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Regulation W and affiliate transactions

A renewed focus. Implications and
approaches for banks to consider.

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Introduction

It's been more than 15 years since the Federal Reserve Board (FRB) implemented Regulation W, which was designed to limit certain transactions between financial institutions and their affiliates. But since 2003, the banking industry has been turned upside down by dramatic market shifts and new regulatory frameworks and practical approaches to measuring, monitoring, and testing compliance with the affiliate transaction rules. For many, this likely had the effect of making Regulation W compliance less of a priority, leaving banks to focus on other more pressing parts of the business. Then, increased regulatory pressure between 2012 and 2015 certainly pushed organizations to review their Regulation W compliance programs and invest further. Although the political environment may have alleviated some of the regulatory pressures, most recently, strategic and business/operating model changes have impacted both US and non-US headquartered institution with US Operations (e.g., the formation of intermediate holding companies (IHCs) by certain large foreign banking organizations (FBOs), business balance sheet optimization strategies across legal entities, and an increased focus to grow retail banking.) These changes have increased the pressure for organizations to once again review their Regulation W compliance programs as the changes alter the underpinning of the current business models. They also necessitate alternatives to existing practices for meeting compliance requirements. The industry needs to build more sustainable

governance and control frameworks that can scale Regulation W compliance controls.

Regulation W resurfaces once again as a priority, and there is a renewed focus as it continues to be included in internal self-identified issues, internal audit reviews, compliance testing, and regulatory reviews. In fact, in discussions about prudential standards, it is often the first topic mentioned in the area of compliance. For starters, regulators have a heightened focus on protecting the depository institution and are limiting activities and driving improvements in risk management, compliance, and controls as a result. They also expect greater transparency from banks, particularly when it comes to legal entity management and intercompany transactions. (Some of these intercompany transactions go beyond the bank to affiliate relationship and expand to a broader cross-section.) In addition, under the FRB's January 2018 proposed guidance on management expectations,¹ there is an increased focus on senior management accountability, governance, and automation of controls and reporting, with a more significant focus on preventative controls versus overreliance on detective controls. Together, these are only a few areas where Regulation W could play a bigger role.

¹ Board of Governors of the Federal Reserve System, "Federal Reserve Board requests comment on proposed guidance that would clarify Board's supervisory expectations related to risk management for large financial institutions" (press release), January 4, 2018, <https://www.federalreserve.gov/newsevents/pressreleases/bcreg20180104a.htm>, last updated February 7, 2018.

For some banks, enterprise-wide compliance with Regulation W has been a particular challenge—and remains so—due to the significant growth in capital market activities, pressure to rationalize compliance and operations, and changes to service models and build out of centralized services centers, service companies for resolvability purposes, and an "overhang" of previous mergers and acquisitions. However, it's time to streamline, optimize, and automate controls for affiliate transactions, where possible, to provide a foundation for future operating model changes. Plus, many banks' current compliance programs may have been unable to keep pace with the complexity

and volume of affiliate activities and pace of automation to report transactions, among other factors. In addition, enterprise-wide compliance requires a top-down program that can identify and mitigate risks across the enterprise, an area in which some organizations continue to struggle with ownership, governance, and policy design.

The changing regulatory landscape, including an increased focus by organizations on efficiency, effectiveness, and transparency, may provide an opening for banking organizations to rapidly evolve their infrastructure and governance surrounding Regulation W. For example, executives may be able to enhance operations processes

Some key challenges that continue to be an issue for the implementation of Regulation W requirements include:

- De-centralized or lack of an end-to-end awareness of regulatory requirements across business and support/control units—particularly technical provisions, such as exemptions, attribution rule, and market terms
- Inaccurate and incomplete affiliate lists and inadequate processes to identify affiliate transactions (according to Regulation W's definition) within risk, financial, and underlying transaction systems; along with gaps in legal entity reporting and looking across compliance requirements that overlap
- Outdated or incomplete policies, and limited procedures that do not provide end-to-end transactional guidance or control expectations specific to Regulation W, across all businesses and functions including the investment bank and front office
- Lack of appropriate documentation and evidence to substantiate 23A exemption usage and 23B market terms requirements
- Control infrastructure that is highly manual and detective in nature and does not implement T or T+1 reporting and preventative controls in regards to Regulation W
- Lack of corporate compliance programs and defined compliance monitoring and testing programs that are also not aligned to appropriate controls
- Limited capture of Regulation W risks in the corporate risk and control self-assessment (RCSA) analysis and/or documentation
- Inadequate monitoring of intraday credit and derivatives for affiliates
- Limited processes that support derivative transactions, including collateral requirements
- Outdated/nonexistent service-level agreements and insufficient pricing methodologies to support charges
- Ineffective training programs across business/support functions
- Overreliance on business certifications that do not have the appropriate substantiation to show compliance with Regulation W
- Inadequate internal audits and testing to determine the level of inherent risk of Regulation W and its technical aspects

that are focused on legal entities to build a consistent, enterprise-wide view of affiliate transactions, as well as the compliance infrastructure, policies, procedures, and controls required to deliver such a view.

In this paper, we'll describe how banks might consider implementing a centralized, end-

to-end Regulation W compliance program by focusing on six components: governance, risk assessment, monitoring and testing, reporting and communication, training, and technology enablement. We will also highlight some specific obstacles banks may be likely to face on the path to compliance, based on our industry insights.

A short history of Regulation W

In April 2003, the FRB issued Regulation W ("Transactions between Banks and Their Affiliates"). At that time, Regulation W represented the FRB's efforts to consolidate more than 70 years' worth of interpretations and rulemaking in a single regulation, adding "W" (fittingly as the 23rd letter of the alphabet) to the list of "alphabet regulations." The long-awaited Regulation W *comprehensively* implemented Sections 23A and 23B of the Federal Reserve Act ("Sections 23A and 23B").² As further guidance to the banking industry, the FRB,³ the Office of the Comptroller of the Currency (OCC),⁴ and the Federal Deposit Insurance Corporation (FDIC)⁵ issued supervisory guidance that has largely served as the industry standard.

In December 2012, the FRB issued Supervision and Regulation (SR) Letter 12-17 ("Consolidated Supervision of Large Financial Institutions"), which reinforced the prominence of Regulation W. The expectations highlighted the need to "implement and maintain effective policies, procedures, and systems to ensure compliance with applicable laws and regulations. This includes compliance with respect to covered transactions subject to the FRB's Regulation W, which implements Sections 23A and 23B of the Federal Reserve Act and limits a bank's transactions with its affiliates."

- 2 As background, Regulation W (along with Sections 23A and 23B) limits the risks to a bank from transactions between the bank and its affiliates and limits the ability of a bank to transfer to its affiliates the subsidy arising from the bank's access to the federal safety net (i.e., lower-cost insured deposits, the payment system, and the discount window). The law and the implementing regulation accomplish these objectives by imposing quantitative and qualitative limits on the ability of a bank to extend credit to, or engage in certain other transactions with, an affiliate. Transactions between a bank and a non-affiliate that benefit an affiliate of the bank are also covered by the statute and regulation through the well-established "attribution rule." However, certain transactions that generally do not expose a bank to undue risk or abuse the safety net are exempted from coverage under Regulation W.
- 3 In January 2003, the FRB issued SR 03-2 ("Adoption of Regulation W Implementing Sections 23A and 23B of the Federal Reserve Act"), which summarized the significant issues addressed in the rule and prevailing guidance to banks. This SR letter highlighted nine key areas addressed in the regulation: derivatives, intraday credit, financial subsidiaries, general purpose credit card exemption, foreign banks, exemption of bank's purchase of affiliate loans, affiliate mutual funds, corporate reorganizations, and valuation and timing rules.
- 4 The OCC issued the *Related Organizations Handbook* in August 2004 as guidance for national banks. The handbook is designed as a reference tool and examination guide to assist bankers and examiners in understanding the various types of related organizations, risks that may be associated with these organizations, and the responsibilities of a bank's board of directors and management to institute strong and effective corporate practices governing the bank's relationships with these organizations.
- 5 The FDIC has weighed in on these issues and has focused on this issue, particularly for insured state nonmember banks. In a Financial Institution Letter FIL-29-2004 "Transactions with Affiliates," the FDIC announced its proposed rule changes to revise Part 303 and add a new Part 324 that would interpret the restrictions on affiliate transactions contained in Sections 23A and 23B of the Federal Reserve Act for insured state nonmember banks. The FDIC's proposed Part 324 cross-references Regulation W, making it clear that state nonmember banks are subject to the same restrictions and limitations. The new Part 324 would also make clear that the FDIC interpret and apply these restrictions and limitations contained in Regulation W with regard to insured state nonmember banks, may grant exemptions from those restrictions and limitations, and is the appropriate agency to make other determinations under Regulation W.

Designing an effective Regulation W compliance program

The framework (see figure 1) is one that can be considered when implementing a robust enterprise-wide Regulation W compliance program. The program is anchored in the center by the regulatory requirements that must be met—including an analysis of the requirements, their applicability to an organization's specific business, and transactions and strategic decisions on the exemptions an organization chooses to leverage against the quantitative requirements. On the outer ring are the necessary core components that are recommended for a strong compliance program. We will explore each of the elements below and provide considerations based on our industry perspectives.

Understanding and analyzing the core Regulation W requirements

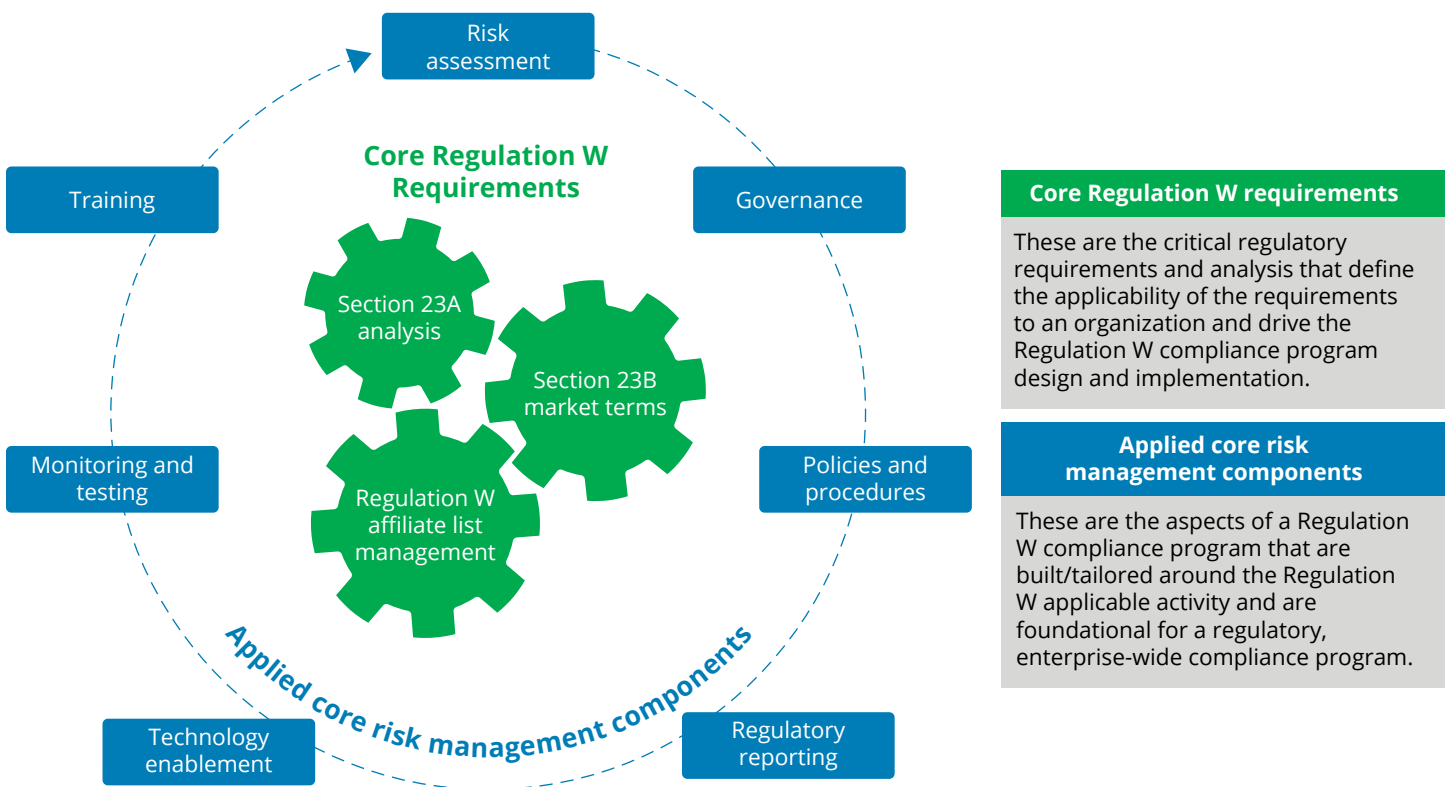
Before an appropriate Regulation W compliance program can be designed that can appropriately

mitigate the risks associated with affiliate transactions through well-designed internal controls and processes, it is very important that a proper analysis of the regulatory requirements and their applicability to the organization's business transactions and products be conducted. This is one of the primary areas where the regulators have identified failures and issues with Regulation W compliance programs.

The following are some challenges we have observed:

- Know your requirements—Limited knowledge of the regulatory requirements across businesses and functions.
- Applicability analysis provides a strong foundation—Lack of analysis conducted of the regulatory requirements and how they apply to specific business products and transactions. For

Figure 1. Recommended Regulation W compliance program



example, many organizations only have controls that cover the “bank side” and do not cover the trading or investment banking transactions where the covered transactions actually exist.

- Knowing requirements that require documentation—Lack of sufficient analysis on the 23A exemptions and how an organization qualifies for them, and then insufficient evidence and support for the usage of the exemptions.
- Linkage between 23B “fair market terms or arm’s length” versus standards applied for tax purposes for transfer pricing (these terms are very high level in the regulation and require more specific definition by an organization, given the methodology, and how to show this can vary significantly for liquid versus complex/structured products and transactions).
- Incomplete affiliate list that is highly manual with lack of appropriate governance and defined roles and responsibilities.

Designing an appropriate Regulation W compliance program is highly dependent on having an appropriate understanding and analysis of the requirements for your organization. Please refer to the “Navigating technical complexity” section for more details and information related to key requirements within the regulation and how to appropriately consider them in your analysis.

Designing an effective compliance program

This section will focus on the outer ring of the framework and the main components to building an effective Regulation W compliance program.

Governance

A robust governance framework is the cornerstone of an enterprise-wide compliance program. Anything less and banks will likely continue to experience issues and challenges related to Regulation W. For example, banking leaders should understand critical terms embedded within the regulation in light of the context of their institution’s legal entity structure, product offerings, and control structure, as noted in the **Understanding and analyzing core Regulation W requirements** section. That means answering questions such as:

- What constitutes an affiliate, given that it may be different from financial intercompany consolidation entities?
- Who owns the affiliate list, and how will affiliates be captured and reported? Has the affiliate list been appropriately analyzed to determine its completeness and overall accuracy?

- What types of covered transactions are conducted by a bank holding company and its businesses? If a business conducts transactions with an affiliate, what process is in place to determine if it is a covered transaction?
- What are the internal policies of conducting covered transactions? How are individual transactions aggregated across businesses for the purposes of compliance with the quantitative limits? How will these be monitored and reported by the business and aggregated by control functions? Who will do this work?
- What collateral requirements apply to an affiliate? How will collateral be allocated, monitored, and reported?
- What transactions are exempt from Section 23A? Who identifies these? How are they captured, monitored, and reported?
- Who determines how to value a covered transaction? Which methodology is used to determine value?
- How are intercompany agreements maintained? How are revenue and expenses charged, cleared and settled, and monitored for payment?

Good governance also enables banks to more swiftly and effectively respond to regulatory requests and actions. This capability will likely be largely determined by the institution’s organizational control structure. Is it centralized or decentralized? Who is the Regulation W policy owner? What other roles and responsibilities need to be attributed across the three lines of defense? What is the nature of the interaction between the depository institution and other entities under the affiliate definition?

Under a centralized structure, a few central functions share accountability. In a decentralized arrangement, accountability is spread across the institution. A decentralized approach can be more challenging because individuals could treat same or similar transactions in different ways, and there is the potential for control duplication and/or gaps. Also given Regulation W needs to be aggregated end-to-end to demonstrate the controls across the organization and how they meet the regulatory requirements, a decentralized approach that is siloed across businesses and functions is likely to pose significant challenges to an organization. Therefore, many banks are now reverting to more centralized operating models with ownership and roles and responsibilities across the three lines of defense clearly outlined.

Regulation W ownership also remains a key question many institutions are still asking. By ownership we mean the Regulation W policy owner or “quarterback” of the

enterprise-wide process and controls—not necessarily a single person or function who would own it in totality. This person or function would own the policy that outlines an institution's compliance risk appetite and framework for Regulation W. Should it be Finance, Compliance, Front Office/Business, Operations/COO, or another control function? All of these options have been observed across both domestic and FBOs. The decision can depend on various factors such as the current process and infrastructure, the legal entity structure, and the breadth and depth of Regulation W-covered transactions across the organization. Organizations should also consider management-level committees and where Regulation W violations and issues can be reviewed. Generally, these committees are cross-functional and include representation from across the business/control functions and can be stand-alone or part of existing risk, regulatory, and legal entity management committees. Whichever approach and ownership model a bank chooses, leaders should define the role, responsibility, and authority for each line of business (LOB) and function, and confirm that the regulation is implemented and enforced in a consistent and transparent way. Plus, each LOB function should have controls that are transparent, documented, monitored, and tested.

Today, the most effective risk management processes are likely to have three lines of defense. This means all relevant individuals must understand their role, their responsibility, and their connection to the process steps for every transaction. This system of governance should lead to robust management and board reporting—as it is applied to Regulation W and its requirements.

First line of defense: LOB. A bank's LOBs, which initiate and execute transactions, compose the first line of defense. The LOBs should verify that appropriate controls are in place to comply with the regulation and differentiate between detective and preventative controls. They are required to "know your affiliate"—especially for businesses with structured transactions and complex intercompany relationships. LOBs should understand how transactions may trigger Section 23A and 23B requirements, and Regulation W, and have appropriate management reporting that is reviewed on a regular and frequent basis. When LOBs have their own risk and control personnel, banks should create a compliance framework that differentiates the roles between LOB compliance and corporate compliance.

With the FRB's guidance issued in January 2018, there is increased focus on the first line of defense and

senior management accountability over key regulatory processes and controls such as Regulation W.

Second line of defense: Corporate compliance organization. The bank's corporate compliance group may develop and own the policy that outlines an institution's compliance risk appetite and framework for Regulation W. As noted earlier, this could vary in some organizations if the ownership resides with finance or another function. Regardless of its role as policy owner, corporate compliance serves as the second line of defense. It should provide an inventory of the regulatory requirements and mapping of the applicability of those requirements to the LOBs and control functions, compliance risk oversight, and transaction monitoring across the enterprise.

In addition, corporate compliance establishes the oversight program, which includes all of the relevant components of a compliance program. As we are outlining in this document, this includes the risk assessment, testing and monitoring, reporting, and training. Other functions that may also act as the second line of defense include:

- Credit risk, which grants credit approval for counterparties, including affiliate counterparties, and monitors for credit exposure.
- Treasury, which allocates the collateral pool and monitors its levels.
- Finance, which sets capital limits and monitors positions. In addition, finance establishes cost allocation methodology, and—with the assistance from tax—establishes market terms guidance.

Key takeaways: Governance

- Formalize roles and responsibilities for Regulation W compliance across the three lines of defense.
- Consider that an aggregated and end-to-end view of Regulation W compliance for the organization is required and therefore siloed business and function models may pose significant challenges.
- Don't forget key functions that should be included in the end-to-end process framework for Regulation W such as Treasury, Credit, Finance, Legal, Compliance and others.
- Designate a management committee with sufficient stature and ability to resolve Regulation W violations and issues.

Third line of defense: Internal audit. Internal auditors validate the structure of the program and test the effectiveness within the LOBs and corporate compliance functions. Internal auditors should perform comprehensive scheduled testing, which includes assessing compliance with laws and regulations as well as internal policies and procedures. Testing and monitoring performed through internal audits would be separate from those performed by corporate compliance on a more routine basis.

As part of their oversight, internal auditors would need to confirm they have the appropriate understanding of Regulation W requirements and then link their testing and validation to the institution's controls across the first and second line of defense. Additionally, they would need to link their knowledge of key controls in other corporate functions, such as credit risk and finance, which have an impact on affiliate transactions involving the bank.

Policies and procedures

A documented and approved Regulation W policy should exist for every banking organization with or without applicable covered transaction activity. The policy should be enterprise-wide and not be siloed to only cover the bank or a single line of business or function. The enterprise policy should outline the regulatory requirements, applicability to the organization, and roles and responsibilities across the three lines of defense framework. Some of the roles, which the policy may articulate, include:

- Board and senior management awareness, monitoring, and oversight (due to far-reaching implications) across the organization—which includes the bank and its affiliates as part of a bank holding company structure—and with a particular emphasis on the sanctity of the depository institution.

- Regulation W Steering Committee or other management committee as noted earlier, which is a governance committee that allows for issue escalation and resolution, policy approval, and strategic decisions.
- An officer for function who “owns the Regulation W policy” and is accountable for an enterprise-wide Regulation W compliance framework oversight.
- Clear roles and responsibilities among first, second, and third lines of defense. Key functions to consider in the framework are Treasury, Credit, Regulatory Reporting, Finance, Compliance, Front Office/Business, Technology/Operations, Bank Regulatory Legal and Legal Entity Management/Corporate Secretary.

In addition to the enterprise-wide policy, there should be documented procedures and standards, which implement the policy at the LOB level for each process step owner.

Risk assessment

Regulation W should be included in the second line of defense/compliance risk assessment process. Based on recent observations and regulatory feedback, the risk assessment should be grounded in the detailed regulatory requirements and supported by a more granular applicability or risk assessment, which further demonstrates the Regulation W risk by business or function. For example, noting Regulation W at a macro level as “high” or “low” risk without any support and documentation to demonstrate the risk by legal entity/business/function may be challenged by regulators and internal auditors, compliance, and other reviewers of the program. The regulation requirements should be parsed in the risk assessment for ease of control establishment, monitoring, and testing of compliance.

In addition, Regulation W should be included in the risk assessment process conducted by the first line of defense or LOBs/functions (i.e., risk and control self-assessment process) and should indicate the risk to its specific LOB/function for the activities under its remit. The goal is to determine the inherent risk, risk mitigants, adequacy of internal control framework, and the residual risk that remains to be managed and controlled.

Based on the assessment of risk, this should drive the LOB/control organization's (first line of defense) monitoring and testing control program. In addition, it can assist in determining the second line of defense—corporate compliance's oversight.

Key takeaways: Policies and procedures

- A documented and approved (board, management committees) Regulation W policy is required regardless of activity
- The policy must be enterprise-wide and applicable to all functions/LOBs
- An owner of the policy should be established
- The policy should clearly outline the risk appetite and roles and responsibilities for compliance across the organization
- Detailed procedures should be established for each function/LOB in the policy to implement the standards and requirements

Key takeaways: Risk assessment

- Map and incorporate Regulation W requirements into the risk assessment program
- Determine completeness of Regulation W requirements applied to business and control functions
- Apply consistent compliance risk assessments to business segments and support functions
- Create a common understanding of the types and nature of transactions with Regulation W implications from an inherent risk perspective
- Align the risk assessment program to other parts of the overall compliance program (monitoring, testing, training)

Monitoring and testing

A critical component of a bank's compliance program is likely to be the monitoring and testing of transactions, as well as the effectiveness of controls. Controls would include:

- Identification of an affiliate through an affiliate list
- Identification of covered transactions by tagging affiliate transactions in financial, credit, collateral systems, or other related transaction systems
- Assignment of collateral, if appropriate
- Monitoring of collateral requirements
- Quantitative limits, market terms valuations
- Pricing execution for intercompany agreements

The testing and monitoring program should be designed based on the institution's organizational structure and should be a reflection of the standards established by corporate compliance for risk assessments.

Several of the previously mentioned functions have their own controls and processes, which may be internal to their functional checks and balances. For example, in regard to market terms requirements or Section 23B requirements for service fees, finance at the LOB and corporate levels may have established front-to-back, and back-to-front, processes for the recording and reconciliation of receipts to the general ledger.

In either a decentralized or centralized institution, corporate compliance should be performing independent monitoring and testing as the second line of defense and should base its assessment of the state of compliance on the effectiveness of the first line of defense's testing and monitoring program. For corporate compliance to form its independent view

of the consolidated compliance risk profile across the institution for Regulation W, it should also consider changes to key controls and the institution's strategy for affiliate transactions. Separately but equally important to consider, are external factors such as regulatory agency examinations, as well as proposed regulations by individual regulatory agencies and their prospective impact to the institution. This independent monitoring and testing can help confirm that the risk assessment process is being appropriately applied and that the monitoring and testing program is effective and sustainable.

The mix of testing versus monitoring typically varies across legal entities, based upon the inherent risk and the effectiveness of control points, which results in residual risk rating. LOBs and control functions with strong testing results may eventually be subject to less frequent testing and instead need regular monitoring. Extensive testing and monitoring may be appropriate for high-risk or error-prone areas. Regardless, independent compliance should be achieved by some type of assurance review by the first line of defense, combined with reviews by the second and third lines as needed.

Key takeaways: Monitoring and testing

- Provide ongoing, periodic monitoring and comprehensive escalation processes for Regulation W
- Formalize accountability across LOBs and support functions aligned to controls
- Determine if the scope and frequency of monitoring and testing is sufficient
- Track intercompany agreements, provide adequate documentation to evidence market standards, payment settlements, and reconciliation of receivables/payables on a timely basis
- Effectively document and flag credit processes for credit approvals (Section 23A) in credit systems as affiliate transactions
- Confirm collateral monitoring is comprehensive and not fragmented across different groups
- Determine the adequacy of the control framework, paying close attention to the completeness of controls across the first LOB.

Training

Banks should consider providing robust training beyond simply meeting Regulation W requirements. This training could include knowledge and understanding around their particular systems, policies, and processes. As a result, functional stakeholders should not only know their role within the process, but they should understand that failure at any point could mean noncompliance with the regulation. In this regard, training is used to communicate accountability and responsibility across an organization.

Effective training also involves collaboration among the various risk and control functions of the various LOBs and the engagement of previously mentioned functions throughout the life cycle of the transaction.

Training can also help address the lack of adequate institutional knowledge of Regulation W requirements and how they should be applied within the business, compliance, and internal audit areas. Even if this knowledge does exist in banks, it typically resides with their regulatory and legal divisions and may not always be communicated across the enterprise. This usually results in LOBs having inadequate controls. Several detective and preventative measures can help mitigate this concern, but training is a fundamental component of a well-designed and comprehensive Regulation W program.

Training programs should not only provide baseline Regulation W awareness, but also target instruction that is aligned with roles and responsibilities across businesses, control functions, and internal audit. The more banks provide comprehensive training programs on a regular basis, the more those programs are likely to help them embed Regulation W compliance standards

Key takeaways: Training

- Analyze training needs on an enterprise-wide basis, so relevant training can be developed and provided at regular intervals (or provided regularly)
- Provide comprehensive training on a regular basis to defined groups that own key controls
- Document, track, and monitor Regulation W training objectives, and confirm that priorities are being achieved
- Include compliance training requirements in annual employee learning and performance goals, particularly for those key control owners of Regulation W

and procedures into their structure and processes. As a result, Regulation W effectively becomes part of the institution's culture.

Consequently, training is often conducted in two parts: 1) baseline training that explains how to apply Regulation W and provides information about the institution's policy to a wide audience, and 2) more customized training to specific LOBs and support/control functions.

Reporting and communication

In creating a compliance framework, banks should consider how they capture data, generate information, and communicate issues and findings to the board, executives, regulators, and other stakeholders. Institutions should establish a formal reporting and communications structure not just to confirm that relevant stakeholders are receiving appropriate and timely information, but also to meet regulators' expectations.

Some common measures that institutions can consider to evaluate Regulation W risk within LOBs or control functions include:

- Overall transaction volume and stated transaction volume with affiliates
- Extent of the use of exemptions
- Volume of covered transactions (both transaction volume and dollar value)
- Complexity of covered transactions
- Use of intercompany agreements (reviewed to determine consistency in issues such as cost methodology and arm's-length transacting)
- Collateral composition and requirements
- Extent of derivative transactions

When developing management-level reporting, banks should consider the timeliness of the reporting and data and push to gather information on transaction/trade date (T) or T+1. Reporting and associated controls past this period can be viewed as insufficient at mitigating the appropriate Regulation W risk.

In addition to management and board reporting, there are also requirements for regulatory reporting on a quarterly basis—the FR Y-8 report. This report collects information on transactions between an insured depository institution and its affiliates that are subject to Section 23A requirements. The FRB uses this information to enhance its ability to monitor bank exposures to affiliates and facilitate Section 23A compliance.

For these formal FR Y-8 regulatory filings, banks should apply regulatory reporting control frameworks and leading industry practices with end-to-end accountability defined, front-to-back and back-to-front testing of data, and a process to support reporting completeness, timeliness, and accuracy. Banks should implement robust reporting processes that use downstream and upstream risk and financial systems to support an “affiliate view” of a depository institution’s books and records. For instance, risk and financial systems should appropriately report Section 23A transactions, including the level of covered transactions, the collateral required to support them, and the outstanding exposure against the quantitative limits. Many banks have also created affiliate systems and registers that pull information from all source systems centrally for Regulation W tracking and reporting of all transactions. The process, or where and how exemptions will be applied to covered transactions, should also be appropriately evaluated within the end-to-end process.

In addition, there is an opportunity for banks to review and optimize their broader legal entity reporting. Depending upon the legal entity structure and headquarters of the parent bank, several different reporting forms are used as event-driven reporting to identify legal entities and associated information. This includes their purpose and type of legal form for compliance with laws and their implementing regulations, including Dodd-Frank Act, Sarbanes-Oxley Act, and Gramm-Leach-Bliley Act, and Bank Holding Companies and Change in Bank Control (Regulation Y), Enhanced Prudential Standards for Bank Holding Companies and Foreign Banking Organization (Regulation YY), and Resolution Plans Required (Regulation QQ). There is commonality and an integration required between the Regulation W affiliates, for example, to the merchant banking rules as part of Regulation Y and some common tracking and data across the FR Y-10, FR Y-8, and FR Y-12 reporting. Therefore, it is important that banks understand the reporting requirements across their legal entity structure reporting and look at “converged” requirements. For those banks that can do this, it

is a significant opportunity for increased efficiency, effectiveness, and transparency across regulatory reporting processes, including Regulation W.

Our recent RegPulse blog covers legal entity management and provides some additional perspectives:

<https://regpulseblog.com/2018/06/04/legal-entity-reporting-common-challenges-and-banking-industry-practices/>

Key takeaways: Reporting and communication

- Deliver consistent and regularly scheduled enterprise-wide reporting to management and the board, proving that compliance issues are aggregated, tracked, and escalated for resolution
- Consider the timeliness of the data and information used in management-level reporting
- Identify triggers for escalation, and/or to flag potential issues, and report accordingly
- Communicate results regularly of Regulation W monitoring and testing within the organization
- Centralize Section 23B reporting to track service-level agreements and intercompany receivables and payables
- Confirm that current management information system (MIS) reporting is appropriately scaled to the risk profile of the organization and that it provides a clear view into credit exposures with the required collateralization across the enterprise for both loans and derivatives
- Verify that reporting frequency and oversight is commensurate with the number and types of transactions
- Determine how manual the reporting processes are to assess if there are opportunities to automate portions of the reporting process
- Consider the synergies and linkages across various legal entity structure reporting and the underlying data used to identify additional optimization opportunities in regulatory reporting processes

Technology

Banks have recently been focused on investing in technology, infrastructure, and automation of controls for Regulation W controls. Many banks are still highly manual, and regulators are now demanding increased focus on streamlining the end-to-end process; linking the affiliate list to financial/credit/front-office systems; developing automated and timely management reporting; and increased automation of internal controls with an increased focus on preventative controls, where possible, versus overreliance on delayed detective controls. With the linkage of Regulation W to legal entity management, risk management, booking model, Volcker, recovery and resolution planning, transfer pricing, and many other areas that impact the bank and its affiliates, investment in technology is almost deemed necessary, especially if banks want to continue to grow revenue and reduce internal costs and redundancies. Considering the synergies of the Regulation W process and controls with other regulatory requirements, this can not only support greater efficiency across the enterprise-wide control framework, but also can be used by banks to support internal use cases and budgets for increased investment in technology and controls. Isn't it time for Regulation W to have automated and preventative controls scaled to the business?

Many banks have institution-applied risk and finance IT systems that can be enhanced to accommodate and effectively capture transaction activity, including affiliate identification, exemption applicability, collateral requirements, quantitative limits, and reconciliation of Section 23B service fees.

An institution should provide an appropriate level of automation, as discussed earlier, but should scale it to its risk profile based on transaction or product type and volumes and analyze the linkage to other bank processes and controls. For example, simple enhancements to trading systems with affiliate identifiers and collateral flag requirements can help with overall control and oversight of compliance. Other enhancements can consider affiliate flags in legal entity systems, increased real-time 23B analysis and saving of transaction data, and Regulation W transaction warehouses or aggregator systems that allow for easier review and reporting.

Other banks with greater volume of transactions and complexity may want to consider more preventative control solutions leveraging some of the new cognitive technology available—such as central rules decision logic, which can be automatically connected to work alongside real-time trade flow and financial/regulatory reporting systems versus hard coding of controls in numerous front-office systems.

Given the overall trend in the banking industry to look for increased effectiveness and efficiency to enable growth, and with all the new technologies available from robotics to cognitive techniques, there are many more options available for banks to consider.⁶

Key takeaways: Technology enablement

- Identify Regulation W processes that are embedded in many risk, finance, and underlying transaction systems
- Determine end-to-end process flows that show handoffs for key processes across business and support functions
- Maintain an ongoing and centralized repository of key Regulation W information, including a complete and accurate affiliate list, covered transactions, collateral requirements, exemptions and type of exemptions, and quantitative limits
- Automate key risk monitoring reports (collateral and 10/20 limits) for level of capacity
- Consider an appropriate balance of preventative and detective controls based on complexity of processes and volume of transactions and activity
- Leverage synergies with other regulatory requirements to build a broader use case for automation within the organization

⁶ For additional information on the options available, read Deloitte's recent report (<https://www2.deloitte.com/us/en/pages/regulatory/articles/bank-front-office-regulatory-compliance.html>)

Navigating technical complexity

The complexity of Regulation W is driven by its broad application across products, LOBs, and control functions throughout the organization. Institutions should focus their resources and attention on several key technical areas, due both to their importance and the challenges they typically present. In this section, we have identified some of these areas and have included thoughts on how to achieve them to ease the path to Regulation W compliance. As we discussed earlier, without appropriately understanding the technical requirements and how they apply to an organization, a bank will likely be challenged to design an effective and efficient Regulation W compliance program.

The Dodd-Frank Act

For the banking industry, Regulation W compliance is already a significant challenge with its complex requirements for many LOBs and control functions and its impact on an institution's day-to-day business activities. Add the Dodd-Frank Act to the mix and compliance becomes even more challenging through tightened requirements and a number of technical changes to Regulation W.

For instance, Section 608 of the Dodd-Frank Act introduced several significant changes that impact the limits and requirements of Section 23A of Regulation W. Section 608 of the Dodd-Frank Act includes the universe of entities that will be deemed as Regulation W affiliates and the scope of products that will be subject to collateral requirements and/or quantitative capital limits. Although the FRB has not yet issued final rules to implement these changes within Regulation W, and it remains unclear when the FRB will finalize changes implementing Section 608 of Dodd-Frank by enhancing Regulation W, the expectation is that this expanded scope would require new controls to achieve compliance. Many banks have already incorporated these changes into their existing programs. Some key changes from the Dodd-Frank Act include:

- **Expanded definition of an “affiliate.”** The definition of an “affiliate” now includes investment funds in which a bank or affiliate acts as investment adviser, even if it does not have an equity stake.
- **Expanded definition of a “covered transaction.”** Derivative transactions and securities lending or borrowing between a bank or a subsidiary and any

affiliate to the extent they cause the bank to have credit exposure with an affiliate are to be deemed as “covered transactions.”

As a result, they are subjected to a 10 percent limit on transactions with any single affiliate and a 20 percent limit on transactions with all affiliates and collateral requirements under Section 23A.

- **Expanded collateral requirements.** The purchase of assets subject to repurchase agreements has been recategorized as an extension of credit and is now subject to the collateral requirements under Section 23A in addition to the quantitative limits that were previously in effect.
- **Continuous collateral maintenance requirements.** Banks and their subsidiaries will also be required to collateralize credit exposure⁷ with their affiliates “at all times.” Before the Dodd-Frank Act, the requirement was that collateral be determined at inception of the transaction, based on a transaction’s “initial value” and that of the collateral at the time of the transaction. Additional collateral was required only to replace retired or amortized collateral. If the collateral deteriorated in value, additional collateral was not required to be posted to maintain the appropriate coverage percentage. The Dodd-Frank Act substantially changes this from the 2010 requirements. It requires maintenance of the required percentage at all times rather than only at the time of the transaction. Therefore, banks will be required to monitor collateral on an ongoing basis and call for additional collateral if the value of the posted collateral deteriorates below the threshold required by Section 23A.
- **Inclusion of affiliate debt obligations in Section 23A requirements.** Credit extensions to a company or person (that is, a non-affiliate) that are collateralized

⁷ Depending on how credit exposure is defined and whether affiliate netting is allowed by the banking regulators, the economic impact of transactions (such as derivatives, repurchase/reverse repurchase agreements and securities borrowing/lending on quantitative limits, and the amount of collateral required under Section 23A) could be quite significant. For risk management purposes, the risk of these types of transactions is typically broken down into current cost or value of replacing the contract today (typically measured by mark to market) and potential future exposure of the transaction. To the extent that banking regulators require potential future exposure may also be included in the quantitative limits and collateralized for purposes of Section 23A, and recognition of affiliate netting were not to be granted, the impact on quantitative limits and amount of collateral required under Section 23A would be significantly greater than if the reverse is decided.

by securities issued by an affiliate are required to be treated as covered transactions under Section 23A. The Dodd-Frank Act expands the type of affiliate collateral that triggers covered transaction status to include a bank's acceptance of any debt obligations of an affiliate. Similarly, the Dodd-Frank Act adds "debt obligations" from an affiliate to the types of collateral that are ineligible to secure an extension of credit to an affiliate. This change puts debt obligations of an affiliate on the same footing as securities issued by an affiliate for purposes of Section 23A.

- **Imposition of quantitative limit and tightening of calculation method on financial subsidiaries.**

The Dodd-Frank Act eliminates the exemption for transactions with financial subsidiaries of a bank making these transactions subject to the 10-percent limit on transactions with an affiliate.

Additionally, the Dodd-Frank Act requires that earnings retained in a financial subsidiary will now count toward the investment limit.

- **Netting arrangements.** The Dodd-Frank Act permits the FRB to issue regulations or interpretations with respect to the manner in which a bank may take netting agreements into account under Section 23A in determining the amount of a covered transaction with an affiliate, including whether a covered transaction is fully secured. Interpretations with respect to a specific member bank, subsidiary, or affiliate will be issued jointly with the appropriate federal banking agency.
- **Revises exemptive authority for covered transactions.** In general, the Dodd-Frank Act permits the FDIC and OCC, in addition to the FRB, to grant exemptions from Section 23A with respect to banks and thrifts under their supervisory power.⁸

Affiliate list

In complying with Regulation W, institutions should maintain an accurate and complete list of entities, which qualify as affiliates. But this is challenging for many, in part because several areas can create an entity, which would be deemed as a Regulation W affiliate under the

rule. Institutions face other challenges as well, some of which include:

- Absence of robust governance processes
- Lack of clearly defined roles, responsibilities, and control processes for preapproving such entities
- Lack of systematic assignment of unique entity identifiers, which flag affiliates and allow credit exposure between the bank and its affiliates to be automatically captured
- Lack of systematic processes for searching, updating, and disseminating the affiliate list to the front office and control functions
- Extensive use of manual processes and lack of centralized systems, which can lead to errors and inconsistent updating

With the Dodd-Frank Act expanding the definition of "affiliate," institutions will be required to implement additional governance processes and controls to capture all investment funds regardless of interest, including those funds where the bank and any affiliates have no ownership interest but act as investment advisers.

Before a transaction is complete, it is essential to know whether it occurs between a bank or its subsidiaries and an affiliate, and, if so, under what conditions would the transaction be permissible. A complete and accurate affiliate list, along with a "know your affiliate" culture is important in this regard. A formal governance process covering affiliate creation, maintenance, and approval responsibilities documented in a Responsibility Assignment Matrix (RACI) and procedure, unique data identifiers, automated updating processes, and the timely dissemination of the updated list and the ability to easily query the affiliate list can also help achieve this objective.

Many banks have chosen to leverage their legal entity management systems, processes, and people to also manage and control the Regulation W affiliate list. This is considered a leading practice so that banks don't create multiple legal entity masters. Regulation W affiliates can be flagged or specifically identified within these broader legal entity management systems for more enterprise-wide control and risk mitigation. Automation will likely be key going forward and to answer the questions: How can affiliates be flagged early in the client onboarding process? How can affiliate lists be embedded in first line and financial systems to streamline monitoring and testing?

⁸ Further, the Dodd-Frank Act prohibits the granting of an exemption from Section 23A if the FDIC determines that such exemption presents an unacceptable risk to the Deposit Insurance Fund. In order to issue an exemption from Section 23A, the Federal Reserve must notify the FDIC of the proposed exemption and provide the FDIC 60 days to object in writing to the exemption if the FDIC determines that the exemption presents an unacceptable risk to the Deposit Insurance Fund. In order to issue an exemption from Section 23A with respect to a national bank or thrift, the OCC must notify the FDIC of the proposed exemption and provide the FDIC 60 days to object in writing to the exemption if the FDIC determines that the exemption presents an unacceptable risk to the Deposit Insurance Fund.

Potential covered transactions

Identifying potential covered transactions is a fundamental part of understanding and building a comprehensive Regulation W compliance program. These transactions are subject to the collateral requirements and/or the quantitative limits under Section 23A. Covered transactions with respect to an affiliate for purposes of Section 23A (including key changes made under the Dodd-Frank Act) include the following:

- A loan or extension of credit⁹ to the affiliate, including a purchase of assets subject to an agreement to repurchase
- A purchase of or an investment in securities issued by the affiliate
- A purchase of assets from the affiliate, except such purchase of real and personal property as may be specifically exempted by the board by order or regulation
- The acceptance of securities or other debt obligations issued by the affiliate as collateral security for a loan or extension of credit to any person or company
- The issuance of a guarantee, acceptance, or letter of credit, including an endorsement or standby letter of credit, on behalf of an affiliate
- A transaction with an affiliate that involves the borrowing or lending of securities, to the extent that the transaction causes a bank or a subsidiary to have credit exposure to the affiliate
- A derivative transaction with an affiliate to the extent that the transaction causes a bank or a subsidiary to have credit exposure to the affiliate

In many organizations, the LOBs are responsible for determining “covered transactions.” Procedures for identifying and monitoring covered transactions may vary across business units. Plus, the mechanism for reporting such transactions can often be manually driven (for example, using a spreadsheet can lead to potential errors).

A challenge is to define enterprise-wide standards, standardized processes, and reporting and monitoring procedures to verify the accurate identification, capture,

and treatment of covered transactions throughout the transaction life cycle.

While LOBs, as first line of defense, should typically identify potential covered transactions, control functions (as the second line of defense) should establish clear requirements regarding the information needed from LOBs, monitor whether the information is received, and conduct the assessment/activities under their remit.

Collateral monitoring

Regulation W requires banks to verify that each of its credit transactions with an affiliate is secured by collateral. The regulation actually specifies the amounts of collateral required—ranging from 100 to 130 percent of the market value of the transaction based on the type of collateral posted. For example, using cash or US government obligations as collateral can be posted at 100 percent of the market value of the transaction, while using stock or real estate as collateral would require it to be posted at 130 percent.

Another Regulation W requirement for collateral states is that a deposit account with the bank that is used for securing credit transactions between the bank and its affiliate must be segregated, earmarked, and identified for the sole purpose of securing such transactions.

There are also limitations on the type of collateral that can be used for securing credit transactions with affiliates (for example, low quality assets, securities issued by an affiliate, and others are considered ineligible). Plus, eligible collateral must meet certain perfection and priority requirements.

Given the specificity of the collateral requirements and also the continuous collateral maintenance requirements specified under the Dodd-Frank Act, some institutions may have difficulty in confirming that the appropriate amount and type of collateral are posted for all covered transactions on an ongoing basis. It is helpful to develop the capability and controls to monitor the amount and type of collateral posted relative to the covered transaction, and then appropriately increase the amount of the collateral if it diminishes in value, or release the collateral once the transaction rolls off. This means institutions should have tight and well-controlled collateral processes, policies, and procedures in place. Central management of the collateral requirements generally works most effectively in practice.

⁹ It is important to note that credit exposure is not defined under the Dodd-Frank Act. Bank regulatory agencies have not yet issued an interpretation on whether the potential future exposure (PFE) associated with these transactions should be included in the calculation of quantitative limits and the amount of collateral required for Section 23A. If the inclusion of PFE is required, the regulatory agencies will also need to issue guidance on the methodology for calculating PFE for these purposes. Furthermore, the issue of whether affiliate netting will be permitted to reduce the amount of covered transactions has still not been addressed by the regulatory agencies.

Exemptions

The use of exemptions has been an area of focus in past and recent horizontal exams conducted by banking regulators. At the heart of the issue is how banks have determined whether a transaction qualifies for an exemption and whether sufficient analysis has been conducted and documentation retained to support the use of the exemption. If an exemption is misapplied or there's insufficient documentation to support the use of the exemption, the transaction would likely become a covered transaction subject to Section 23A quantitative and collateral requirements.

Fundamental to the use of exemptions is a robust process for identifying whether a transaction with a Regulation W affiliate can be transacted under the particular exemption. In this regard, the organization should define procedures that would outline available exemptions, key questions or attributes that the business line or unit can use to help determine whether a transaction is eligible for exemption, and documentation requirements for its use.

For example, the intraday credit exemption requires:

- Policies and procedures to identify intraday exposures with affiliates and to monitor transactions that give rise to intraday credit exposure.
- Monitoring intraday exposures that roll off by the end of the day. If that's not the case, then they must be identified and treated as covered transactions subject to Section 23A collateral requirements and/or quantitative limits.
- Escalation processes for overdrafts that are anticipated to exceed intraday limits and/or are not cleared by the end of the day for an affiliate or group of affiliates (which then could become a covered transaction).

Attribution rule

Under Regulation W, the attribution rule states that any bank transaction with any person is deemed an affiliate transaction subject to Section 23A to the extent that the proceeds from the transaction are used for the benefit of, or transferred to, an affiliate. However, determining the intent of the person or third party during the transaction on whether the proceeds will be used for the benefit of, or transferred to, an affiliate is quite challenging. It puts additional pressure on the front office and control functions to determine potential uses of funds/proceeds extended to third parties. Establishing controls before a transaction is completed

helps identify transactions with the potential for attribution. They typically include the following:

- An approval process that analyzes whether a newly designed product is used for its intended purpose and if it will have any funds benefiting an affiliate
- Credit review of an extension of new funds to assess the potential uses of funds and whether the purpose of the transaction is to extend a to benefit an affiliate
- Account transaction or product reviews to understand how funds are used throughout the life of the transaction

Section 23B requirements: Market terms

Under Regulation W, a bank may not engage in a transaction unless the transaction is on terms and under circumstances, including credit standards, that are substantially the same, or at least as favorable to the bank, as those prevailing at the time for comparable transactions with or involving non-affiliates. In the absence of comparable transactions, the transaction should be based on terms and under circumstances including credit standards that would be offered in good faith, or would apply to non-affiliates.

The market terms requirement applies to virtually all products offered to an affiliate, including extensions of credit, loans, the purchase of assets, and borrowing or selling securities or assets. It also applies to the provision of services to affiliates (discussed further in the following section). Transactions requiring market terms should be supported by a market terms analysis, which can involve comparison of the terms, conditions, and pricing of the transactions relative to similar non-affiliate transactions or external pricing studies.

To comply with this regulation, it may be helpful to articulate enterprise standards and LOB and controls function procedures for applying the market terms requirement, and then tailoring the procedures appropriately in light of the unique attributes of different types of products. It may also be useful to outline routines that should be followed prior to execution and to assess whether the transaction is on market terms. Post-execution follow-up can be helpful in complying with this requirement on an ongoing basis. Given the complexity of doing all this, a matrix that details the following can help develop enterprise standards:

- Type of affiliate transaction or product
- Guidance or standards for assessing market terms for transaction type or product
- Methods for substantiation and timing

- Location of supporting documentation
- Responsibility for conducting the analysis and ensuring market-based terms

This continues to be an area which banks are challenged with given either lack of sufficient detective controls or controls and reporting that are executed at a delayed timing and not necessarily at the time of trade or end of day. Banks are continuing to review their controls to determine how to further automate the market terms checks and reporting and also leverage other controls within the organization such as best execution and transfer pricing controls.

Intercompany agreements

Regulation W devotes substantial attention to the payment of money or the furnishing of a service to an affiliate under contract, lease, or otherwise. Intercompany agreements typically document such services, setting forth the type of and terms by which one legal entity will provide services to another in exchange for fees. The regulation requires that intercompany agreements comply with the market terms requirements of Section 23B. That is, fees paid to affiliates for services need to be on comparable terms with those that would be paid to non-affiliates for similar services.

Separately, there may be revenue-sharing agreements that apply revenue between businesses that book in the bank versus the affiliates.

Banks typically have numerous legal entities with many contractual relationships between them—and tracking these relationships can present some challenges. A centralized repository containing existing and new intercompany agreements, as well as centralized monitoring and maintenance of intercompany agreements with affiliates, is increasingly essential, particularly for large and complex organizations, to comply with Section 23B requirements. An ongoing assessment of whether services to affiliates are comparable with market-based transactions requires accurately capturing the services provided, terms, and conditions.

Additionally, it is important to enforce consistent financial accounting for services provided with respect to booking receivables/payables between different legal entities, based upon the 23B requirements of Regulation W. Standardized booking practices, use of existing financial systems to track legal entity financials, and cash settlement mechanisms should be required for intercompany agreements between legal entities.

Centralized monitoring

Due to the technical difficulties with Regulation W, a bank's ability to develop an effective compliance program will likely hinge on centralized automated monitoring. Quarterly FR Y-8 report filings will be supplemented with more frequent internal daily and weekly reporting that provides the required and more centralized monitoring across all LOBs. It is important that reconciliation of Section 23A and 23B transactions between LOB reporting and the bank's books and records from a centralized view occur frequently. This can help to verify that controls across respective units (controllers, finance, regulatory reporting, legal entity reporting, business units, etc.) are capturing aggregate transactions subject to collateral and/or that they are captured and applied against the quantitative limits applicable under Section 23A.¹⁰

Taking a closer view, regular monitoring is required and differs by product. For traded products in which value is more subject to market movements, the monitoring of positions, collateral, and limits becomes more pressing. This is in contrast to loans in which values usually remain constant and are typically subject to change with its agreed-upon amortization schedule or periodic off-cycle paydowns. In this case, the monitoring of collateral should be more relative to the remaining balance of the loan and assessing if the amount of posted collateral still covers the remaining loan amount. To the extent that the type of collateral posted isn't volatile, there may be opportunities to release collateral as the loan balance decreases.

¹⁰ Please note that Section 23A prohibits a bank from initiating a "covered transaction" with an affiliate if, after the transaction, (i) the aggregate amount of the bank's covered transactions with that particular affiliate would exceed 10 percent of the bank's capital stock and surplus, or (ii) the aggregate amount of the bank's covered transactions with all affiliates would exceed 20 percent of the bank's capital stock and surplus.

Getting to the next level

Banks should consider the necessary investments and changes to their structures and processes to comply with the now more than 15-year-old formalization of the Section 23A and 23B requirements of the Federal Reserve Act, as implemented through Regulation W—especially because federal regulators are continuing their focus, and business models and approaches to intercompany transactions have evolved. It means building a consistent enterprise-wide view of their infrastructures and control framework and developing appropriate policies, procedures, and reporting mechanisms that oversee affiliate transactions. This isn't going to be easy because there are plenty of challenges and complexities involved with Regulation

W. However, banks stand to benefit by reducing the risks associated with regulatory reporting and compliance for Regulation W and improving their legal entity governance and reporting.

As they begin developing their enterprise-wide compliance governance, processes, and technology capabilities to meet current compliance requirements, banks should consider taking a pragmatic view of compliance. This means they should balance what is practical from a cost perspective with what is ideal in the new regulatory landscape. In the long run, this should help them achieve a sustainable and robust compliance program.

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