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August 1, 2011

FSOC Submits First Annual Report to Congress; Includes Recommendations on Money Market Funds, Risk Management

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TO: CLOSED-END INVESTMENT COMPANY MEMBERS No. 63-11
ETF ADVISORY COMMITTEE No. 54-11
MONEY MARKET FUNDS ADVISORY COMMITTEE No. 47-11
RISK MANAGEMENT ADVISORY COMMITTEE No. 5-11
SEC RULES MEMBERS No. 96-11 RE: FSOC SUBMITS FIRST ANNUAL REPORT TO CONGRESS; INCLUDES RECOMMENDATIONS ON MONEY MARKET FUNDS, RISK MANAGEMENT

Last week, the Financial Stability Oversight Council (FSOC or Council) submitted its first annual report to Congress. [1] As required by Section 112 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, the 192-page report addresses significant financial market and regulatory developments, provides an assessment of those developments on the stability of the financial system, and identifies potential emerging threats to U.S. financial stability. Section 112 further requires the report to include recommendations to enhance the integrity, efficiency, competitiveness and stability of U.S. financial markets, to promote market discipline, and to maintain investor confidence. This memorandum briefly summarizes the FSOC's recommendations and its specific observations about money market funds, exchange-traded funds (ETFs), and asset management.

Recommendations

The report recommends reforms in certain areas to address "structural vulnerabilities." These include:

- Implementing structural reforms "to mitigate run risk" in money market funds. In this regard, the report specifies that "the Council should examine, and the SEC should continue to pursue, further reform alternatives to reduce [money market funds'] susceptibility to runs, with a particular emphasis on (1) a mandatory floating net asset value (NAV), (2) capital buffers to absorb fund losses to sustain a stable NAV, and (3) deterrents to redemption, paired with capital buffers, to mitigate investor runs."
- Eliminating most intraday credit exposure of clearing banks to borrowers and

strengthening collateral management practices in the tri-party repo market
- Establishing national standards for mortgage servicing

The report also identifies several areas in which the FSOC believes market participants "should employ heightened risk management" and FSOC member agencies should enhance their level of supervisory oversight:

- Financial institutions should have robust capital, liquidity and resolution planning processes.
- Market participants should have robust processes for measuring and, where necessary, mitigating their exposure to unexpected interest rate shifts.
- There should be robust due diligence practices and processes for monitoring and responding to developments in credit underwriting standards.
- Market participants should employ appropriate due diligence for emerging financial products. The report points to ETFs and structured notes as examples of financial products about which market participants should understand the risks presented, including under strained market conditions.
- Market participants and regulators should keep pace with competitive, technological, and regulatory market structure developments, and should take action as necessary to help ensure that the market structure regulatory framework and operational policies keep pace with changes to trading and other market practices.

Observations in Specific Areas

Money Market Funds (pp. 50-51): The report states that "the run on money market funds added considerably to market stress during the financial crisis." It then briefly discusses some of the "key features" that, according to the report, make the funds susceptible to runs: the stable NAV; maturity transformation; low risk tolerance on the part of money market fund shareholders; the expectation of sponsor support; and the possible expectation of government support in light of the "unprecedented government support of money market funds during the crisis in 2008 and 2009." Following a short description of the SEC's 2010 reforms, the report states that "more should be done to address systemic risks posed by money market funds and their structural vulnerabilities."

Exchange Traded Funds (pp. 66-67): The report observes that ETFs have grown to account for an increased share of the fund industry. It describes the U.S. market as largely comprised of passively managed ETFs with a very small percentage of synthetic ETFs, due to constraints on derivatives-based activity and other Investment Company Act requirements. The report contrasts this with the nearly half of European-domiciled ETFs that use swaps and other derivatives to replicate an index. The report cautions that "U.S. investors and regulators should be alert to the possibility of liquidity or counterparty exposure risks emanating from foreign-domiciled ETFs spilling over to domestic institutions and markets." It also addresses the role of authorized participants and states that liquidity of ETF shares could become constrained, and prices could become more volatile, if authorized participants were to depart from the market.

Asset management (pp. 63-69): This section generally describes, and provides data regarding, various types of investment products. In discussing investment managers, the report states that separately managed accounts generally do not raise "direct financial stability concerns" because any losses fall solely on an account owner. It goes on to say that investment managers pursuing similar strategies across accounts and in "associated" managed funds "could pose broader risks to financial markets by increasing the volume, and thus impact, of managers' trading."

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endnotes

[1] Financial Stability Oversight Council, 2011 Annual Report, available at http://www.treasury.gov/initiatives/fsoc/Documents/FSOCAR2011.pdf.