MEMO# 31000

January 3, 2018

FSOC 2017 Annual Report to Congress - Recommendations of Interest to the Fund Industry

[31000]

January 3, 2018 TO: ICI Members
Investment Company Directors
ICI Global Members SUBJECTS: Money Market Funds
Systemic Risk RE: FSOC 2017 Annual Report to Congress - Recommendations of Interest to the Fund Industry

In mid-December, the US Financial Stability Oversight Council (FSOC) issued its 2017 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 US financial stability. Section 112 further requires the report to make recommendations to enhance the integrity, efficiency, competitiveness, and stability of US financial markets, to promote market discipline, and to maintain investor confidence. This memorandum briefly describes the contents of the FSOC report and highlights the recommendations that may be of particular interest to members.[2]

Content of the FSOC Report

The FSOC report begins with an executive summary and discussion of FSOC's recommendations. It then provides an update on financial developments, including with respect to: US Treasuries, sovereign debt markets, corporate credit, household credit, real estate markets, foreign exchange, equities, commodities, wholesale funding markets, derivatives markets, bank holding companies and depository institutions, nonbank financial companies, investment funds, and new financial products and services. The report next reviews regulatory developments and FSOC activity since the 2016 annual report. In a final section entitled Potential Emerging Threats and Vulnerabilities, the report discusses six areas: ongoing structural vulnerabilities,[3] cybersecurity, asset management products and activities, managing vulnerabilities in an environment of low but rising interest rates, changes to financial market structure, and global economic and financial developments.

Recommendations of Particular Interest to ICI Members

- **Asset Management Products and Activities.** Regarding liquidity and redemption risk, the report notes the adoption by the Securities and Exchange Commission of rules designed to promote effective liquidity risk management, provide for enhanced data reporting, and permit the use of swing pricing under certain circumstances. FSOC recommends that the SEC monitor the implementation of these rules to evaluate whether the chosen regulatory approach addresses potential risks effectively and efficiently. Regarding leverage risk, the report notes that commenters have raised questions about the SEC's proposed rule on the use of derivatives by registered funds, including concerns that the measures for derivatives exposure did not adequately reflect portfolio risk. FSOC recommends that the SEC consider the proposed measures and approach, including whether the proposal addresses risk effectively and efficiently.
- **Wholesale Funding Markets.** The report notes that progress has been made in reducing counterparty risk in the repo markets, but recommends that relevant authorities continue to monitor these markets for any signs of changes in liquidity conditions and any attendant impact on financial stability. With respect to money market funds, the report notes the October 2016 implementation of the SEC's reforms and the resulting shift in assets toward government money market funds. It states that FSOC, in coordination with the SEC, will continue to monitor the impact of these reforms, with particular attention to monitoring the continued availability of funding for institutions that previously borrowed from prime money market funds. With respect to other types of cash management vehicles, the report recommends that regulators consider whether regulatory gaps exist for such vehicles, and evaluate the extent to which additional data would be helpful in monitoring and addressing such gaps.
- **Data Quality, Collection, and Sharing.** The report generally 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. It notes that broader adoption of the legal entity identifier (LEI) by financial market participants continues to be a Council priority and recommends that, where appropriate, member agencies move to adopt the use of the LEI in regulatory reporting and other data collections. Regarding asset management, the report notes that improving the quality of information available to evaluate risks remains a Council focus. It calls for continued efforts among member agencies to promote the consistency of reported information, as well as sharing of data to improve financial stability analysis. The report also notes the Council's support for efforts to improve metrics and analytical tools used to evaluate asset management risks.
- **Regulatory Efficiency and Effectiveness.** The report notes that while the regulatory environment has contributed to improvements in financial stability and the resiliency of financial institutions since the financial crisis, new regulations also have raised concerns about increased compliance costs and regulatory burdens, especially for smaller institutions. The Council recommends that regulators evaluate regulatory overlap and duplication, modernize outdated regulations and, where authority exists, tailor regulations based on the size and complexity of financial institutions.

Rachel H. Graham
Associate General Counsel

Frances M. Stadler
Associate General Counsel & Corporate Secretary

endnotes

[1] Financial Stability Oversight Council, 2017 Annual Report, *available at* https://www.treasury.gov/initiatives/fsoc/studies-reports/Documents/FSOC_2017_Annual_Report.pdf.

[2] In addition to the recommendations summarized below, the report makes recommendations in the following areas: cybersecurity; capital, liquidity and resolution; central counterparties; reforms related to reference rates; housing finance reform; managing vulnerabilities in an environment of low but rising interest rates; changes in financial market structure; and financial innovation.

[3] The report briefly discusses six structural vulnerabilities that were identified in previous FSOC reports: large, complex, interconnected financial institutions; central counterparties; short-term wholesale funding; reliance on reference rates; data gaps and challenges to data quality, collection, and sharing; and financial innovation.
