

Board of Governors of the Federal Reserve System

The Board's Oversight of Its Designated Financial Market Utility Supervision Program Is Generally Effective, but Certain Program Aspects Can Be Improved



Office of Inspector General
Board of Governors of the Federal Reserve System
Bureau of Consumer Financial Protection



Office of Inspector General

Board of Governors of the Federal Reserve System
Bureau of Consumer Financial Protection

Executive Summary, 2020-FMIC-B-005, March 18, 2020

The Board's Oversight of Its Designated Financial Market Utility Supervision Program Is Generally Effective, but Certain Program Aspects Can Be Improved

Findings

The Board of Governors of the Federal Reserve System has implemented practices and processes (1) to ensure governance over the designated financial market utility (DFMU) supervision program, (2) to collaborate with other supervisory agencies in accordance with authorities provided in the Dodd-Frank Wall Street Reform and Consumer Protection Act, and (3) to conduct reviews of material changes filed by DFMUs that meet the Board's responsibilities under title VIII of the Dodd-Frank Act. However, we identified opportunities for the Board to enhance these practices and processes.

Specifically, we found that the Board should publish certain internal delegations of authority and define certain roles and responsibilities within the DFMU supervision program. We also found that the Board can enhance its processes for collaborating with other supervisory agencies. Lastly, we found that the Board can better prepare for emergency changes filed by the DFMUs for which it is the supervisory agency.

Recommendations

Our report contains recommendations designed to enhance the efficiency and effectiveness of the Board's governance over its DFMU supervision program, its collaboration with other supervisory agencies, and its processes for reviewing emergency changes filed by DFMUs. In its response to our draft report, the Board concurs with our recommendations and describes actions that have been or will be taken to address our recommendations. We will follow up to ensure that the recommendations are fully addressed.

Purpose

We conducted this audit to assess the effectiveness of the Board's oversight of its DFMU supervision program. The scope of our audit included delegations of authority and program oversight roles and responsibilities within the Federal Reserve System. We also focused on coordination (1) within the System, (2) between the System and other supervisory agencies, and (3) between the System and the DFMUs for which the Board is the supervisory agency.

Background

Title VIII of the Dodd-Frank Act was enacted to mitigate systemic risk in the financial system and promote financial stability, in part through enhanced supervision of DFMUs. To accomplish this, title VIII grants the Board enhanced authority to supervise the DFMUs for which it is the supervisory agency and to consult with other federal agencies when the Board is not the designated supervisory agency for a DFMU. The Board has created a committee structure for overseeing its DFMU supervision program. Additionally, the Board has established processes to execute an annual supervisory cycle and to review material changes made by DFMUs that may affect the nature or level of risks they present to themselves, their participants, or markets.



Office of Inspector General

Board of Governors of the Federal Reserve System
Bureau of Consumer Financial Protection

Recommendations, 2020-FMIC-B-005, March 18, 2020

The Board’s Oversight of Its Designated Financial Market Utility Supervision Program Is Generally Effective, but Certain Program Aspects Can Be Improved

Finding 1: The Board Has Established Governance Structures for Its DFMU Supervision Program but Can Better Define Certain Aspects of Program Governance

Number	Recommendation	Responsible office
1	Publish in an order or rule subject to the Administrative Procedure Act the internal delegations made to RBOPS for reviewing and approving ANPCs.	Legal Division
2	Define and document which parties at the division director and governor levels will have a role in reviewing and approving enforcement actions for DFMUs.	Division of Reserve Bank Operations and Payment Systems, in consultation with Legal Division and Division of Supervision and Regulation
3	Develop a committee charter for the FMU-CC that includes the committee’s purpose and the members’ roles, responsibilities, and authorities.	Division of Reserve Bank Operations and Payment Systems, in consultation with Legal Division and Division of Supervision and Regulation

Finding 2: The Board Has Implemented Processes for Collaborating With Other Supervisory Agencies, but Those Processes Can Be Enhanced

Number	Recommendation	Responsible office
4	Assess the Board’s core objectives in overseeing DFMUs for which it is not the supervisory agency. Based on this assessment, create guidance that addresses the Board’s preferred method for communicating examination findings to other supervisory agencies.	Division of Reserve Bank Operations and Payment Systems
5	Develop a process for reconciling the Board’s examination findings for DFMUs for which it is not the supervisory agency with those of the other supervisory agencies and for tracking the adoption of the Board’s findings.	Division of Reserve Bank Operations and Payment Systems

Finding 3: The Board Meets Its Title VIII Responsibilities for Reviewing Material Changes but Can Better Prepare for Emergency Changes

Number	Recommendation	Responsible office
6	Discuss with relevant Board and Reserve Bank staff and document <ol style="list-style-type: none">the various situations that could prompt emergency changes.the review process for emergency changes.	Division of Reserve Bank Operations and Payment Systems



Office of Inspector General

Board of Governors of the Federal Reserve System
Bureau of Consumer Financial Protection

MEMORANDUM

DATE: March 18, 2020

TO: Matthew J. Eichner
Director, Division of Reserve Bank Operations and Payment Systems
Board of Governors of the Federal Reserve System

Mark E. Van Der Weide
General Counsel
Board of Governors of the Federal Reserve System

FROM: Michael VanHuysen 
Assistant Inspector General for Audits and Evaluations

SUBJECT: OIG Report 2020-FMIC-B-005: *The Board's Oversight of Its Designated Financial Market Utility Supervision Program Is Generally Effective, but Certain Program Aspects Can Be Improved*

We have completed our report on the subject audit. We conducted this audit to assess the effectiveness of the Board of Governors of the Federal Reserve System's oversight of its designated financial market utility supervision program.

We provided you with a draft of our report for review and comment. In your response, you concur with our recommendations and outline actions that have been taken or will be taken to address our recommendations. We have included your response as appendix B to our report.

We appreciate the cooperation that we received from your staff during our audit. Please contact me if you would like to discuss this report or any related issues.

cc: Michael S. Gibson
Kevin Stiroh
Julie Williams
Marta Chaffee
Jennifer Lucier
Stuart Sperry
Stephanie Martin
Vic Chakrian

Christopher Koopmans
Ricardo A. Aguilera
Cheryl Patterson



Contents

Introduction	8
Objective	8
Background	8
Overview of Title VIII	8
Governance Over the Board’s DFMU Supervision Program	11
The DFMU Supervisory Cycle	12
The Material Change Review Process	13
Finding 1: The Board Has Established Governance Structures for Its DFMU Supervision Program but Can Better Define Certain Aspects of Program Governance	16
The Board Has Established Governance Structures for Its DFMU Supervision Program	16
The Board Should Publish Certain Internal Delegations Related to ANPCs	16
The Board Can Better Define and Document Certain Roles and Responsibilities	17
Recommendations	18
Management Response	18
OIG Comment	18
Finding 2: The Board Has Implemented Processes for Collaborating With Other Supervisory Agencies, but Those Processes Can Be Enhanced	19
The Board Has Implemented Processes for Collaborating With Other Supervisory Agencies	19
The Board Can Further Enhance Its Processes Related to Collaboration on Examinations	20
Management Actions Taken During the Audit	21
Recommendations	21
Management Response	21
OIG Comment	21
Finding 3: The Board Meets Its Title VIII Responsibilities for Reviewing Material Changes but Can Better Prepare for Emergency Changes	22
The Board’s Process for Reviewing Material Changes Ensures That It Meets Its Title VIII Responsibilities	22
The Board Can Better Prepare for Emergency Changes	22
Recommendation	23
Management Response	23

OIG Comment	23
Other Matter for Management Consideration	24
Appendix A: Scope and Methodology	25
Appendix B: Management Response	27
Abbreviations	30



Introduction

Objective

Financial market utilities (FMUs) are multilateral systems that transfer, clear, or settle payments, securities, derivatives, or other financial transactions among financial institutions or between financial institutions and the FMU. FMUs designated as systemically important by the Financial Stability Oversight Council (FSOC), known as designated financial market utilities (DFMUs), play a critical role in fostering financial stability. If not properly managed, they can be sources of financial shocks that affect domestic and international financial markets.

The objective of this audit was to assess the effectiveness of the Board of Governors of the Federal Reserve System's oversight of its DFMU supervision program. The scope of our audit included delegations of authority and program oversight roles and responsibilities within the Federal Reserve System. We also focused on coordination (1) within the System, (2) between the System and other supervisory agencies, and (3) between the System and DFMUs for which the Board is the supervisory agency. To accomplish our objective, we reviewed applicable laws, regulations, and System documents; performed walkthroughs of key processes in the supervisory cycle; and interviewed representatives from the System, other supervisory agencies, and one DFMU. Additional details on our scope and methodology are in appendix A.

Background

Overview of Title VIII

In July 2010, title VIII of the Dodd-Frank Wall Street Reform and Consumer Protection Act was enacted to mitigate systemic risk in the financial system and promote financial stability, in part through enhanced supervision of DFMUs.¹ Title VIII grants the FSOC the authority to designate certain FMUs as systemically important; to date, the FSOC has designated eight FMUs. Title VIII also defines the DFMU's supervisory agency as the federal agency with primary jurisdiction over the DFMU under federal banking, securities, or commodity futures laws (table 1).

¹ Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §§ 801-14, 124 Stat. 1376, 1802-22 (2010).

Table 1. Assignment of DFMUs to Supervisory Agencies

Title VIII supervisory agency	DFMU
Board	CLS Bank International The Clearing House Payments Company LLC (on the basis of its role as operator of the Clearing House Interbank Payments System)
U.S. Commodity Futures Trading Commission	Chicago Mercantile Exchange, Inc. ICE Clear Credit LLC
U.S. Securities and Exchange Commission	The Depository Trust Company National Securities Clearing Corporation Fixed Income Clearing Corporation The Options Clearing Corporation

Source: The Board's public website.

Title VIII requires the Board, and authorizes the other supervisory agencies, to prescribe regulations containing risk management standards for their respective DFMUs. It also requires each of the supervisory agencies to conduct annual examinations of, and authorizes them to review material changes for, their DFMUs. Title VIII grants the Board enhanced authority to supervise DFMUs to help mitigate systemic risk in the financial system and promote financial stability. Thus, other supervisory agencies are required to consult with the Board when fulfilling their roles under title VIII; however, the Board's role is generally limited to sharing its perspectives when consulting with the other agencies.²

² Title VIII does permit the Board to refer certain matters to the FSOC in the event that it disagrees with the supervisory agency. For example, the Board may recommend that the supervisory agency take enforcement action against a DFMU to prevent or mitigate significant liquidity, credit, operational, or other risks to financial markets. If the supervisory agency rejects the Board's recommendation, the Board may refer the recommendation to the FSOC, which may, upon an affirmative vote by the majority of its members, require the supervisory agency to take enforcement action against the DFMU.

THE BOARD'S ROLE IN DFMU SUPERVISION UNDER TITLE VIII

Title VIII grants the Board an enhanced role in supervising DFMUs, including (1) directly supervising certain DFMUs and (2) consulting with other supervisory agencies on their supervision of the remaining DFMUs.

For DFMUs for which the Board is the supervisory agency, title VIII requires the Board to

- prescribe risk management standards
- conduct examinations at least annually
- receive notices of material change filed by the DFMUs

For DFMUs for which the Board is not the supervisory agency, the other supervisory agencies are required to consult with the Board on

- prescribed risk management standards
- the scope and methodology of annual examinations
- material changes filed by the DFMUs

The Board also has the discretion to participate in any title VIII examination led by another agency.

When conducting an annual title VIII examination, the supervisory agency shall determine (1) the nature of the DFMU's operations and the risks it bears, (2) the risks the DFMU presents to financial institutions, (3) the DFMU's resources for monitoring and controlling the risks it presents, (4) the DFMU's safety and soundness, and (5) the DFMU's compliance with title VIII and the supervisory agency's regulations. Title VIII also authorizes the supervisory agency to take enforcement actions against a DFMU.

Material changes are changes to rules, procedures, or operations that could materially affect the nature or level of risks presented to the DFMU, its participants, or the market, including risks associated with the DFMU's payment, clearing, or settlement activities.³ DFMUs must either submit a notice of material change prior to implementing the change or, in the event of an emergency, after the change has been implemented.

DFMUs typically must provide 60 days' advance notice to their supervisory agency of any proposed material change. If the supervisory agency does not object to the advance notice of proposed change (ANPC) within 60 days of it (1) receiving the change or (2) receiving additional information that it requested about the change, whichever is later, the DFMU may implement the change.⁴ The DFMU may also implement the change before the 60-day period ends if the supervisory agency notifies the DFMU that it does not object to the change. Alternatively, if the supervisory agency objects to the ANPC within 60 days, the DFMU may not implement it. A DFMU can immediately implement a material change that

³ Changes that do not meet the materiality threshold are not required to be submitted to the Board.

⁴ The supervisory agency may extend the review period by an additional 60 days for ANPCs that raise novel or complex issues.

would otherwise require an ANPC if an emergency exists and the implementation is necessary for the DFMU to continue to provide its services in a safe and sound manner. In such cases, the DFMU submits a notice of an emergency change no later than 24 hours after implementation of the change.⁵ If the supervisory agency objects to the emergency change, the DFMU must modify or rescind it.

The Board adopted Regulation HH to implement certain statutory provisions of title VIII for the DFMUs for which the Board is the supervisory agency.⁶ Specifically, Regulation HH prescribes the Board’s risk management standards for DFMUs for which the Board is the supervisory agency and defines and describes the Board’s procedures and materiality thresholds for submitting notices of material change.

Governance Over the Board’s DFMU Supervision Program

In its *Rules of Organization*, the Board has delegated to the Division of Supervision and Regulation (S&R) the general responsibility to supervise institutions under the Board’s authority.⁷ For the FMU portfolio, S&R subdelegates supervision authority to the Division of Reserve Bank Operations and Payment Systems (RBOPS). The Board and the Federal Reserve Banks work together to fulfill the Board’s title VIII DFMU supervision and oversight responsibilities. The Board assigns some DFMU supervision and oversight responsibilities to the Federal Reserve Bank of New York (FRB New York) and some DFMU oversight responsibilities to the Federal Reserve Bank of Chicago (FRB Chicago).

The Board created a committee structure to oversee the DFMU supervision program:

- The Committee on Federal Reserve Payment, Clearing, and Settlement (PCSC), consisting of up to three governors, informs and advises the Board of Governors on supervisory and regulatory matters related to payment, clearing, and settlement issues. In this role, the PCSC oversees and provides guidance to staff involved in the supervision and regulation of all FMUs. System DFMU supervision staff

DIVISION OF RESPONSIBILITIES FOR DFMU SUPERVISION AND OVERSIGHT

System—The System encompasses the Board and the Reserve Banks. Together, the Board, FRB New York, and FRB Chicago perform DFMU supervision and oversight.

Board—Title VIII names the Board as the supervisory agency for two DFMUs. As such, the Board retains policymaking authority for its supervision of these two DFMUs. Title VIII also provides the Board with the ability to participate in the oversight of all the remaining DFMUs.

Reserve Banks—The Board assigns some DFMU supervision and oversight responsibilities to FRB New York and FRB Chicago and works closely with them to conduct related activities.

⁵ A DFMU supervised by another supervisory agency submitted one emergency change in 2014, but neither of the DFMUs for which the Board is the supervisory agency have submitted an emergency change.

⁶ Regulation HH, 12 C.F.R. part 234.

⁷ 66 Fed. Reg. 37,686 (July 19, 2001).

brief the PCSC annually on their activities and on an ad hoc basis to discuss extraordinary issues or initiatives.

- The FMU Coordinating Committee (FMU-CC), comprising the directors of RBOPS and S&R and the head of supervision in FRB New York, oversees the DFMU supervision program. The Board's general counsel is also invited to participate in FMU-CC meetings. The FMU-CC meets annually to review supervisory plans and annual roll-up messages and on an ad hoc basis to discuss unusual issues.
- The FMU Supervision Committee (FMU-SC) is a cross-functional committee cochaired by an official from RBOPS and an official from FRB New York and includes officials from RBOPS, FRB New York, FRB Chicago, and the Board's Legal Division. The FMU-SC meets monthly to establish strategic direction, assess effectiveness, and maintain the consistency of the supervisory program across the DFMU portfolio and provide perspectives to supervisory teams on systemic risk considerations.

The DFMU Supervisory Cycle

To perform its examination responsibilities under title VIII, the Board implemented an annual DFMU supervisory cycle. The supervisory cycle has three touchpoints between supervisory teams and the FMU-SC: (1) supervisory plan, (2) midcycle checkpoint, and (3) annual assessment (figure 1). The System combines the supervisory plan and the annual assessment in the same meeting each year; therefore, the FMU-SC approves the annual assessments and the following year's supervisory plans at the same time.

Throughout the supervisory cycle, the System executes its supervisory plan through examinations and continuous monitoring. The System issues the results of its examinations, including its findings, in an examination letter to the DFMU. If the System identifies significant concerns through the supervisory process, supervision staff can use enforcement actions to compel the DFMU's management to address the issues. However, the Board has not issued an enforcement action against an FMU since the FSOC's designation of systemically important FMUs in 2012.

Figure 1. The Supervisory Cycle for the DFMUs for Which the Board Is the Supervisory Agency



Source: Developed by the OIG based on Board documents and interviews.

^a DFMUs are rated according to the ORSOM system. *ORSOM* stands for **o**rganization; **r**isk management; **s**ettlement; **o**perational risk and information technology; and **m**arket support, access, and transparency. This rating system is a supervisory tool used by the System to perform consistent DFMU assessments.

For DFMUs for which the Board is not the supervisory agency, the supervisory cycle follows the same general process, with the following exceptions:

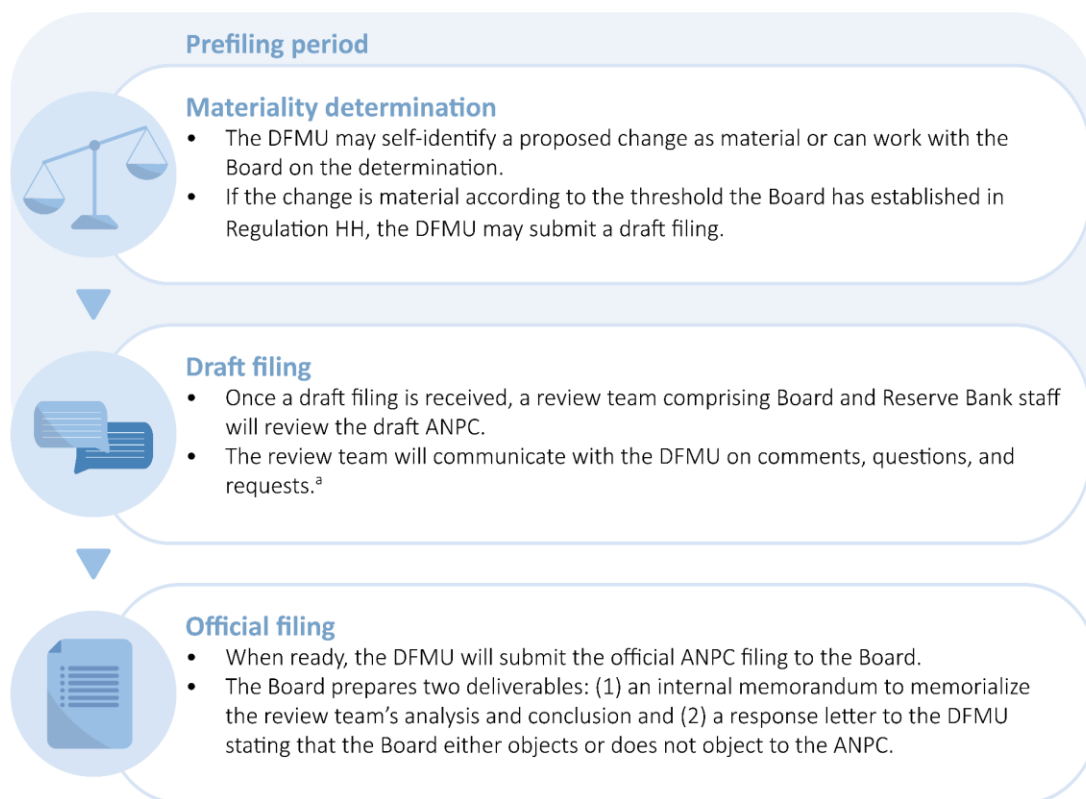
- The System provides the supervisory agency with its approved supervisory priorities and participates in consultation meetings to provide feedback on the supervisory plan; however, the supervisory agency ultimately decides on the combination and scope of supervisory activities.
- When participating in examinations and continuous monitoring activities, the System must coordinate any document requests through the supervisory agency.
- The System may propose examination findings to the supervisory agency in the form of a letter from the Board to the supervisory agency; however, the supervisory agency decides whether to communicate those proposed findings to the DFMU.

The Material Change Review Process

To fulfill its title VIII responsibilities to review material changes, the Board developed a process for reviewing ANPCs. The ANPC process includes three main phases: (1) materiality determination, (2) draft

filing, and (3) official filing (figure 2). The materiality determination and draft filing phases are referred to hereafter as the *prefiling period*. Title VIII does not require DFMUs to submit materiality determination requests or draft filings to the Board; the Board and the DFMUs for which it is the supervisory agency implemented this voluntary process to provide the DFMUs with preliminary informal feedback and questions prior to the official filing phase.⁸ The Board noted that it would use the ANPC review process to review emergency changes implemented by the DFMUs to determine whether they should be rescinded.

Figure 2. The Material Change Review Process for the DFMUs for Which the Board Is the Supervisory Agency



Source: Developed by the OIG based on Board documents and interviews.

^a Material changes for one of the Board’s DFMUs, CLS Bank International, are also sent to the CLS Oversight Committee for its review and response. The CLS Oversight Committee is a cooperative arrangement formed to provide oversight information to and receive input from the central banks whose currencies settle in CLS Bank International. The committee’s review occurs concurrently with the Board’s, but it provides its own response to CLS Bank International.

⁸ A DFMU can officially file an ANPC at any point, given the voluntary nature of the prefiling process.

For the DFMs for which the Board is not the supervisory agency, the material change review follows the same general process, with the following exceptions:

- The Board may have interagency meetings to share its perspectives on materiality, but the supervisory agency, based on its own regulatory requirements, ultimately informs materiality decisions made by the DFM.
- The Board consults on the material change review and coordinates information requests through the supervisory agency.
- The Board recommends to the supervisory agency any follow-up supervisory work and whether to object to the change; however, the supervisory agency chooses whether to adopt the Board's recommendations.



Finding 1: The Board Has Established Governance Structures for Its DFMU Supervision Program but Can Better Define Certain Aspects of Program Governance

The Board has established governance structures for its DFMU supervision; however, the Board can strengthen aspects of program governance. Specifically, the Board did not publish certain delegations of authority for ANPCs in accordance with section 11(k) of the Federal Reserve Act. Additionally, the Board has not fully defined and documented roles and responsibilities for certain parties involved in DFMU supervision and oversight. Governance literature states that providing clear roles and responsibilities is essential to an effective governance system. Defining and documenting these delegations and roles would help to ensure that all parties involved in the program have a common understanding and may help to maintain the governance system during times of turnover.

The Board Has Established Governance Structures for Its DFMU Supervision Program

The Board established governance structures for its DFMU supervision program. Specifically, the Board implemented a committee structure to oversee DFMU supervisory activities. The PCSC and the FMU-CC provide governor-level and division director-level oversight of the program, respectively. The FMU-SC, which is led by senior leaders at the Board and the Reserve Banks, establishes the program's direction, assesses its effectiveness, and maintains the consistency of the supervisory program across the portfolio. In addition, System senior leaders participate throughout the supervisory cycle. They are actively involved in developing, reviewing, and approving supervisory plans, midcycle reviews, and annual assessments.

Further, the Board has documented and standardized practices since the passage of title VIII. In September 2018, RBOPS developed an internal *Designated Financial Market Utility Supervision and Oversight Program Supervisory Framework* (DFMU Supervisory Framework) to provide an overview of the legal basis, governance structure, guiding policy principles, and supervisory policies and procedures for the program; this framework serves as a guide to support the program's execution. Additionally, in July 2019, the FMU-SC updated its charter to clarify the Board's policymaking responsibilities and to grant the FMU-SC formal approval authority for supervisory plans and annual assessments for all DFMUs.

The Board Should Publish Certain Internal Delegations Related to ANPCs

Section 11(k) of the Federal Reserve Act authorizes the Board to delegate, by published order or rule and subject to the Administrative Procedure Act, any of its functions, other than those relating to rulemaking or monetary and credit policies, to administrative law judges, members or employees of the Board, or the Reserve Banks. In 2012, the Board of Governors delegated to the RBOPS director the authority (1) to

approve ANPCs, (2) to extend review periods for ANPCs that raise novel or complex issues, and (3) to request additional information from DFMUs for ANPCs. Although these authorities have been delegated internally, the delegation has not been published in an order or rule subject to the Administrative Procedure Act, as required by section 11(k). Officials in the Legal Division stated that publishing delegations was deprioritized in the past because of resource demands; however, a project is underway to update delegations under section 11(k) of the Federal Reserve Act. If this delegation is not published in an order or rule subject to the Administrative Procedure Act, the Board is not in compliance with section 11(k) of the Federal Reserve Act. Compliance with the act would ensure the transparent publication of such Board delegations.

The Board Can Better Define and Document Certain Roles and Responsibilities

Certain roles and responsibilities within the DFMU supervision program are not fully defined and documented. Our prior analysis of governance literature found that providing clear roles and responsibilities is essential to an effective governance system and that it is a good practice for organizations to document governance processes and structures in bylaws, committee charters, policies, procedures, and other documents.⁹

One example is the roles and responsibilities for issuing enforcement actions against DFMUs. In its *Rules Regarding Delegation of Authority*, the Board of Governors delegated to the Board's general counsel the authority, with the concurrence of the S&R director, to approve certain enforcement actions.¹⁰ However, the applicability of this delegated authority to the DFMU program is not clear. An attorney in the Board's Legal Division stated that enforcement actions for DFMUs would generally follow the same process as enforcement actions for other financial institutions and receive approval from the S&R director and the Board's general counsel. However, in June 2019, the FMU-CC members and the Board's general counsel discussed enforcement actions for the DFMU program, noting that S&R does not envision having a role because RBOPS would be better positioned to manage the process.

Further, it is unclear how an enforcement action would be escalated and approved above the division director level—whether it would be reviewed by the Board of Governors or a governor-level committee. It is not clear which governor-level committee should receive an enforcement action that merits escalation. Typically, the Committee on Supervision and Regulation would review an enforcement action; however, the PCSC oversees DFMU supervision.

Board officials noted that because the Board has not issued an enforcement action to a DFMU, it has not had the opportunity to determine whether the current delegation for issuing certain enforcement actions is sufficient or whether a different approach is needed. In a September 2019 report, we found that the Board can clarify aspects of its enforcement action process for depository institutions, including clearly

⁹ Office of Inspector General, *Strengthening Organizational Governance*, [OIG Insights](#), February 14, 2019.

¹⁰ 12 C.F.R. § 265.6(e).

defining roles and responsibilities of the parties involved in the process and when governors should be involved in enforcement matters; this clarification should capture the nuances of the DFMU portfolio.¹¹

The FMU-CC would also benefit from better-defined and -documented roles and responsibilities. Unlike the other committees that oversee the DFMU supervision program, which have committee charters outlining their purposes and member roles, responsibilities, and authorities, the FMU-CC does not have a charter. The FMU-SC charter summarizes the FMU-CC's role in the DFMU governance structure, but there are no documents defining the FMU-CC's purpose or its members' roles, responsibilities, and authorities. Board officials indicated that the FMU-CC does not have a separate charter because of its limited role in addressing unusual issues.

Defining and documenting roles and responsibilities for issuing enforcement actions and for the FMU-CC could help ensure that all parties involved in the DFMU supervision and oversight program have a common understanding and may help to maintain the governance system during times of turnover.

Recommendations

We recommend that the general counsel

1. Publish in an order or rule subject to the Administrative Procedure Act the internal delegations made to RBOPS for reviewing and approving ANPCs.

We recommend that the director of RBOPS, in consultation with the general counsel and the director of S&R,

2. Define and document which parties at the division director and governor levels will have a role in reviewing and approving enforcement actions for DFMUs.
3. Develop a committee charter for the FMU-CC that includes the committee's purpose and the members' roles, responsibilities, and authorities.

Management Response

The Board concurs with our recommendations. The Board states that there is currently an effort underway to update delegations under section 11(k) of the Federal Reserve Act. It also states that RBOPS and the Legal Division will work with S&R to define and document which parties will have a role in reviewing and approving enforcement actions for DFMUs and to draft a committee charter for the FMU-CC.

OIG Comment

We believe that the actions described by the Board are responsive to our recommendations. We will follow up to ensure that the recommendations are fully addressed.

¹¹ Office of Inspector General, *The Board Can Enhance Its Internal Enforcement Action Issuance and Termination Processes by Clarifying the Processes, Addressing Inefficiencies, and Improving Transparency*, [OIG Report 2019-SR-B-013](#), September 25, 2019.



Finding 2: The Board Has Implemented Processes for Collaborating With Other Supervisory Agencies, but Those Processes Can Be Enhanced

The Board has developed processes for collaborating with other supervisory agencies but can further enhance those processes. Specifically, Board interviewees indicated that the Board could more effectively communicate its examination results for DFMUs for which it is not the supervisory agency by focusing its report messaging on findings related to systemic risk. In addition, when participating in other supervisory agencies' title VIII examinations, the Board does not track whether the supervisory agencies adopt the System's proposed findings. Both of these measures would help the Board fulfill its enhanced supervisory role and support RBOPS's long-term priority of implementing strategies intended to improve the outcomes and processes in which the Board does not have direct supervision authority. Clarifying priorities for proposed findings could enhance the System's ability to emphasize issues that it deems most significant and focus the System's resources on such issues. In addition, tracking the adoption of the System's findings by other supervisory agencies could help the Board consolidate findings and distill common themes to inform future examinations.

The Board Has Implemented Processes for Collaborating With Other Supervisory Agencies

The Board and the other supervisory agencies have implemented processes to ensure that they meet title VIII consultation requirements. Specifically, the Board and the other supervisory agencies confirmed that they meet at least annually to consult on the other supervisory agencies' proposed supervisory plans, and the Board can provide input on the scope and methodology of the other supervisory agencies' examinations. From January 1, 2018, to June 30, 2019, the Board issued 13 proposed findings letters when participating in examinations conducted by another supervisory agency. Additionally, the Board consulted on 13 material changes filed by other supervisory agencies' DFMUs during that time period.

The Board and the other supervisory agencies have also implemented methods to improve collaboration beyond the required title VIII consultations. For example, the Board and the other supervisory agencies use memorandums of understanding to help facilitate information sharing, and the Board meets with the other supervisory agencies throughout the year for continuous monitoring events, proposed examination findings discussions, and key policy question deliberations. The Board has also identified ways to adjust to the other supervisory agencies' processes. First, because the Board and the other supervisory agencies prescribed their own risk management standards for their DFMUs, the Board maintains a regulations database comparing relevant international standards to Regulation HH and the other supervisory agencies' regulations. This provides System staff with a central repository for relevant regulations and other guidance and helps the Board to promote its interpretation of international standards in cases for which it is not the supervisory agency. Second, the Board adjusts its examination letters to match the

preferences of the supervisory agency. For example, when sending proposed findings letters to one of the supervisory agencies, the Board uses that agency's findings nomenclature—*major*, *moderate*, or *minor*—rather than the Board's classifications of Matters Requiring Immediate Attention or Matters Requiring Attention.

The Board Can Further Enhance Its Processes Related to Collaboration on Examinations

Title VIII granted the Board an enhanced role in supervising DFMUs to help mitigate systemic risk in the financial system and promote financial stability. To fulfill this enhanced role, title VIII allows the Board to participate in other supervisory agencies' examinations of their DFMUs but does not require those supervisory agencies to adopt the Board's findings.

The Board can more effectively fulfill its enhanced supervisory role and improve its processes for collaborating with other supervisory agencies by (1) focusing on concerns related to key issues or findings related to systemic risk and (2) consistently tracking whether the supervisory agencies adopt the Board's proposed examination findings.

- Board interviewees indicated that historically, when the Board is not the supervisory agency, it conveys its concerns in a manner consistent with its approach when it is the supervisory agency, which may include communicating minor issues not related to systemic risk. Board interviewees indicated that the Board could more effectively communicate its examination results by focusing on concerns related to key issues or systemic risk.
- The Board does not have a formal process to reconcile its proposed findings with the other supervisory agencies' examination reports. It also does not track the adoption of its proposed findings over time to identify themes and inform future examination consultations. For the three DFMUs that it participates in overseeing, FRB Chicago reconciles the Board's findings to the supervisory agencies' examination report; tracks the adoption of proposed findings; and, in coordination with the Board, considers this information for future examination consultations. However, neither the Board nor FRB New York does this for the three DFMUs that FRB New York oversees.

Since the enactment of title VIII, the Board has been refining the implementation of its enhanced supervisory authority. Specifically, the Board has been determining how to collaborate with other supervisory agencies and their DFMUs most effectively, as well as which issues pose systemic risk.

Focusing on key concerns could help the Board (1) emphasize to the other supervisory agencies which issues it views as most significant to mitigating systemic risk and (2) better focus the System's resources on issues it deems most significant. In addition, reconciling the System's proposed findings against the other supervisory agencies' final examination report and tracking their adoption by the supervisory agency could enhance the System's ability to consolidate findings and distill common themes to inform future examinations.

Management Actions Taken During the Audit

During the course of our audit, RBOPS took the following actions related to its collaboration with other supervisory agencies:

- RBOPS began an initiative that will identify the Board's core objectives and identify key findings or topics that affect systemic risk.
- RBOPS began building capabilities to track several data points for all proposed findings for title VIII exams. The data points include whether the other supervisory agency adopted the Board's findings and the supervisory agency's rationale if it did not adopt the Board's findings.

Recommendations

We recommend that the director of RBOPS

4. Assess the Board's core objectives in overseeing DFMUs for which it is not the supervisory agency. Based on this assessment, create guidance that addresses the Board's preferred method for communicating examination findings to other supervisory agencies.
5. Develop a process for reconciling the Board's examination findings for DFMUs for which it is not the supervisory agency with those of the other supervisory agencies and for tracking the adoption of the Board's findings.

Management Response

The Board concurs with our recommendations. The Board notes that it currently has efforts underway to further refine its core objectives in overseeing DFMUs for which it is not the supervisory agency and to implement tools that will allow it to better track the status of examination findings that were recommended to other supervisory agencies.

OIG Comment

We believe that the actions described by the Board are responsive to our recommendations. We will follow up to ensure that the recommendations are fully addressed.



Finding 3: The Board Meets Its Title VIII Responsibilities for Reviewing Material Changes but Can Better Prepare for Emergency Changes

The Board's process for reviewing material changes submitted by the DFMUs for which it is the supervisory agency ensures that it meets its title VIII responsibilities for reviewing material changes within 60 days; however, the Board can better prepare for emergency changes. The Board has not detailed its process for reviewing emergency changes in internal guidance. Internal control standards note the benefit of documenting processes and communicating necessary information. Board interviewees noted that emergency changes are rare and would generally follow the same process as an ANPC; they also noted that the Board would need flexibility in reviewing them. Creating a framework for emergency change reviews can help the Board prepare for and respond efficiently to emergency changes.

The Board's Process for Reviewing Material Changes Ensures That It Meets Its Title VIII Responsibilities

The Board has developed a process for reviewing material changes submitted by the DFMUs for which it is the supervisory agency to ensure it meets its title VIII responsibilities for reviewing material changes within 60 days. For the five ANPCs filed from January 1, 2018, through June 30, 2019, the Board reviewed the filings and provided its no-objection letters within 60 days. The Board helped to ensure that the ANPC review process was defined and repeatable by including a description of the process in the DFMU Supervisory Framework. Additionally, the Board seeks to strengthen the DFMUs' internal analysis of material changes by actively engaging with them to discuss specific proposed changes and interpretations of the materiality requirements of Regulation HH.

The Board Can Better Prepare for Emergency Changes

Internal control standards note that management should (1) implement control activities through policies, including responsibilities for an operational process's objectives, and (2) internally communicate the necessary quality information to achieve the entity's objectives.¹² Title VIII and Regulation HH provide procedural guidance to DFMUs for submitting an emergency change; however, there is no internal guidance related to the Board's process for reviewing an emergency change once it is submitted. Some System interviewees expressed interest in improving planning around emergency changes and indicated

¹² Committee of Sponsoring Organizations of the Treadway Commission, *Internal Control—Integrated Framework*, May 2013; U.S. Government Accountability Office, *Standards for Internal Control in the Federal Government*, September 10, 2014.

that additional guidance may be useful. Specifically, they noted that they would like to discuss (1) situations that would prompt emergency changes and (2) the process by which they would review such changes. In addition, certain Board interviewees indicated that an emergency change may warrant a higher level of official involvement than an ordinary ANPC or may need to be expedited.

RBOPS officials noted that emergency changes could arise from a variety of situations, so it would be difficult to discuss every condition that might prompt an emergency change. Board interviewees also noted that they have not documented the process for reviewing emergency changes because they are idiosyncratic and the Board would need flexibility when reviewing them; in addition, Board interviewees stated that they would generally follow the same process as an ANPC. Nevertheless, discussing the conditions that may prompt emergency changes and creating a general framework for reviewing emergency changes may help Board staff be better prepared for and able to respond efficiently to an emergency change. In addition, discussing the conditions that may prompt emergency changes and creating a general framework may help the Board anticipate any areas in which the emergency change review process would differ from the ANPC review process.

Recommendation

We recommend that the director of RBOPS

6. Discuss with relevant Board and Reserve Bank staff and document
 - a. the various situations that could prompt emergency changes.
 - b. the review process for emergency changes.

Management Response

The Board concurs with our recommendation. It notes that RBOPS, in conjunction with Board Legal and Reserve Bank staff, will hold a series of discussions in which they will explore emergency changes in an attempt to improve their preparedness.

OIG Comment

We believe that the actions described by the Board are responsive to our recommendation. We will follow up to ensure that the recommendation is fully addressed.



Other Matter for Management Consideration

In an internal 2019 priorities document, RBOPS included a long-term priority to develop and implement processes that support ongoing, timely, and effective communication of policy interpretations, lessons learned, and effective practices for the System's FMU portfolio. RBOPS, in coordination with FRB New York, has taken steps to improve the ANPC process, including implementing regular meetings with DFMUs to discuss future changes or opportunities to improve the ANPC process and refining the scope of follow-up reviews related to the change. RBOPS can further support this priority by evaluating opportunities to streamline the ANPC prefiling period.

The prefiling period, a voluntary process that enables the DFMUs to obtain preliminary feedback before submitting an official ANPC filing, can take multiple years. For the five ANPCs we reviewed, the time between the prefiling period's materiality determination request or submission and the DFMUs' official filing ranged from approximately 2 months to more than 3 years. We also found that there may be several exchanges, including questions, responses, comments, and document requests, to help the Board analyze the ANPC. For example, the prefiling period for one ANPC had five exchanges, with 1 to over 3 months elapsing between responses, and the Board took 4 months to request additional information after the DFMU provided the Board with its response.

Board interviewees noted that the prefiling period can be lengthy because of the preliminary nature of the material change, the complexity of the material change, the quality and quantity of the information provided by the DFMUs, and competing priorities for the DFMUs. In collaboration with the DFMUs, the Board should consider evaluating additional opportunities to help streamline the prefiling period, such as

- creating a framework for DFMUs to consider when submitting draft filings to reduce the number of exchanges of questions, comments, and document requests during the prefiling period
- establishing general time frames for the Board to submit information requests and for DFMUs to respond to these requests to reduce the amount of time needed for each information exchange



Appendix A: Scope and Methodology

Our objective was to assess the effectiveness of the Board’s oversight of the DFMU supervision program. The scope focused on the current state of the program and included delegations of authority and program oversight roles and responsibilities within the System. We also focused on coordination (1) within the System, (2) between the System and other supervisory agencies, and (3) between the System and DFMUs for which the Board is the supervisory agency. To accomplish this objective, we

- reviewed laws, regulations, guidance, and System documents:
 - the U.S. Government Accountability Office’s *Standards for Internal Control in the Federal Government*
 - the Committee of Sponsoring Organizations of the Treadway Commission’s *Internal Control—Integrated Framework*
 - section 11 of the Federal Reserve Act
 - title VIII of the Dodd-Frank Act
 - part 234 of the *Code of Federal Regulations*, Designated Financial Market Utilities (Regulation HH)
 - part 265 of the *Code of Federal Regulations*, Rules Regarding Delegation of Authority
 - *Supervisory Rating System for Financial Market Infrastructures*
 - *Designated Financial Market Utility Supervision and Oversight Program Supervisory Framework*
 - the FMU-SC and PCSC charters
 - memorandums of understanding among the Board, the U.S. Securities and Exchange Commission, and the U.S. Commodity Futures Trading Commission
 - Memorandum of Understanding Between the Board of Governors of the Federal Reserve System and the U.S. Commodity Futures Trading Commission and the U.S. Securities and Exchange Commission Regarding Central Counterparties for Credit Default Swaps (effective November 2008)
 - Memorandum of Understanding Between the Board of Governors of the Federal Reserve System and the U.S. Commodity Futures Trading Commission Regarding Designated Financial Market Utilities (effective September 2014)
 - Memorandum of Understanding Between the U.S. Securities and Exchange Commission and the Board of Governors of the Federal Reserve System Regarding Coordination and Information Sharing in Areas of Common Regulatory and Supervisory Interest (effective July 2008)
 - FMU-SC and FMU-CC meeting minutes
 - FRB New York’s *Supervision Group Procedures—Enforcement Actions*

- the Board’s Designated Financial Market Utilities Material Change Submission Instructions webpage
 - other informational documents provided to us by the System
- performed walkthroughs of key processes in the supervisory cycle:
 - creation of the annual supervisory plan and annual assessment
 - examinations of DFMUs
 - identification, tracking, and remediation of Matters Requiring Attention
 - receipt and review of ANPCs submitted by DFMUs
- interviewed employees from RBOPS, the Board’s Legal Division, S&R, FRB New York, FRB Chicago, the U.S. Securities and Exchange Commission, the U.S. Commodity Futures Trading Commission, and one DFMU
 - we judgmentally selected 6 FRB New York interviewees out of a population of 29 based on the amount of time they spent conducting continuous monitoring at the two DFMUs for which the Board is the supervisory agency. To make the selection, we used time data provided by FRB New York. We determined that the data are sufficiently reliable by consulting with an FRB New York representative to learn how the data are collected and maintained. The results of our interviews were not projected to the entire population of examiners conducting continuous monitoring.
- benchmarked the FMU-SC governance structure with that of the Large Institution Supervision Coordinating Committee
- for all ANPCs submitted from January 1, 2018, through June 30, 2019, for DFMUs for which the Board is the supervisory agency, reviewed key correspondence between the DFMUs and the Board during the materiality determination, draft filing, and official filing phases to assess whether potential efficiencies could be achieved
- for all final examination reports issued by supervisory agencies other than the Board from January 1, 2018, through June 30, 2019, reviewed all major findings or Matters Requiring Immediate Attention that the System proposed but the supervisory agency did not adopt
 - for each instance, obtained a written narrative of how the System followed up on the difference of opinion with the supervisory agency and interviewed select supervisory team members to determine whether there were opportunities for the System to improve its communication with the other supervisory agency

We conducted our fieldwork from June 2019 to January 2020. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective.

Appendix B: Management Response



BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, DC 20551

DIVISION OF RESERVE BANK
OPERATIONS AND PAYMENT SYSTEMS

March 4, 2020

Mr. Michael VanHuysen
Assistant Inspector General for Audits and Evaluations
Board of Governors of the Federal Reserve System
20th Street and Constitution Ave, NW
Washington, DC 20551

Dear Mr. VanHuysen,

Thank you for the opportunity to comment on your draft report, *The Board's Oversight of Its Designated Financial Market Utility Supervision Program is Generally Effective, but Certain Program Aspects Can Be Improved*. We appreciate the effort that the Office of Inspector General (OIG) has put into this report and the recommendations it has provided for improving our supervisory processes.

The draft report contains three (3) findings and makes six (6) recommendations. We agree with the recommendations and have provided our responses below.

1. The Board has established governance structures for its Designated Financial Market Utility (DFMU) supervision program but can better define certain aspects of program governance.
 1. Publish in an order or rule subject to the Administrative Procedure Act the internal delegations made to RBOPS for reviewing and approving ANPCs.
 2. Define and document at the division director and governor levels which parties will have a role in reviewing and approving enforcement actions for DFMUs.
 3. Develop a committee charter for the FMU-CC that includes the committee's purpose and the members' roles, responsibilities, and authorities.

Staff response: The Division of Reserve Bank Operations and Payment Systems (RBOPS) and the Legal Division agree with these recommendations and recognize that there are opportunities to clarify delegations of authority, as well as certain roles and responsibilities within the Board's DFMU supervision program. As your report notes, there is currently an effort underway to update delegations

www.federalreserve.gov

under section 11(k) of the Federal Reserve Act, the results of which will be responsive to OIG's first recommendation. In addition, we agree that defining and documenting roles and responsibilities (i) helps ensure that all parties involved in the DFMU supervision program have a shared understanding and (ii) supports consistent and effective governance of the program over time. Over the course of 2020, RBOPS and the Legal Division will work with the Division of Supervision and Regulation (S&R) to define and document which parties will have a role in reviewing and approving enforcement actions for DFMUs and to draft a committee charter for the FMU-CC.

2. The Board has implemented processes for collaborating with the other supervisory agencies, but those processes can be enhanced.
 4. Assess the Board's core objectives in overseeing DFMUs for which it is not the supervisory agency. Based on this assessment, create guidance that addresses the Board's preferred method for communicating examination findings to other supervisory agencies.
 5. Develop a process for reconciling the Board's examination findings for DFMUs for which it is not the supervisory agency with those of the other supervisory agencies and tracking the adoption of the Board's findings.

Staff response: RBOPS agrees with these recommendations. As OIG notes, since the enactment of Title VIII, the Board's implementation of its enhanced supervisory authority has evolved. Over that time, Board staff has regularly reviewed and adjusted the scope of its supervisory priorities for DFMUs for which the Federal Reserve is not the Title VIII supervisory agency. We have also refined the way in which we communicate our supervisory views to the other supervisory agencies through examination letters. We appreciate OIG's recognition of current efforts underway to further refine the Board's core objectives in overseeing DFMUs for which it is not the supervisory agency and to implement tools that better allow Board staff to track the status of our examination findings that were recommended to the other supervisory agencies. We expect these efforts to come to fruition over the course of 2020.

3. The Board meets its Title VIII responsibilities for reviewing material changes, but can better prepare for emergency changes
 6. Discuss with relevant Board and Reserve Bank staff and document
 - a. The various situations that could prompt emergency changes.
 - b. The review process for emergency changes.

Staff response: RBOPS agrees with these recommendations. As OIG notes, Board-supervised DFMUs have never filed an emergency ANPC and Board staff would expect to follow generally the same process in reviewing an emergency ANPC as a non-emergency ANPC. However, we agree that there is value in considering potential material change scenarios and assessing how our processes may need to adapt in response to an emergency change filing. Over the course of 2020, RBOPS, in conjunction with Board Legal and our Reserve Bank colleagues, will hold a series of discussions in which we explore these issues in an attempt to improve our preparedness.

Thank you for the opportunity to provide comments on this report. We are committed to continually enhancing the Board's DFMU supervisory program.

Regards,



Matthew Eichner
Director
Division of Reserve Bank Operations and
Payment Systems



Mark Van Der Weide
General Counsel
Legal Division



Abbreviations

ANPC	advance notice of proposed change
DFMU	designated financial market utility
DFMU Supervisory Framework	<i>Designated Financial Market Utility Supervision and Oversight Program Supervisory Framework</i>
FMU	financial market utility
FMU-CC	Financial Market Utility Coordinating Committee
FMU-SC	Financial Market Utility Supervision Committee
FRB Chicago	Federal Reserve Bank of Chicago
FRB New York	Federal Reserve Bank of New York
FSOC	Financial Stability Oversight Council
PCSC	Committee on Federal Reserve Payment, Clearing, and Settlement
RBOPS	Division of Reserve Bank Operations and Payment Systems
S&R	Division of Supervision and Regulation

Report Contributors

Jackie Ogle, OIG Manager

John Galvin, Project Lead

Laureen Cepeda, Auditor

Melissa Dorow, Auditor

Gary Vargas, Auditor

Shikha Singhvi, Attorney

Jason Derr, Senior Counsel

Cynthia Gray, Senior OIG Manager for Financial Management and Internal Controls

Michael VanHuysen, Assistant Inspector General for Audits and Evaluations

Contact Information

General

Office of Inspector General
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue NW
Mail Stop K-300
Washington, DC 20551

Phone: 202-973-5000

Fax: 202-973-5044

Media and Congressional

OIG.Media@frb.gov



Hotline

Report fraud, waste, and abuse.

Those suspecting possible wrongdoing may contact the OIG Hotline by mail, [web form](#), phone, or fax.

OIG Hotline
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue NW
Mail Stop K-300
Washington, DC 20551

Phone: 800-827-3340

Fax: 202-973-5044