Dodd-Frank: Top Ten Priorities for Internal Audit

Purpose

Tasked with improving their companies' operations by systematically evaluating and improving the effectiveness of risk management, control, and governance processes, chief audit executives and internal auditors couldn't be operating in a more difficult time with the Dodd–Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) confronting them.

The sweeping financial regulatory reform initiative is not only enormous in scope; its rules are being shaped and reshaped by political and corporate considerations over an extended period of time. Through it all, the chief audit executive and Internal Audit must forge a strong connection with those in the C-suite in order for top executives to stay informed. These 10 priorities are offered not only to raise awareness about key priorities, but also to serve as vehicle for executive-level discussion and improvement within the enterprise.

1 Start now and be informed!

Many companies continue to struggle with a plan for compliance with Dodd-Frank. Internal Audit—a compliance-oriented function—may assist senior management by providing insight and direction based on their past experience and evaluate the effectiveness and completeness of the companies' Dodd-Frank plans. In addition to understanding new systems and processes put in place as a result of the changing regulations, internal auditors will also need to adapt their own processes to meet these new requirements as certain parts of Dodd-Frank may require an independent certification.

2 Be aware of the potential development of new opportunities for revenue-generating products that may transfer regulatory risk.

Financial institutions, as a result of implementing many provisions of Dodd-Frank and other new regulations, may incur significant implementation costs and loss of business revenue. It is anticipated that the pricing of loan products, fees at ATMs, managing of clearinghouses, and other revenue-producing strategies will be developed to cover the lost revenues and potentially recoup the implementation costs. Internal Audit, given its line of site across the organization, is a logical—and necessary—party to include in the discussion with the management team when it comes to understanding the implications of these new opportunities (particularly the governance and control structure) and evaluate whether these new opportunities fit within a company's risk framework.

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3 Participate in the creation of a "living will" and understand the impact on the corporate legal entity structure.

Under Section 165(d) of Dodd-Frank, institutions that are deemed to be "systemically significant"—bank holding companies with assets of $50 billion or more and nonbank financial companies supervised by the Federal Reserve (the Fed)—must submit a plan for the rapid and orderly resolution of their business in the event of material financial distress. The report of the so-called "resolution plans" must be submitted by these systemically significant organizations to the Federal Deposit Insurance Corporation (FDIC) and the Fed annually. The FDIC adopted a final rule[1] on resolution planning and the FDIC board approved an interim final rule[2] requiring resolution plans for insured depository institutions over $50 billion. Internal Audit can play a role in determining whether the living will plans developed by the organization are reasonable and supported by appropriate documentation, that the right people are involved, and that the risks and controls are identified and addressed. Development of viable plans requires affected institutions to conduct a strategic analysis on how they could be resolved under the bankruptcy code and to evaluate credit exposures and other key information across the entities and their affiliated.

More information

- FDIC Adopts Final Rule on Resolution Plans Under Dodd-Frank, September 2011, FDIC
- FDIC Board Approves Interim Final Rule Requiring Resolution Plans for Insured Depository Institutions Over $50 Billion, September 2011, FDIC
- Bank & Thrift Regulatory Update, The Washington Report, September 19, 2011, KPMG LLP
- Pressure to act now: Implications of U.S. Resolution Plans and Credit Exposure reporting for foreign-owned financial institutions, April 2011, KPMG LLP
- FDIC and Fed Propose Rule for Resolution Plan and Credit Exposure Reporting by Systemically Important Firms, Regulatory Practice Letter 11-04, April 2011, KPMG LLP
- Proposed Rule: Resolution Plans and Credit Exposure Reports Required, April 2011, Board of Governors of the Federal Reserve System and Federal Deposit Insurance Corporation

[1] The final rule – issued jointly with the Federal Reserve (the Fed) requires bank holding companies with consolidated assets of $50 billion or more and non-bank financial companies that the Financial Stability Oversight Council (FSOC) designates as systemically significant to submit periodic resolution plans. The final rule, which will apply to 124 financial firms (26 of which are in the United States and the remainder being U.S. subsidiaries of foreign banks), requires the plan to describe the company's strategy for rapid and orderly resolution in bankruptcy during times of financial distress. Companies with more than $250 billion in non-bank assets will be required to file their plans by July 1, 2012, while those with $100 billion to $250 billion in non-bank assets won't be required to file until July 1, 2013. All other firms will be required to submit their plans by December 2013. Along with their living wills, FDIC-insured banks with more than $50 billion in assets will also have to file a separate plan with the FDIC.

[2] The interim final rule, set to take effect January 1, 2012, is intended to clarify that government-insured banks with $50 billion or more in total assets—and not subject to the U.S. Bankruptcy Code—also would be required to submit living wills to the FDIC. The interim rule has not yet been approved by the Federal Reserve and is subject to a 60-day comment period. Approval by the Fed is expected in the near future. The interim rule would require the depository arm at the 37 largest banks in the United States to create their own contingency plans. The so-called resolution proposal would allow the FDIC, acting as receiver, to dismantle the banks outside the bankruptcy process. The FDIC has not identified the 37 banks, although in its announcement said they held $3.6 trillion in insured deposits, accounting for about 60 percent of all insured deposits as of December 31, 2010.

4 Review the new Asset-Backed Securities (ABS) reporting requirements.

For registered ABS initially offered beginning January 1, 2012, securitizers will be required to review the assets to ensure the accuracy of their loan disclosures. Requirements for the reviews, which may be done in-house or by a third party, will vary by type of asset. Internal Audit may have the skill set and experience to assist (or guide others) with the reviews.

More information

- Defining Issues: Regulators Propose Risk Retention Rule for Asset-Backed Securitizations, May 2011, KPMG LLP
- Agencies Propose Rule for Credit Risk-Retention Requirements of Asset-Backed Securities, Regulatory Practice Letter 11-06, April 2011, KPMG LLP
- Defining Issues: SEC Adopts Two Final Rules for Asset-Backed Securities, February 2011, KPMG LLP
- Summary of SEC ABS final rules, The Washington Report, January 24, 2011, KPMG LLP

5 Prepare to comply with new investment rules (Volcker Rule).

Banking entities are generally prohibited from engaging in proprietary trading or investing in—or sponsoring—a hedge fund or private equity fund (although a de minimis investment in a hedge fund or private equity fund is allowed).[3] An organization's activities and investments must be compliant within two years after the rules become effective (the time frame required under the Dodd-Frank). Internal Audit should assess the organization's project plan and time line to become compliant. Additionally, Internal Auditors can help evaluate where their organization's existing internal control policies and procedures are in compliance with the Volcker Rule or whether additional controls should be considered as the proposed Volcker rule includes significant compliance requirements with independent review. Internal Audit should also test the operating effectiveness of these key internal controls.

More information

- Proposed Rule: Regulations Establishing and Governing the Duties of Swap Dealers and Major Swap Participants, November 2010, Commodity Futures Trading Commission[4]
- Bank & Thrift Regulatory Update, The Washington Report, February 14, 2011, KPMG LLP
- Financial Stability Oversight Council –Study of Restrictions on Proprietary Trading and Relationships with Private Funds (Volcker Rule), Regulatory Practice Letter 10-20, KPMG LLP

[3] A banking entity is allowed a de minimis investment in a hedge fund or private equity fund up to 3 percent of the total ownership interest of a fund and subject to an aggregate limit on all investments in such funds equal to 3 percent of the banking entity's Tier 1 capital.

[4] Under sections 4s(f)(1)(B)(i) and (ii), the Securities and Exchange Commission (SEC) is authorized to prescribe the books and records requirements of "all activities related to the business of swap dealers or major swap participants," regardless of whether or not the entity has a prudential regulator. All books and records shall be open to inspection and examination by any representative of the Commission, and under section 4s(f)(1)(D), books and records relating to security-based swap agreements also must be open to inspection and examination by the SEC. Section 4s(g)(4) of the Commodity Exchange Act (amended by the Dodd-Frank Act) specifies that swap dealers and major swap participants maintain a "complete audit trail for conducting comprehensive and accurate trade reconstructions."

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6 Evaluate new compliance risks such as executive compensation, whistleblower provisions and other governance areas.

Issues of immediate concern are those dealing with required disclosures relating to executive compensation, whistleblower provisions, and incentive compensation claw-back requirements. Being noncompliant may result in fines and penalties and damage to an organization's corporate credibility and reputation. Internal Audit may support financial management by providing feedback on how existing processes are operating, as well as providing possible suggestions on how these processes may be improved given the new requirements. Internal Audit can help ensure that all risks are identified, assessed and that appropriate mitigation plans are in place.

More information

- Dodd-Frank: Beyond Financial Services – The Implications and Effects on Nonfinancial Service Companies, August 2011, KPMG LLP

7 Understand the impact (if any) of Title XV, Miscellaneous Provisions, and other recent legislation impacting the supply chain.

Title XV, Miscellaneous Provisions, contained in Dodd-Frank, comprises three key areas: Conflict Minerals, Mine Safety Disclosures, and Payments to Governments by Resource Extraction Issuers. In signing this section into law, it was the intent of the U.S. Congress to ensure industry transparency and give investors and citizens new tools to hold companies and governments accountable for their actions around selected corporate responsibility-type initiatives. Title XV has a direct bearing on reporting requirements on about one-half (at least 6,000) of all publicly traded companies in the United States. Complying with the due diligence requirements of the provision is daunting; some affected organizations say elements of the requirements are unclear and they are waiting for the Securities and Exchange Commission (SEC) to issue the final rule before the end of 2011. However, several corporations and industry groups have commenced work (e.g., tracing conflict minerals in their supply chain), rather than wait for the SEC's final rules, due to the tight time line for implementation once the ruling is finalized. In addition to the Dodd-Frank legislation, there have been actions by state and local governments to curb the use of conflict minerals.[5] Other legislation is in process to eradicate slavery and human trafficking from their direct supply chains for tangible goods offered for sale.[6] Internal auditors should understand how the final SEC rules will impact their organization and ensure appropriate controls are in place around a company's supply chain, which supports management's disclosure. In addition, Internal Audit should participate in reviewing management's assumption around risk rating the supply chain to determine the usage of conflict minerals and management's reasonable country of origin determination.

More information

- Conflict minerals… Does compliance really matter? Ask California, Australia, and the EU- Recent legislation and activity affecting supply chains – a comparison, October 2011, KPMG LLP
- Conflict minerals provision of Dodd-Frank – Immediate Implications and Long-term Opportunities for Companies, August 2011, KPMG LLP
- Dodd-Frank Act – Conflict Minerals (Section 1502) – presentation, September 2011, KPMG LLP

[5] By a vote of 67 to 11, the California state assembly passed a bill (which has since been signed into law by Gov. Jerry Brown) that prohibits state agencies from signing contracts with companies that fail to comply with federal regulations aimed at deterring business with armed groups in eastern Congo. In addition, the Council of the City of Pittsburgh calls on electronics companies and other industries to take the necessary steps to remove conflict minerals from their supply chain and the City Council of St. Petersburg, FL approved a resolution to consider the presence of conflict minerals in electronic products in purchasing and investment decisions.

[6] Recent legislation to eradicate human trafficking and slavery includes Business Transparency on Trafficking and Slavery Act – H.R. 2759 (in process-bill introduced August 1, 2011), and The California Transparency in Supply Chains Act – SB 657 (effective January 1, 2012).

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8 Understand accounting and tax implications.

Certain provisions of Dodd-Frank will have accounting and tax[7] implications. The rule-making process for many aspects of Dodd-Frank are still under development. A public company that anticipates that Dodd-Frank may have a significant impact on its business may wish to provide disclosures of the potential impact (for example, in Management's Discussion and Analysis). Internal Audit can help senior management track these implications, monitor the changes, and provide a regular status report to update the organization.

More information

- The Dodd-Frank Act: Could there be accounting consequences?, September 2011, KPMG LLP
- The Taxation of Dodd-Frank, August 2011, KPMG LLP

9 Adjust audit plans, budget, and resources, as necessary.

The number of new regulatory requirements makes it imperative that internal auditors carefully review their audit plans, budgets, and resources to ensure sufficient focus is given to the organization's key operational risks and related controls, as well as the new compliance challenges. Some departments may need to increase not only the *number* of individuals on their team, but also match the *background and expertise* of those individuals to the task. To set expectations and reduce the potential for future miscommunication, internal auditors may consider an up-front and frank discussion with the CEO, CFO, and Audit Committee to explain how they are meeting these demands—does Internal Audit need to hire subject matter experts or third-party consultants—and the impact it will have on their departments. Regular meetings to update the status of the plan/ budget/resources are highly recommended.

10 Interact with external auditors and participate in peer group sessions.

In many cases, due to the nature of their work, internal auditors have a strong relationship with the external auditor. The internal auditors may seek out guidance and input from external auditors regarding their view of the proposed rules and impact to the organization, timing of the final rules, leading practices, and what they are hearing in the marketplace from other organizations. Internal Audit may also consider seeking input from their peers by participating in peer networking sessions.

[7] Although the Act contains only one tax provision, the Act nevertheless raises a number of important tax considerations.

Why KPMG?

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Contact us

Theodore J. Scallon
Partner
T: 212-954-7059
E: tscallon@kpmg.com

Pascal (Pat) Binetti
Partner
T: 704-335-5395
E: pbinetti@kpmg.com

Emad Bibawi
Partner
T: 212-954-2033
E: ebibawi@kpmg.com

Eric Holt
Partner
Global Lead Internal Audit
T: 713-319-3086
E: ericholt@kpmg.com

Jim Low
Partner
America's Center of Excellence
T: 212-872-3205
E: jhlow@kpmg.com

Hugh Kelly
Principal
T: 202-533-5200
E: hckelly@kpmg.com

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