

**MEMO# 30128**

August 12, 2016

# **FSOC 2016 Annual Report to Congress - Recommendations of Interest to the Fund Industry**

[30128]

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TO: CHIEF RISK OFFICER COMMITTEE No. 22-16  
CLOSED-END INVESTMENT COMPANY MEMBERS No. 13-16  
EQUITY MARKETS ADVISORY COMMITTEE No. 27-16  
ETF (EXCHANGE-TRADED FUNDS) COMMITTEE No. 17-16  
MONEY MARKET FUNDS ADVISORY COMMITTEE No. 20-16  
RISK ADVISORY COMMITTEE No. 5-16  
SEC RULES MEMBERS No. 42-16  
SMALL FUNDS MEMBERS No. 34-16  
UNIT INVESTMENT TRUST MEMBERS No. 6-16 RE: FSOC 2016 ANNUAL REPORT TO  
CONGRESS - RECOMMENDATIONS OF INTEREST TO THE FUND INDUSTRY

In late June, the Financial Stability Oversight Council (FSOC) issued its 2016 annual report to Congress. [\[1\]](#) As required by Section 112 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), the FSOC 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 make 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 describes the contents of the FSOC report and the recommendations that may be of particular interest to ICI members.

## **Content of the FSOC Report**

The FSOC report begins with an executive summary and discussion of the FSOC's recommendations. It then provides an update of financial developments, including with respect to: U.S. Treasuries, sovereign debt markets, foreign exchange, equities, commodities, wholesale funding markets, derivatives markets, nonbank financial companies, and investment funds (including the experience of Third Avenue Focused Credit Fund, a high-yield bond fund that suspended investor redemptions in December 2015). The report next reviews regulatory developments and FSOC activity since the 2015 annual

report. Finally, it discusses potential emerging threats, including: cybersecurity, asset price declines and increasing volatility, risk taking in a low-yield environment, changes in financial market structure, financial innovation, and global economic and financial developments.

## **Recommendations of Interest to ICI Members**

Risks Associated with Asset Management Products and Activities. FSOC has given particular attention to potential risks to U.S. financial stability that may arise from asset management products and activities. In April 2016, FSOC issued a 27-page statement outlining its views regarding these potential risks and next steps to be considered in response to such potential risks. [\[2\]](#); The discussion in the annual report is drawn from the April statement.

Liquidity and Redemption Risk. To help mitigate liquidity and redemption risks pooled investment vehicles, FSOC “believes that the following steps should be considered: (1) robust liquidity risk management practices for mutual funds, particularly with regard to preparations for stressed conditions by funds that invest in less liquid assets; (2) establishment of clear regulatory guidelines addressing limits on the ability of mutual funds to hold assets with very limited liquidity, such that holdings of potentially illiquid assets do not interfere with a fund’s ability to make orderly redemptions; (3) enhanced reporting and disclosures by mutual funds of their liquidity profiles and liquidity risk management practices; (4) steps to allow and facilitate mutual funds’ use of tools to allocate redemption costs more directly to investors who redeem shares; (5) additional public disclosure and analysis of external sources of financing, such as lines of credit and interfund lending, as well as events that trigger the use of external financing; and (6) measures to mitigate liquidity and redemption risks that are applicable to collective investment funds and similar pooled investment vehicles offering daily redemptions.” FSOC will continue to monitor liquidity and redemption risks that could arise with exchange-traded funds (ETFs), “such as the potential for ETFs to disconnect from the price of their underlying securities for an extended period.” FSOC “welcomes the SEC’s policy initiatives” with respect to liquidity risk management and enhanced data reporting and states that, to the extent these or other measures are implemented, FSOC will “review and consider whether risks to financial stability remain.”

Note to members: In a letter dated July 18, ICI responded to FSOC’s work and conclusions to date regarding liquidity and redemption risk in mutual funds. Among other things, the letter explains that FSOC has failed to substantiate its concerns regarding destabilizing redemptions from mutual funds and, indeed, faces high hurdles to do so. The letter includes two appendices: one examining the academic studies cited by FSOC in its April 2016 update, and the other analyzing events in the high-yield bond fund market (with a focus on the period from November 2015 to February 2016). It concludes by requesting that FSOC reconsider its conclusion about financial stability risks relating to liquidity and redemptions in mutual funds. [\[3\]](#)

Leverage Risk. FSOC’s consideration of leverage risk has focused largely on hedge funds. In that regard, FSOC has observed that “leverage appears to be concentrated in a small number of large hedge funds, based on certain measures.” FSOC has established an interagency working group to “share and analyze relevant regulatory information in order to better understand hedge fund activities [to] further assess whether there are potential risks to financial stability.” With respect to registered funds, FSOC “welcomes the SEC’s efforts to limit the amount of leverage that [registered funds] may obtain through

derivatives transactions, strengthen their asset segregation requirements, and require derivatives risk management programs for certain funds.” FSOC intends to monitor these regulatory changes and their implications for financial stability.

**Operational Risk.** While acknowledging that operational incidents to date have not raised financial stability concerns with regard to the asset management industry, FSOC recognizes that this does not preclude the potential for future incidents to pose more serious threats. “As a result, [FSOC] will continue its analysis of potential service provider risks, including by engaging with relevant industry participants and other stakeholders, which may also be useful in better understanding potential service provider risks within the financial industry as a whole. . . . [FSOC] also intends to further evaluate industry practices for managing these risks, such as business continuity and disaster recovery planning for disruptions.”

**Securities Lending.** FSOC notes that regulators lack comprehensive information on securities lending activities across the financial system, thereby inhibiting regulators from fully assessing the severity of potential risks to financial stability in this area. FSOC, therefore, “encourages enhanced and regular data collection and reporting, as well as interagency data sharing, regarding securities lending activities.” In light of recent joint securities lending data collection by the SEC, Office of Financial Research, and the Federal Reserve System, FSOC recommends efforts to propose and adopt a rule for permanent and expanded data collection regarding securities lending practices. FSOC also recommends that agencies work with their foreign counterparts in data-gathering efforts across jurisdictions.

**Resolvability and Transition Planning.** According to FSOC, “[r]esolvability and transition challenges could exacerbate the risks arising from the stress or failure of an asset manager or investment vehicle. In the case of a disorderly liquidation or abrupt failure of an investment vehicle, resolution challenges could amplify the transmission of risks related to liquidity and redemption or leverage.” The FSOC report notes that the SEC is “working to develop a proposed rule . . . to require registered investment advisers to create and maintain transition plans that address, among other things, a major disruption in their business. [FSOC] welcomes the SEC’s efforts in this area and will monitor the effects of any regulatory changes and their implications for financial stability.”

**Changes in Financial Market Structure and Implications for Financial Stability.** FSOC notes that markets have generally performed well in the past year despite increased volatility. Furthermore, access to the markets has increased and costs to investors have fallen. FSOC notes, however, that new risks may be materializing, particularly within fixed income markets, and recommends examination of intraday trading volatility across the “entire interest rate products complex.” The report further states that FSOC “supports regulators in efforts to create greater transparency and resilience of all market participants” and “increased agency coordination of oversight and regulatory developments pertinent to financial stability risks as markets evolve.”

**Central Counterparties (CCPs).** “[FSOC] recommends that the Federal Reserve, CFTC, and SEC continue to coordinate in the supervision of all CCPs that are designated as systemically important financial market utilities.” FSOC recommends that agencies work with each other to “evaluate whether existing rules and standards for CCPs and their clearing members are sufficiently robust to mitigate potential threats to financial stability.” FSOC also recommends that agencies finalize any outstanding rules regarding CCP risk management standards and continue working with international standard setting bodies to “identify areas of common concern as additional derivatives clearing requirements are

implemented in other jurisdictions.” Finally, FSOC recommends that agencies continue to study the interconnectedness of CCPs and their clearing members and the risks associated with this interconnectedness.

#### Reform of Wholesale Funding Markets.

**Repo Markets.** “FSOC recommends continued monitoring as the CCP responsible for settling interbank [General Collateral Finance (GCF)] repo transactions suspends such transactions in July 2016, as well as sustained efforts by regulators and market participants to reduce intraday credit usage in the interbank GCF repo settlement process.” FSOC also recommends continued monitoring of market developments and recent reforms to determine whether the risk of fire sales of collateral by creditors of a defaulted broker-dealer is reasonably mitigated. FSOC recommends expanding and making permanent the voluntary pilot programs initiated by the Office of Financial Research, Federal Reserve System, and SEC to improve transparency and risk monitoring in the aggregate repo market.

**Money Market Mutual Funds and Other Cash Management Vehicles.** The FSOC report notes that the SEC recently adopted structural reforms of money market funds (MMFs) intended to make these vehicles less susceptible to potentially destabilizing runs. The reforms will be fully implemented later this year, and the Council will “continue to monitor and evaluate their effectiveness and broader implications for financial stability, including any unintended consequences.” FSOC noted that in late 2015 and early 2016, there were measurable shifts between different MMF types in anticipation of the implementation deadline. “FSOC recommends that regulators continue to assess the risks posed by other types of cash management vehicles—such as short-term investment funds (STIFs), local government investment pools, pools for reinvestment of cash collateral from securities lending, and private liquidity funds—and whether regulatory gaps exist for these vehicles.” FSOC recommends that regulators consider whether additional data on these other types of cash management vehicles is needed and how to address any data gaps.

- **Reforms Relating to Reference Rates.** FSOC has noted that there are structural weaknesses in the widely used interbank rates in wholesale unsecured funding markets. In light of these weaknesses and the sustained reliance upon London Interbank Offered Rate (LIBOR), FSOC recommends that the “Alternative Reference Rates Committee (ARRC) and other market participants continue to work to identify alternative, near risk-free rates. FSOC further recommends that the ARRC develop a credible implementation plan to achieve a smooth transition to these new reference rates.”
- **Data Quality, Collection, and Sharing.** FSOC notes that data gathering and information sharing continues to be important to the goal of financial stability and addressing potential threats. “FSOC recommends that regulators and market participants continue to work together to improve the coverage, quality, and accessibility of financial data, as well as data sharing between relevant agencies.” The report provides more detailed discussion of specific areas, including securities financing data, the use of legal entity identifiers, and derivatives data.
- **Risk Management in an Environment of Low Interest Rates and Rising Asset Price Volatility.** “FSOC recommends that regulators and market participants continue to closely monitor and assess the heightened risks resulting from reach-for-yield behavior” where “market participants to take on risk to gain higher net yields by

relying more heavily on short-term financing, increasing leverage, or shifting toward assets that are less liquid or contain greater market or credit risk.” Furthermore, FSOC recommends that regulators and market participants continue to closely monitor and assess financial institutions’ exposures to asset classes experiencing increased volatility. In efforts to reduce the risk of market destabilization, FSOC recommends that regulators work to ensure that market participants have robust risk management protocols at all times.

- Financial Innovation and Migration of Activities. FSOC encourages continued evaluation by regulators of “the implications of how new products and practices affect regulated entities and financial markets, and to assess whether they could pose risks to financial stability.” FSOC also recommends that consumer protection policies be reviewed on a rolling basis, particularly in light of new products.

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#### **endnotes**

[1] Financial Stability Oversight Council, 2016 Annual Report, available at <https://www.treasury.gov/initiatives/fsoc/studies-reports/Documents/FSOC%202016%20Annual%20Report.pdf>

[2] FSOC, Update on Review of Asset Management Products and Activities (April 18, 2016), available at <https://www.treasury.gov/initiatives/fsoc/news/Documents/FSOC%20Update%20on%20Review%20of%20Asset%20Management%20Products%20and%20Activities.pdf>.

[3] For a more detailed summary, see ICI Memorandum 30053, dated July 19, 2016. The letter is available at [https://www.ici.org/pdf/16\\_ici\\_fsoc\\_ltr.pdf](https://www.ici.org/pdf/16_ici_fsoc_ltr.pdf).