

MEMO# 27233

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FSOC 2013 Annual Report to Congress Again Includes Money Market Fund Recommendations

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TO: CLOSED-END INVESTMENT COMPANY MEMBERS No. 40-13
EQUITY MARKETS ADVISORY COMMITTEE No. 12-13
ETF ADVISORY COMMITTEE No. 23-13
MONEY MARKET FUNDS ADVISORY COMMITTEE No. 12-13
RISK MANAGEMENT ADVISORY COMMITTEE No. 2-13
SEC RULES MEMBERS No. 44-13
SMALL FUNDS MEMBERS No. 33-13
UNIT INVESTMENT TRUST MEMBERS No. 12-13 RE: FSOC 2013 ANNUAL REPORT TO
CONGRESS AGAIN INCLUDES MONEY MARKET FUND RECOMMENDATIONS

The Financial Stability Oversight Council (FSOC) recently issued its 2013 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 reviews recent macroeconomic developments and provides an update of financial developments. Areas addressed include asset valuations, wholesale funding, bank holding companies and deposit institutions, nonbank financial companies, investment funds (such as money market funds, other mutual funds, and exchange-traded products), and financial market infrastructures. The report next reviews regulatory developments and FSOC activity since the 2012 annual report. Finally, it discusses potential emerging threats, including (i) threats from fire sale and run risk vulnerabilities,

(ii) operational risks, (iii) reliance upon reference rates as a vulnerability, (iv) financial system vulnerability to sudden spikes in fixed income yields, (v) foreign economic and financial developments, and (vi) risk-taking incentives of large, complex, interconnected financial institutions.

Recommendations of Interest to ICI Members

- **Money market funds.** In its 2011 and 2012 annual reports, the FSOC recommended the implementation of structural reforms to mitigate the run risk in money market funds. The 2013 report states that the FSOC “took concrete steps” to support the implementation of such reforms by issuing proposed money market fund reform recommendations under Section 120 of the Dodd-Frank Act. [\[2\]](#) The report indicates that the FSOC is in the process of reviewing the approximately 150 comment letters it received. The report expresses the FSOC’s view that “[t]he SEC, by virtue of its institutional expertise and statutory authority, is best positioned to implement reforms to address the risk that [money market funds] present to the economy.” Consequently, “[i]f the SEC moves forward with meaningful structural reforms of [money market funds] before the [FSOC] completes its Section 120 process, the [FSOC] expects that it would not issue a final Section 120 recommendation to the SEC.” The report recommends that the FSOC’s members “examine the nature and impact of any structural reform of [money market funds] that the SEC implements to determine whether the same or similar reforms are warranted for other cash management vehicles.” It points out that such an examination “would provide for consistency of regulation while also decreasing the possibility of the movement of assets to vehicles that are susceptible to large-scale runs or otherwise pose a threat to financial stability.”
- **Tri-party repo market.** The FSOC report notes some progress in addressing the vulnerabilities in the tri-party repo market that were highlighted in the FSOC’s 2012 annual report. Specifically, it states that reliance on intraday credit has begun to decline and broker-dealers have reduced their reliance on short-term secured funding. The report indicates, however, that “[t]he risk of fire sales in the event that a major broker-dealer faces default remains a financial stability concern.” It states that the FSOC “urges continued coordinated efforts by market participants and financial regulatory agencies . . . to address the remaining risks associated with the tri-party repo market, notably by better preparing investors and other market participants to deal with the consequences of a dealer’s or other large borrower’s distress or default.”
- **Reforms relating to reference rates.** The FSOC recommends international cooperation to develop “high-level principles” for governance, controls, data sufficiency, and oversight of financial benchmarks. Given the vulnerabilities of the London Interbank Offered Rate (LIBOR) and other existing benchmarks, U.S. regulators should cooperate with foreign regulators, international bodies, and market participants to identify alternative interest rate benchmarks that are based on observable transactions and supported by appropriate governance structures. The FSOC further recommends taking steps to promote an orderly transition to alternative benchmarks.
- **Operational risk.** Noting that failed operational processes were the root of many recent, high-profile problems within the financial system, the FSOC recommends continued engagement by regulators, market exchanges, and participants to explore durable solutions to managing complex technology in trading environments and the vulnerabilities exposed by operational malfunctions in 2012. The FSOC report also highlights cyber security as well as financial and other key infrastructures as areas of operational risk deserving close attention.

- Strengthening the regulation of large, complex financial institutions. The FSOC report mentions the FSOC's authority to designate nonbank financial companies for Federal Reserve supervision and enhanced prudential standards. It states that the FSOC is in the final stages of evaluating an initial set of companies for potential designation and that this is an important priority for 2013.
- Increasing the transparency and regulation of over-the-counter (OTC) derivatives. The FSOC report discusses the progress of efforts to implement the G-20 leaders' commitment to centralized clearing and exchange trading of standardized derivatives contracts, as well as the reporting of derivatives contracts to trade repositories and the application of higher capital requirements for non-centrally cleared contracts. The FSOC urges continued development of OTC derivatives reforms.
- Improving the oversight and regulation of nonbank intermediaries. The FSOC report references the "considerable amount of work in progress to address potential risks in the area of shadow banking." It explains that this term is often used to refer to the system of financial activities and intermediaries that conduct maturity, credit, and liquidity transformation without access to the "backstops" provided by the Federal Reserve and Federal Deposit Insurance Corporation. The report lists steps the U.S. already has taken to mitigate these potential risks, including reforms to improve the resilience of money market funds, the tri-party repo market, and securitization. It states that the FSOC, "through its authority to designate nonbank financial companies for supervision by the Federal Reserve and enhanced prudential standards, can expand the regulatory perimeter to certain activities and entities in the shadow banking sector."
- Data resources and analytics. The Office of Financial Research 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 quality of and facilitate access to standardized, aggregate data by the regulators. Cross-border exchange of data among supervisors and regulators should continue to be facilitated in a manner that safeguards the confidentiality and privilege of such information.

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endnotes

[1] Financial Stability Oversight Council, 2013 Annual Report, available at <http://www.treasury.gov/initiatives/fsoc/Documents/FSOC%202013%20Annual%20Report.pdf>.

[2] See Financial Stability Oversight Council, Proposed Recommendations Regarding Money Market Mutual Fund Reform (Nov. 2012), available at <http://www.treasury.gov/initiatives/fsoc/Documents/Proposed%20Recommendations%20Regarding%20Money%20Market%20Mutual%20Fund%20Reform%20-%20November%202013,%202012.pdf>.

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