

MEMO# 26342

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FSOC Annual Report to Congress Includes Money Market Fund Recommendations; OFR Issues First Annual Report to Congress

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TO: CLOSED-END INVESTMENT COMPANY MEMBERS No. 47-12
ETF ADVISORY COMMITTEE No. 27-12
MONEY MARKET FUNDS ADVISORY COMMITTEE No. 46-12
RISK MANAGEMENT ADVISORY COMMITTEE No. 1-12
SEC RULES MEMBERS No. 68-12 RE: FSOC ANNUAL REPORT TO CONGRESS INCLUDES
MONEY MARKET FUND RECOMMENDATIONS; OFR ISSUES FIRST ANNUAL REPORT TO
CONGRESS

The Financial Stability Oversight Council (FSOC) recently issued its second annual report to Congress. [\[1\]](#) As required by Section 112 of the Dodd-Frank Wall Street Reform and Consumer Protection 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. Part I of this memorandum briefly summarizes the FSOC's recommendations and highlights certain other parts of the FSOC report.

In a related action, the Office of Financial Research (OFR) recently issued its first annual report to Congress. [\[2\]](#) Part II of this memorandum briefly describes the OFR report.

I. FSOC REPORT

Recommendations

Below are the FSOC's recommendations that may be of particular interest to ICI members.

- Money market funds. Like the FSOC's 2011 annual report, the FSOC report recommends "the implementation of structural reforms to mitigate the run risk in money market funds." The report notes that the SEC's 2010 money market fund reforms appear to be working as intended but did not address "two core characteristics" of money market funds that "continue to contribute to their susceptibility to destabilizing runs." [3] The report mentions the two alternative reforms Securities and Exchange Commission (SEC) Chairman Mary Schapiro has recommended—a mandatory floating net asset value and/or a capital buffer to absorb losses, possibly combined with a redemption restriction. It expresses the FSOC's support for "this effort" and states that the FSOC "recommends that the SEC publish structural reform options for public comment and ultimately adopt reforms that address [money market funds'] susceptibility to runs."
- Tri-party repo market. The FSOC report states that the FSOC continues to focus intensely on the elimination of most intraday credit exposure and the reform of collateral practices in the tri-party repo market. It indicates that the industry's proposed multi-year timeline for eliminating intraday credit risk associated with tri-party settlement is "unacceptable." The FSOC recommends that the industry "implement near-term steps . . . within the next 6 to 12 months and an iterative strategy over six-month increments to continue both to reduce intraday credit substantially and to implement improvements in risk-management practices across all market participants." In addition, regulators and industry should collaborate on the development of standards for collateral management in tri-party repo markets, "particularly for lenders, such as [money market funds,] that have legal or operational restrictions on the instruments they can hold." [4]
- Bolster resilience to interest rate shifts. Regulatory agencies and private sector risk managers should continue their scrutiny of how potential changes in interest rates could adversely affect the risk profiles of financial firms and extreme but plausible interest rate scenarios should be used in stress testing.
- Maintain discipline in complex trading strategies, underwriting, and new financial products. The FSOC report states that "[e]vents in the past year, including the publicly announced trading loss at JP Morgan Chase, demonstrate the importance of robust risk management when addressing complex trading strategies, illiquid positions, or concentrated exposures to areas of heightened risks." Financial institutions senior management should establish, and directors should approve, strong risk-management and reporting structures to help ensure that risks are assessed independently and at appropriately senior levels. In addition, institutions should establish clear accountability for failures of risk management. Trading strategies, credit underwriting standards and emerging financial products should continue to form an ongoing focus of supervisors' efforts and the FSOC's monitoring of the financial system.
- High-speed trading. The Commodity Futures Trading Commission (CFTC) and the SEC should consider error control and risk-management standards for exchanges, clearing firms, and other market participants that are relevant for a high-speed trading environment. The CFTC and SEC should continue to track developments in current and evolving market structure and analyze the need for policy responses when appropriate.
- The Dodd-Frank Act. The FSOC recommends "complete and expeditious implementation of the Dodd-Frank Act, along with the provision of the resources needed to accomplish this essential task."
- International coordination. The FSOC recommends, among other things:
 - Continued development of international standards and national implementation

- for margin, central clearing, and reporting of OTC derivatives.
- Continued efforts to develop strong and internationally consistent procedures for the supervision and regulation of globally systemically important financial institutions, including appropriate capital and liquidity requirements and internationally accepted resolution regimes.
- Data resources and analytics. The OFR should continue to work with FSOC member agencies to promote and establish, where necessary, data standards for identification of legal entities, financial products, and transactions, and to improve the access to and aggregation of data by the regulators. Cross-border exchange of supervisory data among supervisors and regulators should continue to be facilitated in a manner that safeguards the confidentiality and privilege of such information.

Observations in Specific Areas: Money Market Funds and ETFs

In addition to being the focus of specific recommendations, money market funds are mentioned in several other parts of the FSOC report. For example, in the “Financial Developments” section (pp. 75-76), the report describes the changes in asset levels in different types of money market funds between year-end 2010 and May 2012. It notes the significant redemption activity in July and August 2011 “due to the European debt crisis and the political uncertainty in the United States leading up to the debt limit extension in early August 2011.” It states that prime money market funds have since bolstered their liquidity levels, and that money market funds have reduced the average maturities of portfolio securities. The FSOC report also describes the impact of the low interest rate environment on money market funds. The report observes that, “while on average, [money market funds] have shown a decreased risk appetite in 2012, some funds have sought to increase their risk profile.” [\[5\]](#)

In addition, the section of the FSOC report addressing “Potential Emerging Threats” to U.S. financial stability mentions money market fund exposure to Europe, and refers to “ongoing structural weaknesses” in money market funds. It also calls attention to how money market funds responded to increased uncertainty about euro area stability in June 2011. [\[6\]](#)

Regarding ETFs, the FSOC report indicates that they “remain a popular means of achieving exposure to various market indices” and points to their continued growth. While the U.S. ETF market still consists predominately of passively managed products that track widely followed indexes, alternative index strategies have emerged with “fundamental indexing” products that rebalance their holdings according to proprietary methodologies. The FSOC report states that some view actively managed ETFs as a potential avenue of growth and observes that launches of and filings for actively managed ETFs in 2012 may indicate that “active management may indeed overcome” concerns about daily disclosure of portfolio holdings. The report notes the continued robust growth of the global ETF market and describes remaining concerns about potential risks of the synthetic ETF structure, which is common in Europe. It also states that “the emergence of new types of ETFs and similar products, such as leveraged and inverse-leveraged ETFs, actively managed ETFs, and ETFs based on very particularized asset classes, is a growing trend in the market and a focus of regulators.”

II. OFR REPORT

The Dodd-Frank Act created the OFR to support the work of the FSOC and its member agencies, to collect and standardize financial data, to perform essential research, and to

develop new tools for measuring and monitoring risk in the financial system. Beginning this July, Section 154(d)(2) of the Dodd-Frank Act requires the OFR to prepare an annual report that assesses the state of the U.S. financial system, including an analysis of any threats to U.S. financial stability, the status and efforts of the OFR in meeting its mission, and key findings from the OFR's research and analysis of the financial system.

The OFR report describes the OFR's efforts in four areas: (1) analyzing threats to financial stability; (2) conducting research on financial stability; (3) addressing data gaps; and (4) promoting data standards. As in the FSOC report, money market funds are mentioned frequently throughout the OFR report. For example, the OFR report states that the OFR views leverage, liquidity, and

interconnectedness as among the most important factors affecting financial stability. Based on these factors, "the OFR's highest data and research priorities lie in short-term funding markets," including money market funds, repo markets, and securities lending; and OTC derivatives, particularly credit default swaps. The report indicates that the OFR "also is interested in addressing data gaps about the asset management industry."

Rachel H. Graham
Senior Associate Counsel

Frances M. Stadler
Senior Counsel - Securities Regulation

endnotes

[1] Financial Stability Oversight Council, 2012 Annual Report ("FSOC report"), available at <http://www.treasury.gov/initiatives/fsoc/Documents/2012%20Annual%20Report.pdf>.

[2] Office of Financial Research, 2012 Annual Report ("OFR report") available at http://www.treasury.gov/initiatives/wsr/ofr/Documents/OFR_Annual_Report_071912_Final.pdf. The OFR report notes that it "complements" the FSOC report.

[3] In particular, the FSOC report states that (1) money market funds have no mechanism to absorb a sudden loss in the value of a portfolio security, and (2) there continues to be a "first mover advantage" in the event of a perceived threat to a money market fund's value or liquidity.

[4] See also Box G: Ongoing Vulnerabilities in the Tri-Party Repo Market (p. 133).

[5] The FSOC report includes a chart depicting the gross yield of "5 Outlier MMF Families" (Chart 5.3.9 on p. 76).

[6] See Box H: Money Market Fund Responses to Euro Area Uncertainty (p. 134).