

**MEMO# 34684**

December 21, 2022

# **FSOC Identifies Vulnerabilities in Open-End Funds, Money Market Funds, and Certain Collective Investment Funds in 2022 Annual Report**

[34684]

December 22, 2022

TO: ICI Members

Investment Company Directors

ICI Global Members

LIBOR Transition Working Group SUBJECTS: Alternative Investments

Closed-End Funds

COVID-19

ESG

Exchange-Traded Funds (ETFs)

Financial Stability

Fixed Income Securities

Investment Advisers

Money Market Funds

Pension

Trading and Markets

Unit Investment Trusts (UITs) RE: FSOC Identifies Vulnerabilities in Open-End Funds, Money Market Funds, and Certain Collective Investment Funds in 2022 Annual Report

At a public session on December 19, the US Financial Stability Oversight Council (FSOC or Council) issued its 2022 annual report to Congress.[\[1\]](#) As required by statute, 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.[\[2\]](#) This memorandum briefly describes the contents of the FSOC report and highlights recommendations relating to certain investment funds: open-end funds; money market funds (MMFs); and collective investment funds (not discussed in previous FSOC annual reports).[\[3\]](#)

In other actions during the December 19 public session, FSOC received an update from the Federal Reserve Board (FRB) on the transition from LIBOR to alternative reference rates,

highlighting the importance of remediating legacy contracts before the publication of LIBOR ends. The Council also received a presentation from the FRB on its work on climate-related financial risks, including the FRB's pilot climate scenario analysis exercise and proposed principles for the management of climate-related financial risks for large banking organizations.

During an executive session, FSOC received the following updates: from Securities and Exchange Commission (SEC) staff, a presentation on its proposed rulemaking to address "underlying structural liquidity mismatch in open-end funds;" from Treasury staff, an update on work by the Inter-Agency Working Group on Treasury Market Surveillance; and from Federal Reserve Bank of New York staff, a presentation on market developments related to digital assets.[\[4\]](#)

## **Content of the 2022 FSOC Annual Report**

Chapter one of the report provides a statement of support from the FSOC principals and proceeds substantively as follows:

- Chapter two, the executive summary of the report, observes that "[a]mid heightened geopolitical and economic shocks and persistent inflation, risks to the US economy and financial stability have increased even as the financial system has exhibited resilience to date." It states that the Council has identified 14 specific financial vulnerabilities in five areas (financial risks, financial institutions, financial market structure, operational and technological risks, and climate-related financial risk). This includes vulnerabilities in hedge funds, open-end funds, certain collective investment funds, and money market funds (MMFs) "due to their scale, leverage, interconnectedness, and ability to engage in liquidity and maturity transformation."
- Chapter three of the report includes a section on each of the five areas identified in the bullet above. Each section discusses significant market developments and outlines the Council's recommendations to mitigate the identified vulnerabilities.
- Chapter four of the report details regulatory developments and FSOC activity since the 2021 annual report.

## **Investment Funds**

### **Open-End Funds**

The report states that open-end funds can create risks to financial stability by engaging in liquidity and maturity transformation. It asserts that two features—daily redeemability and potential investment in less-liquid assets—can amplify and transmit stress in the US financial system. According to the report, "[i]nvestors may be incentivized to redeem ahead of others because the remaining investors in the fund bear the cost of meeting large-scale redemptions, creating a first-mover advantage. Funds' asset sales can lead to asset price declines, transmit stress to previously unaffected market participants, and ultimately create broader market disruptions."

The report highlights findings by the Council's Open-End Fund Working Group and notes the SEC's pending proposal to "to better prepare open-end funds for stressed conditions and mitigate the dilution of shareholders' interests."

### **Collective Investment Funds**

The report contains the following discussion:

"Collective investment funds (CIFs) include common trust funds for personal trusts and

collective investment trusts (CITs) offered to tax-qualified retirement plans. Certain funds have grown relative to other investment options in retirement plans, especially for 401(k) and other participant-directed plans. CIFs can be daily valued and traded like shares of mutual funds, but at the same time, are perceived as lower cost and more flexible than investments in mutual funds. Although CIFs and mutual funds are both pooled investment vehicles managed collectively in accordance with a common investment strategy, they are subject to different regulatory regimes. For example, by statute, qualifying CIFs are subject to prudential oversight by banking regulators, are not required to be registered under federal securities laws, and must be administered by a bank acting as a fiduciary. Additionally, the vast majority of funds invested in CITs are retirement funds subject to the Employee Retirement Income Security Act (ERISA) and related regulations promulgated thereunder. Despite these requirements, additional regulation of open-end funds, such as the liquidity risk management proposal discussed above, may make mutual funds more costly compared to other CIFs, including CITs, and has the potential to encourage growth of CIFs."

### **Money Market Funds**

The report asserts that "[l]arge-scale outflows from prime MMFs during the early stages of the COVID-19 pandemic contributed to stress in short-term funding markets," underscoring that "prime MMFs continued to have structural vulnerabilities that can create or transmit stress to short-term funding markets." This section of the report highlights significant growth in prime MMFs, the SEC's pending proposal to address vulnerabilities in prime and tax-exempt MMFs, and changes in the asset composition of MMFs, particularly in response to "the current environment of expected interest rate increases."

### **Recommendations**

The Council's recommendations relating to open-end funds, collective investment funds, and MMFs are stated as follows:

- "The Council is encouraged by the SEC's continued engagement regarding potential reforms of open-end funds, including its recently proposed amendments regarding open-end fund liquidity risk management, swing pricing, and fund reporting, and looks forward to reforms that robustly address the financial stability risks from SEC-registered open-end funds. The Council should also consider whether congruent reforms are needed for open-end funds not subject to SEC regulation. For example, in light of inconsistent reporting across different regimes, regulators should consider whether additional data reporting is necessary to obtain appropriate information concerning these funds so that the Council can gain a better understanding of whether the regulatory differences between the regimes governing CIFs and mutual funds increase the risks of regulatory arbitrage."
- "The Council supports the SEC's efforts to improve the resilience and transparency of MMFs and strengthen short-term funding markets. The Council will continue to monitor initiatives relating to MMF reforms. These reforms will be considered in the broader context of regulatory efforts to strengthen short-term funding markets and support orderly market functioning."

Rachel H. Graham  
Associate General Counsel & Corporate Secretary

## Notes

[1] Financial Stability Oversight Council, [2022 Annual Report](#).

[2] Section 112 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. 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.

[3] The report also discusses the Council's concerns and recommendations regarding hedge funds.

[4] A readout from the meeting is available [here](#).

---

Copyright © by the Investment Company Institute. All rights reserved. Information may be abridged and therefore incomplete. Communications from the Institute do not constitute, and should not be considered a substitute for, legal advice.