a brief period of time (no more than three business days). The regulation also includes a calculation that is tied to a percentage of the risk maintenance margin requirements of its customers and noncustomers, which results in increased capital requirements as the amount of such required risk margin increases. Unsecured receivables, including unsecured receivables from affiliates, are also generally subject to a 100 percent haircut. There are no express capital requirements to cover other types of risk. However, the early warning threshold requirements and the 100 percent margin requirement for proprietary positions do provide an additional capital buffer to address these other risks. These capital requirements, coupled with the requirements for strict segregation of client assets, have permitted orderly wind-downs of firms without loss to customers or disruption to the market attributable to the registered firm. Each FCM and IB must be in compliance with applicable capital requirements at all times and must be able to demonstrate such compliance at any time. Capital and segregation requirements must be calculated daily and any deficiency rectified and reported immediately. There are also detailed recordkeeping requirements relating to the financial condition of FCMs and IBs and to the customer funds held by FCMs. An FCM must provide detailed monthly reports on its financial condition to its regulators (the CFTC and its SROs). IBs provide the same reports semi-annually. FCMs that are also BDs with the SEC may file the financial reporting form used by the SEC (the FOCUS report) with the CFTC, rather than the using the financial reporting form required under the CEA. The SEC does not accept the CFTC form for BDs that chiefly are FCMs. Ongoing financial and other supervision of FCMs and IBs that are members of more than one SRO are shared by the relevant SROs, with the NFA primarily responsible for FCMs that are not members of a DCM. FCMs and IBs are subject to independent audit requirements. In addition, the audit must include tests of the accounting system of the firm, its internal accounting controls, and its procedures for safeguarding customer and firm assets. The audit procedures must provide reasonable assurance that any material deficiencies will be discovered. If deficiencies are found, the auditor must notify the firm, which must then notify the regulators. The NFA and other SROs conduct regular on-site exams. All of the futures SROs participate in the Joint Audit Committee (JAC). JAC has issued a joint audit program. NFA's audit modules follow the objectives established by this program. The JAC program is used for FCMs that are members of an exchange (regardless of whether the FCM is a member of multiple exchanges). Every member firm is to be inspected every 9 to 18 months. The CFTC does not have a routine

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examination program, but might conduct an on-site exam for cause.

If material deficiencies in capital are found, the firm's business may be restricted or other actions taken by the firm's DSRO or the CFTC. They have authority to impose more frequent reporting requirements and/or restrictions on the intermediary's business and/or a requirement to transfer accounts to another FCM. For example, Bear Stearns was subject to daily reporting after its capital dropped 45 percent. (See the discussion under Principle 24.) Note that equity withdrawals of less than 30 percent of excess capital only require notice to the regulators after the fact. Prior notice is otherwise required. The CFTC has the authority to deny a request for a withdrawal.

Affiliate risk generally is addressed through mandatory reporting and filing requirements. Further, the capital calculations of FCMs and IBs must exclude from their current assets any deposits at affiliates, whether licensed or not. Also, certain off-balance sheet items must be reported as non-current assets in the capital computations of FCMs and IBs. There are operational requirements that address management of the risks that may be posed by FCM affiliates. The CFTC is authorized to obtain information about affiliates of an FCM that might jeopardize the FCM's ability to meet financial requirements or to otherwise remain in business. FCMs are required to monitor their affiliates whose activities are reasonably likely to have a material impact on the FCM's financial or operational condition. The FCM's risk assessment filings identify who its affiliates are and the regulators have the authority to ask for additional detailed information from the FCM.

SEC

There are capital requirements only for BDs, not for firms that are just IAs, even if the IA has custody of client assets. The Net Capital Rule (NCR) requires that all BDs maintain certain minimum level of liquid net assets at all times. All BDs are subject to the NCR. If a firm's net capital falls below the level required, the firm must cease doing securities business

The minimum dollar amount of net capital applicable to BDs differ based upon the types of business each firm engages in and the perceived relative risk associated with these activities. A firm's net capital requirement may be determined using either the standard or alternative method. In both cases, the firm must calculate its liquid assets using the formula set out in the NCR. Among other things, the formula applies haircuts (or discounts) to the value of assets on the BD's books based on the nature of those assets (their liquidity, market and credit risks). For example, non-marketable securities are generally subject to a 100 percent haircut/discount. The standard method requires the firm to have liquid net assets greater than the minimum dollar amount specified, which varies based on the nature of the business undertaken by the BD. This minimum amount varies from US$5,000 to US$250,000. In addition, the BD's aggregate indebtedness to all other persons must not exceed 800 percent (for its first year of operation) or 1500 percent (thereafter) of its liquid net capital.

If the BD elects to use the alternative method, the BD must maintain net capital of at least the greater of US$250,000 or 2 percent of aggregate customer debit items. This method was designed primarily for firms that hold customer assets and the debit items tend to increase with the amount of customer business a firm does. This method is used by many of the larger firms. The aggregate indebtedness limit of the standard method does not apply to these firms,

The NCR also permits OTC derivatives dealers and certain other BDs to calculate their net capital using Value at Risk models. The use of this method by BDs that are not OTC derivatives dealers is subject to several conditions, including the supervision of the BD's ultimate holding company. The holding company supervision focuses on its financial and operational condition and its risk management methodologies, with the aim of reducing the likelihood that weakness at the holding company will destabilize the BD or the financial system as a whole. Under the SEC rules, a BD's holding company and its affiliates (known as consolidated supervised entities, or CSEs) may elect to be subject to group-wide SEC supervision. In electing to operate under this program, the holding company must, among other things, compute its group-wide capital monthly in accordance with

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	the Basel standards. However, there are no such firms as of February 2010. All SROs may set capital requirements for BDs at higher levels than the NCR. SROs also may prevent a firm from expanding its business or otherwise limit its business to the extent that the firm fails to maintain sufficient levels of net capital. For example, FINRA prohibits a member from expanding its business when its net capital is less than 150 percent of its minimum requirement and that condition has existed for more than 15 consecutive business days. Customer assets must be segregated from proprietary assets so that if liquidation were to occur, customer assets would not be available to the creditors of the BD. This customer protection rule requires BDs to maintain a reserve account that contains at least the net dollar amount of cash the BD owes to its customers. This may be held in cash, U.S. government securities or those securities guaranteed as to principal and interest by the U.S. government. On one recent large failure of a BD and its affiliates, eligible customers of the BD were made whole through a combination of these requirements and Securities Investor Protection Corporation (SIPC) coverage, but markets were disrupted and counterparties did lose money. The failure of the group had a significant impact on global markets. Adjustments may be necessary to address funding, liquidity and affiliate risks, particularly under stress, more directly. The assessors understand the relevant capital and related rules are under review by the SEC. Capital levels are monitored through filing of periodic and annual reports by the BD and through on-site inspections. Monthly or quarterly reports on capital calculations must be filed with FINRA within 17 days after the period end. The BD must give prompt notice to the SEC and FINRA if it breaches one of the early warning threshold tests (net capital below 120 percent of minimum or below 5 percent of aggregate debit items). Generally, the equity capital of a BD may not be withdrawn without written notice to the SEC, the SRO and, if applicable, the CFTC. An audited annual report must be filed with the SEC and SRO within 60 days of year end. Financial statements must be audited by an independent public accountant meeting the same qualifications and tests for independence as for auditors of securities CIS and issuers. The auditor must review the firm's accounting system, internal accounting controls, and the procedures for safeguarding customer funds or firm assets. There is a similar reporting obligation on the auditor, as for the auditor of CIS and public issuers, if deficiencies are found. FINRA inspects its BD members periodically; the frequency of examination depends on the types of business the BD engages in and the perceived risk of those businesses. For instance, FINRA inspect BDs that hold customer funds and securities at least once every year. Other BDs are subject to less frequent on-site examinations. In addition, the FINRA reviews a BD's capital levels when periodic reports are filed. If a BD is in violation of the NCR or the customer protection rule, it must cease to conduct securities business and must give its regulators immediate notice. The regulators may restrict the ability to withdraw capital from the BD if certain parameters have been broken and the SRO may restrict the activities that the BD may carry on or require the BD to reduce the business on its books. The SEC may also petition the court to place a freeze on the BD's assets. More frequent reporting may also be ordered. The NCR requires that a BD consolidate, for purposes of calculating net capital and aggregate indebtedness, the assets and liabilities of any subsidiary or affiliate for which it guarantees, endorses, or assumes directly or indirectly the obligations or liabilities. The NCR also requires deductions of affiliate positions. In addition, BDs are required to have policies, procedures, or systems for monitoring and controlling financial and operational risks to the BD resulting from activities of affiliates whose "business activities are reasonably likely to have a material impact on the financial and operational condition" of the firm. Included in these requirements are risk management policy information, financial data (including consolidating and consolidated financial statements, securities, and other

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	financial product position data) and financial instruments with off-balance sheet risk, among other things. BDs are required to report quarterly on these matters.
Assessment	Partly implemented.
Comments	The capital rules on both the securities and futures sides are focused on ensuring customers are protected on the failure of a firm. The rules address market risk, credit risk, certain operational and funding risks and asset liquidity and certain operational risks faced by the firm. The formulae are conservative in their treatment of assets and liabilities. This conservatism, coupled with the higher early warning thresholds produces capital buffers that provide additional cover for other risks not expressly addressed, such as broader operational risks (e.g., reputational and legal risks). However, in common with many other jurisdictions, these latter risks are not specifically addressed in the capital formula. In particular, the recent crisis highlighted issues relating to the impact that reputational, funding and liquidity risks may have on regulated firms, particularly under stress. A re-evaluation of the capital rules, risk management expectations and other prudential requirements imposed on FCMs and BDs in light of recent circumstances is warranted. Further, the treatment of affiliate risk would bear reexamination and strengthening, through some combination of changes to the capital rule, enhanced risk management requirements or other regulatory or oversight mechanisms. In particular, all aspects of the exposure to risk at the regulated firm when a related company is in trouble may not be reflected fully. The SEC's temporary rules on reporting of affiliate exposures (Rules 17h-1T and s17h-2T) should be finalized as soon as possible, a project we also understand to be in train, although the assessors understand that their temporary status does not affect their enforceability. The current CFTC capital formula for firms registered with both the CFTC and SEC may not reflect fully the scope of the customer activity by both securities and futures customers as it only mandates the higher of the CFTC or SEC capital amounts—not the combined amount of the two sets of requirements. Because unsecured receivables associated with uncleared OTC positions are excluded as assets under regulatory capital rules, while payables are counted as liabilities, uncleared OTC derivatives are rarely carried in an entity registered as an FCM or BD (other than an OTC derivatives dealer). There are proposed changes to the futures capital rules to address gaps with respect to cleared OTC derivatives transactions and improve the sensitivity of the formula to the actual risks undertaken by the firm which would be helpful. The crisis brought to light weaknesses in the regime governing investment bank holding companies. The conversion of the remaining entities into bank holding companies has, in practice, eliminated the pressure to address these issues at the SEC level at the present time. The wider challenge of the effective supervision of global financial conglomerates is an issue in many jurisdictions. As noted by the Joint Report, the segregation and margining rules under the futures and securities regimes operate differently and serve different purposes. The treatment of the segregated accounts also differs on a bankruptcy. The introduction of risk-based portfolio margining where the margin requirements take into account offsetting positions in related instruments in one account highlight the need for reconciling the two regimes. Also, the recent crisis highlighted some concerns that the risks associated with custody of client assets may not be addressed fully. There are deductions for assets held at affiliates, but the risk of failure of other depositories holding client cash may not be fully reflected in the various applicable rules. For futures firms, margin requirements for particular contracts are set by the exchanges, not the CFTC. At the very least, the CFTC should have authority to review and approve/disapprove these requirements.

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	The audit of a market intermediary may require someone who has experience in the area. Consideration should be given to requiring the audit partner in charge of the audit have some relevant experience. Specific information on the auditor used by a market intermediary should be obtained as part of the application process and tracked so that problem auditors may be identified more easily.
Principle 23.	Market intermediaries should be required to comply with standards for internal organization and operational conduct that aim to protect the interests of clients, ensure proper management of risk and under which management of the intermediary accepts primary responsibility for these matters.
Description	**CFTC** FCMs and IBs that are not guaranteed by an FCM are required to provide certified financial statements to the regulators prior to registration and on an ongoing basis. (See the description of the scope of the certification process described under Principle 21.) Further, FCMs may be required to provide the regulators with current organizational charts that identify affiliated persons; written policies, procedures or systems concerning methods for monitoring and controlling financial and operational risk, capital adequacy, internal controls with respect to market, credit and other risks relating to proprietary and non-customer clearing activities; and fiscal year-end consolidated financial statements. The ongoing review of the firms' internal controls etc. falls within the scope of the SRO audit and surveillance obligations. There is no requirement for an independent periodic evaluation of internal controls and risk management processes for FCMs and IBs other than those associated with the certified financial reporting requirements. FCMs must separately account for customer funds in their records and segregate these funds from their own funds and those of related persons. The amount in segregation must equal 100 percent of the gross account equity of all customers; the value of any under-margined account must be made up from the firm's own funds. FCMs may pool all customer funds in a single account that is clearly identified as belonging to customers. Customer funds must be deposited by the FCM with a bank, trust company, DCO, or another FCM and the depository must acknowledge that these are customer funds. The depository does not have to be at arm's length to the FCM and the other requirements do not address the risk of failure of a depository. Proprietary positions held at an affiliated depository may not exceed a specified threshold; assets above the threshold attract a 100 percent capital requirement. Segregation calculations must be done daily, any deficiencies rectified immediately and the FCM must give immediate notice to the CFTC and DSRO if it is not in compliance with these requirements. The only disclosure document required to be provided to clients is an extensive risk disclosure statement and the firm must keep the clients' signed acknowledgements of receipt of the statements. Customers generally may obtain written contracts, although the specific form and content of the agreement are not mandated. The NFA has a Know-Your-Customer (KYC) rule that is tailored to the requirements of the futures markets. Unlike the securities industry where investors can purchase instruments with varying degrees of risk and that serve very different investment objectives, all futures contracts are highly volatile and risky instruments. In the futures market, the suitability determination has to be made on a customer by customer basis rather than on a contract or transaction basis. The KYC rule requires extensive information about each customer be obtained before opening an account. Based on that information, the FCM has to make a judgment whether the customer requires additional risk disclosures beyond the standard information required by CFTC regulations or to refuse the account because futures trading are too risky for that customer. This standard applies even if the FCM makes no recommendations to the customer. Further, the NFA has a rule that governs both oral and written communications. Among other provisions, it prohibits misleading or high-pressure communications. FCMs must provide each customer with a monthly account statement regarding the details of transactions in the account, as well as charges and credits to the account. The FCM also must

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provide confirmation statements of each transaction by the next business day following the transaction. For customers of an IB, the carrying FCM provides these statements.

CFTC regulations and NFA rules require each registrant (except an associated person with no supervisory duties) to "diligently supervise" the handling by its partners, officers, employees and agents of all activities relating to its business as a CFTC registrant. There is no requirement that any specific person or group have overall responsibility for compliance with regulatory and legal requirements. There is no requirement for a CCO at any futures intermediary. NFA rules do require that a principal subject to NFA jurisdiction be in charge of firm activities such as review of promotional material, review of financial statements and certification of annual questionnaires.

There are extensive books and records requirements for FCMs and IBs. More limited requirements apply to CPOs and CTAs. Further, there are specific requirements that relate to customer protection, risk disclosure, financial and other recordkeeping and net capital compliance. However, the CEA and CFTC regulations do not require intermediaries to adopt specific internal and risk management controls outside of these requirements, nor do they require the testing of these controls, other than through the certification of financial statement requirements. The NFA requires its members to conduct a formal review of their operations on a yearly basis.

With respect to risk management, the CFTC's Risk Surveillance Group (RSG) conducts extensive review and analysis of risks posed by traders, FCMs, and DCOs, including assessment of their risk management practices. On a daily basis, the RSG endeavors: (i) to identify significant financial risks from positions in products that an FCM clears through a DCO and fall within the jurisdiction of the CFTC; and (ii) to confirm that such financial risks are being appropriately managed. The RSG undertakes these tasks at the trader level, the firm level and the clearing level. It identifies both traders that pose risks to FCMs and FCMs that pose risks to DCOs. It also reviews financial resources and risk management practices at traders, FCMs and DCOs.

FCMs and IBs are required to establish and enforce internal rules, procedures and controls to ensure, to the extent possible, that orders received from customers are transmitted before any order in the same commodity for the benefit of a proprietary account. CTAs and CPOs are subject to mandatory conflict of interest disclosure requirements. There is no general requirement that would require all intermediaries to avoid, or establish procedures to mitigate, conflicts of interests with their clients.

SEC

There are rules that require all BDs to have appropriate controls in place to protect the interests of their clients and to manage risk properly. In addition, a BD that is an OTC derivatives dealer must have a system of controls to manage the full range of risks associated with its business activities, including market, credit, leverage, liquidity, legal, and operational risks.

The SEC does not have specific standards that a BD's risk management procedures and internal controls must meet. So long as the relevant systems in place at the BD facilitate its compliance, they are considered to be adequate by the SEC. Under FINRA rules, each firm must implement a supervisory system reasonably designed to achieve compliance with applicable securities requirements and that includes designation of one or more persons responsible for reviewing the BD's supervisory system and taking action to achieve requisite level of compliance. FINRA requires a BD to appoint a chief compliance officer.

IAs must disclose information on its management on Form "ADV." They also must have in place CP&P and are required to appoint a chief compliance officer. All supervisors, including senior management, are subject to liability for failure to supervise.

Every BD is required to periodically inspect all aspects of its business. An examination of the accounting system, the internal accounting controls, and the procedures for safeguarding securities are included in the scope of the annual audit and must be certified by the auditor, who must be registered with the PCAOB. Owing to some gaps in the relevant legislation, the PCAOB does not

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	have authority to oversee the activities of a BD auditor. An IA's CCO is not independent, but must have enough seniority and authority to conduct an independent compliance review and compel others to comply with the CP&P. Only an IA with custody of client assets who chooses to send account statements directly to its clients must have an independent public accountant verify all of those funds and securities by actual examination at the custodian at least once each year. Other IAs do not to have their controls assessed or to report material breakdowns in controls to senior management or to the regulator. Generally BD customer agreements require that disputes be arbitrated. FINRA rules require its members to arbitrate any eligible dispute submitted by a customer. BDs are required to keep records of client complaints. An IA is not required to provide a particular mechanism for the resolution of investor complaints. Customers of IAs may have private rights of action under securities legislation or otherwise. Both the SEC and FINRA have extensive rules governing holding of client assets designed to ensure they remain separate from those of the BD—covering recordkeeping, segregation, use of free credit balances, and excess securities in margin accounts. See the description in Principle 21 regarding IA custody requirements. BDs must obtain KYC information regarding customers when accounts are opened, including the customer's employment status, net worth, annual income and investment objectives and for each cash and margin account, the name and address of the beneficial owner of the account. Also, BDs have an obligation to recommend only those specific investments or overall investment strategies that are suitable for their customers. The concept of suitability also appears in FINRA rules. Registered IAs must make a reasonable determination that the investment advice provided is suitable for the client based on the client's financial situation and investment objectives. AML requirements apply to BDs and some CIS, but not *IAs*. Written contracts are only required for certain types of BD accounts (e.g., margin, options, and discretionary accounts). In practice, many firms have a client agreement to ensure that they are able to enforce contractual provisions against the customer, such as arbitration clauses. FINRA requires prior written authorization for discretionary trading. The investment advisory contract is the basis for the relationship between the IA and its clients. The legal framework specifies items required to be or prohibited from being included in an investment advisory contract, but there is no prescribed form of contract. BDs must provide clients with specific risk disclosure statements for certain types of trading (such as options and futures) in the secondary market. They also must make available prospectuses for new issues and conflict of interest disclosure statements. A BD is required to send its customers written trade confirmations, account statements (monthly if options are held, otherwise quarterly) and other reports disclosing activities and transactions it has taken on the customer's behalf. Registered IAs are not required by statute to provide their clients with any specific documents etc. other than Part II of Form "ADV." An IA's duty to provide other documents to its clients (such as confirmations, statements and proxy related materials for securities held in the account) depend on the terms of its client contracts. There is no general requirement that IAs send account statements to their clients. The BD that is used to carry out trades would be responsible for generating these documents. However, many IAs do send monthly or quarterly client account statements. Only IAs who hold client assets must send statements at least quarterly setting out specific information about the client's assets and transactions during the period. The SEC and FINRA have detailed rules regarding the books and records that a BD must keep. BDs are required to maintain these books and records for specific periods of time and to produce such records promptly to examiners. There are also simpler recordkeeping requirements imposed on IAs to maintain business accounting records as well as those that relate to the fiduciary nature of its business.

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	A BD has a duty of fair dealing towards its customers and is also required under FINRA rules to observe high standards of commercial honor and just and equitable principles of trade, which include the suitability obligation, engaging in fair and balanced communications with the public, providing timely and adequate confirmation of transactions, providing account statement disclosures, receiving fair compensation, disclosing material information, charging prices reasonably related to the prevailing market, fully disclosing any conflicts of interest and giving customers the opportunity to resolve disputes through arbitration. There also are requirements to limit conflicts of interest on investment research. Further, BDs must disclose to their customers if they have any control, affiliation or interest in a security they are offering or with the issuer of the security. Finally, a BD has a legal duty to seek to obtain best execution of customer orders. A BD may have a fiduciary duty to its clients under certain circumstances, either under state common law which varies by state, or otherwise. Generally, courts have held that BDs that exercise discretion or control over customer assets, or have a relationship of trust and confidence with their customers, owe customers a broad fiduciary duty similar to that imposed on IAs. An IA is subject to a fiduciary duty to act in the utmost good faith with respect to its clients. An IA is required to treat all clients fairly where conflicts of interest arise between several of the firm's clients and have written procedures in place to prevent the misuse of material non-public information by the IA or any associated person.
Assessment	Broadly implemented.
Comments	Given the experiences of the recent crisis, a reexamination of the risk management expectations for BDs and FCMs, particularly with regard to management of liquidity, funding, and reputational risks, is warranted. All licensed futures intermediaries (FCMs, IBs, CPOs, and CTAs) should be required to avoid, or establish procedures to mitigate, conflicts of interests with their clients. FCMs and IBs should be required to disclose conflicts of interest to their clients. There may be a need to reassess the disclosure provided to investors regarding complex structured products, to ensure they receive sufficient current information to make informed investment decisions. (See also Principle 14.) See the comment above under Principles 17 and 21 regarding IAs holding client assets at non-arm's length custodians. Note also, that very few IAs are subject to any sort of audit requirement so there is no routine outside confirmation (other than by the SEC through its examination program) that they have the appropriate internal controls in place, even to ensure the requirements regarding not holding client assets are observed. However, for those IAs that are also operators of CIS subject to the ICA, some additional review of the appropriateness of internal controls comes from the CIS board (including its independent directors), the CCO, and periodic certification by CIS officers with respect to certain internal controls. See also the comments above under Principle 22 regarding the general risks associated with where the client assets are held and the lack of limitations that apply if the depository is at arm's length to the FCM or BD.
Principle 24.	There should be a procedure for dealing with the failure of a market intermediary in order to minimize damage and loss to investors and to contain systemic risk.
Description	**CFTC** The CFTC has a contingency plan in place to address failures of FCMs. The CEA and CFTC regulations, in conjunction with the Bankruptcy Code, provide a clear framework for the CFTC to follow in managing the failure of an FCM. Part 190 of the CFTC's regulations and Chapter 7, Subchapter IV of the Bankruptcy Code specifically addresses failures of commodity brokers, including FCMs. The CFTC may apply to court for the appointment of a receiver. Customers of a

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	failed firm are notified as part of the process under the framework. The FCM must notify the CFTC upon the occurrence of one of a number of events, any of which may indicate financial distress. CFTC has the power to restrict activities of an FCM in financial difficulty, require accounts to be transferred or apply to have assets frozen or for the appointment of a receiver/monitor etc. Derivatives Clearing Organizations (DCOs) also have default rules and processes in place to manage the obligations of failing/failed FCMs to minimize the impact of the failure on other participants. These rules may permit the DCO to access a guarantee fund held at the DCO. These default procedures include notices to other participants. As a matter of practice, on a failure there are frequent conference calls among affected regulators and exchanges, both domestic and foreign. **SEC** There is a contingency plan at the SEC for responding to a BD failure. If the SEC staff have concerns about a broker-dealer they will send examiners into the firm to determine if a self-liquidation is possible. If a firm's net capital falls below the required level, the firm must immediately cease doing securities business and must give notice to SEC and its SRO. If a BD fails or is in danger of failing to meet its obligations to customers and the firm is insolvent or not in compliance with applicable financial responsibility rules, the BD will be liquidated under SIPA if a self-liquidation is not possible. As far as possible, client accounts are transferred quickly to another firm. There is no general disclosure requirement that would apply to all cases of financial difficulty. If the firm is a public company, the usual prompt public disclosure of material change standard would apply. Also, a BD is required to tell clients if their accounts have been transferred. SIPC is available to compensate investors if their assets or cash are not available when a BD fails. SIPC does not cover IAs. The legislation does not provide expressly for the SEC to take action if an IA is in financial difficulty. The SEC only has the power to intervene if an IA's financial difficulties are related to a violation of the federal securities laws. If so, the SEC can request that a federal court appoint a monitor, receiver, curator or other administrator. The SEC would not provide notice to an IA's clients or the general public about an IA's financial condition. Information about an IA's financial condition may otherwise be public via Form "ADV" disclosures as IA may have obligations to disclose it is in 'precarious financial condition'. See the detailed discussions under Principles 11 and 12 regarding cooperation with other regulators. For example, on the failure of the Lehman Brothers group, there were daily conversations among the regulators involved in winding up the regulated firms.
Assessment	Fully implemented.
Comments	The crisis brought to light weaknesses in the regime governing investment bank holding companies. The conversion of the remaining entities into bank holding companies has, in practice, eliminated the pressure to address these issues at the SEC level at the present time. As noted by the Joint Report, the treatment of segregated accounts under the futures and securities regimes differs on a bankruptcy. The introduction of risk-based portfolio margining and greater overlap between futures and securities activities highlight the need for reconciling the two regimes.
Principles for the Secondary Market	
Principle 25.	The establishment of trading systems including securities exchanges should be subject to regulatory authorization and oversight.

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Description	See Principle 7 for a description of the legislative and regulatory framework governing authorization and oversight of SROs generally, including exchanges. **CFTC** Apart for the exceptions described below, any market that seeks to provide a trading facility to trade futures, options on futures or options on commodities must apply to the CFTC to become a DCM. The CFTC analyzes the DCM application before deciding to grant or reject the application. The CEA establishes the basis for requiring markets to register. Criteria, procedures, and requirements for designation as a DCM are set out in the CEA and CFTC regulations. A DCM may list for trading futures or option contracts based on any underlying commodity, index, or instrument. However, there are special requirements for security futures products, which are subject to joint CFTC/SEC oversight under rules promulgated by these agencies in 2001. One category of trading system is not subject to regulatory authorisation as required by the Principle Methodology—ECM and another category is exempt from both authorisation and oversight—EBOT. ECMs are merely required to notify the CFTC that they intend to operate under the exemption provided in Section 2(h)(3) of the CEA and they must comply with the requirements of the exemption provision. An ECM becomes a registered entity, like a DCM, and is subject to greater oversight by the CFTC only after the CFTC makes a formal determination that a contract traded on an ECM is an SPDC. This determination has been made for one contract on one ECM. For EBOTs, the only requirements that apply are limited anti-fraud and anti-manipulation provisions. Under the CFTC's regulations, an applicant for contract market designation must provide substantial documentation for the CFTC's approval. A DCM is required to establish and enforce appropriate fitness standards for directors, members of any disciplinary committee, members of the contract market and any other persons with direct access to the facility. DCMs are required to adopt and enforce rules for ensuring the financial integrity of transactions and the market integrity of the trading mechanism. The CFTC provides detailed guidance on all areas of the designation criteria as to the standards it expects an applicant for designation to meet. The CFTC has further stated that it believes that the guidelines issued by IOSCO in 1990 ("Principles for Screen-Based Trading Systems") and adopted by the CFTC on November 21,1990 as supplemented in October, 2000, are appropriate guidelines for an electronic trading facility to apply to electronic trading systems. As regards new products and new or amended rules, the CFTC is required to be informed of the types of products to be traded through the two listing methods—self-certification (as discussed under Principle 7) and CFTC prior approval. The latter is only mandatory for certain listed agricultural commodities. There are also formal listing requirements that must be satisfied for security futures products as part of joint CFTC/SEC oversight. Except for certain enumerated agricultural commodities a DCM may also implement most new rules and rule amendments by self certification. Fair access to the exchange is established via Designation Criteria, Core Principles, Acceptable Practices, and CFTC-adopted guidance. As regards competition, a DCM must endeavour to avoid, unless necessary or appropriate to achieve the purposes of the CEA, adopting any rules or taking any actions that result in any unreasonable restraints of trade; or imposing any material anticompetitive burden on trading on the contract market. The fairness, consistency and transparency of order routing procedures and execution rules are set out in the Designation Criteria, Core Principles, and CFTC guidance. A DCM is required to store all identifying trade information in a manner that enables the contract market to use the information for purposes of assisting in the prevention of customer and market abuses and providing evidence of any violations of the rules of the contract market.

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	SEC **Exchange Trading Systems** An exchange must register with the SEC as a national securities exchange, or be exempt from registration, before it may begin operations. The Exchange Act sets forth the SEC's responsibilities and obligations upon the filing of an exchange application. Once registered, a national securities exchange becomes an SRO. See Principle 7 for a description of the legislative and regulatory framework governing authorization and oversight of SROs generally. In addition to the rules that applies to SROs generally as set out under Principle 7, the SEC reviews exchange applications against criteria specific to the provision of a secondary market, such as relevant information about the operators of any electronic trading system that is used to effect transactions; the operation of the trading system, including, among other things, the means of access; the procedures for entering and displaying quotes; procedures for order routing and execution and reporting; and clearing and settling transactions for reliability, resilience, and fairness; record keeping; and emergency powers. The SEC seeks to ensure, among other things, that an applicant's rules do not confer unfair trading advantages of members over non-members, or investors generally. The SEC also requires, among other things, a list of members and a schedule of all securities listed on the exchange or association; all securities traded on the exchange or association pursuant to unlisted trading privileges; all securities exempt from registration and traded on the exchange or association; and other securities traded on the exchange or association. In addition to satisfying the requirements of the Exchange Act, a prospective exchange or association must demonstrate to the satisfaction of the SEC prior to authorization its ability to operate as part of the national market system as set out in Regulation National Market System (NMS). Regulation NMS contains rules that, among other things, require trading centers to avoid trading through the protected quotations of other trading centers that display automated quotations. **Non-exchange Trading Systems** In addition to exchanges and associations, ATSs operate electronic trading markets. An ATS can register as an exchange or a BD. If an ATS chooses to register as a BD, it must be a member of an SRO and comply with additional reporting and record-keeping requirements set out under Regulation ATS. Like any other BD, an ATS must have sufficient clearing capabilities in place by either becoming a member of a registered clearing agency, or being affiliated with a member of a registered clearing agency through which the ATS can clear and settle trades. ATSs registered as BDs are subject to FINRA rules in addition to Regulation ATS and other SEC rules governing BDs. An ATS that trades 5 percent or more of the volume in a national market system security must: • be linked to a national securities exchange or registered securities association so that the best priced orders in that security that are placed in the ATS and are displayed to more than one subscriber are also disseminated into the public quote stream and provide access to such orders that is equivalent to that of other orders displayed by the exchange or association; and establish objective standards to grant or deny access to the trading system (with respect to that security) and apply them in a non-discriminatory manner. In addition, an ATS must comply with the rules that govern execution priority and obligations that are imposed by the SRO to which the ATS is linked. If an ATS has 20 percent or more of the trading volume in any single national market system security, the ATS must follow certain procedures to ensure adequate systems capacity, integrity, and contingency planning. Currently, no ATS has reached this threshold and in some cases, actively manage their system to avoid exceeding the 20 percent limit.

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	Cross Trading System Issues Continued compliance with the initial registration requirements is a condition for continued registration. Registered exchanges and associations are required to maintain rules, policies and procedures consistent with their statutory obligations and to have the capacity to carry out their obligations and prevent fraudulent and manipulative acts and practices. ATSs that meet the volume thresholds in the rules must publicly disseminate their best priced orders, limit the fees they charge, and satisfy certain system capacity, integrity, and security standards. The SEC has an Automation Review Program (ARP). Staff conducts reviews on application and subsequently (at least annually) of the information technology systems operated by the exchanges, clearing agencies and certain ATSs that publicly display quotations (electronic communications networks or "ECNs") to evaluate whether the systems have sufficient capacity and resiliency to accommodate conditions of increased volume and disruptions to normal operations. All exchanges and ATSs are required to have rule and procedures governing audit trails to aid in the surveillance of their market. In general, an audit trail requires information about the parties to the trade, the security, the type of order, the time of the trade, the number of shares to which the order applies and the price of the trade. Exchanges and ATSs are required to make available to the public monthly electronic reports that include uniform statistical measures of execution quality. FINRA and the SEC have emergency powers, including trading halts, trading suspensions, and the SEC's emergency authority and market closure decisions. The exchanges can impose trading halts and suspensions for a variety of reasons. An exchange also has the authority to suspend trading in all securities on that market, adopt abbreviated trading hours or close the exchange if such actions would be in the public interest. The listing standards of the exchanges address when a listed company is required to notify the exchange of certain material events. The listing of new products is normally subject to the rule filing and approval process described in Principle 7. However, the SEC allows certain new derivative securities products to be listed without a proposed rule change if: • the product meets the definition of "new derivative securities product" set out in the rule; • the exchange that introduces the product has established generic trading rules, procedures and listing standards for the product class that would include the new derivatives securities product; and • the SEC has approved the SRO's standards. The SEC also has the power to issue rules governing the trading of a product, rather than reviewing proposed rules filed by an SRO. It also has broad authority to amend the rules of an SRO as it deems necessary or appropriate to insure the fair administration of the SRO and to conform its rules to the requirements of the Exchange Act. **Fair Access** As discussed under Principle 7, an exchange or association's ability to deny membership to its market is limited. ATSs are required to provide fair access to their systems only if they meet certain volume thresholds. For example, an ATS is subject to fair access with respect to a national market system stock only if it trades five percent or more of the stock's average daily volume over four of the previous six months. The SEC has provided a broader exemption for one ATS using its exemptive authority under the Exchange Act.
Assessment	Broadly implemented.
Comments	**CFTC** The powers of the CFTC over the authorization of DCMs raise no significant issues as regards the

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	IOSCO Principles. Issues concerning oversight are dealt with under Principle 7. However, the lack of an authorization power over ECMs and Exempt Boards of Trade (EBOTs) is not consistent with Principle 25. It should be noted that under the OTC derivatives legislation recently passed by the U.S. House of Representatives, and in the discussion draft versions of OTC legislation offered by the U.S. Senate Banking Committee, both the ECM and EBOT market categories would be abolished. Ongoing oversight, at least of ECMs, is no longer a significant issue, as discussed under Principle 26. **SEC** Based on data published by the SEC and discussions with market participants, the assessors have concluded that the authorization provisions currently applied to some non-exchange trading systems do not fully meet the standards of Principle 25 concerning adequate transparency. The problem lies in the rules governing exchanges and alternative trading systems, known as Regulation ATS, which were introduced in 1998, and in particular the impact on pre-trade transparency, or the publication of best bids and best offers to investors and market participants generally, of the 5 percent rule described above. As IOSCO has observed, "*The wide availability of information on bids and offers is a central factor in ensuring price discovery and in strengthening users' confidence that they will be able to trade at fair prices. This confidence should, in turn, increase the incentive of buyers and sellers to participate, facilitate liquidity, and stimulate competitive pricing.*" The number of active ATS authorized by the SEC, operating under the 5 percent rule (so called "dark pools") and trading NMS stocks has increased from approximately 10 in 2002 to approximately 32 in September 2009. At that time, the trading volume of these dark pools was estimated by the SEC as approximately 7.9 percent of the total share volume in NMS stocks, One consulting firm has put it as high as 12 percent. As the SEC has observed, "*Given this dispersal of volume among a large number of trading venues, dark pools collectively represent a significant source of liquidity in NMS stocks.*" The SEC has published proposed rule changes to reduce the 5 percent limit to a mere 0.25 percent and to extend the definition of an order to cover so called "actionable indications of interest" which are currently being used by some dark pool ATSs and others as a way around the 5 percent limit. The SEC has also proposed exemptions for large orders to enable institutions which trade in large size to execute their orders with other similar sized institutions without causing damaging market impact or short term volatility effects. These proposed rule changes, if implemented, would appear to meet the Principle 25 benchmark that authorization requirements for exchanges and other trading systems provide for adequate transparency. See also the comments under Principle 27.
Principle 26.	There should be ongoing regulatory supervision of exchanges and trading systems, which should aim to ensure that the integrity of trading is maintained through fair and equitable rules that strike an appropriate balance between the demands of different market participants.
Description	**CFTC** The CFTC monitors DCMs and ECMs that trade SPDCs (as determined by the CFTC based on price linkage, arbitrage, material price reference and material liquidity) on an ongoing basis through compliance reporting and "for cause" inquiries. CFTC staff also periodically reviews the programs and procedures adopted by each DCM to ensure compliance with the relevant core principles and to assess the effectiveness of those rules and procedures. A recent amendment to the CEA has given the CFTC powers of ongoing oversight of ECMs in certain circumstances. The CFTC is now empowered to require that ECMs which trade SPDCs comply with 9 Core Principles concerning transparency, anti-manipulation, position limits or accountability levels. The amendment does not apply to EBOTs. The CFTC has emergency authority to direct a DCM or ECM to maintain or restore orderly trading

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	in or liquidation of any futures contract. The CEA authorizes the CFTC to alter or supplement the rules of a DCM under certain circumstances. The CFTC has the power to suspend or revoke a DCM's designation. **SEC** In most cases, trading rules must be pre-approved. There are limited exceptions that permit trading rules to be filed on an immediately effective basis, such as where they are substantially similar to a rule of another exchange. However, the SEC can block a rule from becoming immediately effective for up to 60 days after it was filed, which essentially means the proposal is required to go through the regular notice and approval process. The SEC reviews a proposed rule against the requirements in the Exchange Act and regulations and must take account of the views of respondents to the mandatory public consultation process. A proposed rule change is not approved unless it is consistent with the Exchange Act. Ongoing supervision is carried out by SEC staff which conduct several types of examinations and inspections including routine or cycle examinations and inspections, which test an entity's compliance with applicable laws and regulations; "for cause" examinations and inspections and risk-targeted examination sweeps, that focus on particular compliance risks. These include the staff's inspections of the exchange's regulatory programs, including their examination, surveillance, investigative and enforcement programs, among others. The SEC has the authority to inspect exchanges, associations, ATSs and other market participants to determine whether the various anti-fraud, anti-manipulation and reporting regulations are being complied with. The SEC can also obtain surveillance and/or trading data from the SROs. An exchange or association must have procedures to survey its market and its members for securities laws violations, including violations of the exchange's own rules. The SEC considers on an on-going basis whether an exchange has adequate surveillance measures, as well as sufficient resources, including staff expertise and capital, to monitor its markets. See Principle 29 for a detailed description of the SEC's oversight of clearing organizations. The exchanges are required to maintain certain operational capability standards such that market participants can be confident in the exchanges' ability to handle the foreseeable volume of securities transactions directed to them. The SEC requires that exchanges have adequate computer system capacity, integrity and security to support the operation of their markets. In addition to reviewing the systems capability of an exchange, the SEC will consider whether an exchange has sufficient capital to maintain its automated systems and staff with technical expertise. The exchanges are also required to have rules that preserve the integrity of the market and that protect against risks to market integrity. While the Exchange Act does not set out minimum levels of funding for maintaining the self-regulatory function, the SEC has considered the funding of the self-regulatory functions of an exchange in the context of recent exchange demutualizations. In these filings, the SEC has sought to ensure that fees, fines, or dues collected by an exchange are not used for commercial purposes and that mechanisms have been established that are designed to ensure a proper level of funding of the self regulatory function. The SEC has the authority under the Exchange Act to cancel, suspend or revoke the registration of an exchange or association. The Exchange Act provides the SEC with the authority to impose penalties on exchanges or associations and their members for violations of the federal securities laws and/or SRO rules. Specifically, the SEC has the authority to suspend or revoke the registration of an SRO; censure or impose limitations on its activities; and remove from office or censure officers or directors of an SRO for violations of the Exchange Act or the SRO's rules. The SEC also has the authority to suspend or expel any member or person associated with a member from an SRO for violations of the federal securities laws or rules. The SEC has the authority to enforce an SRO's rules and to compel an SRO to enforce its rules with regard to its members.

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Assessment	Fully implemented.
Comments	The CFTC has issued guidance on how DCMs might comply with the Core Principles and has also described acceptable practices to achieve the same end. Some have argued that this limits the extent to which DCMs are able to diverge significantly from what the CFTC believes to be appropriate. The assessors are not persuaded of this. It is also argued that the move to a principles-based approach has enabled CFTC staff to focus more on the risk management and controls of a DCM rather than engaging in what can become a "tick box" approach of a conventional rule-based examination, which can overlook important systemic issues. This argument may have more merit. If changes are to be made it will be important to ensure that an efficient and effective balance is struck. As regards ongoing regulatory supervision of ECMs, the CFTC has been successful in obtaining legislative amendments which empower it to ensure that, in markets where the CFTC determines that ECMs are significant, they operate in an orderly and transparent manner. A separate issue in the authorization and oversight of exchanges and trading systems is that of capital. Unlike for BDs or FCMs, there are no explicit capital requirements for exchanges at the application or operational stages. The IOSCO Principles are silent on the matter except where an exchange takes principal risk. This situation is unusual, although in the case of most DCMs which are part of groups with integrated clearing organizations, affiliate risk is an issue. In the absence of explicit amounts of required capital, the staffs of the Commissions are required to make judgments as to whether the overall financial resources of the exchanges they monitor are adequate to maintain all their commercial and regulatory functions, staffing levels and IT expenses. The SEC focuses on two aspects, IT capacity and resilience and funding of the self-regulatory functions, although there are other demands on financial resources. The issue of financial resources has been growing in importance with demutualization of existing exchanges and the growing number of new exchanges in futures and derivatives where ownership is concentrated and the owners are themselves "for profit" entities that may assume significant principal risk in their main businesses. Where they are firms active in capital markets, their profit and loss profiles are likely to strongly correlate with the profit and loss profiles of the exchanges they are acquiring or establishing, which might expose an exchange to sudden commercially driven financial pressures in a crisis. Under the principles-based approach employed by the CFTC, it is not clear precisely what the CFTC's powers are in this area and staff are working with Congress to get explicit statutory authority to impose financial resource requirements on DCMs.
Principle 27.	Regulation should promote transparency of trading.
Description	**CFTC** Transparency is mandated by the CEA and CFTC regulations which require transparency and fair treatment. Core Principle 8 requires a DCM to make public daily information on settlement prices, volume, open interest and open and closing ranges for actively traded contracts. Regulation 16.01 requires the DCM to report specified information no later than the business day following the day to which the information pertains. In practice, exchanges publicly disseminate trade data, including last transaction price and size and current bid and offer information, on both a real time (generally for a fee) and delayed basis for free (the delay is at most ten minutes). Third-party data providers typically aggregate and publish data for all exchanges, not just contracts traded on a single exchange. At least one exchange posts quote data on its website on a real-time basis, including the bid-ask spread and the size of the bids and asks, for all of its contracts. The CFTC has generally found these methods of data dissemination acceptable and the only issue that occasionally raises concern is whether exchanges are providing data to third-party vendors on a fair and equitable basis. As regards ECMs, to date the CFTC has determined that only one contract traded on an ECM is a significant price discovery contract. The ECM publishes delayed quotes for this contract for free.

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	Real-time quotes for this product are available by subscription. **SEC** **Equity/option markets** The SEC administers a system for pre- and post-trade transparency for securities traded on exchanges (both equities and options). Over-the-counter trades in national market system equity securities are also covered by that system. Exchange rules require real-time reporting of transactions occurring on the exchanges and FINRA rules require real-time reporting of transactions in equity securities occurring in the OTC market. The dissemination of pre- and post-trade information for equities and options is governed by national market system plans (Plans) that operate in accordance with the Exchange Act. The text of the Plan or amendment thereto must be filed with the SEC. No Plan or amendment is effective unless approved by the SEC, with some limited exceptions for routine filings. The exchanges and FINRA submit all transaction information to the relevant Plan processor for immediate public dissemination. Similarly, exchanges collect order and quotation information from their members and submit their best bids and offers and associated sizes to the relevant Plan processor. Information collected by the Plans is widely disseminated via subscription. Subscriptions must be on terms that are fair and reasonable and not unreasonably discriminatory. Exchanges can offer proprietary market data products via subscription, but offering such products does not eliminate their duties to contribute real-time data to the Plans. Such subscription products must also be offered on terms that are fair and reasonable and not unreasonably discriminatory. Quotes from OTC market-makers whose executed volume in a security is one percent or less of the aggregate trading volume in such security and quotes on ATS that trade less than five percent of the volume in a national market system security are not subject to consolidation and public dissemination through the Plans. One “dark pool” ATS operates under a 20 percent limit approved by the SEC in 2005. The number of active “dark pools” trading NMS stocks has risen from approximately 10 in 2002 to approximately 29 in 2009. For the second quarter of 2009, according to the SEC, the trading volume of these dark pools was approximately 7.2 percent of the total traded volume in NMS stocks. **Debt markets.** In addition, comprehensive systems for post-trade transparency exist for corporate debt securities (through the TRACE system administered by FINRA) and municipal debt securities (through the RTRS system administered by the MSRB). In government securities there is limited pre-trade transparency but no mandatory trade publication. These markets are OTC dealer markets with no central exchange. Their detailed transparency requirements are public and have been intensively negotiated and researched over recent years.
Assessment	Fully implemented
Comments	**CFTC** The CEA and CFTC regulations have not been updated to reflect modern concepts of timely publication. However, consistent with Principle 27, the practice in futures markets is real time publication. A short delay for free publication is the normal practice in many jurisdictions. Derogations for block trades and other trades involving the interaction of futures with cash commodities and swaps appear reasonable. Since the markets the CFTC supervises are all on exchange, as required by the CEA, OTC business, whether carried on by telephone or otherwise, is not an issue as it is in securities markets, nor, until recently, have similar contracts been listed on more than one DCM/ECM. The current exclusion of swap transactions from oversight by the CFTC (or the SEC) and therefore the opacity of this market is a matter of current legislative and regulatory debate. **SEC** In making a judgment as to whether the regulation of the U.S. equity market fully meets the

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IOSCO benchmark that there be requirements or arrangements for providing pre-trade (e.g., posting of bids and offers) and post-trade (e.g., last sale price and volume of transaction) information to market participants on a timely basis, the assessors had to balance several issues. In their view:

- As regards post trade transparency the SEC's requirements fully meet the standard.
- SEC requirements for pre-trade transparency or publicly displayed liquidity, that is bids and offers submitted to and displayed by trading venues such as exchanges, displayed ATSs and ECNs, fully meet the standard. This is estimated to amount to 75 percent of total liquidity in NMS stocks (September 2009). According to most independent research, full implementation of Regulation NMS in October 2007 generated a significant increase in publicly displayed pre-trade transparency.
- A substantial amount of liquidity is not publicly displayed. The SEC believes that this amounted to 25 percent of total liquidity in September 2009. Dark pool ATSs authorized by the SEC under Regulation ATS are one component of this non-publicly displayed liquidity. Internalization of client order flow by BDs is another. The percentage may have grown by more than 20 percent between September 2008 and September 2009 according to some industry estimates. The reasons for this growth are disputed—indeed some query whether there has been an increase at all.

However, the SEC is concerned about the issue and its impact on investors. In the November 2009 release proposing rule changes for dark pools (Regulation of Non-Public Trading Interest) referred to in Principle 25 the SEC sets out, repeatedly, its fears that a two-tier market may be emerging that provides valuable order information on the best prices for NMS stocks only to selected market participants. So, for example, the National Best Bid and Offer (NBBO) or publicly displayed best quote in 1000 shares may be US$5.25 to 29. A dark pool may have a BBO of US$5.26 to 28 in the same size but these better prices are only transparent to, and available for trading by, clients of the dark pool operator. As the SEC has stated, its proposed rule changes are intended to "*to promote the Exchange Act goals of transparency, fairness, and efficiency.*"

In the judgment of the assessors, taking account of the three elements of transparency set out above the issue as to whether the Principle has been fully implemented in U.S. equity markets is finely balanced. However, on balance the assessors' view is that the IOSCO benchmark is met.

In addition to the proposed dark pool rule changes the SEC issued, in February 2010, a Concept Paper on Equity Market Structure in which it seeks public comment on a wide range of market structure issues that have arisen in recent years, including high frequency trading, order routing, market data linkages, and undisplayed or dark liquidity. The commission intends to use the public's comments to help determine whether regulatory initiatives to improve the current equity market structure are needed and, if so, the specific nature of such initiatives. This is a timely exercise.

The assessors have observed that well financed lobbying on these issues has begun. Historically, market regulation has been viewed by many broker dealers, exchanges ad trading system operators as a competitive tool. This phenomenon is not limited to the United States. There is therefore a high probability that data provided by various major market participants will support their own business models and seek to denigrate their competitors' as will the rationales they claim their data "proves." Thus, it is vitally important that, in evaluating the responses, the SEC directly obtains comprehensive raw data on what is actually happening in the equity market, where and when trades are being done, at what prices and with what impact on investors of all classes in order to reach correct conclusions. As observed under Principle 3, the SEC's ability to make policy determinations would be enhanced by a greater use of its authority to request raw data and to develop empirical analysis based on this data rather than relying on data generated and processed by exchanges, SROs and others.

See also the comments under Principle 25.

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Principle 28.	Regulation should be designed to detect and deter manipulation and other unfair trading practices.
Description	**CFTC** In general, Section 4b of the CEA makes it unlawful to cheat or defraud in connection with futures contracts. The CEA also prohibits fictitious trading or trading which would cause the market to reflect a price that is not "*true and bona fide*." As regards insider trading, the CEA provides an explicit but limited scope prohibition against insider trading for certain persons and not for persons generally as is the case in the securities market The CFTC has its own comprehensive market surveillance program to detect and prevent market manipulation. The CFTC's market surveillance program uses many sources of market information to accomplish its objectives. Some of this information is publicly available and some of the information is highly confidential, which includes data from exchanges, intermediaries and large traders. The CFTC is currently in the process of significantly upgrading this system to enhance its ability to detect trade practice violations, including wash trading and trading ahead. When problems develop, **s**urveillance economists prepare weekly summary reports of futures and option contracts for regional surveillance supervisors, who immediately review these reports. Surveillance staff informs the CFTC and senior staff of potential problems and significant market developments at weekly surveillance meetings so that they will be prepared to take prompt action when necessary. Reports and briefings are prepared more often, as needed. The market surveillance process is not conducted exclusively at the CFTC. Surveillance issues are usually handled jointly by the CFTC and the appropriate exchange. If an exchange fails to take actions that the CFTC deems appropriate, the agency has broad emergency powers under which it can order the exchange to take actions specified by the CFTC. Such actions could include imposing or reducing limits on positions, requiring the liquidation of positions, extending a delivery period, or closing a market. As regards domestic cross-market trading issues, there are numerous mechanisms and structures by which information can be shared and cooperation achieved. The Inter-market Surveillance Group (ISG) provides a framework for the sharing of information and the coordination of regulatory efforts among exchanges trading securities and related products to address potential inter-market manipulations and trading abuses. The CEA provides for robust sanctions in administrative and civil cases of manipulation and other unfair trading practices which serve the twin purposes of punishing the wrongdoer and deterring misconduct by others, all in an effort to protect the integrity of the futures market. The sanctions apply across all markets within the CFTC's jurisdiction and to registrants and non-registrants alike. These sanctions include: trading bans, registration sanctions, restitution, disgorgement, fines, preliminary and permanent injunctions, and cease and desist orders. In addition to the civil remedies and penalties available to the CFTC, manipulation, cornering, conversion, false statements to a registered entity or to the CFTC and all other willful violations of the CEA and regulations are also felonies that may be prosecuted by the DOJ and are punishable by a fine of up to US$1 million or imprisonment for up to ten years or both. **SEC** The SEC is an operationally independent agency and brings enforcement cases in the civil and administrative arenas based on the facts and evidence, as appropriate. The U.S. federal securities laws prohibit market participants from engaging in fraud. The Exchange Act prohibits the full range of manipulative, fraudulent and deceptive practices such as price manipulation, disseminating misleading information, insider trading, front running and other activities. In addition to the Exchange Act's broad anti-fraud provisions, the Securities Act, Advisers Act, and ICA all contain anti-fraud provisions which provide a meaningful and useful arsenal for combating

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fraud across sectors of the securities industry. Charges may be brought under any or all of these provisions in, for example, a manipulation case depending on the facts and evidence. The anti-fraud provisions of each of these Acts operate in a complementary, not duplicative, manner.

The federal securities laws empower the SEC to prescribe rules that it deems necessary and appropriate to protect investors and the public interest. These requirements and prohibitions are supplemented by rules of the SROs.

Laws in the United States are developed and established through the judicial system as well as through legislation. The broad anti-fraud provisions of the Exchange Act make it unlawful to engage in fraud or misrepresentation in connection with the purchase or sale of a security. It is well established in case law that illegal insider trading is a violation of the anti-fraud provisions of the Exchange Act. Interpretations of the anti-fraud provisions by federal courts provide valuable flexibility for the successful prosecution of new schemes for insider trading. The definition of what constitutes illegal insider trading can and has evolved through case law. This process provides the SEC with the agility to attack novel insider trading schemes head on. The typical theories used in insider trading cases, classical and misappropriation theories, are examples of the successful evolution of federal case law in this area and are well-accepted theories across the federal courts, including the U.S. Supreme Court.

The SEC regularly brings insider trading enforcement actions against:

- Corporate officers, directors, and employees who traded the corporation's securities after learning of significant corporate developments.
- Friends, business associates, family members, and other "tippees" of such officers, directors, and employees, who traded the securities after receiving such information.
- Other persons who misappropriated and took advantage of confidential information from their employers.

Where the SEC identifies a possible gap in judicial interpretation of securities law, it has the ability to seek to close that gap through rulemaking. For example, because issuer selective disclosure bears a close resemblance to "tipping" and insider trading and their adverse market effects are essentially the same, the SEC promulgated Regulation FD. Regulation FD targets the practice of issuer selective disclosure by establishing requirements for full and fair disclosure by public companies

In addition, the Exchange Act imposes liability for short-swing profits in the issuer's stock upon all persons required to file reports under Section 16(a) of the Exchange Act (officers, directors, and beneficial owners of more than ten percent of any class of equity security). These statutory insiders must disgorge to the issuer any profit realized as a result of a purchase and sale or sale and purchase of covered equity securities occurring within a six-month period.

The SEC investigates and enforces a wide variety of misconduct under the anti-fraud provisions of the Exchange Act. Examples of these fraudulent practices and market abuses include: inter-positioning, front running, unauthorized trading in customer accounts, undisclosed revenue sharing, breach of best execution, excessive mark-ups, suitability violations and a variety of colloquially described activities involving "boiler rooms," "churning," "scalping," "pump and dump" and other forms of manipulative schemes. Hacking into client accounts at on-line brokerage firms and trading in their accounts has emerged as a problem in recent years. The Enforcement Division has brought many cases addressing this and other forms of securities fraud stemming from on-line activities and new technology.

With respect to gathering and analyzing information, monitoring market participants, and generating alerts, the SROs collect and analyze information relating to trading activities. Exchange and FINRA systems capture order details throughout the lifecycle of a trade. Unusual trading activity is reviewed to determine whether fraudulent activity is occurring. FINRA spends more than US$30 million per annum on market surveillance technology necessary to keep pace with market developments. Market surveillance by NYSE Regulation is estimated to cost

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	US$62 million in 2009 with a further increase scheduled for 2010. The SROs may take remedial action for violations of such rules or refer violations of federal securities laws to the SEC. The SEC also has an office within the Division of Enforcement that monitors the markets for suspicious activity. This office serves as a liaison for the SROs, each of which has primary responsibility for monitoring their respective markets. The SEC and SROs work closely and collaboratively in exchanging information regarding suspicious market activity. The SEC's surveillance systems technology requires significant investment to bring it up to date. Cross market issues are dealt with under the auspices of the ISG. See reference above under CFTC. As regards other foreign linkages, see the description and comments under Principle 13. As to whether the sanctions available for violations are effective, proportionate and dissuasive, in fiscal year 2008, the SEC brought 671 enforcement cases, which was its second highest number in history. Additionally, in fiscal year 2008, the SEC obtained orders in judicial and administrative proceedings requiring securities violators to disgorge illegal profits of approximately US$774 million and to pay penalties of approximately US$256 million. The SEC is responsible for civil enforcement of the federal securities laws. In addition to the significant number of civil cases the SEC brought in fiscal year 2009, criminal prosecutors filed indictments, informations, or contempt charges in 154 SEC-related criminal cases. In fiscal year 2008, criminal prosecutors brought 108 SEC-related cases. The SEC files its cases in U.S. federal courts and in administrative proceedings. As in other civil cases, the SEC's burden of proof is that of preponderance of the evidence. The SEC may seek either temporary or permanent injunctive relief in a U.S. federal district court. It can seek a broad range of sanctions. In civil suits, the SEC seeks injunctions, which are orders that prohibit future violations. A person who violates an injunction is subject to fines or imprisonment for contempt. The SEC also may ask a federal court for emergency relief, generally in the form of a temporary restraining order. The SEC may also request that a court issue an order "freezing" assets to preserve the ability to obtain monetary relief at the successful conclusion of the case and return money to defrauded investors. In a civil action, in addition to injunctive relief, the SEC may and typically does, seek other equitable relief to remedy the harm caused by the violation. Such relief may include an accounting or disgorgement of ill-gotten gains where a defendant has profited from a violation of law. The SEC is also authorized to seek civil money penalties and court orders barring a defendant from serving as an officer or director of a public company or from participating in an offer of penny stock. The SEC may also institute administrative proceedings against a person or an entity regulated by the SEC or any person that it believes has violated or is violating the law. Administrative proceedings provide for a variety of relief, including a censure, a limitation on activities (in the case of a regulated entity or associated person of a regulated entity) such as suspension or revocation of registration (in the case of a regulated entity), suspension of up to twelve months or a bar from the industry (in the case of an associated person), a cease-and-desist order, accounting or disgorgement, or civil money penalties. In both civil injunctive actions and administrative proceedings, the SEC has the power to enter into enforceable settlements. In the typical settlement, the settling party neither admits nor denies the SEC's allegations. In a civil action, the SEC requests that a court issue an order reflecting the settlement. In administrative proceedings, a settlement order is entered by the SEC describing findings of fact tied to the violations of the federal securities laws. The SEC may suspend trading in a particular security or a group of securities and national securities exchanges have the authority to suspend or remove a security from trading. In addition, the Exchange Act empowers the SEC to deregister and de-list securities for the protection of investors and to approve or reject voluntary and involuntary deregistration and de-

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	listing of shares requests from issuers or exchanges, pursuant to rules of the applicable exchange. By rulemaking, the SEC has adopted the policy that in any civil lawsuit brought by it or in any administrative proceeding of an accusatory nature pending before it, it is important to avoid creating, or permitting to be created, an impression that a decree is being entered or a sanction imposed, when the conduct alleged did not, in fact, occur. This rule is designed to address situations where the SEC settles a case only to have the defendant or his or her counsel take issue with the legal or factual basis for the SEC's action. Thus, where there is a settlement of an enforcement action, the defendant settles "without admitting or denying" the allegations. This language safeguards the deterrent effect of the sanctions in that the defendant cannot, without breaking the terms of the settlement, denounce publicly the basis for the SEC action. The SEC enforces the "neither admit nor deny" provision in its settlements.
Assessment	Broadly implemented.
Comments	**CFTC** The issue which accounts for the assessment is the very narrow scope of the insider dealing provisions in the CEA. The statute's current prohibitions on insider trading generally cover trading on the basis of CFTC, exchange, or SRO information by certain persons associated with those institutions. However, trading ahead or front running has been charged by the commission under the CEA's general anti-fraud provision when persons traded for their own account (or through a associated account) ahead of a customer or an employer for whom the person was trading. The assessors strongly support the recommendation in the Joint Report for a further extension of the insider dealing offence to misappropriation and trading on the basis of material non-public information from any government authority. The assessors recognize that there may be legitimate reasons for different approaches to insider dealing for securities and futures given the differences in the nature of the markets. However, the assessors also recommend that the CFTC undertake a study to examine whether there should be an expansion of insider trading prohibitions beyond what is recommended in the Joint Report. Such a study would complement the current debate in Europe as to the appropriate coverage of insider trading laws in derivatives markets. The assessors also strongly support the recommendation to require FCMs and IBs to erect Chinese walls between their research departments and their traders. If implemented, this latter measure would replicate the measures the SEC imposed on equity BDs following the misuse of research in the dotcom bubble and would be a step towards a harmonised approach in this area. **SEC** The absence of additional offences of insider trading may be a limiting factor in the SEC's enforcement effort in this area. However, it has not prevented the SEC from prosecuting cases under the civil law and existing specific offences of insider trading in connection with a tender offer (Rule 14e–3) and under rules that define (i) when a purchase or sale constitutes trading on the basis of material, nonpublic information (Rule 10b5–1); and (ii) the circumstances in which a person has a duty of trust or confidence for the purposes of the misappropriation theory of insider trading (Rule 10b5–2). The courts appear to have been willing to be supportive when interpreting the law. But criminal convictions and civil judgments generally depend on proving a breach of a duty of care and that the person acted with intent. **Cross market comparison** There is a major difference in the efficiency with which overall market surveillance is carried out in the securities and futures markets. In the equity markets no one body sees the whole picture. FINRA now monitors trading on most exchanges except NYSE and Chicago Board Options Exchange (CBOE) and on all the ATSs. Further consolidation is under discussion to create a consolidated surveillance structure to oversee the consolidated market. However, with current technology it will still be difficult to look through to identify the underlying traders. In contrast, in

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	the futures markets the CFTC, working in cooperation with the exchanges, sees almost the total picture across all futures as a matter of daily routine and can identify the major traders who are clients of the FCMs, if necessary, with ease and in a timely fashion. Its ability to measure the financial exposure of all FCMs on a daily basis and changes in the size and ownership of the open interest is significantly in advance of what the SEC and the equity exchanges can achieve now or in the near future. However, in the case of both the SEC and CFTC, their IT resources are limited and outdated due to budgetary limitations and the problems of planning long-term IT projects when the commission's budget is determined annually by Congress. However, in 2009 the CFTC has been able to commit to spend almost US$26 million on IT, up from US$11 million in 2008.
Principle 29.	Regulation should aim to ensure the proper management of large exposures, default risk and market disruption.
Description	**CFTC** As discussed in connection with Principle 23, the CFTC deals with the issues of large exposures, default risk and market disruption via its Risk Regulatory Surveillance Group (RSG). The RSG has developed or obtained access to a number of automated systems and applications, which collectively permit the RSG to receive timely data on clearing members and large traders. The RSG attempts to be proactive rather than reactive. Accordingly, RSG staff attempts to identify traders and FCMs who might pose risk before a market becomes volatile, not just after the volatility appears. Concentration of risk is a key indicator that the RSG focuses on when it examines data. If there is a problem in a futures market, both the CFTC and DCMs have a number of emergency powers such as the power to suspend and halt trading, set margin, position limits, and price limits, and impose "circuit breakers" or otherwise intervene in the market. The CFTC can also alter or supplement the rules of a registered entity and direct a registered entity to take such action as in the CFTC's judgment is necessary to maintain or restore orderly trading in or liquidation of any futures contract. CFTC enforcement powers are comprehensive and authorize civil injunctive actions for failing to comply with requests for required information and subpoena enforcement actions for failure to comply with subpoena demand for documents or testimony. Failure to comply with a court order is punishable as contempt of court. DCMs must have rules which provide for the exercise of emergency authority, in consultation or cooperation with the commission, where necessary and appropriate, including the authority to—liquidate or transfer open positions in any contract; suspend or curtail trading in any contract; and require market participants in any contract to meet special margin requirements. The CFTC has provided guidance on these procedures. In terms of information sharing, the CFTC and DCMs have executed agreements to share information that is prompted by, among other things, large exposures. The CFTC essentially has the same information that DCMs have with respect to large exposure information. Wherever the exchanges manage position limits, they inform the CFTC of any exemptions granted. The exchanges are able to monitor the exposure size within each contract on an intraday basis. Frequent conversations occur between exchange and CFTC staff when liquidation or acquisitions of large exposures create a heightened concern. The increasing volume traded on an ECM that settles off a futures contract has prompted the CFTC to increase oversight of certain "linked contracts." The CFTC has issued rules regarding a category of contract deemed to be SPDCs which encompasses linked contracts. Under these rules, ECMs and clearing organizations will have the same reporting obligations with respect to SPDCs as DCMs have for futures contracts. In the meantime, a hybrid situation exists in which the ECM is reporting a form of large trader positions but not yet meeting the quality standards the CFTC requires. Internationally, the key documents are the Declaration on Cooperation and Supervision of

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	International Futures Markets and Clearing Organizations and its companion Exchange Memorandum of Understanding. (For international information sharing and cooperation more broadly see Principle 13.) If an FCM is executing transactions on a DCM, then such FCM must clear such transactions through a DCO. In general, most DCOs publish their default procedures on their websites. In practice, 90 percent of all futures contracts clear through the DCO which is part of the CME group. Issues concerning the bankruptcy of an FCM are dealt with in Principle 24. **CFTC Regulation of DCOs** The CFTC supervises DCOs in three main ways. First, the CFTC evaluates applications from entities seeking to become DCOs. Second, the CFTC conducts periodic reviews of registered DCOs. Third, the CFTC surveys, on a daily basis, DCO exposures and compares such exposures to DCO financial resources. Additionally, the CFTC may review and approve DCO rules. Under the CEA, an entity that wants to register as a DCO must submit an application to the CFTC which demonstrates that it complies with the Core Principles applicable to DCOs. The CFTC provides guidance to applicants on how to demonstrate compliance with the core principles. The Core Principles set out a range of requirements including adequate financial, operational and managerial resources; appropriate standards for participant and product eligibility; adequate and appropriate risk management capabilities; the ability to complete settlements on a timely basis under varying circumstances; standards and procedures to protect member and participant funds; efficient and fair default rules and procedures; adequate rule enforcement and dispute resolution procedures; and adequate and appropriate systems safeguards, emergency procedures and plans for disaster recovery. There are also record keeping requirements, obligations to report to the CFTC, public availability of its rules and operating procedures and obligations to share information domestically and internationally. As regards ECMs, transactions executed on an ECM, if cleared, must be cleared by a clearing organization that satisfies the requirements of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) as amended by the CFMA. This includes DCOs, registered securities clearing agencies, various banks and clearing organizations supervised by a foreign financial regulator that one of the U.S. federal financial regulators has determined satisfies appropriate standards. **SEC** For a detailed assessment of clearing and settlement in securities markets see the CPSS IOSCO reports. The only explicit large exposure disclosure requirements imposed by the SEC cover BDs with outstanding options positions to the extent that those positions exceed an aggregate position of 200 or more option contracts on the same side of the market covering the same underlying security or index. In addition, to the extent any option position exceeds certain limits; the firm is required to decrease the position. These reports generally must be submitted on the day that the position parameters are exceeded or change. Continuous monitoring of BDs' open positions and large exposure is primarily the responsibility of the clearing agencies They receive data on a real time basis and review positions at end of day and frequently intraday. Under the Exchange Act, clearing agencies are SROs and have full self regulatory powers and responsibilities, including the power to discipline participants for violation of any provision of the rules of the clearing agency by expulsion, suspension, limitation of activities, functions and operations, fine, censure, or any other fitting sanction. They have authority to require increased margin and/or collateral deposits. Clearing agencies generally do not compel participants to reduce their exposures, although increased margin calls may cause a participant to reduce its exposure. The securities depository registered with the SEC requires that all settlement

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	obligations of participants be fully collateralized. The rules of a clearing agency must be pre-approved by the SEC. The SEC conducts on-site examinations of each clearing agency on a two-year cycle and "for cause" using examiners with particular knowledge and expertise in relevant subject matter such as VAR modeling. A BD must also comply with the rules of each SRO of which it is a member such as an exchange or FINRA. To the extent that a BD fails to furnish information requested by an SRO, the SROs have rules as to what action the SRO may take. The margin rules also help SROs control the risk of open positions. The SEC has entered into MOUs with other domestic regulatory agencies regarding the clearance and settlement of financial products which provide, inter alia, for consultation in order to minimize the adverse effects of market disruptions. These include the CFTC and the Federal Reserve. In addition, the SEC has entered into bilateral agreements with various international agencies that allow the SEC to share information on a timely basis. Information regarding large options positions is shared on a case by case basis, as appropriate. The SEC participates in five of the recently established international colleges of regulators although the U.S. BD component of these groups is relatively small. When a BD must be liquidated, the United States bankruptcy laws will apply. In addition, if a BD holds customer funds or securities, SIPA may also apply. Finally, if the BD is a member of a clearing agency, the clearing agency rules may apply to the rights of the clearing agency to close out any open exposures to its defaulting clearing members. Clearing agencies are required to publish their rules and procedures on their web sites including those relating to participant defaults. Apart from the corporate finance rules on disclosure of beneficial ownership of positions by insiders (see Principle 15), there is no automatic disclosure of the beneficial ownership of securities. The SEC must rely on the rule which requires BDs maintain records regarding all securities positions and the accounts to which they belong. This information includes the size of every position held in each account and the identity and address of the beneficial owner of each account. BDs are required to provide this information to the SEC upon request.
Assessment	Fully implemented.
Comments	The difficulty which the SEC faces in obtaining beneficial ownership details of securities holders is typical of securities regulators globally. However, in the United States, it compares poorly with the ease and timeliness with which the CFTC can obtain large trader information in futures and related markets. This is a limitation which the authorities should consider correcting.
Principle 30.	Systems for clearing and settlement of securities transactions should be subject to regulatory oversight and designed to ensure that they are fair, effective and efficient and that they reduce systemic risk.
Description	A separate CPSS-IOSCO assessment was conducted for the securities markets. Arrangements in the futures markets were not assessed.
Assessment	
Comments	

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FINANCIAL SECTOR ASSESSMENT PROGRAM

UNITED STATES OF AMERICA

THE 2006 ASSESSMENT OF THE ANTI-MONEY LAUNDERING/COMBATING THE FINANCING OF TERRORISM REGIME AND RECENT DEVELOPMENTS

TECHNICAL NOTE

JULY 2010

INTERNATIONAL MONETARY FUND
LEGAL DEPARTMENT

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Contents Page

Glossary 3

I. Introduction 3

II. Overview 4
A. Money Laundering and Terrorism Financing Situation 4
Money laundering 4
Terrorism financing 8
AML/CFT strategies and priorities 9
B. Key Findings from the Mutual Evaluation Report and Progress Reports 9

III. Financial Action Task Force 2006 Anti-Money Laundering/
Combating the Financing of Terrorism Mutual Evaluation and
Subsequent Developments 10
A. Legal System and Related Institutional Measures 10
Main findings of the 2006 MER 10
Developments since the 2006 MER 11
B. Preventive Measures—Financial Institutions 12
Main findings of the 2006 MER 12
Developments since the 2006 MER 13
Developments since the 2006 MER 18
C. Preventive Measures—Designated Non-Financial Businesses and Professions 19
Main findings of the 2006 MER 19
Developments since the 2006 MER 19
D. Legal Persons and Arrangements and Non-Profit Organizations 23
Main findings of the 2006 MER 23
Developments since the 2006 MER 24
E. National and International Cooperation 26
Main findings of the 2006 MER 26
Other developments since the 2006 MER 27
F. Resources and Statistics 29
Main findings of the 2006 MER 29
Developments since the 2006 MER 29

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GLOSSARY

AML/CFT	Anti-Money Laundering and Combating the Financing of Terrorism
APG	Asia Pacific Group on Money Laundering
BSA	Bank Secrecy Act
CDD	Customer due diligence
CFR	Code of Federal Regulation
CIP	Customer Identification Program
DNFBPs	Designated non-financial business and professions
DOJ	Department of Justice
FATF	Financial Action Task Force
FIs	Financial institutions
FinCEN	Financial Crimes Enforcement Network
FINRA	Financial Industry Regulatory Authority
FIU	Financial Intelligence Unit
IRS	Internal Revenue Service
MER	Mutual evaluation report
ML	Money laundering
MSBs	Money services businesses
NPOs	Non-profit organizations
NRPM	Notice of Proposed Rulemaking
OFAC	Office of Foreign Assets Control
OEM	Other enforceable means
PEP	Politically-exposed person
POC	Proceeds of crime
SARs	Suspicious activity reports
SR	Special Recommendation
TCSPs	Trust and company service providers
TF	Terrorism Finance
TN	Technical note
UN	United Nations
UNODC	United Nations Office on Drugs and Crime

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I. INTRODUCTION

1. **This technical note (TN) is intended to provide an overview of the anti-money laundering and combating the financing of terrorism (AML/CFT) regime of the United States.** It is based on the findings of the June 2006 mutual evaluation report (MER) prepared by the Financial Action Task Force (FATF) with respect to the U.S. compliance with the FATF 40 Recommendations plus 9 Special Recommendations, and on more recent information provided in two progress reports made by the United States to the FATF (May 2008 and June 2009), and one report to the Fund in the context of the 2009/10 U.S. FSAP assessment. The TN focuses on progress made since the 2006 FATF evaluation by the U.S. authorities to the legal, regulatory, and institutional framework to address the most significant deficiencies identified in the MER. It also indicates those areas where no or limited progress has been made. This TN aims at providing a factual update of developments in the U.S. AML/CFT regime; it does not constitute a reassessment by the Fund of the U.S. AML/CFT regime and does not re-rate levels of compliance with the FATF standard. In addition, it includes estimates of the amount of proceeds generated by criminal activity since the MER, and encourages the United States to take this information into account in evaluating the money laundering (ML) situation and the measures adopted.

2. **The latest mutual evaluation of the U.S. AML/CFT framework was conducted jointly by the FATF and the Asia Pacific Group on Money Laundering[1] (APG) during two on-site visits to the United States from November 7–18, 2005, and January 9–23, 2006.** The MER was adopted by the plenary meetings of both organizations—in June 2006 by the FATF and in July 2006 by the APG. The MER provided an overview of the AML/CFT measures in place in the United States during these visits and immediately thereafter. It was based on the review of the relevant AML/CFT legislation, regulations and other requirements, the institutional framework, and other systems in place to deter ML and terrorism finance (TF) through financial institutions and designated non-financial businesses and professions (DNFBPs). The MER indicated the level of compliance with the FATF 40+9 Recommendations, taking into account the effectiveness of implementation of AML/CFT measures in place, and provided recommendations on how certain aspects of the framework could be strengthened.

[1] The APG is an FATF-style regional body for the Asia/Pacific region, of which the United States is also a member.

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3. **The progress reports to the FATF were made pursuant to the FATF procedures that require evaluated members to report back to the FATF plenaries on steps taken to address deficiencies noted in their MERs with respect to the Recommendations that were rated as partially compliant or non-compliant.**[2] In the case of the United States, these were Recommendations 5 (customer due diligence (CDD)), 12 (CDD and recordkeeping for DNFBPs, 16 (suspicious transaction reporting and internal controls for DNFBPs), 24 (regulation and supervision of DNFBPs), 33 (transparency of legal persons), and 34 (transparency of legal arrangements). In line with FATF procedures, the United States is expected to make its next progress report to the FATF in June 2010.

4. **The report to the Fund described progress in addressing deficiencies identified in the 2006 MER relating to the FATF Recommendations that were rated partially compliant or non-compliant, and highlighted other significant AML/CFT developments since 2006.**

5. **The FATF has been discussing several issues regarding the AML/CFT standard that are relevant to key deficiencies identified in the MER.** To the extent that these discussions result in changes to the FATF Recommendations (e.g., regarding customer due diligence, application of the risk-based approach to AML/CFT, and transparency of beneficial ownership and control of corporate vehicles and trusts, and DNFBPs), the outcome of those deliberations may have a direct impact on future U.S. compliance with the standards.

II. Overview

6. **The following sections of the TN provide summary background information on the U.S. ML and TF situation, strategies, and priorities, as well as summary information from the MER and the progress reports.**

A. Money Laundering and Terrorism Financing Situation

Money laundering

7. **Since the time of the 2006 MER, both the availability of U.S. criminal statistics and the general approach to understanding ML risks have evolved.** The MER, taking asset confiscation data as its starting point, came to the conclusion that illicit trafficking in narcotics is a major source of proceeds for ML in the United States and that fraud and firearms violations are also significant sources of confiscated assets. It stated that the

[2] Under the 2004 Methodology for Assessing Compliance with the FATF 40 Recommendations and the 9 Special Recommendations, there are four levels of compliance: compliant, largely compliant, partially compliant, and non-compliant.

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prevalent method of ML, as reported in suspicious activity reports (SARs), involved the use of cash, wire transfers, and correspondent accounts by both individuals and businesses.

8. **This note does not attempt to exhaustively re-analyze the U.S. ML situation nor report comprehensively on profit-making crime in the United States.** However, current publicly available data on domestic proceeds of crime (POC) raises questions about the relative significance of drug-related proceeds vis-á-vis those from other profit-making crimes. Much further work would be required to make anything more than impressionistic suggestions; estimates of POC are problematic, imprecise, and involve collating non-harmonized data from widely disparate sources. For example, 2001–2005 estimates of the annual proceeds of illicit trafficking in narcotics in the United States are in the $60–$65 billion range.[3] However, these figures are difficult to reconcile with the 2005 United Nations Office on Drugs and Crime (UNODC) World Drug Report, which suggests that the combined North American (U.S., Mexican, and Canadian) retail sales of cocaine, opiates, cannabis, amphetamines, and ecstasy are close to $140 billion.[4] Turning to other less documented crimes, we can find estimates for various forms of fraud—securities, insurance, mortgage—of some $125 billion,[5] and the U.S. Department of Health and Human Services presented an estimate for health care fraud of around $60 billion.[6] Verifying each of these specific estimates would require much more detailed research than would be appropriate for this note. Nevertheless, comparing the upper range of estimates for proceeds of drug trafficking with the lower range estimates for fraud leads to the conclusion that fraud and other white collar crimes could generate proceeds at least equal to, if not significantly greater than, those associated with drug trafficking.

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[3] Joseph T. Rannazzisi, Deputy Assistant Administrator, DEA-DOJ, regarding "Breaking the methamphetamine Supply Chain: Law Enforcement Challenges" before the Senate Committee on Finance, September 12, 2006; "Stumbling in the Dark," *The Economist*, July 26, 2001.

[4] United Nations Office of Drugs and Crime, *2005 World Drug Report*, Volume 1, pp. 130-143 (Vienna, 2006). These levels invite comparison to an earlier (1989) estimate of the Financial Action Task Force (FATF) of U.S. drug-related POC of about $108 billion. FATF Working Group on Statistical and Methods, *Narcotics Money Laundering - Assessment of Scale of the Problem*, 1989, Financial Action Task Force on Money Laundering, *report*, February 7, 1990.

[5] U.S. presentation to the FATF, "Fraud, Financial Filings, and Market Effects" (October 2009). This overall level is generally consistent with press reports on several of the more prominent individual cases, *see, e.g.*, "Another Week, Another Lawyer Change for Allen Stanford," *The Wall Street Journal*, May 18, 2010; Diana B. Henriques, "Madoff Judge Endorses Trustee's Rule on Losses," *The New York Times*, March 1, 2010.

[6] William Corr, J.D., Deputy Secretary, U.S. Department of Health and Human Services, "Effective Strategies for Preventing Health Care Fraud" testimony before the Senate Judiciary Committee, October 28, 2009. It is not clear if this should be considered as a component of the insurance fraud cited above, or an additional form of fraud.

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9. **This observation may have important implications for AML/CFT policy, priorities, and systems, since the laundering typologies associated with traditional cash-based drug trafficking on the one hand, and fraud and other white-collar crimes on the other, can be very different.** A key feature of fraud and other white-collar crimes is that the proceeds generated are often already in the formal financial system in non-cash form, obviating the need for placement and thus by-passing most entry level CDD measures. Another key feature is the importance of the use of corporate vehicles and opaque beneficial ownership information, as emphasized in numerous government reports and legislative testimony.[7] While the U.S. AML/CFT regime has significantly evolved over time, U.S. authorities may wish to examine the extent to which it has adapted from an historical focus on drug trafficking-related ML to address the total range of ML risks facing the U.S. financial system and economy. For example, one conclusion of the 2006 MER, that stricter implementation of the AML/CFT requirements in the financial sector has tended to lessen the use of financial institutions (FIs) for ML, could be correct for drug-related and other offenses associated traditionally with the cash-based underground economy, while being less accurate for many white-collar crimes. An even greater strategic and tactical re-evaluation could be warranted should the United States make tax evasion a predicate offense for ML[8]

10. **Another observation that derives from these individual POC estimates is that the overall POC level is likely to be high in absolute terms.** Since the U.S. economy is the largest in the world, it is reasonable to expect that its illicit sector generates significant proceeds. More work would have to be done before confidently aggregating the estimates for the individual crimes noted above, to say nothing of other crimes such as prostitution, robbery

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[7] E.g., DOJ Senate Testimony November 2006; FinCEN Senate Testimony November 2006; DOJ Senate Testimony June 2009; Department of Homeland Security Senate Testimony June 2009; Treasury Senate Testimony November 2009, DOJ Senate Testimony November 2009; and Government Accountability Office report April 2006.

[8] There are no accurate or credible estimates of U.S. tax evasion, which is a component of the tax gap. The tax gap includes non-payment of owed taxes due to: taxpayer error, conflicting legal interpretations, misinterpretation of the facts, and outright tax evasion. Three sources suggest that the total U.S. tax gap is in the region of $500 billion. The first report indicates that the current value of the net Federal tax gap is around $400 billion (or around 15 percent of gross tax receipts). This estimate includes only a fraction of international tax evasion, a fraction of excise evasion, and excludes evasion of state and local taxes, from U.S. Treasury Report "Update on Reducing the Federal Tax Gap and Improving Voluntary Compliance," 2009. The second report indicates that the international tax gap was estimated at $100 billion or more annually in 2009 and contains unverified material suggesting that around half of that may be evasion, see U.S. Department of Treasury, Treasury Inspector General for Tax Administration, Office of Inspections and Evaluations, 27 Jan. 2009. A Combination of Legislative Actions and Increased IRS Capability and Capacity Are Required to Reduce the Multi-Billion Dollar U.S. International Tax Gap. The third set of reports, estimates of tax gaps at the state level, suggest that state level tax gaps could average around $1 billion per state or $50 billion annually (see for example, State of California, Legislative Analyst's Office. Feb. 2005. *California's Tax Gap).*

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and other property-related crimes, counterfeiting and smuggling.[9] However, for the purposes of strategic policy-making in this area, precision is less critical than understanding the orders of magnitude. Adjusting the U.S. government-sourced estimates for drug trafficking, fraud, and the other crimes cited above into real 2009 dollars, suggests a minimum figure of around $275 billion (excluding tax evasion), which could be considered a point of departure for such an understanding. Whatever the actual number, the U.S. domestic POC figure is probably among the highest in the world.[10]

11. **Moreover, the United States' role as one of the important international financial centers in the world also exposes it to ML from crimes committed in other countries.** While one component of criminal banking and investment strategy clearly involves a desire for concealment and secrecy, it is probable that U.S. financial and real estate assets are attractive to criminals as well as to law-abiding investors, and that a significant percentage of foreign criminal assets that are expatriated from their country of origin will end up in the United States—especially in the final "integration" stage of the ML process.[11] This hypothesis is strengthened by numerous reported ML cases involving large amounts of proceeds

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[9] Government and academic analysts have ventured various valuation estimates for other significant profit-generating crimes in the United States, all of which should be further tested for consistency and accuracy. For example, sexual exploitation has been estimated at $14.6 billion (Anne Rasmusson, "Commercial Sexual Exploitation of Children: A Literature Review," The Alliance for Speaking Truths on Prostitution and The Center for Urban and Regional Affairs of the University of Minnesota, June 1, 1999 (derived from estimated expenditures of $40 million per day in 1999); property crimes at $17 billion (U. S. Department of Justice, Federal Bureau of Investigation, *Crime in the United States 2008*, September 2009); cigarette smuggling at $5 billion (Associated Press, "ATF stings put 250M illegal cigarettes on streets," Yahoo News, January 22, 2010—citing a Department of Justice estimate of lost annual tax revenues for state and local governments); and the counterfeiting and piracy of products at $261 million (U.S. GAO. Intellectual Property: Observations on Efforts to Quantify the Economic Effects of Counterfeit and Pirated Goods, GAO-10-423, April 2010—estimating domestic value of goods seized in one year). In general, the statistical situation with regard to estimating proceeds of crime in the United States is far from satisfactory and work on improving the empirical basis for assessing ML risk and developing AML policy should be a priority.

[10] The total domestic POC is not equivalent to the amount of money laundered in a jurisdiction. First, some domestic proceeds may be expatriated for laundering in other countries and some foreign proceeds are imported and laundered domestically. Second, as tax evasion (among some other behaviors) is not currently a predicate crime for ML, its proceeds would be criminal, but transactions using those proceeds may not be laundering. Finally, ML is usually conceived in terms of the financial transactions that are involved, which would be a different measure than the value of the proceeds that provide the "raw material" for laundering.

[11] One illustrative measure of the attractiveness of U.S.-based assets is the inward portfolio investment statistics provided by the Coordinated Portfolio Investment Survey (CPIS). According to 2008 data, over 20 percent of the pool of all portfolio investments invested outside of the country of origin are held in U.S. equities and long- and short-term debt. International Monetary Fund, *2008 Coordinated Portfolio Investment Survey.*

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originating from other countries.[12] In this regard, U.S. authorities should be encouraged to continue their efforts to broaden the ML criminalization provisions to fully include the laundering of the proceeds of some significant foreign crimes—including fraud, as noted in the 2006 MER. On the other hand, U.S. criminals who expatriate their illicit proceeds to other jurisdictions, including through cash smuggling, wire transfers, and correspondent banking facilities, create ML threats and challenges for other countries, including those with weak AML/CFT regimes and more limited resources.[13] This implies a proportional responsibility for U.S. authorities in the area of international cooperation, and highlights the importance of effectively addressing the current lack of compliance with FATF Recommendations on transparency of ownership and control of companies and trusts.

12. **The size of the U.S. economy and its leading position in the global economy and financial system thus raise more general issues for ML risk analysis and strategy.** The question is not whether the U.S. AML/CFT system is robust in absolute terms—the FATF assessment report makes it clear that that is the case. The question is whether it is sufficiently robust to meet the special challenges that arise from having high domestic POC and from being an attractive venue for foreign criminals to bring their illicit assets. In this regard, the U.S. authorities should be encouraged to continue their efforts to improve and strengthen their AML/CFT regime to meet the high level of relative threat with which it is faced.

Terrorism financing

13. **Terrorism finance has been a main concern for the U.S. authorities since the events of September 11, 2001.** At the time of the mutual evaluation, no clear trend in the volume of suspicious activity reports (SARs) related to TF had been discerned. The authorities believe that wire transfers and non-profit organizations (NPOs) are vulnerable to TF. Enhanced enforcement of anti-terrorism laws has also made the use of NPOs for TF purposes less transparent. Investigations of TF cases have identified the use of front companies and nominees to wire funds, as well as FIs and money servicing businesses

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[12] For example, some $7.5 billion of Russian assets was laundered through the Bank of New York in the late 1990s (Transcript of the Allocation Hearing Pursuant to the Guilty Plea of Lucy Edwards in the United States District Court for the Southern District of New York, February 16, 2002); Riggs Bank held between $4–8 million of General Augusto Pinochet's illegal deposits (U.S. Senate Permanent Subcommittee on Investigations – "Money Laundering and Foreign Corruption: Enforcement and Effectiveness of the Patriot Act, Case Study Involving Riggs Bank," released in conjunction with the Permanent Subcommittee on Investigations' Hearing on July 15, 2004)); and Ukrainian former prime minister Pavel Lazarenko was convicted of laundering $21.7 million of proceeds of his corruption in the United States, including the purchase of a $6.7 million mansion (U.S. v Lazarenko, slip op. 06-10592, 9th Cir. Ct App, Sept 26, 2008.

[13] Those threats and challenges also arise when foreign criminals, who carry out part of their laundering in the United States, expatriate their partially-laundered proceeds to other countries.

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(MSBs). Reverse structuring of transactions has also been observed through the use of large transaction amounts to minimize paper trails.

AML/CFT strategies and priorities

14. **The United States has been committed to combating ML and TF on several fronts, including through aggressive financial investigations.** At the time of the mutual evaluation, the U.S. strategy was based on three main goals: (1) cut off more effectively access by criminals to the international financial system; (2) enhance the ability to target major ML and TF organizations and systems; and (3) strengthen and refine the AML/CFT regime for financial services providers. The authorities stated that highest priority has been given to safeguarding the stability of its core financial system, in particular depository institutions. The strategy included, *inter alia*, private sector outreach and interagency coordination and information sharing, and prioritized the following objectives:

(a) prevent the misuse of charities to aid terrorists;
(b) develop measures to deal with the risk posed by cash;
(c) examine the feasibility of regulating new payment/non-face-to-face systems;
(d) enhance supervision and enforcement of Bank Secrecy Act (BSA) requirements;
(e) enhance private sector consultation;
(f) provide more and better guidance to financial institutions;
(h) improve consistency in the implementation of AML/CFT regulation at all levels of government; and
(j) launch Bank Secrecy Act (BSA) Direct to establish and maintain a government-wide data access service for information collected under the BSA and other sources.

15. **The recently issued U.S. National Security Strategy (May 2010)—which includes sections on deterring threats to the international financial system, strengthening international norms against corruption, and transnational criminal threats and threats to governance—reinforces the continuing relevance of financial integrity to the strength of the U.S. financial system and economy and to national security.**

B. Key Findings from the Mutual Evaluation Report and Progress Reports

16. **At the time of the FATF mutual evaluation, the United States had implemented an AML/CFT system that was broadly in line with the international AML/CFT standard.** The evaluators found that the United States had significantly strengthened its AML/CFT regime since its previous mutual evaluation (June 1997), including through enhanced legislation and aggressive law enforcement activities. The most high-profile development was the enactment of the USA PATRIOT Act (October 2001), both an anti-terrorism and anti-money laundering statute. Notwithstanding the above, the evaluators

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considered that there remained a number of deficiencies in the overall AML/CFT framework, notably in the preventive measures applicable to financial institutions and DNFBPs, and in the transparency of legal persons and arrangements.

17. **As of March 2010, many of the recommendations made by the evaluators to address the identified deficiencies had not been addressed in full or in part, but efforts are underway, notably to introduce uniform legislation that would require information on beneficial ownership and control of legal persons and arrangements across all the states.** These issues are discussed in more detail in the following sections.

III. Financial Action Task Force 2006 Anti-Money Laundering/Combating the Financing of Terrorism Mutual Evaluation and Subsequent Developments

A. Legal System and Related Institutional Measures

Main findings of the 2006 MER

18. **The evaluators found that the United States had implemented an AML/CFT system that was broadly in line with the international standard and that it had significantly strengthened its AML/CFT regime since the previous mutual evaluation, including through enhanced legislation and aggressive law enforcement action.** The United States criminalized ML and the TF covering most of the categories of offenses required by the FATF standard. The requirements of the United Nations (UN) conventions and Security Council Resolutions on TF were effectively implemented. The report noted that U.S law enforcement authorities had achieved impressive results with respect to investigations and prosecutions, as well as asset freezing, seizure, and confiscation.[14] The 2006 MER noted that the Financial Crimes Enforcement Network (FinCEN) is the United States' financial intelligence Unit (FIU), and that FinCEN substantially met the FATF standard.

[14] Note that the annual amount of proceeds of crime confiscated in the United States as indicated in the 2006 MER was about $240 million (although this total is likely to have understated the actual situation as it is not clear that it included all federal level confiscations and it excluded state level confiscations). The authorities have suggested that current confiscations amount to approximately $2 billion annually (apparently including deferred prosecution agreement settlements but excluding confiscations at the state level—more precise information is difficult to obtain). The $2 billion represents less than one percent of the estimated annual POC (excluding tax crimes). This suggests that, while the United States may have an effective system for confiscating proceeds of crime, there is significant room for improvement in this area. In addition, the authorities may wish to consider improving their systems for collecting, collating, and publishing information about the amount of proceeds of crime confiscated.

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Developments since the 2006 MER[15]

19. **In the 2006 MER, the evaluators noted the need to expand the list of domestic and foreign predicate offenses for money laundering, revise the system used to list Taliban-related names, enhance the "equivalent value" confiscation regime, and broaden the definition of "transaction" to cover all conduct consistent with the Vienna and Palermo Conventions.** The authorities reported that legislative proposals have been drafted and are currently being discussed with various members of Congress. The proposals seek to amend the ML statutes in order to expand the list of predicate offenses to include any offense in violation of the laws of the United States, punishable by imprisonment for a term exceeding one year, and to include any act or activity occurring outside of the United States that would constitute an offense if the act or activity had occurred within the jurisdiction of the United States.

20. **The United States also indicated in its March 2010 update report that, subsequent to the 2006 MER, it closed a significant loophole in its ML legislation that was created by a June 2008 U.S. Supreme Court decision.** In its decision, the U.S. Supreme Court defined "proceeds" as "net profits" and not as "gross receipts" (See *United States v. Santos*). Subsequently, in May 2009, *Santos* was legislatively overruled with the addition of a new paragraph to the federal AML statute, which now defines "proceeds" to include "gross receipts" of an unlawful activity.

21. **In the 2006 MER, the evaluators recommended to strengthen FinCEN's analytical outputs (for law enforcement purposes), and to continue efforts to improve the quality of SARs received from all sectors.** They also recommended that FinCEN adhere to the principles governing international information exchange in terrorism-related requests for assistance from foreign FIs. With regard to increasing the value added to its analytical outputs and adherence to the principles governing information exchange, no significant progress has been reported. However, FinCEN is reported to have taken the following principal measures to improve suspicious activity reporting practices and the quality of SARs:

- In 2006, FinCEN began receiving quarterly SAR error reports for various sectors that are used to identify financial institutions with systemic errors, in order to refer these institutions to their regulators. These reports are revised yearly and were expanded in 2009 to include a separate report on the insurance industry SARs.

- In March 2007, FinCEN implemented an improved SAR for MSBs that also provided data in a format more suitable for law enforcement and analysts.

[15] See Table 1.

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- In October 2007, FinCEN published a new reference on common errors seen in SAR filings that provides tips for avoiding these errors and makes suggestions for establishing more efficient and effective AML programs.

- Provided SAR feedback to the insurance and casino sectors with the intention to do so for other sectors.

- Published analytical reports based on Bank Secrecy Act/SAR filings focused on mortgage loan fraud and ML, with publications made in November 2006, April 2008, February and March 2009, and February 2010.

- Focused its twice-yearly publications, *The SAR Activity Review–By the Numbers*, and *The SAR Activity Review–Trends, Tips, and Issues,* on particular industries (so far covering securities, commodity futures firms, and casinos).

- Provided guidance to the industry on how to file SARs and enhanced the electronic SAR filing process to reduce filing errors.

B. Preventive Measures—Financial Institutions

Main findings of the 2006 MER

22. **At the time of the mutual evaluation, the vast majority of deposit-taking institutions were subject to the full range of AML/CFT requirements, including those relating to customer identification (customer identification program (CIP)), internal controls and procedures (AML program), record keeping, and reporting of suspicious activities.** In the securities sector, brokers and futures commission merchants were subject to similar requirements, but some investment advisers and commodity trading advisors (in their capacity as asset managers) were not. Although life insurers (since May 2006) and MSBs were required to establish AML programs and file SARs, they were not subject to the CIP rules except when conducting funds transfers in amounts above $3,000. Overall, the evaluators found that U.S. legislation addressed in detail a substantial number of the FATF requirements on CDD. However, they noted that certain key elements were not fully addressed by law or regulation as required under the standard but rather by "other enforceable means" (OEM), in particular, the examination manual used by the Federal Banking Agencies. The evaluators also concluded that there were no requirements for financial institutions to look beyond a customer to establish the identity of the beneficial owners in all cases.

23. **There were extensive AML/CFT record-keeping requirements for most FIs, although the requirements for the BSA-covered products in the insurance sector were more limited.** The requirements for wire transfers, however, were not deemed in line with the standard because the applicable threshold beyond which the ordering institution was required

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to obtain, verify, and maintain full originator information (US$3,000) was above the threshold designated in the standard (US$1,000).

24. **The MER also noted that the United States had an extensive but complex regulatory and supervisory framework for AML/CFT.** FinCEN had core responsibility for administering the regulatory regime under the BSA and has delegated its authority to examine FIs for compliance with the BSA to the eight federal financial regulatory agencies responsible for functional supervision of the relevant financial sectors. In certain cases, this authority has been further delegated to self-regulatory authorities responsible for functional supervision. Although some parts of the financial services sector were regulated for safety and soundness purposes at the state level which, according to the United States often includes compliance with AML requirements, there had been no delegation of BSA compliance supervision responsibilities to the state authorities. The evaluators noted, however, that there was close cooperation between federal and state regulatory authorities on compliance supervision. The United States has indicated that most states use the Federal Financial Institutions Examination Council (FFIEC) BSA/AML Examination Manual as a resource for their examiners.

25. **In general, the evaluators concluded that regulators have broad legal authority and adequate powers to supervise, conduct examinations, obtain information, and enforce the BSA requirements against financial institutions and their employees.** They noted evidence that these powers were being used regularly and extensively. The authorities reported significant additional regulatory enforcement actions taken against FIs found to be non-compliant with AML requirements since 2006.

Developments since the 2006 MER

26. **Recommendation 5 was rated as partially compliant. Evaluators identified eight key deficiencies for which recommendations were made.** These are discussed below along with the follow-up steps taken by the U.S. authorities.

1) **Issue:** No obligation in law or regulation to identify beneficial owners except in very specific circumstances (i.e., correspondent banking and private banking for non-U.S. clients).

Recommendation: Introduce a primary obligation to identify the beneficial owners of accounts (which may, of course, be implemented on a risk-based approach with respect to low-risk customers or transactions).

Update: The United States reported limited progress with respect to this recommendation. The authorities reported issuing guidance on obtaining customer beneficial ownership information and developing a comprehensive strategic action plan to effectively enhance access to beneficial ownership information. While not directly related to this recommendation, the United States also reported that it is assessing vulnerabilities related to

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corporate transparency, including conducting outreach and developing a strategy for dealing with problems associated with shell companies and their beneficial ownership. No primary obligation has been introduced requiring FIs to identify beneficial owners of accounts. In March 2010, the United States issued multi-agency guidance (Guidance on Obtaining and Retaining Beneficial Ownership Information) that seeks to clarify and consolidate "existing regulatory expectations" for obtaining beneficial ownership information for "certain accounts and customer relationships."[16] The authorities also acknowledge that there are still fundamental unresolved deficiencies regarding the availability of beneficial ownership and control information with respect to legal persons and arrangements (see discussion of measures being considered above and for FATF Recommendations 33 and 34).[17]

2) **Issue:** No explicit obligation to conduct ongoing due diligence, except in certain defined circumstances.

Recommendation: Introduce an explicit obligation that financial institutions conduct ongoing due diligence, rather than rely on an implicit expectation within the SAR requirements and on the existing guidance.

Update: The authorities did not report any progress with respect to this recommendation. The United States continues to maintain that the ongoing due diligence requirement is met through the AML program and SAR legal obligations of FIs. They state that the BSA AML program requirement requires covered FIs to ensure and monitor compliance with the BSA requirements, including through a system of internal controls to assure "ongoing compliance."[18]

The authorities also indicated that for securities broker-dealers, the Financial Industry Regulatory Authority (FINRA)—the self-regulatory organization for securities dealers)—has issued an AML template for small firms to assist broker-dealers comply with their BSA

[16] The guidance does not alter or supersede previously issued regulations, rulings, or guidance related to CIP requirements and is not set out in law, regulation, or other enforceable means as required by FATF Recommendation 5.

[17] Additional Elements 33.4 and 34.3 of FATF Recommendations 33 and 34 point to the desirability of having measures in place to facilitate access by financial institutions to beneficial ownership and control information of legal persons and arrangements to allow them to more easily verify the customer data. To the extent that this is lacking, the ability of financial institutions to effectively implement their due diligence requirements under the applicable FATF Recommendations may be adversely affected.

[18] FATF Recommendation 5 establishes an explicit obligation (to be set out in law or regulation) to conduct ongoing due diligence on business relationships. This obligation extends to scrutinizing transactions or customer activities and updating of customer records.

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obligations, particularly with respect to the detection and reporting of suspicious activities.[19] The authorities further indicate that the federal banking agencies consider CDD to be an ongoing process and expect FIs to do so on a risk-sensitive basis through their examination programs.[20] The authorities cite enforcement actions taken by federal banking and securities regulators for non-compliance with the AML program requirement including for deficient CDD and enhanced due diligence practices.

3) **Issue:** Customer identification for occasional transactions limited to cash transactions only.

Recommendation: In the case of occasional transactions, extend the customer identification obligation to non-cash transactions.

Update: The authorities did not report any progress with respect to this recommendation. They assert that it is inconceivable that an FI would conduct an occasional transaction utilizing non-cash instruments, and that a bank would first require a non-account holder to either open an account or convert the instrument to cash. They further state that no examples were identified during the assessment where such non-cash transaction had occurred.[21]

4) Issues 4) and 8) were addressed together in the U.S updates:

Issue 4): No requirement for life insurers issuing covered insurance products to verify and establish the true identity of the customer (except for those insurance products that fall within the definition of a "security" under the federal securities laws).

Issue 8): The effectiveness of applicable measures in the insurance sector (which came into force on May 2, 2006) could not be assessed.

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[19] The FINRA template is not a law or regulation and acknowledges that CDD may not be explicitly required by the BSA AML rules. It does, however, state that it is not possible to have an adequate AML program or suspicious activity reporting program without conducting appropriate ongoing customer due diligence.

[20] FATF Recommendation 5 stipulates that this requirement be set out in law or regulation.

[21] FATF Recommendation 5 requires the obligation to be set out in law or regulation. The Expanded Procedures of the BSA examination manual used by federal banking regulators, e.g., under Funds Transfers (page 20) procedure 6; and of section 12 of the FINRA small firm AML template for the securities sector "Suspicious Transactions and BSA Reporting" (*Rule: 31 C.F.R. §103.33(f) and (g))*, suggest that in the U.S. context, non-cash instruments are used for occasional transactions, e.g., purchase of travelers checks, money orders, cashier's checks, drafts, prepaid cards, etc., with personal checks and credit cards. One-off wire transfers can also be paid for and received using non-cash instruments.

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Recommendation: Implement a CIP requirement for the insurance sector.

Update: The United States reported that it has issued a final ruling requiring an AML program for insurance companies that includes a customer identification requirement. The ruling requires insurers to obtain "all relevant customer-related information necessary for an effective program" either from its agents and brokers or from other sources. The authorities claim that such information should assist insurers to assess ML risks and identify red flags. The United States maintains that failure to adequately identify the true identity of customers could result in non-compliance with the regulatory obligations.[22]

FinCEN reviewed 641 SAR filings during a one-year period to identify, *inter alia*, typologies, patterns, trends, vulnerabilities, and ML risks in the insurance sector. The United States maintains that the SAR filing analysis shows that insurers are identifying and reporting suspicious activities including information on policyholders, beneficiaries and other parties associated with policies, and hence that the CIP program requirement is being implemented.[23]

5) **Issue:** No measures applicable to investment advisers and commodity trading advisors. (See first entry for Recommendation 5 above.)

Recommendations: Extend AML/CFT measures to investment advisers and commodity trading advisors, and the limited number of depository institutions that are currently not covered. Extend AML/CFT obligations (including the "politically-exposed persons (PEPs)," requirements) to investment advisers and commodity trading advisors, in line with those applicable to the rest of the securities industry.

Update: The authorities reported that FinCEN had issued a Notice of Proposed Rulemaking (NPRM) for AML programs for investment advisors and commodity trading advisors, but it was withdrawn in October 2008 because too much time had elapsed and FinCEN needed to re-issue a new one to make it meaningful. No new Notice of Rulemaking has been issued. The authorities are of the view that investment advisors and commodity trading advisors are not

[22] FATF Recommendation 5 imposes an explicit requirement to identify and verify customers' identity.

[23] The authorities did not indicate whether the sample of 641 SARs provides a reasonable basis for concluding that there is broad-based implementation in the insurance sector. Neither did they state whether any such conclusions were corroborated by the findings of on-site AML examinations. In addition, basing CDD compliance implementation solely on a very limited analysis of SARs is at best an indirect indicator, and inadequate.

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entirely outside of the AML regime as they must conduct/hold client-related financial transactions/assets through other financial institutions that are subject to BSA requirements.[24]

6) Issues 6) and 7) were addressed together in the U.S. updates:

Issue 6): Verification of identity until after the establishment of the business relationship is not limited to circumstances where it is essential not to interrupt the normal course of business.

Issue 7): No explicit obligation to terminate the business relationship if the verification process cannot be completed.

Recommendation: Other than with respect to non-face-to-face business, securities transactions, and life insurance business, limit the circumstances in which institutions may open an account prior to completing the verification process, and introduce a presumption that institutions should close an account whenever the verification cannot be completed, for whatever reason. If necessary, accompany this with some form of indemnification against other conflicting statutes.

Update: The authorities maintain that the United States has met this requirement under the CIP requirements. To support this position, they state that the CIP requirement stipulates that programs "…must contain procedures for verifying the identity of a customer … within a reasonable period of time after the account is opened."[25] The CIP should also include provisions that describe "…the terms under which a customer may conduct transactions while the [financial institution] attempts to verify the customer's identity" and "[w]hen the [financial institution] should close an account, after attempts to verify a customer's identity fail." The authorities also state that their risk-based approach to customer identification would result in the termination of a business relationship where verification of identity of customers cannot be completed. The authorities prefer the risk-based approach over the more rigid requirement to close an account in the event that CDD cannot be completed.[26]

[24] See evaluators' recommendation above which calls for the mentioned institutions to be directly covered by the AML/CFT requirements.

[25] See, for example, 31 Code of Federal Regulation (CFR) 103.121(b)(2)(ii) and 31 CFR 103.122(b)(2)(ii).

[26] FATF Recommendation 5 explicitly requires FIs to terminate the business relationship in these circumstances.

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Developments since the 2006 MER[27]

27. **In addition to the above, the 2006 MER made additional recommendations to improve the preventive measures regime for financial institutions with respect to FATF Recommendations that were not rated as non-compliant or partially compliant.** Limited progress was reported to address these recommendations except for the following measures:

Enhanced BSA Examinations of MSBs

28. **The Internal Revenue Service (IRS) reported that it has increased the number of BSA examiners to 385, an increase of 70 since the 2006 MER.** In addition, the IRS has:

- Trained BSA examiners to conduct MSB examinations and increased the number of examinations of MSB principals.
- Entered into Memoranda of Understanding (MOUs) with 43 states and Puerto Rico that allow for comprehensive exchange of information and reporting on licensed and chartered MSBs, including information related to examinations and BSA violations. Standardized forms are being tested for state reporting to the IRS.
- Prepared draft procedures for conducting joint examinations of MSBs and has commenced concurrent examinations with select states. This should allow for the conduct of more efficient cost effective examinations.
- In concert with FinCEN and state regulators, developed a BSA/AML examination manual for MSBs that contains risk-based elements. The IRS, FinCEN, and state representatives have provided training to IRS and state examiners on how to use the manual.
- Identified an increased number of MSBs including through improved information sharing with FinCEN and state financial regulators.

Proposed AML program rule for non-bank residential mortgage lenders and originators

29. **On July 15, 2009, FinCEN issued an Advance NPRM to solicit public comment on a wide range of questions pertaining to the possible application of AML program and SAR regulations to non-bank residential mortgage lenders and originators.**

[27] See Table 1.

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C. Preventive Measures—Designated Non-Financial Businesses and Professions

Main findings of the 2006 MER

30. **The United States was found to be non-compliant with the following DNFBP-related recommendations: Recommendation 12 (CDD and recordkeeping for DNFBPs) and 16 (suspicious transaction reporting and internal controls); and partially compliant with Recommendation 24 (regulation and supervision of DNFBPs).** The evaluators noted that measures were being considered to extend the AML/CFT requirements to these sectors but that accountants, lawyers, other legal professionals, real estate agents, and company service providers were not subject to the AML/CFT requirements. Trust companies are defined as financial institutions and, depending on their charter, are subject to all or most of the same BSA requirements as other financial institutions under the BSA.

31. **In June 2005, FinCEN issued an interim final rule requiring certain dealers in precious metals, stones, or jewels to establish an AML program.** At the time of the mutual evaluation, there was limited application of AML/CFT requirements for dealers in precious metals, stones, or jewels other than the obligation to establish an AML program (i.e., internal controls and procedures) by January 1, 2006. There were no explicit obligations for CDD measures, record-keeping, and suspicious transaction reporting, although the United States maintains that such measures would be necessary to implement an AML program. FinCEN delegated examination authority for dealers in precious metals, stones, and jewels to the IRS. The evaluators noted that the IRS planned to commence compliance examinations of these sectors by mid-2006. Civil and criminal penalties are available for non-compliance.

32. **Casinos were the only category of DNFBPs that was subject to a range of BSA requirements including suspicious activity and large cash transaction reporting, recordkeeping, and the establishment of AML programs (i.e., internal controls and procedures).** These requirements applied to state-licensed casinos, tribal casinos, state-licensed card clubs, and tribal card clubs. Gaming establishments with gross annual revenue of US$1 million or less do not fall within the BSA definition of "casino" and are, therefore, not subject to these requirements. Internet gaming is prohibited in the United States.

Developments since the 2006 MER

33. **Recommendation 12 was rated as non-compliant with the following three main deficiencies.** These are discussed below along with the follow-up steps taken by the U.S. authorities.

1) **Issue:** Casinos are not required to perform enhanced due diligence for higher-risk categories of customers, nor is there a requirement to undertake CDD when there is a suspicion of ML or TF (Recommendation 5).

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Recommendations: Explicitly require casinos to perform enhanced due diligence for higher-risk categories of customers and to undertake CDD when there is a suspicion of money laundering or terrorist financing.

Update: The authorities interpret Question 14 of FinCEN's Guidance to casinos "How comprehensive must a casino's procedures be for detecting suspicious activity?"[28] to mean that:

" [t]he extent and specific parameters under which a casino or card club must monitor customer accounts and transactions for suspicious activity must factor in the type of products and services it offers, the locations it serves, and the nature of its customers."[29]

The authorities also reported that FinCEN is in the process of publishing "suggested best practices" for casinos and card clubs that will provide guidance on risk-based approaches to compliance with the BSA requirements that would address customer risk profile issues.

2) **Issue:** Accountants, dealers in precious metals and stones, lawyers, and real estate agents are not subject to customer identification and record-keeping requirements that meet Recommendations 5 and 10.

Recommendations: Extend customer identification, record-keeping, and account monitoring obligations that are consistent with FATF Recommendations to these sectors as soon as possible.

Update: The authorities did not report any substantive progress with respect to this recommendation. However, they reported the drafting of American Bar Association Good Practices Guidance (ABA Guidance), which largely follows the FATF Guidance, and which is intended to provide practical guidance on implementing a risk-based approach to AML/CFT. The ABA Guidance has not yet been adopted or published, but the authorities anticipate that it will be adopted during the summer of 2010.[30]

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[28] November 2007 document of Frequently Asked Questions.

[29] FATF Recommendation 5, to which Recommendation 12 refers, establishes an explicit requirement for conducting enhanced CDD for higher-risk customers, transactions, and business relationships. This requirement should be set out in law, regulation, or other enforceable means. CDD is also required whenever there is a suspicion of ML or TF. The latter should be set out in law or regulation.

[30] The proposed guidance would not be classified as "law or regulation," or "other enforceable means" for purposes of the FATF Recommendations.

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3) **Issue:** None of the DNFBP sectors is subject to obligations that relate to Recommendations 6, 8, or 11 (except for casinos in relation to Recommendation 11).

Recommendations: Extend obligations that relate to Recommendations 6, 8 and 11 to all DNFBPs. (This does not apply to casinos in relation to Recommendation 11.) No AML/CFT obligations have been imposed on these DNFBPs. In the short term, a proposed final rule should be issued to expedite the introduction of AML obligations for "persons involved in real estate closings and settlements." Prepare an advance notice of proposed rulemaking in the near future in relation to the trust and company services providers (TCSPs) sector to extend both the AML Program and CIP requirements to this sector.

Update: The authorities did not report any progress with respect to these recommendations.

34. **Recommendation 16 was rated as non-compliant with five main deficiencies identified by the evaluators.** These are discussed below along with the follow-up steps taken by the U.S. authorities.

1) **Issue:** Casinos are the only DNFBPs that are required to report suspicious transactions; however, there is a monetary threshold on this obligation.

Recommendations: Remove the monetary threshold on the SAR reporting obligation for casinos and extend the obligation to report suspicious transactions to the other DNFBP sectors.

Update: The authorities did not report any progress with respect to this recommendation.

2) **Issue:** Accountants, lawyers, real estate agents, and TCSPs are not subject to a prohibition on "tipping off" or protected from liability when they choose to file a suspicious transaction report.

Recommendations: Accountants, lawyers, real estate agents, and TCSPs should be made subject to the "tipping off" prohibition and should be protected from liability when they choose to file a suspicious transaction report.

Update: The authorities did not report any progress with respect to this recommendation.

3) **Issue:** Accountants, lawyers, real estate agents, and TCSPs are not required to implement adequate internal controls (i.e., AML programs).

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Recommendations: Accountants, lawyers, real estate agents, and TCSPs should also be required to implement adequate internal controls (i.e., AML programs).

Update: The authorities did not report any substantive progress with respect to this recommendation. They state that these DNFBPs conduct their activities through financial institutions and thus are not entirely outside of the AML regime.[31] In addition, the authorities report that consideration is being given to extending coverage of AML requirements to mortgage lenders and originators.[32]

Issue: Dealers in precious metals, precious stones, or jewels are required to implement AML programs; however, the effectiveness of implementation cannot yet be assessed.

Recommendations: Continued work is needed to ensure that dealers in precious metals and stones are aware of their obligations to establish AML programs and are implementing them effectively.

Update: The authorities reported that beginning in 2010, the IRS had begun nation-wide examinations of dealers in precious metals, stones, and jewels. In addition, FinCEN and the IRS are delivering examiner training and conducting outreach to entities subject to AML rules. The authorities also reported that they are providing guidance to IRS examiners on BSA regulations, industry products and practices, conducting examinations, and on how to assess risk. Additionally, the authorities stated that the IRS and FinCEN have collaborative discussions with field examiners, on a quarterly basis, to discuss examination issues. The authorities expect that collaboration between FinCEN and IRS should allow for feedback and assessment of the AML program implementation.

4) **Issue:** There are no specific obligations on accountants, lawyers, real estate agents, or TCSPs to give special attention to the country advisories that FinCEN has issued and which urge enhanced scrutiny of financial transactions with countries that have deficient AML controls.

Recommendations: The authorities should require accountants, lawyers, real estate agents, and TCSPs to give special attention to the country advisories that FinCEN has issued and which urge enhanced scrutiny of financial transactions with countries that have deficient AML controls.

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[31] FATF Recommendation 14 requires countries to impose direct requirements in this regard on DNFBPs.

[32] This would be more relevant to the FATF Recommendations dealing with the financial sector (lending activities are financial activities under FATF definition of financial institutions) than to real estate agents.

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Update: The authorities did not report any progress with respect to this recommendation.

35. **Recommendation 24 was rated as partially compliant with two main deficiencies identified by the evaluators.** These are discussed below along with the follow-up steps taken by the U.S. authorities.

1) **Issue:** There is no regulatory oversight of AML/CFT compliance for accountants, lawyers, real estate agents, or TCSPs.

Recommendations: Accountants, lawyers, real estate agents, and TCSPs should be made subject to AML/CFT obligations and appropriate regulatory oversight. In the case of TCSPs, a registration process should be introduced for agents engaged in the business of providing company formation and related services (perhaps with a *de minimis* threshold to ensure that single-company agents are not required to register).

Update: The authorities did not report any progress with respect to these recommendations.

2) **Issue:** The supervisory regime for Nevada casinos is currently not harmonized with the BSA requirements.

Recommendations: The work to further harmonize Nevada's regulatory requirements with the BSA should continue as rapidly as possible.

Update: The authorities reported that effective July 1, 2007, Nevada casinos with gross annual gaming revenue exceeding US$1 million became subject to the BSA requirements in the same manner as all other casinos.

D. Legal Persons and Arrangements and Non-Profit Organizations

Main findings of the 2006 MER

36. **The evaluators found that U.S. compliance with Recommendations 33 and 34 dealing with the transparency of legal persons and arrangements was very weak and rated both as non-compliant.** They found compliance with the FATF Recommendation SRVIII dealing with non-profit organizations (NPOs) to be strong.

37. **In its March 2010 update report to the Fund, the U.S. authorities provided a number of Senate testimonies that consistently point to the lack of transparency and availability of corporate formation as inhibiting law enforcement efforts.** For example, U.S. Customs and Immigration Enforcement officials testified before the Senate Committee (June 2009) that the lack of information available on the true ownership and control of shell companies adversely affects the effectiveness of international cooperation because it "…

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limits our abilities to work jointly with our international law enforcement partners and can inhibit our ability to take quick action where it may be required."

Developments since the 2006 MER

38. **The evaluators rated FATF Recommendation 33 as non-compliant with two main deficiencies identified by the evaluators.** These are discussed below along with the follow-up steps taken by the U.S. authorities.

1) **Issue:** While the investigative powers are generally sound and widely used, there are no measures in place to ensure that there is adequate, accurate and timely information on the beneficial ownership and control of legal persons that can be obtained or accessed in a timely fashion by competent authorities.

Recommendations: Undertake a comprehensive review to determine ways in which adequate and accurate information on beneficial ownership may be available on a timely basis to law enforcement authorities for companies which do not offer securities to the public or whose securities are not listed on a recognized U.S. stock exchange. The evaluators noted that it is important that this information be available across all states as uniformly as possible. They further recommended that the federal government seek to work with the states to devise procedures which should be adopted by all individual states to avoid the risk of arbitrage between jurisdictions. The evaluators noted that the January 2006 threat assessment indicates that the U.S. authorities are aware of the problems created by company formation arrangements and that they had formulated a program to try to address the issue. They noted that this should be pursued on a shorter time scale than seems to be envisaged at present. In particular, they also recommended that the proposal to bring company formation agents within the BSA framework and to require them to implement AML Programs and CIP procedures should be taken forward in the very near future.

Update: No substantive results were reported, but the authorities believe that significant efforts have been made to address this key deficiency. The following are some of the main developments reported:

- U.S. Senate hearings and other official reports have been held stressing the ML/TF risks associated with companies formed without adequate documentation on beneficial ownership and control.[33]

[33] E.g., Department of Justice (DOJ) Senate Testimony November 2006; FinCEN Senate Testimony November 2006; DOJ Senate Testimony June 2009; Department of Homeland Security Senate Testimony June 2009; Treasury Senate Testimony November 2009, DOJ Senate Testimony November 2009; and Government Accountability Office report April 2006.

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- Legislation (Bill S.569: "Incorporation Transparency and Law Enforcement Assistance Act") has been proposed but not yet enacted. Passage of a final draft is hoped for in 2010.

- U.S. Treasury, the Department of Justice, and the Department of Homeland Security continue to consult with Congress and the private sector to amend the draft Bill S.569. A draft Administration Bill was sent to Congress in April 2010 to, *inter alia*, address the following issues of Bill S.569:

  - Clarify and limit the beneficial ownership definition and information disclosure requirement.

  - Eliminate expansion of AML obligations to company formation agents in favor of broader civil and federal criminal liability for non-compliance.[34]

  - Establish documentation requirements.

  - Establish provisions to address the transfer of ownership of legal entities.

  - Individual states are reported to have begun to seek ways to address the lack of beneficial ownership and control information. As a result of these efforts, Nevada and Wyoming—two states identified in the United States Money Laundering Strategy as having significant vulnerabilities in this area—have modified their State incorporation processes. Both states passed new legislation outlawing bearer shares. Wyoming is also reported to have enhanced the information requirements for registered agents and legal entities.

  - Ongoing efforts to enact uniform corporate laws in all states to address the lack of beneficial ownership and control information. A Uniform Law was adopted in 2009 by the National Conference of Commissioners on Uniform State Laws, but none of the states are reported to have taken steps to enact this law.

2) **Issue:** There are no measures taken by those jurisdictions which permit the issue of bearer shares to ensure that bearer shares are not misused for money laundering.

Recommendations: No recommendations were made for this issue.

Update: All states are now reported to prohibit the issuance of bearer shares.

[34] The FATF definition of "TCSPs" extends full coverage of the standard to "formation agents of legal persons."

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39. **Recommendation 34 was rated as non-compliant with one main deficiency identified by the evaluators.** This is noted below along with the follow-up steps taken by the U.S. authorities.

1) **Issue:** While the investigative powers are generally sound and widely used, there is minimal information concerning the beneficial owners of trusts that can be obtained or accessed by the competent authorities in a timely fashion.

Recommendations: Implement measures to ensure that adequate, accurate, and timely information is available to law enforcement authorities concerning the beneficial ownership and control of trusts.

Update: No progress was reported to address the evaluators' recommendation. The authorities state that the underlying issues are closely related to those of Recommendation 33 for legal persons; hence, they plan to address the issue of trust ownership and control after the corporate entity issues are resolved.

In addition, the authorities indicated that as part of the pending legislation to address Recommendation 33, they will conduct a study on trusts and other legal entities not covered by the legislation to identify whether the lack of available beneficial ownership information (for partnerships, trusts, or other legal entities) raises concerns about the involvement of such entities in terrorism, ML, tax evasion, securities fraud, or other misconduct; and whether it has impeded investigations into entities suspected of such misconduct.

E. National and International Cooperation

Main findings of the 2006 MER

40. **Overall, the evaluators concluded that the United States has broad and adequate policy and operational level mechanisms to facilitate interagency cooperation and coordination.** However, they noted that cooperation mechanisms in the law enforcement area appeared to be fragmented. At the operational level, there was overlap between the jurisdictions of the various law enforcement agencies, requiring more refined coordination. The joint task force model seemed to the evaluators to be generally effective, provided that it is appropriately resourced and developed. The authorities have undertaken a number of initiatives to overcome these problems including through significant reorganization efforts. The evaluators noted that it was too early to assess the effectiveness of these measures.

41. **The evaluators also found that the United States routinely engaged in cross-border cooperation on AML/CFT issues and that it could provide extensive mutual legal assistance on the basis of treaties, multilateral conventions, and in response to rogatory letters and requests from ministries of justice.** Most of the bilateral treaties entered into by

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the United States do not contain dual criminality requirements, and, where they exist, they mostly relate to requests for assistance requiring compulsory or coercive measures, in line with the standard.

42. **It was noted that the United States had implemented a flexible and efficient system for providing international cooperation in relation to freezing, seizure, and confiscation.** Requests for assistance in tracing and identifying assets did not always require formal proceedings and could be satisfied using less formal mechanisms such as through direct police-to-police communication. The evaluators concluded that the U.S. extradition regime was based on a solid and flexible legal framework that largely relied on bilateral agreements subject to dual criminality. They found that the system was efficient and effective and allowed the United States to extradite its own nationals.

43. **FinCEN, law enforcement agencies, and regulators were allowed to provide their foreign counterparts with a wide range of international cooperation.** Similar mechanisms existed to facilitate international cooperation diagonally (e.g., from Financial Intelligence Unit (FIU) to law enforcement, or from law enforcement to regulators).

Other developments since the 2006 MER[35]

44. **The 2006 MER also made additional recommendations to improve the regime for national and international cooperation with respect to FATF Recommendations that were not rated as non-compliant or partially compliant.** With respect to national cooperation, the United States has provided the following statistics on IRS examination and related national cooperation issues:

- FinCEN has entered into information-sharing MOUs with 42 state MSB regulators. Included in quarterly MOU reports are enforcement actions taken against MSBs.

- FinCEN is reported to be in contact with states, notably Florida, regarding the referral of MSBs with significant BSA violations.

At the federal level, the IRS provides FinCEN with information including with respect to violations and enforcement action. According to FinCEN, the IRS also has information-sharing MOUs with 43 state MSB regulators. FinCEN also has an information sharing MOU with the Puerto Rico Office of the Commissioner of Financial Institutions that regulates Puerto Rican MSBs. The IRS-State MOUs provide that the states will furnish the IRS with

[35] See Table 1.

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their MSB BSA reports of examination and that the "IRS may provide FinCEN with access to information received from the State under the terms of this MOU."

45. **The U.S. authorities reported that the Organized Crime Drug Enforcement Task Force (OCDETF) Fusion Center was recently established to improve intelligence to help target and combat sophisticated international drug trafficking and ML organizations.** The Fusion Center brings together into a common database, unfiltered information for investigation and prosecutorial purposes. The Fusion Center recently entered into a partnership with the International Organized Crime Intelligence and Operations Center which provides a new data source for U.S. law enforcement.

46. **The United States also informed that in March 2009, it received an adverse decision in the United States District Court for the District of Columbia case *In re any and all funds or other assets in Brown Brothers Harriman & Co. Account #8870792 in the name of Tiger Eye Investments Ltd., et al.*** The court held that the U.S. international confiscation assistance statute does not permit a U.S. court to issue an order for the pre-trial restraint of property that is not yet subject to a foreign confiscation judgment, and that a U.S. court can only restrain property already ordered confiscated by the foreign country. The court decision has been appealed. According to the authorities, although this case is a legally binding precedent for only one of the U.S. federal district courts, it is nevertheless a noteworthy development.

47. **The update provided by the U.S. authorities also states that it has entered into Mutual Legal Assistance Treaties (MLATs), Instruments, or Protocols with 80 countries or multilateral organizations, up from 50 in July 2005.** Recently, the United States and the European Union completed 27 new MLATs, Instruments, or Protocols which substantially assist the authorities in addressing TF and ML matters. These agreements disallow bank secrecy as the basis for the denial of mutual legal assistance (MLA) requests and allow easier access to bank and other financial information to assist designated law enforcement agencies in TF and ML cases. Currently, only a few U.S. MLATs require dual criminality and most allow for broad cooperation on offenses that are criminalized in the requesting country.

48. **The United States informs that it has bilateral extradition treaties with 133 countries, and that many of them were recently updated to provide for dual criminality for extradition purposes.** As of February 1, 2010, the 27 new Extradition Treaties, Instruments, or Protocols are reported to have come into effect between the United States and European Union countries that provide for dual criminality and cover ML and TF as extraditable offenses. Since the 2006 MER, updated extradition treaties or protocol are reported to have come into effect with the United Kingdom and Israel, both in 2007 that *inter alia*, allow for less cumbersome documentation requirements.

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49. **The U.S. authorities have clarified that where older list treaties are in effect, they are often supplemented by various multilateral conventions, such as the United Nations Convention for the Suppression of the Financing of Terrorism, the Transnational Organized Crime Convention (which came into effect in July 2005), and the United Nations Convention Against Corruption (of which the United States became a party in 2006).** It states that such conventions expand the list of extraditable offenses existing in the older bilateral treaties to cover all of the offenses set forth in the multilateral conventions. With regards to "ad hoc and unilateral" extradition according to the principles of the Terrorist Financing Convention, the United States presumes that it refers to extradition in the absence of a bilateral extradition treaty. It notes that under Article 11(2) of the Convention, a State Party "may, at its option" allow for extradition under the Convention, if its domestic law allows for such extraditions. In most cases, it is stated that the law requires that there be a bilateral treaty to effect extradition, but the United States maintains that under Article 11(1) the offenses covered under the Terrorist Financing Convention are additional extraditable offenses under the older, list-based extradition treaties.

F. Resources and Statistics

Main findings of the 2006 MER

50. **The evaluators concluded that, overall, the authorities were well-equipped, staffed, resourced, and trained.** They noted concerns about the adequacy of resources within the IRS to undertake examinations of the very large number of institutions for which it is responsible, namely: MSBs; insurance companies; non-federally regulated credit unions; credit card operators; casinos and card clubs; and dealers in precious metals and stones. There are approximately 206,081 entities under the IRS's supervisory jurisdiction. The evaluators highlighted the need to significantly increase the resources of the IRS to enable it to properly discharge its oversight responsibilities for these sectors, particularly for the supervision of MSBs.

Developments since the 2006 MER[36]

51. **The 2006 MER also made additional recommendations to strengthen resources and statistics with respect to those FATF Recommendations that were not rated as non-compliant or partially compliant.** In response, the authorities have provided information on, *inter alia*, improved resources for the IRS to conduct examinations of MSBs (See Section B: Preventive Measures—Financial Institutions).

[36] See Table 1.

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52. **The Department of Justice has also informed that its new Consolidated Assets Tracking System now allows authorities to track the statutory basis for any seizures and/or forfeitures, so that any seizure or forfeiture under the terrorism forfeiture law can be identified as a separate category.**

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Table 1. Other FATF Recommended Action Plan Items to Improve the AML/CFT System (2006) for Recommendations that were NOT rated as Partially Compliant (PC) or Non-Compliant (NC)

FATF Recommendations	Evaluators' Recommendations
	Legal System and Related Institutional Measures
1. Criminalization of money laundering 2. Criminal intent and criminal liability of legal persons 3. Provisional measures and confiscation 26 Financial Intelligence Unit SR III Freezing and confiscating terrorist assets SR IX Cross-border movement of monetary instruments	(i) expand the list of domestic and foreign predicate offenses for money laundering; (ii) revise the system used to list Taliban-related names; (iii) enhance the "equivalent value" confiscation regime; (iv) broaden the definition of "transaction" to cover all conduct consistent with the Vienna and Palermo Conventions; and (v) In addition, the evaluators recommended strengthening Financial Crimes Enforcement Network's (FinCEN) analytical outputs and continuing efforts to increase the quality of suspicious activity reports (SARs) received from all sectors. It was also recommended that FinCEN adhere to the principles governing international information exchange in terrorism-related requests for assistance from foreign financial institutions (FIs).
	Preventive Measures—Financial Institutions
6. Politically-Exposed Persons (PEPs) 7. Correspondent banking 8. Non-face-to-face transactions and new	(i) introduce an explicit requirement that the opening of individual correspondent accounts should involve senior management approval; (ii) extend the PEPs requirements to investment advisers and commodity trading advisors;

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technologies) 9. Reliance on third parties 10. Record keeping SRVII Wire transfers 11. Attention to complex and unusual transactions 21. Special attention to transactions from certain countries 13. Suspicious transaction reporting 15. Internal controls 22. Foreign branches and subsidiaries 18. Shell banks 23. Regulation and supervision of FIs 29. Supervisory powers 17. Sanctions 25. Guidance and feedback SRVI Alternative remittance systems	(iii) introduce a requirement that the relying financial institution should obtain immediately from the introducing institution customer identification details; (iv) comply with the Financial Action Task Force (FATF) batch wire transfer requirements including reducing the *de minimus* threshold to US$ 1,000; (v) extend full recordkeeping requirements to the insurance sector; (vi) require/extend recording requirements to the insurance and securities sectors with respect to transactions with persons from/in countries that do not or insufficiently apply the FATF Recommendations; (vii) remove the SAR reporting threshold and extend the SAR obligations to investment advisers, commodity trading advisors and insurance intermediaries; (viii) extend the AML program requirement to the limited number of exempted non-federally regulated depository institutions and to unregistered investment companies, investment advisers and commodity trading advisors; (ix) ensure that insurance companies apply anti-money laundering/combating the financing of terrorism (AML/CFT) measures to their foreign branches and subsidiaries; (x) require all financial institutions to screen prospective employees for high standards; (xi) enhance supervision and enforcement for AML/CFT compliance in the credit union, insurance and securities sectors; and

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	(xii) enhance supervisory capacity for the Internal Revenue Service (IRS) with respect to the large number of institutions for which it is responsible including and especially the money services businesses (MSB) sector.
	National and International Cooperation
31. Domestic cooperation 35–40. International cooperation, mutual legal assistance, provision of mutual legal assistance without dual criminality, freezing seizing confiscating at foreign request and asset sharing, extradition, and international cooperation and exchange of information SR I Ratification and implementation of UN instruments SRV International cooperation	(i) close the remaining gap between the policy level and the operational law enforcement work; (ii) implement more refined law enforcement coordination at the operational level; (iii) review the money-laundering (ML) offenses to ensure all conduct required to be criminalized by the Vienna and Palermo Conventions is covered; (iv) include "participation in an organized criminal group" as a foreign predicate offense as required by Article 6(2)(c) of the Palermo Convention; (v) transpose all United Nations (UN) Security Council Resolution 1267(1999) designations in the Office of Foreign Assets Control (OFAC) list; (vi) provide a formal legal basis to allow for equivalent value seizure upon a foreign request; (vii) extend the list of domestic and foreign predicate offenses to all 20 designated categories; (viii) review older list-based extradition treaties to ensure that they do not pose an obstacle to extradition; and (ix) allow extradition according to the principles of the UN Terrorism Finance

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	(TF) Convention on an ad hoc and unilateral basis.
	Resources and Statistics
30. Resources 32. Statistics	(i) ensure that the IRS is adequately resourced to effectively supervise all of the entities for which it is responsible; (ii) ensure that all of the statistics required under FATF Recommendation 32 are collected and maintained; (iii) include confiscation as part of the terrorism- and FT-related statistics to be held; and (iv) maintain more comprehensive statistics for supervisory actions especially in the MSB sector.

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